The economy

Going down?

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Why the housing slump may spell recession

THREE years ago Rose Hill estates was a dairy farm in Loudoun County. Now it is in the front line of America's housing slump. The rolling fields are dotted with cut-price McMansions. The asking price for new houses, complete with gourmet kitchens and "extended libraries", has been slashed by 20%. But business is slow. The pace of home sales in the county has halved since last year while the stock of unsold homes has doubled. "The region is glutted with new houses," says Lenn Harley, an estate agent. "The market is dead."

Loudoun County, an exurb of Washington, DC, is an extreme example. But there is no longer any doubt that America's housing bust is both bigger and more abrupt than many expected. Nationally, new home sales are down 17% from a year ago, and sales of existing homes have slumped 12%. By some measures, prices are now officially falling. New numbers released this week by the National Association of Realtors (NAR) suggest that the median price for existing homes fell by 1.7% in the year to August, the first such national drop since 1993. The median price of new houses fell by 1.3%.

And although August's figures were less grim than expected, there is clearly more to come. The supply of existing homes for sale is up 60% from a year ago, is at a 13-year high and is still rising. Builders are at their glummest in 15 years. Even the NAR, long the chief cheerleader of the housing boom, now admits that prices will drop further.

Today's debate is less about the scale of the housing slump than its consequences. Will America be dragged into recession or will lower oil prices help the economy shake off the property bust? Most Wall Street economists put the odds against a recession, but a noisy minority claim it is virtually inevitable.

Who is right? The economy is slowing sharply—economists now expect annualised GDP growth of around 2%, or well below trend, in the third quarter—and much of the macroeconomic impact of the housing bust is still to come. The most direct and least debated effect is the drag on overall output as builders cut back. Given the plunge in new home starts and the builders' gloom, residential investment is probably falling by around 15%-20% at an annual rate and is likely to do so for at least the next few quarters. That alone will shave a percentage point off overall economic growth.

Add in the effects on employment, and the impact will be bigger. Early in this expansion, a large chunk of job growth came from housing. During 2004 and 2005 it was around 15%, or about 20,000 jobs per month. As housing stumbles, economists at Goldman Sachs reckon the industry will shed jobs at a similar pace, pulling overall job growth below 100,000 a month and pushing up the unemployment rate. Again, much of the effect lies ahead: builders were still adding workers in August.

These direct consequences of the housing bust will slow the economy. Whether it is dragged into recession depends on the indirect effects, particularly how consumers react. And that is where the real controversy lies. Pessimists argue that a housing bust will sharply crimp consumer spending. More important, Americans will feel less wealthy if their house prices tumble. Nor will they be able to use their houses as giant cash-machines, financing their spending by withdrawing the equity. By some estimates, half the equity money cashed out of homes is spent.

Optimists make several counter-arguments. First, they play down the link between mortgage-equity withdrawal and consumption, pointing out that the pace of equity withdrawal has already slowed without dire consequences. Robert Mellman of JPMorgan reckons that the pace at which Americans withdrew cash from their homes fell from a high of 7.9% of disposable personal income in the third quarter of 2005 to 3.3% in the second quarter of 2006. Although consumer spending slowed over that period, it did not collapse. If the mortgage-equity link is weaker than expected, then falling house prices may have a milder effect on consumer spending. Possibly so; though the figures so far do not prove it, not least because a drop in equity withdrawal may take time to show up in lower spending.

Second, optimists argue that the chilling effects of weak house prices will be countered by other boosts to the consumer, particularly from lower fuel prices and strong income growth. Richard Berner of Morgan Stanley points out that wages and salaries have grown by 8% in the past year, and that petrol prices have fallen by 60 cents a gallon in the past month.

No one doubts that lower fuel prices are fattening consumers' wallets and boosting their spirits. Consumer confidence is rising, after tumbling in August. Nonetheless, these spending supports are less sturdy than they seem. Much of the increase in worker compensation was in stock options for the highest-paid rather than broad-based wage rises; if unemployment rises thanks to the housing shake-out, overall income will suffer. As for oil, it is hardly cheap. In the short term, lower-cost fuel helps the over-stretched consumer. But it will not remove the pain of a housing bust that is far from played out.