Slowdown in Housing Won’t Shut Down Economic Growth

After years of press predictions that the hot housing market was about to cool down, the inevitable seems to be unfolding. Compared with the same period a year earlier, sales of new and existing homes slowed over the first four months of 2006, inventories of unsold new homes rose sharply and new and existing home prices softened. With mortgage interest rates creeping up, it is conceivable that housing may weaken further.

But there’s no reason to think that the overall economy is threatened, as when stock prices did an about-face in 2000, helping to send the country into recession.

First, housing construction is not the large part of the economy that many believe. It accounts for about 6 percent of gross domestic product (GDP). In terms of real growth of GDP, the difference in housing’s impact between a good year and bad one isn’t huge. For example, from 2002 to 2005 (good years), real residential fixed investment (RFI) accounted for less than a half percentage point of real GDP growth per year on average. In the “down” years of 1988 to 1991, RFI detracted an average of a quarter point per year. These facts suggest that a downturn in housing would need to be extraordinarily large to drag down the economy. Such a collapse is unlikely, given current economic fundamentals, including rising employment and income and the expectation of low and stable inflation.

A second reason not to panic is that other sectors are taking up housing’s slack. Nonresidential construction should rise 9 percent this year, its biggest jump since 2000, according to forecasts by the Associated General Contractors of America. Office and industrial vacancies are falling thanks to job growth and a lack of building over the past several years. Business capital spending, in general, has been growing briskly, and most forecasters anticipate a year of double-digit growth.

Third, even if housing sales fall as much as expected this year, they will still be the third best on record (after 2005 and 2004), according to the National Association of Realtors.

Perhaps the slowdown isn’t leading to disaster but returning the market to a state of normalcy after 10 years of increasing construction, sales and higher prices.

Does the housing slowdown mean that the much-talked-about bubble has burst? I don’t like to spend much time talking about a housing bubble—or a bubble of any kind—because it’s impossible to determine when prices en masse have reversed course until long after the turning point. But, no doubt, some of the air has been released, at least along the coasts and other regional “hot” spots.

Keep in mind that what happens to housing in one part of the country doesn’t necessarily happen elsewhere. For example, the St. Louis area, along with most of the Midwest, didn’t see the astronomical price hikes that hit certain other parts of the country in recent years. Prices rose only 8 percent last year in St. Louis, compared with nearly 40 percent in Phoenix and 13 percent nationwide. Because prices in St. Louis have risen only moderately, it’s reasonable to expect they won’t decline that much—if at all. (St. Louis hasn’t had a nominal decline in housing prices since 1982.)

On balance, the probability of a generalized housing crash seems remote. The last one occurred in 1979-1982, when the economy was in the throes of the worst recession since the Great Depression. Mortgage interest rates hit the high teens then. Unemployment neared 11 percent. The rate of inflation was often almost as high. Growth in GDP averaged less than 1 percent a year then. Today’s numbers are head- and-shoulders better.

A crash would occur today only if housing prices didn’t just slip, but fell off the cliff. And that’s highly unlikely, given that the national average market price of a new, single-family home has declined only twice since 1964, the last time being 15 years ago.

That said, I don’t want to minimize the risks that have recently developed in the housing sector, which appears to be on a manageable descent following several years of climbing to levels few thought likely. This descent should remain manageable as long as the Federal Reserve Bank of St. Louis and the Federal Open Market Committee does its job—keeping underlying inflation low and stable—and as long as employment and income growth remain solid despite persistently high energy prices.