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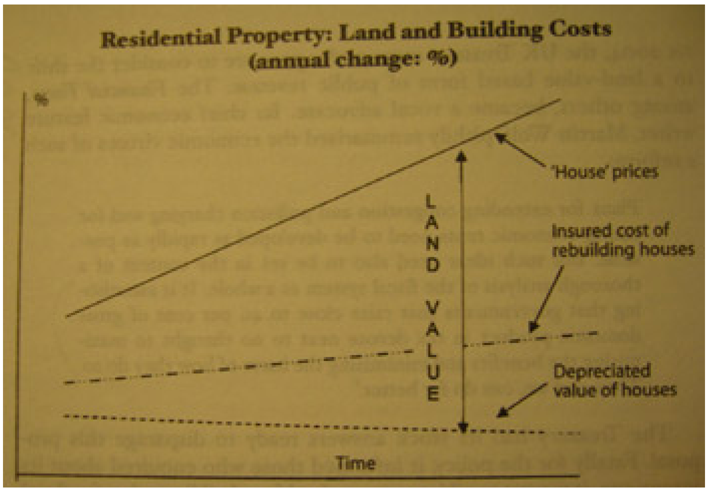
Boom Bust - UK housing bubble set to burst

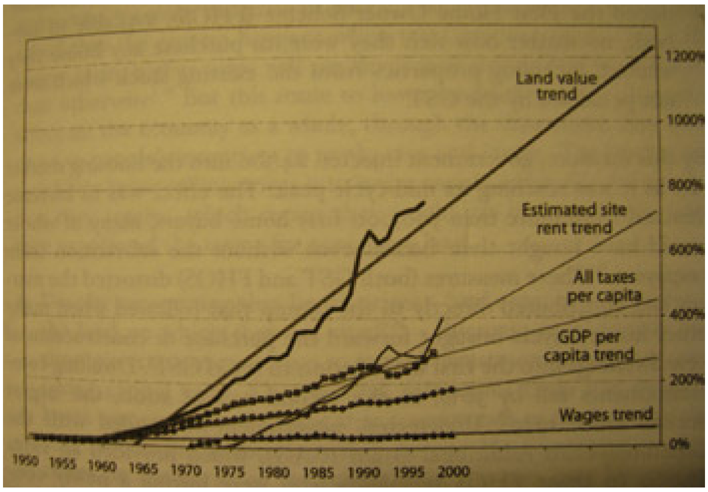
Buy a new car and you can be fairly certain that in 5 years time its resale value will be HALF what you paid for it. It's logical really. Wear and tear shortens its useful remaining life. This reduces what it is worth to the next owner.

Turn to houses and all logic seems to go out of the window. If your timing is right, you can buy a new house, live in it for 5 years, then sell it for TWICE what you paid for it!

It doesn't make sense does it... until you work out that during those 5 years the value of the bricks and mortar didn't, in fact, go up at all. The thing that went up was the 'market' value of the patch of dormant soil the house is sitting on.



Graph: all is not what it seems, the rise in house prices is, in fact, all about increasing land values. The true value of the bricks and mortar is reflected in the depreciating value of the house and what an insurer will pay out to cover the cost of rebuilding it should it, for example, be destroyed by fire.



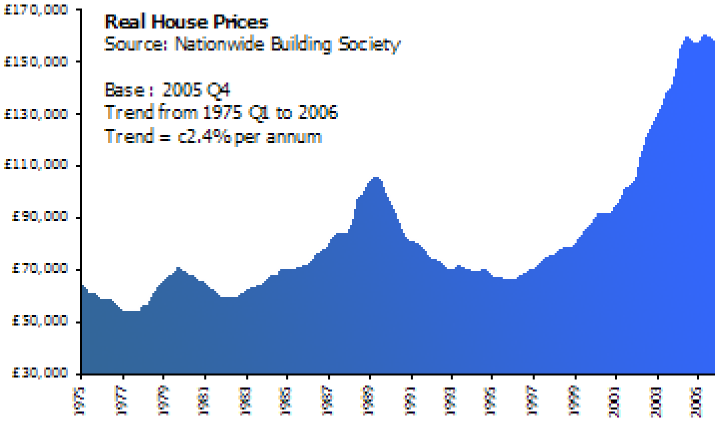
Graph: the rise in land values (and what can be charged for rents) is on a different planet to the insignificant rise in living wages since the 50s. Perhaps this helps explain how it was possible to support a family on a single male income in the 60s and 70s.

