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Bad news for first-time buyers: prices will fall

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The housing market could be down for five years – which won't help the Government or those trying to afford a home

After the financial crisis, almost everyone in Britain seemed to agree on three principles of household economics. First, and most important, house prices should fall and never again be allowed to reach the absurd levels of 2007. Second, people should save more and borrow less, especially against their dwindling property assets. Third, banks should not lend money on the reckless assumption that house prices can only go up.

In the next few years all three of these principles, summed up in the cliché that houses should be for nesting not investing, are likely to hold sway.

The bad news for Britain and especially for the Lib-Con coalition is that achieving these widely applauded objectives will probably wreck its economic strategy and may even unravel Margaret Thatcher's property-owning democracy.

I suspect that David Cameron and Nick Clegg pray nightly for a resumption of property inflation, a revival of mortgage borrowing and for banks to lend again on the assumption that house prices can never go down. It seems, however, that their prayers will go unanswered.

Before discussing some of the unintended consequences of falling house prices, let us consider the facts. The rebound in house prices that began in the spring of 2009, after Gordon Brown and the Obama Administration finally made an adequate response to the financial crisis, appears over, as shown by figures this week, which revealed the third fall in house prices in as many months.

I am not a housing sceptic who has been anticipating a crash for years. On the contrary, with the exception of a column in April 2008 warning that Britain faced a housing Armageddon, I have been generally bullish about housing since the mid-1990s. I have most of my own savings tied up in housing and continue to believe that it will be a good investment in the long term.

However, if house prices are no longer rising, then their natural direction, in a market where momentum always plays a significant role, will be down. The main reason can be seen in the chart, showing how house prices have moved in Britain and America in relation to incomes.

British house prices rose to an record high early in 2008 — well above previous peaks in relation to the incomes that supported them. Then they began to fall sharply in the spring of 2008, as momentum reversed after the collapse of prices in the US. They rebounded strongly from the summer of 2009 onwards, without reaching their long-term average or even their gently rising 50-year trend.

This rebound surprised many commentators who focused excessively on historical experience and kept predicting a collapse of 30 or even 50 per cent, similar to the one in the US, but it was actually quite easily explained by events in the world economy at the time. Interest rates had been cut almost to zero and the banking system had been stabilised by government intervention.

This transformed the economic fundamentals, because mortgage costs are such a powerful influence on house prices, although not quite as powerful as income growth. With interest rates suddenly slashed and banks insured against insolvency, last year's rebound made sense because people who would otherwise have been forced to sell could afford to keep their homes.

I believe that the normal level for house prices will remain higher than it has been in previous decades, because I expect interest rates to remain below 2 per cent for at least the next five years and probably until the end of this decade. But higher does not mean rising — because housing is still expensive by historical standards, interest rates cannot be reduced much further and house prices are more likely to fall than to rise from this point.

To make matters worse, disposable incomes will be reduced by cuts in public spending and rising taxes, while demand for housing will be hit by the two other principles of sound household finance — higher savings and more responsible behaviour by the banks.

Responsible banking in a world of stable or falling house prices would permanently eliminate mortgages with tiny deposits worth just 5 or 10 per cent of a property's value. In future, deposits of 20 per cent will be a minimum. The riskiest borrowers, including most first-time buyers, should expect to stump up deposits of 30 or even 40 per cent or to pay penal interest rates to reflect the risks of default. The inevitable result of this return to prudent banking will be many years of saving before a typical first-time buyer can dream of buying a home.

This process will be sufficient to transform Britain into a nation of savers rather than borrowers and consumers. But the increase in savings will threaten the Government's economic strategy, even its ideology.

The obvious problem is that more saving means less spending, which in turn means fewer jobs and lower tax revenues for the Treasury. Thus the increase in savings created by a stagnant housing market will make the Government's financial targets more difficult, if not impossible, to achieve.

In the meantime, the hiatus in the housing and mortgage markets will transform British society and politics in several unexpected ways. Young people will no longer be able to become homeowners until they have saved substantial deposits, probably not until they are well into their thirties. This may mean delayed marriages and childbirth.

Less speculatively, the financial obstacles to first-time buyers will mean far more families living in rented accommodation. The political effects of transforming a large part of British society from homeowners back into renters could be profound. The transformation of Britain's working class into property owners was one of the main factors behind the political success of the Thatcherism.

Meanwhile, private landlords are likely to replace first-time buyers as the main customers for new or surplus homes. Landlords, however, will only buy houses if prices fall to levels that offer good prospects of capital appreciation and decent returns on capital from rents. In the long run, house prices will always be determined by the needs of investing as much as nesting.

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