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faulty towers?

city centre housing markets in the UK

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Abstract

The national housing market is at a critical juncture. For several years, commentators have been debating what will happen when house prices stop increasing. Now we are about to find out. Are price rises unsustainable – part of a housing bubble that is set to burst, sending the market spiralling downwards? Or has the rapid growth in house prices been built on firm foundations, providing a much softer landing?

This has important implications for city centres. If the pessimists are right, prices are going to fall and the downturn is going to hit city centre markets particularly hard. If the optimists have it, no significant adjustment is necessary to bring prices into line with their long term values. City centre markets will remain a good investment over the next few years.

The evidence suggests that the national housing market is overvalued, but not to the degree some suggest. Over the past ten years, the property market has helped make city centres happening places. Over the next five years, this will not be the case. In the long-term, city centre housing markets will prosper again. But they will always be volatile.

This paper draws extensively on the quantitative and qualitative research undertaken for City People *(Nathan and Urwin, forthcoming). To be published in January 2006, this report draws on the experiences of Manchester, Liverpool and Dundee. It provides a detailed understanding of the demand for city centre living in Britain.*

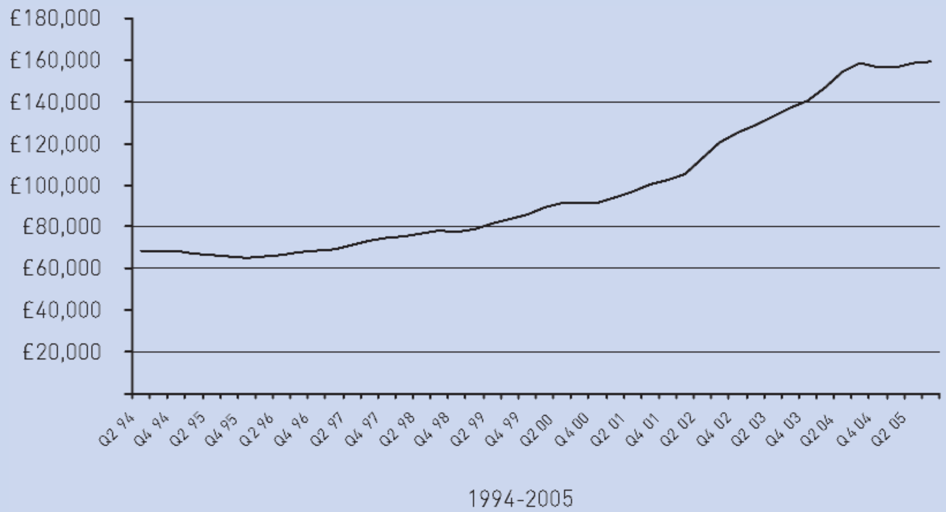
Introduction

One of the most visible signs of progress in urban Britain has been the rapid increase in city centre living. Developments in the city centre housing market have been central to the re-imaging of our core cities. New residential developments provide the visual proof that they have changed, indications of a new found health and vibrancy. Today's flagship developments are tomorrow's city landmarks, and such signs of prosperity are thought to be important in attracting skilled workers, investors and visitors. Undoubtedly, the dramatic extension of living in urban cores has delivered real improvements in the built environment of city centres.

The future of city centre living will largely depend on developments in the housing market.[1] Although the city centre housing market has very distinct characteristics, its progress will be greatly dictated by developments in the national market – and there are divergent views about the likely trajectory of national house prices. Pessimists and optimists agree that a market readjustment is necessary. They disagree about its size, scale and significance.

A pessimistic picture has been painted by the International Monetary Fund (IMF, 2005) and *The Economist* (2005a, 2005c, 2005g). They believe that a housing market bubble has pushed prices way beyond their long term sustainable value. A large readjustment is necessary and prices will fall. As we will see, this implies that city centre markets are particularly vulnerable – with falling prices, and market activity falling off.

