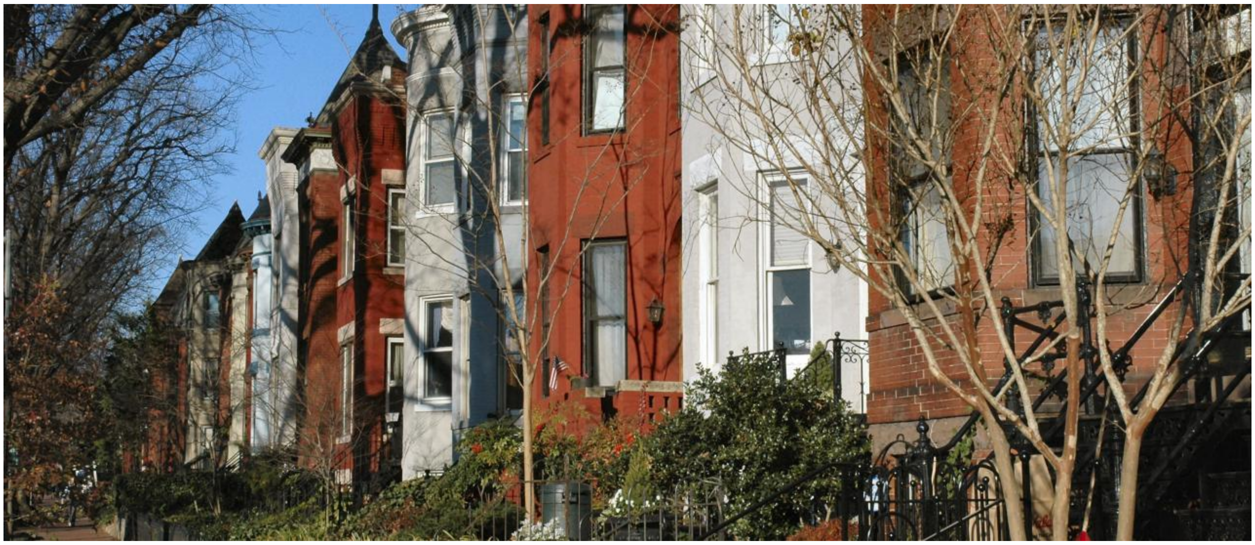
A New Look at The Housing Market



By Amine Ouazad , INSEAD

A new formula for forecasting house prices suggests easy credit can do more harm than good when it comes to creating a fair and open housing market.

The collapse of the subprime mortgage industry in 2008 and the subsequent credit crunch led to upheaval in the U.S. property market. In many cases black and minority homeowners who were disproportionately affected by the banking scandal remained frozen out of the recovery as credit easing attempts by governments backfired. Instead of increasing home ownership amongst minority groups, and breaking down barriers to “better” neighbourhoods, by relaxing borrowing constraints the government was actually driving low-income households out of the property market.

The impact of credit restraints on house prices has been a phenomenon largely un-noticed or under-estimated by governments, real estate agents, and property valuation web sites. Another forgotten factor when estimating house price fluctuations has been what the industry refers to as ‘willingness to pay’, in other words a householders’ readiness to spend extra to live closer to a better school, improved amenities or a particular community .

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In our research **Structural Demand Estimation with Borrowing Constraints**, Romain Ranciere, Associate Professor of Economics at the Paris School of Economics, and I found significant links between these two factors, to the extent that willingness to pay for amenities driven by the availability of credit, accounts for about 20 percent of real estate price sensitivity.

Our research explicitly takes into account the extent to which householders' bids for real estate affects market prices – and how such bids are driven by the availability of mortgage credit. Our research gathered extensive comprehensive data on all households, property transactions and mortgage applications, as well as a range of amenities, in the San Francisco Bay area between 1990 and 2010.

Why more credit equals greater segregation

The methodology (which is based on the idea that differences in probability of mortgage approval across neighbourhoods shape the choice set of prospective home buyers) highlighted amongst over things the impact of credit availability on neighbourhood movements. While one may have thought greater access to mortgage would create a fairer, and possibly less segregated, world, what happens is quite the opposite.

In fact we found relaxed credit constraints helped householders to move into areas of their choice, most often areas populated by people like themselves. While this led some black households to leave their mostly black districts for more racially mixed neighbourhoods with better schools and amenities, it had a greater impact on white households, who used the increased credit to move out of racially mixed neighbourhoods to live in mostly white areas.

During the boom-time of the early 2000s, construction in these mostly white neighbourhoods couldn't keep up with the increased demand, and the increase in purchasing power (due to greater credit accessibility) pushed the average property out of the price range of minority groups. This resulted in even more segregated communities and in some cases white gentrification of neighbourhoods previously inhabited by black or minority households.

The problem of racially divided communities and the displacement of traditionally low-income households is not limited to San Francisco. Around the world, governments have attempted to put in place social policies addressing the displacement of minority groups. Many of these solutions

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included increasing householders’ access to mortgage credit.

Government policy rethink

We can now see that making more credit available does not necessarily create a fairer world, nor does it open the way for low-income and minority groups to climb the ladder into better neighborhoods. And, in fact, it could leave them worse off. Hopefully our model will help governments trace back the cause of salient city transformation for more effective policies.

On the flip side, our research gives householders, real estate agents and developers a greater awareness of how the volatility in interest rates and access to credit affects the value of their properties and leaves them better able to judge whether houses that look like a good investment today will withstand the impact of a rise or decline in credit availability.

Investors will be able to get a more accurate and long-term assessment of the return on investment their property offers by monitoring the credit availability and its impact on the yield: ratio of rent to annualised house price. If bank lending policy changes quickly, house prices are also likely to change rapidly, which adds uncertainty and an element of risk to any investment.

And just as investors use the model to understand their own exposure, central banks can use it to observe how the flow of credit from financial institutions ultimately affects house prices, and adjust their policies appropriately.

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