UK HOUSING MARKET TRENDS

Summary

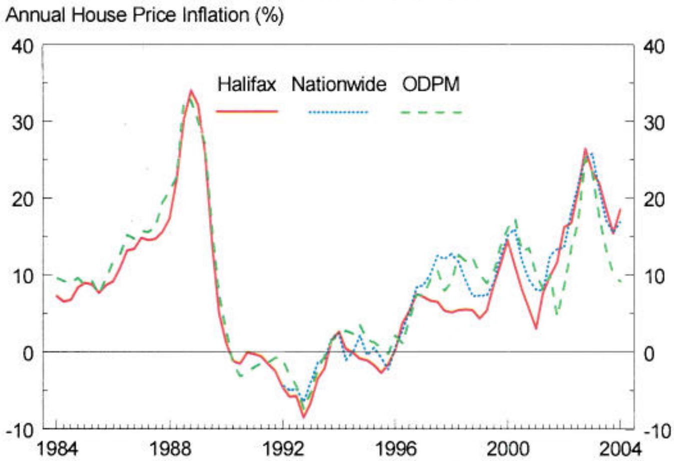
- **The UK housing market has in the past been a source of instability in the British economy.**
  - This occurred most recently in the late 1980s when the combination of loose monetary and fiscal policy and a housing boom led to RPIX inflation above 10%, interest rates at 15%, 1.5m families with negative equity and a consumption-driven recession – the longest since the second world war.
- **Currently house price inflation remains strong….**
  - Data released this month continues to indicate that the housing market is re-accelerating following a period of slowing growth throughout 2003. The Halifax and Nationwide building societies are reporting annual house price inflation of around 20 per cent.
- **…. particularly so in the Northern regions, Scotland and Wales.**
  - House price inflation in the North East, the North West, Yorkshire and the Humber, Scotland and Wales remain above 20 per cent – substantially higher than in the rest of the UK: 8 per cent in London and 4 per cent in the South East.
- **Looking forward, expectations are for a <u>gradual</u> cooling of the housing market….**
  - Increasing employment and robust consumer confidence are expected to persist. However, with rising levels of personal debt and the possibility of further interest rate rises, indicators still point to a slowdown in house price inflation over the next few years, but perhaps later than expected at the Budget forecast.
  - The house price to earnings ratio is at a historic high. However the MPC consider there to have been an upward adjustment in the sustainable level of house prices relative to earnings and if income gearing (interest payments as a percentage of income) is taken into account real house prices have risen at a more sustainable rate than prior to previous house price declines.
- **…. and Mervyn King noted the first signs of a possible moderation in house price inflation in his recent speech to the CBI.**
  - Mr. King said: *"there are some early signs, from surveys, of a slowdown in the housing market"*. Mr. King was referring to The Royal Institute of Chartered Surveyors' May housing market survey which commented that: *"The housing market remained robust in May though the pace of price rises slowed for the first time in six months. Tight market conditions continue to put upward pressure on prices, but interest rate rises and speculation over future increases have cooled buyer demand."*
- **Furthermore, the Treasury remains confident in the view taken at the time of the Budget 2004.**
  - While a moderation in the growth of house prices is widely expected by the Treasury and other forecasters, it is because of Britain's forward-looking and pre-emptive approach to macroeconomic policy that the economy remains on track, with sustained economic growth – although this does not rule out the possibility of greater house price volatility in the near future.

Introduction

1. Strong house price growth has been a significant feature of the UK economy over the past few years. While this may have helped to maintain household consumption growth during a temporary slowdown in world demand, it is generally recognised that house prices have been rising at unsustainable rates relative to income growth. Key concerns highlighted by the media are that households may be overstretched and that there has been a substantial worsening of affordability for first-time buyers and key-workers. The risks are that many households are highly exposed to future interest rate rises or an unemployment shock, which could result in a collapse in housing market activity. However, while a moderation in house price inflation is widely expected by the Treasury and other forecasters, the adjustment is expected to occur in a steady way consistent with stability and sustained economic growth – although this does not rule out the possibility of greater house price volatility in the near future.

