



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group

The housing market: the bubble is bursting

Introduction: correction or crash?



The housing market is now slowing significantly, partly reflecting the persistence of abnormally tight credit conditions. Forecasts for house prices worsen with each revision. And it is no longer unusual to speculate that nominal house prices could fall by as much as 10% over 2008 and a further 5% in 2009.^{1, 2} In other words, prices in December 2009 could be some 15% lower in nominal terms than in December 2007. This is a substantial drop by any standards. But should this be regarded as a “correction”, after the near tripling of house prices over the past 10 years, or should it be regarded as a “crash”?

The terminology used is not unambiguous but the Oxford Shorter English Dictionary defines the terms as follows:

- Correction: the action of putting right...errors.
- Crash (figurative): a sudden ruin, failure or collapse, especially of a financial undertaking.

It is reasonable, therefore, to define a house price “correction” as a relatively orderly “putting right” of the overvaluation of residential property, the “bursting of the bubble”, whereas a “crash” implies sudden collapse. Few would dispute that a house price bubble has developed in recent years in the UK, after a period of over-easy credit. It is now bursting. But this is a “correction” rather than a “crash”, as are the current developments in the US housing market (which have been far more severe to date) and the developments in the UK market in the early 1990s.

Having said that both the current events and those of the early 1990s are both “corrections”, it is nevertheless instructive to compare in some detail the expected developments this time with those observed in the early 1990s.³ However, difficult the current situation, it is still not expected to be as severe as 15-20 years ago.

Comparison of the early 1990s correction and today’s situation: interest rates

Starting with interest rates, the following table gives an idea of the movements in interest rates between (i) 1988 and 1993 and (ii) 2005-present.

Taking 3 month interbank rates as a proxy for mortgage rates in the earlier period, they rose from an average of 9% in 1988Q1 to 14¾% in 1990 before slipping back to 11½% in 1992. These cripplingly high interest rates led to a recession and a painful housing market correction.

Fixed-rate mortgage rates have picked up this year reflecting the credit crunch – especially for mortgages with 95% loan to value (LTV) ratios – but the increases are still relatively modest compared with the late 1980s and early 1990s. This is even applicable to those mortgagors who took out a 2-year mortgage in 2006 and now find they have to reset their mortgages at higher rates. Under these circumstances, and even though many will find the increases in mortgage payments difficult (not least of all because they may have other debts that need servicing and high food, fuel and utility prices are cutting into their disposable incomes), a re-run of the early 1990s, in terms of the number of mortgagors who default, is unlikely.

Table 1: interest rates

		Interest rate of UK resident banks & building societies on sterling mortgages to households (%), not seasonally adjusted		
	3 month interbank lending rate (%)	2-year (95% LTV) fixed rate mortgages	2-year (75% LTV) fixed rate mortgages	Standard variable rate (SVR) mortgages
1988:	10.93	Na	Na	Na
<i>Of which:</i>				
1988Q1	9.02	Na	Na	Na
1988Q2	8.44	Na	Na	Na
1988Q3	11.38	Na	Na	Na
1988Q4	12.49	Na	Na	Na
1989	13.89	Na	Na	Na
1990	14.77	Na	Na	Na
1991	11.51	Na	Na	Na
1992	9.62	Na	Na	Na
1993	5.93	Na	Na	Na
2005	4.69	5.08	4.82	6.53
2006	4.8	5.26	4.95	6.52
<i>Of which:</i>				
2006Q1	4.53	5.00	4.68	6.38
2007	5.96	6.18	5.84	7.44
2008:				
January	5.61	6.42	5.97	7.51
February	5.61	6.52	5.74	7.5
March	5.86	6.6	5.8	7.24
April	5.89	6.94 (sic)	6.08	7.24

Notes: Sterling interbank lending rate, 3 month, mean of LIBID/LIBOR. The BoE's mortgage interest rate series start in January 1995. The LTV is the loan to value ratio.
Source: Bank of England, www.bankofengland.co.uk.

Lending behaviour

Of course, interest rates do not explain all. There is also the issue of lending practices. In the late 1980s, perhaps counter-intuitively, the average “loan to value” (LTV) ratios were much higher than in recent years, as shown in the table below. This made the housing market especially vulnerable to negative equity in the early 1990s as house prices fell.

Table 2 also shows that, even though the income multiple of loans has been higher in recent years than in the late 1980s/early 1990s, interest payments as a % of income has been lower reflecting lower interest rates. As an addendum, the final column on the number of loans made for house purchase clearly shows the rapid decline in the number of loans in 2008Q1 as the credit crunch bites into the mortgage market.

