Housing & The Economy: Current Controversies

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The Transmission Mechanism from Housing to the Economy

- **20 years ago, few economists thought housing was important (3%-4% of GDP). Many still do not! However, 4 events changed the view:**

(i) The unexpected rise in consumers' expenditure in the UK in the late 80s ➔ a housing wealth effect.

(ii) UK's decision not to join EMU in 2003 – partly due to structural housing market differences.

(iii) The support provided by housing to the US economy in the early years of the century – again a wealth effect.

(iv) The effects of the credit crunch.

Potential Routes

- **Contributions to aggregate demand – primarily consumers' expenditure (approximately 60% of GDP) → wealth effects, collateral for loans, lower interest rates under asymmetric information.**

- **Contributions to aggregate supply – directly through housing supply, but also through crowding out or crowding in of private investment. Also effects on migration.**

The Transmission Mechanism from the Economy to Housing

- **Less controversial that the macroeconomy affects housing.**

- **But the causes of the boom and slump are still controversial. Was it due to a bubble or was it due to fundamentals? This matters a great deal for policy.**

Housing & The Economy: Macro Housing Policies for the Future

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3 Questions

- **What are the key drivers of instability in housing markets?**

- **Why has the UK borrowed so spectacularly over the last 10 years or so?**

- **What policy changes are most effective in bringing stability?**

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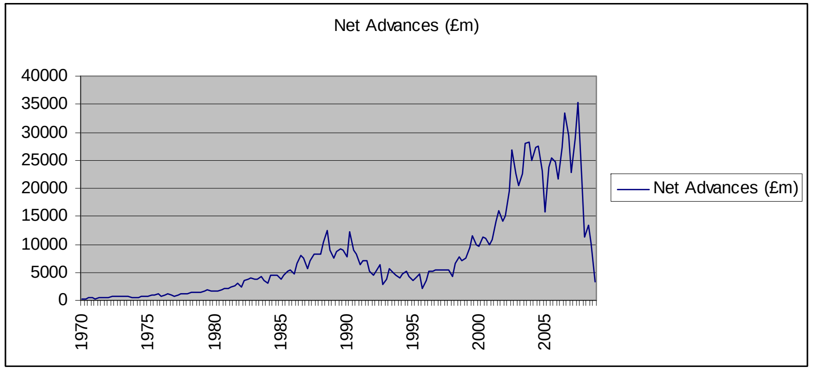
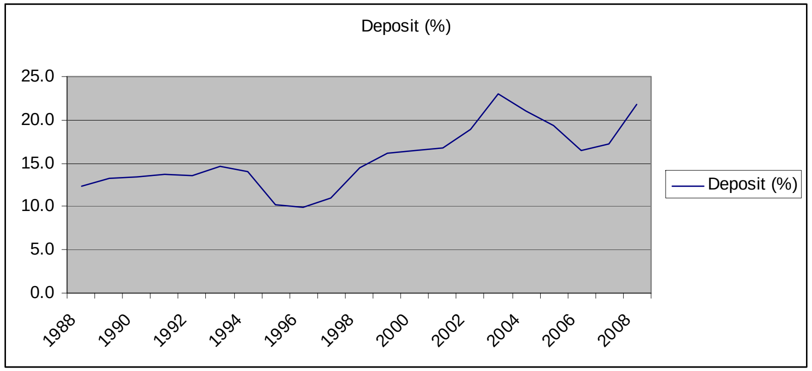
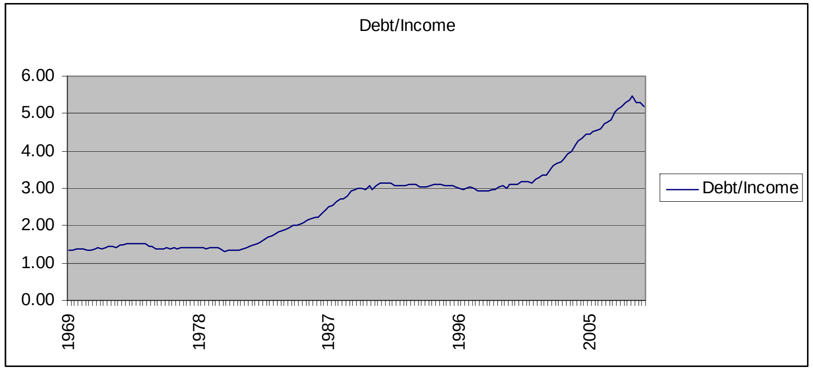
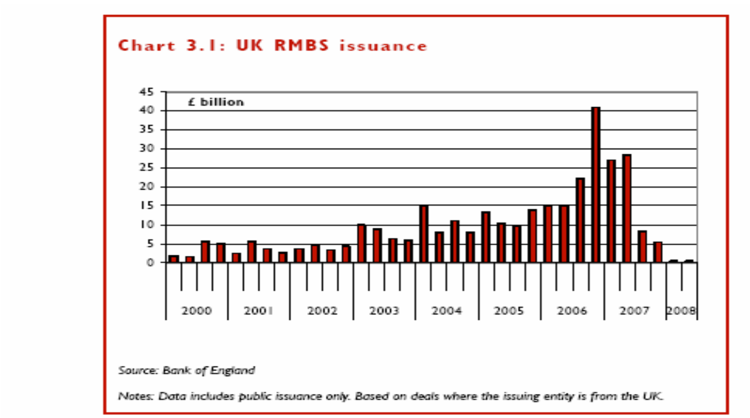
Key Lending Indicators









