GLAECONOMICS

Current Issues Note 20

The housing market and the economic climate

By **Sandeep Sankoli** and **Analena Gilhome**

Transport for London

LONDON DEVELOPMENT AGENCY

MAYOR OF LONDON

copyright

Greater London Authority
February 2008

Published by
Greater London Authority
City Hall
The Queen's Walk
London SE1 2AA
www.london.gov.uk
enquiries **020 7983 4000**
minicom **020 7983 4458**

ISBN: **978-1-84781-141-7**

Cover photograph
© shutterstock.com

This publication is printed on recycled paper

For more information about this publication, please contact:
GLA Economics
telephone 020 7983 4922
email glaeconomics@london.gov.uk

GLA Economics provides expert advice and analysis on London's economy and the economic issues facing the capital. Data and analysis from GLA Economics form a basis for the policy and investment decisions facing the Mayor of London and the GLA group. The unit is funded by the Greater London Authority, Transport for London and the London Development Agency.

Contents

1. Introduction

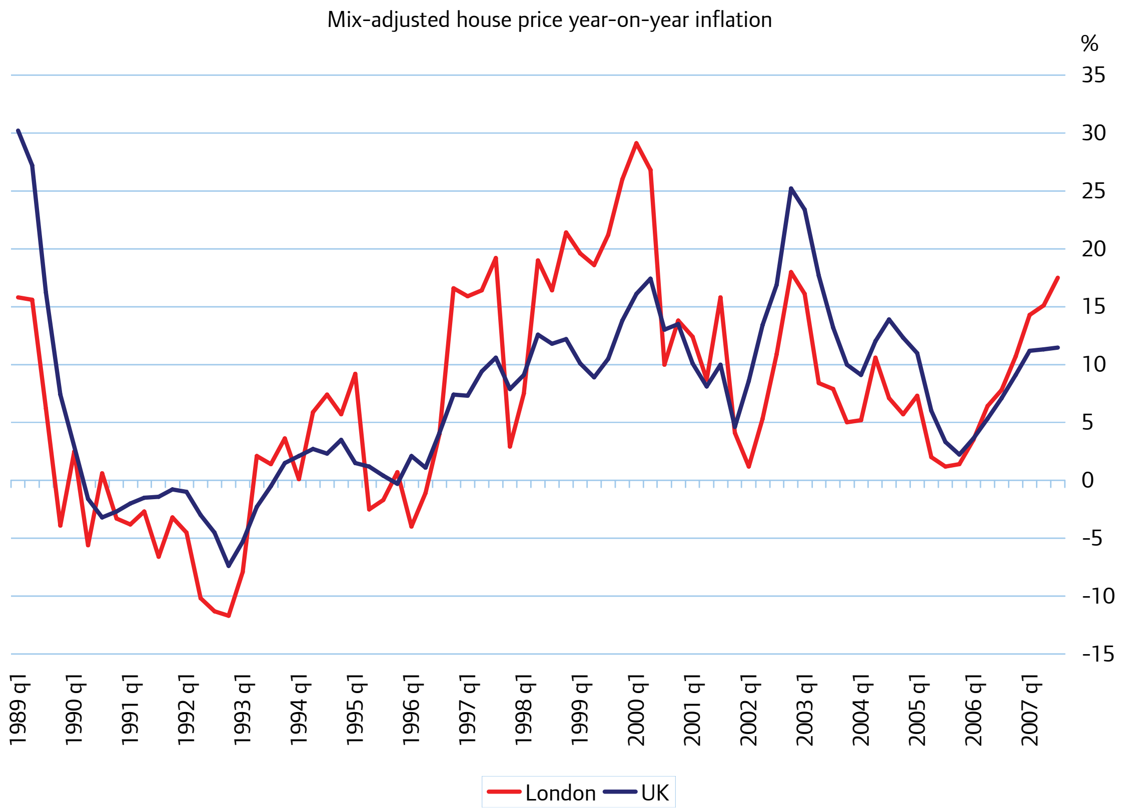
Residential property plays an important role in society. In addition to its primary purpose of meeting the housing requirements of the population it is also a growing investment asset class. Occupational use of property can be divided into rental property and owner occupied property. Given the importance of housing, both of these are subject to a large number of economic dynamics, which will be discussed in this paper.

2. Background research

The UK housing market has a significant impact on the UK economy as almost 78 per cent of households are privately owned[1]. Home ownership rates are amongst the highest in Europe and housing is the biggest form of wealth in the UK.

Annual house price inflation, as measured by the Department for Communities and Local Government (DCLG), stood at 17.5 per cent in London in Q3 2007 making it five consecutive quarters that house price inflation in London exceeded that of the UK. Figure 1 shows house price growth has been particularly strong over the last decade — the UK and London have enjoyed positive growth since 1996.

Figure 1: House prices – UK and London



Source: Communities and Local Government

[1] Communities and Local Government

Some forecasts indicate there will be further growth in house prices in the UK and London, with London expected to be higher than the UK. There is a general consensus amongst most commentators, including Communities and Local Government, the Royal Institution of Chartered Surveyors and Hometrack, that house price growth became more subdued in the second half of 2007.

Halifax Bank of Scotland (HBOS) forecasts (Table 1) suggest that in 2008 house prices in London will continue to grow despite drops in prices in other regions of the UK. The power of the London economy, its attraction as a world city and its central geographical position are the factors cited as making London unique from the rest of the country. Demand could remain strong if high levels of net migration in the city continue and on the back of wealthy foreign individuals and investments.