Table 2: Loans for house purchase (first time buyers & home movers): selected indicators

	LTV	Income multiple of loan, median	Interest payments as % of income, median	Number of loans, thousands
1988	85	2.22	18.7	1,256
1989	74	2.22	23.7	886
1990	74	2.22	26.5	783
1991	74	2.26	21.6	722
1992	78	2.26	17.7	873
1993	79	2.29	13.4	951
2005	44	2.95	15.3	1,015
2006	46	3.07	15.6	1,126
2007	43	3.16	17.8	1,017
2008Q1	29	3.14	18.5	142
2008Q1 (annualised)	Na	Na	Na	568

Note: LTV: loans for house purchase as % of total value.
Source: Council for Mortgage Lenders, www.cml.org.uk.

Negative Equity

In addition to the relative caution of lenders in the recent housing boom compared with the late 1980s, there is another reason why negative equity should now be less of a problem than in the early 1990s. Far fewer homes were bought and sold at the height of the recent boom than in the late 1980s.

According to an analysis by the *Financial Times*, Britain should escape a negative equity crisis of the scale of the early 1990s unless there is an unprecedented slump (25%) in house prices.⁴ The table below shows the FT's calculations of the number of people who would fall into the negative equity trap, given specific price falls.

Table 3: Falling property prices and negative equity

Fall in property prices (%)	Number of people in negative equity (million)
5	0.2m
10	0.35m (2.8% of people owning their own homes)
15	0.5m (5% of mortgagors, 2% of all households)
20	1.2m
25	1.8m (1 in 14 households)
30	2.5m
35	3.5m

Source: Chris Giles, "Fewer homes at risk than in 1990s", *FT*, 26 April 2008.

Mortgage arrears and repossessions

Negative equity really hits people if/when their homes are repossessed. For those able to service their mortgage commitments and are sitting tight, it is of less significance. The early 1990s witnessed a rapid, painful increase in repossessions as interest rates rose and arrears and defaults increased (especially when people lost their jobs). In the years 1990-93, there were 250,000 repossessions.

Even though repossessions are rising - the Council for Mortgage lenders is forecasting an increase to 45,000 for 2008⁵ - there are currently no expectations the situation will deteriorate as dramatically as in the early 1990s. If, however, the economy fell into recession and unemployment rose as sharply as in the early 1990s, this relatively optimistic scenario would clearly need major revision.

Table 4: Mortgage arrears and mortgage possession actions in the county courts

	Mortgages in arrears, end period (% of all loans)		Mortgage possession actions (England & Wales)		
	6-12 months in arrears	Greater than 12 months in arrears	Claims issued	Orders made	Properties taken into possession
1988	0.56	0.14	Na	Na	Na
1989	0.66	0.13	Na	Na	Na
1990	1.13	0.30	143,350	103,508	43,890
1991	1.77	0.77	186,649	142,905	75,540
1992	2.00	1.32	142,162	126,881	68,540
1993	1.77	1.54	116,181	105,283	58,540
2005	0.32	0.12	114,764	70,964	14,600
2006	0.33	0.14	131,219	90,680	22,400
2007	0.33	0.12	137,697	95,187	27,100
2008Q1 (seasonally adjusted)	Na	Na	38,688	27,530	Na
2001Q1 (annualised)	Na	Na	154,752	110,120	Na

Sources of data:

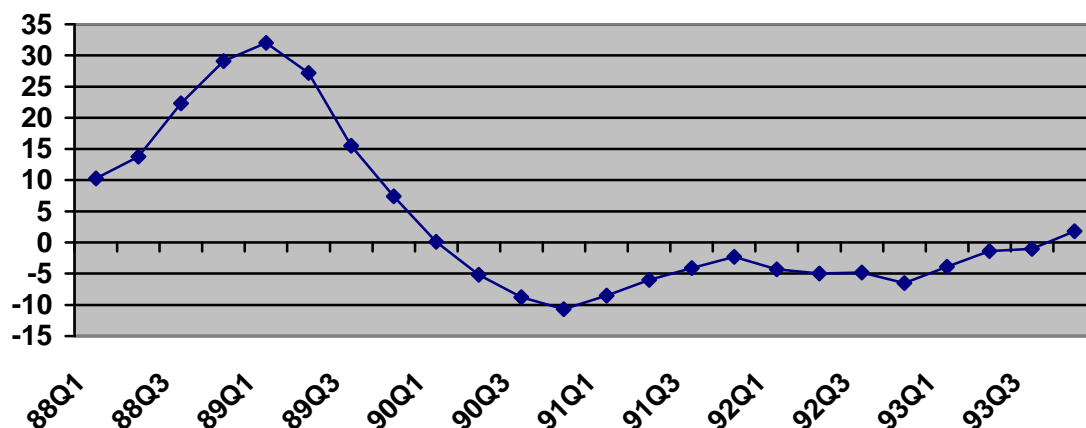
Mortgages in arrears: Council for Mortgage Lenders, www.cml.org.uk

