

# The different determinants of house prices economics essay



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House prices are determined by demand and supply. If demand rises (shift to the right) or if supply falls (shifts to the left), the equilibrium price of houses will rise. Similarly, if demand falls or supply rises, the equilibrium price will fall.

So, the house prices rise so rapidly in the 2000s, but fall in the 2008. The reasons lie primarily in change in the demand for housing. There are various factors that affected the demand for housing are described in the below;

Incomes (actual and anticipated):- In the beginning of the 2007 was time for rapidly rising incomes. The economy was experiencing an economic “boom”. Many people wanted to spend their extra incomes on housing; either buying a house for the first time, or moving to a better one. Many people thought that their incomes would continue to grow and were thus prepared to stretch themselves financially in the short term by buying an expensive house, confident that their mortgage payments would become more and more affordable over time. In 2008/09 by contrast, were periods of recession, with rising unemployment and either falling or much more slowly growing incomes. People had much less confidence about their ability to afford large mortgages.

The cost of mortgages:- in early 1990s the mortgage rates were less than now. That meant people could afford larger mortgages and thus afford to buy more expensive houses. But mortgage interest rates were now rising. Many people found it difficult to maintain existing payments, let alone to take on a larger mortgage. In 2003 mortgage rates were generally reduced

again, once more fuelling the demand for houses. Even when the interest rates rose gradually over the period from 2004 to 2007 they didn't come close to the rates reached like before. By 2008/09, however, higher mortgage interest rates were becoming increasingly unaffordable for many people and this was one factor contributing to the initial downturn in housing prices.

The availability of mortgages:- in the housing boom in 2003 to 2007, mortgages were readily available. With house prices rising, banks and building societies were prepared to accept smaller deposits on houses and to lend a larger multiple of people's income. After all, if borrowers were to default, lenders would still have a very good chance of getting all their money back. In the beginning of the 2008 banks and building societies were more cautious about granting mortgages. They were aware that, with falling house prices, rising unemployment and the growing problem of negative equity, there was an increased danger that borrowers would default on payments. In 2008/09 the problem was compounded by credit crunch, meaning that banks had less money to lend.

Speculation:- in the housing boom, people generally believed that house prices would continue rising. This encourages people to buy as soon as possible and take out the biggest mortgage possible, before prices went up any further. There was also an effect on supply. Those with houses to sell held back until the last possible moment in the hope of getting a higher price. The net effect was rightward shift in the demand curve for houses and leftward shift in the supply curve. The effect of this speculation, therefore, was to help bring about the very effect that people were predicting. In 2008, <https://assignbuster.com/the-different-determinants-of-house-prices-economics-essay/>

the opposite occurred. People thinking of buying houses held back, hoping to buy at a lower price. People with houses to sell tried to sell as quickly as possible before prices fell any further. Again the effect of this speculation was to aggravate the changes in prices- this time a fall in prices.

Speculation in recent years has been compounded by the growth in the “buy to let” industry, with mortgage lenders entering this market in large numbers and a huge amount of media attention focused on the possibilities for individuals to make very high returns.

### **The relationship between demand and price:-**

When the price of a good rises, the quantity demanded will fall. This relationship is known as the law of demand. There are two reasons for this law:

People will feel poorer. They will not be able to afford to buy so much of the good with their money. The purchasing power of their income has fallen. This is called the income effect of a price rise.

The good will now cost more than alternative or substitute goods and people will switch to these. This is called the substitution effect of a price rise.

Similarly, when the price of a good falls, the quantity demanded will rise. People can afford to buy more and they will switch away from consuming alternative goods.

### **The demand curve:- ( show the demand curve for the housing price in uk)**

Other determinants of demand:-

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Income:

Tastes:-

Distribution of income:-

Movement along and shifts in demand curve:- it is assumed that none of the determinants of demand other than price changes. The effect of a change in price is then simply illustrated by a movement along the demand curve. But when any of the determinants change then new demand curve needs to be created. If a change in one of the other determinants cause demand to rise like price rises then the whole curve will shift to the right. This shows that at each price more will be demanded than before.