Table 1: Percentage change in house prices across the UK

% year-on-year			
Region	**2007 Estimate**	**2008 Forecast**	**1997-2007**
North	**2**	**-2**	192
Yorks & the Humber	**1**	**-2**	184
North West	**0**	**-2**	174
East Midlands	**1**	**-1**	190
West Midlands	**1**	**-1**	167
East Anglia	**3**	**1**	205
South West	**2**	**1**	206
South East	**8**	**1**	192
Greater London	**9**	**2**	223
Wales	**1**	**0**	203
N. Ireland	**5**	**0**	311
Scotland	**10**	**4**	138
UK	**5**	**0**	**189**

Source: HBOS

The extent of any downturn in the housing market will be influenced by how much price rises have been driven by fundamental determinants of housing demand and supply — such as average per capita incomes, population and the real cost of home ownership, including interest rates — and how much they have been driven by expectations of future house prices. If the contribution of expectations is large, a change in sentiment regarding future house prices is more likely to lead to an actual decline in prices. David Miles, Chief Economist at Morgan Stanley, carried out a model using these variables and results showed that, on average, almost 60 per cent of the rise in real house prices over the period 1996–2006 could be explained by these fundamentals. The degree of unexplained variance (40 per cent) is therefore significant and may have much to do with expectations. The International Monetary Fund estimates that around a third of house price increases over the past decade cannot be explained by fundamentals. However its model fails to take into account migration and supply constraints, both of which have arguably been contributing factors to house price growth in the UK and

London in particular in recent times. Nevertheless, it seems the contribution of expectations is not trivial and therefore needs to be considered carefully.

Forecasts and expectations

Our expectation of a housing market slowdown, rather than crash, combined with the weakening relationship between house prices and consumption, suggests that the impact on consumption and the economy will not be as substantial as some commentators appear to expect. This aligns with a recent GLA Economics forecast for a slowdown in economic growth in 2008 in London[2] and is further supported by the view from the Royal Institute of Chartered Surveyors.

"It is clear that the housing market continues to feel the strain of depressed market conditions. The recent credit crunch continues to hit confidence in the market, with Chartered Surveyors feeling the most pessimistic about price expectations since 1998. However, while underlying economic fundamentals remain sound and the labour market remains strong, large falls in prices remain unlikely. Employment would have to fall sharply before enough supply entered the market to create a significant dip. "

Jeremy Leaf (RICS)

3. Potential risks to the housing market

Interest rates — The cost of borrowing money is a significant factor in determining mortgage rates and the ability to repay loans. As interest rates rise, mortgage repayments tend to become more expensive and the likelihood of defaulting on payments becomes stronger. Previous house price crashes in 1973-74 and in the early 1990s were during periods of particularly high levels of interest.

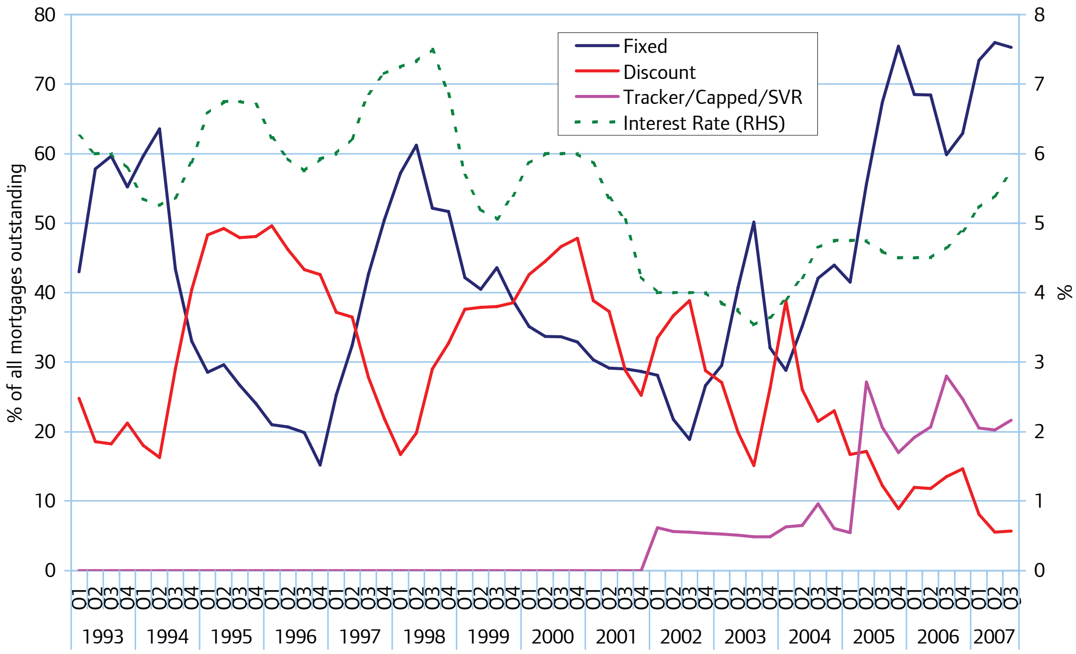
The prospect of future further interest rate cuts may help to stabilise a slowing housing market. However, the Monetary Policy Committee's ability to make rate cuts may be constrained if inflation picks up further. In addition, the real impact a base rate reduction has on households' ability to make mortgage repayments depends on the extent to which mortgage lenders pass the reduction on to consumers, particularly for new fixed rate mortgages or those on interest-only mortgages.
Leading mortgage lenders claim that future base rate reductions may not be passed to borrowers automatically. Indeed, most lenders have failed to cut their fixed rate deals since the last Bank of England cut in the base rate[3].

Mortgage indebtedness — There are various types of mortgages on offer in the market ranging from fixed rate nominal to variable or index linked. We need to consider whether certain mortgages and those who are pushing themselves financially will be able to cope with a fall in house prices. Historically, fixed rate and discount mortgages have been popular, however the popularity of discount mortgages over the last three years has declined rapidly, perhaps due to expectations that interest rates are likely to rise.

