



PricedOut.org.uk
The campaign for affordable house prices

Note on HM Treasury Prime Ministerial Briefing 'UK Housing Market Trends'

This briefing was requested by the Prime Minister in April 2004 after he had read the article by Martin Wolf in the Financial Times 'A housing collapse draws nearer'¹ which highlighted the author's concerns about a bubble in UK housing and its vulnerability to a price correction.

Key text in the Martin Wolf article:

"Since 1956, UK house prices have risen, in real terms, at a trend rate of 2.1 per cent a year. Over the long term, this has made housing an excellent investment. But house prices have also gone through huge cycles. At their peak in 1973, prices were 43 per cent above trend. In 1988, they were 36 per cent above trend. At the end of last year, they were 37 per cent above it. Given this history, it is reasonable to worry about a house price fall.

When Tony Dye, of Dye Asset Management, says UK house prices could fall by 30 per cent over the next five years, people should listen. He was right about equities when legions of bulls were wrong. He could well be right now, since such a fall would only bring prices back to trend levels.

Far less plausible than Mr Dye's view is the belief that the torrid rate of house price increases will slow smoothly, leaving price levels comfortably poised at what had previously proved a giddy level. If this were to happen, the fundamental determinants of house prices must have shifted in an extraordinary way....

Only one argument can be made for the view that current house prices are supported by a change in fundamentals. This is "affordability", which points to low nominal rates of interest and the consequent modest level of debt service obligations.

This argument runs into three difficulties. First, it conflicts with the equally ad hoc argument that houses are a hedge against inflation, used widely in the 1970s. Second, no empirical work finds the level of nominal interest rates a determinant of the real price of housing. Third, it suggests that a change in nominal interest rates should affect the real quantity of housing services people wish to consume over their lifetimes.

The conclusion is that we are seeing a classic bubble. Optimists will respond that sceptics said just this a year or two ago. But the market has not become safer because it has continued to rise at unsustainable rates. On the contrary, it has become less safe, just as the stock market was no safer in early 2000 than in 1996, after three years of massive price rises, but less so.

The one bullish argument remaining is that the housing market is not like the stock market. That is true. Unfortunately, the differences make it more vulnerable to bubbles, not less: it is impossible to sell housing short; it is painful to move out of the house in which one lives; and it is disconcerting for potential buyers to watch houses become more expensive year after year.

¹ 'A housing collapse draws nearer' Martin Wolf, Financial Times, 16th April 2004

<http://www.economics.ox.ac.uk/members/andrew.farlow/Newspaper%20articles/The%20Financial%20Times%20Newspaper%2016%20April%202004.pdf>

All these are reasons why momentum can dominate the market. The very success of macroeconomic policy has also allowed the momentum to continue longer than before. Yet the result is not safer house prices. Nobody knows when the bust will come. But come, I believe, it will.” (Copyright: Financial Times)

Political Observations

The briefing obviously highlights Tony Blair’s interest in the issue of UK house prices, and his nervousness about potential price falls. It does at least show that Blair was concerned about potential warning signs being reported by respected economic commentators and was asking for informed advice about possible government responses. Unfortunately the advice he received from the Treasury as a result was poor.

It sheds some light on the state of Number 10 and Treasury relations. The document suggests Tony Blair’s distance from a key area of domestic economic policy and contains a strong sense of the tension between the two parts of government – with what appears less than full disclosure of HMT policy discussions and dilemmas.

For a civil service briefing some of the material here is strikingly political in tone and would not appear out of place in a Brown speech of the time. See for example paragraph 37 *“due to Britain’s forward looking and pre-emptive approach to macroeconomic policy”* or paragraph 26 *“The success of the new economic policy framework in delivering economic stability with low interest rates and strong labour market outcomes”*.

These paragraphs suggest that the Treasury had to some extent ‘fallen for its own hype’ and failed to maintain a proper sceptical distance between the Ministerial world view and what should be a more long sighted civil service perspective.

Observations on Buy-to-Let and First Time Buyers

Unlike government and Treasury public statements since 2004 and up to the present day², this briefing is interesting in demonstrating the ***government’s knowledge that the new Buy-to-Let sector was strongly likely to be leading to the substantial displacement of First Time Buyers from the UK housing market.***

Yet despite this, there has been no indication from government about whether this trend is a desirable outcome for government housing policy, and if it isn’t, what steps could be taken to address the issue.

See for example the following extracts from paragraphs 9, 10, 11 and 12:

- *“Another notable feature of the housing market has been the decline in the proportion of first time buyers (FTBs) taking out loans for home purchase. By the end of 2003 the proportion of loans for house purchase to FTBs fell to an all time low of 28 per cent, well below its post 1993 average of 46 per cent.”* Paragraph 9
- *“FTBs have become ‘deposit constrained’... This may impinge upon rates of household formation. If FTBs are unable to afford a home then they could remain within their parents household for longer than desired”* Paragraph 10

² See for example the current Treasury Consultation Paper on the Private Rented Sector:

http://www.hm-treasury.gov.uk/d/consult_investment_ukprivaterentedsector.pdf

- *“However, the falling numbers of new entrants has not had the expected cooling effect on the housing market as the growing trend of buy-to-let may have taken up much of the slack.”* Paragraph 11
- *“The Buy-to-Let market has seen significant growth in recent years ... The increase in activity may have the effect of crowding out FTBs, as typically, rental properties and those being sought by FTBs often have the same characteristics”.* Paragraph 12

Observations of the Quality and Nature of the HMT Analysis

There are several striking, and worrying, elements to the quality of this HMT analysis.

