tutor2u™

Supporting Teachers: Inspiring Students

Economics Revision Focus: 2004

AS Economics

The UK Housing Boom

tutor2u™(www.tutor2u.net) is the leading free online resource for Economics, Business Studies, ICT and Politics.

Don't forget to visit our discussion boards too as part of your Economics revision.

Revision Focus on the UK Housing Boom

AS Syllabus Requirements (AQA Paper 3)

Students should be able to explain and evaluate relationships between the housing market and developments in the national economy including the effects on aggregate demand, inflation, unemployment and the balance of payments

How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions?

Alan Greenspan
December 5, 1996

The scale of the current housing boom

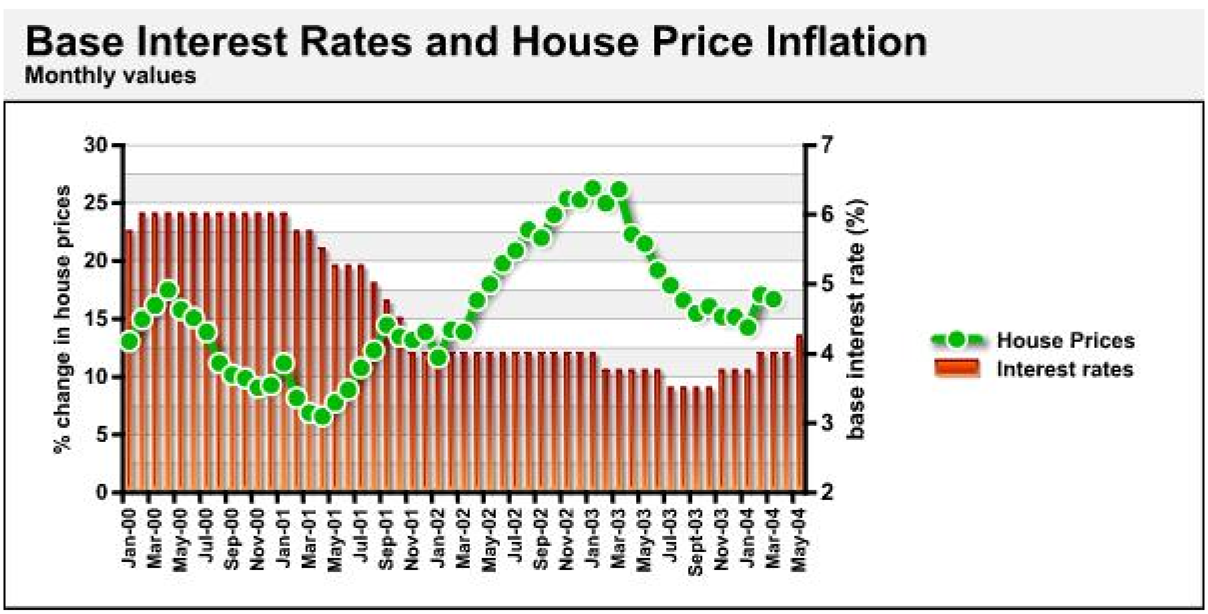
1. **High house price inflation**: During 2003, UK house prices grew by an average of 19% following a 20% rise in 2002. In the 1980s UK house prices grew on average by 14.5% per year but it was a very different story in the 1990s when the average rate of inflation was just 1.3% per year. Indeed for the first half of the last decade, prices were falling in many parts of the country.
2. **Expensive housing!** The average house price in the UK is now £145,000 – and rising by up to £100 per day depending on which part of the country you are living in. The average daily wage in the UK is £95 a day
3. **First-time buyers:** There were 520,000 first time buyers in 2002 – but this figure had fallen to 310,000 last year – this is 29% of the number of people purchasing a property
4. **Wealth accumulation**: The total value of Britain's housing stock has nearly doubled over the last five years according to the Halifax and is estimated to be worth £2.97 trillion - nearly three times the value of the housing stock a decade ago. The same Halifax research finds that "more than half of household wealth is derived from the value of residential property."
5. **Consumer borrowing**: Home-owners have been borrowing huge sums secured against the value of that wealth. Mortgage equity withdrawal has reached record levels. In the third quarter of 2003, the Bank of England estimates that £13.4 billion of mortgage equity withdrawal was completed – and some economists are forecasting that equity withdrawal in 2004 will top £60 billion.
6. **Housing Transactions**: Around 1.5 million homes were bought and sold last year – compared to a total housing stock of over 24 million properties. And the number of new homes built was low by historical standards
7. **Mortgages:** There are 11.4 million properties with a mortgage still outstanding – the majority of these mortgages are on variable interest rates
8. **An international perspective:** The housing boom is not unique to the UK. Similar booms have occurred in recent years in Australia, the United States, Spain and Ireland. There is a strong correlation between what is happening to real incomes in each country and the annual growth of house prices. Strong economic growth has boosted property values.

