MICROECONOMICS AT WORK EXERCISE

A MARKET IN ACTION

REFERENCE: 'Don't panic – unless you're an investor' (by Robert Harley)**,** *The Australian Financial Review,* 27 November, 2003, p. 49.

CHAPTERS RELEVANT TO THIS EXERCISE: Chapters 3, 7.

OVERVIEW

This article is about the market for housing, specifically *existing* housing. While this market (and the prices that are set in the market) is, as the article notes, 'underpinned by the forces of supply and demand' (and its operation explained by the conventional supply and demand model) it needs to be understood in terms of two special elements. One is the fact that a proportion of the stock of assets is held not as a personal asset (which provides a home for the owner) but as a (financial) investment: the owner anticipates that they will earn a return on holding the asset either or both from (i) renting it and (ii) capital gain. The demand for houses thus derives from *both* 'home-owners' and 'investors', the latter group including what have sometimes been referred to as 'amateurs' i.e. people who do not engage in business or financial investment as a primary activity. The second special element (arising in part because of the first) is that demand is influenced by the *expectation* of future price trends, and in the prospect of capital gain being made.

QUESTIONS

1. Explain the term 'boom psychosis' as used in the article.

2. Why might the price of housing fall? What evidence is there that this is happening?

3. Explain the effect that interest rates may have on this market.

4. What reasons are given for believing that housing prices will *not* in fact fall to a significant extent?

5. Explain what the real estate agent quoted meant by there being a 'different market' only three months earlier.

6. What do you consider to be the most important factors affecting demand in this market?