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Economics Revision Focus: 2004

AS Economics

Housing Market and Interest Rates

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Revision Focus on the Housing Market and Interest Rates

AS Syllabus Requirements

Students should be able to explain relationships between the housing market and developments in the national economy including monetary policy

To what extent should trends in the housing market dictate the interest rate decisions of the Monetary Policy Committee when they make their monthly decisions?

The influence of house prices

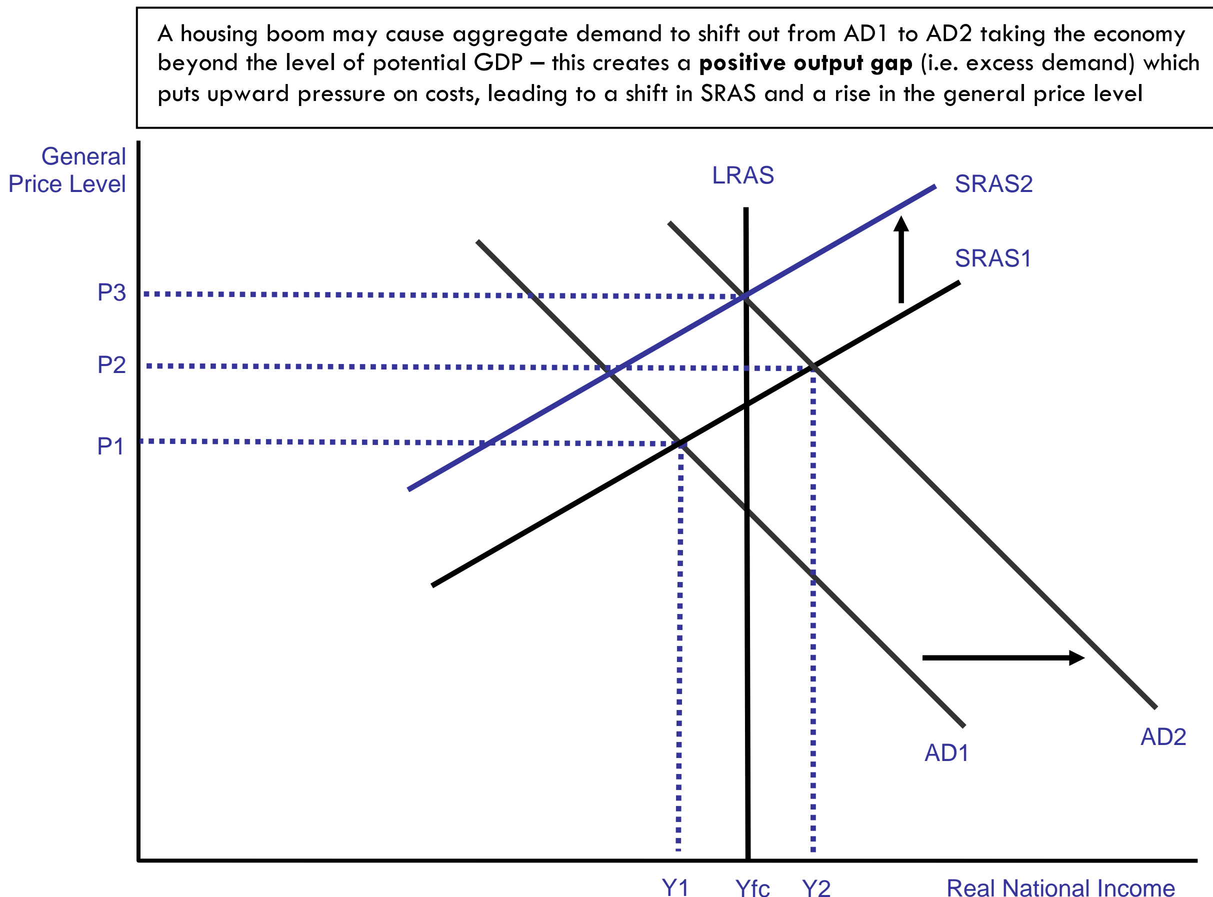
The job of the **Monetary Policy Committee** is to set official interest rates in order to meet the government's inflation target of **2%** for the **consumer price index**

The housing market can contribute to inflation in a number of ways

Rising property values feed through directly into official inflation measures. The main items included under housing in the consumer price index are

