

# What extent could government policies affect house prices



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In 2009 British house prices has first to their annual decline since at least 2002. According to the British media, home prices in London actually faced the worse prices down 5.3%. The London Housing Prices are perhaps one of the most popular issues of discussion in UK. To some extent this is due to the fact housing prices have nearly trebled since the mid 1990s. Because of this landlords have seen huge gains of wealth which has left with a apparently impossible task for those trying for buying a house.

Since the Wall Street crash in 1929, the economies situation in 2009 was described as ' the worst financial crisis. The unemployment, credit crunch, failing banks and businesses led the economy into a prolonged recession. The UK housing market is cyclical and is quite familiar with the booms and busts of the economic cycle. The UK housing market is very fundamental sector in the economy. The country performance as a whole is closely related with the performance of the housing market. Before the crises the situation of the country's economy was that there was huge amount of money flowing in the economy, due to attractive demand banks were confident to lend the money, but the dealings of 2009 came about when the banks failed to collect all the money back they lent, therefore they reduced their lending which leads to collapse of large banks in the market. Ultimately the result effected the consumers that now it became difficult for them to obtain a mortgage from banks. Now the only way to get hold on a house left with cash transaction which results in fall in demand for housing. People started to rent a house rather buying. Therefore, a decrease in demand for housing results in house prices were failing.

This is perhaps due to the factors that determine the prices of houses in a free market. So if we study the last three years of the housing market it will show us a very interesting picture. But at this stage we need to take into consideration those factors which affect the housing prices. Following are the key factors that play a very important role to determine housing prices in a free market

Source: <http://www.mortgageguideuk.co.uk/house-prices/what-factors-effect-house-prices/>

## **Factors That Affect House Prices in UK**

House prices are affected by a combination of supply and demand factors.

### **Demand Side Factors:**

These are the basic factor which plays an important role in determination of the house prices. If demand is higher than the supply housing prices will increase and if demand for the house is lower than the supply ultimately prices will decrease. The new housing society's development is very low in UK as compare to demand, which is the fundamental reason for higher housing prices. For house prices to fall, the demand would need to fall extensively.

Of course there are many factors that determine demand for houses.

Economic Growth / Real income.

High economic growth and diminishing unemployment increases disposable income meaning people can spend more on buying a house. It also increases

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confidence in buying a house. Moreover, the significant rise in Per Capita Income enables people to spend more on buying a house in a free market. By tradition, the mortgage ratio was 3 times of the salary. For instance, if there is a person who earns £20, 000 the building society would lend him £60, 000. Therefore, rising incomes leads to rise in housing demand which further enables house prices to rise.

On the other hand if the economy goes into a recession and unemployment rises, the demand for buying houses would fall significantly.

### Interest Rates

Interest rates affect the cost of paying for a mortgage. Mortgage Interest Rate is the most important factor that affects housing prices. The cost of interest payments on mortgage depends on the interest rate set by the Bank of England. If interest rates are raised, the cost of mortgage repayments rises this discourages people from buying and it may force people to sell. For instance, in 1992 interest rates were rose over 12% which caused a large fall in demand for housing and house prices fell. However, in 2009 interest rates have been cut very low (1. 5%) but demand is still falling. Though it is cheap to pay a mortgage, but, this is outweighed by the fact mortgage availability is low and confidence is low.

### Availability of Mortgage Finance

Study shows that in 50s, 60s and 70s, there were strict restrictions about the availability of finance. However, with the increase in deregulation of the banking sector there has been rise in competition in the number of mortgage

products like interest only, self certification mortgages and mortgages up to 6 times income have enabled people to get more mortgages, which leads to increasing demand for housing. However, during the credit crunch of 2008, the number of mortgage products on offer fell due to a deficiency of finance in the money markets which leads to decrease in demand.

### Demographics / Population

The growing levels of net migration are increasing demand for houses. The immigration from Eastern Europe, like Poland and Romania are enhancing the UK population. Therefore, initiating increase in demand.

Moreover, growing number of households are demographic changes such as number of people living alone. E. g. rising divorce rates have raised number of single people living alone.

### Future Price Expectations.

There is an aspect of hesitant buying in the housing Market. This is mainly the case in the buy to let market. When people look forward to falling house prices in 2008, it may give confidence to people to sell and cash in their capital gains. If we are not careful falling prices can create a multiplier effect where others are positive to sell. Obviously, most people buy a house to live in, not as an investment. But, diminishing prices will encourage some prospective homeowners to rent rather than buy.

### Speculation

Everyone doesn't buy a house to live in it. An increasing number of property investors buy houses to try and make both capital gains and income from renting. During the past few decades the number of buy to let investors in the UK has risen. Although UK house prices have increased faster than inflation, renting has also become expensive which is the main substitute to buying a house.

## **Supply side Factors**

This is a second most important factor that affects the housing prices in a free market. A decrease in supply is also responsible to raise housing prices, especially in long term. Some predict UK housing prices will significantly rise in long term due to long-term shortage of supply. In the US housing market, they currently have a surplus of supply so a bounce back in the property market is unlikely.

