COUNCIL of MORTGAGE LENDERS

Managing the Housing Market

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MANAGING THE HOUSING MARKET

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PREFACE

This report has been written by
Charles River Associates Ltd, London.
It forms part of the CML commissioned research programme
on strategic and policy issues related to
the mortgage and housing market.

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INTRODUCTION

- With interest rates now set by the Bank of England and the possibility of UK entry into EMU, this report aims to evaluate in broad terms the case for, and likely effectiveness of, policy instruments other than monetary policy, to regulate cyclical movements in the UK housing market.

- There is considerable interest in designing policy to mitigate strong cyclical and regional price variation, particularly in the current context of:

  - Large and persistent regional house price differentials, and the problems this caused in the labour market;

  - The impact that problems in the housing market can have on the management of interest rates and inflation; and

  - The prospect that, if the UK enters EMU, interest rates will cease to be under direct UK control and other policies will be needed if the housing market is to be managed.

HOW VOLATILE ARE HOUSE PRICES?

- House prices are cyclical with three peaks in the UK since 1970 (1973, 1979 and 1989). They are also highly variable, more than doubling from 1978 to 1989 and falling by a quarter between 1989 and 1996. The UK has one of the highest levels of house price volatility in Europe. Finally, house prices are more volatile than GDP and average earnings, but strikingly as volatile as share prices.

- In explaining house price volatility, theories often stress the unresponsiveness of housing supply to prices, especially in the short term, and the idea of speculative price bubbles. Because of supply constraints, it is widely accepted that property prices are largely demand driven and move almost independently of construction costs.

- However, none of the forces responsible for the demand shocks that have caused turbulence in the housing markets in the past, such as large swings in incomes and interest rates and one-off events such as exception demographic pressure and financial liberalisation, seems likely to be as pronounced in the future.

- Taken together the evidence suggests that speculation has occurred and has in the past made an important contribution to house price volatility. There are good reasons to believe that speculative bubbles are less likely to occur in the future. However, the fundamentals remain in place for speculation to have an effect as housing supply has not become more responsive to prices, and unexpected demand shocks may still occur.

THE CASE FOR INTERVENTION

- Is intervention required in the housing market? There are two broad arguments that suggest a case for intervention. The first of these is evidence of considerable past price volatility and latent future volatility, which argues that intervention is needed to curb speculative bubbles. This is examined in Chapter 2 and appropriate remedies for potential future speculative bubbles are discussed in Chapter 4.

- The second argument is that volatile house prices may have harmful external effects elsewhere in the economy. This argument focuses on the key links between housing market volatility and the rest of the economy, namely:

  - Its interaction with the government's management of the economy as a whole;

  - Its implications for the labour market; and

  - Its effect on consumer protection in the mortgage market.

- Household level data – though not conclusive – tends to support the argument that consumption and housing are jointly determined. This evidence leads to the conclusion that the government should not intervene in the housing market to stabilise the economy. If anything, the prescription is the other way round – measures that foster macroeconomic stability are also likely to tame housing market volatility.

- There are several arguments that suggest a need for intervention because of the relationship between housing and labour markets. Firstly, it may take a long time for house price differentials to feed back to stabilise regional job markets. Second, when speculative bubbles occur, they lead to distortions at the regional level. Finally, national pay scales can lead to seriously skills shortages in some professions, such as education and health sectors, where workers are priced out of the housing market (for example, in London and the South-East).

- A final argument for intervention is that volatile house prices may affect consumers in the mortgage market. During the readjustment in house prices in the early 1990s, many borrowers suffered from negative equity and there were unprecedented numbers of repossessions. The most highly geared home-owners – first-time buyers – were the most likely to suffer negative equity. This is less likely to occur in the future because:

- Mortgage providers have increased the flexibility of loan conditions, allowing greater scope for borrowers to transfer negative equity onto new properties, to take contribution holidays, or to make additional payment when they have unexpected income;

- Lower house price inflation may make house price volatility easier to understand; and

- More borrowers are covered by mortgage payment protection insurance.

- The risk to consumers is now lower than during the last house price boom, but it still seems more likely that borrowers – rather than lenders – are misperceiving the risks.

POLICIES TO MANAGE THE HOUSING MARKET

- Our analysis indicates that there is a limited case for intervention, but policies must not impede the functioning of the markets and should be targeted on specific goals of preventing speculative bubbles, achieving greater regional price stabilisation and protecting vulnerable borrowers.

- Consideration could be given to redesigning the transactions tax regime. Because of the doubts about the effectiveness of stamp duty in minimising speculation and price volatility, and its potential costs to the economy, it is worth considering alternatives. One possibility is to make the tax conditional on the length of time the property is held. This could help to combat speculative bubbles and provide an automatic stabiliser across regions.

- It may be beneficial to further stimulate the private rental sector to help increase labour mobility and reduce house price volatility. This could involve bringing forward the capital gains tax relief to be given to private landlords and aligning council taxes more closely to property values.

- Intervention might also be useful to help mortgage borrowers better understand the risks they face. These are best tackled through product disclosure and education to increase borrowers' understanding of the risks associated with house purchase. Improving disclosure of information is a key objective of the FSA in taking over responsibility for regulation of mortgages.

CHAPTER 1 Introduction

With interest rates now set by the Bank of England and the possibility of UK entry into EMU, the CML commissioned Charles River Associates (CRA) to evaluate in broad terms the case for, and likely effectiveness of, policy instruments other than monetary policy, to regulate cyclical movements in the UK housing market. As economists, it was natural for us to start by asking: why intervene in the housing market at all? Markets generally work best when they function unimpeded, and there have to be strong external effects to justify the costs that intervention inevitably imposes. The case that is generally made for intervention is that, over the last thirty years, the UK housing market has been characterised by strong cyclical and regional price variation.

There is considerable interest in designing policy to mitigate these cycles, reflecting concerns such as:

- A recent rise in the income multiples that households are borrowing, and associated fears of a repeat of the house price crash of the late 1980s;
- Large and persistent regional house price differentials, and the problems this causes in the labour market;
- The impact that problems in the housing market can have on the management of interest rates and inflation; and
- The prospect that, if the UK enters EMU, interest rates will cease to be under direct UK control and other policies will be needed if the housing market is to be managed.

These are legitimate concerns, but they do not in themselves constitute an economic case for intervention. The 'volatility' of prices – their tendency to vary over time – is only a matter of economic concern if it is a sign that the market is failing to deliver housing efficiently to those who want it. In that case, the volatility is 'excessive' in the sense that prices overshoot the levels necessary for the market to function efficiently.

This is particularly a matter of concern if volatility is largely driven by speculation – and thus by ultimately unsustainable financial motives – rather than being the necessary signal for efficient transactions.

So the initial questions for our research had to be: are prices too volatile, and if so why? Before considering what alternative policy instruments there are, and how they might affect the housing market, we therefore start Chapter 2 by looking at what drives house prices, and whether prices are likely to be as volatile in the future as they have been in the past. In Chapter 3 we look at the evidence of market failures, and what form they take, the need for Government intervention and the particular concerns it should seek to address.

In Chapter 4 we turn to the matters of most policy interest: possible responses to the market failures identified in Chapter 3, and which of them are most likely to be effective in remedying the underlying problems of the housing market.

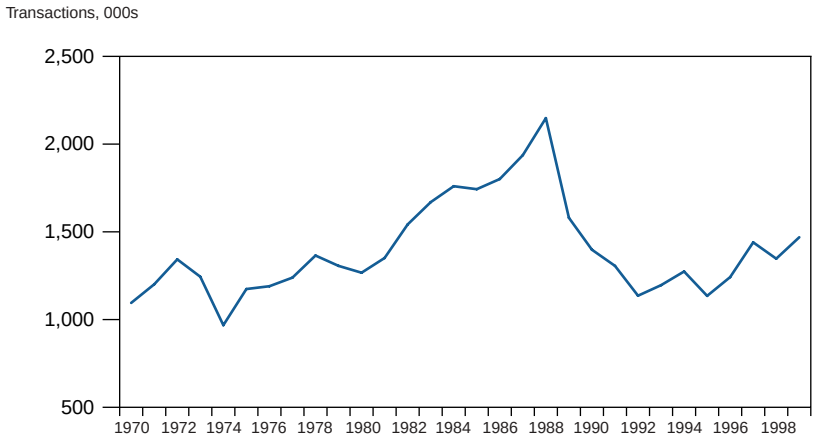
Chapter 5 summarises our conclusions. We do not aim to argue the case for particular policy proposals in detail – that would be a very different and much more detailed task. However we hope that the policy suggestions that emerge, and the logic on which they are based, will be of interest to those thinking about the design of policy.

CHAPTER 2 How Volatile are House Prices?

UK house prices are highly volatile – almost as volatile as stock market prices. There is some evidence that speculation contributes to it, but most of this volatility just seems to reflect the characteristics of supply (which is fairly fixed) and demand (which is strongly cyclical).

We focus on price volatility because it is a potential symptom of problems. The volume of transactions also varies a good deal through time (as shown in Chart 1), but this can generally be taken as a symptom of a market working efficiently. Transactions occur between willing buyers and sellers, and it is only possible to say that the volume is 'too low', for example, when external restraints prevent buyers from buying (eg, restrictions on mortgage finance) or sellers from selling (eg, if they are locked in by a negative equity situation). Such external restraints are normally easy to identify directly, and one does not need to look at the volume of transactions to see whether they occur.

CHART 1: NUMBER OF PROPERTY TRANSACTIONS



Source: *Inland Revenue*

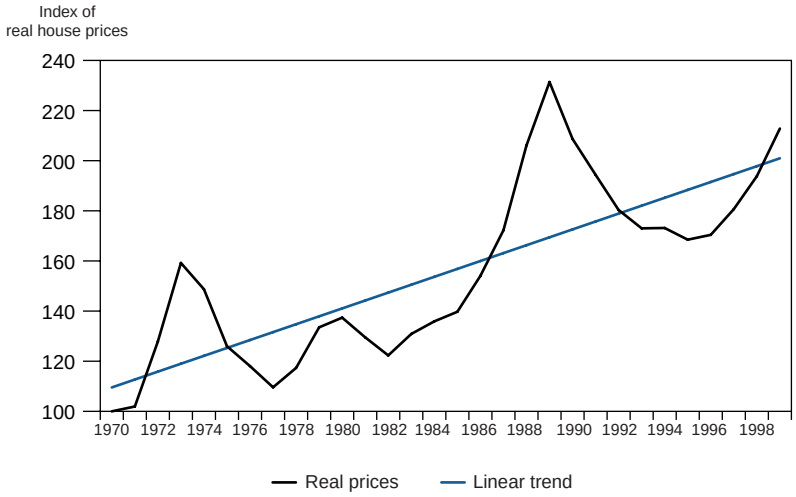
House prices are likely to be much more stable in the future than they have been in the last thirty years. This is because the new macroeconomic framework has helped to stabilise key elements of the overall economic environment, because the UK now enjoys a more stable demographic profile, and because the housing finance market is mature and competitive.