Causes of the current housing boom

Asset price booms rarely have a unique cause. They are products of the wider economic environment prevailing at the time – and the UK housing boom is no different.

What have been the main factors driving house prices higher on the demand side?

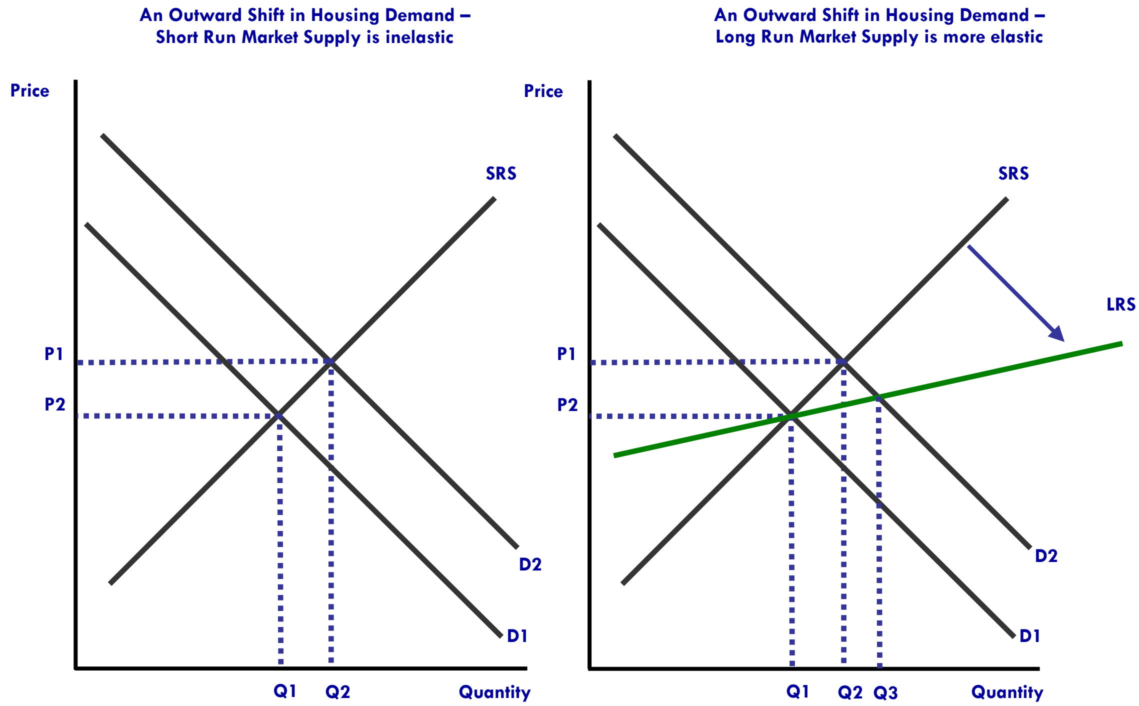
1. Falling unemployment and high employment rates (the highest in the EU) – unemployment in the UK on the claimant count is less than 900,000. And using the Labour Force Survey measure, it is at a record low of 4.8% of the labour force.
2. A period when real disposable incomes have increased over several years – the economy has been growing for the last twelve years, and real incomes has increased as a result
3. Historically low mortgage interest rates and apparently a greater willingness among the main mortgage lenders to loan out an increasing ratio of people's incomes when funding a home purchase. Interest rates have been unusually low over the last few years. They reached 3.5% during the summer of 2003 and have been below what some economists feel is a neutral rate of interest of around 5% for over 2 years
4. A high level of speculative demand – built on the expectations that prices will continue rising – this includes a strong speculative demand from overseas
5. The effects of the boom in the buy-to-let market (over 143,000 buy-to-let mortgages were taken out last year taking the total number of buy-to-let mortgages to over 400,000



What have been the main factors driving house prices higher on the supply-side?

