Economics of Home-ownership

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What is happening to house prices and why? Is this a good time to buy? Prices rocketed up, and then crashed over the last four or five years. Does that mean they have reached a peak? What makes them rise? Which sort of mortgage provides the best value for money?

This article explores all of these questions, and discusses various suggestions for calming the housing market, none of which look very promising. Rising house prices make older generations richer. All of this money has to come from somewhere, and represents a massive transfer of wealth in favour of the baby boomer generation, whose housing in most cases is worth more now than it cost them in mortgage payments including the interest they paid. For them house buying was merely a cash flow problem. Is this likely to continue?

Property prices

It was only in the 1960s that mortgages became widely available, and home ownership in the UK really took off. Since then property prices have been cyclical, with prices in high demand areas rising ahead of the rest, and falling off before them: almost a ripple effect from richer to poorer areas.

As prices rise, buyers are desperate to get in before they become unaffordable in the hope of gaining from the property growth. But as prices peak and drop off confidence falls, and can take some time to recover. Once the recovery is clearly seen, the cycle starts again with people eager to get in before prices get too high for them. Falls can be much sharper than the rises.

The long term trend has been for property prices to rise with earnings, fluctuating around the growth in earnings on a cycle that is typically about 10 years long – the deeper the trough the longer it takes to recover. In more recent years they have risen significantly more, before the crash.

The last property cycle was unusually long. It lasted almost 20 years from a low point in 1990 to the next low point in 2009. This was followed by one of the most dramatic collapses in property prices ever recorded. There are lessons to be learned from what has happened over the last four or five years, but they tell us more about the impact of economic collapse than they do about long term trends in property prices. To understand these, we should look over a much longer period of time.

UK property prices nationally grew at an average rate of RPI + 2.04% per annum between 1975 and 2012. If we limit the period to 2006 before the crash then the average rate was RPI + 3.35%. The table below shows how this varied regionally around the country.

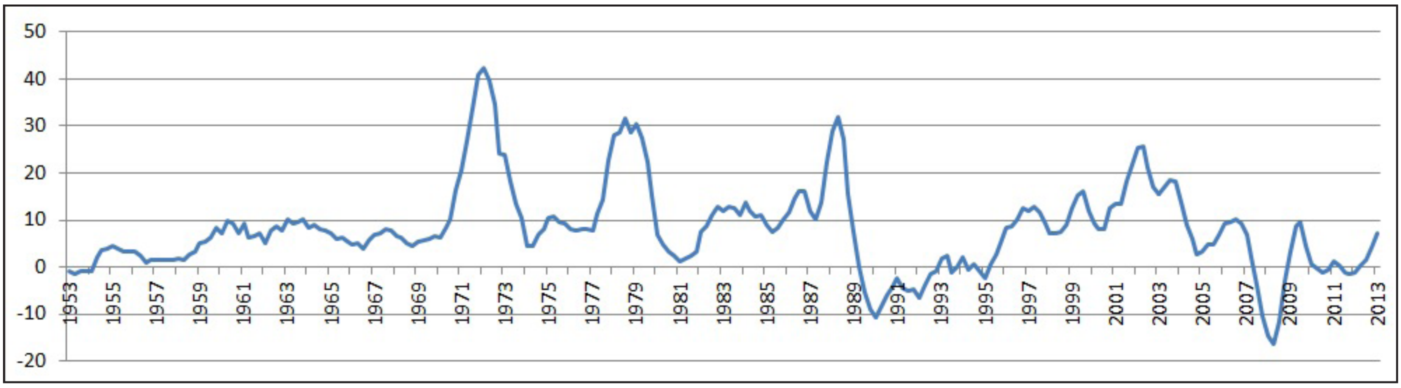

Fig 1: UK house price inflation since 1952 (Nationwide)

Table 1: Average annual growth in house prices since 1975	Average rise pa to 2012	Real increase net of RPI to 2012	Real increase net of RPI to 2006
North	7.01%	1.49%	2.84%
Yorks & Humberside	6.80%	1.29%	2.68%
North West	7.52%	1.97%	3.50%
East Mids	7.44%	1.90%	3.23%
West Mids	7.26%	1.73%	3.01%
East Anglia	7.60%	2.05%	3.30%
Outer South East	7.91%	2.35%	3.52%
Outer Met	7.95%	2.38%	3.42%
London	8.57%	2.96%	3.86%
South West	7.84%	2.27%	3.50%
Wales	7.04%	1.51%	2.88%
Scotland	6.76%	1.25%	2.30%
Northern Ireland	6.13%	0.66%	3.27%
UK	7.48%	2.04%	3.35%
Average rise in UK earnings	7.44%	1.17%	1.60%

Many people think the increases in house prices in the years leading up to the crash were unsustainable, and that the crash was in effect a correction.