National House price trends

Chart 1 - HOUSE PRICES



2. Over the past few years' house prices have grown at rates not seen since the late 1980s' housing boom.

3. Based on the ODPM index, annual house price inflation reached almost 33 per cent at the end of 1988. Following this period of exceptional growth, nominal house prices fell by 12.3 per cent as income gearing (interest payments as a percentage of income) peaked at close to 15 per cent, unemployment rose significantly, ¼ million homes were repossessed and 1½ million homeowners faced negative equity.

4. More recently, towards the end of 2002 house price inflation rates peaked at 25 per cent. In 2003Q4 UK nominal house prices were 122 per cent higher than when they peaked in the late 1980s. Currently income gearing is low – close to 7 per cent – unemployment is close to it's lowest since 1979, repossessions are at a historic low and negative equity is estimated to be close to zero.

5. Throughout 2003, annual house price inflation slowed on all four major quarterly measures, with the Land Registry being the only measure not to record four consecutive falls in the annual rate. The ODPM reported annual inflation in 2003Q4 of 10.1 per cent, down from 23.4 per cent in 2003Q1, while data from both the Halifax and Nationwide showed falls of around 10 percentage points over this period. However, this downward trend was reversed in 2004Q1, with the Land Registry, Halifax and Nationwide all showing a re-acceleration in their annual inflation rates.

6. Data available for May, from the three main monthly house price indices, show that the housing market remains buoyant, maintaining the re-acceleration seen since the turn of the year (shown in chart 1). Figures from the Nationwide indicated a further pick up in house price inflation, with a monthly price increase of 1.9 per cent, and the rate of annual house price inflation rising to 19.5 per cent. This is in line with the Halifax's May figure, which showed an annual growth rate of 21.8 per cent. Although these figures remain below the exceptionally high rates of

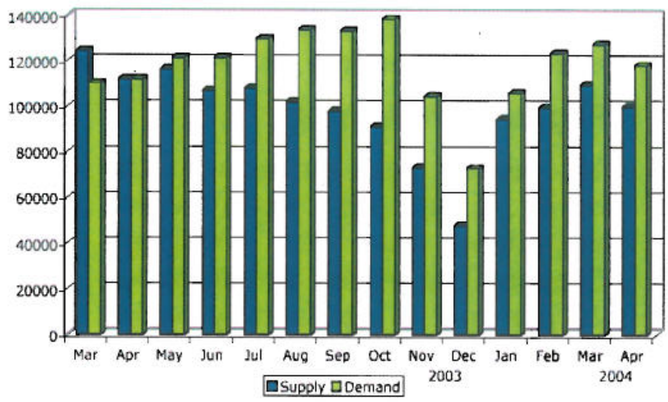
nearly 30 per cent seen at the beginning of 2003, they are the highest in the last twelve months and have also exceeded most expectations. Furthermore, following March's slowdown, the ODPM measure of house prices annual rate of inflation rose to 10.0 per cent in April, driven by strong monthly growth of 4.5 per cent. However, there have been wide regional variations, which are addressed below.

7. The UK average house price is reported by Halifax as £157,849, by Nationwide as £149,020 and by the ODPM as £168,600.[1]

Other housing market indicators

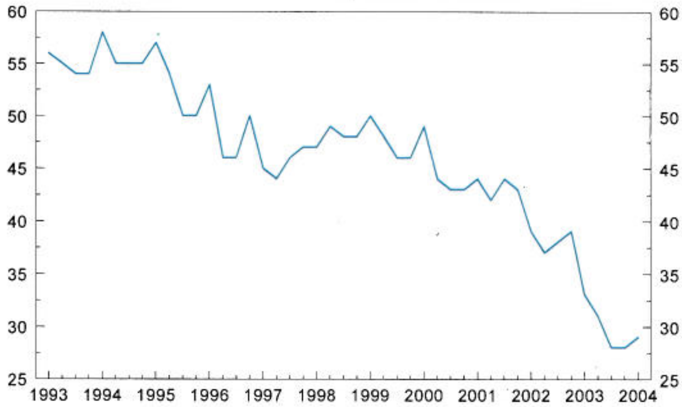
8. Non-price based measures of activity continue to indicate that demand for housing is still strong. The Rightmove market indicator (chart 2) shows that demand outstripped supply for the twelfth consecutive month in April and that the level of demand is slightly above the same time last year (albeit below the previous two months).

