[Writer Name]

[Supervisor Name]

[Subject]

[Date]

Housing Market

Many economists thought that when the U.S. housing boom ended, so would the overall economic boom. Yet housing starts and sales are down from peak levels, and while various reports indicate housing prices are still ahead of year-earlier levels, that masks the fact prices indeed have declined over the past six months. So why has the decline in housing not yet reduced the GDP and real growth rate of the U.S. economy? A declining housing market can negatively affect the economy in three ways. First and most obvious, there are fewer construction workers, fewer purchases of construction materials, and reduced income for brokers. Second, home-equity refinancing is reduced as prices level off and then decline, which, in turn, reduces consumer spending. Third, defaults and foreclosures increase, not only wiping out individuals who bought more house than they can afford, but many financial institutions as well. It is the third effect that will finally bring the economy down.

The good news, it won't happen for several years, well past our ability to forecast. The rash of defaults and foreclosures usually peaks about three years after interest rates rise and housing prices level off and then decline (Evans, M. 2006). History has proven this to the economy, this current process of interested rate hikes started in 2005, suggesting that, the major negative impact of a declining housing market will not his until 2008. There will be some modest decline in the real growth this year and next, but an increase in real GDP (BEA, 2006).

GDP slowdown may give Fed pause, according to businessweek.com (Englund, M. MacDonald R. 2006). The U.S. economy grew at a disappointing 2.5% rate last quarter, raising market expectations that the Fed will suspend interest rate hikes. U.S. gross domestic product for the quarter underperformed. The underperformance of second quarter GDP relative to our expectations was largely a function of a big fixed investment due to a shortfall in the volatile equipment and software component, which fell 1%.

The supply and demand

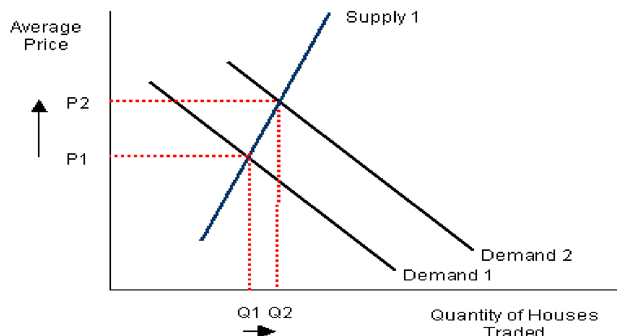
For every housing transaction there is a seller and a buyer. The seller will decided the price that they are willing to accept for the property and that they think the property can achieve. The buyer will decide what they are willing to pay for

a property. However there are factors that will heavily influence the demand and supply of houses. These factors are: Demographic Income Price of Housing, Interest Rate Cost and Availability of credit /Mortgage, Consumer preferences, Price of substitutes Price of compliments.

Supply of housing: In order to produce a new housing supply the following factors are required: Land Labour Other Inputs (Electricity, Building Materials).The quantity of housing produced for sales is determined in relation to the cost of the factors mentioned above. Second hand housing supply is determined by the number of people willing to sell their properties and the factors described above don't affect this.

Demand and Supply: Every time that the demand of houses increases faster than the supply of house, the price tends to go up. The number of new houses built is low compared with the increase of the demand; this situation is one of the main reasons why housing prices rise.

A Sellers Market



When the market demand for properties in a particular area is high and when there is a shortage of good quality properties (i.e. supply is scarce) then the balance of power in the market shifts towards the seller. This is because there is likely to be excess demand in the market for good properties. Sellers can wait for offers on their property to reach (or exceed) their minimum selling price.