Up to the year 2000 the **growth in house prices** (RPI + 1.6%) fluctuated around the **rise in earnings** (RPI + 1.59%). But since then it has grown by significantly more, implying that people were spending higher multiples of their earnings on buying a house. In the 1970s mortgages were typically limited to three times income, or in the case of a couple to three times the first income plus the second income. Preceding the financial crash they were being offered at as much as five times income, and even now people are commonly offered four times their income.

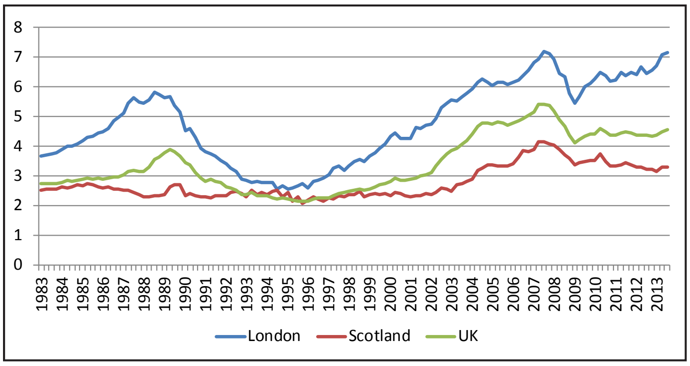

Fig 2: House prices as multiple of earnings (Nationwide)

According to the Nationwide, across the UK as a whole house prices have risen from 2.7 times **average earnings** in 1983 to 4.4 times in 2013. In London the increase was much greater: from 3.7 times income, to 6.7. In Scotland it was considerably less, rising from 2.5 to 3.1. The comparison in each case is based on regional average full time worker's incomes from the Office for National Statistics.

Interest rates are also lower, and are not expected to return to the levels experienced in the 1970s and 1980s. The average **Bank Base Rate** in the 1980s was 11.7% whereas in the ten years leading up to the crash it was 4.8%. The cost of borrowing has genuinely fallen, making higher mortgages more affordable. So £ for £ the cost of borrowing in the ten years to 2009 was 59% less than the average cost in the 1980s. But the benefit was cancelled out by a 61% increase in the ratio of house prices to earnings for the UK as a whole. The net effect is that monthly mortgage repayments take a similar proportion of household income now as they did in the eighties, despite the dramatic increase in house prices since then. The exception to this is London where there has been an 82% increase in the ratio of house prices to earnings, and mortgage costs are taking a substantially increased proportion of household income.

Higher levels of inflation meant that anyone buying a house in the eighties could expect their mortgage costs to steadily fall in the years that followed in relation to their household income. They can still be expected to fall now, but by a much smaller amount, spreading the strain of house purchase over a much longer period. Inflation averaged 7.44% pa in the 1980s compared with 3.26% over the last ten years.

Higher inflation also meant that the net value of the house as an asset grew faster in the eighties than it does today, so the risks of anyone falling into negative equity were much less, and home owners had the security of an asset that was growing in value. I can remember my boss at the National Housing Federation telling me in 1989 that his house had earned more than he had in that year: it had increased in value by more than his gross earnings.

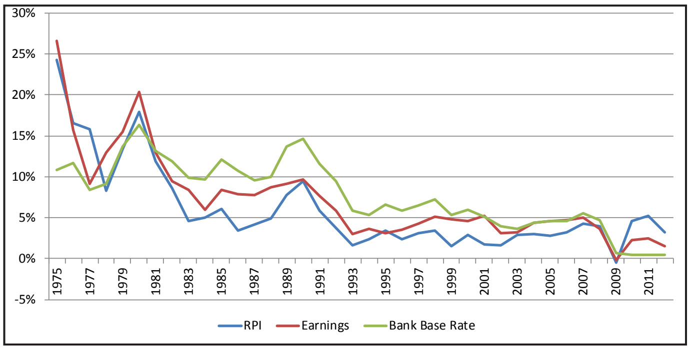

Fig 3: Bank base rate compared with earnings and RPI

Why house prices are rising

Following the crash in 2009 houses prices in the UK as a whole only began rising significantly in the last year, and in some parts of the country (eg Scotland) they remain stagnant. But as in previous housing cycles, London house prices rose much earlier, and have far outstripped the rest of the UK. There are a number of reasons for this:

• London came out of the recession earlier than the rest of the UK, and suffered less of a fall in real (net of inflation) earnings. This looks like a long term trend, with the London economy increasingly outstripping the rest of the UK.