---

[2] London's Economic Outlook 2007
[3] http://www.telegraph.co.uk/news/main.jhtml?xml=/news/2008/01/07/nrates107.xml

Figure 2: Type of mortgages outstanding in the UK

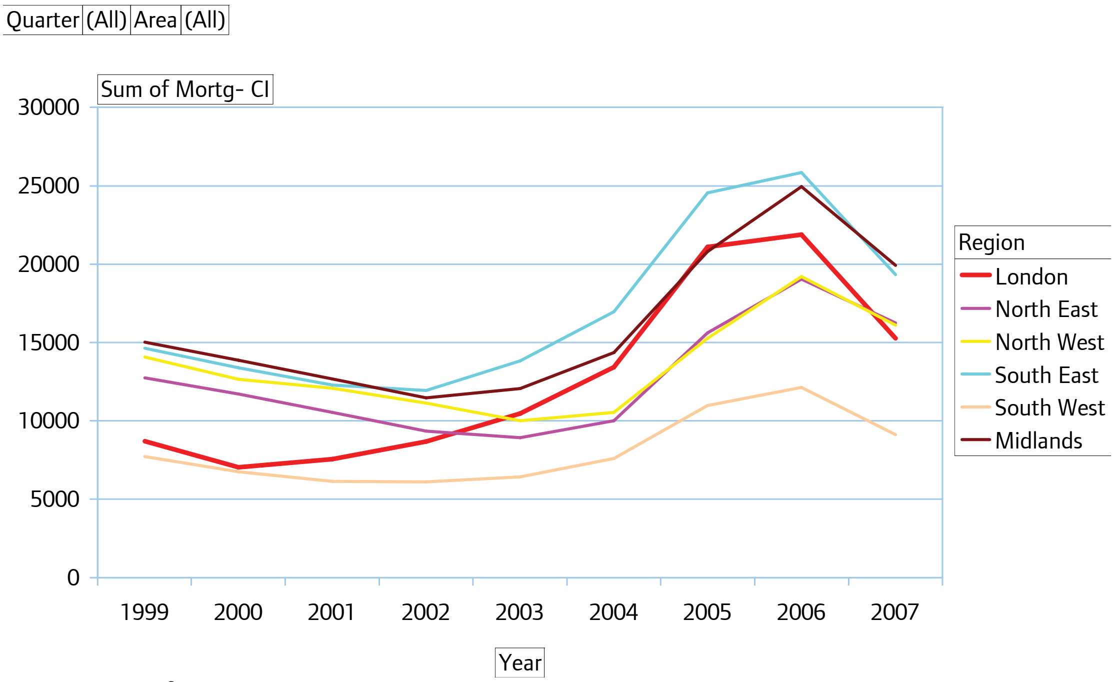


Source: Council of Mortgage Lenders & Bank of England

Currently a large proportion of buyers take out fixed rate mortgages with almost 80 per cent of outstanding mortgages in the UK on a fixed rate as shown in Figure 2. However the proportion of borrowers taking out fixed-rate mortgages fell to 65 per cent in November 2007 from a peak of 77 per cent in June, as borrowers anticipated future base rate falls. This trend away from fixed rates is likely to continue with the expectation of further rate reductions in early 2008.

The most common type of mortgage is a repayment mortgage where payments are made to cover interest costs and repay the capital. Figures for 2007 from the Council of Mortgage Lenders (CML) show that 67 per cent of first-time buyers opted for a repayment mortgage. Some borrowers however opt for an interest-only mortgage, but with a specified repayment vehicle, such as a savings plan, designed to cover the repayment of capital at some point. However, the CML's statistics show that in 2006, 17 per cent of first-time buyers took out an interest-only mortgage without any specified repayment vehicle.

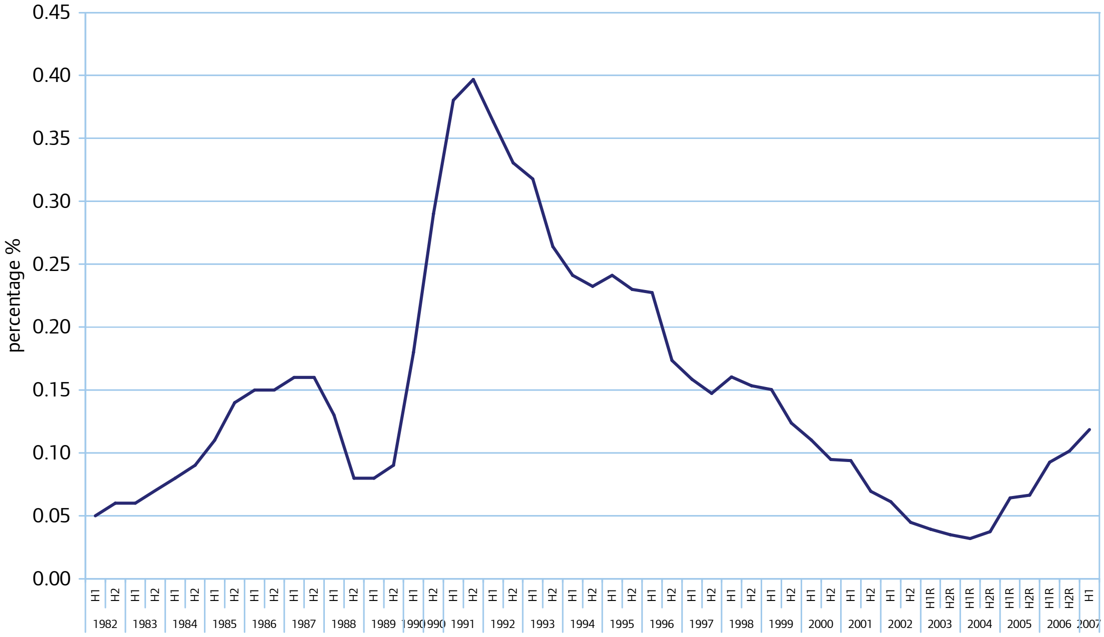
Figure 3: Court actions entered into



Source: Council of Mortgage Lenders

Court actions entered into for mortgages were at some of the highest levels in 2006 (due to an increase in interest rates) but fell back down again in 2007. The Council for Mortgage Lenders estimates that in the first half of 2007, 14,000 properties were taken into possession in the UK, which equates to 0.12 per cent of all loans. However this is lower than the levels if the early 1990s as repossessions reached almost 0.40 per cent of all loans as illustrated in Figure 4.