Chart 2 - Rightmove market indicator



9. Another notable feature of the housing market has been the decline in the proportion of first time buyers (FTBs) taking out loans for home purchase. By the end of 2003 the proportion of loans for house purchase to FTBs fell to an all time low of 28 per cent, well below its post-1993 average of 46 per cent (chart 3). This falling trend has received a high level of media attention over the past year.

Chart 3 - First time buyers as % of all loans



10. Although monthly mortgage repayments remain relatively affordable, many potential buyers are being priced out of the market. In particular, FTBs have become 'deposit constrained', as while their income is enough to support monthly mortgage payments, they are simply unable to save up a large enough down payment to make house purchase feasible. This may impinge upon rates of household formation. If FTBs are unable to afford a home then they could remain within their parents' household for longer than desired.

11. With rising interest rates, a buoyant housing market and a growing debt burden – especially in terms of graduate debt – the prospects for FTBs do not look likely to improve. The Council of Mortgage Lenders forecast that the proportion of FTBs would remain around its current low levels, approximately 29 per cent in both 2004 and 2005. However, the falling numbers of new entrants has not had the expected cooling effect on the housing market as the growing trend of buy-to-let may have taken up much of the slack.

12. The Buy-to-let mortgage sector has seen significant growth in recent years and is estimated to be around 4 per cent of lending for house purchase. The

[1] The Nationwide and ODPM estimates of the average house price are non-seasonally adjusted.

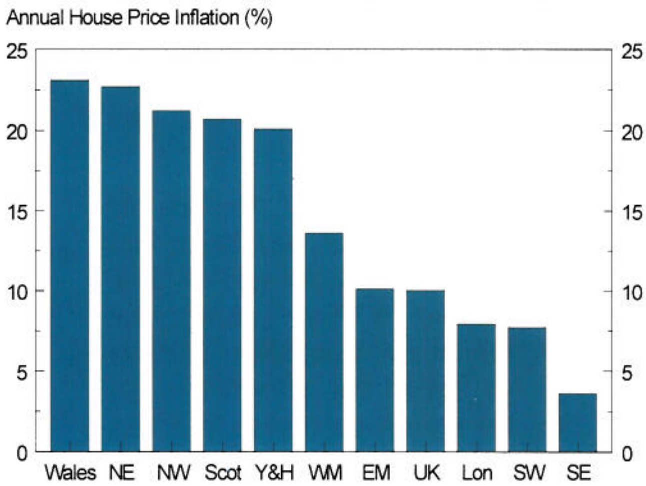
increase in activity may have the effect of crowding out FTBs, as typically, rental properties and those being sought by FTBs often have the same characteristics – such as one or two bedroom flats. Furthermore, it is also possible that the support that landlords are providing to the market may disappear rapidly. This depends on whether landlords are speculating on capital growth or have entered the market for long-term rental income. If it is the former, and landlords have not factored in the effects of rising interest rates, rents may not cover rising mortgage costs and may choose to exit the market. However, the Council of Mortgage Lenders has indicated that landlord sentiment is more geared to the longer-term and as such they do not expect support for the market from buy-to-let to decline sharply. It should also be noted that data on the buy-to-let sector is fragmented and anecdotal – therefore, strong conclusions should not be drawn.

Regional breakdown

13. House price inflation in the North East, the North West, Yorkshire and the Humber, Scotland and Wales remain above 20 per cent – substantially higher than in the rest of the UK.

14. Based on ODPM's annual regional house price inflation rates for April 2004, the Northern regions, Scotland and Wales recorded far higher rates of growth than in the South (chart 4). The highest rate of inflation was in Wales at 23.1 per cent and the lowest was recorded in the South East at 3.6 per cent.

