Research Notes

Housing Bust Wealth Effects

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The ongoing housing bust in the U.S. is very worrying on a number of fronts: building activity stalled, lost construction jobs, a major financial mess created from the subprime crisis, and the potential wealth effect on consumption as the value of the U.S. housing stock falls. In this note, we try to generate a rough calculation of how much consumption will decline in 2008 due to falling house prices.

In nominal terms, the value of goods and services consumed in the U.S. in 2007 was $9.733 trillion dollars. The Federal Reserve's Flow of Funds data indicates that US households held real estate assets worth 20.155 trillion. There were 10.509 trillion of home mortgages owing on these, so let's say that homeowners have about $9.65 trillion worth of equity in real estate at the end of 2007. It seems that the actual equity in the home, net of any loans against it should be the best measure of homeowners' wealth, so I use real estate equity for these estimates.

Let's assume housing wealth declines by 3% in nominal terms this year. This assumption seems quite plausible since NAR reports that the median house prices in January, 2008 dropped by 5% nominal in year over year terms. To be fair, the NAR median price may reflect changes in the composition of houses offered for sale. In difficult time, there may be some higher value houses not put on the market. Most homeowners will not put their house on the market this year, but nonetheless the value of their homes will be declining in most cases as the overall market declines. Therefore a conservative estimate of a 3% nominal price decline seems reasonable. Such a decline in real estate values would mean a decline in real estate equity of $0.29 trillion.

There is considerable debate around how to measure the impact of housing wealth on consumption. A 2007 paper by the CBO surveys the recent estimates of the effect of housing wealth. Most estimates of the marginal propensity to consume (MPC) out of wealth range from 2 to 9 cents per dollar. The effect is typically expected to be cumulative, so the higher MPC estimates usually reflect the impact after several years (in the medium or long run).[1] [2]

With a 4-cent MPC, then the decline in consumption that corresponds to this $0.29 trillion decline in housing wealth would be $0.0116 trillion or $11.57 billion. This is pretty tiny, generating only a 0.12% decline in consumption for the year. Since declines in housing wealth take several periods to have their full effect, so we will likely see the effect of last years' decline also contribute to a decline in consumption spending this year. Looking forward if the total effect is on the order of 7 cents over several years, we would expect that consumption would decline by about $20.26 billion, or about 0.21% of the level of consumption.

These estimates seem quite small. However, the other factors driving consumption, current and expected labour income, credit conditions and stock market wealth, are all looking very worrying as well.

On its own the housing wealth effect does not seem large enough to drive consumption negative. But, the confluence of other negative

[1] See CBO 2007. Table 1, p.6.
[2] I agree with Macroeconomic Advisers that there is no Mortgage Equity Withdrawal Effect (MEW) on consumption once housing wealth effects have been accounted for.

factors that the housing bust has seeming unleashed will likely result in at least a couple of quarters of negative real consumption growth this year.

My view is that the housing bust will be a long process, which could mean many quarters of housing wealth effects acting as a drag on consumption growth. We could see a year or so full year of small declines in consumption growth (4 quarters) as consumers sort out the combined effects of the housing bust and credit crunch on their own situations. If so, it would be similar to the 1991 recession, but more protracted.

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