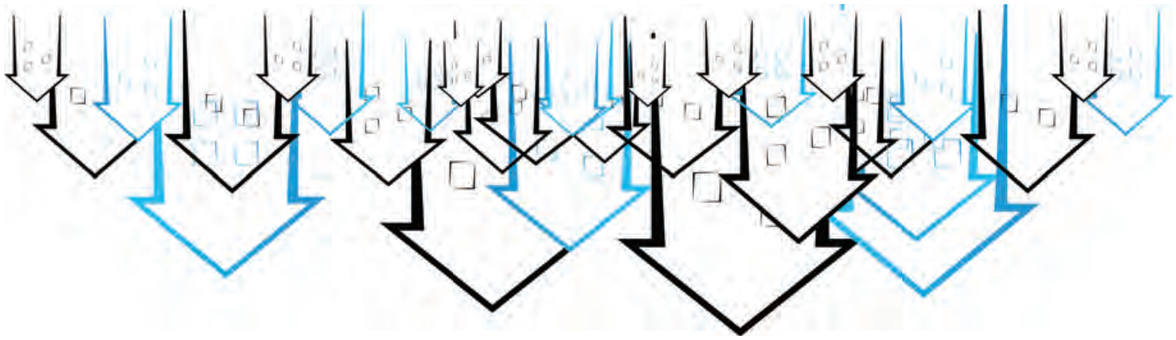

THE MORTGAGE MINEFIELD

Will we ever learn from the housing bubbles of the past? wonders Rob Wood

Economies have enough problems without politicians making more. The UK chancellor's huge mortgage guarantee scheme will just make the housing market problem worse. It will push up prices, which could come back to bite the UK in a few years. It is not a risk worth taking.

Household finances are under tremendous pressure and subsidising mortgage costs seems like one way of helping. But the Help to Buy scheme will be only a short-term sticking plaster. The government will guarantee up to 15% of a mortgage if the buyer puts down a 5% deposit, cutting the cost of a mortgage.

Unfortunately, that will ultimately worsen housing affordability. Raising supply – not increasing demand – is the only solution to high house prices, and supply is unlikely to respond very much to this scheme. House prices trebled between 1995 and 2007, but led to only 25,000 more housing starts each year.

The government's scheme will mostly just push prices further out of reach. Then, with housing affordable only with a subsidy, it will be difficult for the government to withdraw the aid, meaning this temporary scheme could become permanent.

Higher prices mean households stretching themselves further and running greater risks in the event that their circumstances change. They also make the wider economy more vulnerable. As the government-sponsored Barker Review put it: "The consequences of the way in which the housing market operates should be a concern for everyone."

The housing market is already recovering rapidly across the whole country. Estate agents say buyer interest rose at the fastest rate on record in August. Yorkshire and Humberside saw the second-fastest price rises in the country after London in the third quarter, according to building society Nationwide. Prices in Manchester rose 10% a year earlier, faster than London's 7%.

Admittedly, the market is recovering from a depressed position relative to its peak, but economic policy needs to look beyond the here and now. If prices rose by a 10th over the next year, as surveyors signal, we would be halfway back to the previous peak.

Importantly, prices are not recovering from historically low levels. The house price to earnings ratio is 20% lower than its bubble-time high in 2007, but 20% higher than its long-run average.

Housing is a good signal of what is happening in the wider economy. European Central Bank president Mario Draghi's magic words last summer and the Bank of England's Funding for Lending Scheme lowered bank funding costs. The resulting tumbling mortgage interest rates, improving mortgage availability and rising optimism are driving a consumer-led recovery, reflected in house prices, too. The market failure that the mortgage scheme is meant to address – an under-supply of risky, low-deposit mortgages – is easing.

The Bank of England now faces a quandary. If it takes action to slow the housing market, it would be like taking away a punch bowl that George Osborne is pushing out. The bank would be using untested tools and working against its own policy of keeping interest rates low. Big rises in house prices may ultimately make the bank more cautious about withdrawing stimulus when the time comes, because it will be hard to judge how stretched the household sector is.

The UK economy should see a strong second-half performance this year, engineered by persuading consumers to spend more and save less. Policy is working and the economy is on the recovery track now. Help to Buy would be a risk too far. This cycle has a long way to go yet, but higher house prices make the economy more vulnerable rather than stronger. This subsidy scheme will push up prices without solving any of the real problems. Will we ever learn?

Rob Wood is UK economist at Berenberg Bank