How Does Supply and Demand Affect the Housing Market?

By MARY HALL | Updated Mar 20, 2020

Real estate is a tangible asset made up of property and the land on which it sits, and like other assets, real estate is also subject to supply and demand.

The prices of homes, like stocks and bonds, depend heavily on the law of supply and demand. But just what kind of relationship does the housing market have to this law?

Learn more by reading below about how this economic theory works, and how it impacts the real estate market.

KEY TAKEAWAYS

- The housing market is a solid example of how supply and demand work within an industry.

- When there is a glut of housing available in a market, homeowners may lower their prices due to less demand in the market.

Supply and Demand

The law of supply and demand is a basic economic principle that explains the relationship between supply and demand for a good or service, and how their interaction affects the price of that good or service.

When there is a high demand for a good or service, its price rises. If there is a large supply of a good or service but not enough demand for it, the price falls.

The theory of supply and demand is one of the most basic principles in economics. Supply and demand work against each other until the point at which the equilibrium price is achieved—that is the price where supply is equal to demand in the market.

Demand

The law of demand dictates that people will have low or no demand for a good that has a higher price. That happens, of course, when all other factors remain equal. People tend to sacrifice something that comes at a higher cost, which curbs demand. Similarly, lower prices drive demand, meaning consumers value and purchase something more when it's cheaper.

Supply

When it comes to the law of supply, prices drop when there is an increase in the supply of a good or service in the market. But when prices increase, the number of goods and services tend to drop. That's because it tends to cost more to produce and sell goods at a higher price.

Real Estate Supply and Demand

The housing market relies very heavily on supply and demand, which is why it is very prominent in the industry. Each housing transaction involves a buyer and a seller. The buyer places an offer on a property, leaving the seller to accept or reject the offer. The law of supply and demand dictates the equilibrium price of a property.

> **Important:** Supply and demand work against one another until the point at which a property's equilibrium price is reached.

A low supply may drive prices up, which is what tends to happen with bidding wars. A specific property may be in demand by multiple parties who try to outbid each other by increasing their purchase price offer. The bidding war ends—depleting the supply—when the seller accepts one of the offers.

When there is a high demand for properties in a particular city or state, and a lack of supply of quality properties, the prices of houses tend to rise. When a weak economy and an oversupply of properties leads to low or no demand for housing, the prices of houses tend to fall.

Factors Affecting Housing Supply and Demand

Supply and demand is never an easy thing to measure in the real estate market. That's partly due because it takes a long time to construct new homes and fix up old ones to put back onto the market. Similarly, real estate is not like other industries in that it takes a lot of time to buy and sell homes and other properties.

Some of the factors that influence housing demand include lower interest rates or borrowing costs. When interest rates are low, people are generally willing to take on more debt. They may be able to finance the purchase of a home because the amount of interest they have to pay isn't burdensome. If more buyers flood the market, the demand for housing increases. And if there's a limited supply of housing inventory, that makes people in a low interest rate environment want to purchase even more.

Meanwhile, the supply of housing is in a constant state of change. Inventory may increase when people are moving—some may downsize, others may try to make more room for an expanding family, while others may purchase their first home. Similarly, there may be an increase in development and new home construction, adding to the existing inventory.

On the other hand, housing inventory decreases during times of natural disasters—such as floods and earthquakes—and when existing properties are demolished. Land property is also a finite resource, so the amount of new developments is generally limited.

Housing Market Crash

One of the major causes of the Great Recession that followed the financial crisis in the mid-2000s was the housing market crash. It was a direct result of the law of supply and demand.

During the lead up to the financial crisis, consumers were enjoying relatively low borrowing rates. Banks began to offer low rates on mortgages and were encouraged to relax their lending realize their dreams. These consumers, called subprime borrowers, were able to snag a home with low down payments and low credit scores.

During this time, speculative buyers also began entering the market, driving up demand for housing and, at the same time, cutting into the available supply. All of this, in turn, drove prices up to very lofty levels.

The market couldn't keep up, and investors who were merely in the market to make some money—many were buying and flipping homes in a very short period of time—began pulling out of the market. Demand started to drop and, so did prices. The collapse of the real estate market in 2007 created an oversupply of houses and decreasing property prices.

The Bottom Line

The housing industry and its economic factors depend on supply and demand because it is a transactional market that uses buildings and properties. The law of supply and demand creates the circumstances in which buyers and sellers interact.

l and low supply in housing stock, owners often ir homes. But if there are a ton of properties for sale d up getting less than their asking price.

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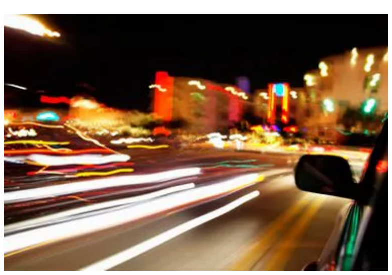

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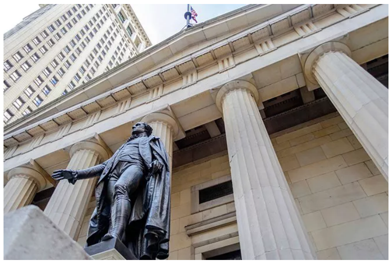

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