

## What influences house prices and why do governments intervene?

For over ten years through to the end of 2007 the UK saw consistent increases in house prices, a trend mirrored in many other countries around the world. However, the onset of the 'credit crunch', first in the US precipitated by the excesses of the sub-prime mortgage market, and the subsequent economic downturn led to a widespread international depression in the housing market with the UK being particularly badly hit. So, what really caused the recent bursting of the housing market bubble and what does economic theory tell us should influence how much we pay for our properties? Furthermore, under what circumstances, if at all, should governments intervene in the housing market and thus influence prices?

The first question is relatively easy to answer: the bubble burst primarily due to *market failure*.<sup>1</sup> The longer observed double-digit rises in house prices lasted, the more lenient lending practices became. In the end, people could borrow 100% or more of historically high house prices with no deposit. However, asymmetries of information were occurring in two ways: the lenders did not want to know the capacity of the individual to maintain repayments with self-certified mortgages widespread (insiders often referred to sub-prime loans as ninja loans – no income, no job, no questions asked); while individuals borrowing the money did not realise they were taking on more than they could ever possibly hope to pay back. Furthermore, the problem of *asymmetric information* was accentuated by the practice of lenders in the US selling on their sub-prime loans. These loans were then aggregated into large pools together with more reliable debts and issued as a type of bond known as a mortgage-backed security whose yield were supported by the pass-through of payments of interest and principal from the underlying pool of mortgage debt. This also created a *moral hazard* for lenders who had less incentive to ensure borrowers could repay loans.

Thus, while the US Federal Reserve and other financial authorities initially believed that the sub-prime crisis was an isolated phenomenon, what happened instead was the rapid spreading of the crisis to other markets, in no short part due to the way the loans were sold on, rolled-up and then in some cases sold on again. This ultimately led to widespread interventions in the financial system with governments around the world bailing out banks and injecting increasingly larger quantities of money into the system. The severity of the global depression necessarily caused policy makers to overlook the more traditional moral hazard implications associated with bailing out failed banks.

Further analysis of the recent financial crisis and global recession would be a digression. So, onto the second question: what in theory influences house prices and can we use these factors to analyse what has happened over the last decade to the UK housing market? Ultimately it is the two cornerstones of economic theory, *supply* and *demand*, and the various factors that influence how these two concepts interact together to reach *equilibrium*, which set the price of property.

### Economic growth

As we have seen in the UK over the last decade, the fortunes of the economy and housing market have closely mirrored each other. It is clear the two have an interdependent but complex relationship. A strong economy has a positive effect on consumer confidence, expectations, employment and wealth, all of which will have a positive effect on demand and prices in the housing market. Equally, falling house prices will reduce consumer wealth, creating a negative effect on consumer spending and consumer confidence. Therefore, there will be a fall in aggregate demand and a reduction in injections into the circular flow of income between producers and consumers. This will lead to lower *economic growth*, unless other factors over-ride this. The inverse of both of these scenarios is also true.

### Mortgage interest rates

Mortgage interest rates are traditionally influenced by *monetary policy* through the *central bank's base rate of interest* (in the UK, this is set by the Bank of England and currently stands at 0.5%). As

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<sup>1</sup> Please note, definitions of italicised terms may be found in the Scrutiny Unit's [Economics Glossary](#).

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the base rate comes down so, generally, do mortgage interest rates (although not necessarily by an equivalent amount) and thus so do mortgage repayments. Assuming individuals have access to these mortgages, which is not always the case, such circumstances should mean the cost of buying a home is relatively cheaper which will, in theory, have a positive effect on demand and prices.

However, what we saw in late 2008/early 2009 in the UK was the unusual combination of historically low interest rates coupled with rising mortgage interest rates. This was primarily driven by banks' lack of willingness to lend between themselves and to anyone but the most reliable customers – a direct consequence of the lack of confidence in the financial system following the credit crunch and the large write-downs many banks experienced due to sub-prime lending. These tendencies were reflected in the *London Inter-bank Offered Rate (LIBOR)*, the interest rate at which banks borrow unsecured funds from each other in the London wholesale money market. The LIBOR has increasingly been used by lenders as the benchmark by which to set mortgage interest rates as it is seen to better reflect the actual costs banks incur day-to-day in borrowing money (as opposed to the Bank base rate). The gap between the LIBOR and the Bank base rate peaked in autumn 2008 at 1.3 percentage points, the exact time when the Bank began to cut the interest rate aggressively from 5% to its current level.