• With recession and currency instability in the larger economies (USA, Japan, and Europe) some global investors sought a safe haven for their money where it could be expected grow by more than any fall in the currency, and would not be heavily taxed. Foreign investors do not currently pay capital gains tax on profits they make on UK properties and property taxes in the UK are capped at a relatively low level: the only tax on property values is the Community Charge used to fund local authorities, the top band of which has a 1991 value of £320,000. This has encouraged foreign investors to buy the more expensive properties in the UK, with London being the biggest pool. At its peak **foreign purchasers** bought 75% of the properties sold in central London boroughs. This may not be a long term trend. Capital Gains Tax at 28% is being introduced for foreign investors in British property from 2015. The introduction of a Mansion Tax as proposed by both the Liberal Democrats and Labour would have an even bigger impact if it ever comes in. Once the more developed economies climb out of recession, other investments should become more attractive, reducing the flow of foreign investment into the London housing market.

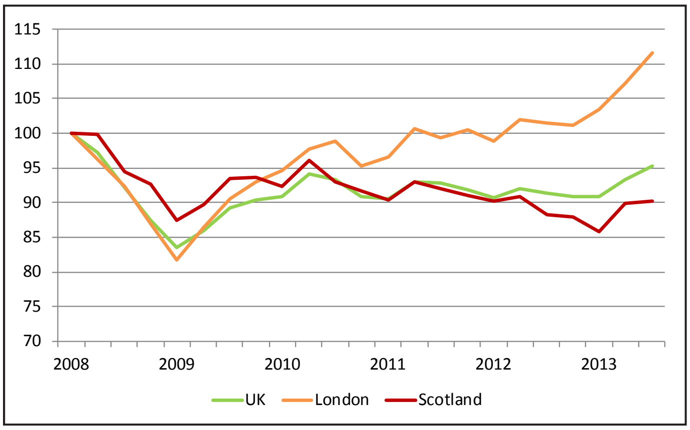

Fig 4: House prices since the crash (2008= 100)

After the initial bounce back from a low in 2009, house prices across the rest of the UK have only just begun to pick up. In Scotland they have been particularly depressed, which may reflect uncertainties over the impact independence might have on the housing market: markets take a gloomy view of uncertainty.

Policies aimed at stimulating the economy and lifting it out of recession should affect house prices across the UK. Some have been deliberately aimed at housing to get it moving again:

• Quantitative easing has injected money into the economy, increasing the money supply, without increasing earnings. The inevitable consequence is to inflate asset values, both equities (the Stock Markets), and properties. Once this stops, as it must and probably will soon, this boost to property prices will be removed.

• Relatively low interest rates have reduced the cost of home ownership compared with renting. This applies right across the UK, and is expected to continue for another year or two, after which interest rates are expected to rise back to more normal levels, typically around 2% to 3% above inflation. They are still expected to be much lower than they were in the seventies and eighties.

• Rising house prices give a feel-good factor, particularly to home owners. The Conservatives have long thought that growth in house prices boosts their electoral support, and appear to be following a deliberate policy of blowing a bit of a housing bubble by providing mortgage guarantees, and other assistance that effectively lowers the costs and widens the availability of mortgages. That is likely to end in 2016 following the next election.

Neither the government nor the Bank of England is likely to remove these stimulants until they are confident there is sustained recovery. The Governor of the Bank of England has made this explicit, suggesting interest rates will not rise until unemployment falls below 7%, and even then will progress slowly.

Housing Market

Prices only rise because demand outstrips supply. This is true for any market. Demand for housing is driven by the increase in the number of households, which comes from a combination of population growth and net immigration, plus a slight trend towards smaller households.

Official UK government **statistics** predict a growth of 221,000 households per year on average over the ten years from 2011 to 2021, a rise of 10%. Most of it is expected to come from an aging population with the largest increases where the head of household is between 55 and 85 years old. Two thirds of the increase will be from households without dependent children. The average number of people per household is expected to fall slightly from 2.36 to 2.33 over this period.

The biggest increase in households will be in London where most boroughs will increase by between 1% and 2% pa. The rest of England can expect rises averaging around 0.5% pa with some regions experiencing a decline.

Those that cannot afford to buy remain in the rental sector where rents across England have **risen** by 4.58% since 2008, compared with a 4.71% fall in house prices. Only in London have house prices risen more steeply than rents since 2008, by 11.65% compared with 6.79% for rents. London rents are more than twice the median for England at £1,250 a month in 2013, compared with a median of £585 across England as a whole. This further emphasises the pressures building up in the London housing market.