This should beg a lot of questions, like who are the principle beneficiaries of this trend in land values? Like, why, in this green and pleasant land is it fast becoming unaffordable for young adults to set themselves up in a permanent home close to jobs and public services? Like, is it right that you should have to commit half your adult earnings to paying off the perverse interest loaded cost of that 80 square metres of land hidden under your house - a plot otherwise sufficient to keep a sheep or two in grass, in a country where unpopulated land, from the window seat of an aeroplane, does not look to be in short supply.

It is clear that we can not look to government, nor the mainstream media for answers to these questions. Neither are about to take responsibility for the approaching recession.

So why does it happen?

Firstly, people who assume that the value of a home will only ever go up, may not be old enough to have bourne witness to the damage done by the last market crash. If you break history down into periods of 8 or 9 years, such an assumption proves to be highly unreliable.



Graph: house prices 1975 - 2006 illustrating that what goes up, also comes down. See here for the latest version of this graph.

More reliable is the observation that over the last few hundred years (excluding the war years) roughly every 18 years people have found themselves at the bottom of a deep economic recession and, since so much of the UK's wealth is invested in property, these recessions and the fortunes of our housing market are inextricably intertwined.

It is well understood now that busts follow speculative bubbles - periods of intense buying activity - much of it speculative investment - with the promise of easy profits. Take the Dot.com bubble.

In the case of housing, the bubble is primed by easy-to-arrange bank loans at times of irresistibly low interest rates. At such times property starts to look like a golden investment, offering returns of say 10-20% per annum (and no capital gains tax to pay on selling) compared to a saving account's feeble few percent return (before tax).

It is easy to see how the borrow and spend mentality becomes contagious in times of near zero interest rates and over-zealous lending. When rates are low the conditions are right for the housing market to pick up again. The construction industry re-engages to capitalise on rising prices, and as demand outstrips supply of viable plots (many held off the market in the hope of making even higher profits on sale), the bidding war begins, land prices rocket, and as homeowners see this increase reflected in the increasing market value of their homes, they release equity to buy big ticket items (cars, holidays). Consumption grows, confidence and feel-good abound... then the government (now at hands length through the Bank of England) finally acts to 'cool' this unsustainable growth in indebtedness by pushing up the interest rates.

When interest rates rise, repayments on those loans that seemed such good value just a few years ago, also rise and start to hurt. Affordability becomes an issue. Buyers get cold feet, demand drops, the certainty of an easy and profitable future sale evaporates, building firms shed employees, unemployment rises, repossessions climb and, hey presto, we wake up one morning with a headache at the bottom of a deep pit.

Having a mortgage of 4-6 times your salary and less job security is stressful. But bankers understand that most people prioritise keeping the roof above their heads ... in fact, the banks profit handsomely from the proportionately much higher loans that inflated land prices enable them to make. It becomes a self-perpetuating cycle. The principle losers are those that lose their homes or are stuck with an unnecessarily high burden of debt repayments and a house that may take another 8 years to return to its pre-crash value.

Civil servants and politicians aren't thick. If there was a will to change this pattern which generally hurts the many to the benefit of the few, it might be done by taxing the unearned incomes from land (tax 'money for nothing'). It might be possible for the treasury to collect enough income from this to entirely substitute, if not dramatically reduce, income tax, VAT, and the multitude of further 'stealth' taxes which burden and discourage hard workers and entrepreneurs.