RECENT EVIDENCE

Volatility over the business cycle

Chart 2 shows how real (inflation adjusted) property prices have behaved since 1970. They are clearly cyclical, with three peaks (1973, 1979 and 1989), and highly variable – they more than doubled from 1978 to 1989, and fell by over a quarter between 1989 and 1996, for example.

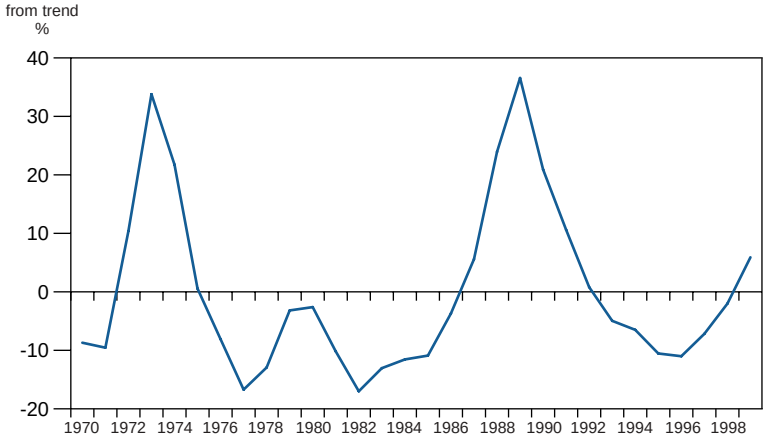
CHART 2: REAL UK HOUSE PRICE INDEX 1970-1999 (1970=100)



Source: DETR and CRA calculations

They also increase in a trend-like way, as average earnings increase, and a clearer picture of the volatility emerges when one strips out this long-term trend. The results in Chart 3 show that deviations from trend are not symmetrical: prices tend to go much further above trend when houses are overvalued than they go below trend when houses are undervalued.

CHART 3: REAL HOUSE PRICES – DEVIATIONS AROUND LONG TERM TREND (1970-1999)



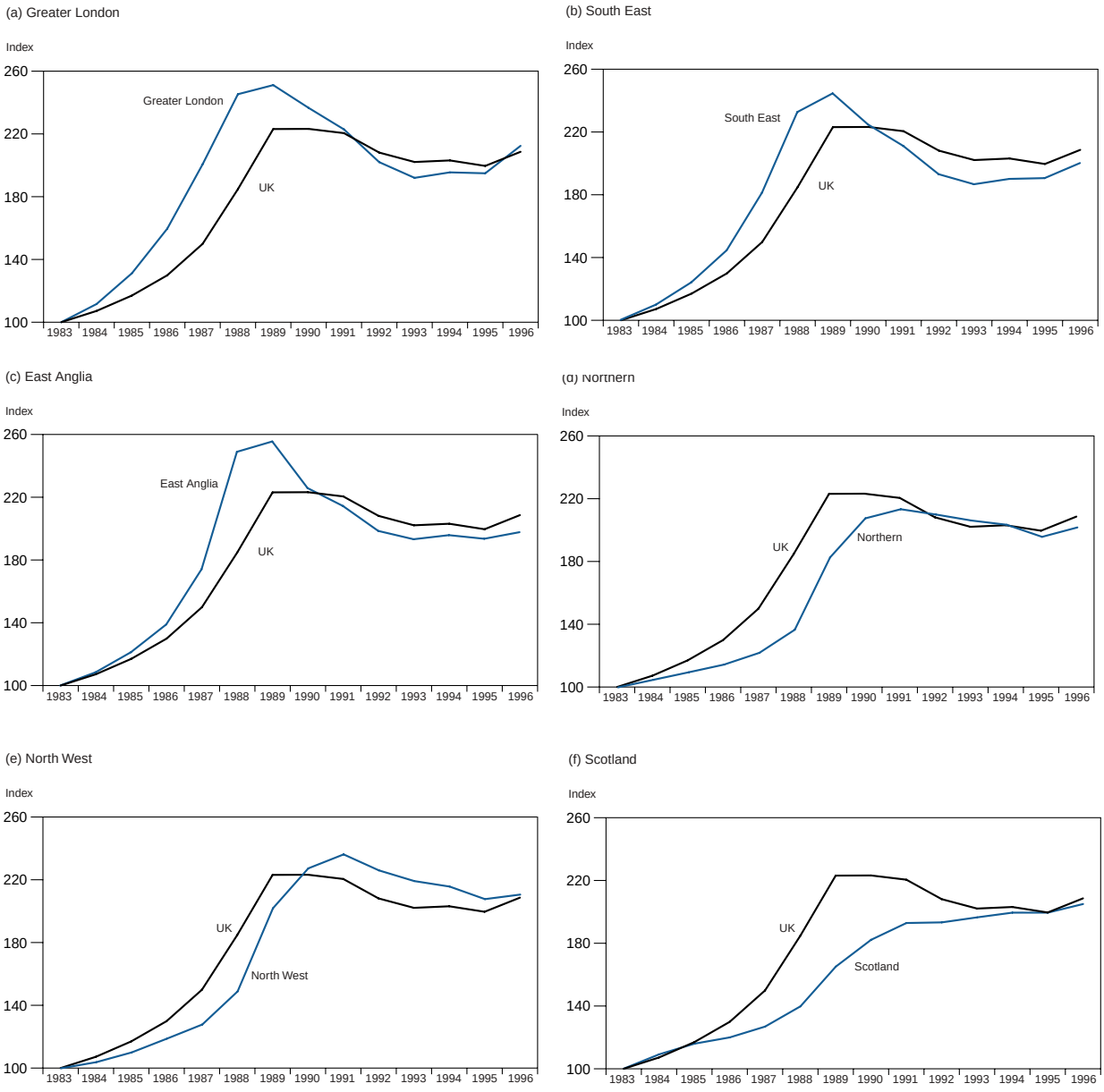
Source: DETR and CRA calculations

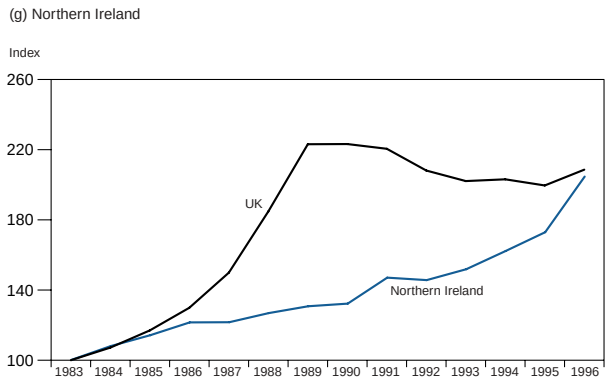
Volatility by Region

National average prices can give a misleading impression of volatility at the regional level where house prices are in fact largely determined. Averaging effects may either lead them to understate volatility at the regional level (house prices may be rising in some regions and falling in others), or to exaggerate the regional picture (if transactions mostly occur where prices are changing fastest).

Chart 4 shows the behaviour of national and selected regional house prices in nominal (ie, cash, not inflation adjusted) terms over the last business cycle, from 1983 to 1996.

CHART 4: UK AND REGIONAL HOUSE PRICES, 1983-96 (1983=100)





Source: *Halifax Price Index*

Over the cycle as a whole, the regions all had quite similar rates of house price inflation: regional average rates ranged from 5.8% to 7.0% per year, compared with a national average of 6.2%[1]. But behaviour within the cycle differed a good deal from one region to another, and as a result there are large differences in the volatility of the annual growth rates.

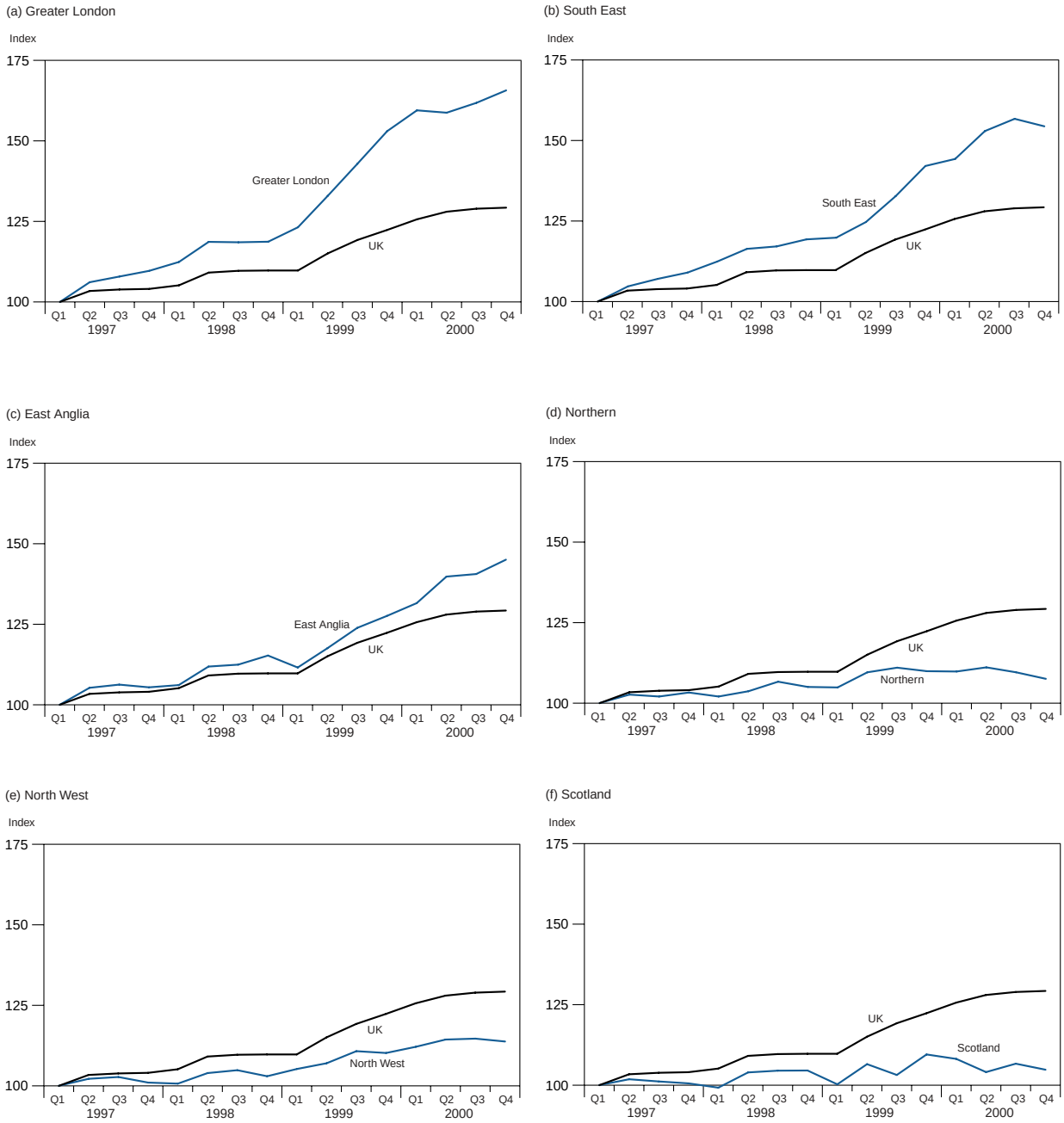
House prices were much more volatile in London, East Anglia and the South East than the national average would suggest. In these regions they were two to three times more volatile than those in Scotland and Northern Ireland, for example. Moreover, the 1989-95 slump in house prices was less severe in the North than the South, and did not occur at all in Scotland or Northern Ireland. As a result, the problem of negative equity in the early 1990s was also most acute in the South (Meen and Andrew, 1998).
It also seems that house price changes in London, the South East and East Anglia tended to lead national movements, while those in the North, Scotland and Wales tended to lag. For instance, from 1983 to 1990, house prices in London always rose faster than the national average, while after 1990 the position was reversed. This suggests that house price cycles have propagated from one region to another: in the past they have originated in the South East and spread to other areas later on.