Chart 4 - ODPM REGIONAL HOUSE PRICES



15. However, there are signs that some areas of the South may be re-igniting, with the ODPM reporting annual inflation up 3pps to 7.9 per cent in London in April. Furthermore, Rightmove's latest figures for June show that year on year, London once again showed a healthy rise of 12.2 per cent, up from 11.3 per cent in the previous month. They also report annual inflation of 18 per cent in the South West and monthly inflation of 3 per cent in the South East.

16. Despite the recent stronger performance in the South, the Halifax continue to expect the North and Wales to outperform the rest of the country for the remainder of the year, therefore resulting in a further narrowing of the North/South divide. This continues the trend seen from late 2002 onwards, in which the North has grown rapidly and the South has see more moderate rates of growth.

17. The market over the past year in most regions has been characterised by stronger price growth at the lower end of the price range (i.e. flats and terraced houses). The sharp increase in prices between March and April sees a continuation of this trend, with the average UK price for flats and terraced houses rising by 7.2 per cent and by 5.2 per cent respectively, compared with 3.1 per cent for detached properties.

Evaluation of housing market prospects

18. Demand for housing clearly remains strong at present, supported by increasing employment, accelerating earnings growth and consumer confidence above it's long-run average. House prices may therefore continue to rise sharply

in the short-term. However, with issues around declining affordability for FTBs and high levels of personal debt, combined with the possibility of further interest rate rises, underlying economic factors are pointing to a gradual cooling of the housing market in the medium term – although this does not rule out the possibility of greater house price volatility.

Forward-looking indicators

19. The Royal Institute of Chartered Surveyors' (RICS) May housing market survey has noted that the market may be showing tentative signs of having peaked, as highlighted by Mervyn King in his recent speech to the CBI. The RICS survey said that:

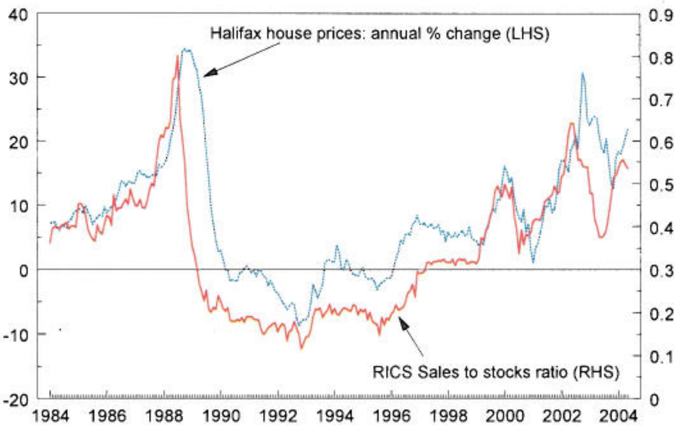
"The housing market remained robust in May though the pace of price rises slowed for the first time in six months. Tight market conditions continue to put upward pressure on prices, but interest rate rises and speculation over future increases have cooled buyer demand."

20. The survey identified that:

- The balance of surveyors seeing a rise in prices fell slightly in May, but still remains strong.
- New buyer enquiries for properties fell in May, the first decline since last December and was the largest drop since April 2003.
- Surveyors reported that completed sales fell 5% for the quarter to May compared to the previous 3 months.
- House prices were very buoyant in the northern regions and Wales, with a mild slowdown recorded in most of the southern regions (where decline in buyer enquiries have been most notable).

21. In addition to these factors, the RICS *sales to stock ratio* fell for the first time in ten months in April and continued to fall in May. The RICS sales to stock ratio has proven to be a particularly good leading indicator in recent times with downturns in this measure usually presaging a moderation of annual house price inflation in the following months (chart 5).

Chart 5 - RICS Sales to stocks ratio



22. Other forward-looking indicators suggest a similar picture. For instance, although the number of loans approved for house purchase – as measured by the Bank of England – remains high, it has been falling in recent months, which could also signal that the market is due to start slowing.

