Housing: Small Economic Sector With a Big Impact

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The Upshot

Housing is a pretty tiny part of the economy. But housing also plays an enormous role in creating economic booms and busts. This is one of the most important paradoxes of how the economy works that policy makers are only now starting to grapple with adequately.

In the United States, residential investment is about 4 percent of total economic activity in normal times, and about 3 percent lately. But it experiences far more extreme ups and downs than the economy as a whole, especially over the last decade. Spending on food and beverages is a larger share of the overall economy, but you never hear of a recession being triggered by a downturn in the grocery store and restaurant industries. In 2008, overall G.D.P. fell 2.8 percent. Residential investment fell 24.3 percent.

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The Wild Swings in Housing

When the total economy shifts, the housing market rises or falls much more sharply.

%

+10

0

-10

-20

Residential Investment

Total G.D.P.

2000

2002

2004

2006

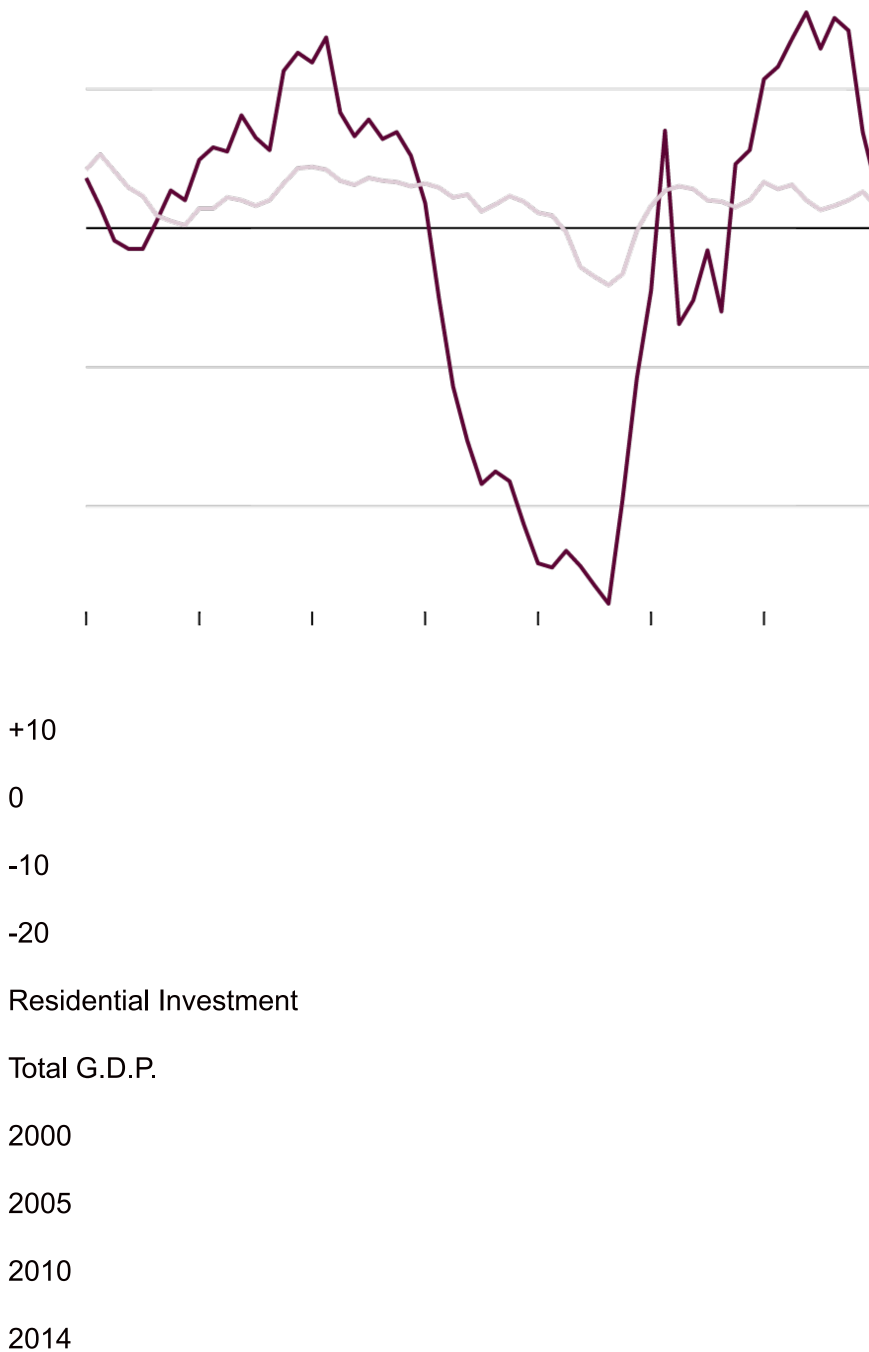
2008

2010

2012

2014

%

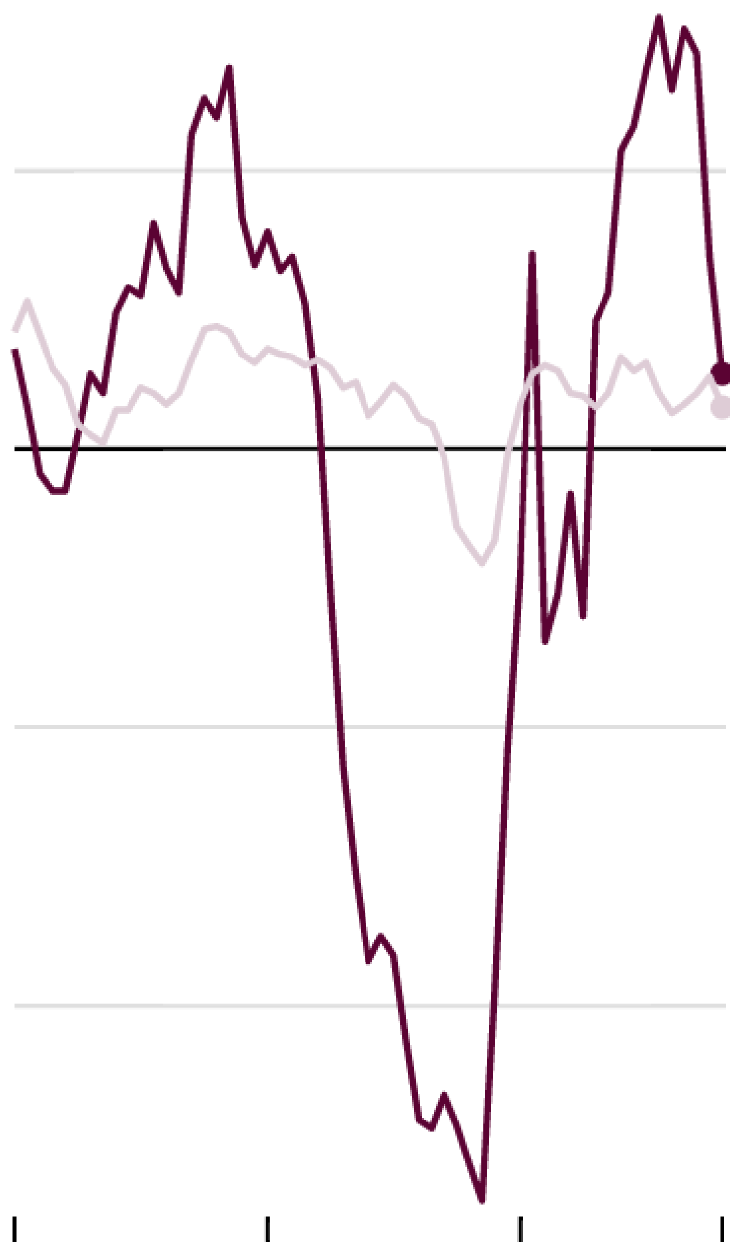


But that’s only part of the reason housing is so important to economic cycles despite its relatively small size. A home is not just something people consume; it is also in many cases their largest asset. So swings in home prices can change individual’s perceptions of their wealth (and hence their spending on everything else).

Photo
A construction worker on the roof of a single-family home in Miami this spring. Credit Joe Raedle/Getty Images

Most homebuyers use borrowed money, so the sector is deeply intertwined with the credit system; when housing takes a dive, overextended home owners bail out and banks incur losses, which can ripple through the broader economy. As Atif Mian and Amir Sufi have shown, borrowed money is crucial to

understanding why spending on most everything dried up when housing turned down a few years back.



But even though housing plays a huge role in the ups and downs of economic cycles, it has too often been an afterthought for the people charged with setting economic policy. To them, it is just one of many important industries, no more and no less. You see hints of this, for example, in transcripts of Federal Reserve policy meetings from 2006 and 2007, when many officials were analyzing the decline in home prices and building activity that was under way through a narrow lens that made them unable to see how widely the damage could ripple.

