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Characteristics of the current housing boom

The new edition of the annual *Housing finance review* shows that the current housing market boom is not simply a repeat of the last boom and bust. Together with its usual analysis of significant housing market changes and policy developments across the UK, this year's *Review* also has an international theme. It includes an analysis of the management of housing market inflation in European countries following European Monetary Union (EMU).

- **Despite UK house prices rising by 60 per cent between 1995-2000, mortgage repayment-to-income ratios for first-time buyers have remained stable, even in London. This is partly due to much lower interest rates, which also mean that house-price-to-earnings ratios can be a misleading indicator.**

- **Repayment-to-income ratios have also remained stable because rising mortgage costs have excluded households with lower incomes and without savings from buying. In part this reflects the relatively prudent approach of mortgage lenders, who clearly remain mindful of the costs to the industry of the last boom and bust cycle.**

- **Net equity withdrawal by home-owners in 2000 rose slightly to £11.4 billion, accounting for 1.93 per cent of consumer spending in the year, well below the 1988 peak of 6.98 per cent in the last housing market cycle. The rise in net equity withdrawal during the current housing market boom has been dampened by sharp increases in first-time buyers' deposits.**

- **Since EMU, a number of European countries have experienced significant house-price inflation. Nonetheless, European Central Bank decisions on interest rates for the Euro countries take much less account of house-price movements than do those of the Bank of England Monetary Policy Committee.**

- **There is, as yet, no indication of the Euro countries seeking to regulate the housing market following the loss of national control over interest rates. There are, in any event, both practical and political constraints on using fiscal instruments to do so.**

- **For the UK entry into EMU, and the loss of interest rate control, would be likely to result in somewhat increased house price volatility. However, this should not be overstated, and should be considered against the potential benefits from eliminating exchange rate uncertainty and transaction costs.**

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Restrained housing market boom

UK house prices rose by 14 per cent in 2000, despite both the abolition of mortgage interest tax relief (MITR) during that year and a small increase in average gross mortgage rates to 6.7 per cent.

Nevertheless, there was only a modest increase in the mortgage-to-income ratios for first-time buyers in all parts of the UK. Even in London, where house prices rose by 18 per cent over the year, the ratio for first-time buyers only rose to 21.6 per cent - nowhere near the 1989 peak of 31 per cent in the last housing market boom. In part, this was because the incomes of first-time buyers rose more rapidly than average earnings in London. As a result, a smaller proportion of Londoners were able to obtain a first mortgage.

The different characteristics of the current upswing in the housing market cycle and the boom and bust of the late 1980s and early 1990s can be seen in the movements in the key housing market and income trends for London over the last thirty years (Figure 1). In particular, this shows that in the late 1980s affordability worsened, partly because of the upswing in house prices but far more fundamentally because of the steep increase in mortgage repayment costs, as interest rates were sharply raised to tackle inflation.

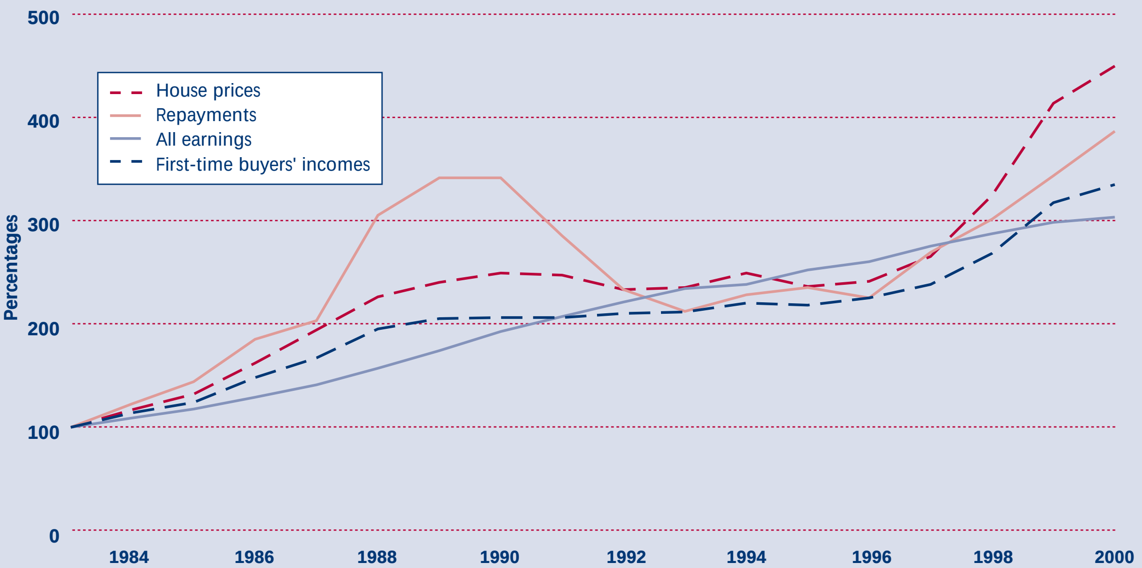
The recent increase in house prices has been offset by lower interest rates, leading to a more moderate rise in repayment costs. First-time buyers' incomes lagged behind the growth in average earnings during the housing market downswing in the mid-1990s, but have now risen above the trend to a similar extent as that experienced a decade earlier (Figure 1).