23. Furthermore, Rightmove report that asking prices actually fell 0.4 per cent in the first full week of June, with London leading the downturn. Prices in the capital fell by 1.6 per cent in the final week of the June and rose by just 0.6 per cent over the whole of the previous month. The property website said "*This month's index may show the first clear evidence of the long-expected slowdown in the housing market.*" but qualified this by stating that "*While one week of declining asking*

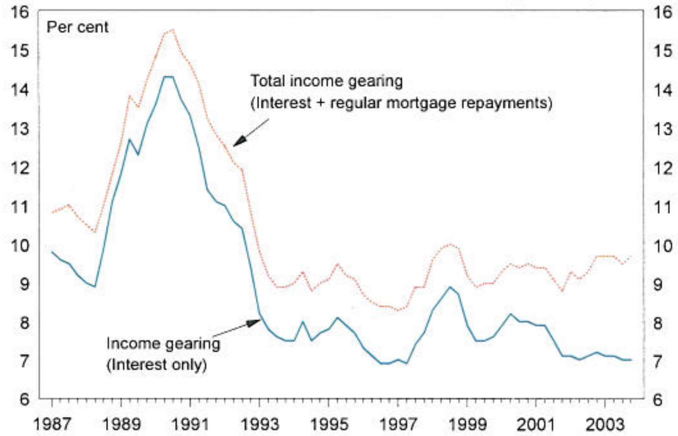
prices does not reliably predict the future trend of [actual] *prices, this may be the first factual indication that four interest rate rises are beginning to bite".*

Household balance sheets

24. The build-up of personal debt has received much media attention over the past year. Recent focus has been on the level of household debt approaching £1trillion. April's data from the Bank of England show that total lending to individuals currently stands at £985 billion, and if household debt continues to grow in line with recent trends, £1 trillion should have been reached sometime in the second week of June. However, the Bank of England will not publish June's figures until 29 July.

25. Debt secured on housing accounts for 82 per cent of total lending to individuals and the annual growth of secured lending was 15.2 per cent in April, a record high. This largely reflects the sustained strong growth in house prices.

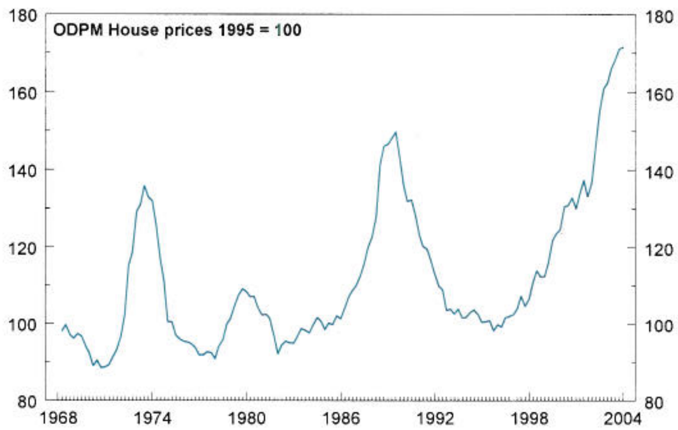
Chart 6 - Household sector income gearing



26. The high level of personal debt relative to income carries potential downside risks to economic prospects – which could feed through to the housing market – as households are more vulnerable to any significant future adverse shocks. But there are important reasons to believe that households' overall balance sheets are and will remain consistent with macroeconomic stability. Quite unlike the late 1980s, the low interest rates delivered by greater macroeconomic stability have ensured that household interest payments remain low by historical standards. The ratio of interest payments to household disposable income (Chart 6) has remained close to 7 per cent since 2002, compared to it's peak of over 15 per cent in 1990 when consumers were hit at the same time by rises in interest rates well into double figures and rapidly rising unemployment. The asset side of the household balance sheet remains strong – though to some extent this reflects strong rises in house prices contributing to increased housing wealth – with household net wealth over 50 per cent higher than at the beginning of 1997, despite the recent fall in equity prices. The success of the new economic policy framework in delivering economic stability with low interest rates and strong labour market outcomes has made people more confident in taking on new risks.