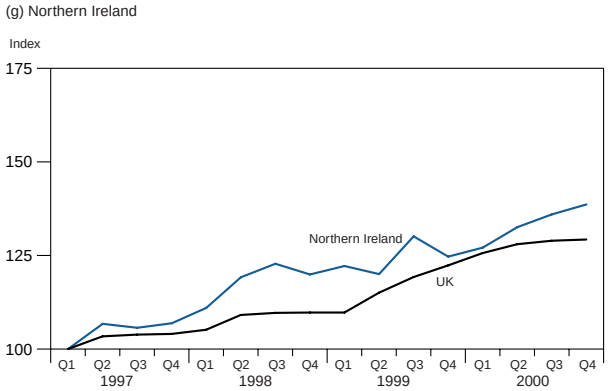
One exception to this picture is Northern Ireland, whose house prices seem almost unrelated to those in Great Britain. They rose by 10% a year less than the national average before 1990, but by almost 8% a year more afterwards. This is partly because the region experienced a less severe business cycle than the rest of Great Britain, and house prices may also have reflected specific regional influences such as the 1998 Good Friday Agreement and the house price boom in the Republic of Ireland.

Since 1997, as shown in Chart 5, prices in London and the South East have again increased relative to the UK. By 2000, regional differentials had reached their highest

level since 1989, prompting fears at the FSA that another house price crash was imminent in the Greater London region. Other commentators however have different opinions, some believing that there will be a 'soft landing' with prices in other regions catching up to London levels, and others claiming that the housing market has changed and that there will be a permanent London premium.

CHART 5: UK AND REGIONAL HOUSE PRICES 1997-2000 (1997=100)



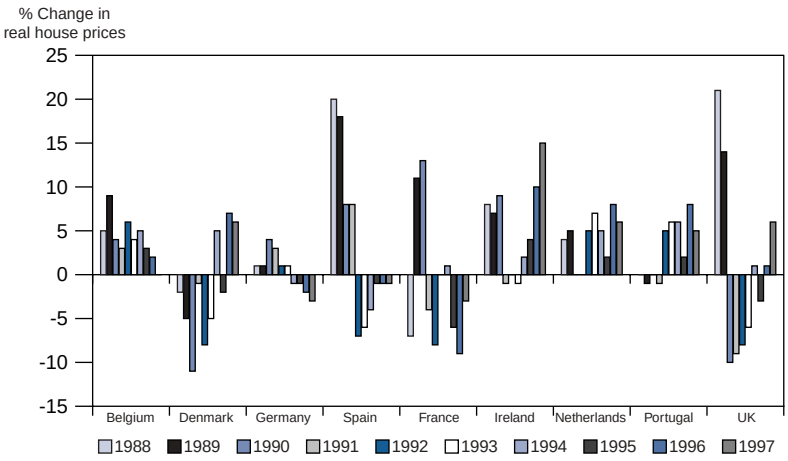


Source: *Halifax Price Index*

Volatility Compared with Continental Europe

How does the volatility of UK house prices compare with that in other European countries? While it is hard to make detailed house price comparisons across Europe, because national statistics are collated in different ways, the broad trends confirm that the UK has a high level of volatility. Chart 6 shows changes in real house prices for 8 continental European countries and the UK over the period 1988 to 1997.

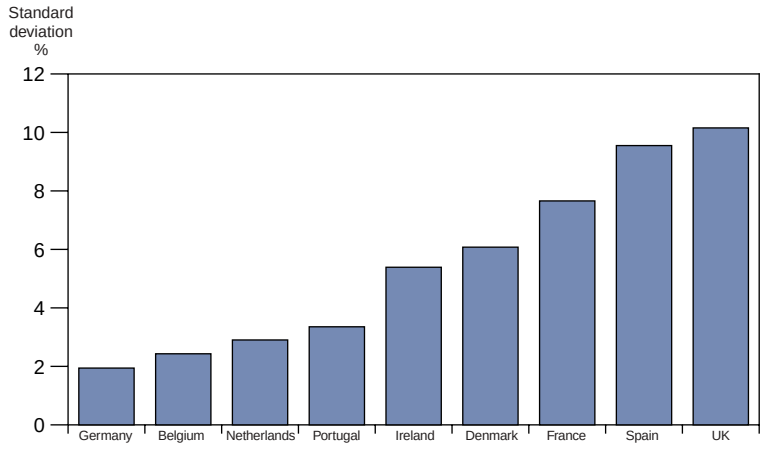
CHART 6: REAL PROPERTY PRICES ACROSS EUROPE



Source: *Maclennan, Muellbauer and Stephens (1999)*

In some countries (Spain, France and Ireland most clearly) there has been substantial variation, while in others (Belgium, Germany, the Netherlands and Portugal for example) house prices have been relatively stable. But overall, in this period at least, house prices have been more volatile in the UK than in any other European country, with only Spain showing a comparable degree of volatility. This emerges most clearly in Chart 7, which shows the standard deviation, a statistical measure of variability, of prices.

CHART 7: STANDARD DEVIATION OF THE ANNUAL CHANGE IN REAL PROPERTY PRICES



Source: CRA calculations based on Maclennan, Muellbauer and Stephens (1999)

Volatility Relative to Other Indicators

Comparing house prices with other key economic variables gives a further sense of how variable they have been over the last thirty years. In real (inflation-adjusted terms), they have alternately over- and under-performed the growth of GDP by a considerable margin, as shown in the first panel of Chart 8. They have also shown more variation than real average earnings (second panel), which over the long run are thought to be the main determinant of real house prices.

Most strikingly, house price inflation is almost as volatile as the rate of increase in share prices, as measured by the FTSE All-Share Index (last panel). Shares are the main 'risk based asset' in households' investment portfolios, and warnings are compulsory on advertisements for packaged investment products based on them, because of the well-known risks involved. House prices are not quite as volatile, and owning a house clearly has other benefits apart from its potential as an investment. However, it does seem legitimate to ask whether similar standards of disclosure and warning should not be imposed on the mortgage market. We return to this idea in Chapter 4.

CHART 8: ANNUAL REAL GROWTH – HOUSE PRICES VERSUS OTHER ECONOMIC VARIABLES

Source: *DETR and National Statistics*

WHY ARE HOUSE PRICES SO VOLATILE?

To sum up, the evidence from the UK economy in general, from the regions and from other European countries all shows that house prices have experienced relatively large price cycles.

What has made house prices so volatile? This question is not just of interest in its own right. If we can understand the past drivers of price volatility, we can also begin to assess the prospects for future volatility, and decide what policies would be appropriate for dealing with it.

Tax changes could be an explanation – if the demand for houses is fairly unresponsive to prices, then any change in taxes will tend to be reflected in the market price. Certain tax episodes – such as the abolition of double MIRAS allowances near the height of the housing boom of the late 1980s – are thought to have contributed to instability. But over the longer term, housing demand seems likely to be fairly responsive to prices. And

tax changes alone would be insufficient to account for the degree of volatility the UK has experienced.

In explaining house price volatility two theories have been widely discussed:

- One that the supply of housing is very inelastic – that is to say it responds very little to prices, especially in the short term – while the demand for housing is subject to shocks such as changes in inflation and interest rates. These characteristics mean that prices have to vary a great deal, just for the market to keep supply and demand in balance.

- The second that there are speculative price 'bubbles'. In this story, the demand for housing is largely driven by expectations about future house prices. This means that prices may move much more than is needed simply to balance supply and demand, leading to problems of resource misallocation.

These theories are not mutually exclusive – speculation could clearly be one of the demand shocks in the first theory. But how much of the volatility does each explanation account for?

Unresponsive Supply

There are several reasons why the supply of housing is unresponsive to prices:

- Housing is very durable, so the flow of new housing onto the market is small in relation to the stock of housing in existence, and even quite large changes in the amount of new housing would make little difference to the overall supply picture.

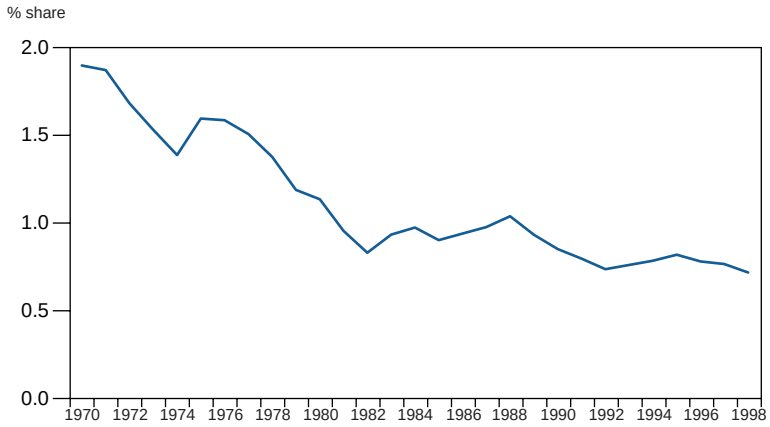
- Furthermore, it takes one to two years to build new houses, it is costly to subdivide existing houses, and housing requires inputs, particularly land, that are difficult to obtain. It is also argued that the planning system perpetuates this, because it does not make enough land available to meet the effective demand. All this means that there is little flexibility in the flow of new housing.

