



Perspectives by Ruth Lea

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The credit crunch is hitting the housing market: but it should not be as bad as the early 1990s

Introduction

The Bank of England's recent survey into credit conditions did not make comfortable reading.¹ The survey confirmed that lenders had reduced the availability of mortgages in the 3 months to mid-March and that the Bank "expected a slightly larger reduction" over the next 3 months. The Bank also expected reduced availability of unsecured personal loans. Small businesses were also expected to feel the squeeze. This survey evidence of tightening credit conditions is consistent with a host of other indicators including interbank market rates, where the spread between the Bank Rate (5% since 10 April) and 3-month LIBOR (around 5.9% recently) has widened reflecting the continued stress in the interbank markets.

The Bank, though mandated to prioritise inflationary pressures, must surely also be concerned about the effects of the worsening credit squeeze on the real economy, in general, and the housing market, in particular. Indeed, it has expressed its concerns about the worsening credit conditions. Arguably rather belatedly in the day, the Bank is now responding to the problems in the financial markets by providing more liquidity, easing the criteria for providing long-term funds and cutting official rates (though last week's cut from 5.25% to 5% had no beneficial impact on 3-month LIBOR at all; if anything LIBOR slightly ticked up). There is little doubt that the Bank is preparing to act further to alleviate the stresses within the interbank markets.

One aspect of the recent unwanted increase in market rates is the unwelcome ticking up of mortgage rates and the tightening of lending criteria at a time when the housing market is beginning to look vulnerable.

The current housing market vulnerabilities inevitably give rise to speculations of a spectacular housing market slump, not least of all because the ratio of house prices to earnings has risen sharply since 1997. Average house prices are currently 5.65 times male average earnings, which is close to a record high.² The average house price in the UK has almost tripled over the past 10 years and this has easily outstripped the increase in earnings. Comparisons are being made with the US, where the housing market has slumped. But conditions in the UK are different for two main reasons. The first is the over-

supply of property in the US, which is not the case in the UK, and, secondly, the lending practices in the US, not least of all concerning sub-prime mortgages, have been slacker than in the UK.

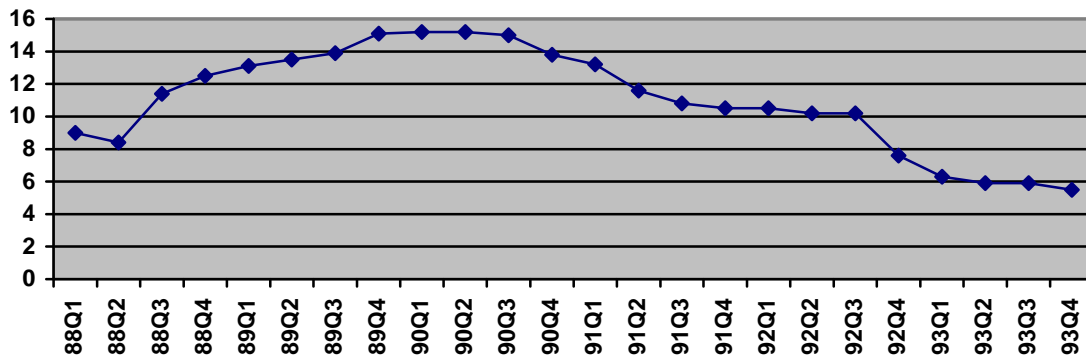
Comparisons are also already being made with the house market crash of the early 1990s. Without wishing to appear complacent, the current policy-making context is very different from that time. In the early 1990s, the UK was trapped in the ERM and could not cut interest rates. Partly as a consequence, there was a painful recession. Provided there is not a sharp increase in forced sales because of an inability to service mortgage payments (if, for example, if unemployment sharply increases), there should not be repetition of the early 1990s housing crash this time round.

The 1990s housing crash and economic recession

The 1990s housing crash followed the late 1980s housing boom, the main driver of which was the over-buoyant economy, resulting from over-loose fiscal and monetary policy. As the then Chancellor Lawson has since openly acknowledged he “undoubtedly underestimated the strength and duration of the boom of the 1980s, and thus the inflationary forces unleashed”.