Figure 1: Average UK house prices adjusted for inflation



Source: Nationwide

> " The market is shifting from a seller controlled market to one dominated by the buyer "

But many of those inside the industry – developers, real estate agents and mortgage lenders – are more optimistic. They contend that the dramatic increase in prices represents an increase in the long term sustainable value of houses. Some readjustment may well be necessary, but it is not very significant: a short period of flat prices may do the trick. That means city centre markets should face a much easier ride over the next five years.

About this paper

This paper explores these two views, and what they mean for UK city centres. Neither suggests that the city centre housing market has no future. Both pessimists and optimists would agree that the prospects for city centre living are good in the long term.

The issue is what is going to happen over the next few years. It is important for policy-makers – and those in the property industry – to get a clear view of the landscape ahead.

The UK housing market today

House prices boomed between the late 1990s and 2004 (see Figure 1) - far exceeding growth of GDP and wages. That trend has come to an end. National average house prices rose 3.5% July-September 2005, down from 16.3% over the same period in 2004. Furthermore, the number of completed sales has decreased dramatically (Land Registry, 2005). Land Registry data shows there to be about a third fewer transactions in the first quarter of 2005 compared to 2004 (Land Registry, 2005b).

The market is shifting from a seller controlled market to one dominated by the buyer. The number of viewings per sale is increasing.[2] Sellers seem to be asking prices that buyers are reluctant to accept.[3] Short-term capital gains are definitely not a certainty.

So the market is now at a critical juncture. For several years, commentators have been debating what will happen when house prices stop increasing. Now we are about to find out. Are price rises unsustainable – part of a housing bubble that is set to burst, sending the market spiralling downwards? Or has the rapid growth in house prices been based on firm foundations, providing a much softer landing?

Flimsy foundations?

According to *The Economist*, global price developments in the residential property market "look like the biggest bubble in history" (*Economist*, 2005a). As prices increased by over 150% between 1997 and 2004

(*Economist*, 2005a), the UK housing market is a leading example of what has been going on across the world. It is now significantly overvalued. In today's low inflation environment, the necessary readjustment means house prices are going to fall.

Pessimists point out that house prices are always likely to diverge from their long term sustainable values. At any point in time, it is very difficult to know what that value is. People buy and sell houses infrequently, so information about what a house is worth is only available intermittently. Properties are different, so judging prices is hard – for a property, and for the market as a whole. Furthermore, compared to other financial investments, purchasers receive relatively little professional advice about the size of investment they make in residential property. This makes it even easier for people to pay prices that do not match underlying values.

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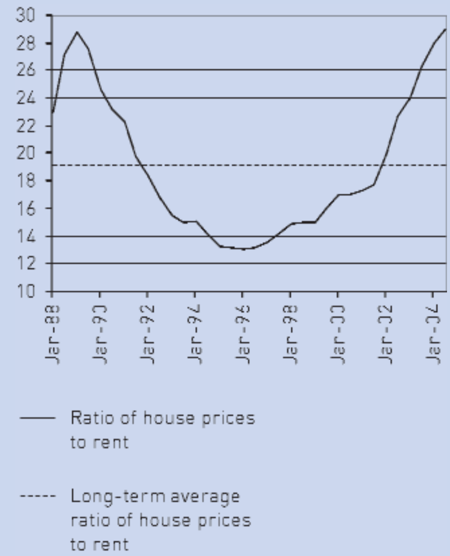
If house prices tend to diverge from long term sustainable values, the housing market will always be vulnerable to bubbles developing. Many believe this has happened recently. People have bought houses because they expect house prices to rise. Buyers have come into the market with the expectation of making capital gains. In doing so they have pushed up prices, thereby creating a self-fulfilling prophecy which encourages even more buyers to enter the market. Fuelling this, a lot of borrowing has gone on. Banks have helped the bubble expand by applying relaxed lending standards, possibly allowing people to overextend their mortgages.[4]

How can we measure this? Cave and Giles list a number of possible means for gauging any overvaluation. These include the house prices to income ratios, the debt servicing to cost ratios and large statistical regressions. Measured with any of these methods the market appears overvalued (Cave and Giles, 2005).