As UK housing price rise then the demand curve in the right shift in the last few years but when the housing price fall down then the demand for the house will be the left curve.

Give the diagram pp35

### **Supply and price:-**

When the price of house rises the quantity supplied will also rise. There are three reasons for this:

As firm supply more, they are likely to find that beyond a certain level of output, costs rise more and more rapidly. In that case housing agent want to build more and more house.

The higher the price of the housing market, the more profitable to do housing business. So, housing agent will thus be encouraged to sell more houses by switching from the less profitable housing business.

Given time, if the price of the house remains high, new people will be encouraged to set up business, but the people will not be able to buy houses if the income is not increased.

Other determinants of supply:-

Like demand, supply is not simply determined by price. Other determinants of supply are as follows;

**The Costs of production:-** the higher the costs of production, the less profit will be made at any price. As costs rise, housing agents will cut back on the sale of houses. The main reasons for change in costs are as follows:

**Change in input prices:** cost of production will rise if wages, raw material prices, rent, interest rates or any other input prices rise.

**Change in technology:** technological advances can fundamentally alter the costs of production.

**Organisational change:** various kinds of cost-saving policies by the organisation can lead to changes in demand. Like lots of organisations having downsized their staffs because of that, leading to unemployment and people losing jobs. As a result, income goes down and demand for houses decreases.

Government policy: cost will be lower by government subsidies and raised by various taxes. Same as housing price in the UK effected by government policy which are the favour of the people or not, if the policy from the government is good for the people than people will buy house otherwise not.

A change in demand:- if one of the determinants of demand changes other than prices, the whole demand curve will shift. This lead to a movement along the supply curve to the new intersection point. If the rise of the house buyer's income rise than demand of the house will increase. Also, if the income not change the demand will stay remain.

A change in supply:- if one of the factor of supply changes other than price the whole supply curve will shift. This will lead to movement along the demand curve to the new intersection point. When the housing price rise because of the less supply and high mortgage rate than automatically the supply for the house decrease.

### **Diagrams pp-45.**

house-prices-85-09. jpg

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### **YES House Prices may Fall**

The ration of house prices to Incomes has risen to an all time high. This means that the average worker is unable to afford a house in many areas, this will lead to a fall in prices

Demographic factors suggest the population is likely to fall soon. Therefore there will be less people willing to buy houses.

Low Interest rates have helped keep the housing market strong however they may rise in the future as the economy picks up and inflation rises above its inflation target.

Rising house prices have encouraged speculation. This means people buy houses as a way to make capital gains. However as prices start to fall these people will start to sell causing a bandwagon effect of an ever increasing rate of falling house prices.

Some areas of the country are more vulnerable to falling prices these are the areas which saw the biggest increases in the 90s

With changing social attitudes. Couples may be more likely to live their parents for longer

## **NO- House Prices are Unlikely to Fall**

The ratio of house prices to incomes has increased but this is sustainable because inherited wealth is increasingly being used to buy houses.

Housing has a high income Elasticity of Demand (YED), therefore people are willing to spend a higher % of their income on housing

Despite a stagnant population there is an increasing tendency for smaller households e. g. single parents single old people and children leaving home earlier.



Supply of housing has not been increasing. The number of new houses built was the lowest since the war, also many council houses built in the 1960s are being knocked down, because they were associated with various social problems

Many houses in London have been bought by foreigners

## **In depth Reasons Why House Prices are Falling**

### 1. Shortage of Mortgage Finance

At the moment, the lack of mortgage finance is one of the most significant factors in falling demand for housing. The Council of Mortgage Lenders suggest that mortgage approvals have fallen to the lowest levels since 1991. Up to July 2007, mortgage lenders were very competitive and eager to attract customers with mortgage products such as 100% mortgages and high income multiple mortgages. However, the credit crisis has led to banks struggling to raise finance, therefore they have had to reduce their mortgage lending. To ration mortgages, they have removed many mortgage products, especially 'subprime' products. They have also increased the cost of many other mortgages. (see: credit crisis explained) In particular, mortgage lenders are requiring large deposits. This makes it difficult for first time buyers to get a mortgage.

