

EconWorld2023@Tbilisi

Overbuilding and Recession: A new Drawback of Housing Market Boom-and-Bust Cycle

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ABSTRACT

In this paper I unveil a new mechanism through which a housing market boom leads to a recession after the housing market bubble bursts. Overbuilding, the increased residential construction triggered by optimism or fake news instead of the economic foundation, crowds out physical investment during the boom because of general equilibrium effect. This crowded-out physical investment will induce a recession (or amplify the loss and prolong the span of the recession) via the scarcity in physical capital. Relative intratemporal elasticity of substitution (to intertemporal elasticity), financial friction and idiosyncratic shock can aggravate this crowd-out effect through consumption substitution, liquidity easing and precautionary saving. In addition to these three engines, wealth distribution also plays an important role in catalyzing these effects and causing an inequality problem.

KEYWORDS Heterogeneous Household; Consumption; Expectations; Great Recession; Business Cycle; VAR
JEL E21, E22, E30, E51, E58