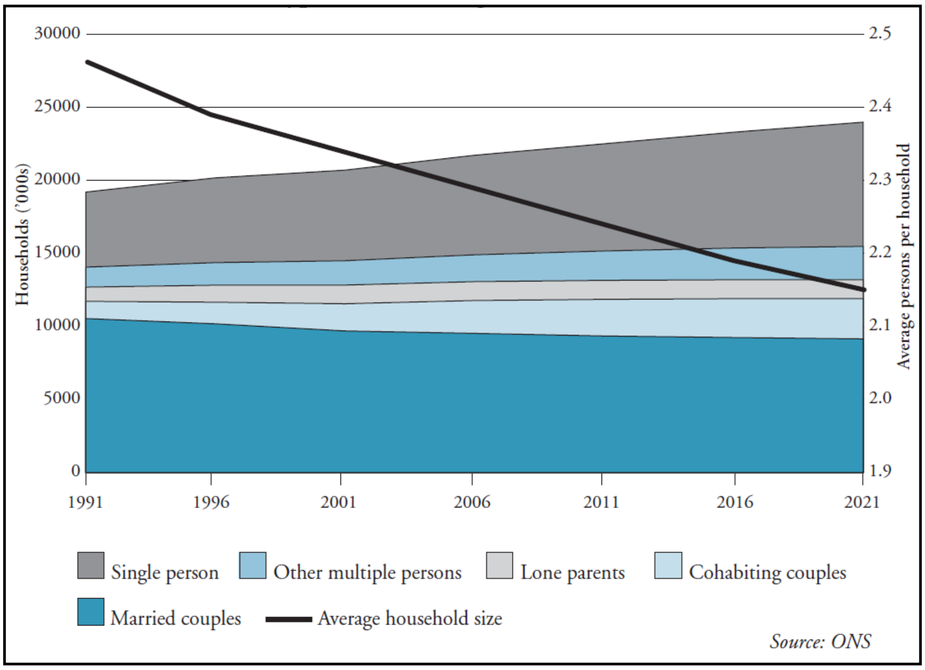

Fig 5: Household types and sizes in England (Barker Review)

The supply of housing

Compare this growth in demand with the growth in supply of housing. According to UK government **statistics**, over the ten years from 2003 the average number of new houses built in England was only 136,672, barely 60% of what we need. The last five years since the beginning of the financial crisis have been particularly bad, averaging 101,192 new houses pa. Yet if we look over the last 44 years (since 1969) the average number of new houses in England was 221,000. If we could get back to that average it looks as though new supply might more or less match new demand, although there would probably still be substantial regional differences.

Much of the drop in the supply of new housing is due to the lack of investment in public and social housing, rather than in the building of housing for sale or private rent. In the mid 1970's social housing (including by councils) accounted for half of the new buildings going up. Since the early nineties it has accounted for a mere 16%. The most obvious conclusion to draw from this is that the private sector has failed to step in to meet the demand for housing by the least well off in society, and the government has failed to provide sufficient subsidies to bridge the gap between what they can afford to pay for their housing and the cost of providing it. Current policies to cap welfare benefits including housing benefit make investment in housing for the less well-off even riskier.

The dramatic increase in the gap between supply and demand inevitably fuels pent-up and unfulfilled demand. This has not yet been fully reflected in increased house prices because of a lack of available credit for mortgages. But it would not take much loosening in the availability of mortgage funding to result in another rapid increase in house prices.

The rising demand for housing is very uneven across the country, and the poorer areas in some regions have seen streets of boarded up properties for which there is little viable demand. Some Local authorities implemented 'market renewal' policies, demolishing large quantities of excess

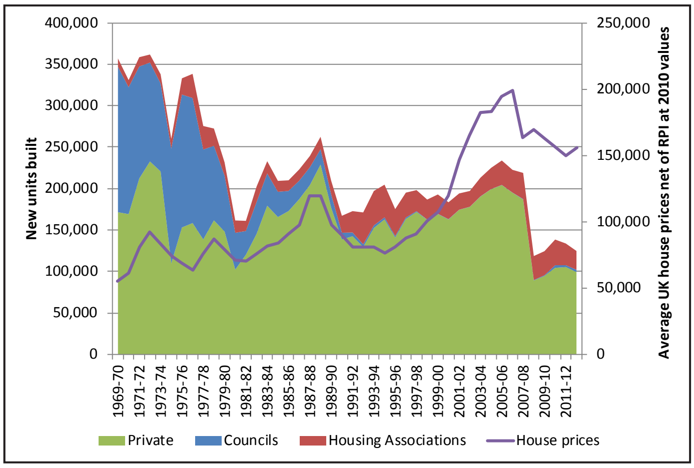

Fig 7: New housing by tenure UK (cumulative)

housing so as to maintain the value of the rest. Few people would want to buy where property prices were expected to fall. Properties threatened with market decline become dilapidated, as further investment in them no longer makes economic sense.

The underlying cause is a lack of economic growth in these areas, many of which originally developed during the industrial revolution around particular industries such as ship building, mining, or steel.