### 2. The ratio of house prices to incomes has risen to an all time high.

In the UK the ratio of house prices to incomes is 50% higher than the long term average (1975-2005) Source : Economist (1) This means that many potential buyers are struggling to be able to get a mortgage. This problem

has been exacerbated by the credit crisis (see also: ratio of house prices to income UK)

### 3. House Prices Unaffordable for First Time Buyers.

In particular, it is becoming increasingly difficult for first time buyers to get on the property ladder. This is mainly due to the rise in house price to earnings ratio. In the past this problem was got around by banks being willing to offer 'generous' mortgages (e. g. interest only, self certification, 100% mortgages). For example, in the past, the Abbey National lent 5 times a borrower's salary. This increased generosity in lending helped to keep the market buoyant without addressing the underlying problem of overvalued house prices. The Credit crunch has now made this difficult. (see also: ratio of house prices to income for first time buyers)

### 4. House Prices can Fall – even with limited Supply.

For those who believe house prices can never fall, it is worth remembering the case study of Japan. In the 1980s there was a similar boom in house prices in Japan. But since the peak of 1991 house prices in Japan have fallen for 14 consecutive years, leading to considerable economic problems such as lower consumer spending. House Prices have also started to fall in the U. S. A. US prices have now fallen considerably since their peak in 2007.

### 5. Speculation in UK Housing Market.

Traditionally, the view of the housing market is that it is not just an asset, but a place to live. Therefore, unlike the stock market, house prices won't rise and fall due to speculation. However a lot of demand for UK housing is <https://assignbuster.com/the-different-determinants-of-house-prices-economics-essay/>

coming from buy to let investors. Many buy to let investors are in the market for the long term; however, now that prices are falling, some of these speculators are likely to leave the market causing a significant drop in demand.

#### 6. Herding Effect of UK Housing Market.

In a research paper Alex Hamilton argues that much of the housing market is dominated by herding behaviour. (Source 2) This means that a lot of the rise in demand is caused by market sentiment rather than economic fundamentals. Now the market sentiment has changed people are less confident about buying. In a recent paper, the OECD stated that 15% of UK house prices were not reflected in economic fundamentals but 'froth' and 'speculation'. As house prices fall, there is no incentive to buy. Many are waiting for house price falls to end.

#### 7. Volatility of UK Housing Market.

The UK housing market suffers from severe supply constraints as a % of the total housing stock. The number of new houses built is relatively small. Therefore a change in demand magnifies any change in price. It only takes a small rise in demand to increase prices. But similarly it could only take a small fall in demand to cause significant price falls as in 1991.

#### 8. UK Sensitive to any Change in Interest Rates.

There are record levels of consumer borrowing in the UK. This is a combination of mortgage borrowing and personal debt like credit cards. The total level of debt is £1.168 trillion. Source (3) Therefore even a modest rise <https://assignbuster.com/the-different-determinants-of-house-prices-economics-essay/>

in interest rates could have a very adverse effect on consumer confidence and spending. Therefore the housing market is particularly vulnerable to any rise in interest rates that may occur. – even if it is only through an increase in bank rates (as opposed to base rates). Also, even though the Bank of England have cut interest rates, many homeowners are not seeing these rate cuts passed onto them. Mortgage costs have been stubbornly high.

Living costs are also been squeezed by oil, electricity and food prices.

