

The dynamics of the housing market prices and the business cycle: a Var analysis for the European Monetary Union.

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Abstract

The role of wealth as a determinant of household consumption choices has been thoroughly analysed by economic theory both from macro and micro perspectives; for example, the permanent life-cycle theory links long-run consumption not only to disposable income but also to the net wealth owned by each consumer over his entire life. The components of each consumer's wealth are real and financial assets: the latter ones are diversified in deposits, securities, equities and investment funds shares according to the different risk profile of each economic agent, while the first ones mainly consist of dwellings. In the short run the prices of financial assets are generally more volatile than those of the dwellings, since financial markets, according to the efficiency market theory, (see Fama, 1970), include very quickly all the information affecting the value of a given asset. But in the long-run also housing prices present huge upward and downward shifts; such dynamics reflect the different information which have been imbedded in the housing market in the long-time. The high volatility of the dwellings' prices in the long-run can create bubbles in the housing market, and when they burst they can potentially cause huge losses to each household in terms of her net wealth, with negative consequences both on her consumption planning and investment choices. In a macroeconomic framework these combined effects negatively push on aggregate demand with a huge shock to Gross Domestic Product (GDP) and on the business cycle of a country, increasing unemployment. Moreover, bigger is the size of the GDP of the country and larger is the correlation among the financial markets of each world area, larger can be the final impact on the employment. In this paper we focus on the literature that studies the relationship between the housing market prices and the business cycle and then we analyze with a Vector Autoregressive model (VAR) and a Vector Error Correction model (VEC) this relationship in the Euro Area on the supply side. The data source is the Euro Area Statistics of the Monthly Bulletin-European Central Bank and the variables utilized are the quarterly growth rate of the Residential Property Prices and the quarterly growth rate of the Employment for the period 1981:Q1 – 2010:Q4.

VAR and VEC models have been estimated by two lags for the two variables considered. The impulse response function according to the Cholesky factorized decomposition points out that the response to an innovation in the quarterly growth rate of the Employment is persistent for the quarterly growth rate of the Residential Property Prices.. In particular in the VEC model the response of the Employment to the shock in Residential Property Prices becomes persistent after six quarters. This last outcome confirms that huge upward or downward movements in the housing market prices affect the business cycle, in particular a fall or an high increase in the value of the dwellings determine a multiplied effect in the same direction in the employment in the Euro Area.

Keywords: *Housing Market Prices, Volatility, Financial Markets, Business Cycle, VAR.*

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