Lloyd George and Winston Churchill proposed such a plan in 1909 as part of the People's Budget. The budget recommended a 20% tax on the unearned increases in privately owned land's value (to be paid at the point of sale or when passed on following the owner's death), plus a tax on land privately owned but sitting vacant.

Fred Harrison, makes a persuasive argument for government acting to put an end to the boom & bust cycle in 'Boom Bust - House Prices, Banking and The Depression of 2010'.

The last time house market crashed in the UK was 1989. 17 years on, the prognosis does not look good.

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Progress and Poverty - Henry George
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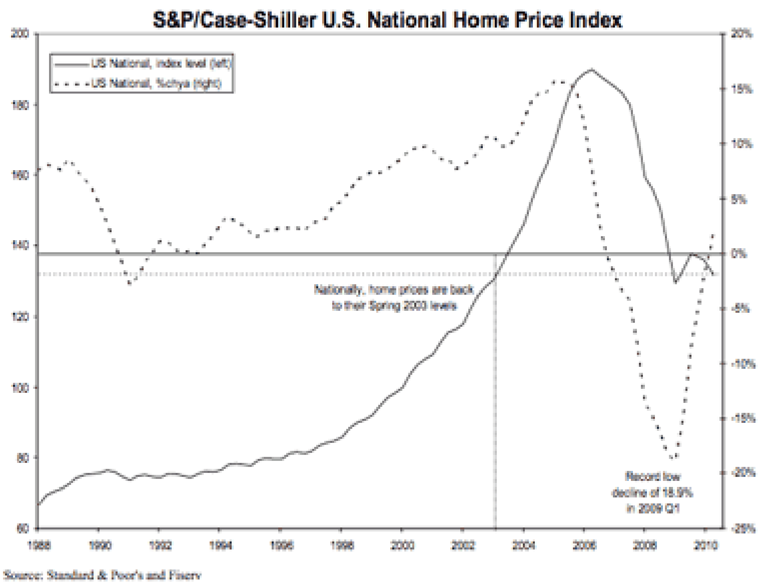
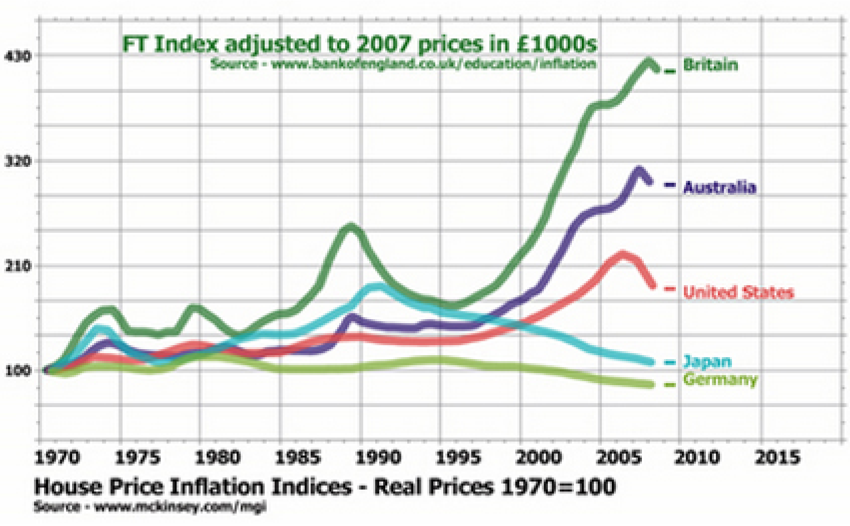
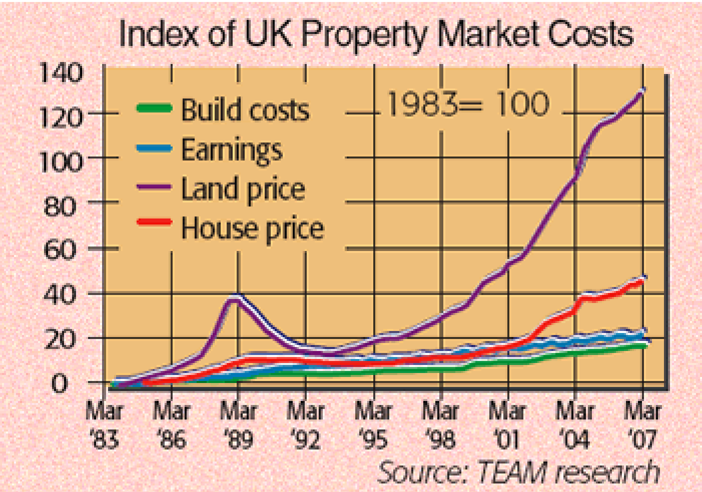