Chart 9 illustrates both of these points, using the ratio of new completions to the total housing stock for the period 1970 to 1999. The ratio is small – under 2% per year - and has fallen over this period from 1.9% in 1970, when there were 350,000 new completions and a housing stock of 18.7 million, to 0.8% in 1995 when new completions were only 190,000 and the stock was 23.8 million. At that rate it would take 125 years to turn over the housing stock.

The number of new houses is also relatively insensitive to changes in price. The number of completions did increase somewhat after the large price rises of the late 1980s, for example, but only from around 0.8% to 1.0% of the stock. Recent formal statistical analysis (Meen, 2000) confirms this. It shows that the supply elasticity[2] in the UK is only about 0.32, in sharp contrast to estimates for other countries. For example, research

on the US suggests an elasticity of between 9 and 16 (Meen, 1998). Because the total flow of new housing is small in relation to the stock, and because changes in prices produce only a relatively small change in the flow, changes in new completions are very small indeed in relation to the housing stock. They have only a very marginal effect on the total number of properties, and on the balance between supply and demand.

CHART 9: RATIO OF COMPLETIONS TO HOUSING STOCK



Source: *DETR*

It is widely accepted that supply constraints cause property prices to be largely demand driven and move almost independently of construction costs. Because supply is so inelastic, a given change in demand will also tend to lead to big price changes – much larger than would be the case in a country like the USA where the supply responds better to prices.

Variations in demand

The supply side is only one part of the story: however inelastic supply may be, it takes variations in demand to produce house price swings. The main influences on the demand for housing have been found to include:

- **Macroeconomic variables:** changes in real incomes and real and nominal interest rates;
- **Financial deregulation:** the relaxation or tightening of regulations governing mortgage lending; and
- **Demographic change:** changes in the structure of the population, particularly the proportion of people at the age for first house acquisition.

These are likely to remain the principal sources of demand shocks – and thus of price volatility in the future. Let us consider the prospects for each of them in turn.

Macroeconomic Variables

The UK economy has suffered from a stop-go macroeconomic cycle for decades. The Government that came to power in 1997 has made important changes in both monetary and fiscal policy to promote macroeconomic stability. It gave control of monetary policy to the Bank of England, which has been set a goal of achieving a stable inflation rate (currently 2.5%). This has the advantage of preventing political intervention in the setting of interest rates and should lead to a more consistent and long-term approach to price stability.

It also introduced a fiscal policy framework under which the Government's deficit can vary over the cycle, but which prevents Government debt from increasing dramatically over the longer term. Again this should promote economic stability. Since these new frameworks were introduced, stability has indeed improved: inflation is lower and more stable than for several decades, and inflation expectations have come down. Most analysts believe that growth is likely to be significantly steadier in the future than it was in the 1980s and early 1990s. With stable overall growth should come stable personal income growth and employment. And low inflation should result in less variation in both real and nominal interest rates. All this – if sustained – will lead to less volatility in the UK housing market.

But the UK economy is open to the rest of the world and still subject to external shocks – through fuel prices, financial crises and the like – and regional economies can go at very different speeds within a stable overall picture. Even though macroeconomic stability is the norm at present, measures to improve the supply side would not be a waste of effort.

Financial Deregulation and Mortgage Market Developments

The UK mortgage market underwent dramatic deregulation in the 1980s, removing the last vestiges of mortgage rationing, giving households access to a much wider choice of mortgage providers, and increasing competition. There was a step change in loan-to-value ratios and in the amount of mortgage finance, which resulted in an upward shock to the housing market. While there are significant changes to mortgage regulation currently underway these are unlikely to affect the housing market in the same way.

The mortgage market is currently characterised by strong competition with new evolving growth markets. These developments too are highly unlikely to result in future housing market shocks.

Developments in the mortgage market include:

- CAT-marked mortgages, introduced in 2000. Few lenders yet offer CAT-marked mortgages, where products must meet a set of minimum standards on a range of features set down by the Treasury. They could yet become the focal point of

competition in the way that CAT-marked products have in the pensions and long-term savings market, for example.

- Flexible mortgages and fully fixed mortgages. These product innovations are having a growing impact on the market.

- The Buy to Let market. In the past, those buying to let paid higher rates of interest than owner-occupiers, and rental incomes were not included when assessing a borrower's ability to meet mortgage payments. The Buy to Let initiative devised by the Association of Residential Letting Agents (ARLA) seeks to stimulate the growth of the private rental sector by removing these penalties.

- Securitisation of lenders' mortgage books. Mortgage lenders occasionally sell portfolios of mortgages on the capital markets. We expect this to grow, reflecting its potential to cut costs at a time when retail funds are becoming increasingly expensive because of competition in the deposit market. This trend will further reduce barriers to the entry of new mortgage providers, but will not fundamentally change the market.

- More intense competition for those parts of the market that have been poorly served, such as the self-employed or those with poor credit histories.

Demographic Change

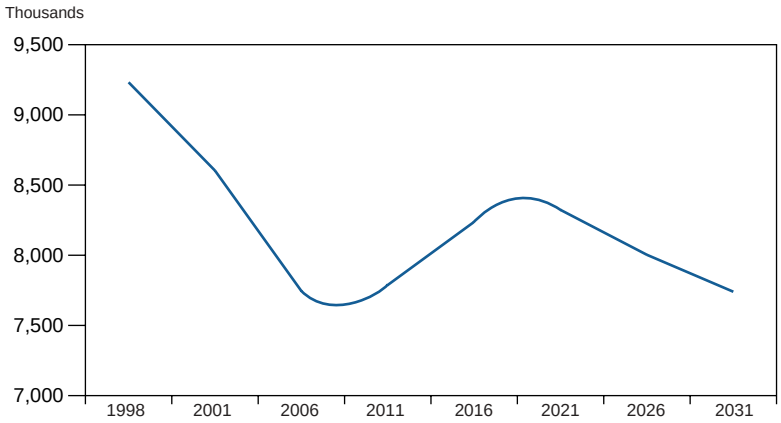
In the 1980s, two demographic trends were at work, both tending to increase the demand for housing. The 'baby boom' generation reached the twenty-five to thirty-four age range, swelling the size of the demographic segment responsible for the majority of first-time buyers. At the same time, average household size fell (from 2.91 in 1971 to 2.35 in 1998), increasing the demand for housing units in relation to the size of the population.

Over the next ten years, however, these trends will tend to work in opposite directions, resulting in greater stability in demand. As shown in Chart 10, the number of people in the 25-34 age range will fall by around 20% over the next ten years, which will tend to reduce the number of first time buyers.

However, the number of households will continue to increase, reflecting the aging population and other factors reducing average household size, though at a lower rate than in the past. The number of households will increase at 0.5% per annum over the next decade, compared with over 1% per annum in the 1990s.

Some new factors may enter the equation. For example, changes in student finance, in particular their increasing reliance on loans to finance their studies, may reduce the likelihood of buying a house in the first years of employment. This could lower housing demand in the next decade, but the effect is likely to be small and transitory compared with the broad trends above.

CHART 10: POPULATION PROJECTIONS OF INDIVIDUALS AGED 25 TO 34 YEARS OF AGE



Source: *DETR*

To sum up, none of the forces responsible for the 'demand shocks' that have caused turbulence in the housing market seems likely to be as pronounced in the future as it has been in the past. This implies that – if the supply and demand story is the whole truth – house prices are likely to be less volatile in the future. This makes it all the more important to know whether there are other sources of instability, in particular speculation.

Speculative bubbles

The other type of explanation for volatility is that there are speculative 'bubbles'. This possibility is important because speculation distorts prices away from the fundamentals of supply and demand, and gives clear grounds for intervention. In 'bubbles', prices rise because consumers expect them to rise further in the future. Thus a price rise that was initially required to balance supply and demand can trigger expectations of further rises that become self-fulfilling. At worst, speculation can lead house prices to rise at an accelerating rate until they meet an external check, such as rapidly-rising interest rates. The process can then go into reverse, with price declines also becoming self-perpetuating for a time.

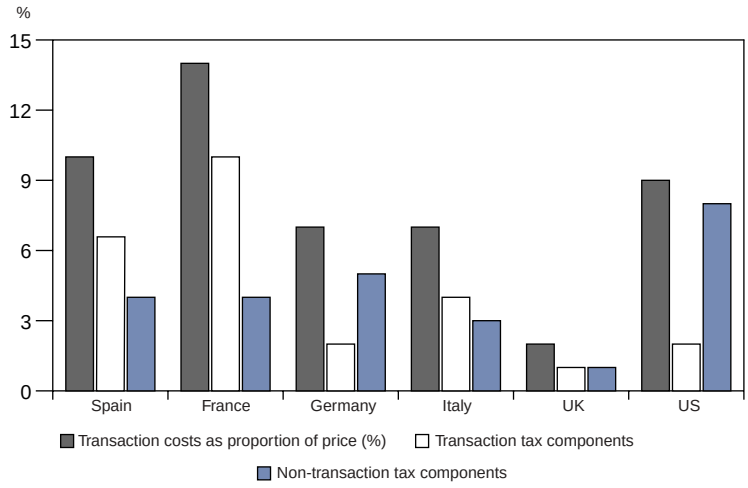
It is hard to show whether actual prices diverge from the level that the fundamentals of supply and demand would justify. Evidence that there are bubbles in UK housing prices typically comes from less direct sources such as:

- The way housing price changes at different times are related to one another;
- The levels of transaction costs, loan-to-value ratios and capital gains taxes;
- Survey evidence on the reasons why people move; and
- The low elasticity of supply of housing.

The pattern of price changes through time. This provides some of the most persuasive evidence. Analysis suggests that expectations of future price changes (as proxied by previous price changes) help to explain actual price changes. This suggests that speculative bubbles are important (Levin and Wright, 1997), because it supports the notion that price increases are self-perpetuating.

Transaction costs, loan to value ratios and transactions taxes. This evidence is less direct, but also points to bubbles. Speculation is worthwhile when the gains from increases in house prices exceed the transaction costs, so the lower the costs, the smaller the expected price increase needed to spark a buying 'frenzy'. UK transactions costs have been low by international standards, as shown in Chart 11, making speculation more worthwhile. The cost of a typical property transaction is as much as 14% of the sales price in France for example, but averaged only about 2% in the UK. Both the tax and non-tax components are low in the UK, whereas in some European countries, owner-occupiers are subject to capital gains taxes, and in the US there are substantially higher intermediary charges[3].