The fact that most of the growth in the economy is focussed in the south and east of the country exacerbates the problem. Economic measures aimed at cooling over exuberance in the south can kill hopeful signs of recovery in the

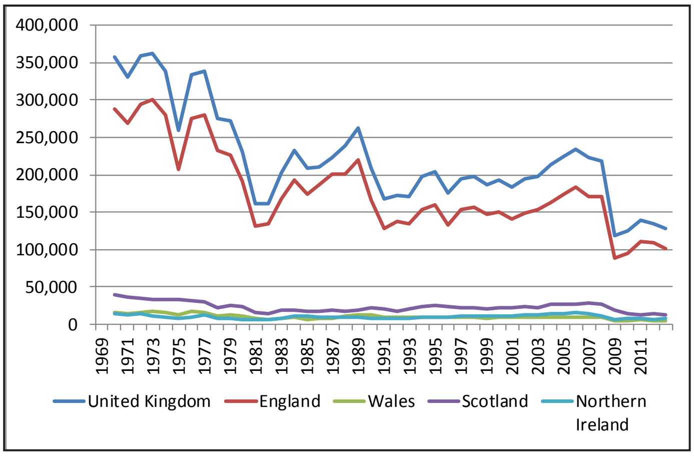

Fig 6: New houses built since 1970

north, and vice versa. The problems in the housing market are a reflection of these economic realities more than the cause of them, although the resulting lack of investment adds to the spiral of decline.

In general, free markets work because supply expands or contracts in response to demand. Where demand outstrips supply, prices rise, and that in turn encourages suppliers to produce more. For some reason the UK housing market does not appear to work in that way. The **Barker Review** in 2006 found that 'UK house building is only half as responsive as the French, a third as responsive as the US and only a quarter as responsive as German house building; and over the last 10-15 years, supply has become almost totally unresponsive, so as prices have risen, the supply of houses has not increased at all'. In the years immediately following the Barker Review there was a small increase in house building, but following the financial crisis in 2008 it almost halved.

Why has house building slowed down? Opinions vary on this.

Three main causes have been put forward to explain the present malaise:

- Difficulties in obtaining mortgages, so that potential purchasers are unable to borrow sufficient money to purchase a home
- The hoarding of potential building sites by developers so they can profit from the increasing gap between demand and supply
- Shortage of potential building sites due to popular opposition to planning permission for new developments, and the length of time it takes to obtain it.

The construction companies argue that they are inhibited in building more housing because not enough people are in a position to buy them. They have lobbied the government to underwrite some of the lending risks especially to first time buyers, and to increase the supply of mortgage finance.

It suits them to blame the shortage of supply on weak demand resulting from a failure in the supply of mortgages. It would not be in their interests to build more houses than they could readily sell in any particular market, nor even to build enough to stop prices continuing to rise.

The Labour Party recently blamed the lack of new building on developers that hoard land, and some 'stick-in-the-mud' councils **refusing to release land** for house building. They have proposed giving councils the power to compulsorily purchase sites with planning permission that are not being developed or to charge fees on them. This is in deliberate contrast to the coalition government's emphasis on improving the availability of mortgages.

This reflects a long held view that those holding building land should be taxed on it, as a disincentive to hoarding. **Those opposing** the development of green field sites frequently point to the extent of land banking to refute the need for any loosening of planning constraints. But taxing potential sites is fraught with technical difficulties over defining which land should be taxed and by how much. It might encourage developers to hold onto promising sites without seeking planning permission so as to avoid the tax, thus defeating the purpose. It could encourage the owners of land to hang on to it in anticipation of a more favourable tax regime in the future.

It might well have the very opposite effect to the one intended by reducing the pool of available building sites with planning permission which would do nothing to improve the supply of housing. Developers need to do a certain amount of land banking in order to assemble sites, take them through the planning process, and ensure a smooth flow of work.

According to a report by **Savills** in July 2012 new housing development in London is about 20,000 units a year, one third below the Mayor of London's 30,000 target, and well below the 36,000 a year needed to match the growth in demand from new households. Of the sites suitable for mainstream housing (ie excluding the most expensive prime market) 27% were owned by house builders, 17% by councils and housing associations, and 55% by private individuals, companies or developers. They identified sites with capacity for 500,000 units of housing, half of which were within large developments involving 500 or more units. They blamed the gap in supply on the need for extra investment into these larger development schemes. Of these sites 40% either had planning permission or were in process of obtaining it. So there were sites for about 200,000 already available for building (and another 300,000 that were not yet in planning) from which only 20,000 units a year were expected. Is a ten year pipeline really necessary to support a regular supply?