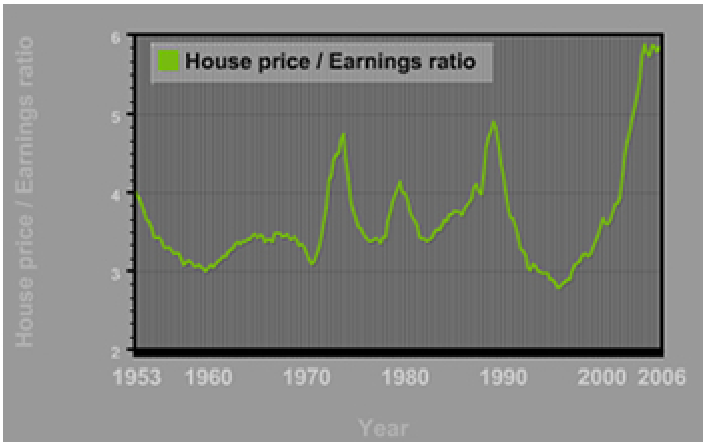
US National Home price index at June 2010 suggests US house prices heading down again after a brief stimulus driven recovery



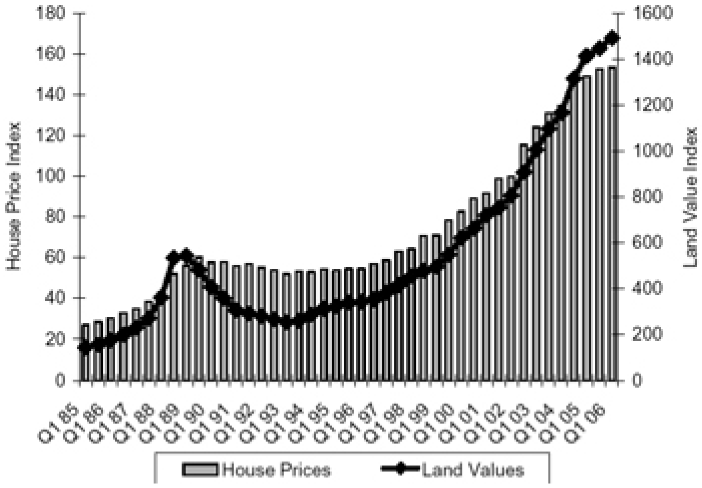
Graph: How recent house price inflation compares by country