CHART 11: TRANSACTION COSTS



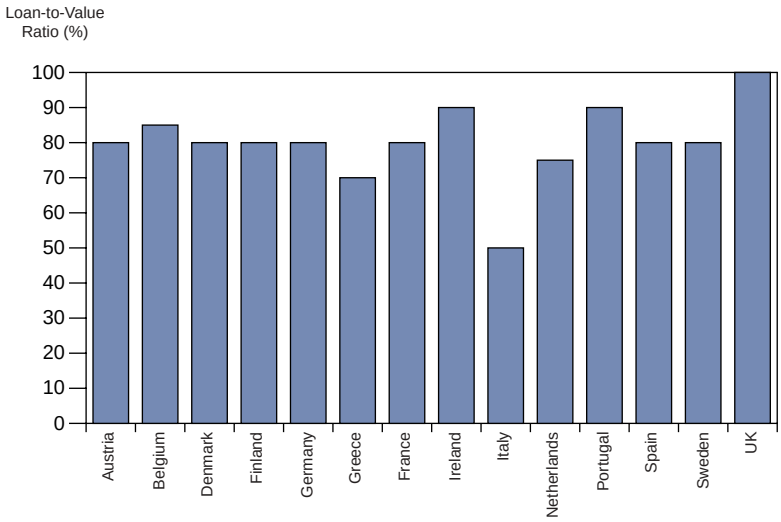
Source: *CRA calculations based on Maclennan, Muellbauer and Stephens (1999)*
Note: *The UK figures reflect costs before the increase in stamp duty in the April 2000 budget.*

The returns from speculation are higher if owners can borrow much or all of the value of their dwellings, because this reduces the amount of their own funds the owners need to tie up. UK loan-to-value ratios are higher than those in continental Europe. As shown in Chart 12, UK buyers can borrow up to 100% of the value of their property at the lender's discretion. At the other extreme, the maximum loan-to-value ratio in Italy is limited by law to only 50%.

On average, the loan-to-value ratio for UK first time buyers is around 80%, while that for other buyers is around 65%. Owners' housing equity increases as house prices grow,

but the percentage increase is greater the higher the loan-to-value ratio. If the capital gains are used to finance further house acquisition a higher-value property can be afforded, propagating the price increases[4]. There are clearly limits to this process, as the amount that people can borrow is also limited by their earnings, and the point will eventually be reached where households have exhausted their borrowing capacity, but this is just one of the checks that bring bubbles to an end.

CHART 12: NORMAL MAXIMUM LOAN-TO-VALUE RATIOS ACROSS EUROPE



Source: *European Mortgage Federation (1999)*

Finally, speculative activity is if anything encouraged by the UK's tax treatment of residential property: the capital gains and imputed income accruing to owner-occupiers are free of tax, raising the returns from investing in housing compared with other assets. These tax concessions are particularly important when the general rate of inflation is high.

Survey evidence. At first sight, survey data on why people move tends to throw doubt on the idea that speculation is important. Housing is largely viewed as a consumption need rather than an investment product, and surveys give little indication that price expectations affect the timing of moves. But while house buyers may not think they are speculating, they do undertake two kinds of activity that could have this effect:

- Trading up in good times, where buyers move to more expensive properties to increase their prospective gains from the rise in house prices, then trade down and release purchasing power later in the cycle; and
- Premature entry by first-time buyers, who bring house purchases forward[5] to avoid being excluded by high prices later in the bubble.

The low elasticity of supply of housing. The UK's inelastic supply situation also makes the housing market more prone to speculation, because increases in demand and prices draw out very little more supply, and prices tend to be unstable upwards. This helps produce the pronounced asymmetry of the housing price variations shown previously in

Chart 2. As a result, even if only a relatively small proportion of buyers act in a speculative fashion, they can have a pronounced effect on the overall price of housing.

Taken together, the evidence suggests that speculation has in the past made an important contribution to house price volatility. There are good reasons to believe that speculative bubbles are less likely to occur in the future than they were in the 1980s and 1990s:

- As we have seen, there are likely to be fewer demand shocks. The new macroeconomic framework, for instance, means that there is less chance of unexpected economic growth starting them off;

- Lower inflation in itself reduces the returns to speculation. It also raises the possibility that house prices will actually fall in cash terms in future downturns, penalising speculation; and

- Lower inflation and lower nominal earnings growth means that mortgage payments fall away less quickly as a share of household budgets, putting a brake on peoples' willingness to take on large borrowings.

However, the fundamentals remain in place for speculation to have an effect. Unexpected demand shocks are still possible. For instance, potential external shocks to the UK economy could lead to macroeconomic instability.

CONCLUSIONS

The main conclusions from this section are as follows:

- UK house prices have been highly volatile in the recent past.

- Much of this volatility was due to a combination of unstable demand with unresponsive supply.

- There is also some evidence that speculative bubbles have contributed.

- It seems likely that prices will be substantially more stable in the future, largely as a result of improvements in macroeconomic management and demographic changes.

- But volatility remains possible, as housing supply has not become more responsive to prices, and unexpected demand shocks are still possible.

In the next section, we turn to look at whether this justifies intervention in the housing market.

CHAPTER 3 The Case For Intervention

Is intervention required in the housing market? There are two broad arguments that suggest a case for intervention: evidence of considerable past price volatility and latent future volatility.

One argument is that intervention is needed to curb speculative bubbles. This is because bubbles – when they do occur – always distort markets and this calls for remedial action. The evidence in Chapter 2 suggests to us that bubbles have occurred in the past and could occur again in the future. This could constitute a valid reason for intervention, and we look at appropriate remedies in Chapter 4.

The other set of arguments is that volatile house prices may have harmful external effects elsewhere in the economy. This set of arguments is analysed further in the present chapter. It focuses on the most critical linkages between housing market volatility and the rest of the economy, namely:

- Its interaction with the government's management of the economy as a whole;
- Its implications for the labour market; and
- Its effects on consumer protection in the mortgage market.

Time and space do not allow us to examine all of the important linkages from the housing market, and for example we have not examined implications for the construction industry or the market for household goods.

THE HOUSING MARKET AND THE MACROECONOMY

Even though house prices are not one of the Bank of England's explicit targets when setting interest rates, they do have to be taken into account in managing inflation. This is partly because they have a mechanical effect on how inflation is measured – not only do they affect the RPI itself via mortgage-servicing costs, but they also affect the underlying RPIX index through housing depreciation.

More importantly, changes in house prices may change individuals' consumption decisions, and thus affect the real economy. Recent research by the Bank of England and the CML, for example, suggests that mortgage equity withdrawal (MEW) is related to increased consumption. The strength of the housing market may have encouraged the

use of MEW to finance spending, the majority of which is spent on home improvements, and supported consumption growth overall (Davey and Earley, 2001).

This sort of relationship could arise either 1) because both are affected by the same set of outside influences, or 2) because house price inflation actually causes changes in consumption. These alternative explanations would have very different implications for whether to intervene in housing markets. There is a case for controlling house prices to help stabilise the real economy if house prices affect consumption, but not if both are changing together as a result of other outside factors.

Which explanation is closer to the truth?

1. *House prices and consumption have common determinants.* In this view of the world, both are driven by factors such as people's expectations about future incomes and wealth, and intervening in the housing market will have no effect on the macro-economy. A permanent increase in household incomes would raise both consumption and the demand for (and hence the price of) housing. For instance, during the 1980s, high economic growth and low inflation prompted consumers to believe they would have permanently higher incomes, and consumption and house prices both rose steeply. If this hypothesis is right, then younger households – with a longer working life ahead of them – would be expected to see the greatest increase in consumption; or

2. *There is a causal relationship, with house prices driving consumption.* If this is correct, then intervention in the housing market would have a substantial macroeconomic effect. Housing is a very large proportion of household wealth, and could affect consumption in several possible ways:

    - As the value of housing wealth rises, owner-occupiers may reduce their saving for bequests and raise current consumption;
    - Those who trade down in the housing market (and thus benefit from increased housing wealth when prices rise) perhaps have a higher propensity to consume[6] than those who trade up, perhaps because they are beyond the peak savings ages; and
    - Increases in house values raise the scope for home-owners to borrow to finance consumption. This is probably the most important effect. The financial liberalisation of the 1980s led to unprecedented mortgage equity withdrawal that was used to fuel consumption.

In any of these scenarios, older households with more housing wealth would increase their consumption most.

Household level data – though not conclusive – tends to support the argument that consumption and housing are jointly determined. For instance, Orazio and Guglielmo (1994), using data from the Family Expenditure Survey, found that younger households see the greatest changes in consumption when prices rise, consistent with this idea.

This evidence leads us to conclude that the government should not intervene in the housing market to stabilise the economy. If anything, the policy prescription is the other way around – measures that foster macroeconomic stability are also likely to tame housing market volatility.

HOUSE PRICES AND THE LABOUR MARKET

When house prices in different regions move very differently (Chart 4 above), it can be very expensive for people to move to areas where jobs are. But regional differences in house prices that reflect the demand and supply of housing are not in themselves a cause of concern. They may just show that the market mechanism is working - if booming London house prices reflect a booming London economy, it is not clear that intervention is justified. High house prices in a region will tend to increase the cost of labour and damp job creation there, which should help to promote job creation in other areas.

But there are several labour market arguments that do suggest a need for intervention. Firstly, it may take a long time for house price differences to feed back and stabilise regional job markets, and there is a case for policies that help the housing and labour markets to work more rapidly.

Second, when speculative bubbles occur, they lead to distortions at the regional level. Large regional price differences due to bubbles have significant costs in terms of reduced labour mobility. Expanding industries in areas of high house prices will find it more difficult than they should to attract labour, with adverse consequence for growth and productivity. Some firms may subsidise employees' housing to enable staff to relocate, but this imposes further costs on other businesses and deters expansion. When the bubble bursts, the rapid fall in house prices can lead to owners facing negative equity situations (where the value of the mortgage is in excess of the value of the house) and being unable to move. This can prevent people moving to areas of low unemployment and reduce mobility in the labour market still further.