Figure 4: Mortgage repossessions as a percentage of all outstanding mortgages in UK



Source: Council of Mortgage Lenders

Consumer spending — House price movements can cause changes in consumer spending via a number of 'causal channels'. In recent years, these may have been weakening for the following reasons:

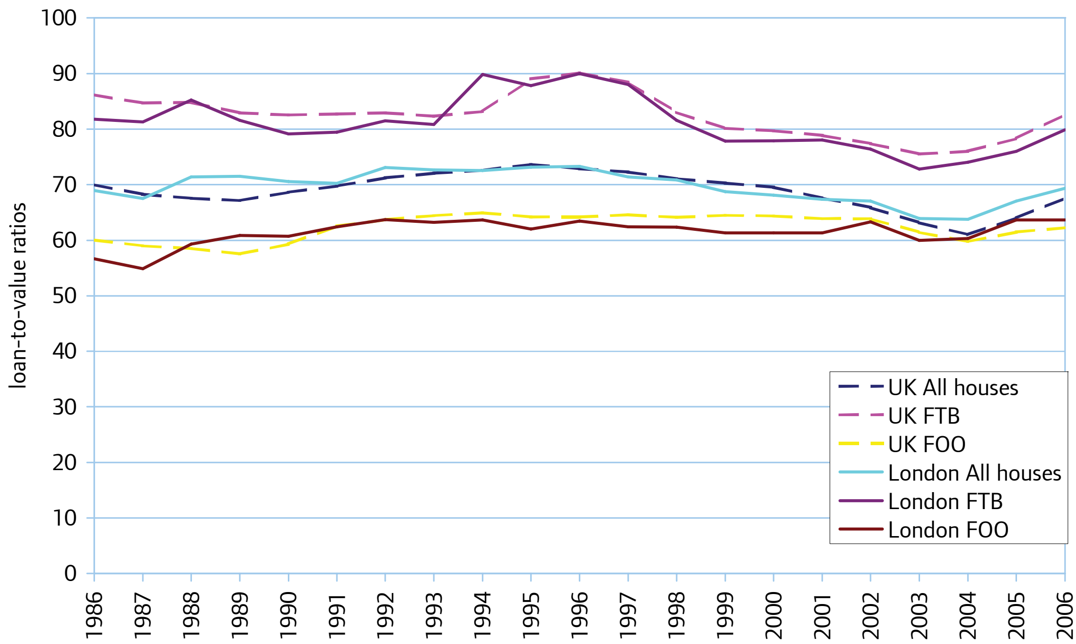
- Housing is used as collateral for loans – when house prices rise the value of collateral is higher so lenders will lend more at lower interest rates, in turn causing spending to rise. However, households' dependence on house price gains to facilitate spending is likely to have been weakened with the rise of more flexible forms of unsecured credit, such as credit cards. Also, the amount of collateral at homeowners' disposal was already substantial at the start of this decade, so the boost to spending from further house price rises due to this reason is now likely to be limited; and,

- Housing wealth forms part of households' precautionary savings. As house prices rise, the need to hold other forms of wealth as precautionary savings is reduced, which may encourage spending. However, households' desire for precautionary savings may have declined in recent years as the economic environment has been relatively stable. In addition, given housing equity had reached high levels by the beginning of the decade, it is likely that many households have more than enough equity in their homes to satisfy the need for precautionary savings.

The correlation between house prices and consumer spending seems to occur because common factors such as expectations of future income affect both consumption and house prices, rather than because of strong causality between house prices and consumption. It is likely that in recent times house prices have been influenced by a set of variables that have a lesser impact upon consumption. Factors which have a greater influence on house prices than consumption, such as rates of household formation, investment demand and interest rates, are more likely to have driven house prices in recent years, explaining some of the divergence between house prices and consumer spending.

First time buyers — Soaring prices have pushed the cost of homes out of reach of many potential first-time buyers. The initial hurdle for most first time buyers is saving the required minimal deposit, which ranges from 5-10 per cent of the value of the home. Falling prices could make home ownership more affordable for first time buyers, and their 'pent up' demand could sustain prices. However, the fear is that today's buyers could potentially become trapped in negative equity if house prices were to fall significantly, or if they take out loans with a high loan-to-value ratio which have been growing rapidly in recent years, but are not quite as high as in the late 1980s or mid 1990s (Figure 5).

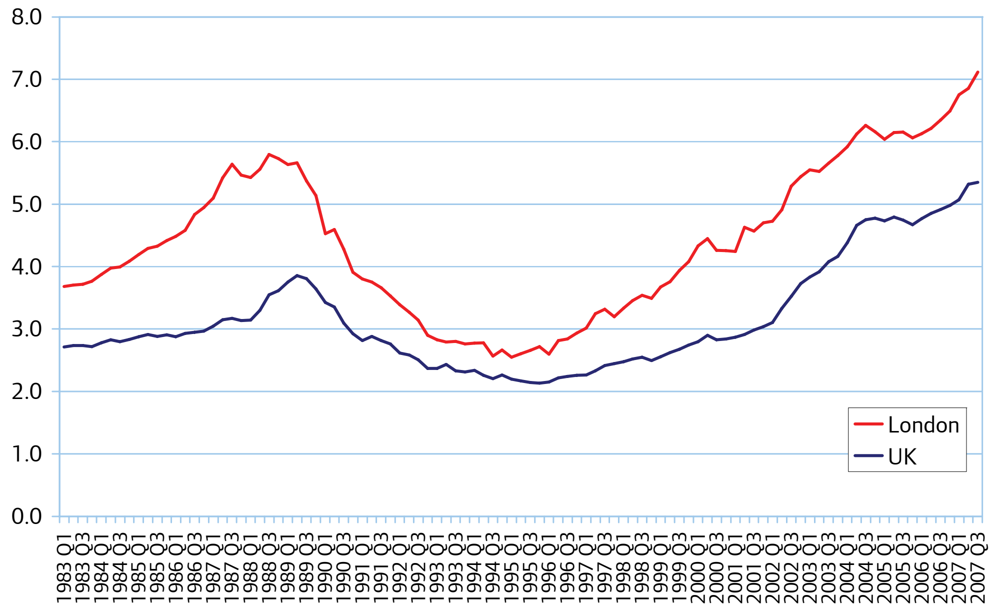
Figure 5: Average loan-to-value ratios



Source: Communities and Local Government and GLA Economics Calculation

The house price to earnings ratio for first time buyers in London has always been higher than the UK (Figure 6). Both ratios have recently reached their highest levels of 7.1 and 5.3 respectively. The strong house price growth shown in Figure 1 has pushed the ratios to levels at which a growing numbers of households will face affordability constraints. Raising income multiples may not necessarily be a viable option as sub-prime lenders are generally riskier and banks are cutting back their lending to households as they face difficulty in selling on the mortgage debt to other investors. All this places a greater risk on first time buyers — changes in the wider economic climate, particularly higher levels of unemployment, higher food and energy prices and a downturn in the housing market, could have serious consequences.