Another rule-of-thumb indicator of the sustainability of house prices is the change in the ratio of prices to rents over time.[5] Sustainable house prices reflect the benefits of future ownership. This is the discounted present value of future rent levels – rent levels represent the amounts saved by the owner-occupier who does not have to rent or the rental income for an investor.

The Economist has taken the average ratio of prices to rents during 1975-2000 as a comparator for the last five years and found that, by this proxy, the current market is overvalued by 50 percent.[6] It used this figure, not to claim that house prices needed to fall by a third necessarily, but that a significant readjustment was extremely likely.

Figure 2: Ratio of house prices to rent in the UK



Source: IMF

Reaching similar conclusions, a recent IMF report stated that traditional techniques for estimating the sustainable level of house prices suggest that the overvaluation could be in the range of 25 to 60 percent (IMF, 2005). Figure 2 above illustrates one scenario.

Another feature of the housing market over recent years has been the inflow of investor money. The buy-to-let market has boomed over the last ten years. The first buy-to-let mortgages were marketed in 1996 (Rhodes and Bevan, 2003). At the end of 2004, there were over 525,000 outstanding buy-to-let loans (Scanlon with Whitehead, 2005). In part, this has been fuelled by the fact that the housing market has performed well relative to other potential investment destinations, especially the stock market. Both individual and institutional investors have shown increasing interest in residential property in recent years and have earned substantial returns as a result. Many believe the changes to the rules regarding self-invested personal pensions (Sipps) due to come into play in April 2006 will add further to the level of investor activity in residential property.[7]

The increased presence of investors in the housing market has important implications. First, some forms of investment serve to inflate housing bubbles. Some syndicate investments based on high pressure selling bring poorly informed money into the market, and are run by organisations who have an incentive to oversell the market.

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Second, it is easier for an investor than an owner occupier to transfer his capital out of housing. If there are investors reliant on capital gains, they may choose to sell up as soon as a sustained decline in prices becomes evident or other alternative investments (such as the now better performing stock market) arise. Pessimists claim this adds to potential instability. Investor dominance may make it easier for the bubble to burst. Investors leaving the market quickly will add to the number of sellers relative to buyers and bring prices down. Other owners will fear that prices will fall further and may also rush to sell their property, an action that– if widely taken – brings prices down.

Bad news for city centres?

This does not bode well for the city centre housing market, which is increasingly investor-driven. Whereas investors were purchasing about 40% of properties on the market five years ago, they are now snapping up around 70%.[8] Worse, the nature of many of the owner occupiers in city centres suggests they could react by selling up and moving on, accelerating the downward spiral of house prices.

So if house prices fell, they would fall fastest here. Few city centre residents have a long term commitment to their neighbourhood. They are young people at an early stage in their life cycle so they are not held to a particular area by family or community ties. At some point in the not too distant future, these people envisage themselves moving to another home – probably suburban, perhaps rural – with more interior and exterior space, better suited to family life.[9] It is relatively easy for such people to up-sticks and move on.

Furthermore, within the owner occupiers living in the city centre there is a high concentration of relatively young people taking their first step on the property ladder. These people had property market performance at the front of their minds when they decided to make city centres their home.[10] Most city centre owner occupiers will move out one day. It is a matter of time. Relative house price performance will be one of the crucial factors in deciding the moment.

There will be more trouble if the slowdown in the housing market affects the economy as a whole. There is a strong empirical relationship between the state of the housing market and the level of consumption and output. A pressing concern for the present government is that falling house prices could drag the whole economy towards slower growth. And if this happens an economic slowdown will hit city centre housing markets hard.