House price to earnings ratio

Chart 7 - House price to Earnings ratio



27. The house price to earnings ratio has been a particular focal point for economists and commentators who are predicting a house price crash. Indeed the ratio has reached record levels recently (chart 7) and is well above the peaks seen in both the mid-1970s and the late-1980s.

This could indicate that house prices have been growing at an unsustainable rate relative to earnings, however it must also be noted that there may well have been an upward adjustment in the equilibrium level of the house price to earnings ratio.

28. There are good reasons to think that the long-term level of house prices relative to earnings has risen because house prices reflect the balance between rising demand and restricted supply for housing in the UK; and in addition, the success of the new economic policy framework in delivering economic stability with low interest rates and strong labour market outcomes has made people more confident in entering the housing market. This is supported by comments from the MPC in the minutes of their meeting, 5 & 6 May 2004. "*The Committee's central projection* [for house prices] *reflected a judgement that the sustainable ratio of house prices to earnings was higher than its previous long-run average, but was still probably below the current ratio, so that house prices were likely to rise less rapidly than earnings at some stage*".

29. Recent work within HMT, to update an early-2003 International Monetary Fund model of UK house prices, has shown that the current acceleration in real house prices has not been to a similar degree as that seen leading up to the peaks of annual inflation seen in the 1970s or late-1980s and subsequent collapses. This model combines real interest rates and income gearing evidence (chart 6) and as such presents a fuller picture of house price determinants than the much quoted house price to earnings ratio. This implies that although the house price to earnings ratio does appear high, when debt-servicing costs are taken into account the extent to which this level is unsustainable is less obvious.

30. Articles' such as those by Martin Wolf ("A housing disaster in the making") and recent press reports of Tony Dye's prediction of a "30 per cent fall" in house prices may therefore appear overly pessimistic if the sustainable house price to earnings ratio has indeed risen. However, as the MPC point out, the current level of the ratio may be above that which is believed to be sustainable and so greater house price volatility cannot be ruled out. However, due to Britain's forward-looking and pre-emptive approach to macroeconomic policy, any adjustment in house prices is expected to occur in a steady way.

Implications for the Budget Forecast

[redacted]

[redacted]

[redacted]

33. [redacted]

[redacted]

Conclusion

34. Currently house price inflation remains strong. Data released this month continues to indicate that the housing market is re-accelerating, after slowing throughout much of 2003. This is particularly the case in the Northern regions, Scotland and Wales where house price inflation is substantially higher than in the rest of the UK.

35. Demand for housing is supported by increasing employment, accelerating earnings growth and consumer confidence above it's long-run average. House prices may therefore continue to rise sharply in the short-term. However, with issues around declining affordability for FTBs and high levels of personal debt, combined with the possibility of further interest rate rises, underlying economic factors are pointing to a gradual cooling of the housing market in the medium term. Mervyn King noted the first signs of a possible house price inflation moderation in his recent speech to the CBI, which has been reinforced by Rightmove reporting "*the first clear evidence of the long-expected slowdown in the housing market.*"

36. Although prominent indicators, such as the house price to earnings ratio, are considered unsustainably high it is important to view this in the context of lower debt servicing costs and the current more stable, lower inflation environment. When this is taken into consideration it implies that although the house price to earnings ratio does appear high, the extent to which this level is unsustainable is less obvious. Thus, in comparison to the late-1980s, current rates of house price inflation relative to income growth may be more sustainable than at first apparent – indicating that a subsequent crash may not be that likely.

37. Furthermore, the Treasury remains of the view taken at the time of the Budget 2004. While a moderation in the growth of house prices is widely expected by the Treasury and other forecasters, it is because of Britain's forward-looking and pre-emptive approach to macroeconomic policy that the economy remains on track, with sustained economic growth – although greater house price volatility cannot be ruled out.

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Economic Assessment