There is more to high house prices than constrained supply

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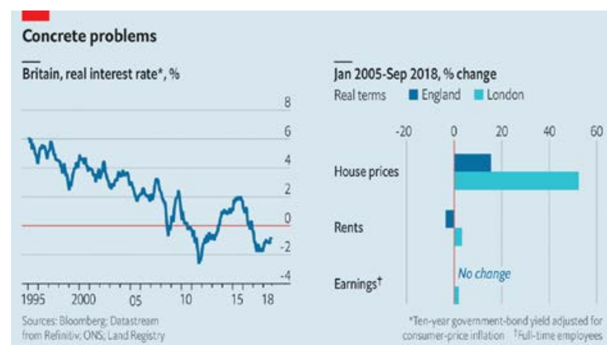
To get house prices down, increase supply. The logic seems unarguable. Britain's house prices have inflated hugely in recent decades: by 161% in real terms since 1996. Barriers to construction, such as the green belt—zones of protected countryside around cities—are clear to see. If politicians were to remove them, overcome nimbyism and build more houses, more people could afford to buy. That would arrest a decline in home ownership that has been particularly sharp among young people. In 1991, 67% of British 25- to 34-year-olds owned property; today only 37% do.

So goes the conventional wisdom. But even as policymakers have at last begun to embrace building, a new school of thought has gained prominence. Its advocates, the most vocal of whom is Ian Mulheirn of Oxford Economics, a consultancy, say high prices have little to do with supply shortages. They put the blame somewhere else: global financial markets.

Most studies of Britain's housing market link a 1% increase in the number of houses to a fall of around 2% in prices. If that is accurate, supply constraints cannot explain a boom as big as Britain's. Applying these numbers, Mr Mulheirn calculates that had Britain built 300,000 houses per year since 1996, rather than around 200,000, adding 9% to Britain's housing stock, prices would still have risen by about 134% in real terms in 1996-2017.

The true explanation, the argument goes, is found by viewing a house as a financial asset. It produces implicit income: the saving on rent achieved by owning the property rather than renting it (or equivalent digs) from a landlord. Like all streams of income, this can be valued using an interest rate. And just like the dividends offered by stocks, or the coupons offered by bonds, monthly savings on rent, capitalised as house prices, have soared in value as global real interest rates have tumbled (see chart).

Another version of the same argument says that house prices should be bid up until the cost of home ownership—which includes mortgage interest, as well as the lost opportunity to invest in something else—is about equal to rent. Over two decades the real cost of capital has roughly halved, says Mr Mulheirn. So you would expect prices to have roughly doubled.



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To bid prices up to the point where rental yields are comparable to bond yields, households need sufficient access to mortgage credit. That might not have been available, were it not for the "financialisation" of housing—the liberalisation of mortgage lending, sometimes funded by foreign capital, in the 1980s and 1990s. One such reform was the advent of buy-to-let mortgages in 1996, which made it easy for individual investors to speculate on property by becoming landlords. Foreign investors may also have contributed to the frenzy.

If financial conditions can move house prices so much, how to tell if there is a housing shortage? One way is to look at rents, which measure only the supply and demand for a place to live, without any financial component. They paint a startlingly different picture. Since 2005 English rents have fallen in real terms.

Even in pricey London, they are up by less than 4%.

Some caveats are necessary. Falling real interest rates are a global phenomenon. Yet housing trends and rental yields vary widely, even within countries. In posh bits of north London they are below 3%; in, say, parts of Liverpool they can exceed 10%. Many globally successful cities have seen rents rise hugely. In San Francisco, for example, where planning regulation is forbidding, rents are 31% higher in real terms than in 2005. Such places would benefit greatly from more supply, with knock-on effects on national economies. High house prices in London may reflect an expectation that building constraints will bite harder in future as the city continues to thrive, causing rents to accelerate.

The historical link between interest rates and house prices is weak. That is because predictions of future capital gains tend to be what inflate and shrink property-market bubbles. America, Ireland and Spain experienced huge property-price booms in the mid-2000s, even as interest rates rose. Decades of low rates have not restored Japanese house prices to the high they reached amid the speculative fervour of the late 1980s and early 1990s.

That is to build on Mr Mulheirn's logic, however, not to demolish it. In fact, you might argue that the risk of speculative overheating is another reason not to focus on supply. Those countries that built freely during the 2000s had bigger crashes after the financial crisis, leaving behind ghost towns of vacant homes in places like Nevada and many parts of Spain.

You can't handle the roof

Suppose financialisation and low interest rates are to blame for high prices. What, then, should policymakers do? Countries with greater restrictions on mortgage lending, such as Germany, have seen house prices grow much less over the long term than Britain has. But they also have lower rates of home ownership. That would not appeal to politicians in Britain, where "getting on the property ladder" is seen as crucial to financial security. Buy-to-let investors can be discouraged—indeed, Britain has hit them with much higher taxes in the past couple of years. But that will have only so much impact, since professional firms with large portfolios and access to capital markets can replace individuals. Increases in government subsidies for homebuyers will only inflate prices further.

A sensible approach would be to build more where rents are rising, make life easier for tenants—and abandon the notion that buying a home is a rite of passage. Attitudes could shift naturally if housing were to underperform for a while. Indeed, an implication of the financialisation thesis is that rising interest rates could put the decades-long housing boom into reverse.

Sure enough, housing markets in rich countries have begun to look wobbly as global interest rates have crept up. In London, where the prospect of Brexit is also hitting demand, real house prices have fallen by over 2% during the past year. Perhaps young people trying to scrape together towering deposits to buy their first home should hope that the supply sceptics are right. If so, the problem of high house prices might disappear on its own.