The UK House Price Bubble Illusion

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Bubble? What bubble? The last Economic Outlook from the Organisation for Economic Co-operation and Development argues that UK house prices are overvalued by 30%, or even more. It also warns of the danger of a protracted period of house price falls, with dire implications for consumer spending. The OECD is not alone. But these pessimists are wrong.

If there were a bubble, there would exist a systematic, albeit temporary, deviation of prices from fundamentals. Our research shows, instead, that fundamentals adequately explain the current level of house prices.

Like many others, the OECD appears to base its conclusions on two pieces of unreliable evidence. One is the ratio of house prices to rents. The second is an equation estimated by the IMF in which housing supply, the changing age structure of the population, shifts in UK credit conditions and nominal interest rates play no role. It is hardly surprising that this equation turns out to be useless.

In our research, however, we do take these and other factors into account. We also model prices at the regional level. The great advantage of the latter is that it generates more precise estimates and more robust conclusions.

Our econometric model satisfactorily explains fluctuations in house prices from 1972 to 2003. It captures the effects of income, the size and age composition of the population, the housing stock, and interest rates. It also builds in the effect of recent house price growth, including transmission from leading regions to others, the so-called “ripple effect” from London house prices.
We distinguish between the short-run and long-run effects of house-building and population growth. We allow for the effects of stock markets and for differences between regions. We also examine the effect of today’s easier credit conditions. These not only have a direct effect on the level of real prices, but also change the relative importance of real and nominal interest rates: the former become more important and the latter less so.

If we estimate our model for data up to 1996 and then forecast the subsequent period, we generate predictions that are in line with the rapid price rises that happened. Our conclusion, therefore, is that we can readily explain the evolution of prices in this recent period by lower interest rates, higher real incomes per household, higher population growth (partly from immigration) and low rates of house-building.

If we compare what actually happened with what our model says would have occurred, we can state that house prices would have been 25 percent lower in 2003 if real incomes per house had stagnated between 1998 and 2003. Had interest rates remained at 1998 levels, house prices would have been 7.5 percent lower. But this understates the true role of interest rates, since it ignores their impact on incomes and the level of the stock market. For the 1988-99 period, however, now almost ancient history, we do find some symptoms of a policy-induced bubble.

We also examined house price developments for the period 2004-2010 on a range of assumptions about possible developments in income, population, house-building, inflation and interest rates. We find that only quite dismal scenarios – more dismal than any now contemplated by main-stream forecasters - would produce falls in nominal house prices and, even then, these would be small. London and the South are the regions where such scenarios would have the largest effects.

If we assume just a mild slowdown in the economy for a couple of years, which is more pessimistic than today’s consensus, house prices still rise in nominal terms in London and the country as whole. The figures for 2006
would be about a 3 per cent rise for London and 5 per cent overall. If we assume a gloomy scenario, instead, in which inflation rises, interest rates increase by 1.5 percentage points, real per capita income does not grow and the stock market stagnates before resuming growth in 2008, house prices in London and the South decline by about 1 per cent in 2006 and 2007. Needless to say, still gloomier, though less probable, scenarios can produce national house price declines. The risks may be low, but they are not zero.

Since cash from Real Estate Investment Trusts will be injected into the market in 2006 and the stock market has also been so strong, the deterioration in housing affordability is likely to continue. This would further confirm the largest redistribution of wealth from young to old in British history.

The believers in the bubble were wrong. They are still wrong. But, paradoxically, their alarmism may have helped to prevent the bubble they fear from developing. It has not, or at least not yet.

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