Where is housing heading?

After the hurricane: lessons learned and unlearned from the credit crunch

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In December 2013, the Chartered Institute of Housing (CIH) began a new series of policy discussions on the key issues facing housing over the next five years.

Two years after the coalition government published its housing strategy *Laying the Foundations*, and 18 months ahead of the General Election, we wanted to take the opportunity to pause and consider developments since 2010: where we have ended up, what's worked, what hasn't, what we've learnt about the policy positions of the main parties and where things might be heading next.

We've commissioned a series of leading commentators to give us their views on these and other issues across different policy areas over the coming months. In this eleventh essay, Kenneth Gibb, professor of housing economics at the University of Glasgow, looks at the impact of the credit crunch on housing and housing policy. What lessons have been learned and how will it shape future decisions?

We hope you will enjoy the essays and that they will stimulate debate over the critical period in the run-up to the election.
11. After the hurricane: lessons learned and unlearned from the credit crunch

Shelter from the storm
Like its predecessor, the 2015 General Election will take place against the still important repercussions of the 2007-08 credit crunch, subsequent recession and the continuing age of austerity. Housing and mortgage markets were prime movers in (or triggers of) the international financial crisis. The housing sector in the UK in particular has been fundamentally altered by these events. Difficult choices will inevitably arise concerning housing policy and its fit with wider economic policy questions that will feature prominently in the election campaign. And if these difficult choices are not explicitly examined by politicians then they need to be vigorously highlighted by CIH and housing commentators. The Labour Party’s Lyons Review and Kate Barker’s recent book are just the latest substantial contributions to this debate. One relevant housing aspect of the Scottish Referendum is the now likely dismantling of the UK system of housing benefit.

In this essay we ask what was anticipated and what was learned from the crisis? We also ask what has changed in terms of how analysts look at economic policy, financial markets and the like, and whether this has implications for housing questions? Looking to next year, what does this mean for housing policy choices? The essay starts by summarising what actually happened and its chain of consequences.

Before the Flood
Several writers, academic and otherwise, have written extensively and clearly about the causes of the credit crunch and financial and economic crises that followed. For my part, I would stress, first, the structural imbalances between major trading regions (e.g. China and the United States and the inherent weaknesses in parts of the Eurozone). Second, the monetary policy choices of the USA after the tech crash around 2001 had the unintended consequence of sending Wall Street to look for ever-more exotic ways of earning returns, and ultimately encouraged excessive risk-taking. Third, failures in the regulatory regime not only encouraged investment banks to out-source, off-shore and set up unregulated subsidiaries but also failed to put in place barriers to moral hazard, thereby encouraging yet further risk-taking. Fourth, into all of this grew the sub-prime mutant offspring of the hitherto tremendously successful US securitized mortgage market.

The trigger for the crisis was a new mortgage product, itself premised on ever-rising prices and characterised by moral hazard: which in this case arose because each player sold on and then walked away from each transaction until the product was left in the hands of investors who thought they were insured by other, only slightly less exotic, financial products. It had not mattered that the most risky sub-prime borrowers might not repay, as long as the property could be resold. But as the mortgage market shifted downwards in term of risk and more of the new loans market became sub-prime it was not surprising, with hindsight, that there was an unprecedented general collapse in US home prices. We return to the hindsight question later.
The initial problem was that banks could not trust the valuation of the assets held by other banks and investors, to whom they were until then providing lots of short-term, wholesale or bank-to-bank loans. This interbank market had become a key lubricant of an historically highly leveraged (meaning high debt-to-assets ratios) private baking system globally. When it seized up this drove banks and other core financial businesses to the wall – on both sides of the Atlantic. Not only did credit freeze up with massive deflationary consequences for real economies, but governments like those of the USA and UK had to stand behind their banks, bail them out and otherwise shore up their economies, with longer-term consequences for public debts and deficits. In EU, along with widespread national housing market collapse, this also led to the collapse of domestic economies (and governments) in some Eurozone countries like Greece, Ireland, Spain and Portugal.

