TRULY AS SAFE AS HOUSES?

HOUSE PRICES MAY BE RISING RAPIDLY IN MOST OF THE UK BUT THE MARKET IN LONDON IS A DIFFERENT STORY, SAYS **STEVEN BELL** OF DEUTSCHE ASSET MANAGEMENT.

The recent twenty-five basis point cut in UK base rates caught the city by surprise. In a display of pessimism remarkable even by economists' standards it was interpreted as 'what does the Bank of England know that we don't?'. The Bank of England Committee's statement mentioned lower than expected growth at home and abroad. Yet the controversy around the decision arises out of the interaction between interest rates, inflation and the housing market.

House price inflation has a direct impact on our targeted RPIX measure (which excludes mortgage interest payments, but not house prices) and it is possibly the dominant influence on the fluctuations in consumer spending. Rarely has there been greater divergence of opinion in the outlook for UK housing markets, with some predicting a continued boom and others predicting an imminent collapse.

The housing market bears point to the elevated level of house prices relative to incomes and note a number of parallels to the bubble conditions in the late 1980s. The housing market bulls note that, in terms of affordability, record low interest rates mean house prices could rise much further before straining the bank balances of borrowers. So, who is right?

To answer this question, we must consider the key drivers of the housing market. In this, there should be relatively little controversy. In the UK, the supply of new homes is negligible relative to the outstanding stock, so over any reasonable period we can ignore supply. Demand has, as its number one influence, the number of people. Income is then the most important effect, after which we have interest rates and credit conditions more generally.

BOOMS AND BUSTS. The explanation for why house prices have risen so strongly in London in both absolute and relative terms can be easily traced to the relative economic performance of that region. In 1995-2000, London had the highest growth in wages and the highest growth in employment. Indeed, there was a substantial influx of highly-paid foreign workers. (I discussed this issue in my last What Next? contribution in *The Treasurer*, July-August 2002). Those sectors in which foreign workers are predominantly employed – international finance, media and global technology – are all now in a severe downturn, with no end in sight.

Employment and incomes have been cut very hard in those sectors. As a result, the top end of the London housing market has fallen substantially. However, we do not see this in the statistics published by the Halifax and Nationwide, which exclude higher priced properties. It is also difficult to detect this effect in other indices that are not adjusted for the changing mix of properties. Nonetheless, there is no doubt that higher priced properties in London have suffered declines of 10-25% over the past year. It is also clear that prices in the normal bracket in London have not declined though their rate of increase has slowed.

Outside of the London commuting zone, the local housing market has benefited from the number of returning migrants who have lost their jobs in London. Just as this depresses property prices in Fulham, so it raises them in Newcastle and elsewhere. Moreover, as the weakening property market in London has eliminated the risks of a rate rise, so the whole swap curve has rallied, which has fed through to lower fixed rate mortgages. It is now possible to get a three-year fixed rate mortgage for 4%, compared with 6% two years ago. The weakness in London's economy has therefore boosted property prices outside the M25.

SIMILAR TO THE 1980s. A similar phenomenon occurred the last time house prices weakened in London in the late 1980s. The market peaked in August 1988 in London and the South East, but the boom began in 1989 in other regions. Eventually house prices fell almost everywhere in the UK as interest rates and unemployment rose. But that does not need to happen this time round.

HARD OR SOFT LANDING? I think the debate between 'hard' and 'soft' landings for the housing market misses the point to some extent. We could easily have a hard landing in some regions, which aggregates up to a soft landing for the UK as a whole. Recent house buyers in the higher priced regions of London have already had a hard landing. A more interesting issue, in my opinion, relates to the question of whether we will have a mild credit crunch later this year.

In recent years, there has been an explosion of credit extended to the UK household sector. As interest rates and unemployment have declined, there has been an improvement in the credit performance of borrowers. Credit scoring systems inevitably reflect this. To the extent that interest rates and unemployment remain low such an improvement will be sustained.