Home Ownership by the Young

Home-Ownership Rates (%)

	Aged 20-24	Aged 25-29
1984	35	60
1988	41	64
1993/4	34	59
1996/7	28	54
1999/0	27	54
2005/6	20	46

Issues (1)

- **The appropriate policies for the future depend on the causes of the last boom/slump – fundamentals versus bubbles.**

- **There has been a tendency (at least in the UK) to assume that the boom was a pure bubble and the market is overvalued. This is far from clear from the econometric evidence. Fundamentals appear to have been very important.**

- **Despite the increase in mortgage debt, the proportion of the under 30s who are owners has fallen sharply and the aggregate ownership rate has been constant this century at 70%. Are mortgage markets fulfilling their primary function?**

Issues (2)

- **But there has not been a shortage of mortgage funds since the early 80s. Is there a case for securitisation? Securitisation in the US arose from a particular set of institutional characteristics in the 1930s. Is it the case that "one size fits all"?**

- **Mutual lenders have generally (although not always) fared better than the banks. Is there a case for local banks, because of asymmetric information, relying more on retail deposits?**

Issues (3)

- **Long-run affordability problems have not disappeared. Increases in housing supply reduce the likelihood of similar future events.**

- **Even if the aggregate ratio of mortgage debt to the market value of the housing stock is constant in the long run, the ratio of debt to income will still be rising, increasing the riskiness of the system to external shocks.**

- **House prices are unpredictable, but not because they are efficient. Ignore any short-term house price forecasts!**

- **General inflation targeting may add to the instability of housing markets (if supply is inelastic), but should central banks target asset prices?**