- Rent levels and mortgage interest payments
- Council tax and rates, water and other charges, housing repairs and other maintenance charges and the prices of do-it-yourself materials
- Household insurance and estate agents' fees

Rising house prices boost household wealth and consumption and can lead to **demand-pull inflation**



A housing boom may cause aggregate demand to shift out from AD1 to AD2 taking the economy beyond the level of potential GDP – this creates a **positive output gap** (i.e. excess demand) which puts upward pressure on costs, leading to a shift in SRAS and a rise in the general price level

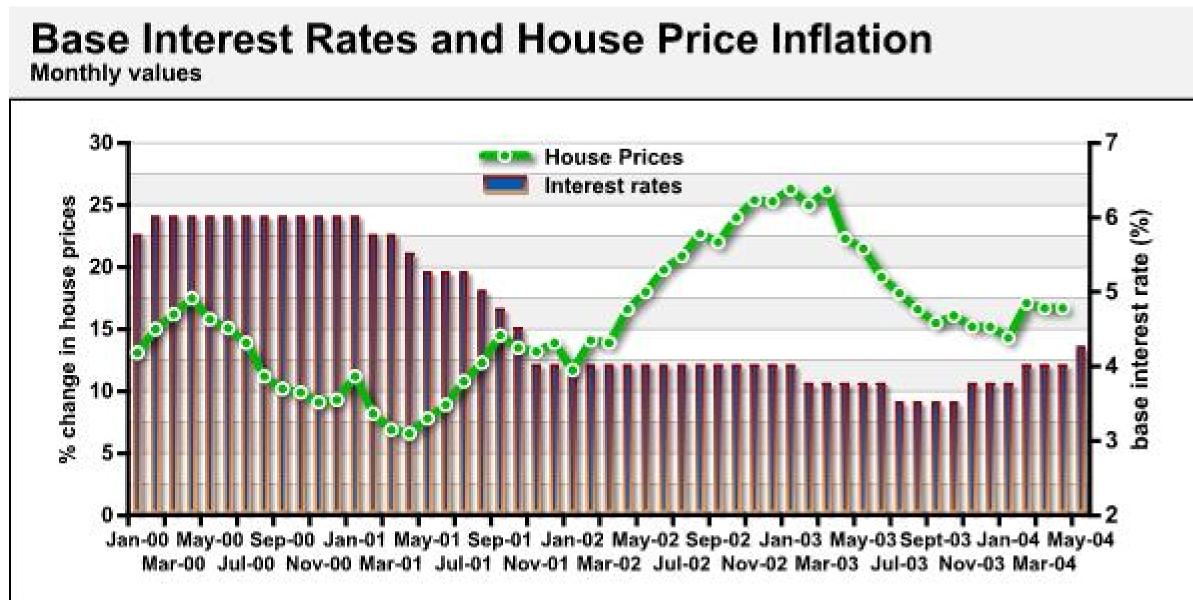
The indirect effects on RPI inflation relate back to the **transmission mechanism** of a rise in housing demand on **aggregate demand** and the **output gap** but also on costs and prices in the construction sector. For example a boom in house-building would put upward pressure on **land prices**, architect's fees and higher **wage costs** in the construction industry. These would feed through into a rise in **cost-push inflationary forces.**

So the Bank of England must take house prices into account when setting interest rates – it watches the monthly developments in the housing market with great care and it knows that interest rate decisions will affect millions of home-owners as well as those unable to get onto the housing ladder

The interest rate "balancing act"

1. Raising interest rates too much may trigger a sharp fall in housing demand because of increased mortgage costs and a speculative selling of houses by landlords in the buy-to-let sector. This might tip the housing market into a severe downturn with all the risks for the economy that follow from that – including negative equity, exposure to mortgage debt etc. An increase in base interest rates over and above expectations — from their current level of 4.25 per cent to 6 per cent, rather than to about 5 per cent, could trigger a housing recession.
2. The Bank is hoping that the housing market will slowdown in an orderly fashion – e.g. a fall in the rate of house price inflation as demand is constrained by reductions in affordability
3. But so far the British housing market is showing few signs of responding to gentle rises in interest rates – which is the best way to boil a frog? The evidence is that the housing market is slow to respond to a "tightening of monetary policy" i.e. the demand for homes seems to be fairly **interest inelastic** (at least in the short term)

