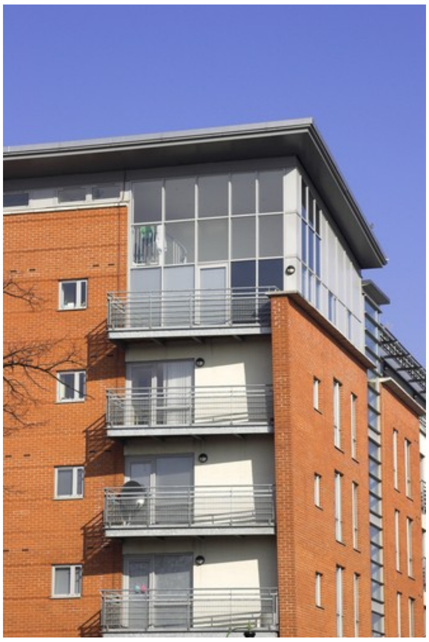
Markets in Action: The UK Housing Market

This chapter applies supply and demand concepts to the housing market. The determination of price levels in local housing markets are great examples of microeconomics in action! Each day there are hundreds and thousands of separate negotiations between buyers and sellers with prices being offered and agreed before a final transaction is made.

The price that is established with each housing transaction in the market depends on

- The price that the seller is willing to agree for their property.
- The actual price that the buyer is willing and able to pay.



A Sellers Market

When demand for properties in a locality, area or region is high and when there is a shortage of properties then the balance of power in the market shifts towards the seller. They can wait for offers on their property to reach (or exceed) their minimum selling price. Indeed early potential buyers may come straight in with an offer in excess of the asking price in order to avoid the possibility of losing the property that they want.

A Buyers Market

When there is a glut of properties available on the market (excess supply), the balance of power switches to buyers. They have the luxury of a wider choice of housing and they should be able to negotiate a price lower than the published price. Sellers may require a quick sale and this puts extra bargaining power into the hands of buyers.

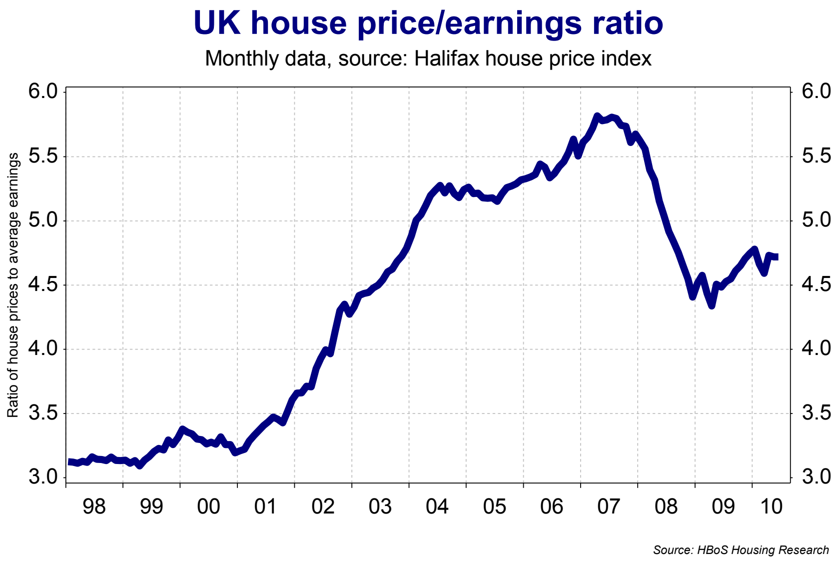
Housing Demand

The demand for housing is the quantity of properties that homebuyers are willing and able to buy at a given price in a given time period. Some of the conditions of demand in the market are as follows:

1. **Real Incomes**: As living standards rise, so the demand for housing expands, including demand for more expensive properties as people move “up market.”
2. **Mortgage Interest Rates**: Since most homes are purchased with a mortgage, changes in interest rates affect demand for housing. A rise in mortgage rates increases the cost of financing the loan on the purchase of a property.
3. **Consumer confidence**: Consumer confidence is vital for if expectations for the future performance of the economy deteriorate and people become less optimistic about their own financial circumstances, they may be tempted to delay entry into the market for property.
4. **Economic Growth**: When the economy is enjoying sustained growth and rising prosperity, improved confidence raises the number of homebuyers. The reverse is true in a recession.
5. **Unemployment**: In areas or regions when unemployment is above the national average, incomes will be lower and this limits the number of people who are able to afford properties.

6. **The Price of Substitutes**: For people wanting to buy their own home, the main alternative is to rent – so a higher cost of renting could lead to an increased demand for owner-occupied homes.