Finally, another external effect arises in professions where national pay scales are used or only limited flexibility is possible. Here labour mobility problems can also seriously reduce the supply of services. This is particularly problematic in the educational and health sectors, where wages are not set on a market basis. Recently the Government has proposed additional measures to help workers who are essential to the community to purchase property in areas where they would otherwise be priced out of the market. The Housing Green Paper publication *Quality and Choice: A Decent Home For All* (April 2000) introduced a Starter Home Initiative (SHI), targeted towards groups such as nurses, teachers and the police, to address the recruitment and retention problems which are believed to stem from the lack of affordable accommodation. The SHI is targeted at first-time buyers and is intended to help 10,000 key workers to purchase property in areas where there skills are in acute shortage, such as London and the South East. Policy options being considered include shared ownership, repayable equity loans, cash grants to assist with a home purchase, and subsidised mortgages.

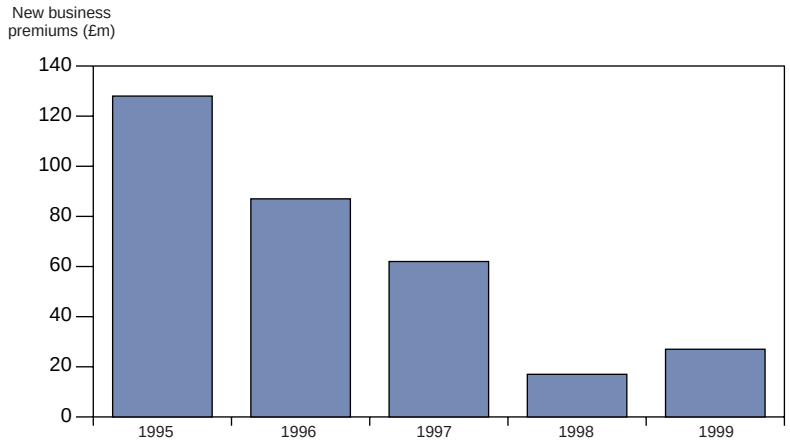
CONSUMER PROTECTION IN THE MORTGAGE MARKET

While the mortgage market as a whole is mature, liberalised and stable, and does not require intervention, there are policy concerns about the vulnerability of some classes of borrower. These reflect a perception that mortgage providers do not always make appropriate risk assessments, while the large nominal increases in house prices seen in the past have made buyers complacent about the risks associated with investing in housing. This means they may be exposed to 'consumer detriment'[7] when they take out mortgage finance, perhaps over-investing in housing compared with other assets, and assuming more risk than they intend.

Providers' risk assessments have been criticised on two grounds:

1. During the 1980s and early 1990s, mortgage providers required borrowers to pay Mortgage Indemnity Guarantee insurance (MIG) to protect the provider from the risk of default. This was thought to have encouraged higher loan to value ratios and – by protecting mortgage providers from risk – to have removed their incentive to undertake thorough risk assessments. Though borrowers paid for MIG at a rate consistent with the risk they posed, the insurance premium was included in the mortgage payment, making them relatively insensitive to its cost. In recent years, mortgage providers have reduced their use of MIG and become self-insuring, which should encourage a closer assessment of risk. Interestingly, this coincides with a period where first-time buyers have been offered lower loan to value ratios.

CHART 13: MIG NEW BUSINESS PREMIUMS, 1995-99



Source: *Association of British Insurers*

2. It has also been alleged that the regulatory capital requirements on mortgage lenders do not encourage risk assessment. The rules allow them to keep the same level of capital, whatever the loan to value ratio or the income and repayment history of the borrower. Does this lead to excessive lending, and allow mortgage providers to make

riskier loans at higher interest rates with few cost implications? This seems unlikely, because lenders still have the incentive to avoid defaults. Most mortgage providers manage their businesses using models of economic capital that appropriately reflect the relative risk of the borrower. Moreover, lenders' credit scoring and risk assessment techniques have become increasingly sophisticated.

The longer low inflation persists, the more cautious mortgage lenders are likely to become about who they lend to, and how much they lend. High levels of inflation used to mean that nominal mortgage payments quickly become small relative to income, and negative equity situations were unlikely. But in a low inflation environment mortgage lenders are likely to scale down the amount they are prepared to lend both as a proportion of the property's current value and the multiple of the borrower's income.

Borrowers' risk assessments can also be a public policy issue. Protecting consumers from overextending themselves in the housing market is in some ways analogous to attempts by the FSA to prevent excessive share trading (such as day trading on the stock market): individuals may misperceive the risks and rewards and suffer considerable harm as a result.

During the readjustment in house prices in the early 1990s, many borrowers suffered from negative equity and there were unprecedented numbers of repossessions. The most highly geared home-owners – first-time buyers – were the most likely to face negative equity. This is less likely to occur in the future:

- Mortgage providers have increased the flexibility of loan conditions, allowing borrowers to transfer negative equity onto new properties, to take contribution holidays, or to make additional payment when they have unexpected income;

- Lower house price inflation may make house price volatility easier to understand; and

- More borrowers are covered by payment insurance: 33.4% of all mortgages advanced in the second half of 2000 were protected by insurance, and over 2.3 million UK mortgage holders (21.1% of the total) are now protected by mortgage payment protection insurance (ABI/CML press release 5 June 2001).

The risk of consumer detriment is lower than during the last house price boom, but it still seems more likely that borrowers – rather than lenders – are misperceiving the risks. Recent sharp rises in income multiples mean this remains an area of policy concern.

CONCLUSIONS

The evidence suggests that there are three valid sorts of reason for intervening to prevent volatility in the housing market:

- The possibility of future bouts of speculative activity, which distort prices and impose costs on housing market participants;

- The need to reduce regional house price differentials, which harm labour mobility and adversely affect the economy as a whole; and

- The need to protect vulnerable mortgage borrowers from taking on too much risk.

The management of the economy, however, does not require specific interventions in the housing market.

The implications of this diagnosis for the design of policies to manage the housing market are covered in the next section.

CHAPTER 4 Policies to Manage the Housing Market

The diagnosis in Chapter 3 suggests that – if there are to be interventions in the housing market – they should have a number of specific goals:

- They should combat speculative 'bubbles' in house prices. This in turn suggests that intervention should be designed to have most effect when prices are accelerating as they do at the beginning of a price bubble;
- They should assist housing and labour market stabilisation between regions. This suggests that policies such as transaction taxes should be designed to act as automatic regional stabilisers; and
- They should help to improve risk assessments by borrowers.

This section looks at some of the policy alternatives that are available in practice, and how effectively they would address each of these specific goals. The policies include taxes on housing transactions, measures to stimulate the rental sector, changes in planning restrictions, and risk disclosure requirements in the mortgage market. Table 1 summarises how these policies relate to the goals.

TABLE 1: GOALS/POLICIES MATRIX

Goal/Policy	Transactions taxes	Stimulating the rental sector	Planning changes	Risk disclosure
Preventing speculative bubbles	Helpful if targeted on speculative transactions	Helpful: raises supply elasticity	Helpful: raises supply elasticity	May help by cutting demand in price upswings
Stabilisation between regions	Helpful if it acts as an automatic stabiliser	May help by raising supply elasticity	May help by raising supply elasticity	May help by cutting demand in regional price upswings
Protecting vulnerable borrowers	No effect	May help by cutting demand in price upswings	No effect	Helpful

All four of the suggested policies could have at least some beneficial effect in preventing speculative bubbles, and the design of the transactions tax is the most important

consideration. Measures to stimulate the rental sector, and risk disclosure in the mortgage market potentially help with all three goals.

We do not cover all possible policies. We have omitted a number of possible measures from consideration – for example direct controls on housing prices or on mortgage lending, because they would in our view impose much larger costs than any benefits they would generate. Others, such as taxing imputed rental income, seem unlikely to be politically feasible. And still others, such as encouraging mortgage lenders to lean against the cycle seem unlikely to be effective.

TRANSACTION TAXES

Transactions taxes can take a number of forms, including stamp duty, tenure taxes and taxes on secondary properties, which we review in turn. They all drive a wedge between what the buyer is willing to pay, and what the seller is prepared to accept for a property. They thus depress the number of housing transactions and tend to reduce the economic benefits they bring.

There are two main economic justifications for such taxes: their roles in dampening house price swings - the focus of interest for this paper – and in raising revenue for the Government.

Not all taxes are very effective in dampening house price movements, and stamp duty in particular seems poorly designed for the purpose. Transactions activity tends to increase strongly when house prices accelerate, and it may therefore be possible to design a transactions tax in such a way as to dampen price volatility quite effectively.

Stamp duty

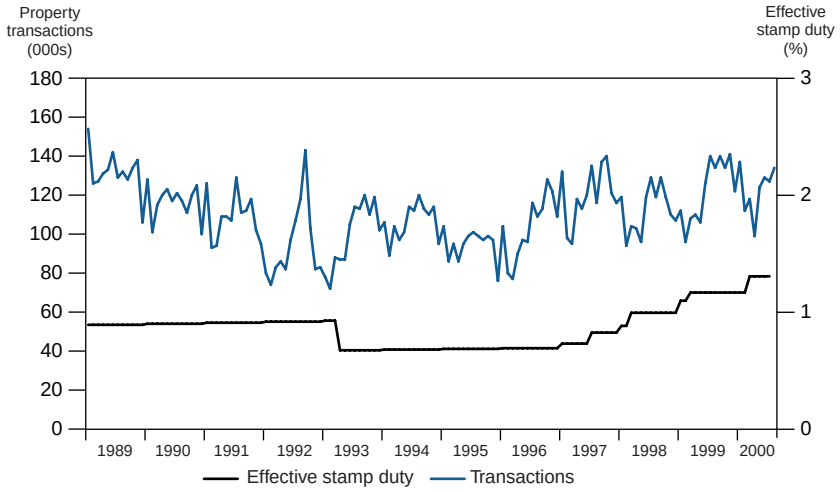
Duty is paid by the purchaser once contracts are exchanged. In recent years, the rate of stamp duty has been changed significantly. Traditionally, stamp duty was used rather passively, with a 1% charge being imposed on all property transactions, which had a certificate of value over £30,000. This threshold was subsequently raised to £60,000 in March 1993. However, under the present administration stamp duty has been used much more actively, with four changes since March 1997. These policy changes resulted in stamp duty being subject to annual revisions, with rates being banded and progressively increased in line with property values, to the current limit of 4% on property valued over £500,000.

In principle, stamp duty reduces the returns from moving house and should cut the number of transactions, but there is actually very little evidence for such an effect. We therefore undertook our own statistical investigation, using monthly data over the period January 1989 to June 2000.

The stamp duty framework was frequently amended during this period, so it should give some indication of how effective the tax has been at regulating the volume of

property transactions. We worked with an effective duty measure, designed to capture changes in both the duty rate and the value thresholds at which duty became payable[8]. Chart 14 shows the monthly volume of property transactions, together with the effective rate of stamp duty, over the period.