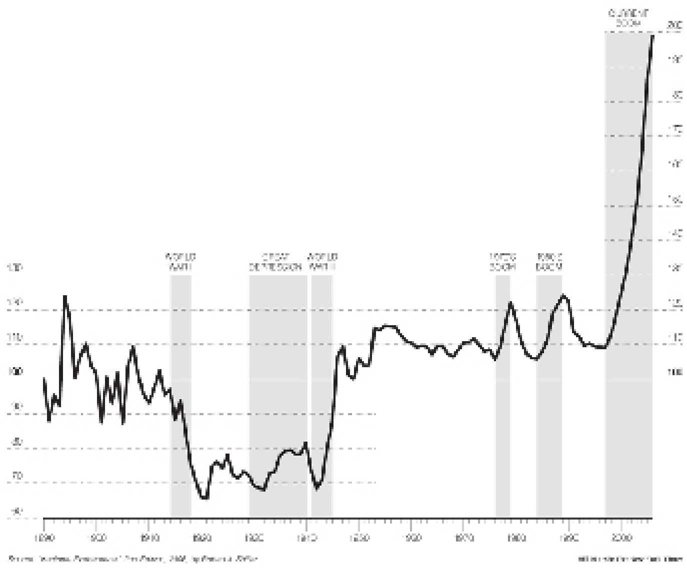
Graph: mmm... UK land prices looking a bit peaky?



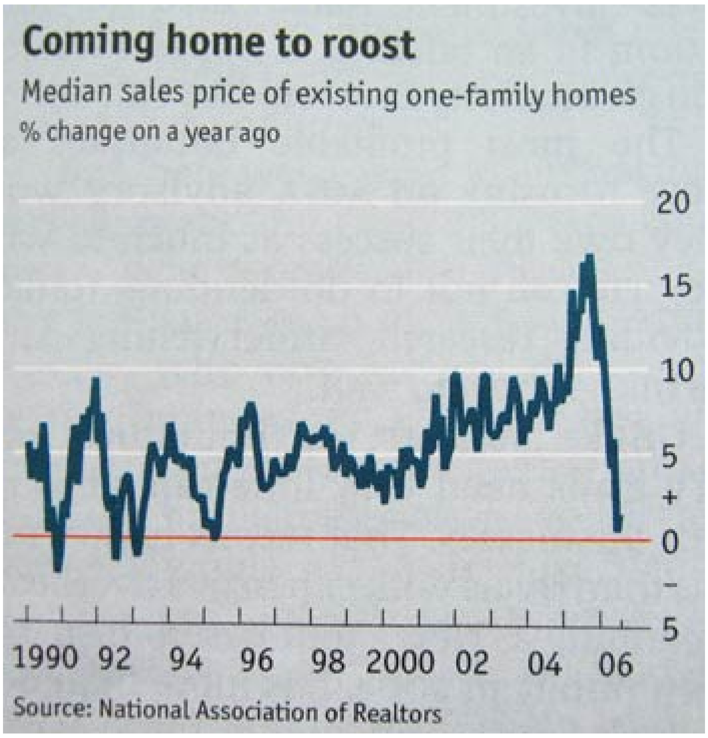
Graph: Average UK house price to earnings ratios - 3.5 times earnings is usually considered the maximum for sound lending.



Graph: It's not about the value of bricks and mortar. Since the '89 crash, UK land values fell, then have risen to alpine heights, with house prices necessarily rising to accomodate this. Residential land values have risen by 764% (x 7) since 1986. For more, visit Section 10 of the very helpful Housing Statistics Briefing May 2006 report from English Partnerships.



US house prices 1890 - 2006, plotted by Robert J.Shiller
of Yale. Click graph for detail. Then compare with the recent % change in US house prices. Or, an analysis of the Japanese experience.



Graph: % year on year increase/decrease in house prices in the US, clearly indicating that the price bubble has already burst.

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Housing Bubble: Market Crashing? Yes, In Slow Motion.

Above: Fred Harrison on how the UK's tax system allows rich landowners to milk the poor during boom times.

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Higher UK mortgage rates hit lower income earners
Young homebuyers contend with £20k additional debt
Filings for repossessions in US up 93% vs a year ago
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New house buyer enquiries down and unsold stock up (July)
Near 1m UK buy-to-let mortgages now, up x 33 from 28k in '98
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200 businesses launched to capitalize on UK mortgage arrears
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