Effective demand for housing – property affordability



Demand in a market is only effective when potential buyers have the ability to pay. Nowhere is this truer than in the property market.

In recent years the boom in house prices in the UK caused a major affordability problem for millions of people wanting to enter the market for the first time. The ratio of average prices to incomes climbed higher and made it much more expensive to take out a mortgage. The decline in effective demand has been an important factor bringing about an end to the boom as first-time-buyers have gradually disappeared from the market.

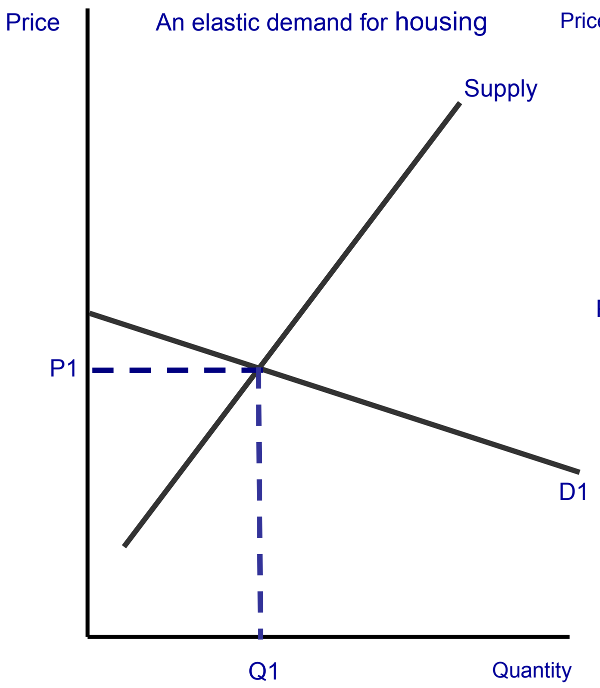
Since the summer of 2007 house prices have been falling and as a result, the ratio of prices to earnings has dropped indicating an improvement in this measure of housing affordability. However although properties look more affordable at first glance, the difficulties in getting a mortgage following the credit crunch means that demand in the property market has remained subdued.

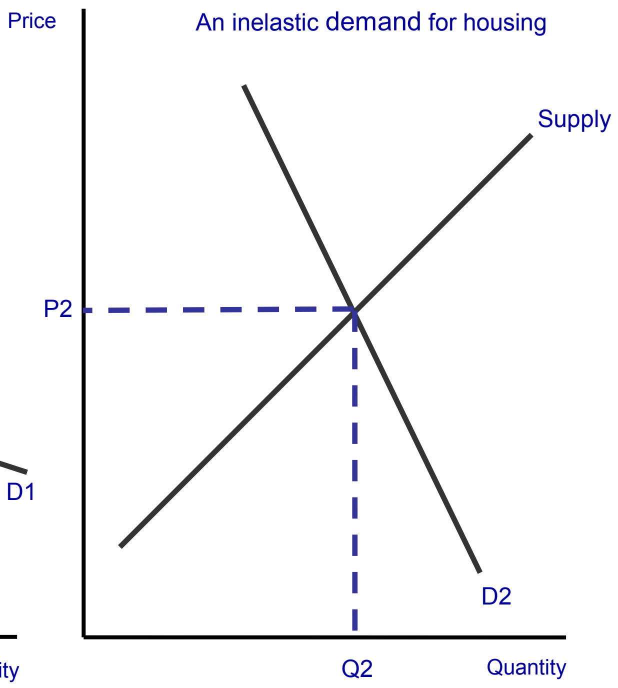
Expectations of future price movements and housing demand

Expectations of changing prices can have a considerable bearing on the demand for all types of property. Consider this question. Should 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 one of major investments that we expect will provide us with substantial capital gains? The answer is probably a mix of the two!

Price elasticity of demand for housing

Price elasticity of demand (Ped) measures the responsiveness of demand for a product to a change in its own price. When housing is regarded as a necessity and when there are few close substitutes available, we expect demand to be inelastic. This may well force up the eventual market price when a transaction is agreed.