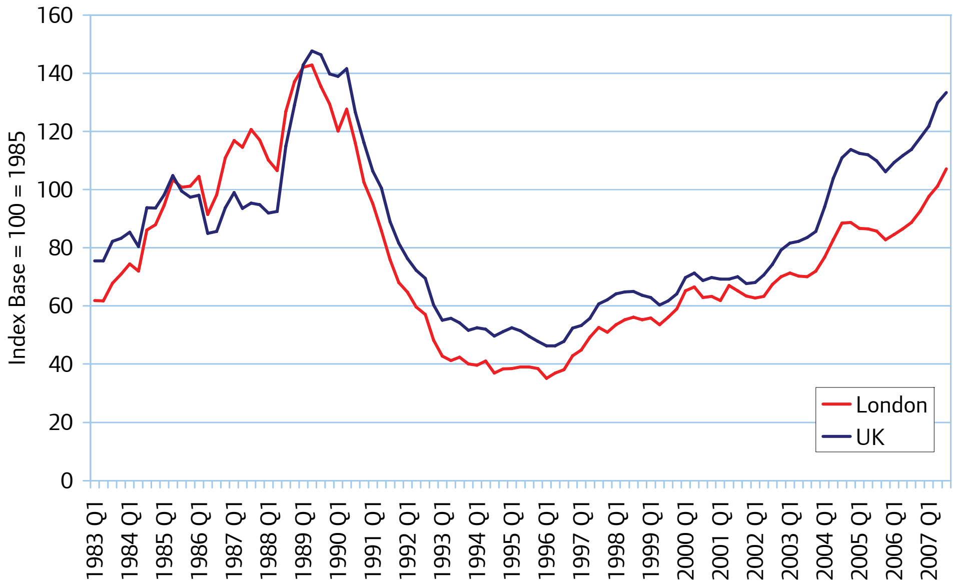
Figure 6: First time buyers – house price to income ratio



Source: Nationwide

UK first time buyers spend a higher proportion of their take home pay to service their mortgage debt than Londoners, as shown by the index of mortgage repayments as a percentage of take home pay (Figure 7). The index takes the value of 100 in 1985. An increase in the index indicates worsening affordability. The general upward trend in Nationwide's affordability index since the mid-1990s suggests that affordability is gradually worsening over time. However, the index still remains below the height of the late 1980s boom. The UK index is approaching levels experienced in the late 1980s, but the London index remains some way off.

Figure 7: First time buyers – index of repayments as a percentage of pay



Source: Nationwide

New developments and targets — Homes in the planning pipeline may slow down and we may be in danger of not meeting housing targets. Expectations in the short term are that new starts levels will be lower than last year although homes currently under construction will complete. However the developers may find themselves cutting into their profit margins if house prices slow as their business models may rely on expectations of growth. The supply of new-build stock therefore will remain tight for a number of reasons:

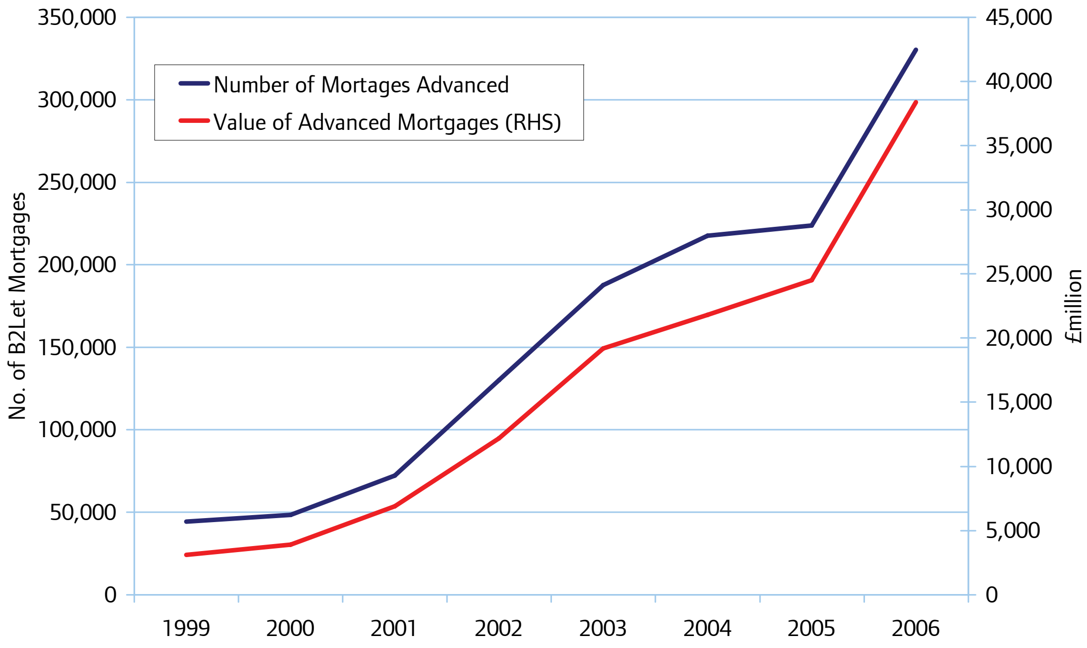
- Developers' sales expectations have declined.
- For virtually the whole of the past decade house price growth substantially exceeded growth in building costs. In contrast, if house price growth slows, it may only match the rate of increase in build costs over the next five years. The tightening in supply of new build homes will be exacerbated if input costs (including labour, plant and materials) begin to increase more rapidly than in the past (for example, if imported materials become more expensive on the back of a falling pound).
- Developers are not expecting the planning system to be sped up or risk taken out of the system in terms of securing planning permission in the immediate future.

