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How Housing Booms Unwind: Income Effects, Wealth Effects, and Feedbacks through Financial Markets

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Abstract

This paper considers dynamics in the reversal of booms in the housing market. We analyze three related mechanisms which govern the propagation of changes in the housing market throughout the rest of an advanced economy: wealth effects, income effects, and effects through financial markets. As the decade-long boom in the US housing market unwinds, we anticipate that there will be small wealth effects transmitted to the economy, but there will be large income effects affecting the rest of the economy and substantial financial market effects. If the current decline in housing starts and residential investment echoes the declines of the last three housing downturns, we estimate that gross national product (GNP) growth will be reduced by close to 3 per cent. Beyond the decline in housing investment, the recent turmoil in

financial markets makes a recession induced by housing market conditions increasingly likely.

Key Words:

Housing cycles

residential investment

recession

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Notes

*Peak and trough dates are for gross residential investment. For housing starts, peak and trough dates are:

*Changes in S&P Case–Shiller metropolitan price indexes.

**Boston began to fall in October 2005, stopped falling in February 2007 (down 7.9 per cent), and then rose between February and June 2007 by 1.9 per cent.