It **highlights a noticeable weakness of HMT in-house analytical capacity on the UK housing market.**

- The paper fails to examine in any detail the substantive and well argued concerns of Martin Wolf’s article – even getting the title of the original article wrong. It glosses over Wolf’s arguments on affordability and his cautions against thinking prices would ‘slow smoothly’.
- The briefing is over reliant on data from RICs and Rightmove – neither of which are the most robust sources of housing market data.
- It is also highlighted in the lack of citation of internal HMT analysis (suggesting there wasn’t very much...)
- The sharing of analysis between the Treasury and the Bank of England appears very weak – with the paper only citing quotes from Bank speeches and MPC minutes (which would have been readily available on the internet) and giving no suggestion that the Treasury has seen or analysed the underlying Bank calculations – and any possible private Bank policy concerns. Given the importance of co-ordination and joint responsibility between the Bank and HMT on housing market stability this is a worrying gap.
- There is very little mention of academic or economist work that was occurring at the time (for example there is no mention of the then recently published papers from Andrew Farlow at Oriel College, Oxford that was heavily cited by Martin Wolf or of the several econometric and financial analyst studies that were suggesting an overheating UK market at the time)

There are several elements **that suggest that the Treasury was becoming worryingly complacent and short term and had major lacuna in its policy analysis.** This includes:

- Underplaying what was then a red hot rate of price growth of 20% + per annum during 2002, 2003 and 2004 (for example paragraph 36 *“in comparison to the late 1980s, current rates of house price inflation relative to income growth may be more sustainable than at first apparent”*) which should have been much more concerning to any responsible policy maker at that time.
- Taking a world view that seems to forgot about the cyclical nature of the UK housing market – almost slipping into ‘it’s different this time’ without sufficient analytical justification (see paragraphs 27 and 28: *“it must also be noted that there may well have been an upward adjustment in the equilibrium level”* and *“There are good reasons to think that the long-term level of house prices relative to earnings has risen because ... [of] the success of the new economic policy framework in delivering economic stability”*)
- A complete lack of any examination of the role of mortgage finance and new mortgage lending models in increased levels of demand and higher prices. By 2004 many of the main financial

innovations that would prove so damaging were already in place and growing rapidly – for example the growth of RMBS and securitisation in mortgage financing had already started, as had the growth of niche sector mortgage lenders (particularly in the Buy to Let sector) as well as the rise of new larger UK mainstream mortgage lenders with new financing models (for example Northern Rock, which had launched its controversial ‘together’ mortgage as early as 1999).

- The briefing fails to address the potential problems associated with greater levels of risk-taking due to the sustained period of low interest rates; indeed the fact that this made people *“more confident in entering the housing market”* (paragraph 28) is seen as an unproblematic positive. (See also paragraph 26 *“The success of the new economic framework in delivering economic stability with low interest rates and strong labour market outcomes has made people more confident in taking on new risks.”*)
- Surprisingly there is not a single suggestion within the briefing paper for ways in which government might consider policy changes to help dampen the booming housing market, temper the explosion in high risk mortgage financing or reduce the level of risk that these trends posed to the wider UK economy.

Quotes from PricedOut to go with the story

General:

“Brown’s Treasury was asleep at the wheel in spotting the clear dangers from an overheating housing market. This briefing highlights a Treasury that was complacent, analytically weak and worryingly party political”

“There was a red hot and overheating UK housing market when this briefing was written. The role of the government department responsible for economic stability should have been much greater caution – seeking to slow obvious excesses developing in mortgage lending and the Buy-to-Let sector.”

“The Treasury’s failure has caused great damage to the UK economy and to society at large – damaging First Time Buyers and Owner Occupiers alike.”

“This briefing clearly set the approach for Treasury policy as the UK sailed towards the credit crunch – to do nothing.”

“It should raise serious doubts in the next government’s mind about the level of expertise within the Treasury on UK housing policy and the dangers of overreliance on a department which so obviously failed to ask the tough questions needed to ensure economic stability”

Buy-to-Let / First Time Buyers specific:

“This document shows that the government knew that First Time Buyers were being priced out of the housing market by the Buy-to-Let sector – but were happy to do nothing to stop this happening”

“As early as 2004 the Treasury recognised that Buy to Let was having a significant damaging impact on First Time Buyers, yet no changes to government policy were made”

“This shows a government more than happy to benefit from the feel good effect of rising house prices yet unconcerned about reigning in the negative social consequences.”

“Government public statements to be helping First Time Buyers were in private being undermined by the government’s failure to act on its own analysis”

“Sadly little seems to have changed, even after all the damage inflicted on the UK speculative housing investment. The Treasury is currently planning further tax breaks to Buy-to-Let investors, which can only further push First Time Buyers away from the dream of ever owning their first home”.

William Griffith, PricedOut

Mobile 07810 821501