In his April 1988 budget the Chancellor cut income taxes and in the first half of 1988 he reduced interest rates in order to maintain his exchange rate policy of tracking the Deutschemerk at 3DM to the pound (the pound kept overshooting its target), thus stimulating the already buoyant economy and housing market. He also announced in his April 1988 budget that he would end “double MIRAS” (double tax relief for co-habitees) in August of that year. The result was to pour oil onto the house market flames. There was a rapid increase in transactions up to summer, stoking up prices, which then even more rapidly fell away. Meanwhile in the second half of 1988, interest rates were raised aggressively to cope with the inflationary pressures which were then building up. Retail prices inflation was in double digits by the fourth quarter of 1989. The base rate had touched 7½% in mid 1988. By the end of that year the base rate was up to 13% and in 1989 it increased further to 15%.

Sterling interbank lending rate, 3 month (%)

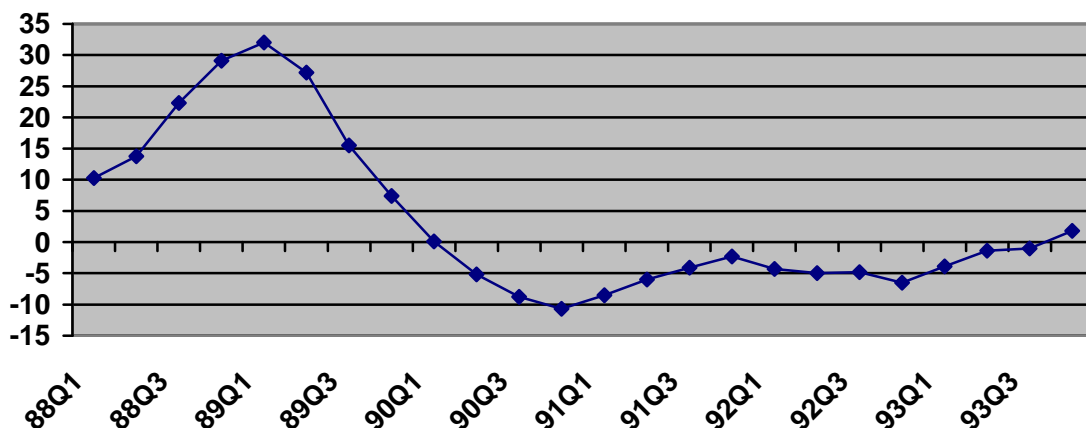


Source: Bank of England website, www.bankofengland.co.uk. The data are quarterly averages for the mean of LIBID (bid rate) and LIBOR (offer rate).

Membership of the ERM provided the final turn of the screw on the economy and the housing market. Britain was locked in to Germany's high interest rates and the Chancellor, by then Norman Lamont, was extremely constrained in his room for manoeuvre. The pound's expulsion from the ERM in September 1992 was, without exaggeration, the economy's salvation. Interest rates could then be reduced – and reduced they were. Base rate was reduced from 10% in September 1992 to 7% by the end of the year. By the end of 1993 the base rate was 5½ %. The economy recovered and has been growing ever since.

The course of the boom and bust in the housing market can be seen in the chart below. According to the Nationwide House Price Index, prices in the final quarter of 1988 were some 32% higher than a year earlier. The peak average price was achieved in 1989Q3 (at £62,782). By 1993Q1 a trough of £50,128 was reached – 20% lower in nominal terms, more in real terms. The falling prices were devastating for many homeowners; they experienced negative equity as the value of their properties fell below their outstanding mortgages.

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



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

Not only did the roller-coaster interest rates trigger a housing boom and bust, the double digit interest rates between 1988 and 1992 led to recession in the economy. Indeed the two events were mutually reinforcing. As economic activity fell away (GDP fell by nearly 1½% in 1991 and was almost flat in 1992), businesses were bankrupted and between 1990 and 1993 unemployment rose by over 1 million in total. The sharp rise in unemployment was one of the reasons behind homeowners inability to maintain the interest payments on their mortgages, the consequent rapid rise in repossessions and forced sales. Properties taken into possession rose from nearly 44,000 in 1990 to over 75,500 in 1991, compared with a relatively modest, albeit rising, 22,700 in 2007.³ Forced sales provided another downward twist on house prices.

Whatever the difficulties the housing market faces over the next year or two, there is at least one consolation. The Bank of England is in a position to cut interest rates, providing the credit crunch and inflationary pressures can be contained, to support the housing market as the UK could not do when it was tied to the ERM between 1990 and 1992.

References

1. Bank of England, *Credit Conditions Survey, Survey results, 2008 Q1*, April 2008, available from www.bankofengland.co.uk.
2. David Smith and Helen Davies, "Are house prices really set to plunge?", *Sunday Times*, 6 April 2008.
3. Official data from the Ministry of Justice, www.justice.gov.uk

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