As far as the UK housing market was concerned, the credit crisis was the tipping point that ended a long, if uneven, period of rising house prices and demand-side pressures. We should however recall that prior to the 2007-08 crisis, housing commentators were worrying about affordability problems, lack of access for first-time buyers and the corresponding growth of buy to let (BTL) alongside the perennial supply shortage in both the market and non-market sectors. A maturing mortgage market was slowing down in terms of first loans but continuing to expand in the remortgaging sector and the BTL sector. Traditional home loans were not the focus (and sub-prime lending was less an issue than in the USA, although some lenders such as Northern Rock were exposed by dint of over reliance on wholesale borrowing). There were also significant disparities in regional housing markets with strong growth in some usual places (e.g. London and the Home Counties) but also in less likely ones such as Northern Ireland.

The subsequent downturn was quite unlike the previous (1989-93 or so) housing market recession. Government intervention, including an element of leaning on the weakened banks, helped keep repossessions to lower levels than in the 1990s. The post-2007 collapse was much more of a volume rather than a house-price crash. Key indicators this time were the big reductions in the volume of transactions, mortgage lending and new build supply alongside a fall in (asset) land prices. House prices fell less than the previous bust though they did subsequently take a long time in parts of the country to return to their previous peaks. The credit crunch also curtailed lending to social housing, already hit by its reliance on a buoyant private housing market to provide cross-subsidy and the planning system to deliver new affordable housing under planning obligations. Again, there was major regional variation – London went down but recovered quickly; much of northern Britain fell less far but struggled to regain market momentum (till as late as 2012 or 2013) and still other areas, such as Northern Ireland, suffered very badly indeed.

We knew from the last recession that a failing housing market can deepen and prolong wider economic difficulties by reducing consumer confidence and lowering spending directly associated with housing activity (hence the desire by the Labour Government to limit the fallout from the housing market in 2009-10). While the dominant drivers of the recession were undoubtedly the credit crunch and international declining demand, the size of the housing sector in a debt-fuelled, unbalanced economy should not be
overlooked – housing wealth effects on personal consumption followed by the household de-leveraging reducing consumption, should not be discounted in terms of destabilizing macro-economic impacts. The pre-crash willingness to spend on the back of mortgaging housing equity may also help explain the large relative UK growth in unsecured consumer credit debt.

Britain went on to experience a lengthy period of falling or flat GDP – the so-called L-shaped recovery – and this was hindered by, and helped explain, the faltering uneven recovery of the housing market and record low levels of housing supply. The wider economy was aided on the one hand by quantitative easing and sustained, historically low, interest rates, but hampered at the same time by the coalition’s fiscal policy: austerity measures were a political rather than an economic choice regarding how deeply and how quickly to attempt to curb the deficit. While the UK had a widening fiscal deficit in 2007, it was not abnormal until the subsequent response to the crisis, which was the primary cause of the alarming increase in the deficit’s size and scale thereafter.

What are the implications of this narrative for the future of the housing market?

First, housing market crises are different, unique to their historical periods and unlikely to be exactly repeated. While it is essential that we understand what caused the 1989-93 and 2007 onwards market busts, we need to recognise that they have important dissimilarities and must be contextualised appropriately. This also means that policymakers cannot use the last war’s policy tools uncritically but rather need to respond nimbly to the present situation. The most recent crisis also occurred in a post-devolution world wherein divergent policy responses occurred and can provide helpful evidence of innovation.

Second, governments will in some cases be ineffectual in the face of massive systemic problems such as a near meltdown of the global financial system. As a corollary, it may just not be possible to kick-start or resuscitate a national mortgage market. Appropriate policies in such circumstances are to support the weak and disadvantaged and do all that can be done to enable or facilitate the market’s recovery, even though this may take some time.

Third, ideological forces may act to exploit the opportunities provided by crisis. In a wider social policy context, the welfare reforms programme initiated after 2010 represent such a set of circumstances with profound effects on housing providers, tenants and localities – and an as yet not fully understood set of unintended consequences of policies that were too often premised on unevidenced and, as it turned out, faulty assumptions about behaviour.

**Slow train coming**

An important question (and one famously asked by the Queen) is why did no one among the ranks of professional and academic economists see this coming? Moreover, there is a second forward-looking question – what should we now do differently both in making policy and in terms of ‘doing’ economics?
We should distinguish between those who were demonstrating concern prior to the collapse and the wider economics consensus before and after the credit crunch. Working with my colleague Alex Marsh, we have been looking into this question a little more systematically, reviewing a wide, mainly US literature but particularly concerned with the housing and real estate academic journals and working papers. viii Below I summarise and further explore what we have found.