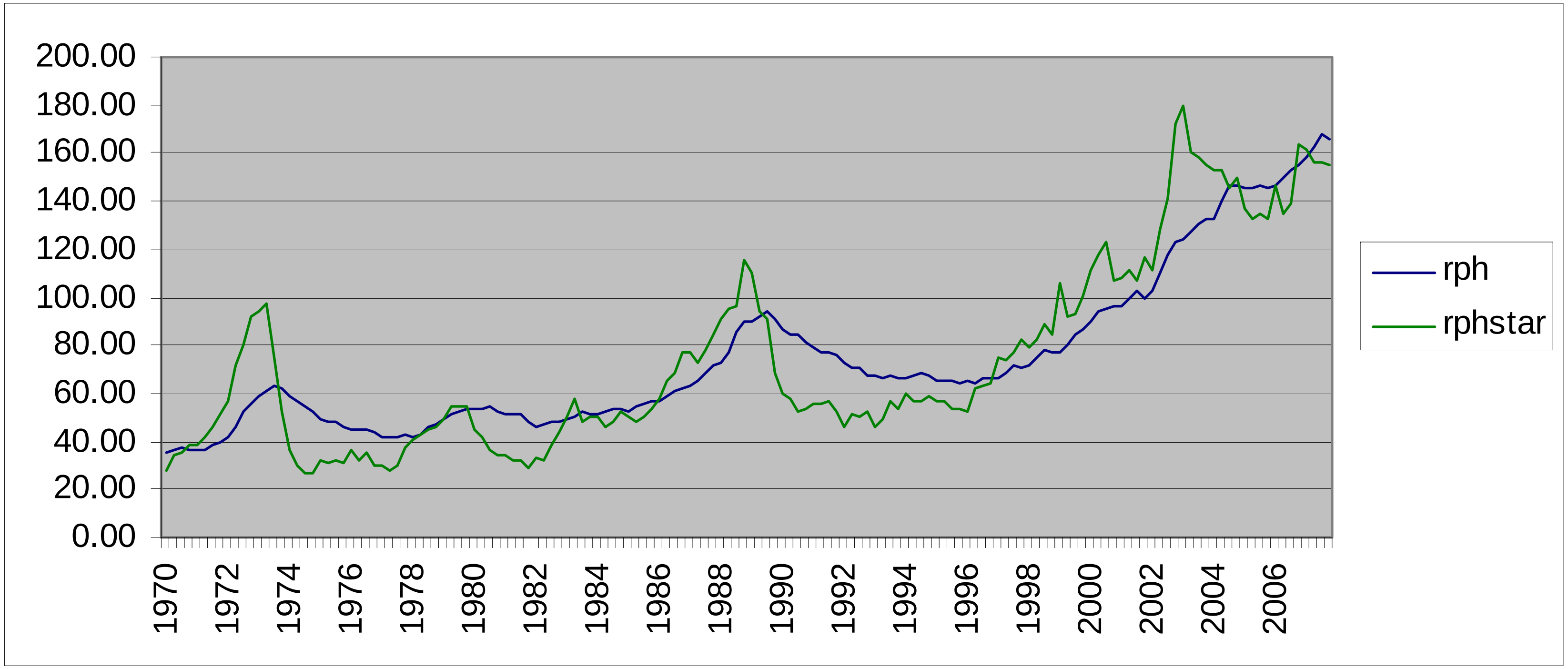
Can conventional price models explain the boom?

- **Based on Meen (2008, Urban Studies), extending the data to 2007.**
- **Conclusions:**

(i) The coefficients of the price model are stable. Models estimated up to 1996 can forecast the period to 2005 fairly well.

(ii) There is some evidence of over-valuation between 2005 and 2007, but small compared with some estimates e.g. IMF.

Actual and equilibrium real prices



Lending Controls and FTBs

- Mortgage credit shortages are not new. They were a standard part of the market until the early 80s.
- Controls were tried in the 70s but were not very successful.
- More fundamentally, controls on LTVs would target FTBs because (i) existing owners already have high equity (ii) FTBs are the group most at risk. But, from the above:

(i) FTBs generally already require large deposits

(ii) Arguably, they are not the underlying cause. Rather if, for existing owners, the income elasticity of housing demand is high and with weak supply, real prices will rise, squeezing FTBs. Arguably borrowing controls on existing owners are more appropriate.

(iii) This also implies that the debt/income ratio rises over time, increasing market risk.

A return to mutualisation?

- Building societies, although not immune to the credit crunch have generally fared better than banks.
- They rely less on wholesale markets.
- Do we need more local banks with local knowledge relying on retail funds?

Long-Run Affordability

- **Unless credit shortages are permanent, affordability problems will return since there remains an underlying housing shortage, generally choked off by a rise in real prices.**
- **Credit restrictions have their main effect on the timing of entry to ownership.**
- **NHPAU model predictions suggest a return to trend in the medium term and there could be overshooting if credit constraints disappear.**

Asset Price Targeting

- **Greater emphasis on asset prices has been suggested by some. But central banks have generally not been keen.**
- **This needs a good understanding of house price dynamics and, if bubbles occur, the appropriate policy response is far from clear.**
- **But there can be an inconsistency between general inflation targeting and housing market stability, particularly is housing supply is inelastic.**

House Price Forecasts

- **There is still disagreement whether housing is the underlying cause of the credit crunch or merely a trigger to deeper problems e.g. perverse incentive structures.**
- **But accurate house price predictions are a requirement.**
- **Having spent many years carrying out short-term house price forecasts, my view is that the error margins are so large, that the basis for valuing mortgage-backed securities is very weak.**
- **Good models of the past can be constructed, but this does not mean they can be used to predict the future.**
- **Need for policies that are robust to a range of possible market outcomes.**