However, there is another factor that credit agencies always fail properly to take into account. By extending credit to new sectors, lenders provide a safety net for poor quality credits, which reduces the default rates on existing credit. Consider, for example, an individual who is struggling to repay their mortgage and car loan and is bumping up against the limit on their credit card. Suppose that a new credit card company gives him or her a deal to transfer their balance and expand their credit limit by, say, £5,000. They will find it easy to meet all their payments on existing credits – until they exhaust this new higher credit limit.

This may take six months, a year, or even more. Eventually, of course, if they are living beyond their means, the default will occur but on a larger scale. I expect some lenders to suffer significant problems as a result of the over-extension of credit in the higher end of the London property market, particularly in buy-to-let. Although buy-to-let mortgages are normally not offered on 90-100% loan-to-valuation ratios they are disproportionately in new build where prices can weaken markedly.

KNOCK-ON EFFECTS. If the weakness in the labour market in London continues and a broader-based credit problem occurs, lenders may take fright and curtail their extension of new credit through the UK. This could cause a double whammy, which reduces sharply the ability of marginal borrowers to obtain credit with consequent effects on consumer spending.

If this happens, will I therefore expect a hard landing for the UK economy? After all, consumer spending has been the bedrock of our continued steady expansion. With a substantial increase in National Insurance contributions due in April, the answer you might think is "yes". In fact, if there is a slowdown in consumer credit, consumer spending and the housing market, I would expect the Bank of England Monetary Policy Committee to respond quickly with lower rates. In these circumstances, base rates could easily be cut further, perhaps to 3%. This would provide a substantial support to consumers, limiting default rates, boosting credit demand and credit supply and mitigating any decline in house prices more generally.

STILL A STABLE MARKET. The housing market will not collapse in this cycle, although certain sectors will see major house price declines. The consumer may have a more bumpy ride in 2003 but the ultimate balance of the economy with inflation this low should be steered comfortably by the Bank of England.

Ironically, perhaps, it is a strong recovery in the world economy that offers the greater threat to the housing market: in those conditions, the Bank of England may feel able to raise interest rates and this could put into reverse some of the gains that have occurred from interest rate reductions in recent years. But vigorous world growth and interest rate rises in Euroland and the US seem a long, long way off yet.

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FIGURE 1
RATIO OF HOUSE PRICES IN THE NORTH TO LONDON.

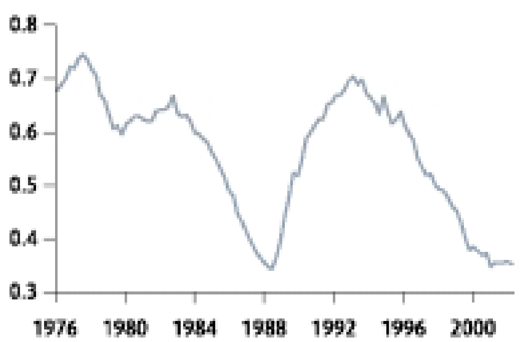


FIGURE 2
EMPLOYEE JOBS (SEPT 1995=100).

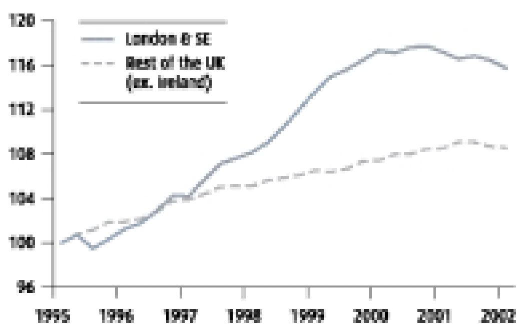
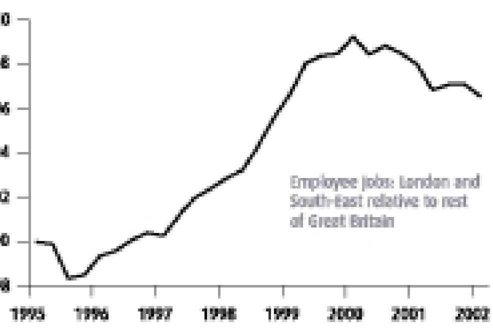


FIGURE 3
LONDON JOBS BOOM OVER. (SEPT 1995=100)



Source: ONS and DeAM