In the short run Supply of housing is fixed because it takes time to build houses. Therefore in the short run demand affects prices more than supply.

However if the supply of housing is inelastic then an increase in demand will lead to a big increase in price.

In the long Run the supply of housing is affected by many factors:

### Market Reaction

If people observe house prices increasing and they expect prices to keep on rising, more people will buy a house. Also, when confidence in the market is high, lenders are more willing to lend mortgages with small deposits / large

income multiples. But now in 2009 confidence is very low, people see house prices falling so don't want to buy and banks don't want to lend mortgages without a big deposit.

#### Location

The locality causes major variations in UK house prices by geographical area. Even within different areas of London, house prices can vary terrifically.

Availability of planning permission. This is difficult to obtain in rural areas.

Opportunity cost for builders e. g. are there better returns from other types of investment.

Existing houses may be knocked down because they are deemed unfit to live in.

An increase in the cost of building new houses will shift supply to the left.

In the UK, it is argued there is a significant shortage of housing is this explains why house prices have risen much faster than inflation and earnings. However, in the US, the supply of housing increased in the period upto 2008 and therefore, the excess supply and falling demand led to a big fall in demand. However, it is important to note that house prices can still fall, even if there is a shortage of supply. In 1992, house prices in London fell over 20%, even though we can say supply is inelastic. A shortage of supply just means they will be on average higher. It doesn't mean they are incapable of falling.

**[http://www.uk-houseprices.co.uk/housing\\_market/factors\\_affecting\\_prices.html](http://www.uk-houseprices.co.uk/housing_market/factors_affecting_prices.html)**

## **Why House Prices are falling in the UK**

Since the peak in July 2007, UK house prices have fallen considerably.

Following are the main reasons for falling house prices:

Difficulty of Getting Mortgage due to credit crunch.

Low affordability (high house price to income ratios)

Economic recession and rising unemployment.

Nobody wants to buy when house prices are falling.

## **Government Interventions in Determining the Interest Rate in UK**

It is the responsibility of Monetary Policy Committee (MPC) and Bank of England to set Interest rates in UK. The MPC works independently from the Government. Before 1997, interest rates used to be set by the Chancellor. It was argued, with a degree of justification, interest rates were subject to political motivation. The government now just sets the MPC an inflation target of  $CPI = 2\% \pm 1$ . The MPC aims to keep inflation as close to this target as possible. If inflation is above or below this level, the governor of the Bank of England has to write a letter of explanation to the chancellor. In theory, they only target inflation; however in practice they may consider the effects of interest rate changes on economic growth, unemployment, and to a lesser extent the housing market and the exchange rate.



## **[http://www. articleclick. com/Article/Factors-that-Affect-Property-Value/2491](http://www.articleclick.com/Article/Factors-that-Affect-Property-Value/2491)**

The Government is in a way trying to prevent house prices falling by:

Bailing out banks and encouraging them to lend e. g. RBS, Northern Rock etc.

The MPC is drastically cutting interest rates to make borrowing cheaper. The government is putting pressure on the banks to pass these rate cuts on.

Reduction in VAT and increased spending, could limit the extent of the recession.

On the other hand, in the current economic crises it is difficult to see any government policy which could successfully prevent house prices fall. This is due to that there is a very strong negative momentum in houses prices, people think that they are overvalued and banks don't want to lend. Hence it doesn't make any difference what so ever government says or tries to do.

The only policy which really would have stabilized house prices would be better stabilization of the credit boom and bust. If the government had forced banks to save more and share credit in the boom, the boom would have been less and banks would now have more resources to maintain lending in the current recession.

So, the government can't really stop house prices falling. But, they should find much better policies to prevent a repeat of the boom and bust we have experienced twice in the past 17 years.

## **London Housing Market**

### **Problems in the London Housing Market**

#### **First Time Buyers struggling to get on Property Ladder**

The house prices have been increasing faster than incomes, which is making it more difficult for first time buyers to get on the property ladder. According to the Halifax the first time buyers in London need an average deposit of over £41, 000. So it becomes difficult for them to arrange the huge initial investment to get hold on a house.

#### **Supply Growing slower than demand**

The number of new houses and housing societies being built in London is very low. The main reason for this is the limited area of land within the city where new houses can be built. However the demand for various factors is keep on growing, such as net immigration and changing demographic factors.

#### **Shortage of Housing for Key Public Sector Workers**

The high rise in house prices to earnings means that there are many public sector workers like; nurses, teachers, fireman, policeman and civil servants are struggling to get hold on the property. For instance, comparing the average income of teachers in Greater London, the ration of House Prices has increased 4 times income (2003) to 7 times income (2009).

With a shortage of key public sector workers the NHS, for example, has to encourage the migration of foreign nurses to fill the many gaps in its London hospitals.

## **Speculative Buying creating potential for Boom and Bust**

There is a significant rises in house prices has been seen by the London Housing Market, regardless of the monetary falls in the early 1990s, it is seen as a good investment. As a result it has encouraged investors from abroad and UK to buy a house and make huge capital gains. In response to this the market has squeezed by increase in demand.

