Will the negative wealth effect, from falling home values, lead to less consumption growth?

Yes, and with a slow recovery in income growth, the result is a drawn out overall recovery

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The housing market collapse in the U.S. has not only stalled the real estate, construction and related industries, but also further contributed to restrained consumers’ expenditures. Four factors are holding down consumption growth. First, the population is increasing more slowly, and the average age is rising. Slowed population growth in an aging population would alone mean less consumption growth post-recession. But that is not the only factor. The second important driver is the renewed interest in building up savings and paying down debt. The result is that less of the income dollar is spent, more is saved. And third, income is rising slowly, a trend unlikely to change over the next few years. Job growth has improved but the new jobs typically pay less than the job the current unemployed used to perform. In all, fewer young people, with a slower earner path, or saving more money. Therefore, consumer demand is and likely will continue to rise slowly. But there is one more important factor.

Across the United States, home values are approximately one-third lower in 2012 than they were before the housing market started to collapse in the second half of 2006. Obviously, some families in certain metro areas (like Las Vegas or Phoenix or Fort Myers Florida) have suffered even greater loss in home equity.

Household income is of course the most important determinant of household consumption. But it is widely recognized that the value of assets also plays a role in affecting household consumption. When the value of assets increases by price increase of stocks or homes for instance, households tend to spend more even if their current income flows are unchanged. This is called the wealth effect. The households increase their expenditures by either liquidating some of the increased assets, or by reducing the amount of saving for the future (or borrowing more).

Two thirds of American households own their own residence, a higher proportion than is typical among developed economies. For many if not most, the equity in their home is their biggest and most important investment. The result is that real estate holdings by the household sector is a bigger share of total household assets than one finds in other
countries, roughly one third of all household assets. And therefore, losing a third of the value of these real estate holdings represents a very significant hit on total household wealth.

Non-real estate holdings by the household sector generally consist of bonds and stocks, in that order. And most of these holdings are in the form of mutual funds, in various retirement or trust funds. In fact, while two thirds own their own home, not more than 2 in ten households own stock directly, according to the Survey of Consumer Finances (2007) conducted by Federal Reserve Board.

The value of homes generally rose every year in the last half century. Indeed, the rate of increase picked up in the 1990’s. Many economists assumed that consumer spending was positively influenced by the rise in value. Some went as far as suggesting refinancing families were treating home equity like an ATM. Research shows that housing wealth elasticity tends to range between 0.03-to-0.18. And that is a larger reaction than a change in the value of other assets, generally speaking. But over the past half decade, home values suffered very sizable declines, perhaps reversing the wealth effect on consumption. Indeed, in a recent speech, Federal Reserve Chairman Bernanke suggested consumer spending could be as much a $200 billion–to-$375 billion lower per year, as consumers react to the loss of equity in their homes (depending of course on the actual loss in value for a specific family — implying some families cut back even more). This is a big number, perhaps 2 percent of total consumption per year. Another 3-to-5 percent of income is being saved. Finally, consumption represents two-thirds of total economic activity. Therefore, the observed wealth effect is a very important determinant in the current economic environment.

Still, there are those who argue that the wealth effect is being overestimated. This argument generally suggests that only discretionary spending is affected. For example, what a family spends per week on groceries is not really impacted by a rise or drop in household wealth. Buying a new car instead of a used car, and which model, could be affected by a change in wealth. Whether one agrees that the observed wealth effect in the current economic environment is large or overstated, no one would dispute that it is not just current purchasing that is impacted.

Saving is held in financial assets. Saving is also, according to economic theory, deferred consumption. The assets therefore are meant to be cashed in someday, to pay for children’s college or marriage or for retirement and the like. A change in asset values therefore has to change plans and expectations. A drop of as much as one third in the most important class of assets has to have a big impact on future plans. And that in turn impacts current expectations, which in turn impacts short term spending and
saving patterns. Perhaps the argument then is whether the wealth effect is very large (as much as 2 percent) or whether the secondary impart on plans and expectations results in a change that large. This might all sound academic. It is anything but to marketing analysts.

The last point to make is that many observe housing finally reaching a bottom in 2012, in terms of both home construction and therefore home values. If the value of homes starts to recover, will the wealth effect, direct or indirect, drive up consumption rates? To be sure, the price, production recovery of housing and related activity (such as furniture and appliance production and sales) all play key roles in the economy. But there is one more even important factor. Fundamental attitudes and expectation do not change quickly under any set of circumstances. A big switch from significant and long-term declines, to the beginning of some recovery is unlikely to rapidly drive up wealth and therefore a positive and significant wealth effect. Rather, something more gradual can be expected, and perhaps only after some delay. Put another way, consumers need to be reassured the losses are over and the recovery in value is real. This does not happen overnight.

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Figure 1:
The percentage of families holding stocks and houses and the average value of holdings by income class

Source: FRB "Survey of Consumer Finances (2007)"