There are two reasons why. First, city centre living is a lifestyle choice. City centre flats are less a place to live (forever) and more a way to live (for now). People choose to live in city centres because it allows them to socialise easily and frequently and to take full advantage of the city centres' bars, cafes, pubs, clubs and restaurants. So, for many, especially those likely to move into new and recent developments, city centre living is partly attractive because it is affordable. If a downturn leaves people unable to live the lifestyle they bought into, city centre living itself may become less attractive for some.

Second, turnover is high in city centres. Each year a lot of people leave and a lot of people enter. In 2001 around 30% of residents in Liverpool and Manchester city centres had moved in during the previous 12 months. A slightly smaller number of people left during the same period.[11] If people lived in city centres for a long time, the impact of an economic downturn might be that people adapted their behaviour while remaining in the city centre. Given turnover is high, the next wave of incomers will need to be happy with a different, less affluent city centre lifestyle. Property prices might need to fall further still before city centres became attractive again.

Worse, the downturn in the national housing market has coincided with an emerging problem of oversupply in city centres. More and more one- and two-bed flats are being constructed in and around our city centres. In Manchester there are nearly 7,000 developments under construction or with planning permission.[12] In Liverpool, there are over 40 schemes on site, set to create 3,000 new units (Liverpool Vision, 2005). A further 80 schemes are anticipated, representing 4,000 more units, although it is unlikely that these will all be completed (City Residential, 2005).

This suggests players in the market do not fully understand demand. City centre living could be easily misinterpreted as a change in preferences towards flat living. Indeed, some commentators claim that demand for city centre living could grow as families and over-50s increasingly decide to make the city centre their home (Knight Frank, 2005b). Our research suggests this is unlikely. Lack of space both inside flats and outside, plus the chaotic, dirty and noisy environment mean that city centres are not thought to be suitable places to bring up children. These are deeply ingrained attitudes that are unlikely to change in the short term.[13]

“Lack of space both inside flats and outside, plus the chaotic, dirty and noisy environment mean that city centres are not thought to be suitable places to bring up children”

Young, mainly single people are happy to live in city centres for a short phase of their lives. The pluses outweigh the minuses. But this means that for now, there is a limit to the size of the market. And the potential purchaser pool is unlikely to grow if people are getting nervous about the performance of city centre properties. Furthermore, investors may have failed to realise the extent to which city centre living has been led by students. As higher education growth rates slow, so will a key driver of demand.

All of this makes oversupply a live concern amongst estate agents and policy makers.[14] Developers leapt on the bandwagon, just as the market was nearing saturation. Without an increase in supply, it would be likely that the prices of city centre properties would perform poorly relative to national averages. With a dramatic increase, it becomes a near certainty.

Safe as houses?

So much for the pessimistic view. Many contend that there is no bubble in the housing market. They claim that current house prices represent the true value of the UK's housing stock. If true, there is no need for a major readjustment. Price shifts would take place without a visible impact on house prices, inflation pushing up incomes while house prices stay flat. If this happened, city centre markets would perform relatively well, and worries about oversupply would evaporate.

Optimists point out that a stable macro environment has nurtured high employment levels and allowed strong earnings growth. Demand has grown more quickly than supply. House building has been at historically low levels. Protection of Britain's treasured green belt and tough planning regulations mean real supply constraints will remain a feature of the market in the medium-to-long term.[15] Meanwhile, not only are households earning more, but there are more households. ODPM figures suggest that if the number of households were unconstrained by supply, the falling average household size and immigration adding to population growth would mean 18% more households would exist by 2021 in England (ODPM, 2004).[16] This would mean homes for 189,000 households would have to be built each year. In 2002/3, only about 138,000 were built (Office for National Statistics, 2004).

All these are very valid points. However, they would significantly impact on both the rental value of housing as well as prices. In

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other words, these arguments do not provide an explanation as to why the ratio of prices to rents has grown in the way Figure 2 indicates.[17] To claim that the housing market is not overvalued, the optimists need to provide an argument based on market fundamentals to explain why average prices have risen at a faster rate than average rents.