If hoarding really is a major problem, a better solution might be to announce that VAT will be introduced on new build developments, perhaps starting at 5% in three years, and rising gradually over a few years to the full 20%. This would remove the anomaly that VAT is charged on renovating old houses, but not on pulling them down and rebuilding from scratch. Current market conditions may well provide the best opportunity for rectifying this. In the long run it would reduce the amount developers could afford to pay for building sites, putting a downwards pressure on land prices. In the medium term it would provide a strong incentive for developers to build on the sites they already hold before the rise in VAT fully kicks in.

To clarify the impact of this, consider how a developer bids for potential sites. They work back from the forecast value of the completed houses, less the cost of construction, and a margin for profit, to calculate how much the site is worth to them. They then buy the sites on which they expect to make the most profit. Construction companies will argue that taxing the holding of development land will raise the cost of housing, but in reality it is the level of demand in relation to the supply of housing that determines house prices. Taxing the holding of land will depress development land values and provide an incentive to get on with construction. It will only reduce the availability of potential housing land if there are more valuable alternative uses for it, or the owners expect conditions to become more favourable if they hold on to it. At the present time land with a permit for housing is worth more than any other use. There might need to be a discretionary element to deal with some marginal brownfield sites that might otherwise not be economic to develop.

Developers are skilled at buying up land on which they expect to gain planning permission. The value of land with permission to build housing can be many times that of agricultural or waste land, and it is on this added value that some of the biggest profits can be made. Planning Gain agreements under Section 106 of the Planning Acts enable local authorities to demand something for the benefit of the community in exchange for granting planning permission. This was originally introduced to fund infrastructure to support the new housing, such as drainage, transport improvements, or the expansion of local schools. In recent years it was often used to fund a proportion of affordable social housing, particularly in London. There is evidence that the impact of this has been to depress land values rather than the price of housing, which is determined by the market. To the extent that it raises development costs it might make some developments uneconomic, but only where alternative uses for the land have a higher value.

There are limits to how far any of this can be taken because developers have to invest huge sums of money to build new houses, and the risks must be balanced by profits or the whole process will grind to a halt. Uncertainty caused by politically motivated interference in the housing market could also have a numbing effect.

Planning regulation

There is a very widely held view that planning regulation is weighted too heavily in favour of the status quo. Those who live on the edges of towns and villages take pleasure in being surrounded by open countryside, and object strongly to anyone spoiling their environment by building on it. They couch their arguments in terms of 'protecting the greenbelt' and the need to prevent England being concreted over by greedy developers for their own profit. But the fact remains that the shortage of available building sites is a major factor in the rise in house prices and the shortage of house building. The Barker Review of Housing Supply in 2006 concluded that in large part this shortage was a result of planning restraints.

The Economist newspaper and many other commentators have suggested that rather than fanning the flames of demand to increase the supply of new housing, the government should be doing more to loosen planning regulations to increase the supply of building land. Other countries have succeeded in this much better than the UK, while still preserving a richly varied countryside. We are almost unique in suffering from this particular problem, by giving so much power to NIMBYs.

Most European countries have much stronger zonal planning regulations than the UK. The principle they most commonly follow is that all land is zoned and within each zone limits are set to what you can or cannot build. There is far less emphasis on obtaining individual planning permissions for each development, which substantially reduces the scope for NIMBYs. Each administrative district has to balance the demand for new housing against the protection of rural and other environments. National, regional, and district plans each reflect the need for new housing development, and ensure that demand does not outstrip supply. This approach applies in Germany, France, Holland, Denmark, and many other countries.

Providing you have sufficient land, you will be granted planning permission in **France** to build or enlarge properties within the rules set out in the 'certificate d'urbanisme'. The only other factors that come into play tend to concern drainage or other public health issues. It is the same for new build in France, where planning permission typically takes about 2 months to complete, and is largely a matter of checking that the proposed development fits within the zonal rules. When properties in France are in close proximity to listed historical buildings the aesthetics of the proposal will also be taken into consideration.

In response to the Barker Review the Labour government introduced measures to speed up the planning process using the internet and setting target time limits. They began a shift towards a more zonal approach to planning by introducing Regional Spatial Strategies and Local Development Frameworks.

In March 2013 the Coalition government's National Planning Policy Framework came into force, very much in line with the conclusions of the Barker Review. This introduces a "presumption in favour of sustainable development" to ensure new development projects are not held up unless they are against a local community's collective interest. The planning process has to consider the impact of new developments on the local economy, and ensure that there is a ready supply of housing to meet demand now and in the future whilst enhancing the "natural, built and historic environment". **They shied away** from making planning consent a technical issue as to whether a developed complied with an agreed local plan and left democratically elected local politicians to determine it. But they introduced a much stronger appeals procedure the effect of which is intended to achieve a similar objective. Simon

Jenkins responded in [The Guardian] that this would 'sacrifice our countryside to market forces, invite corruption, and sink us in urban sprawl'.