Prior to the crisis there had been a long-running debate as to whether there was a speculative bubble in several national housing markets. However, many of the housing market models used were built on arguments around economic fundamentals (income growth, interest rates, demographic change, profitability, etc.), which tended to de-emphasise and even reject the possibility of bubbles. ix These fundamentals arguments were also restated for the UK. x To capture speculative bubbles in such models required adding specific psychological drivers that played an important role, for instance frenzy effects or momentum trading and unique local factors. xi Mainstream economists were generally unhappy with what they saw as ad hoc tinkering with models that should only really be about fundamentals. One influential paper by Goodman and Thibodeau argued that housing markets were based on fundamentals but speculation could in fact exist but only locally, only temporarily and not generally. xii

US economists did not see the crisis coming in the sense that they did not see a turning point in the market prior to the crash. xiii It is true that there were a few papers that argued that fundamentals could not actually explain the rise in US house prices prior to the collapse. xiv However, we concluded that it was difficult to separate out possibly two simultaneous changes going on in the housing market – bubble-like speculative processes and structural change in the mortgage market in the form of the rapid growth of sub-prime lending. xv

While it was true that in the pre-crash literature there was a growing interest in the changes to the lending industry, it was really only in the midst of the crisis that more critical analyses began to emerge of the way housing markets operated. This was the result of the emerging recognition that the housing market was not performing anywhere close to where fundamentals suggested it should have been. In other words, models based on those fundamental drivers like rising incomes, mortgage liquidity and such like suggested much less dramatic upward pressure on house prices and, crucially, less volatility than was actually occurring. xvi

Why is this the case? There was undoubtedly a strong conservative element in the academy that promoted a particular vision and worldview of the economy, financial systems and housing phenomena. This was important arguably for research funding, promotion and publication but arguably (and inefficiently) left many potentially fruitful avenues of economic analysis, innovation and creativity unpublished and unsupported. xvii

While there has been a reaction since the crash in economics classrooms and among varied non-mainstream economic writers, one should not underestimate the resilience of the mainstream neo-
classical orthodoxy. The emergence of various ‘occupy’ movements, anti-economics dissidents and heterodox economics societies (including in my own university) has been functional and enlivening, but they neither speak with one voice nor always hit the target with their criticisms. They are also up against an intellectually rich, varied and internally-coherent economic worldview which continues, in my opinion, to do useful theoretical and applied work across many areas of research (in addition to doing other things less well). Neo-classical economics is also sufficiently flexible that it has evolved to embrace aspects of competing traditions, such as the recent fashionable wave of behavioural economics, as well as embracing opportunities that flow from new technological possibilities to model theories and test them econometrically.

However, you do not have to be completely opposed to the economics mainstream to see that something is seriously wrong: particularly with macroeconomics and the way it is translated into economic policy for sectors such as housing. Apart from failing to see the importance of asset markets as a destabiliser in the critical period after 2005, there is a growing sense that simplistic macro-economic thinking is becoming bound up with policy-making which, even a mildly sceptical economic reading indicates, has little to support it.

A longstanding, influential blog by the UK economist Simon Wren-Lewis, Mainly Macro, has developed a trenchant critique against what he calls ‘media macro’ - where faulty or otherwise weak claims, made by media economists, politicians and commentators, are asserted about the beneficial value of austerity to reduce the deficit during a phase of weak or negative economic growth. Under such claims, austerity is viewed in retrospect from 2014 as unquestionably successful and non-challengeable. Concerns have and should be voiced (e.g. by Ha-Joon Chang in The Guardian) about what is often simplistic and politicised economic commentary. Taking a Keynesian counter-cyclical perspective to using deficits in recession, allowing a longer time to reduce the subsequent deficit and being more creative with capital programmes (such as for instance returning to the debate about reclassifying council borrowing for housing programmes, or at least relaxing borrowing caps in England) – are all policies and economic standpoints that are far from discredited, as soon as one gets beyond the rarely evidenced and often scarcely credible economics of the Westminster media bubble.