#### 9. Predictions for House Prices UK.

Many economists predict significant house price falls. For example Mr Calverley, argues in his book, ' Bubbles and how to survive them', that house prices could fall by 50%. Former advisor to Gordon Brown David Miles also predicts falls in house prices. He points that much of the rising demand for housing is speculative. As David Miles states:

“ However, one third to one half reflects changes in expected house price inflation – that is a speculative element of demand, which is likely to be volatile,”

See also: (economists predict 20% fall in prices)

#### 10. Sub Prime Mortgage collapse

The problems in the US Housing Market have adversely affected investor confidence. Therefore, it is becoming more difficult to sell mortgage debt. It is likely banks will become more conservative in mortgage lending. See:

Credit Crisis explained

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## 11. Northern Rock and effect on consumer Confidence

The problems at Northern Rock, HBOS and the general malaise in the mortgage industry have severely dented consumer confidence in the Mortgage industry and consumer confidence

House price falls are necessary for the housing market to readjust. However, in the short term, this adjustment has been exacerbated by the shortage of mortgage finance.

### **demand and supply for housing**

The determination of prices in local and regional housing markets is a classic example of microeconomics in action! We are seeing the interaction between buyer and seller with prices being offered and agreed before a final transaction is made. In this section we focus on the demand and supply side factors that determine the value of properties in a market.

Each housing transaction in the UK depends on

- (a) The price that the seller is willing to agree for their property with the prospective buyer
- (b) The actual price that the buyer is willing and able to pay.

Buyers place offers for a property that the seller can either accept or reject

### **A Sellers Market**

When the market demand for properties in a particular area is high and when there is a shortage of good quality properties (i. e. supply is scarce)

then the balance of power in the market shifts towards the seller. This is because there is likely to be excess demand in the market for good properties. Sellers can wait for offers on their property to reach (or exceed) their minimum selling price.

## **A Buyers Market**

Conversely when demand both for new and older housing is weak and when there is a glut of properties available on the market, then the power switches to potential buyers. They have a much wider choice of housing available and they should be able to negotiate a price that is lower than the published price.

<http://tutor2u.net/economics/content/diagrams/housing9.gif>

When the demand for houses in a particular area increases (perhaps because of an inflow of population into the area, or a rise in incomes following a fall in unemployment), there is upward pressure on market prices.

Often the supply of available housing in the market is relatively inelastic. This is because there are time lags between a change in price and an increase in the supply of new properties becoming available, or other homeowners deciding to put their properties onto the market.

When demand shifts outwards and supply is inelastic the result is a large rise in market price and a relatively small expansion of the quantity of houses traded. As supply becomes more elastic over time, assuming the conditions of demand remain unchanged, we expect to see downward pressure on

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prices and a further increase in the equilibrium quantity of houses bought and sold.

<http://tutor2u.net/economics/content/diagrams/housing10.gif>

## **The Aggregate Demand for Housing in the UK**

The market for owner-occupied housing is sensitive to changes in market demand and supply. The strength of these factors often explains disparities in house price inflation between and within the major regions of the United Kingdom.

Demand conditions for housing influence both the willingness and ability of people to make house purchases. Some of the most important conditions of demand are listed below

Growth of real incomes - privately owned housing is a normal good for most people. As average living standards rise, the total demand for housing expands, as does the demand for more expensive properties as people look to move "up market".

Consumer confidence - confidence is vital in the housing sector. If expectations for the future performance of the economy deteriorate and people become less optimistic about their own financial circumstances, they are tempted to curtail their search for a new home or delay entry into the owner-occupied sector.

Equally when the economy is enjoying sustained growth and rising prosperity - improved confidence raises the number of home buyers and shifts the

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balance of power in the market towards the seller if properties are in short supply.

Jobs - because financing a house purchase involves making a long-term commitment through a mortgage lender, changes in unemployment levels exert a significant impact on housing demand. For example in areas when unemployment remains persistently above the national average, average incomes are likely to be lower and confidence among buyers will be negatively affected

These three factors, incomes, employment and confidence are critical in determining the direction of house prices. When these three factors are rising the conditions are normally in place for sharp upward movements in prices. However other economic variables also come into play.

Expectations of future price movements - is housing to be regarded as a consumer durable that provides a flow of services to the owner over a long period? Or should we think of a house purchase, as a major financial investment that we expect will provide us with substantial capital gains in the long run? The answer is probably a mix of the two! Certainly in the 1980s the housing sector boomed because of a strong speculative demand for properties.