Hence this time round the central 'affordability crisis' in London is about those households unable to afford access to the market, rather than about those that purchased in an upswing only to see a sharp rise in interest rates. Another key feature of the current difficulties in gaining access to the market is the sharp rise in the level of first-time buyer deposits over the last five years. The average first-time buyer deposit in 2000 was over £15,000 for the UK as a whole, compared with less than £5,000 in 1996: at just over 20 per cent of house prices, this is the highest level for two decades. In London, the average deposit in 2000 was almost £28,000. This underlies the current concerns about the inability of key workers to obtain housing in London and other high price localities.

The very different characteristics of the current housing market upswing raise a number of issues. One obvious question is the role of inherited housing wealth in financing deposits. Past research has found only a very limited connection and predicted a slow but long-term rise in the levels of wealth derived from housing market inheritances. However, the greater potential availability of inherited housing wealth may be far more critical in determining the capacity of households to enter the market during the peak years of the housing market cycle.

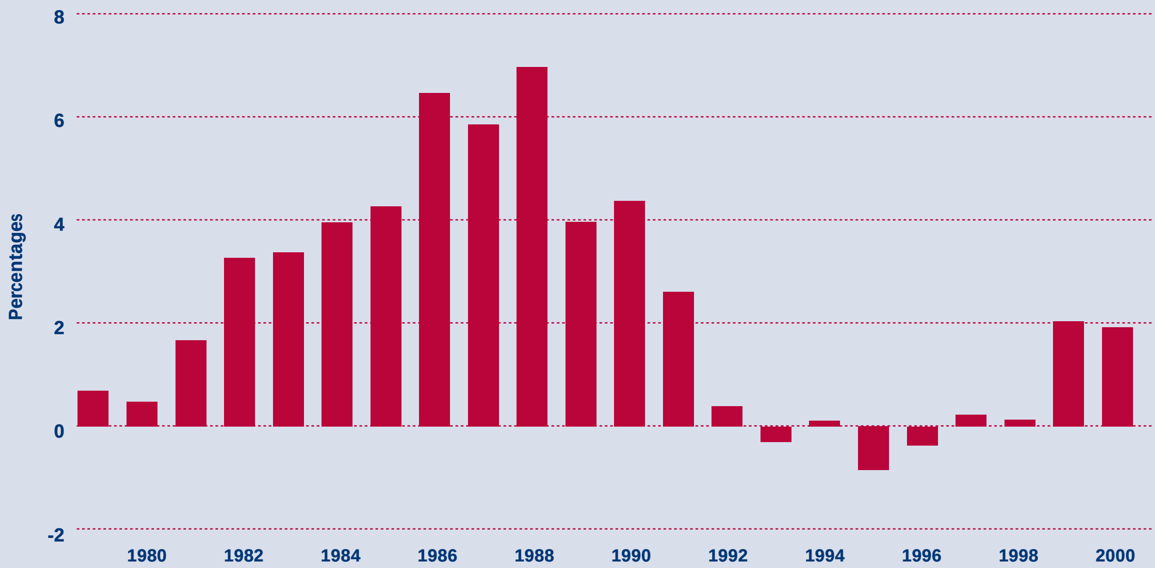
Current rising house prices therefore do not seem to be due to imprudent lending. Indeed, the modest rises in the levels of mortgage advances and repayments relative to incomes, and the rise in levels of deposits, suggest that lenders have remained very mindful of the lessons from a decade ago.

Figure 1: Trends in London earnings, house prices and mortgage repayments



Sources: CML/DETR Survey of Mortgage Lenders, New Earnings Survey

Figure 2: Equity withdrawal as a percentage of consumer spending



Sources: Housing finance review 2001/02

Equity withdrawal

The continuing strong rise in house prices in 2000 also contributed to a further small increase in the cash level of net equity withdrawal in 2000, to £11.4 billion. However, as a proportion of total consumer spending this fell back slightly to just 1.93 per cent, compared with 2.0 per cent in 1999 (and 6.98 per cent in 1988 at the peak of the last housing market boom) (Figure 2). In part, the *recent* levels of net equity withdrawal were constrained by the rise in first-time buyers' deposits.