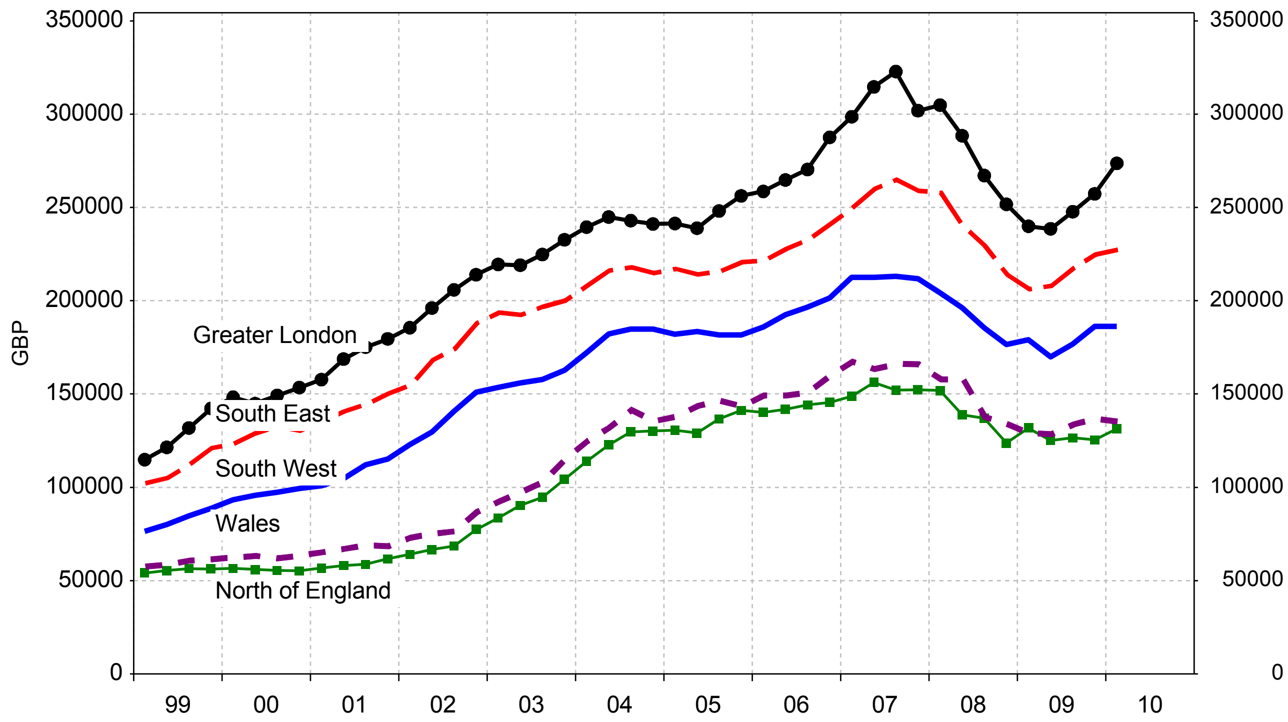




The price elasticity of demand for a property depends on the availability of close substitutes – for example the supply of rented housing. If you have set your heart on a particular property, or are convinced that you need to live in a specific area, perhaps to live within a school catchment area or because you want to be close to friends and family, then you will be far less sensitive to the market price and demand will become price inelastic.

A Selection of Regional House Price Averages

Average house prices £s, seasonally adjusted, source: Halifax house price data



Source: Reuters EcoWin

Housing Supply

The housing supply is the total flow of properties available at a given price in a given time period. The supply will be a mix of newly-built housing and older properties. For new housing, the conditions of supply include the following:

1. **Costs of production** for construction companies
   a. Employment costs (including wages, overtime payments and employment taxes).
   b. Costs of purchasing land for housing development.
   c. Costs of purchasing building components and raw materials.
   d. Costs associated with achieving planning consent from local authorities.
2. The **number of construction companies** in the market and their business objectives.
3. The extent to which property builders can achieve **economies of scale** in house building and reduce their constructions costs by implementing innovation in building projects.
4. **Government taxation and subsidy** of new housing developments

Elasticity of Housing Supply

The supply of new housing tends to be inelastic in the short run which means that house prices are determined almost exclusively by demand factors such as income, unemployment and interest rates. Several reasons have been put forward for the low price elasticity of supply of housing:

1. Construction companies cannot suddenly plan and then build thousands of new homes in areas when there is an increase in demand. One reason is the existence of planning regulations and other constraints on new housing developments.
2. Supply is also restricted by the limited availability of skilled labour such as bricklayers and electricians and other factor inputs needed in the construction process.

