MOVING FROM THEORY TO PRACTICE . . .

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Priced to Perfection

The housing market appears to have stabilized at much higher valuations than were previously reckoned possible. A common measure of affordability is the ratio of average house prices to average earnings, since income must ultimately pay for the acquisition of a property financed with a loan. Looked at this way, homes are even more overvalued than they were at the peak of the boom in the late 1980s: the ratio stands at 6.0, compared with 5.2 in the third quarter of 1989. Much the same message emerges from another valuation method, which, rather like the price-to-dividends ratio for equities, measures the relationship of house prices to rents.

Yet, such yardsticks are not the final word. When homebuyers work out whether a property is affordable or not, the cost of servicing a new mortgage as a chunk of take-home pay is more salient. On this basis, valuations are also stretched, but homes are still considerably more affordable than they were at the end of the 1980s.

a The decline in borrowing costs over the past decade goes a long way to explaining why house prices have proven so irrepressible. . . . This fall in the initial debt-servicing burden on mortgage borrowers has underpinned the rise in house prices over the past decade. Homebuyers have also benefited from greater competition in the market. This has whittled down the margin between banks' deposits and home-loan rates, so lowering the cost of mortgages.

Buyers have also been encouraged by the Bank of **b** England's quarter-point cut in the base rate to 4.5% last August. This followed a tightening in monetary policy that lifted the base rate from 3.5% in October 2003 to 4.75% in August 2004. A more important relief to homebuyers over the past couple of years, however, has come from unusually low longer-term interest rates. . . .

The resilience of the housing market owes much to these exceptionally benign credit conditions. The recent upsurge in immigration may also be supporting the market. But purely domestic factors such as planning restrictions, by contrast, are less important than is sometimes suggested. Other countries—notably Australia—have also avoided a bust in their housing markets, and have instead seen price increases flatten out. This suggests a common cause: low interest rates worldwide.

But what has been given can be taken away. Monetary policy around the world is tightening to keep inflation at bay. The Bank for International Settlements—the central banks' bank—said on June 26th that the squeeze must continue. The Bank of England is expected to push the base rate back up to 4.75% later this year.

Britain's homebuyers are vulnerable to quite **c** small increases in the cost of mortgages because they have taken on so much debt during the good times. Overall household borrowing has risen from 110% of disposable income in 2000 to 150% at the start of 2005. The burden of repaying so much more debt means that the total servicing charge is high even at low interest rates.

ANALYZING THE NEWS . . .

The market price of houses in Great Britain increased rapidly between 1997 and 2006. During that time period, the prices of houses increased by 175%; during 2002 and 2003, house prices increased over 20% a year. This, however, was not the first time house prices increased rapidly in Great Britain. Since the early 1970s, British housing prices have increased rapidly in a short period of time on four separate occasions, only to see prices collapse even more rapidly. This time, however, the housing price increase is playing out differently. We can use the balance sheet, banking lending, and money channels to analyze what was transpiring in the British financial markets in 2006.

a The bank lending channel explanation of monetary policy emphasizes the behavior of bank-dependent borrowers. Households who borrow money for home mortgages are a type of these bank-dependent borrowers because they are limited in their alternatives to financing house purchases. As the Bank of England has pursued expansionary monetary policies over the past several years, banks' ability to lend for mortgages has increased significantly. Households have responded by borrowing more funds for home purchases, thus increasing house prices in Britain as well as contributing to the increase in British aggregate demand.

b In keeping with money channel explanation of monetary policy effect on output, the expansionary policy by the Bank of England has lowered market interest rates on home mortgages. These lower interest rates have encouraged more household borrowing to buy homes thus pushing up housing prices and increasing aggregate demand.

c The balance sheet channel explanation of monetary policy effect on output tells us that a high level of borrowing negatively impacts households' net worth. An increase in interest rates will increase households' debt-servicing burden and thus reduce the value of the households' net worth by reducing the present value of the households' assets. This increased debt-servicing burden will, in turn, reduce aggregate demand as households spend less. The impact on the housing market is that the demand for houses may slacken and price increases may moderate.

For further thought . . .

Do low mortgage rates in Britain necessarily imply that the Bank of England is pursuing an expansionary policy? Why or why not?