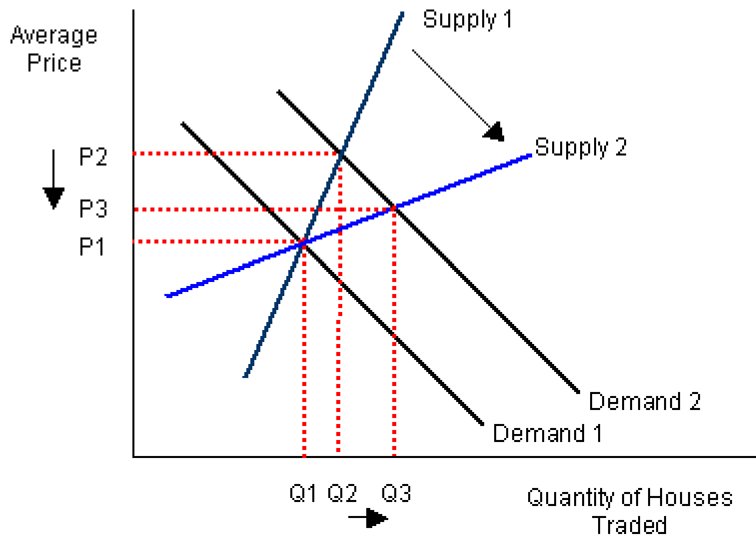
A Buyers Market

Conversely when demand both for new and older housing is weak and when there is a glut of properties available on the market, then the power switches to potential buyers. They have a much wider choice of housing available and they should be able to negotiate a price that is lower than the published price.

When the demand for houses in a particular area increases (perhaps because of an inflow of population into the area, or a rise in incomes following a fall in unemployment), there is upward pressure on market prices.

Often the supply of available housing in the market is relatively inelastic. This is because there are time lags between a change in price and an increase in the supply of new properties becoming available, or other homeowners deciding to put their properties onto the market.

When demand shifts outwards and supply is inelastic the result is a large rise in market price and a relatively small expansion of the quantity of houses traded. As supply becomes more elastic over time, assuming the conditions of demand remain unchanged, we expect to see downward pressure on prices and a further increase in the equilibrium quantity of houses bought and sold.



Market structure

The housing markets in nearly three-fourths of the top 52 U.S. cities including such sometimes overlooked places as Cleveland, Milwaukee and Minneapolis are

showing signs of overheating, with housing prices greatly exceeding gains in personal income, observers, in our opinion, is that these "local" markets represent a big enough slice of

economic activity that should they falter, we could see a fairly hefty impact on aggregate U.S. economic growth (June 22, 2006). It figures that even if housing prices simply stagnate, the cost to GDP could be almost half a percentage point this year and more than a full point in 2006.

Regulations and recession

The commerce department reported that new home sales fell three % last month to a seasonally adjusted annual sales pace of 1.131 million units, it was the first decline since an 11.5% drop in February. Analyst pointed to the drop in sales last month and the downward revision for May as fresh evidence that housing is slowing considerably, due at least in part to impact of higher mortgage rates (2006, MSNBC.com). Sales of both new and existing homes set records for five straight years as the housing industry enjoyed a boom powered by the lowest mortgage rates in four decades. However, with the increase in interest rates this year as the Federal Reserve tightens credit conditions in hopes of slowing the economy and keeping inflation in check. "The housing market peaked a year ago and has been slowly deflating ever since," (Zandi, Mark 2006). "The U.S. can expect another year of lower sales with price declines in some parts of the country", Zandi, Mark 2006). The big worry is that home sales will fall so sharply that it could send shock waves

through the economy, much as the bursting of the stock market bubble in 2000 contributed to the recession the next year. So far the decline in housing is contributing to an economic slowdown, but analyst are not forecasting a recession anytime soon (2006, MSNBC.com).

Since the Producer Price Index is the first indicator of inflation, it is the measure of wholesale prices at the producer level for consumer goods and capital equipment. Likely impacts of the PPI on the financial markets are Interest Rates, Stock Prices, and exchange rates. Larger than expected quarterly increase in price inflation or increasing trends is considered inflationary; this will cause the bond prices to drop and yields and interest rates to rise. Higher than expected price inflation on the stock market as higher inflation will lead to higher interest rates. High inflation has an uncertain effect. It would lead to depreciation as higher prices mean lower competitiveness. Higher inflation causes higher interest rates and a tighter monetary policy that leads to appreciation.

The analysis and high price inflation is bad news for the bond market. A weak percent rate of change of the price of deflators if received favorably by bond investors; a strong inflation report causes concern the Fed might need to intervene and raise interest rates, a negative for fixed income markets. The PPI categories and respective weightings are; finished

consumer goods 40%; Food 26%; Capital Equipment 25%; and energy 9%. The data covers three stages of production; finished goods, intermediate goods, and crude materials. The latter two stages are important because they provide an early indication of price changes in the pipeline and forewarn of rising prices. The PPI can be volatile, it is best to use the six-month to one-year moving average. The bond market reacts negatively to larger than expected increase in the PPI. It is always a good idea to look at more than a few months of data to get a sense of changes in established trends. Monthly changes in the PPI are mainly volatile because of sharp fluctuations in food and energy prices. The core PPI eliminates the sharper fluctuations.

Works cited

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