Economic SYNOPSES
short essays and reports on the economic issues of the day
2011 ■ Number 6

Housing's Role in a Recovery

Michael W. McCracken, *Research Officer and Economist*

Three years ago an article[1] in this publication discussed the relationship between housing and the "R" word—"R" meaning recession, a term no one wanted to use (lest they jinx the economy) but nevertheless were thinking about. Now, after the worst recession since the Great Depression, we consider a different "R" word—recovery. The fact that many of the same concerns in the housing market remain raises this question: How important is housing in an economic recovery?

Somewhat surprisingly, the housing component of GDP (more formally known as residential investment) tends to be a solid contributor to GDP growth during a recovery. Historically, residential investment has contributed only about 5 percent of GDP—a small share considering the consumption component is close to 70 percent. Nevertheless, smaller components such as residential investment do at times punch above their weight, which is evident when their effects are measured using growth rates rather than levels. That is, although residential investment is a small component of GDP in levels, it can contribute substantially to the GDP growth rate for short periods of time.

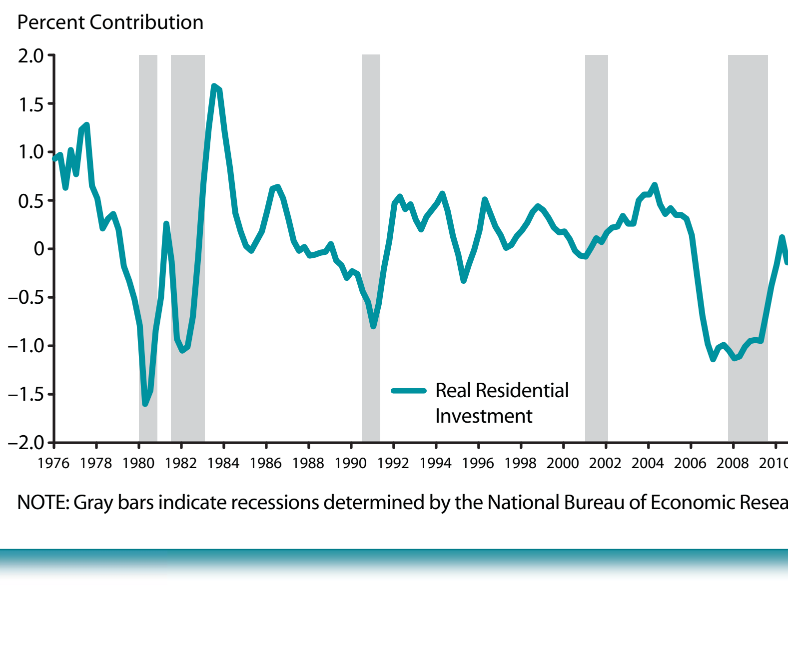
The chart illustrates the relationship between residential investment and the business cycle over the past 35 years. It plots the rolling 4-quarter percentage contribution of residential investment to GDP growth. Over the period, residential investment contributed on average a meager 3 basis points to GDP growth. In contrast, excluding the recent recession, residential investment typically contributes at least 50 basis points to GDP growth within two years following a recession. This suggests that, although residential investment is not a major component of GDP growth on average, its growth typically helps during an economic recovery.

However, a year and a half after the official end of the recent recession, residential investment has yet to make a sizable contribution to GDP growth and is, in fact, presently making a *negative* contribution. To some degree this should be expected. The dramatic declines in housing prices during the recession created a glut of existing homes either already on or waiting to be put on the market once prices stabilize and start increasing. This "shadow inventory" of existing homes substantially dampens the need for new home construction.

Housing tends to contribute significantly to an economic recovery.

So does this mean we won't see continued recovery in the coming year? Not necessarily. It does, however, suggest that the contribution from residential investment is likely to be smaller than normal, or that it may be delayed substantially. In any case, it should be kept in mind that residential investment is not the only expenditure component of GDP. As noted above, consumption is the largest component of GDP and, as such, is most likely to contribute

Residential Investment Contributions to Percent Change in Real GDP, Rolling 4 Quarters



NOTE: Gray bars indicate recessions determined by the National Bureau of Economic Research.

significantly to GDP growth. However, such consumption-driven growth can also be hindered, at least indirectly, by residential investment, through its effect on the employment of construction workers—a group with a current unemployment rate of over 20 percent and thus unlikely to be in a spending mood. ■

[1] Thornton, Daniel L. "Housing and the 'R' Word." Federal Reserve Bank of St. Louis *National Economic Trends*, February 2008; http://research.stlouisfed.org/publications/net/20080101/netpub.pdf.

Posted on February 24, 2011