There has been considerable discussion of the possibility that ongoing troubles in the housing market could push the economy into recession.\footnote{A recession is typically defined as a sustained period (two or more quarters) of negative growth in real gross domestic product (GDP).} But it is very unlikely that the decline in housing alone will cause a recession. Any recessionary effect on the economy caused by housing will be a consequence of its effect on consumption.

Real GDP is a measure of the economy’s current production. Sales of existing houses have no impact on current production because these houses were produced sometime in the past. The only direct effect housing has on current economic growth comes through the “residential investment” component of GDP, which includes current construction and improvements of single- and multi-family housing. Residential investment accounts for only about 5 percent of GDP; consequently, the effect of residential investment on economic growth is relatively modest. The chart shows this effect by plotting quarterly GDP growth with and without residential investment. (It also shows the quarterly growth rate of residential investment.) Excluding residential investment has only a small effect even during the 1970s and early 1980s, when the growth of residential investment was considerably more volatile than during the past two decades.

Since residential investment peaked in the fourth quarter of 2005, its decline has reduced growth of real GDP by an average of about 0.85 percentage points. This decline has largely been offset by nonresidential investment, which has continued to grow at a brisk pace.

Thus, as noted above, if the troubles in the housing industry were to cause a recession, it would have to be because of their effect on consumer spending. Consumers base their spending decisions not only on their current income, but also on their wealth. Other things the same, an increase in wealth should induce consumers to spend more of their current income. Hence, a decline in wealth could generate a decline in consumer spending. For many people the net worth of their home is the single most important source of wealth. Consequently, a decline in home prices can make people less wealthy, causing them to consume less. Because consumption accounts for about 70 percent of GDP, even relatively small changes in consumer spending can have a relatively large effect on output growth.

Estimates suggest that the wealth effect associated with changes in equity values is weak or nonexistent. The wealth effect associated with housing wealth is stronger.\footnote{See Case, Karl E.; Quigley, John M. and Shiller, Robert X. “Comparing Wealth Effects: The Stock Market vs. the Housing Market.” Advances in Macroeconomics, 2005, 5(1), pp. 1-34.} Wealth effects are very difficult to identify and measure, however. Consequently, it is difficult to precisely determine the effect of the recent decline in home prices on consumption and, hence, output growth. It is interesting to note that growth of real consumption expenditures since the second quarter of 2006 has remained strong—in the range of 3 percent—despite the downturn in the S&P/Case-Shiller home price index since then.

\[\text{Effect of Residential Investment on GDP}\]