Nonetheless, the 4.7 per cent growth in consumer spending over the last year could not be directly attributed to an increase in net equity withdrawal, even if house price growth may have contributed to an overall 'feel good' factor. While in the late 1990s the volatility of equity withdrawal was a major factor affecting overall levels of household savings and consumer credit, this time the direct process of equity withdrawal is far less apparent.

Moreover, given the abolition of MITR and the benefits for economic growth of relatively strong consumer spending, equity withdrawal does not now raise quite the same issues as it did a decade ago. Equally, a slow-down in the housing market over the next year, with a consequential downturn in equity withdrawal, will only have a limited impact on consumer spending. The likely downturn in equity withdrawal is nonetheless another factor adding to concerns about the impact of the worldwide economic slow-down on the UK economy.

The impact of interest rates

In early 2001 house prices continued to rise, but mounting concerns about worldwide economic slow-down led the Bank of England to reduce the base rate to 5 per cent. As a result, interest rates for mortgages have fallen to their lowest level for more than thirty years.

While the economic slow-down should see house price increases ease back to sustainable levels, the fall in interest rates is likely to prevent any immediate falls in house price rises in 2001. However, if record low levels of interest rates are, in the short term, a boon to would-be first-time buyers they are also a potential danger in the years ahead.

Economic recovery would almost certainly bring higher interest rates, with higher repayment costs for households that bought while interest rates were at historic low levels. The potential for such a delayed affordability crisis for first-time buyers is all the greater with low inflation, as mortgage costs are only very gradually eroded as a proportion of household incomes over the lifetime of a mortgage.

Conversely, home-buying households have a far less effective safety net for a continued or worsening economic situation than was the case a decade ago. The proportion of households taking out mortgages after October 1995 has grown progressively. These households are potentially excluded from any Income Support (or Job Seekers' Allowance) help with their mortgages for nine months after qualifying for the basic welfare benefit. At the same time, figures from the Council of Mortgage Lenders suggest only a modest rise in the numbers of households taking out private mortgage policy protection insurance. Thus, while in 2000 mortgage arrears and possessions fell to their lowest levels for more than a decade, the potential for a damaging resurgence remains.

House prices and EMU

The *Review* includes an article by John Hawksworth which shows that house-price inflation across Europe has been uneven over the last decade, but has been far higher in some European countries than in the UK. For example, over the 1990s, house prices in the Netherlands and Ireland rose - in real terms - by 90 per cent and 110 per cent respectively. In Ireland, sharp reductions in interest rates as part of the transition to EMU intensified an existing boom.

Since January 1999, following their entry into EMU, interest rates for all member countries have been set at a single rate by the European Central Bank (ECB). The 'Euro' countries consequently lost the opportunity to use interest rates to moderate house-price inflation.

The statements of the ECB President following interest rate decisions rarely cite house prices as a key factor. This contrasts with the far greater prominence the Bank of England Monetary Policy Committee (MPC) gives to house-price movements. In part this reflects the greater prevalence of longer-term fixed-rate mortgages across Europe, and far lower levels of mortgage debt in many Euro countries. The housing market is typically less sensitive to short-term changes in levels of interest rates in Euro countries, when compared with the UK.

Nor is there, as yet, any indication of Euro countries using fiscal or other national policy instruments to regulate the housing market following their loss of national control over interest rate policy. There are, in any event, both practical and political constraints on the use of fiscal instruments to regulate the housing market.

While, for example, both the Irish and Dutch governments could phase out MITR as one means of damping house-price inflation, neither country currently appears to have the political appetite to move in that direction. With MITR already abolished, this option is no longer available to the UK government.

Despite recent increases in stamp duty on higher value properties, stamp duty in the UK remains lower than in Ireland and some other Euro countries. However, as stamp duty can only be changed once a year in the Budget it is, like all other taxes, a relatively crude weapon compared with interest rates that can be changed monthly by the MPC (or every two weeks in the case of the ECB).

For the UK entry into EMU, and the loss of interest rate control, would be likely to result in somewhat increased house price volatility with consequential detrimental effects on overall macroeconomic stability. However, this should not be overstated, and should be considered against the potential long-term microeconomic benefits from eliminating exchange rate uncertainty and transaction costs.

About the study

The 2001/02 **Review** provides the usual detailed statistical picture of housing finance and policy developments in England, Scotland, Wales and Northern Ireland. Succinct commentaries accompany 114 tables (many with data from 1970 onwards).

The edition also includes articles exploring overseas experience, including one on 'The management of house-price inflation within EMU' by John Hawksworth of Price Waterhouse Coopers.

How to get further information

The full report, **Housing finance review 2001/2002**, is published for the Foundation by the Chartered Institute of Housing (ISBN 1 903208 16 5). It is priced £50 to organisations (payable on account; please click on the order form) or £25 to individuals (payable by credit card or personal cheque email: pubs@cih.org).

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