Alex and I concluded, tentatively, from this review of the recent housing economics literature, first, that housing economics has probably done better than macroeconomics in at least considering these issues seriously. Second, it is fundamentally hard to analyse multiple changing factors in real time and thus capture turning points and crises as they are happening. Third, we should not underestimate the challenges to academic economists who wish to pursue research in opposition to the mainstream. Fourth, the focus on bubbles took place within a standard economics paradigm using its tools rather than drawing on different perspectives (such as those of Minsky and his analysis of financial crises). Despite the sense of resilience in the mainstream and its remarkable capacity to assimilate important alternate views of the world, it remains striking that many hitherto conventional housing economists in countries badly affected
by the crisis now are actively seeking alternative and, to their mind, more convincing models and accounts of the problems that beset the housing markets – for example in Spain, Greece and Ireland.

**Changing of the guards**
The election beckons and housing-related issues will surely loom large: inaccessible homeownership, in-work poverty premised on housing benefit support, lack of new housing supply, affordability problems, the bedroom tax, a possible mansion tax, universal credit and the end of direct payments, regulation and the rental market, unmet housing need, and specifically how to fund affordable housing supply. Underpinning many of the housing policy issues will be the emerging economic context of interest rates, consumer confidence, income levels and the distribution of income, as well as the future trajectory of the public finances.

Commentators will offer many proposals, many of which will be viewed as steps along the way to achieving long-term primary policy objectives. There are also genuinely radical proposals such as the tax reforms proposed in the [Mirrlees Review](#). However, in practice, we might only expect one or two concrete policy proposals at the margin added to the existing stock of policies (one or two of which will probably be consigned to history, whoever wins in May). While the long-term goal might be permanently to increase the responsiveness of housing supply, the reality might be a series of policies to stimulate supply in the short run or to assert change e.g. on the basis of localising planning decisions. But the two goals (long-term radical programmes and shorter-term increments towards them) may not subsequently converge because the timescale will be too long. At the same time a financial stability policy goal might be to systemically reduce speculative pressures in the housing market through rental alternatives, tax reform, mortgage regulation and more supply – to make homeownership a normal and rather boring consumption good rather than an asset that encourages undiversified personal savings. But we are unlikely to see such an undoubtedly sane strategy or even the espousal of such goals in any manifesto (certainly not in a joined-up way).

The housing debate is often framed in terms of tenure – what do the declining levels of homeownership and lack of access mean for the economy (alongside the continuing growth of the rental market)? Andrew Oswald has argued that homeownership can be associated with high levels of unemployment, though the evidence is stronger at the macro than the micro scale. There is a tendency among economists to support a larger and more flexible rental sector in the interests of access, fluidity and a better-functioning labour market. What seems to have happened in recent years has in part been a tenure switch in the existing housing stock rather than new investment so it could be argued that this shift has not been helpful to those who would encourage more housing supply. On the one hand, this might be indicative of the long-term problem of encouraging institutional investment into the sector. On the other hand, other economists have focused on the stability, flexibility and responsiveness of the system as a whole (and therefore support a degree of tenure transition in the existing stock). They support the wider concern about policies promoting specific tenures rather than focusing attention on whether or not housing per se helps to promote wellbeing and opportunity.
Housing is also important to economic stability, to the labour market and to the hard infrastructure essential to cities and regions. Both main parties support long-term new town expansions. Yet it remains unclear how supply will be permanently increased, and how this will be done safely and without exacerbating building cycles and market instability.

Housing is undoubtedly a complex, expensive (in terms of public resources) and problematic economic sector as far as policy-making is concerned. But the economic case for housing is compelling and needs to be made. There have always been competing claims for scarce public capital and housing needs to have the ammo to fight it out more effectively. We need to better utilise the arguments about the negative consequences of volatility, under-investment and the like. But we must also underline the positive benefits to enhanced productivity, labour markets and so on that a well-functioning, flexible, balanced (and slightly dull) modern housing sector can deliver.

Despite the large volume of specialist and generalist economists currently writing about housing and mortgage markets, the profession was not served well, generally, in the recent cycle of boom and bust. There are important lessons to learn from this experience but also other innovations and techniques that are worth pursuing and adding to our tool box for thinking about the housing sector from an economics perspective. A pluralist approach that pragmatically looks for useful techniques and levers to better understand the applied economics problem, and one that would include the neo-classical mainstream, should be the default setting.

Acknowledgement
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III See end note 2.


V see Simon Wren-Lewis *Mainly Macro* website.


xv Marsh and Gibb, op. cit.


xix see endnote 5.