One possible scenario is that changes in the monetary and fiscal policy frameworks have permanently improved the economic environment. This means that purchasers are operating in a different house-buying world than they were 10 or 20 years ago.

The Bank of England’s independence is central to this argument. Depoliticising interest rates should mean less rate variation and a smoother business cycle. The Government’s accompanying fiscal rules also help deliver stability. All of this means potential homeowners can be confident of lower interest rates and better job prospects. Buying a home becomes cheaper and less risky. We thus enter a new paradigm in which people are rightly more willing to invest more of their money in housing. Prices shift upwards faster than rents.

But not even the biggest optimists think this is the whole story. First, economic outcomes are not only determined by economic policies.[18] A policy framework cannot prevent external shocks, it can only respond to them. Today’s policy framework has not yet faced a severe test. Even if it can deal well with external shocks, significant impacts on employment and earnings are unavoidable. Second, just as lower nominal interest rates are likely to be a feature of our economy in the future, so is lower inflation. Lower inflation means the real burden of mortgage debt will be eroded more slowly. In real terms (i.e. taking inflation into consideration), after-tax interest rates are not low by historical standards (*The Economist*, 2005a).

This means there is still room for overvaluation – but it will be small, and manageable. A relatively brief period of house price stability may be enough to bring prices into line with the long term value. Or, given the low-inflationary environment, perhaps a small fall in prices is required.

Good news for city centres?

This means city centre housing markets have a sunnier outlook too. First, a small readjustment will not trigger a wider slowdown. City centre residents’ incomes and lifestyles will not be under threat. Second, if the size of the readjustment is small, both owner-occupiers and investors may have difficulty reading price signals to work out what action would maximise returns on their investment.

Third, if the optimists are right and prices are not going to fall significantly the high costs of moving home mean many owner-occupiers are unlikely to respond by moving out. It may make more sense to accept a short period of poor relative price performance.

Fourth, not all investors are ready to pack their bags. Evidence from stakeholders suggests that well-informed speculative investors, playing the market purely for capital gains, have already left the arena.[19] The gains they demand have not been a feature of the market for a year or so now. This makes a dramatic and sudden market collapse much less likely.

Of those left in the city centre, many will be committed to their property as a long term investment. For example, amongst buy-to-let investors, two distinct types of actors can be identified: part-time and full-time landlords (Rhodes and Bevan, 2003). Full-time landlords – holding on average 47 units – apply strict selection criteria to the properties they hold and are quick to get rid of badly-performing properties. Part-time investors – holding on average just six units – invest in the property market as an alternative to a personal pension. On a year-to-year basis, such investors are happy as long as they cover their costs. Their main concern is that the property provides significant capital growth before their retirement.

Other recent research suggests that more than two-thirds of landlords have a full-time job or mainly rely on another income (Scanlon with Whitehead, 2005). Combining the two studies, it may be that part-time landlords hold around around a fifth of all buy-to-let properties.[20] As long as long term prospects are reasonable and the costs of managing their asset are low, these part-time investors are unlikely to withdraw from the city centre housing market.

From this perspective, the immediate future for city centre markets is much less bleak. Indeed, a strong desire to live in city centres remains. Economic, demographic and social drivers have helped create the conditions for the growth of city centre living, and cultural changes reinforce the trend. Availability and affordability have prevented some people from entering the city centre housing market until now. A relatively small adjustment might be enough to bring in a large number of first time buyers that previously have had to choose tenancy over owner-occupation. The market may be able to absorb much more of the increase in supply without a detrimental impact on prices than the pessimists' case suggests.

“Over the past 10 years, city centre markets have grown rapidly. Over the next five years, there will be less going on”

An evaluation

City centre living is here to stay. In the long-run, it is a market that will grow and thrive. Many of today's students envisage themselves as tomorrow's loft-living professionals. Furthermore, demographics indicate that the 20-30 age group will expand and, as trends for postponing families continue, the number of people at the stage of the life cycle when city centre living is most likely to appeal is increasing.

