Researchers discover new way the housing market affects the economy

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(Phys.org) —New research from the University of Georgia and Miami University helps explain how a 1997 amendment to the Texas Constitution that relaxed restrictions on mortgage lending boosted statewide retail sales and provided evidence for the importance of using housing as collateral to relax constraints on borrowing, what economist call "the collateral effect" of the housing market.

The research was published in the *American Economic Journal: Macroeconomics*.

"Since Texas became a state in 1845, they've always had an attitude of protecting the homestead, going back to the days of Stephen F. Austin. There was an idea you can't foreclose on any loan because you'd be taking people's homes away," said William Lastrapes, economics professor in UGA's Terry College of Business and co-author of the research. "This runs deep in their history. So it took them from 1845 until 1997 to actually make a change to allow people to borrow on their home equity for general spending purposes."

When the amendment passed, Texas homeowners suddenly had the same credit freedoms as the rest of the nation. They could borrow against the equity in their houses to do things like buy a new car, go on a trip or pay for their children's education.

It also provided Lastrapes and co-author Chadi S. Abdallah, a former UGA graduate student and current assistant professor of economics at

Miami University, with real-world data from a "natural experiment." By examining the Texas economy before and after the amendment passed and making comparisons to surrounding states' economies, the researchers were able to isolate what effect the amendment had on statewide consumer buying.

"What we learned is that borrowing restrictions mattered. Policymakers in the state thought they were doing the right thing by preventing foreclosures, but when they relaxed those restrictions, people responded and increased their spending," Lastrapes said. "After looking through the data, we found that the amendment had an important effect on consumer behavior: retail spending in Texas was 2 to 3 percent higher than it would have been had the amendment not passed."

That percentage change equals millions of dollars that consumers otherwise would not have spent. The amendment not only provided a boost to the state's overall economy, it also showed that policymakers can spur growth by softening credit markets-even when house prices remain stable.

"The standard thinking is that when home prices go up, people feel richer and they spend more money. Our work suggests another way that housing likely influences the rest of the economy," Lastrapes said. "Rather than feeling richer, consumers see higher home prices as freeing up opportunities for borrowing, which allows them to buy more stuff. More generally, since our research helps explain consumer behavior, our findings have important implications for issues as diverse as how people respond to tax cuts and how best to finance college expenses."

The relevance of housing collateral effects has been debated theoretically for years, but the circumstances around the Texas amendment provided researchers the chance to study what happens in practice.

"In a lot of professions, like medicine, when you want to find out the effectiveness of a certain medicine, you can set up an experiment to isolate the effect of the drug," Lastrapes said. "In economics, you can't do that. So what we do a lot these days is to look for natural experiments. Some changes in policy can allow us to observe a 'treatment' group (Texas in this case) and a control group (everyone else), just like in real experiments."

Based on the success of the research, Lastrapes and Abdallah plan to delve deeper into what happened before and after the Texas amendment, next time focusing on entrepreneurs.

"Many small businesses are financed by home equity, since this reduces the bank's risk of the venture not working out," Lastrapes said. "Small businesses create a lot of jobs and a lot of wealth. So, understanding the credit market constraints they face, and how they deal with such constraints, is an important issue for economists and policymakers."

Provided by University of Georgia