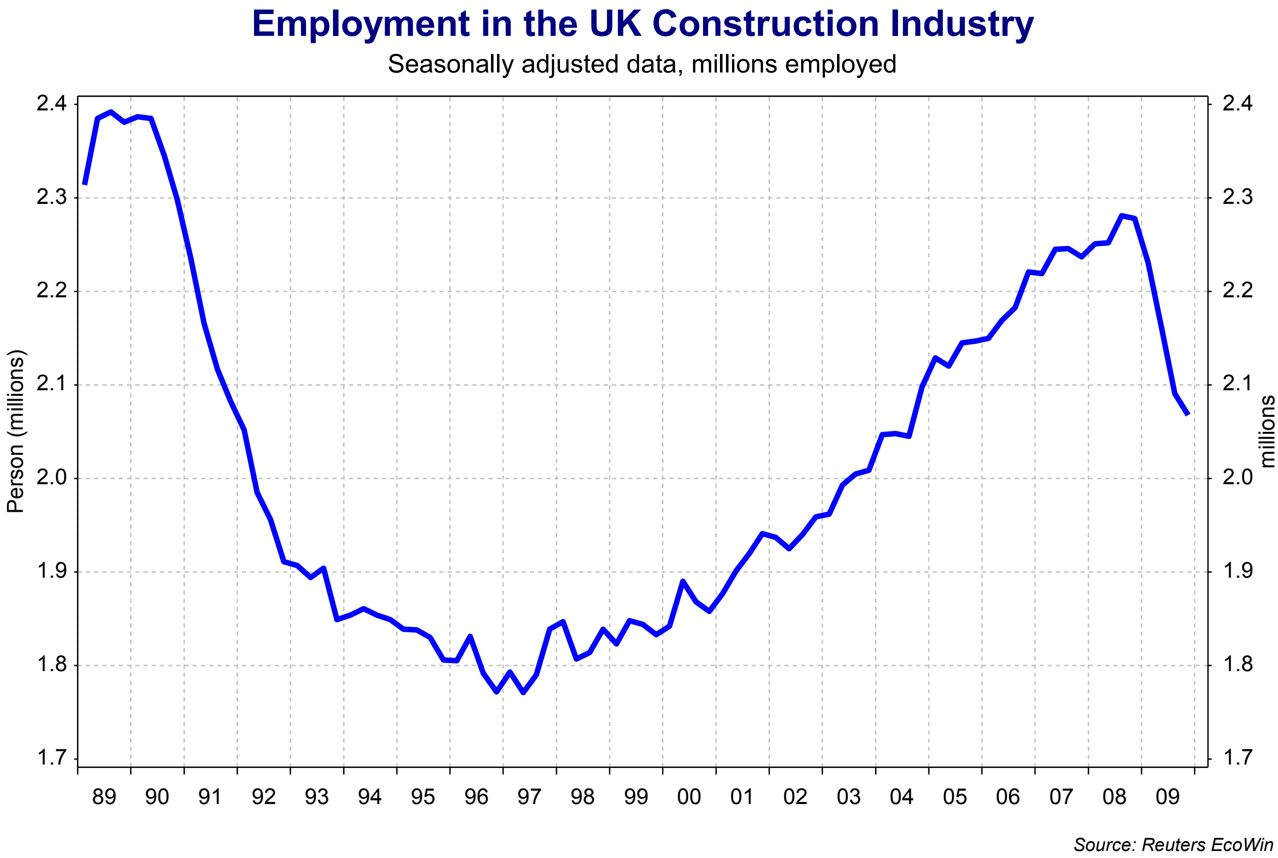
The Need for More Housing Supply

Increases in UK house prices are due in part to supply shortages in the market according to the House Builders' Federation (HBF) which revealed that new home building is failing to keep pace with demand. A spokesman for the HBF said: "The country needs 200,000 new homes annually to keep pace with the growth in households. With only 160,000 being built, we have a serious problem."

Source: Adapted from the House Builders' Federation web site

Why housing matters

- Asset prices have grown in importance – 70% of homes in the UK are privately owned
- The rented sector accounts for 30% of properties – around 12% are rented from private landlords
- Millions of jobs linked directly or indirectly to the property / construction sectors – this emphasises the importance of inter-related markets and industries in the economy
- Changes in household wealth can affect consumer spending on goods and services – falling prices can lead to reduced consumer confidence and demand
- Over 15% of aggregate demand (AD) is linked directly and indirectly to housing activity
- Construction accounts for 7% of GDP and employs over two million people.



The 2008-09 UK Housing Slump and the UK Recession

- The sub-prime mortgage crisis in the USA spread globally leading to the collapse of Northern Rock and Lehman Bros bankruptcy in September 2008.
- The supply of mortgage finance dried up as many mortgage lenders withdrew from the market. There has been a fall in loan to valuation ratios – higher deposits are needed to get a home loan. The ability to borrow money to buy a house is the life-blood of the market.
- We have seen a big change in market expectations among both buyers and sellers and construction companies – many building firms have cut back on the number of new properties (falling demand has led to a contraction of market supply).
- House prices have slumped with declines of >15% pa. It is estimated that nearly 1/3rd of homeowners will suffer negative equity where the market value of a house is worth less than the debt on it.
- During the housing slump there has been a large rise in demand for social housing putting pressure on local councils. The demand for private rented homes has also increased.