This also raises the question of land values as developers have often paid a premium for the land and their business model is therefore dependent on them obtaining a 10-15 per cent profit.

Land values – Another consideration is whether land values will come down in a downturn in the market, or whether the downturn, particularly in London (where land values are highest) will not be that significant.

Buy-to-let landlords – Target-led development has encouraged major scheme developers to concentrate on flats and small properties in order to deliver maximum homes at high densities. The number of buy-to-let mortgages has been growing since their inception in 1999 as reflected in Figure 8.

Figure 8: Buy-to-let mortgages in the UK



Source: Council of Mortgage Lenders

A slump in buy-to-let demand or widespread sell-off could release a large amount of property on to the market and could lead to dropping prices in sectors favoured by landlords (for example city centre new build flats). This may increase market instability and create a real danger of panic selling in a down-turning market.

As the potential for capital gains falls there may be:
- less new demand for buy-to-let (which may be exacerbated if mass EU immigration tails off as the arrival of new member states slows);
- the possibility that existing buy-to-let owners sell off; and
- less bank loans available for buy-to-let purchasers (already, buy-to-let mortgages have dwindled as banks become more picky about borrowers[4].)

According to the Royal Institution of Chartered Surveyors, new landlord instructions dropped below the long-run average in the last quarter of 2007, while the proportion of landlords choosing to sell when tenants left rose. They predict that new supply onto the investment market will slow in 2008, possibly quite sharply, but question whether existing landlords will sell. Issues to consider include whether landlords are able to re-mortgage to fixed rate deals and the strength of rental growth.

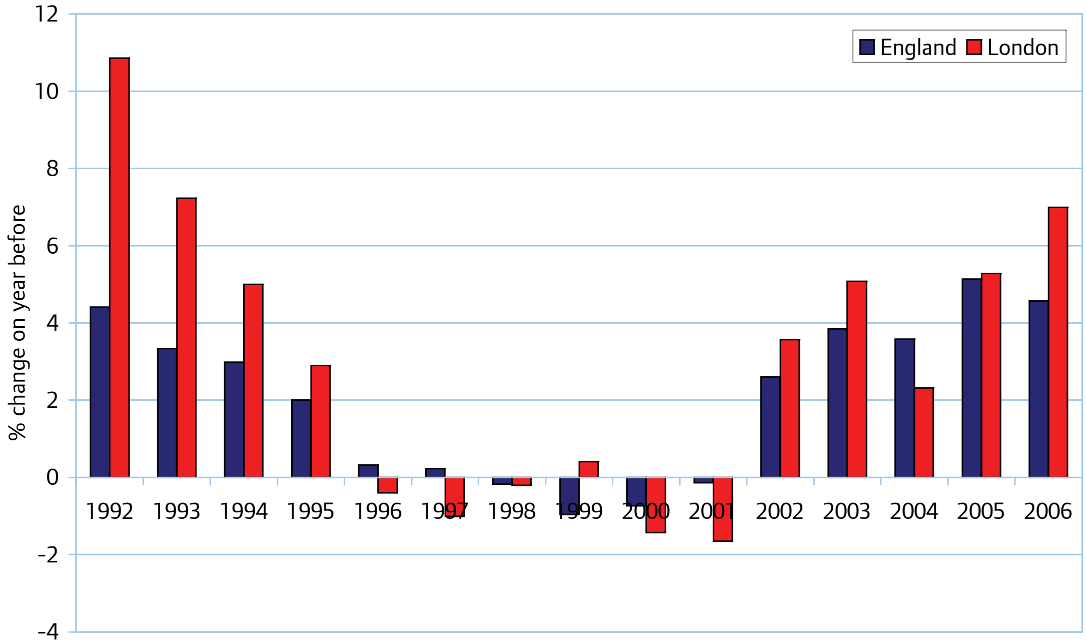
[4] Knight Frank Winter 2008 Residential Review;
http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/01/02/cnhouses202.xml

Council for Mortgage Lenders research in 2005 found that over 60 per cent of buy-to-let landlords said they expected to stay in the residential market for over 10 years. Inexperienced landlords were far more likely to say that they would sell because of stagnating house prices, but the vast majority of landlords are in a position to withstand adverse circumstances. As buy-to-let landlords become more knowledgeable and professional, the buy-to-let market is likely to become an important and stabilising part of the overall housing market. A report by Michael Ball for the Social Market Foundation 2004 found that the impact of buy-to-let on the housing cycle is likely to be limited as:

- housing transactions have high costs, which deter strategies of rapid entry and exit; and
- landlord investors have the near certain prospect of long-run rises in house prices, so they would jeopardise long-term gains if they sold up in a falling market.

Private rented stock – The private rented sector in London makes up 19 per cent of the market compared to 12 per cent in the UK. A downturn in house prices may affect private rent levels and the stock of private rented accommodation. As Figure 9 shows, growth in private rented stock slowed after the last housing market crash, and stock actually contracted several times from 1996 to 2001.