It is too early to say how much impact the change in planning regulations might have, but it does appear to be a step in the right direction.

A major consequence of this imbalance between supply and demand is that housing in the UK has become a speculative asset. In most of the better-off parts of Europe house prices have been much more stable than in the UK. The Barker Review pointed out that real rates of inflation in house prices across Europe (averaging 1.1%) were less than half those in the UK (2.4%). As a result they experienced much less difference in the benefits of home ownership over renting. This is most strongly seen in the richer European countries. In many of the countries that joined the EU in recent years house prices have been even more volatile than here. In Ireland the availability of German-level interest rates following their joining the Euro combined with rapid economic growth and inflation lead to a housing boom fuelled by excessive borrowing. They were the first casualties of the financial crisis, soon to be followed by Greece, Portugal, Spain and to a lesser extent Italy. In all these countries house prices have fallen substantially, whilst in Germany and Austria they have remained steady throughout the crisis.

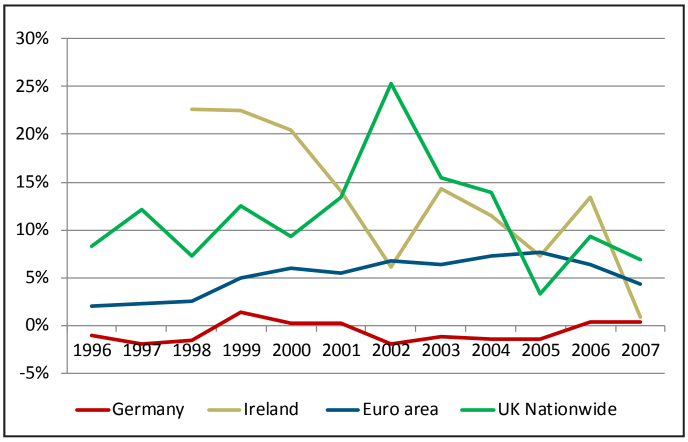

Fig 8: House price inflation in Europe before the crash

It is only in the UK that we talk about a 'housing ladder'. Once you get onto it, you are assured of an increasing asset, and can expect to move into more expensive housing as your wealth increases. During my lifetime my home has increased in value by more than it cost me to purchase it, including the interest paid on my mortgages.

From an investment point of view, house buying in the UK is purely a cash flow problem: how much of it you can buy is limited by how much cash you can raise. There are risks of course, and there have been a couple of severe housing crashes in the early 1990s and again twenty years later, which have resulted in some people losing substantial amounts of money, and being trapped in negative equity. But the downside risk remains very small compared with the potential and actual gains from home-ownership.

Inflation and interest rates

There is a relationship between interest rates and inflation: at times of high inflation, some of the interest paid to lenders has to compensate them for the loss in the value of money. In 1997 the Bank of England was given the task of setting bank base rates to target inflation at around 2.5% on the Retail Prices Index (RPI). In December 2003 this was changed to a target of 2% on the new Consumer Prices Index (CPI), which excludes housing costs such as mortgage payments, and provides a common basis for measuring inflation across the European Union.

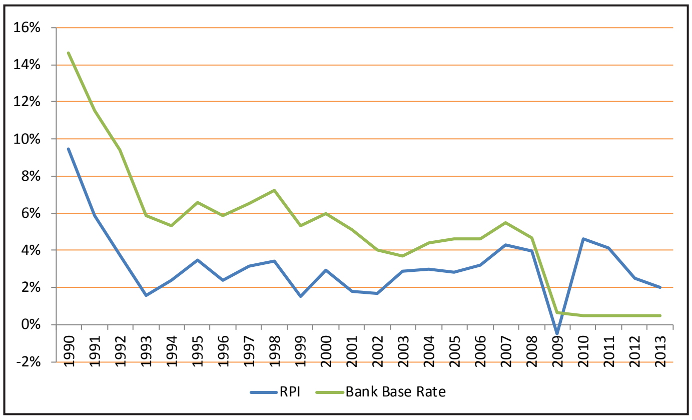

Fig 9: Bank base rate and inflation

Then in 2009 we had the financial crisis, and began the longest and deepest recession for 100 years or more. The Bank of England reduced interest to 0.5% and when that did not lift the gloom, began printing money through quantitative easing. Other countries did much the same.

This has resulted in a most unusual situation of negative real rates of interest (interest net of inflation). In other words interest rates have failed to compensate lenders for the drop in the value of their money.