1. **Scarcity**: Continued shortages of good quality existing properties on the market
2. **Low level of new housebuilding** – housing supply has proved to be remarkably slow to respond to the demand for properties – i.e. there is a **low price elasticity of supply** for housing. This is something that policy will seek to address in the years to come – but any success in improving the total supply of housing will be long term
3. **Rising wage costs** in the construction industry – not least because of shortages of skilled labour especially in regions of very low unemployment

4. **Rising land prices** – which clearly affects the costs of developing land for new residential construction projects



When you add together a strong level of demand (in most regions) and a limited and inelastic housing supply, one can see why prices have risen so quickly. In most parts of the country the balance of power in the market remains with the seller – because of housing scarcity.

The economic consequences of the housing boom

How has the housing boom influenced the rest of the economy over the last three or four years?

Consumer confidence and spending: To some analysts the surge in house prices has been an important factor supporting consumer confidence and spending at a time when the global economy has been weak and investment and exports have been in the doldrums. Without the housing boom, the risks of a full-blown recession would have been much greater, instead the economy experienced a modest growth-pause (or "soft-landing") before resuming a return to trend or above-trend growth.

Borrowing and debt: Pessimists believe that the housing boom threatens to be a much more malign influence on the economy. It has encouraged an unsustainable level of consumer borrowing and debt, contributed heavily to the trade deficit and risks leading to a much sharper downturn in the near term.

Around 15% of total consumer spending is linked directly or indirectly to the fortunes of the housing sector – and since consumption is now at a record high as a percentage of GDP, it is obvious that rising house prices have contributed to very strong consumer demand and borrowing. The scale of equity withdrawal is one obvious symptom of this. There is a strong correlation between house prices and consumer spending – indeed this correlation is higher for the UK than the European Union average. Much of this extra spending has gone on imports – contributing to a record balance of trade deficit in goods – a deficit that has touched £46 billion in each of the last two years

Inflation: So far – the rampant inflation in housing has not translated itself into any noticeable and significant rise in consumer price inflation – which remains remarkably stable by the standards of the last thirty years, and well below the government's inflation target.

Has the link between house prices and general price inflation been broken for good?

Perhaps not, for inflation is influenced by many factors on both the demand and supply-side of the economy and most of them remain favourable to a benign low-inflation situation for the time-being. Among include the effects of rising productivity and technological change on production costs; the deflationary effect of the boom in cheaper exports from the fast-growing emerging market economies such as China; a fall in inflation expectations and weak commodity prices.

Forecasting the future for the housing market

It is very difficult to predict what will happen next to the housing market. The current boom has proved to be very resilient and there are big differences of opinion between economic analysts and other commentators on what will happen.

It is widely assumed that **house prices are now over-valued** – because of the excess demand, prices have soared beyond their **long-run fundamental equilibrium level**. Clearly, with house prices over-valued, there is a danger that a sudden loss of confidence could trigger a market collapse. And this risk will increase the longer house prices rise at rates in excess of ten per cent per year because house prices relative to earnings will continue to rise. *But so long as UK interest rates rise only modestly, as is generally expected, the probability of a full housing market crash is fairly low.*

The optimistic scenario is based on the following:

1. **Prices:** affordability is less of a problem now because of lower interest rates. The high demand for housing is a natural reaction to an economy adjusting to permanently lower interest rates. But price increases will naturally level off – rising prices will cause a contraction of demand
2. **The economy –** the macroeconomic background for the UK remains benign – low unemployment, strong economic growth and rising real incomes will keep confidence and expectations positive – a recovery is expected in the global economy – this will support UK growth in 2004 and 2005
3. **More supply -** an increase in housing supply will help to relieve shortages in the medium term
4. **Interest rates -** the Bank of England has the flexibility to cut interest rates in the event of a dramatic fall in house prices and the government could use some stimulatory fiscal policy measures to boost demand in the market (e.g. relaxation of stamp duty)

The pessimistic scenario is based on the following:

1. **Too much speculation:** Housing has become too much of a financial asset rather than a durable good – people have lost sight of what housing should provide for people
2. **Squeezed out of the market -** Housing affordability has worsened and the number of first-time buyers has shrunk – they are the life-blood of the market – if they disappear, demand will dry up
3. **Bye-bye to buy to let boom -** The buy-to-let boom will eventually come to an end and many of these investors – not in the market for the long term – will seek to sell their properties to release the equity and move their wealth away from property into stocks, bonds etc – this will increase housing supply and cause a fall in prices

4. **Fears of higher inflation and higher interest rates -** Interest rates will have to rise and they may rise more than the financial markets are expecting – the Bank of England will eventually have to choose between house prices and inflation – it cannot allow its policy dilemma to persist for much longer. The very high level of oil prices is a factor suggesting that inflation is starting to return