

Anatole Kaletsky Brace yourself for a 30 per cent fall in house prices



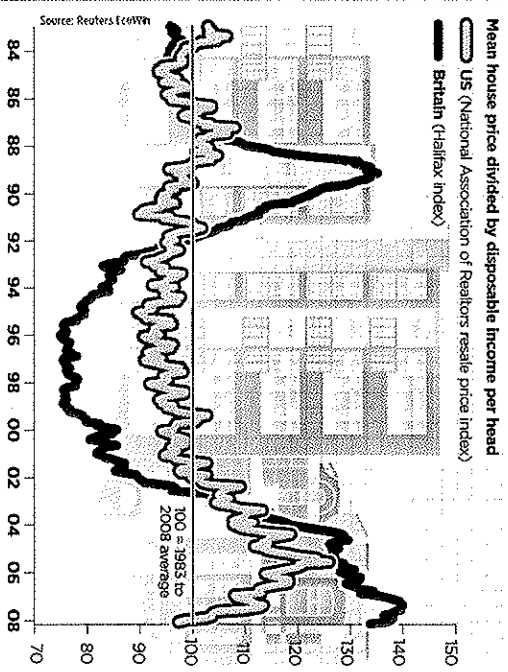
Crisis? Disaster? Catastrophe? Choose your word

After the biggest monthly drop in house prices since Black Wednesday one simple question is on thousands of lips in Britain this week: "How low can they go?"

A picture can be worth a thousand words, so let me double my usual allowance of enlightenment (or confusion) by drawing your attention to the chart. The two lines on this chart provide what I believe to be the most accurate comparison possible between the housing cycles in America and Britain. It shows the relationship of average house prices to average disposable incomes, the broadest and most relevant measure of the money available to households in each economy for buying homes.

The message from this comparison can be summarised as follows: the boom in the British housing market has been much bigger than the one in America. And the long-dreaded correction in British house prices has hardly even started. So if you believe that events in America since house prices peaked there about 18 months ago could accurately be described as a "crisis" or even a "disaster", you had better reach for the Book of Revelations to find an appropriate word for Britain's economic prospects in the next year or two.

So my question about the likely direction of house prices is simply answered: "a lot lower". Trying to quantify the fall with any precision is a mug's game, but here are a few statistics. House prices in both America and Britain roughly tripled in the decade to 2005, but US incomes rose considerably faster, partly because of inflation. As a result, the house-price-to-income ratio, which gives a rough measure of the affordability of houses, peaked at



26 per cent above its long-term average level in America, whereas the peak in Britain was 41 per cent above. Since 2005 American house prices have fallen by about 15 per cent and are now below their historic average relative to incomes.

Despite this, US house prices are still falling steeply and almost everyone expects at least another 5 per cent decline. British house prices, by contrast, have fallen by only 4.5 per cent from their peak level in absolute terms and, relative to personal incomes, are still 34 per cent above their long-term average. Moreover, homeowners are more extended on average in Britain than in America — total mortgage borrowing here is worth 125 per cent of the nation's disposable income, compared with 103 per cent in the US.

In sum, any simple comparison with the recent US experience suggests that house prices here should probably fall by a further 30 per cent in the next two years, even assuming that personal incomes per head continue to grow by about 5 per cent annually, as they have done for much of the past decade.

There are, however, several reasons to believe that house prices in Britain may not fall quite as steeply as they have in the US. First, it is reasonable to believe that in the long run house prices in Britain should rise in relation to personal incomes, while in America this ratio should remain roughly constant. The main reason is that Britain is a small country with severe planning restrictions, as a result of which the long-term supply of housing cannot grow as it does in the US. Having said this, housing

supply in Britain recently has been growing, while housing starts in America are now in rapid decline. Housebuilding now also accounts for a slightly higher proportion of GDP in Britain than it does in the US. So over the next year or two, the supply-shortage argument in Britain will not be remotely sufficient to prevent a house price decline.

Interest rates are another reason why house prices in Britain are unlikely to fall as far as suggested by simple comparisons with disposable incomes. Interest rates are much lower than they were in the 1980s and early 1990s, both in absolute terms and relative to the rate of inflation. As a result, homes are much more affordable than they were 20 years ago, even though they appear to be just as expensive in relation to average incomes as they were in 1989.

It is likely, therefore, that the ratio of house prices to average incomes will not fall far below its long-term average, as it did in the mid-1990s and may even hit bottom somewhat above this average level. But remember that a return to this long-term average would mean a house price decline of between 20 and 30 per cent, depending on what happens to personal incomes.

But surely this is impossibly pessimistic? After all, most experts still concur with the prediction from the Halifax this week of a "low single-digit percentage decline" — in other words 5 per cent, or at worst 10 per cent, in the year ahead. The trouble is that similarly reassuring predictions were being made about the US housing market a year ago. In the financial futures and spread-betting markets, however, where people back their views with their own money, recent trading

implies a house price decline of 14 per cent in the year ahead followed by a similar decline in 2009 — very close to the 30 per cent fall suggested above. In citing such figures, I am not suggesting that futures traders have any better idea than the Halifax: if there is one thing we have learnt in the past few months it is that markets are often wrong. I am merely saying that the significant fall implied by futures prices and income statistics, as well as by the American experience, is perfectly possible.

It is also worth recalling that, contrary to popular belief, very steep declines in house prices have occurred in the past. Between 1989 and 1996, as shown in the chart, the house-price-to-income ratio in Britain fell by 45 per cent. And while part of this was due to the steady rise of personal incomes, the absolute level of house prices fell fairly sharply — by 13 per cent in Britain as a whole, and by 29 per cent in London, where house prices were much more expensive in relation to incomes than in the rest of the country in the late 1980s, just as they are today. A fall in average house prices of 20 to 30 per cent in the next few years would be quite consistent with historical experience and would only bring house prices back to their level of early 2004.

In sum, conditions in the British housing market today are broadly similar to those in America a year or two ago. The question is whether the Bank of England and the Government will respond to the housing downturn as energetically as the Federal Reserve Board, the White House and the US Congress. The American Government has risen to the challenge of the credit crunch and housing crisis; the test for British institutions has only just begun.