Popular Economics Weekly

WEEK OF JUNE 5, 2006—WORLDWIDE HOUSING BUBBLES

How have U.S. housing prices behaved compared with those in other countries? We are at the low end of appreciation rates, believe it or not. The Economist Magazine reports that from 1997 to 2004 South African homes appreciated 227 percent, Ireland 187 percent, Britain 139 percent, and the U.S. of A. just 65 percent! This is during the "Greatest real estate boom of all time," according to the Economist.

Why? London's Financial Times attributes it to abnormally low interest rates, which were much higher in other industrialized countries at the beginning of the boom. So the U.S. is not the only country that has experienced generation-low interest rates. Average British mortgage rates have fallen from 12 to 6 percent, reflecting the 2-decade long period of low inflation that has brought down interest rates worldwide.

There have only been 2 mild recessions over that time, as well. What can stop the housing boom is therefore a sharp increase in interest rates. This hasn't happened to date, in spite of 9/11, a War on Terror and record deficit spending. It is therefore hard to imagine what could.

But housing booms do ultimately end. A recent study by the Bank for International Settlements reported in The Times examined 16 housing booms in various countries since 1970, and found that only six had ended in sudden busts. All but one, however, led to a recession.

In fact, price stagnation is more likely the end. Australia's housing boom ended 18 months ago, and prices have been flat since. Price stagnation in the Netherlands hurt consumers enough that it led the economy into a recent recession.

When should real estate markets return to normal? Even if rents were to rise 2.5 percent per year, it would take 12 years to bring the U.S. house-to-price ratio back to its long-term norm, said The Times. That already seems to be happening with rents now rising as housing prices soften.

But U.S. real estate is showing only small signs of slowing. The Office of Federal Housing Enterprise Oversight (OFHEO) first quarter report showed that single-family home prices rose 12.5 percent in a year, but just 2 percent in the first quarter 2006. "The anticipated moderation of economic growth seems to be underway," said Fed Chairman Bernanke in his most recent speech, which might be an overstatement. "Consumer spending, which makes up more than two-thirds of total spending, has decelerated noticeably in recent months. As had been expected, recent readings also indicate that the housing market is cooling, partly in response to increases in mortgage rates," said Bernanke. It is hard to say what numbers he is looking at.

UNEMPLOYMENT—May's unemployment rate fell to 4.6 percent, though only 75,000 private payroll jobs were created. Monthly private payroll growth in the Establishment survey has fallen steadily from its 200,000 figure in February. The unemployment rate fell because the Labor Department's Household survey indicated that 288,000 more were employed. But it is a much smaller sample that includes the self-employed.

LABOR PRODUCTIVITY—Q1 productivity was revised upward to 3.7 percent, while so-called unit labor costs sank to a 1.6 percent annualized gain from 2.5 percent in the preliminary estimate. In the past year, labor costs rose just 0.3 percent, meaning there is absolutely no wage inflation. In fact, real hourly compensation (after inflation) shrank 0.9 percent in a year, matching the largest year-over-year decline in 11 years, according to CBS Marketwatch.

BUSINESS ACTIVITY—Both ISM Purchasing Management survey indexes fell in May, as did factory orders. ISM's service sector index sank 5 points, though employment, prices and exports orders rose sharply. Manufacturing's index fell 3 points, though prices were also higher. It reflected the loss of 14,000 manufacturing jobs in the Labor Department's employment report. Manufacturing employment hasn't shrunk overall in the past year, however, for the first time in years.

RETAIL SALES—May sales were robust, in spite of Bernanke's pronouncements. This is why his remarks have to be taken with a grain of salt. The recent stock market decline was caused by Bernanke's grim warnings on inflation, which isn't moderating at present. May same-store sales rose 4.4 percent, mainly in the mid and high-income ranges. Wal-Mart sales suffered, indicating that more expensive gas had hurt the low-end shoppers.

The slowing jobs picture can be favorable for interest rates, since a slowing jobs market, combined with higher-than-expected labor productivity (and lower unit-labor costs) will keep product costs and prices in check. We think that the Fed should call a temporary halt to interest rate hikes at their June 28 FOMC meeting, therefore.