There is decent evidence that a number of other countries are experiencing new housing bubbles — mostly, advanced nations that skirted the worst of the last downturn like Canada, Germany, Australia and the Nordic countries. But even seven years after housing was at the root of a global crisis, there are still no solid answers as to what exactly constitutes an economic risk and how policy can combat it.

There are two pieces of good news on this front in recent weeks. The International Monetary Fund has

unveiled a new Global House Price Watch website and is devoting more of its research efforts to the complex interaction between home prices, regulatory policy, monetary policy, and the economy. (Min Zhu, the I.M.F. deputy managing director, titled a piece announcing the push, “Era of Benign Neglect of House Price Booms is Over.”)

And more substantively, last week the Bank of England released its regular financial stability report and announced new measures to try to stop a new British housing bubble before it can inflate. (Some would argue they’re too late, particularly for metropolitan London, but that’s a discussion for a different day.)

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Mark Carney, the Bank of England governor, also announced a new cap on mortgages. A British bank can’t issue any more than 15 percent of its mortgage portfolio to buyers who are taking on debt of more than 4.5 times their income.

Mr. Carney said at a news conference last week that the biggest risk to the British economic expansion is housing excesses, and that the bank is trying to nip them in the bud. “Because we’re acting early, we don’t have to reverse mistakes that have been made; we’re acting to prevent those from happening. We’re taking out insurance. Said a different way, we’re putting in place in effect a firebreak on high loan-to-income lending, on riskier lending.”

These are baby steps. The evidence of whether economic policy makers have really learned anything about how to avoid the boom-bust cycle in housing that brings the rest of the economy along with it will come with the next downturn. But in the meantime, the research by the I.M.F. and action by the Bank of England are early and important examples that American officials will want to study closely as they try to figure out how to rein in the kind of boom-bust cycle that has had such lasting consequences.