The LIBOR currently stands at less than 0.1 of a percentage point above the bank base rate and this has been reflected in the recent trend of falling mortgage interest rates as confidence returns to the banks and some competition consequently returns to the mortgage market.

With the Bank base rate having remained at its historic low of 0.5% for the last eight months, there has been much speculation regarding when the rate will start to edge up. Notably the *CPI inflation rate* has not fallen as far as expected and is likely to rise somewhat in the coming months. However, with the economy still in *recession* and the Bank's programme of *quantitative easing* yet to finish, some commentators have suggested that the base rate may remain unchanged throughout 2010.<sup>2</sup>

### **Access to mortgage finance**

It is a common misconception that the value of a property is independent of the willingness to lend. This misconception encourages lenders to become more lenient in their lending practices as prices rise and defaults on mortgage payments diminish. This was one reason why the recent housing bubble was born. Increased access to mortgage finance also contributed to the large increase in buy-to-let investors over the last decade which in turn increased demand for housing and thus price.

Conversely, scarce access to mortgage finance has contributed to the depression in the housing market that has been evident over the last year or two. Despite very recent improvements in the mortgage finance market, the majority of affordably priced mortgage products available require large deposits (averaging 25% of the value of the property compared with the long-term average of 10%). Such high loan-to-value ratios impact most upon first-time buyers, people on low to average incomes and those wishing to re-mortgage.

### **Employment and earnings**

Many cite high levels of employment, particularly in the financial services sector, for the growth in the UK housing market in recent years. In particular, the rise of the big bonus culture in the City created upward price pressure on the London property market which spilled over to other regions and countries in the UK.

### **Unemployment**

Insecurity over future incomes created by *unemployment* (or the threat of unemployment) will have a negative impact on demand for housing. However, it should be noted that consequential impacts from unemployment, such as home repossessions, may increase the supply of housing available which will again have an impact on price.

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<sup>2</sup> ["Interest rates 'to stay low for years'"](#), *The Guardian*, 12 October 2009

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### Demographic changes

The shift towards increasing numbers of one-person households has had a positive effect on housing demand in recent years: in 2008 there were an estimated 3.6 million one person households that were owner occupied in England, representing around 25% of all owner occupied dwellings. Furthermore, household growth is estimated to increase by 221,000 households per year over the next 20 years which will influence the demand for housing and consequently the price.

### House building/housing supply

Given the forecast demographic changes over the next twenty years, clearly if the housing stock does not increase alongside this, available housing will become scarcer and thus prices will rise. Equally, if too many new homes are built compared with the demand for housing, this would most likely have a depressing effect on house prices. It is widely argued that one reason the current housing market has not fallen further and is now showing tentative signs of recovery is because a relative *scarcity* of available housing has propped up prices. For example, compared with September 2007, the current volume of property on the London property market is down by almost 50%.<sup>3</sup> Indeed, many cite the lack of housing supply in the UK as a clear sign that the market is failing and therefore the Government should intervene more widely.

Another factor that may have stopped house prices from falling further than predicted over the last couple of years is the occurrence of “accidental landlords” – that is the fall in house prices prompted home-movers to let their old properties out rather than sell. This has limited the supply of properties in the sales market and increased the stock of homes available to let. If this trend were to reverse as the housing market begins to recover, this would mean some of the elevated rental supply may return to the sales markets, with possible negative implications for house prices.

### Expectations (self-fulfilling prophecy)

The recent housing boom was also characterised by the expectations of the media, commentators, investors, estate agents and the public at large that house prices would continue to rise and rise. And for a long while they did, partially fuelled by these self-fulfilling expectations – i.e. we expected house prices to rise, so people continued to buy houses at inflated prices, and by such actions house prices rose further.