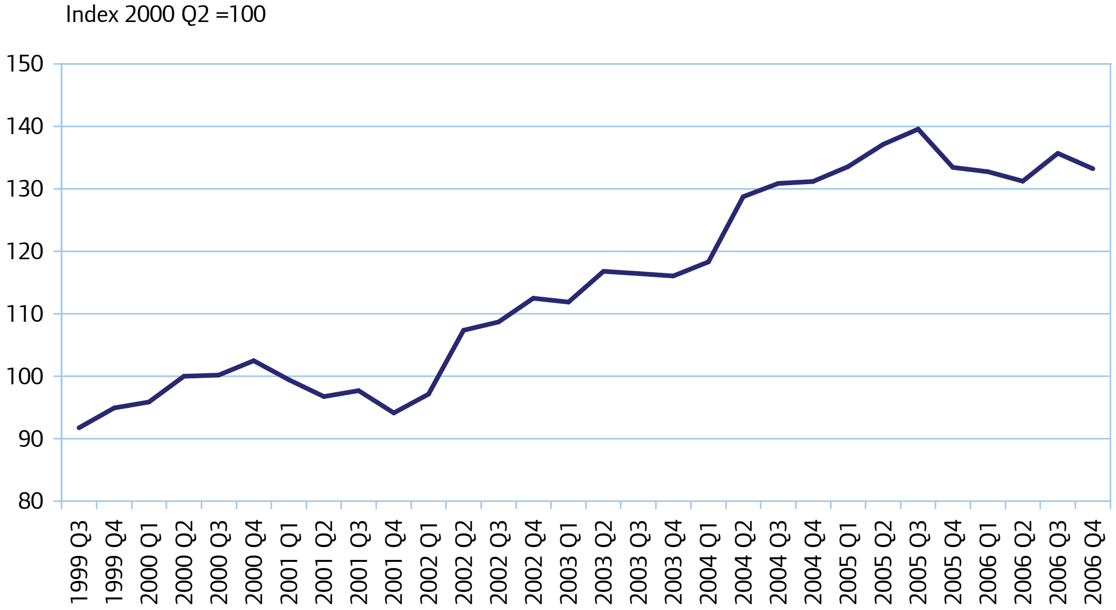
Figure 9: Growth in private rented stock



Source: Communities and Local Government

Throughout the early part of this decade the ratio between house prices and rents have diverged greatly, although this has remained relatively flat over more recent years as shown in Figure 10.

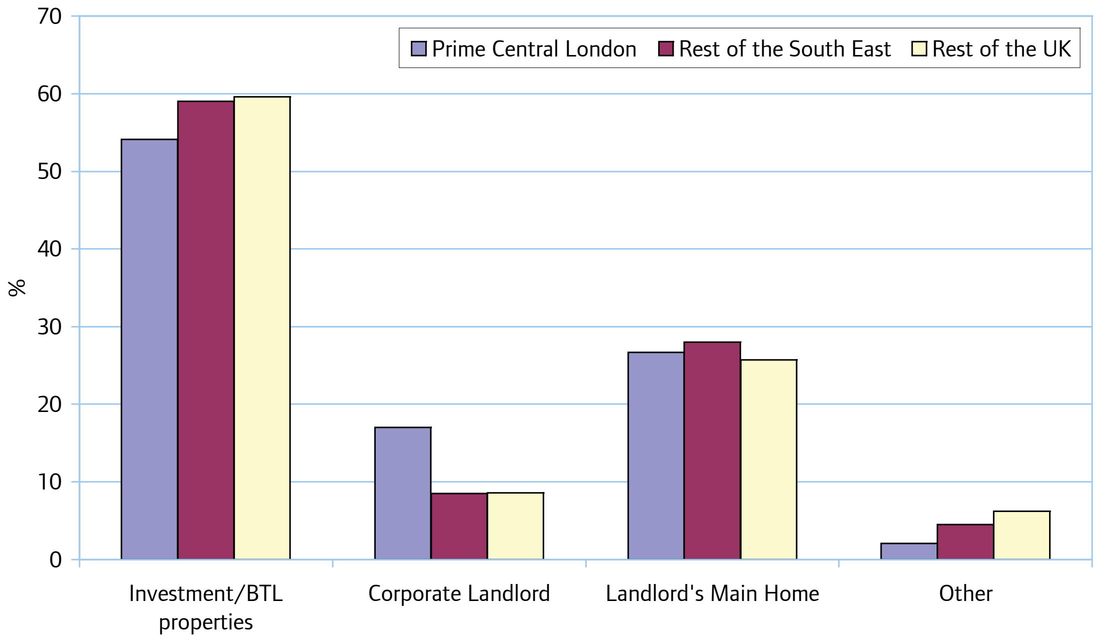
Figure 10. Ratio of UK house prices to rents



Source: Communities and Local Government and GLA Economics calculation

The proportions of landlords that are corporate, buy-to-let or renting out their former home could be important. These proportions differ for London and the rest of the UK — for example, there are a higher proportion of corporate landlords in central London (see Figure 11).

Figure 11. Source of rented residential properties coming onto the market 2005



Source: Association of Residential Letting Agents

There may also be a role for more institutional investors to enter the market to provide more stability, better quality management and an increase in supply of private rented stock. The advantage of institutional investment funds could help to stabilise the private rented market as they would operate a different business model to a private buy-to-let landlord with long-term strategies and place more expectations on a stable long-term income yield return rather than capital growth. This is bolstered by the fact that returns from residential property have been outperforming those from commercial and other equity investments over the last few years.

Low-income families — There are several possible impacts on this group that need to be considered. Low-income earners who have climbed the first rung of the property ladder may be some of the hardest hit by a housing market downturn. If they are in precarious forms of employment, they will be most at risk of losing their job if the economy begins to slow, which would make mortgage repayments difficult to meet. Those with mortgages coming up for renegotiation (that is, the fixed interest rate they were previously on is renegotiated) may face higher repayments as banks raise their mortgage rates. Also, low-income earners will find it more difficult to get a mortgage as banks tighten their lending criteria and require larger deposits. On the other hand a fall in prices could make property more affordable for them in the longer term.

Low-income earners currently living in social housing are likely to be insulated. However if the supply of new affordable homes falls and targets are unable to be met, there may be implications for waiting lists for social housing.
There are also implications for housing need, as private landlords often own temporary accommodation, and a downturn in the market could worsen homelessness.

The Construction Industry — This industry employs 200,000 workers in London (4.5 per cent of London's employment). In the past, construction employment in London has been more volatile than construction employment in the rest of the UK. However any slowdown in new build activity could be accompanied by job losses in the sector. Although this depends on the nature of construction work, as many skills are adaptable to the commercial market, and the opportunities to work on various large-scale regeneration projects such as Stratford and King's Cross may counter these effects.