CHART 14: VOLUME OF PROPERTY TRANSACTION AND CHANGES IN STAMP DUTY



Source: *Inland Revenue (Property Transactions) and CRA Calculations (Effective Stamp Duty Rate)*

We then used regression analysis[9] to test whether changes in the effective stamp duty rate helped account for the number of property transactions. The analysis was augmented with a number of additional drivers of housing demand, and 'dummy' variables to capture seasonal effects[10]. Despite testing the hypothesis extensively, we did not find evidence that the effective stamp duty rate significantly influences the volume of property transactions.

There are two possible reasons for this finding: either the level of transactions tax is simply too low to affect the number of transactions, or buyers treat transactions taxes as a 'sunk' cost which does not impact on their decisions.

Circumstantial support for the first idea is to be found in the much higher level of transactions costs, and the much smaller number of transactions in other European countries. If this is right, then considerably higher transaction taxes would be needed to cut the number of transactions (and the level of house prices).

But even then, there are arguments against stamp duty:

- Even if it is effective in curbing transactions and cutting prices, it may not lead to greater price stability. Evidence from securities markets shows that volatility can even increase in response to the imposition of such taxes.

- It may also have significant side effects, since increasing the costs of moving may reduce labour mobility. Labour mobility in the UK, for example, is only ⅓ that in the US – which does not impose any property transactions taxes (though as we have seen transactions costs are high for other reasons).

Because of the doubts about the effectiveness of stamp duty in minimising speculation and price volatility, and its potential costs to the economy, it is worth considering alternatives. We look at two such alternatives:

- A tenure tax on housing capital gains; and
- Taxes on second properties.

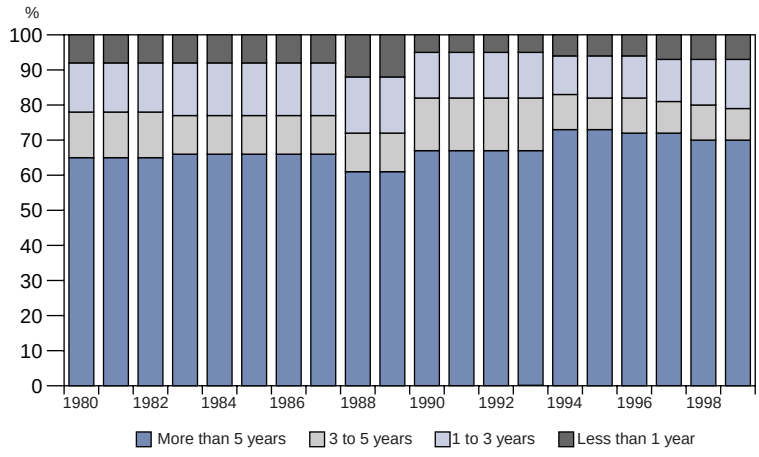
Tenure tax

Tenure taxes designed to discourage excessive housing turnover and the associated speculation are used in Italy and Germany. In those countries, capital gains on housing are taxable, but only if the property is sold within a certain period after purchase. This has the advantage that it does not affect consumers who wish to trade-up and hold onto the property. How would such a tax operate in the UK?

Chart 15 categorises the stock of owner-occupied housing in England and Wales by length of tenure over the period 1980 to 1999. The pattern has changed over the period, with short tenures increasing in the 1980s as the property market strengthened, and reaching a peak around 1989 when speculative activity in the UK housing market was arguably at it greatest. Short tenures then fell in the early 1990s, reflecting the slowdown in housing market turnover. The variation in the flow of housing transactions by tenure duration must be even larger (though figures are not available).

The majority of people own their houses for 5 years or more, and are clearly not speculating. One might therefore set a 5-year threshold for exempting transactions from the tenure tax.

CHART 15: OWNER-OCCUPANCY BY LENGTH OF TENURE, 1980-1999

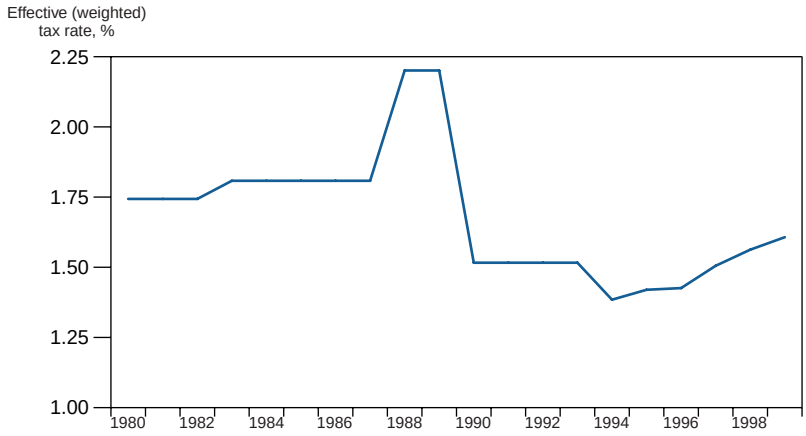


Source: *DETR/Labour Force Survey*

To illustrate the possible effects of a tenure tax over the period 1980 to 1999, we applied a different hypothetical tax rate to housing capital gains for each of the DETR tenure duration categories[11].

We simulated the hypothetical effective overall tenure tax rate based on these tenure-specific rates. The result is illustrated in Chart 16.

CHART 16: HYPOTHETICAL EFFECTIVE TENURE TAX RATES, 1980-1999



Source: DETR/LFS

As anticipated, the effective rate reflects the cyclical nature of the housing market, rising in periods of speculative activity such as the late 1980s. The tenure tax can be targeted more closely on damping speculation, a considerable advantage over stamp duty. It could also act as an automatic stabiliser across regions. If a particular region – such as London recently – experiences a sharp increase in the level of transactions, sellers there will face an increase in the effective tax rate, compared with other regions.

Despite apparent advantages there is room for doubt as to whether the tenure tax could be effective at these rates, particularly given the scant evidence that stamp duty has affected the number of transactions. If it were imposed at high enough rates so as to be effective it could have significant side-effects. While the main aim is to deter buyers from speculating the tax would be paid by the seller. If the majority of transactions that occur during a boom are purchases brought forward, it is likely that many of these will involve buyers intending to hold property for some time; these people would face a tax, even though they are not speculating. A tenure tax would deter sales by people who recently made purchases but find they need to move again soon – a typical situation for first-time buyers who are the most mobile part of the home-owning population – and could reduce their mobility. To avoid this side effect one might have to build in an exemption for first-time sellers.

Taxes on second properties

One way to speculate in housing is to acquire a second property when prices are rising fast. At worst, the excess returns from property speculation result in housing being hoarded, with some second residences empty for much of the year. Higher taxes on second properties could discourage this. Capital gains tax is already imposed when home-owners sell any secondary property, but increasing the rates charged on second homes would further discourage multiple-property ownership in areas where prices are rising fast and potential first-time buyers are being priced out of the market.

Other measures to discourage second home-ownership in such areas include:

- Higher rates of stamp duty on purchases of secondary properties; and
- Increased council tax charges. Currently most owners pay reduced rates on such properties, and the Countryside Agency has calculated that simply making the 224,000 second home-owners pay the full rate of council tax could raise £150 million a year. The Rural White Paper (November 2000) gives local authorities the discretion to charge full Council Tax on second homes.

However effective such policies might be at discouraging holding second properties, it seems very unlikely that they would do much to reduce price volatility. The second home market represents a very small proportion of the overall housing market. In 2000 CML research estimated that 2% of households in the UK (some 500,000 households) had second homes (Gilbert, 2000).

ENCOURAGING THE RENTAL SECTOR

The rental sector accounted for 7.9 million dwellings or 32% of Britain's housing stock in 1998. The Housing Act 1988 deregulated the supply-side of the private rental sector, allowing landlords to set market rents. However, there has only been a small rise in the size of the private rental sector since 1989 from 9.1% of the nation's housing stock to 10.6%. A larger rental market could have two types of desirable effects:

- It could help to increase labour mobility. Rented housing allows people to move without paying the fixed costs of owner occupation, and Cameron and Muellbauer (1998) found that people living in private rented accommodation have the highest rates of mobility of any segment of the population, even allowing for their age and other characteristics. A larger institutional private rental sector would help mitigate the kind of pressure on the labour market, which was evident in the south-east in the late 1980s.
- It could also reduce house price volatility. If housing moves between the rental market and owner-occupation, it can increase the flexibility of supply in the owner-occupied market. This effect occurs because rental prices adjust more slowly than owner-occupied prices.

At present, the tax system is biased against the rental sector – unlike owner-occupiers, landlords are subject to income and capital gains tax, and the council tax system also works against them. Even though the private rental system is growing it is still small. The small size of the rental sector in the UK is thought to be partly due to this tax distortion, and equalising tax treatment could promote the rental sector. So what could be done in this regard?

- Capital gains tax. The Government has recently introduced measures to reduce the tax burden on private landlords but more could be done. In April 1998, relief was granted on the capital gains of private landlords, provided they hold onto the property for a further ten years. This measure will thus take full effect only in 2008, and arguably the benefits would make it worth accelerating the phase in of this measure.

- Income tax. Full tax parity between owner-occupancy and private rental would require either that landlords' rental income be exempt from tax or that it be matched by a similar tax on the value of housing services in the owner-occupancy sector. A tax on the imputed rental income of owner-occupiers (ie, the rent saved by being an owner-occupier rather than a tenant, after adjusting for the costs of maintenance and property taxes) was levied in the UK up to 1964, and is still widely used in parts of continental Europe. Reintroducing such a tax would have the effect of taxing the large accumulated capital appreciation of houses in the South East, and would strongly discourage large cumulative price increases. Despite its theoretical appeal, it seems very unlikely that this could be justified politically, and levelling the playing field between the rental and owner-occupier sector through lower taxes on rental properties appears more feasible.

- Council tax. The bias against private rental reflects the fact that rental units are typically smaller than owner-occupied accommodation, and that effective council tax rates are higher for smaller properties. Accordingly, a policy of aligning property taxes more closely with the value of the property would help create greater parity. There is also a strong equity case for this – typical households do not pay significantly less than the most affluent households, and Westminster – one of the most expensive boroughs in England – has the lowest council tax rate. A property tax which makes more active use of different property valuation banding, allowing greater variations between and within regions, would assist the regeneration of the private rental sector and help reduce the potential barriers to labour mobility.