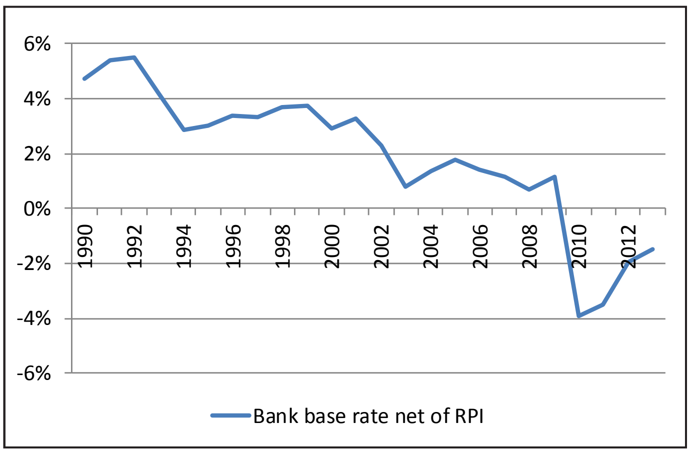

Fig 10: Bank base rate and inflation

If we look at the long term trends between 1989 and 2013 the Bank of England base rate has averaged 1.95% pa above the RPI, whilst house prices across England have increased at an average annual rate of 2.2% above the RPI or 5.75% gross pa over the same period.

Anyone who could borrow at an average rate of interest lower than the 5.75% increase in house prices was getting their housing for nothing: on average their houses will have increased in value by more than the interest on their mortgage. Compare this with the cost of renting, which across England and Wales averages between 4% and 6% of the value of properties with no return to the tenant:

This has created a huge incentive to own your own home in the UK, particularly in the richer areas of the south and east of the country, less so in Scotland and some areas of the north.

Anyone buying now should recognise the exceptional nature of the present mortgage market, and make sure they will be able to afford the expected increase in interest rates as things gradually return to normal. No matter what interest they are offered in the short term, they would be wise to consider whether they could still afford their mortgage if rates rose to 5% or 6%. Mortgage calculators are readily available on-line to show the monthly mortgage repayments at different interest rates and for any length of mortgage.

Short term fixed-interest mortgages do nothing to help with this, since few expect rates to rise significantly until 2016 and then only quite slowly so they do not choke off the recovery. In most cases these fixed rate mortgages then switch to the lender's standard variable rate (**SVR**), which is typically well above the rates of interest on trackers. Brokers benefit from short term fixes because they encourage the borrower to return to them for help in obtaining a new loan, increasing their fees.

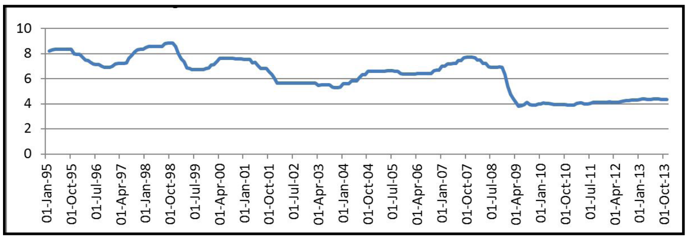

Fig 12: Standard Variable Rate for mortgages

As a rough guide we might expect long term RPI at around 2.5%, long term Bank Base Rates at about 3%, earnings growth at 4.5% and property prices a little higher than that. But short term fluctuations can also be expected, and could be quite extreme. The sums are quite simple: if long term trends are anything to go by, house prices rise with earnings, which reflect growth in the economy, and in the past have averaged RPI +2%. The main risk is that you never quite know where you are in the housing cycle, and can lose money if you buy too close to the top of the market and have to sell before it picks up again, which in low value areas might take several years, during which some households could be trapped in negative equity.

Can we expect these long term trends to continue? Unless something happens to change the underlying fundamentals, there is no reason to suppose that they will not. There does not appear to be any possibility that the supply of housing will be sufficient to meet demand in the south and east of England in the foreseeable future. Elsewhere in the country it largely depends on growth in the local economy. The only realistic danger for those wishing to buy their own home in one of the more successful areas is a long term recession like the one that hit Japan in the 1990s and from which they have still not fully recovered. That was accompanied by deflation and extremely low interest rates, protecting the owners of property from some of the consequences of a collapse in their housing market.

Even now it is possible to obtain a tracker mortgage fixed at 1.99% above Bank Base Rate (currently giving an interest rate of 2.49%), which on past trends should more or less provide free housing in the longer term for all those who can overcome the cash flow problems and access the finance. Such loans are only available to the least risky borrowers, requiring relatively small loans in relation to the value of their property, with incomes that are more than sufficient to meet the repayments, which rules out all except the most fortunate first time buyers. They still have to begin on the bottom rung of the ladder and work their way up.

The Author in Association with - LandlordZONE Rental Property Knowledge

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