In the short term, what effect will the housing market have? Part of the higher ratio of prices to rents reflects an increase in the sustainable value of housing. But this does not explain all of the change. In other words, the market is overvalued to some extent. And, given the low-inflationary environment, property prices are likely to fall. Coinciding with an increase in supply, this readjustment could be particularly severe in city centres, reflecting the markets' sensitivity to cycles in the housing market and the economy more generally.

The city centre housing market is not going to provide the same 'feel good' factor to city centres as it has done in recent years. Estate agents and policy makers will not be able to point to spiralling house prices as signals of demand. Similarly, developers will be much less likely to initiate large scale, city-defining developments in the immediate future.

Over the past 10 years, city centre markets have grown rapidly. Over the next five years, there will be less going on – slower price growth, a slower pace of new development. But as city centres continue to improve as a place to be, the demand to live there will get even stronger. City centre living has enduring appeal. The city centre housing market will recover – and prosper.

Notes

1 This paper focuses on the private sector. Social housing is not discussed here, but it does play an important role in city centre housing. Research undertaken for *City People* finds a significant level of social housing within the city centre. In Liverpool 47% of households are in social housing, 31% in Manchester, and 27% in Dundee (2001 census figures). Not all people live in households though – communal establishments contain a lot of students in all three of these city centres – so these figures overemphasise the role of social housing.

2 *City People* stakeholder interviews, Liverpool and Manchester, August 2005.

3 With housing markets, figures on sale levels can provide an insight into the state of housing market before price adjustments (Krugman, 2005).

4 This reflects the perverse incentives of banks. Higher house prices increase the market value of collateral on banks' loans and raise the value of their own property holdings and therefore their capital so it is in their own (short-term) interest to lend as much as possible when prices are rising. The incentives work in the opposite direction when prices are falling, meaning their role exacerbates both the boom and bust.

5 It does no more than offer an indication, however. It is of little value if the stock of housing for rent is very different from the marketable stock, for example. Arguably this is the case in the UK.

6 Interestingly, the same measure does suggest that the housing market was undervalued through most of the 1990s.

7 Sipps allow people to manage their own pensions by being more specific about where their pension is invested. Changes to the rules regarding what can and cannot be invested in Sipps will be greatly relaxed from April 2006. These changes will make it possible for people to include specific individual properties in their pension for the first time. Some commentators have suggested the result will be

a sudden surge in demand for property, especially buy-to-let flats, although the overall impact is very difficult to predict.

8 *City People* stakeholder interviews, Manchester and Liverpool, May 2005.

9 *City People* focus groups, August 2005.

10 *City People* focus groups, August 2005.

11 2001 Census data. This extremely large figure is partly explained by the large student population of the two cities.

12 Data from Manchester City Council

13 *City People* focus groups, August 2005.

14 *City People* stakeholder interviews, Liverpool and Manchester, August and September 2005.

15 The number of dwellings completed has been falling since the 1960s and reached the lowest level for over 50 years at the end of the 1990s. The dramatic reduction in public sector constructions largely explains this trend. (HM Treasury, 2005).

16 Government figures suggest there will be about 5% more people in the UK by 2021, see: www.gad.gov.uk/Population/2003/uk/wuksumcc.xls. Average household size is expected to fall from 2.34 in 2001 to 2.14 in 2021 (ODPM, 2004).

17 Trends have not changed drastically over the last five years. Neither have expectations of the future value of housing changed significantly.

18 Although it is possible that people's expectations of the future economic climate are largely dictated by the policy environment, especially in an economy that has not been severely affected by huge external shocks in recent years.

19 *City People* stakeholder interviews, Liverpool and Manchester, August 2005.

20 Although we do not know what proportion of buy-to-let investors in city centres are part-time rather than full-time.

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