

The Macroeconomic Impact of Real Estate Prices

We have spent the last year closely monitoring labour markets to assess their impact on inflation, arguing that [changes in global labour markets](#) will create a floor under inflation and keep it stickier for longer than most analysts expect. However, although conventional models focus on the impact of excess demand, to which strong employment and wage growth can contribute, they fail to explain the [decline of inflation amid persistent strength in labour markets](#). This draws dominant approaches, which rely on the Phillips curve, into question. As we have noted elsewhere, in G7 economies, there is currently no apparent relationship between labour-market strength and inflation.

We have therefore shifted our attention to asset markets. Most conventional approaches to inflation dismiss asset-price inflation as having at best a muted impact on inflation. However, we have detected some evidence of a link between asset-prices and profit-margins on the one hand, and inflation on the other. Disaggregating asset markets, we have developed an interest in how real estate prices might drive inflation.

The channels by which this would happen are by raising business costs, driving up wages (so workers can compensate against the cost of accommodation), and drawing investment away from productive forms of investment that would raise output and labour productivity. In a simple exercise, we decided to look at the US economy over time, to see if we can detect any link between real estate returns on one hand, and inflation and growth on the other.

- We constructed a dynamic capital asset pricing model (dCAPM) to see how the returns to investment in real estate compared to the overall market returns. In our model, this relative return compared with the market return is estimated by a parameter, beta. Our proxy for the market return was the return on the S&P 500. This is shown in **Figure 1**.
- While – as is well known – property offered disappointing returns compared to other asset classes—our model shows that the returns to property are increasing, albeit from a low base. There are some signs that returns to property may now be flattening off.
- We also compared the beta for real estate to the growth rate. We found some correspondence between beta and growth rate, so that in general, as beta rose, growth in GDP per capita declined. This is shown in **Figure 2**.

- Very tentatively, for most of the period we observed, we see some kind of a relationship between the change in the rate of inflation and the change in the value of beta over time. After the 2008 financial crisis, the relationship, such that it is, breaks down. See **Figure 3**.