Changes to the system of housing taxes and subsidies - government policies affect the housing sector in a myriad of different ways ranging from benefits for council taxpayers on low incomes to the payment of stamp duty on the most expensive properties.



Throughout most of the 1980s and 1990s the government offered home buyers an explicit subsidy in the shape of mortgage interest relief at source or MIRAS. Chancellor Brown decided to phase this subsidy out of the system - MIRAS has now disappeared. The effect has been to dampen down housing demand, but do little substantial to stop house prices rising.

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

house-price

Graph shows volatility of UK House prices

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

### **Demand Side Factors:**

1. Economic Growth / Real income.

Rising incomes enable people to spend more on buying a house.

Traditionally, there was a mortgage ratio of 3 times your salary. Basically if you earned £20,000 the building society would lend £60,000. Therefore rising incomes enable house prices to rise.

However, the ratio of house prices to income can vary considerably. For example, between 1995 and 2007, the ratio of house prices to incomes have increased significantly. see: House Price to Incomes ratios

If the economy goes into a recession and unemployment rises, the demand for buying houses would fall significantly.

2. Interest rates.

Interest rates affect the cost of paying for a mortgage. Interest rates are very important as mortgage repayments are usually the biggest part of a homeowner's monthly spending.

In the UK, the majority of homeowners have a variable mortgage which means an increase in rates will cause the cost of mortgages to rise, deterring people to buy.

People on fixed rate mortgages will be insulated from fluctuating rates for 2-10 years. Therefore changes in interest rates can have a time lag of up to 18 months before their full effect is noted on demand for housing.

It is also important to consider real interest rates (interest rates-inflation)

The Bank of England set base rates and these usually affect all commercial rates. However, sometimes the Bank of England cut interest rates, but, commercial banks don't pass these cuts onto consumers. In the first half of 2008, the Bank of England cut rates by 0.5% from 5.5 to 5.0%, but the cost of mortgages is still rising.

### 3. Consumer confidence

During times of high consumer confidence, people are more willing to take out risky mortgages to be able to buy a house. For example, in the period 2001-07 100% mortgages and interest only mortgages were quite common. In the early 00s, people were optimistic about the housing market and so took out mortgages with a higher debt to income ratio.

### 4. Availability of Mortgage Finance

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In the 50s, 60s and 70s, there were stringent restrictions about the availability of finance. However, with deregulation of the banking sector increased competition has seen a rise in the number of mortgage products. Products such as interest only, self certification mortgages and mortgages up to 6 times income have enabled people to get more mortgages, thereby increasing demand for housing. However, during the credit crunch of 2008, the number of mortgage products on offer fell due to a shortage of finance in the money markets.

See: Credit Crunch Explained

## 5. Demographic factors

There has been a rising number of households in the UK. The number of households can rise faster than the population if the average family size declines and there are more single people living alone.

Demand for housing in the UK has been increasing for various reasons such as:

an increase in divorce rates

an increase in net immigration from Eastern Europe.

Increase in life expectancy and more old single people

Children leaving home early

Less marriage

## 6. Speculation

Not everyone buys 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. This buy to let investor is typically more volatile, they will buy when house prices are rising and sell when the market appears to turn. This makes house prices more volatile because speculators will buy in a boom and sell in a bust. The number of buy to let investors in the UK has risen in the past decade.

However, there are quite high fixed costs in selling a house, such as stamp duty and estate agent fees. It is not like dealing in shares where you can easily buy and sell. Many buy to let investors claim they are in for the long term.

## The price of rented accommodation

Although UK house prices have increased faster than inflation, renting has also become expensive which is the main substitute to buying a house

## 7. Inherited wealth.

Many people use inherited wealth to buy houses. This might explain why there has been rising ratios of house price to incomes. It is also becoming more common for parents to lend children a deposit to help get their first house. In other words higher house prices are not deterring people from buying a house – people are finding ways around it.

## 8. Unemployment

Low unemployment is often associated with rising demand for houses.

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## **Supply side Factors**

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.

## **Long Run Supply**

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

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.

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