Prime Property - The London housing market is still performing stronger than the rest of the UK. The Financial Times House Price Index reported that London house price inflation for October was over 17 per cent year on year. This is nearly twice as much as the next highest region in the UK. However, most analysts are expecting London house price growth to be slower during 2008 because of the expected slow down in the economy. Any job losses in the City and reductions in City bonuses are likely to lead to less activity in the London housing market — the absence of a spending spree by those earning large City bonuses has been blamed for poor quarterly performance across the prime London market in the last quarter of 2007.

4. Comparison of the general economic climate in previous downturns

The housing market is not an isolated market. It is influenced and impacted upon by various economic factors. Historically, sudden drops in house prices have only occurred in an environment of rapidly rising unemployment and/or interest rates, as for example in the early 1990s. Current employment forecasts for London and the UK do not suggest rapidly rising unemployment, and an interest rate trigger is absent. A house price crash therefore seems less likely than in the early 1990s. However, we should be cautious as to how much unemployment would need to rise in order to precipitate a crash in a climate of falling, rather than rising, interest rates.

Table 2: Comparing the general economic climate in the early 1970s, early 1990s and now

	Growth of House Prices	Unemployment	Interest Rates	Inflation	Expectations
Early 1970's crash	Between 1971-1973 there was an almost 40% rise in average house prices	Fairly low at around 2% prior to the crash.	Grew from 7 to 12% in the early 1970s	Inflation grew rapidly along with unemployment, creating a period of stagflation	
Early 1990's crash	Between 1990 and 1995 house prices fell by around 10% on average.	Unemployment grew from around 6% in the late 1980s to around 10-12% in the early 1990s with London fairing worse than the UK.	Around 17%	Between 7 and 8% in the early 1990s	
Situation now	Rapid growth over late 1990s and early 2000s. Particularly higher levels of growth in London.	Unemployment in UK is currently at its lowest level since 1975.	Around 5-6%. Long term interest rates likely to remain low	Expecting a year of slightly above target inflation at around 2.5-3% but still relatively low in comparison to previous periods.	RICS house price balance dropped to its lowest level since November 1992 - 49% more Chartered Surveyors reporting a fall than a rise in house prices.

There are some parallels between the UK property market now and before the 1990s crash. Both periods are characterised by rapidly rising house price rises. The main driver behind the late 1980s-housing boom was the over-buoyant economy resulting from loose fiscal and monetary policy. (In April 1988 income taxes were cut and interest rates were reduced in order to maintain exchange rate policy of tracking the Deutschemark at 3DM to the pound.)

In contrast, the more than tripling of house prices in the past 10 years reflects a combination of low unemployment, tight supply and low interest rates. In addition, the availability of easy credit has been a key factor contributing to rising house prices, and is now a key risk as well. Both periods have seen stretched affordability. Today, huge mortgages are the issue; in the 1990s it was high interest rates.

A major difference between then and now is that current economic prospects look slightly better than they did in the early 1990s. Then, the combination of high inflation and high interest rates saw businesses go bankrupt and unemployment rise by more than a million. People were forced to sell their homes, as repayments could not be met. The influx of property onto the market saw house prices crash, and negative equity took hold for many. Currently, there is no interest rate trigger and inflation is not at the levels it was in the late 1980s — few commentators are expecting an out-and-out recession with rapidly rising unemployment. If prices stagnate or fall, sellers are more likely to be able to afford to sit tight rather than cut their price substantially, provided employment remains high[5]. The outcome may be market inertia and a drop in sales volumes, but not a glut where buyers can drive prices down.

5. Possible policy implications

Although it needs to be remembered that the economy and housing market are very different today to conditions prior to previous housing market crashes, it may be useful to look at how Governments have responded to previous house price crashes. There were three main policy responses to the "boom and bust" and "feast and famine" and very high mortgage rates of the 1970s:

- the bridging grant in early 1973 — a temporary subsidy from the Government to building societies to enable them to not raise mortgage rates. Interest rates came down for a time. But in July and August 1973 market interest rates rose steeply again and mortgage interest rates were raised to 11 per cent.
- the "£500 million loan" in 1974 — loans were offered to building societies to help maintain their lending while avoiding a further increase in the mortgage rate. The loan was temporary, provided on the basis that interest rates would come down before too long. Loans totalling £100 million a month were provided for five months. Interest rates came down much as expected.
- the "guideline" scheme and informal stabilisation "funds" (1975) — thought to be a longer term way of maintaining stability in house purchase finance in a world of large and rapid increases in market interest rates. The mortgage stabilisation fund would be built up when market interest rates were comparatively low and drawn on when interest rates rose against building societies and their inflow of funds diminished. Interest in the scheme lapsed when the Conservative government took office in 1979.

---

5 http://www.telegraph.co.uk/opinion/main.jhtml;jsessionid=0E40UDFVA5STNQFIQMFCFFWAVCBQYIV0?xml=/opinion/2008/01/02/do0202.xml

The first two responses were emergency measures; but the "guideline" and stabilisation "fund" were intended to influence building societies' policies in a way that would prevent a recurrence of boom and bust experienced between 1971 and the end of 1974. Of the three interventions, the "bridging grant" had only very short-lived success. The £500 million loan in 1974 appears to have been more of a success in avoiding a further large increase in mortgage rates on top of the increase that there had already been in 1973 while providing sufficient funds to support a fragile housing market.

There were only four years between the setting up of the "guideline" system and the informal stabilisation "fund" (1975) and the general election in March 1979. That was too short a period to determine whether or not the system would have worked. Lags in the system were too long for the guideline to be used as a short-term measure.

In response to the 1992 crash, housing market packages were introduced to capitalise on the housing market recession. A select group of housing associations were given 100 days to spend £557 million of government grants plus £400 million of private cash on 180,000 empty homes, which had already been built.

GLAECONOMICS

Greater London Authority
City Hall
The Queen's Walk
London SE1 2AA

Tel: 020 7983 4922
Fax: 020 7983 4137
Minicom: 020 7983 4458
Email: glaeconomics@london.gov.uk

www.london.gov.uk/mayor/economic_unit

Transport for London

LONDON DEVELOPMENT AGENCY

MAYOR OF LONDON