

UNCERTAINTY AND HOUSING

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In a market economy, uncertainty is everywhere. Real estate developers face interest rate risk with their construction loans as well as uncertainty about sales once their inventory comes to market. Consumers also face uncertainty in the real estate market. A mortgage requires monthly payments far into the future. Yet jobs can disappear with little warning, and a consumer's wealth can also fluctuate sharply with movements in stock and bond prices. All this can cause much anxiety for both real estate investors and consumers looking to buy their first home.

Economists have long understood that uncertainty can powerfully shape economic decisions. Greater uncertainty about demand or the cost of financing can cause real estate developers to postpone new construction. Likewise, increased uncertainty about their future income might cause consumers to buy a smaller house, or postpone the home-buying decision altogether. Lenders

might also react forcefully to uncertainty, denying mortgages to riskier borrowers when uncertainty spikes. These collective decisions in response to uncertainty can cause a sharp slowdown in housing markets, and even recessions.

This negative impact of uncertainty on credit and housing markets might be particularly large during and after a financial crisis. These crises are marked by massive volatility in financial markets, and tremendous uncertainty about future regulatory and financial policies. For example, Dodd-Frank was passed in 2010 and regulations surrounding the housing market and banks have been in flux for a number of years since, as new agencies like the Consumer Financial Protection Bureau develop new rules. While the housing market has recovered somewhat in part due to low interest rates, household consumption and economic activity have been remarkably weak since the crisis. Could then the increase in uncertainty during and after the financial crisis help explain the relatively weak outcomes in housing and other consumer credit markets?

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ness School) and Edison Yu (Federal Reserve Bank of Philadelphia) suggests that indeed, economic uncertainty can have a huge impact on both the demand for

consumer credit—mortgages and credit cards—as well as on the supply of consumer credit. The authors tackle this question by first developing a local measure of economic uncertainty for 3000 US counties from 2000 first quarter through the final 2013 quarter 4. For each county, this measure weights the volatility of the share price of public firms by the employment shares inside the county. For example, if a county's employment is tilted towards oil and gas, and those firms have very volatile stock prices in a quarter, then this measure would suggest that individuals in those counties might face more uncertainty about employment in that quarter.

The authors find that this measure of uncertainty can predict county-level employment outcomes several quarters in advance. That is, when uncertainty spikes in a county, employers tend to slow down hiring, leading to weaker job growth subsequently. The evidence also strongly suggests that this feeds into local housing and credit markets. But the effects differ dramatically depending on a borrower's credit score. In particular, borrowers with good credit scores sharply reduce their demand for mortgage and consumer credit when uncertainty spikes. These borrowers for example already enjoy cheap and plentiful access to credit. And an increase in uncertainty—greater employment risk—that could impede repayment could hurt their credit score and cause high-credit-score borrower to lose valuable access. They thus shy away from debt when uncertainty increases. Banks and credit card companies however appear to push greater credit towards these “safer” borrowers when uncertainty increases.

New research by Rodney Ramcharan (joint with Amir Kermani (Hass Business School, Berkley), Marco DiMaggio (Harvard Business School) and Edison Yu (Federal Reserve Bank of Philadelphia) suggests that indeed, economic uncertainty can have a huge impact on both the demand for consumer credit—mortgages and credit cards—as well as on the supply of consumer credit.

The results are the opposite for the low-credit-score borrowers. When uncertainty increases, these individuals appear to increase their demand for credit. This is consistent with risk-shifting behavior. These borrowers already have limited access to credit. And their incentives to gamble using debt can be quite strong when there is greater risk. If things work out positively, then low-credit-score borrowers can benefit tremendously. For example, if house prices rise, then as equity holders, these borrowers can benefit from leveraged returns. But if the gamble goes badly, then low-credit-score borrowers can walk away from debt relatively cheaply. They after all already had limited access to credit in the first place, and so the cost of default is low. Lenders appear to anticipate this behavior. When uncertainty increases, lenders disproportionately reject mortgage

loan applications from low-credit-score borrowers. Also, credit card companies cut sharply the credit lines to these borrowers.

Taken together, the evidence in DiMaggio, Kermani, Ramcharan and Yu (2016) suggests that economic uncertainty might significantly affect consumption and consumer credit decisions. These findings also suggest that the increase in economic and policy-related uncertainty commonly observed during and after a financial crises could independently impede the supply of credit, reducing consumption and economic activity over an extended period. The heterogeneity across credit-risk types also suggests uncertainty could drive financial constraints across the business cycle for some kinds of borrowers. This all means that when considering difficult to reverse real estate investments, investors might need to be especially mindful of both aggregate uncertainty—what is happening in Washington DC and Wall Street—but also local uncertainty: How risks detected on Wall Street might play out eventually on Main Street.



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