## **Facts about London Housing Market**

There are over three million households in London.

The amount of new developments of houses and housing societies in London represents a very tiny proportion of the total stock even less than 0. 5 percent.

## **London House Prices**

Average London property price is : £351, 028 April 2007

The most expensive area is Kensington, Knightsbridge and Chelsea - average house price is £918, 000.

The cheapest area in London is Barking and Dagenham where average house price is £181, 802.

1990s the market witnessed falling prices with some house owners experiencing negative equity.

The supply and demand graph show what has happened, due to declining incomes and consumer confidence and growing unemployment, the demand for housing shifted to left from D1 to D2. The Initial price was at P1 but due

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to surplus supply where demand goes beyond supply) there was downward force on prices to decline to  $P_2$ . Therefore the housing market in this case is restricted from area  $OP_1E_1Q$  to  $OP_2E_2Q$ . The supply curve for housing at any moment is actually unchanging. So a decrease in demand decreases prices rather than Quantity.

After the utmost recession the UK economy jumps into action with an increase in GDP of 0.1%. The current position of the housing market in the UK is quite astonishing. House prices have been increasing constantly since May 2009 according to nationwide. With the low interest levels of 0.5% by the Bank of England have helped make mortgages more reasonable. Some argue that house prices have risen due to a shortage in supply since home owners are tentative to sell at current prices. The diagram shows a pointed recovery in the prices of houses from early 2009, and a constant rise up till now.

Source: <http://www.bankofengland.co.uk>

A further explanation for this sharp rise in prices could be due to a lack of supply in the housing market. There is ambiguity in the market which is averting people from putting their estate on the market, this theory of hesitation and reluctance to put the property on the market can be shown on a supply and demand diagram below.

Source: <http://www.nationwide.co.uk/hpi/archive.htm>

S2

P3

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S

S1 Higher demand with squat supply has led to the situation in the diagram. Due to low interest rates, affordability of housing has improved, lifting demand from D1 to D2. At the same time reluctant home owners have not put their properties on the ladder, leading to a fall in supply for houses from S1 to S. Overall this creates an upward force on prices from P1 to P3.

Q2

Q

### **Prediction:**

Anticipating amidst such an unsure economic environment can gently be depicted a challenge. Reviewing at the data of house prices it can be said that in the short-term future prices are probable to increase, as they have done in recent times, but in the medium to long-term are possible to fall down. House prices are possible to change with respect to region; London is most probably going to see a relative raise in prices as other area may not see such a positive coefficient of growth in prices. It is essential to be rational in ones judgement since interest are indubitably going to rise, an signal that mortgage rates will rise that's why demand will decrease in the housing sector, gloomy prices. Pay rates are likely to increase again in the next few years, results in more confidence and belief in buyers so one could argue demand may rise. Assumption will also play an important role; housing is generally seen as a good investment, and buying a property during the start of the growth can lead to great rewards, if house prices go on

increasing. But it is simple said than done, the economy is on a feeble  
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improvement, increased taxes are likely and the public is expected to cut back their expenditure as people will wish to cut the size of their liability load. Interest rates will play an important role, there are many factors that will keep interest rates low; the UK budget deficit is increasing to 12% of GDP, this shows a deprived financial position of the government. To get better their position the government will compel lofty taxes and lower expenditures. But if taxes rise, this depreciation fiscal policy could slow down improvement so interest rates are likely to stay low. Given the overall fragile revival the Central Bank is to be expected to keep interest rates low. Given the increase of VAT back up to 17.5%, expanding oil prices and growing house prices the government may raise the traditionally low interest rates to stop any future inflationary anxiety, but in my judgment interest rates if they will raise in the near future are not likely to increase before the end of 2010.

Source: <http://www.economicshelp.org/economics/uk-economy-2010/>

[http://www.mortgageguidk.co.uk/blog/interestinterest-rate-predictions/http://www.statistics.gov.uk/cgget.](http://www.mortgageguidk.co.uk/blog/interestinterest-rate-predictions/http://www.statistics.gov.uk/cgget.asp?id=19)

<http://www.statistics.gov.uk/cgget.asp?id=19>

## **Conclusion**

In general it seems that the UK's housing market has seen the poorer, and is expected to enjoy its boom days in the near future. But it is hard to evaluate the healing as it will depend upon the future interest rate. The size of the interest rate will have its according impact, if we experience a reasonable increase in the interest rate than we can anticipate a good constant recovery while mortgage repayments will not shoot up and people will have time to adjust to the increase, expecting that people's earnings rise along with the <https://assignbuster.com/what-extent-could-government-policies-affect-house-prices/>

interest rate. A big raise in the interest rate might slow down the Housing market growth, since there will be a rapid variation in the mortgage repayments, this may further discourage the housing market transferring the economy into a double-dip recession. The performance of the economy is a key role in the next few years, and this is extremely dependent upon government policies. To risen the overall economic growth, government may try an augmentation strategy, but this again will be very arguable as the government is already in a poor financial picture. So the government wishes to play around with its tools it has in hand to twist the economy back into a secure position, which will then along with it lead to a health UK Housing market.