### Opportunity costs

The *opportunity cost* of owning a property is the interest earned on bank deposits less the cost of renting. If you own a house, it effectively pays you an income - the money you would have spent in rent. If a mortgage is less than an individual would spend renting, then even if house prices are not rising owning a house is effectively providing the individual with economic benefits. Therefore the relative cost between owning and renting and the subsequent *substitution effect* will influence consumption choices and have an effect on demand.

### Government intervention

Governments can also influence the supply of and demand for housing through direct intervention in the market. Whether the UK Government should intervene in the housing market has recently been the subject of much debate. Those against any intervention would suggest that we are just seeing a healthy and natural correction in the market after a decade of unprecedented and unsustainable house price growth. However, others say the housing market now is so important to the UK economy that the Government is right to act. So, why do governments intervene in the housing market?

One of the main reasons to intervene in a market is to make it work more efficiently. Housing has a range of attributes which make it difficult for markets to work efficiently. These include:

- Slow adjustment of supply and demand, and in particular relatively inelastic supply.

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<sup>3</sup> [“Low stock volumes push prime London house prices higher”](#), Knight Frank Press Release, 25 September 2009

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- Housing is seen as a 'necessary good' but takes a large proportion of income and wealth.
- For both consumers and producers, the housing market is particularly dependent on financial markets.
- Investments are location specific.
- Longevity of investment and specificity/irreversibility of asset.
- Emphasis on housing in social policy and regulation.
- Housing is a complex good with multiple attributes: necessary/luxury, asset/consumption.

Governments may also intervene in the housing market to correct for a specific example of market failure (for example insufficient supply), or to achieve a greater degree of equity in the availability and quality of housing and stock. Notably, housing may be seen politically as an important means of wealth redistribution. This is partly because housing is often considered as a *merit good* (a good an individual should have on the basis of need, rather than an ability/willingness to pay).

Equally, governments may have other reasons for intervention. For example, falling house prices can have a negative wealth effect which may impact on economic growth. Lower prices reduce consumer wealth and can create negative equity. This means that consumer spending will fall which may in turn impacts the wider economy.

The UK Government has intervened in the housing market in a range of ways over the years. Famous examples include the 1980 Housing Act which gave local authority tenants the "right to buy" their council property at discounted prices, and the Mortgage Interest Relief at Source ([MIRAS](#)) scheme which was first introduced in 1969 and subsequently abolished in 2000. Notably, the announcement of a then forthcoming change to MIRAS provision in the 1988 Budget created a short-term rise in the price of property followed by a sustained fall post-implementation. Current examples include the Government's [HomeBuy](#) scheme to enables social tenants, eligible key workers, and first time buyers to buy a share of a home, and also the stamp duty holiday for properties up to the value of £175,000 (scheduled to end on 31 December 2009). Most recently, the FSA has proposed increased regulation of the mortgage finance market, to ensure the market failure resulting from the excess sub-prime lending of recent years does not occur again. In particular, self-certification mortgages (which accounted for almost half of all mortgages offered in recent years) would be banned under the proposals with lenders required to verify borrowers' incomes.

### Conclusion

While it is easy to highlight the main influences on house prices, what is more difficult to ascertain is how each of these factors interact together to ultimately determine which way house prices will go and how fast.

The UK has always had an obsession with house prices. Yes, house prices go up, house prices go down, but perhaps what we should really be doing is completely ignoring them until we have a good reason to move. Rises and falls in the price of a property are nominal values, and the money an individual has in a property is not liquid money that can easily be converted into something else other than property.

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Further sources:

Begg, Dornbusch and Fischer, *Economics*, 7th edition, chapter 15

DCLG National Housing and Planning Advice Unit, [Housing requirements and the impact of recent economic and demographic change](#), May 2009

[LSE Housing Economic and Finance webpage](#)

Soros, G., "The crisis and what to do about it", *The New York Review of Books*, v55, no 19, December 4, 2008