Multiplier effects: Searching for an economic boost from the housing rebound

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The second of a two-part series examining the importance of housing to the U.S. economy. To read the first article, click here.

ARTICLE HIGHLIGHTS

- The economy is improving, but not as well as it should given the slow rate of job and wage growth since 2009.
- Home sales and prices rallied sharply in 2013 providing a much-needed boost to the economy.
- The full effects of a housing turnaround have yet to be realized in the economy because many indirect benefits have yet to be felt.
- We anticipate that housing will continue to slowly “normalize” over the next three to five years, and increasingly contribute to economic growth over that span.

It is clear that the broader U.S. economy is growing and the risks of an impending second recession are diminishing. But the economy is not performing as well as it should, given the current stage of the recovery. Nor is it performing as well as it has during similar stages of past recoveries. Given the uninspiring growth in jobs and wages during the past four years, this may be the weakest recovery since World War II.

Reasons for this lackluster performance include uncertainty about regulatory and tax policies, weakness in foreign economies and new potential threats to the financial system, such as rising interest rates. These factors are clearly affecting individuals’ and business leaders’ calculations when it comes to making big spending decisions.

These issues, though, pale in comparison to the housing sector, which is the single biggest reason the recession was so deep and the ensuing recovery so anemic. In this second of a two-part series, we will examine the importance of this segment to economic expansion, and the role it will likely play in restoring a normalized rate of economic growth over the next three to five years.

Housing’s widespread impact on economic activity

Housing has started to come back to life this year, with home sales and valuations both rising at a strong clip (see chart). Home prices have rallied sharply in many areas across the country, indicating that overall economic conditions are
improving. But judging by the headline figures, it appears housing has played only a limited role in overall economic growth. In recent quarters, residential fixed investment — or spending on new homes — has represented slightly less than 3% of gross domestic product (GDP).

However, this is a misleading view of housing's contribution, as the headline data doesn't capture much of the sector's pull on economic activity. Take existing home sales, which dwarfed new home sales by a ratio of 10-to-1 in June.1 Outside of expenses such as realtor and finance fees, moving costs and furnishings, sales of existing homes are not included in the GDP report because they don't represent a new good or service. Spending on existing homes that aren't for sale is just as significant; it can add up to almost 40% of the average homeowner's monthly expenses. Include all of the direct costs of building, buying, furnishing and maintaining a home, and this segment's contribution to GDP jumps to between 15% and 20%, making it one of the largest segments of the economy.

But the story doesn't stop there. Merely adding up the direct impact of housing on the U.S. economy ignores how integral housing is to behavior and spending across the entire economy. This multiplier effect boosts housing's overall importance to the economy and its recovery from the recession. For example, new home construction requires direct expenses for building materials, architectural services, construction crews and specialized contractor services, in addition to other ancillary costs such as landscaping improvements, new furniture and moving expenses. Naturally, all of these expenses are calculated as income to the providers of those goods or services, who then use the money to pay for other things.

Because housing is such a large expense, its ripple effect through the economy is larger per dollar spent than for most other spending categories. While estimates of housing's multiplier effect are wide-ranging, they generally fall in the range of 1.3 to 1.62 dollars in economic impact for each dollar spent. Put another way, a dollar spent in the housing sector benefits the economy more than if it was spent elsewhere.

Housing's "wealth effect” on consumer behavior

A big-picture reading of housing's impact must also take account of the psychological impact that housing investment has on consumer behavior. Much has been said of the so-called "wealth effect" from stock investments — when those
assets appreciate in value, their owners gain more confidence to spend. But research by economists Karl Case and Robert Shiller, the founders of one of the most closely watched home-price indexes, concluded that changes in housing wealth have a much bigger influence on spending than those involving other financial assets, including stocks.\footnote{3}

A big component of housing’s wealth effect is retirement security. As of 2010, median equity held in primary residences was more than double the median balance held in retirement accounts\footnote{4}, leaving the home as the primary retirement vehicle in the U.S. As home values continue to recover, homeowners are more likely to feel more secure about their retirement and loosen up their spending. Economists generally believe that 3\% to 5\% of the change in the value of our homes flows through to changes in spending patterns over time. Thus, the value of our homes affects our perception about retirement in the long run and our sense of comfort in the short term.

While it is difficult to prove this positive wealth impact since the recession, rebounding home prices should ultimately reestablish this relationship. After all, 65\% of American families own the home they live in\footnote{5}, and home prices recently posted their biggest year-over-year gain in more than seven years.\footnote{6}

**Escaping the recent past**

Of course, it will likely be a number of years before the mortgage mess is completely wiped up and housing activity returns to a “normal” rate of growth. That’s because housing’s influence over the economy was even more pronounced before, during and after the recession, thanks to a confluence of record-low interest rates, easy credit and the proliferation of exotic mortgage products.

In fact, had housing not been at the center of the downturn and behaved in a more historical fashion, the recession that ran from December 2007 through June 2009 would have ended two quarters earlier, economic growth would have been 2 percentage points better, and the recovery (the amount of time it took for the economy to return to its pre-recession level) would have occurred a full 18 months faster (see chart).

Many of the problems created by housing continue to work through the system. Today, for example, the delinquency rate on single-family mortgages is 9.72\%, compared to a long-term average of about 3\%\footnote{7} and almost one-fifth of homeowners
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with mortgages remain underwater. Compounding the difficulties of climbing out of this deep pit are drastic regulatory changes that are not yet complete four years after the recession officially ended. Borrowing requirements are still in flux, so lending institutions are imposing restrictive qualifications. Uncertainty about housing values still abounds, particularly now that interest rates are rising again.

Then there’s the problem of supply constraints. Since the recession, a majority of the construction crews were either laid off or the companies themselves went out of business. During this time, construction material supply chains dried up as well, leaving the industry much smaller today than it was just a few short years ago. Today, there are roughly 2.6 million employed directly in this industry and that figure would have to nearly double to return to normal. In the meantime, construction firms may struggle to find crews to build new houses.

Verdict: A full housing recovery is 3 to 5 years away

A return to “normal” would mean roughly doubling the number of homes constructed today, bringing lending requirements to a level that allows the average family to obtain a mortgage, and recouping all the value housing lost over the past five years.

Even so, household formation — one of the best measures of housing demand — suggests the sector is well on its way to a full recovery (see chart). New households have been forming at an annual clip of 521,000 in recent months, up from the 450,000 average between 2008 and 2011.  

![Household formation chart](chart.png)

While still below the long-term average of 1.25 million new households per year, the figures don’t account for natural housing degradation, or the amount of the housing stock that must be replaced annually due to disrepair or age.
Taking all of the above factors into account, we anticipate that housing demand will slowly return to its long run trend growth rate over the next three to five years. We expect only about an extra 0.5% growth in GDP in 2013, with that contribution rising to between .75% and 1% by 2015. Further, we expect an additional 2.5 to 3 million new jobs over the next three to five years from increased housing demand — or roughly 50,000 to 75,000 jobs per month as the sector regains its footing.

We believe the foundation for housing’s full recovery is already in place, and that old relationships between home values and spending are beginning to resurface. The implications for the economy are significant, both in terms of the direct impact on growth and the wide-ranging ripple effects that this all-important sector is capable of producing.