Evaluation



The Bank of England targets inflation but not house prices

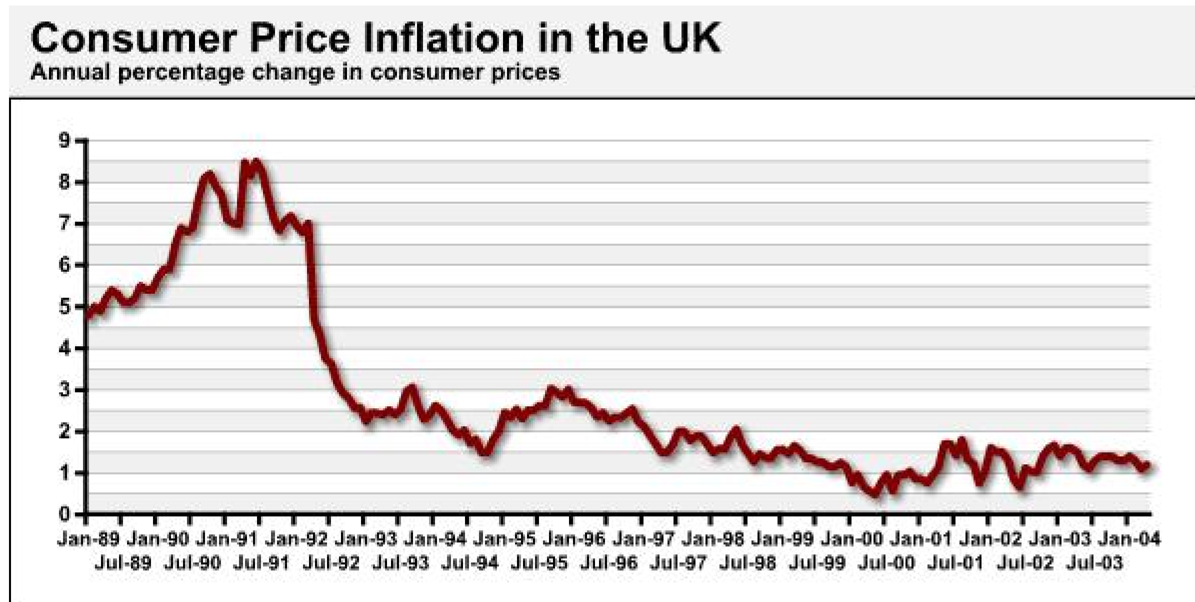
Although the housing market is a factor taken into account when the MPC meets to make interest rate decisions, the **Bank of England has no firm target for what it wants to happen to house prices.** It does not target asset prices such as housing or share prices. Instead it targets the annual change in the general level of consumer prices for goods and services.

There are many other factors that the Bank of England must consider when setting interest rates:

- The current rate of growth of **real GDP** and estimates of the **output gap –** house prices affect consumer demand, but we must remember that aggregate demand is the sum of other components (e.g. AD = C + I + G + (X-M)
- The rate of growth of **wages** / labour costs – because higher wage costs may cause firms to pass on higher costs to consumers in the form of increased prices
- Trends in the prices of **raw materials and commodity prices** (including oil, copper etc) – the Bank of England has been watching very carefully the surge in world oil prices
- What is happening to the **sterling exchange rate –** a strong pound keeps import prices down and may cause a slowdown in our exports. A weaker pound boosts our export sales (adding to AD) but also makes imports more expensive
- Trends in **unemployment** – a measure of how much spare capacity there is in the economy
- **Business and consumer confidence**
- The **economic cycles of other leading countries** with which we trade most heavily (e.g. demand and output growth in the Euro Zone and the United States)

The evidence is that the recent housing boom has not yet fed through to any obvious acceleration in consumer price inflation in Britain – but the Bank of England understands that the housing market has a big effect on consumer confidence, borrowing and spending. So the market will always be a factor in their decision-making.

The chart below shows that consumer price inflation has remained low and stable in recent years. Indeed inflation has been below the 2% target for the last three years.



Interest rates and mortgage costs

Every quarter-point rise in mortgage interest rates adds about £15 to the monthly cost of a £100,000 repayment mortgage, so the effect of the rate rising from last summer's low of 3.5 per cent to 5 per cent would be to increase monthly repayments on a £100,000 mortgage by about £90. This would cause a fall in the ***effective disposable incomes*** of home-owners