Mortgage possession actions in the county courts (England & Wales): Ministry of Justice, "Statistics on mortgage & landlord possession actions, 2008Q1", 9 May 2008.⁶

House prices

There are many respected indicators of house price movements. The Nationwide House Price Index (HPI) is one of these respected measures. The course of the boom and bust in the housing market in the late 1980s and early 1990s can be seen in the chart below.

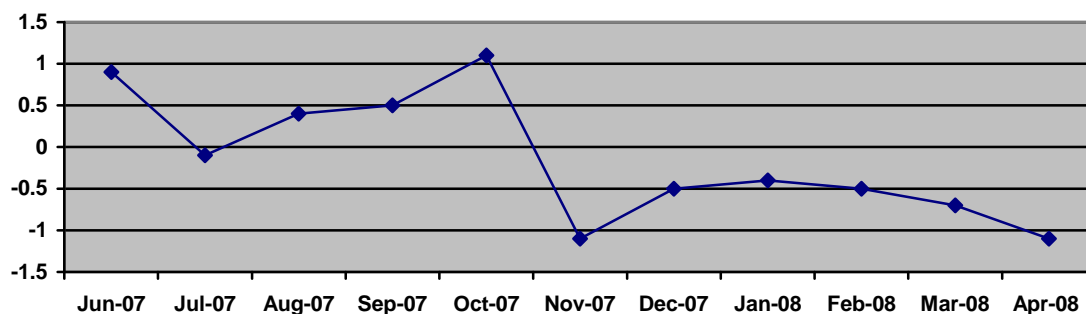
Annual % changes in house prices (Nationwide HPI): 1988Q1 to 1993Q4



Source: Nationwide, available from www.nationwide.co.uk/hpi

Nationwide's latest data show a rapid decline from buoyancy in mid 2007, prior to the August credit crunch, to falling prices in 2008. In April 2008, prices fell by 1.1% in the month to be 1.0% lower than a year before. A fall of 10% by the end of 2008 is entirely feasible.

Monthly % changes in house prices: June 2007 to April 2008



Impact on the real economy

The weakening housing market will, of course, have major implications for the real economy. Not only are house prices falling but the indicators of housing market activity are undoubtedly declining. Mortgage approvals are well down (see table 2, above, for an indication of the fall-off in the number of loans made in 2008Q1), partly reflecting the credit crunch, and housing transactions have fallen.

Falling house prices undermine consumer confidence and can hit household consumption. Moreover, with falling housing transactions, the economic output of the property sector is likely to decline and jobs are likely to be lost. Similarly, construction output in the house-building sector looks set to contract. Official data for England, for example, showed that housing starts in 2008Q1 were 21% lower than in 2007Q4 and 24% lower than in 2007Q1. The equivalent data for housing completions were (minus) 12% and (minus) 18%.⁷

These knock-on effects will inevitably slow GDP and contribute to higher unemployment – thus raising the possibility of an outright recession in the economy.

References

1. David Miles, "House price falls won't send the UK into a recession", 24 April 2008, available from www.telegraph.co.uk.
2. Housing Minister Caroline Flint recently exposed, albeit inadvertently, her Department's view that prices would fall by "at best" 5-10% later this year. See Gordon Rayner, "Flint unwittingly briefs the world of the Cabinet's fears", *Daily Telegraph*, 14 May 2008.
3. See also Ruth Lea, "The credit crunch is hitting the housing market: but it should not be as bad as the early 1990s", *Arbuthnot Banking Group Perspective*, 21 April 2008.
4. Chris Giles, "Fewer homes at risk than in 1990s", *FT*, 26 April 2008.
5. Norma Cohen, "House prices falling as repossession orders rise", *FT*, 10 May 2008.
6. Mortgage possession claims: the first stage of the repossession process is when homeowners are threatened with action. Claims come before possession orders, when a court grants an order for the possession of a home. Most of these orders do not result in the property being repossessed.
7. Department of Communities and Local Government, "House Building, 2008Q1", 15 May 2008, available from www.communities.gov.uk.

**Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674**