PLANNING RESTRICTIONS

Relaxing planning restrictions would make housing supply more responsive to prices. But land is scarce in the UK and covering greenfield sites in the South-east with new developments is not popular. Rather than relying on planning restrictions, one option would be to introduce a 'Greenfield tax' for new properties in the countryside, whose proceeds could be channelled into a tax breaks for Brownfield developments and conversions of derelict buildings to encourage the regeneration of cities. Proposals

already introduced in this respect include the Planning, Policy and Guidance Note 3 (PPGN3, March 2000) whose main objective is to improve the quality of housing development, together with the better use of previously developed land and existing buildings, thereby limiting the loss of green field sites. The policy target is that by 2008, 60% of all additional housing should be provided on previously developed land or through the conversion of existing buildings.

Much of the excess demand for housing is from first-time buyers, consisting of either a single individual or small family unit. There is a case to be made for offering incentives to developers to convert existing derelict tower blocks or buildings into low cost accommodation to meet this demand. Planning authorities could promote this policy by introducing a quota system, whereby a proportion of all properties on suitable housing developments are allocated to socially registered landlords or housing associations.

Policy is moving in the right direction, with the new planning guidance emphasising the importance of affordable homes and in the recent White Paper, the Government committed itself to encourage affordable housing in rural areas and market towns. In addition the 2001 budget announced a series of measures to increase supply:

- a 150% accelerated payable tax credit for owners and investors for the costs they incur in cleaning-up contaminated sites.

- 100% capital allowances for owners and occupiers for the costs of creating flats over shops and similar commercial premises for letting, enabling them to obtain up-front tax relief on their spending.

- a 5% reduced rate of VAT for the cost of converting residential properties into a different number of dwellings; for example, a house into flats;

- an adjustment to the zero rate of VAT to provide relief for the sale of renovated houses that have been empty for 10 years or more.

- extending the 5% reduced rate of VAT to the renovation of homes empty for three years or longer to bring more properties back into use; and

- extending the 5% reduced rate of VAT to cover conversions of residential property into residential communal homes such as care homes and homes with multiple occupation, helping those who are unable to live alone.

Although, these policies are helpful, given the relative size of the secondary market in housing compared to the market for new houses we doubt whether this in itself will be sufficient to effect price volatility. However, they could have an effect on mobility and reduce distortions in the labour market.

THE STRUCTURE AND AVAILABILITY OF MORTGAGE FINANCE

In a liberal financial environment like that of the UK, it is the behaviour of mortgage lenders and borrowers rather than official rules that mainly determines the outcomes for the housing market. Have borrowers and lenders taken this responsibility on board, or are UK mortgage lending practices contributing to high house prices and price instability?

High income multiples and loan to value ratios are often used to illustrate increases in the risk of lending. For instance, an FSA survey (1999) into lending practices found signs that the credit standards were falling. The survey found upper range income multiples towards three and a half or three and three quarters times prime income. Other lenders even raised the limit to four or even five times income. Average mortgage advances have generally increased over time, but have typically been limited to 90% or 95% of the value of the property. The FSA survey shows that in 1998 12% of all loans by established lenders were for between 95-100% of value (although CML figures show this to have abated since then).

More recently, the FSA has warned mortgage lenders about the high London house price premiums and income multiples which are both at historic heights. Howard Davis (Chairman of the FSA) also warned lenders to take account of the potential affordability problems faced by borrowers. Pointing out that: "One particularly worrying trend is the continuing rise in loans at high income multiples … The proportion of loans in this category has risen sharply and represented as much as a third of new lending in recent quarters." [Speech at the CML Annual Conference (December 2000)]. However, as we discussed in the previous chapter, lenders' credit scoring and risk assessment techniques have become increasingly sophisticated. Higher income multiples should therefore be seen in this context.

In a more controlled financial environment, it might be possible to directly restrict the loan to value ceiling to 80% or 85%, levels typical of continental Europe and often enforced by regulation in other countries. This type of policy would increase borrowers' required initial deposit, and would probably have its greatest impact on first-time buyers. It would probably be very effective at reducing risky mortgage lending, but would do so at a very large cost[12]. It would, for example, prevent lending to people who expect their incomes to increase, and restrict the behaviour of mortgage providers, even if they have made correct risk assessments. It would run counter to the overall tenor of policy towards financial services – of allowing firms and their clients decide for themselves within clear information and consumer protection frameworks.

It is also unclear whether current lending practices contribute to volatility or speculation, and accordingly whether lending restrictions would have much benefit in terms of dampening volatility or preventing speculation. The real grounds for concern in high income multiples and loan to value ratios lie in the risks they may pose to borrowers.

These concerns are better tackled directly through product disclosure and education to increase borrowers' understanding of the risks associated with house purchase. This would be especially timely now, as the FSA – which has championed such an approach for other financial services products – is taking over responsibility for the regulation of mortgages. For long-term investment products, the FSA has stipulated the disclosure of providers' 'persistency rates', which are thought to reflect frequency with which savers have been sold the wrong products.

In the case of mortgages, one possibility would be to publish providers' default rates. These rates could be stratified by loan to value ratio and income multiple in order to help borrowers to understand the risks involved.

CONCLUSIONS

Intervention in the housing and mortgage markets – if it is to occur at all – must not impede the functioning of the markets, and should be targeted on the specific goals of preventing speculative bubbles, regional price stabilisation, and protecting vulnerable borrowers. Accordingly, we believe there is a case for limited intervention. Amongst the policy suggestions that emerge are:

- A redesign of the transactions tax regime. One possibility would be to consider making the tax conditional on the length of time the property is held. This could help to combat speculative bubbles, and provide an automatic stabiliser across regions;

- Bringing forward the capital gains tax relief to be given to private landlords, and aligning council taxes more closely to property values, to help stimulate the private rental sector; and

- Disclosure of mortgage providers' default rates, stratified by loan to value ratios and income multiples, to help borrowers understand the risks they face in the housing market.

CHAPTER 5 Conclusions

The main findings of this report are as follows:

- The housing market has been highly volatile in the past. House prices have been almost as volatile as the stock market, and more volatile than the rest of Europe, but this does not in itself give grounds for intervention. Much of this volatility is due to a combination of shocks to demand and unresponsive housing supply, but speculative 'bubbles' also seem to have played a role.

- The fundamental conditions for housing price volatility remain. Supply is still unresponsive to prices, and there is little to prevent bubbles in future as the conditions for it are in place. However;

- The housing market will probably be less volatile in future. Many of the factors that caused booms and busts in the past, such as large swings in income and interest rates, and one-off events such as exceptional demographic pressure and financial liberalisation will be less pronounced. In addition;

- Macroeconomic and housing policies are moving in the right direction. A more stable macroeconomic environment both reduces the probability of demand shocks, and their impact through speculative behaviour. Policies on encouraging the rental sector and stimulating affordable housing are also likely to improve the working of the housing market.

- Evidence leads to the conclusion that measures that foster macroeconomic stability are also likely to tame housing market volatility.

- There are several labour markets arguments that suggest a need for intervention.

Policy proposals need to help dampen volatility when there is speculative activity, stabilise prices across regions, and protect vulnerable borrowers, without imposing large costs on the housing market. Consideration should be given to three areas:

- The form taken by transaction taxation. In this Report we consider a 'tenure tax' that exempts long-term residents. This tax could restrain the housing market only when transactions and prices are accelerating, as in a speculative boom, and would provide automatic stabilisation across regions. Despite apparent advantages there is room for doubt as to whether the tenure tax could be effective, particularly given the absence of evidence that stamp duty has affected the number of transactions.

- Stimulating the private rental sector. This could include bringing forward the capital gains tax relief to be given to private landlords, and aligning council taxes more closely to property values, to help stimulate the private rental sector.

- That mortgage lenders disclose default rates. This would allow borrowers to form appropriate assessments of the risks they are taking. In the longer term, this should also make speculative behaviour by home-owners less likely.

Notes

1 There is still some debate at to whether this will be robust over time. Holmans 1990 suggests this is only true if we consider a sample starting since 1968. Examining a longer time-series finds the gap between North and South has widened over time.

2 The elasticity is a measure of how price-sensitive something is. It is calculated as the percentage change in the supply of housing for a percentage change in price. An elasticity of 0.32 implies that a 10% increase in price would raise supply by 3.2%, whereas an elasticity of 9 means that a 10% price increase would cause supply to almost double.

3 It has also been argued (by Levin and Wright, 1997) that transaction costs do not represent a barrier to speculation at all for important classes of house-buyers. First-time buyers and those already committed to moving will see these costs as effectively 'sunk', that is, amounts they inevitably have to pay to obtain the house they want. This means that the level of transaction costs will only affect the decision to speculate for other classes of people.

4 For example, if a household has an 80% mortgage on a £100,000 house, it has housing equity of £20,000. If the house goes up in value by 10%, the household makes a capital gain of £10,000 and its equity increases to £30,000. If this is used as a deposit with another 80% mortgage a house worth £150,000 can be purchased.

5 Theoretically speculation could also occur through delays in contract terms or consumers taking advantage of bridging loans.

6 The propensity to consume is the ratio between consumption expenditure and total income.

7 Consumer detriment is the damage that consumers incur as a result of making insufficiently informed purchases. It is most likely to occur in the markets for complex, long-term products, and is not necessarily dispelled by effective competition among providers in these markets.

8 The effective rate of stamp duty was calculated by using Inland Revenue data to stratify property transactions according to sales price bands, which were then applied as weights for the various threshold rates. For instance, in 1989, stamp duty was charged at a flat rate of 1% on all property transactions over a £30,000 threshold. The total value of residential property transactions in 1989 was £82 billion, with the total value of sales involving property priced over £30,000 being £73 billion. Therefore, with 89% of the value of property transactions being subject to a stamp duty rate of 1%, the effective stamp duty rate was calculated as 0.89. This measure was continuously revised to reflect changes in the price distribution of property and changes in the regulations governing changes in stamp duty rates and thresholds.

9 Regression analysis is a statistical technique for finding the underlying relationships embedded in complex sets of data.

10 The basic model can be expressed as:

$$Prop_t = a + b\ SDR_t + g PMV_t + j\ D_t + e_t$$, where:

$Prop_t$ refers to the level of property transactions, measured by the ratio of the number of property transactions divided by the UK housing stock

SDR_t refers to the effective stamp duty rate

PMV_t refers to other property market variables (including the level of industrial production, mortgage interest rates, average earnings, UK house price index, inflation)

D_t refers to monthly dummy variables, designed to capture month of the year effects.

11 The hypothetical tax rates we used were:

Housing held for less than 1 year: 10%
Housing held for 1 to 3 years: 5%
Housing held for 3 to 5 years: 1%
Housing held for over 5 years: Exempt

12 The Government has recently taken an interest in the issue of over-indebtedness and responsible lending via the DTI's Debt Taskforce.

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