Figure 1: Real Estate Returns Relative to S&P500 Returns

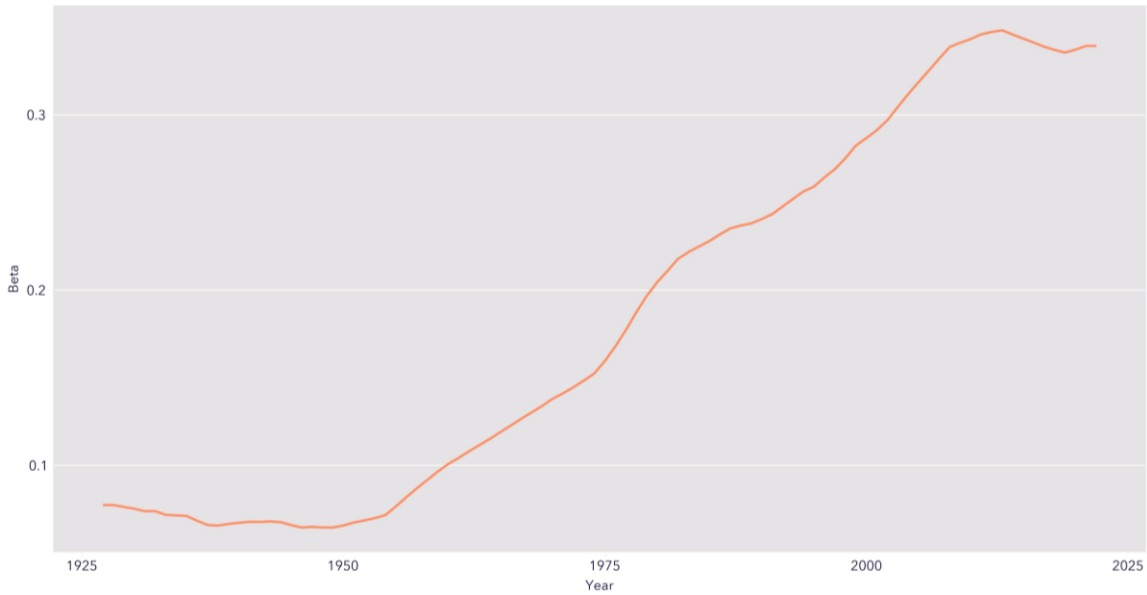


Figure 2: Relative Returns to Real Estate and GDP Per Capita Growth

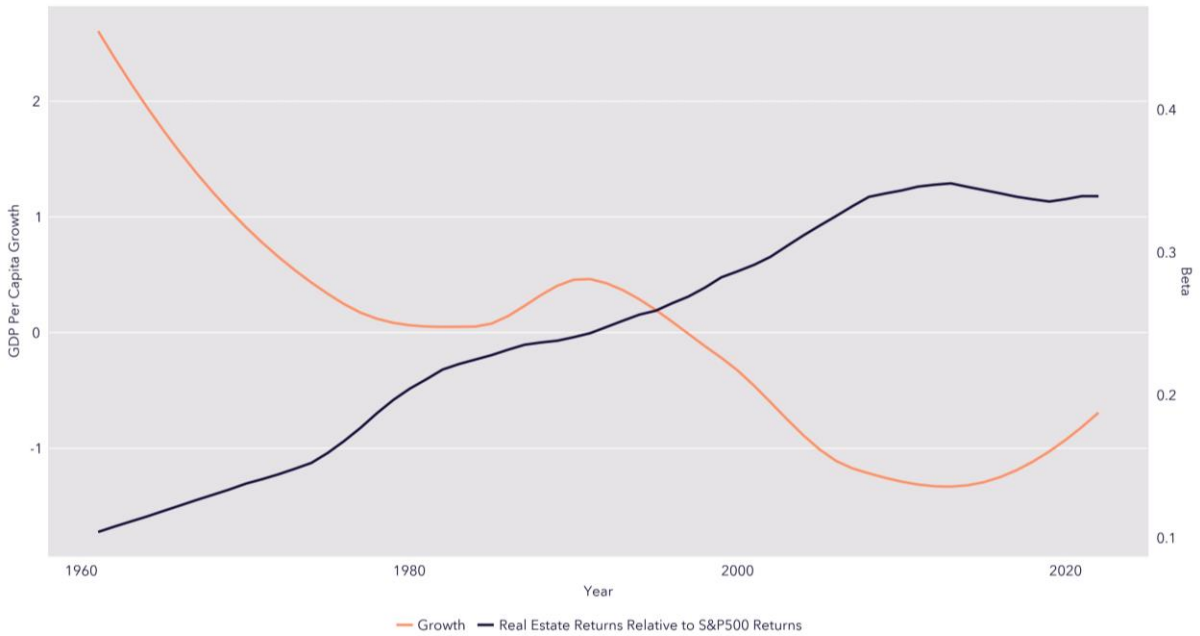
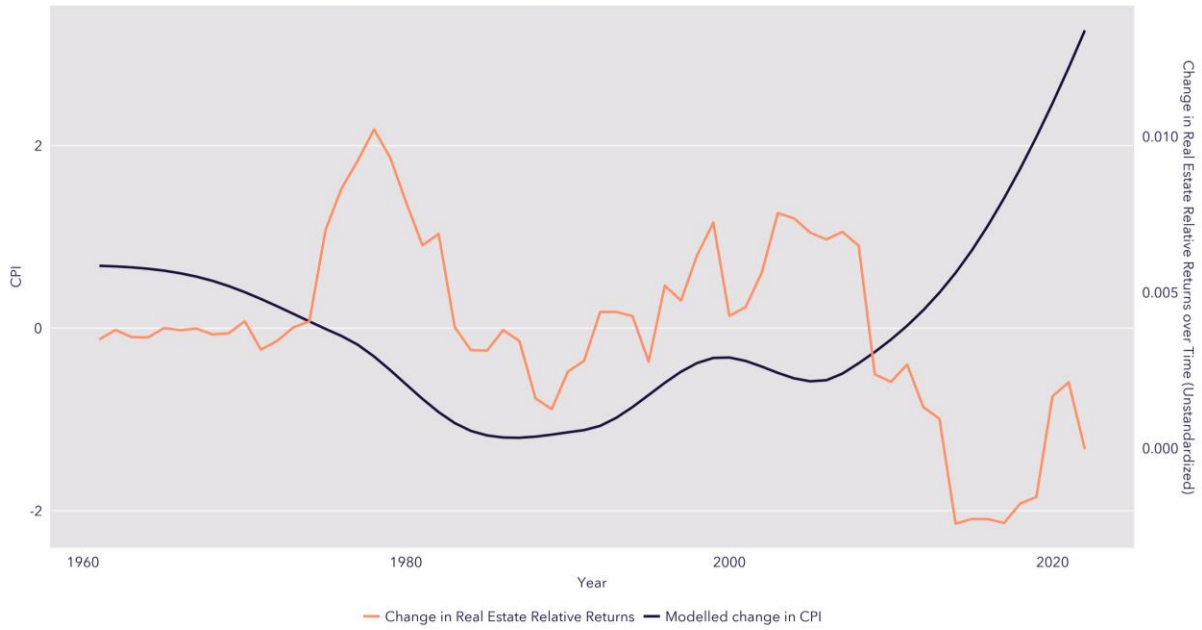


Figure 3: CPI (Modelled) and Change in Beta Over Time



Nothing definitive can yet be inferred from these findings, but they do point us in the direction of future research. On the face of it, we judge this to be a good avenue of inquiry, as it may help us to get a better handle on the causes of the most recent surges in the inflation rates of major Western economies.