

Real Estate Versus Financial Wealth

REAL ESTATE VERSUS FINANCIAL WEALTH IN CONSUMPTION

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- *This study derives estimates of the impact of changes in financial and housing wealth on the level of consumer spending in the economy.*
 - *The effect on consumer spending due to a change in housing wealth is four times larger than the effect resulting from a change in financial wealth.*
 - *The continued rise in housing values has largely offset the three-year decline in financial wealth resulting from a falling stock market.*
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Housing has remained one of the strongest sectors of the economy despite sagging economic growth, a weak job market and rising uncertainty over geo-political conditions. Home prices in many areas of the country continue to increase, offsetting some of the drop in household wealth resulting from the three-year decline in the stock market. Additionally, low mortgage interest rates have provided households with an opportunity to reduce their housing costs or take cash out of their homes to sustain consumer spending and pay down debt.

THE STUDY

This study estimates the impact of changes in real estate and financial wealth on consumer spending. There is abundant evidence to suggest that households that feel wealthier will spend a larger share of their income even if they do not spend the gains themselves by selling stock or cashing out equity from their home. Furthermore, the impact of changes in financial wealth or real estate wealth will not necessarily be the same. Spending patterns will vary depending on how much each form of wealth increases or decreases.

FINDINGS

This study finds that changes in real estate wealth, primarily housing, have a substantial impact on consumer spending. For each dollar increase

in real estate assets less mortgage debt, consumers spend an additional 8 cents in that year. By comparison, a one-dollar increase in financial assets leads to increased spending of 2 cents in the current year. The impact of changes in housing wealth is therefore four times as large as the impact of changes in financial wealth.

These conclusions are used to evaluate two sets of circumstances characterizing the U.S. economy recently:

Decline in the Savings Rate. The U.S. savings rate steadily declined from 6.5 percent in 1995 to just over one percent in early 2001. Consumers' were saving very little out of current income and instead were ratcheting up spending relative to income during this period. The authors show that slightly less than half of the decline in the savings rate can be accounted for by consumers' increased spending brought about by rising financial and housing wealth. Other factors account for the rest of the decline in the savings rate over the period.

Financial Market Decline. Financial markets declined sharply after peaking in early 2000. Consequently, the additional spending that a rising stock market brought about – about 2 cents for every dollar increase in financial wealth – shifted into reverse causing downward pressure on consumer spending. At the same time, spending generated by increases in housing wealth – about 8 cents for every dollar increase – continued to bolster spending during this period. Based on these estimates, the authors show that since early 2000, each effect almost equally offset the other leading to very little overall impact on consumer spending despite a swooning stock market.

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While no one doubts the significant impact of housing on the economy, it is not always clear how these effects interact with other changes in economic conditions. As the authors' estimates make clear, the housing sector not only supports the economy during good times, but also provides offsetting benefits when financial markets deteriorate or the economy weakens. A healthy housing market not only directly benefits the real estate industry, but also conveys numerous benefits to the rest of the economy by acting as a stabilizing force during the ups and downs of the business cycle.

* The complete report is available at <http://www.realtors.org/research/>