

The US Housing Bust and Soaring Oil Prices: What next for the world economy?

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Cecilia Frale & Daniel Gros*

The acute phase of the financial market problems that started in the summer of 2007 now seems to be coming to an end. This is the right time to focus once more on the fundamentals that caused the crisis in the first place. The key factor that drove the build-up of the imbalances that subsequently gave rise to the crisis was obviously the boom (and now bust) in housing markets, mostly in the US, but also in a number of other countries.

There can be little doubt that increasing house prices fuelled growth up until about 2007. As house prices are now falling almost everywhere, the question arises as to whether the bust in housing will also lead to a bust in the wider economy.

Falling house prices are not the only factor influencing growth prospects in the US and Europe, however. Another rapidly developing threat to growth comes from the seemingly inexorable increase in oil prices, which in real terms are now close to the levels last seen during the oil crises of 1973 and 1981. On the last two occasions oil prices spiked, the world economy experienced a severe recession, so the question arises as to whether the current level of oil prices will also have a strong negative impact on growth.

It is often argued that the present run-up in oil prices is different because it is not due to a disruption of supply, but rather to a strong growth in demand from emerging market economies (EMEs). For industrialised economies like the US and Europe, however, it does not really matter whether the supply of crude oil that is available to them falls because OPEC decides to lower output (as in 1973 and 1981) or whether the available supply is increasingly going to other countries (EMEs, mainly China).

Moreover, the data suggest that oil (and in general commodity) prices tend to impact house prices (in industrialised countries). The peak of crude oil prices in both 1973 and 1981 coincided with a sharp turning point for house prices (at least in the US): before the peak in oil prices they were increasing, but fell thereafter. This is not surprising, since higher oil prices lower the purchasing power of consumers in industrialised countries, which should lead to decreased demand for non-tradables, such as housing.

* Cecilia Frale is LUISS Fellow at CEPS, Daniel Gros is Director of CEPS. The authors would like to thank Paul De Grauwe for his contributions to the ideas in this Commentary. This Commentary draws on a longer treatment of this question published in CEPS Working Document No. 294 (downloadable at http://shop.ceps.eu/BookDetail.php?item_id=1666).

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Industrialised countries are thus currently facing a triple shock: an increase in the risk premium because of financial market stress, a fall in house prices and a deterioration in terms of trade due to higher commodity prices. While monetary policy seems to have some success in alleviating the first, it remains to be seen how the remaining two risk factors will impact on the US and European economies.

What can we learn from the past about the risks for the US and European economy from these two risk factors? In CEPS Working Document No. 294, we perform an empirical analysis of the likelihood of good/bad times arising from large swings in both the real estate sector and the price of crude oil. This analysis then allows us to answer the question: How likely is it that the US (or the European) economy will experience a significant fall in output given that house prices are now falling rapidly and given that oil prices are reaching record levels? We prefer this way of expressing the question to the more usual formulation: Can the US avoid a recession? This preference is attributable to the fact that a prolonged period of sub-par growth (which technically would not constitute a recession) could lead to a loss of output as large as, or potentially even larger than, a sharp, but short contraction of output (which would qualify as a recession). We define a 'bad time' of output as a situation in which actual output is below potential by an amount that is so large that its probability of happening is only 5%.

We find that, for the US, house prices (and residential investment) do have a strong impact on the likelihood of extreme deviations of GDP from potential. By contrast, this is not the case in most of Europe, where house prices are significant for predicting large output losses only in Scandinavia, the UK and Spain.

Our estimates suggest that given the present rate of decline in house prices in the US, the likelihood of a substantial negative output gap for the US is over 50%. This is not necessarily a prediction of a recession in the US as our measure refers to output relative to potential. If growth in the US were to continue per annum at below 1% (which was the rate during Q1 2008), the US would still experience an output gap early next year of close to -2% of GDP, which would be exceptional by the standards of the last two decades of low variability.

By contrast, the estimated probability of a large output gap developing is rather low for most European countries (except Spain). Examining the impact of oil on the economy yields a similar result: the oil price seems to matter for the US, but not for Europe, except (again) for Spain. This is not surprising given the fact that the oil intensity of Europe (barrels of oil needed per unit of GDP) is one half of that of the US and given that European exports to oil-exporting countries are much greater than those of the US.

For the US the probability of having a large output gap surpasses 80% if one puts present oil prices into the model.

The main conclusion is that it is highly likely that a large output gap will develop in the US, even if it can technically avoid a recession. The results also suggest that at least a partial decoupling should be expected since in Europe (with the exception of Spain) neither the housing market nor the price of oil plays the same role as in the US.