

# Affordability and Housing Supply

A review of the implications  
for the West Midlands of the  
National Housing and Planning Advice Unit  
recommendations

for the West Midlands Regional Assembly

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**GREEN BALANCE**

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## **SUMMARY OF FINDINGS**

S1 Market housing affordability targets were introduced into the land use planning system on the advice of Kate Barker in her *Review of Housing Supply* published in March 2004. Her Review focused on increasing housing supply as a means of reducing house prices, even though this is an extremely inefficient approach. The rise in house prices in the first place had been underpinned instead by low interest rates and easy borrowing. She identified a lack of supply and responsiveness to prices in the private house building market, but wrongly assumed – without any evidence at all – that this was due to an inadequate supply of land through the planning system.

S2 A group of economists led by Professor Geoffrey Meen of the University of Reading was commissioned by the Government to model the relationship between increasing housing supply and reducing house prices (to improve affordability). This confirmed that very large increases in construction would be needed to have any real effect on affordability. Even building one million more houses in England than currently planned, in the ten years to 2016, would reduce the affordability ratio that year from 6.24 to 5.36 at best. This would remedy less than two years' deterioration in affordability up to the base date of 2004, and would fail to return affordability to anywhere near its ratio of 3.47 in 1997. There would in any case be insufficient households to occupy the extra million houses built. Also, the model was developed on the assumption that the housing market was in equilibrium in 2004 and not an inflating bubble. Now that this has been shown by events to be wrong, the value of the entire model must be called into question.

S3 In the West Midlands, housing land supply increased as the market boomed. The number of planning permissions available increased every year after 1999, and overall land supply (including firm commitments in approved plans) grew more than 60% in the seven years to 2008. Since 2006 over 100,000 plots have been continuously available for house building. Gross completion rates barely responded to the extra land made available, however. Throughout the period 1997 to 2008, completions were in the range of 16,000 to 20,600, with demolitions resulting in lower figures for net completions. Since 2002 there has always been a land supply in the region sufficient to allow at least five years' building at the net completion rate. An insufficiency of land cannot be held to be the limitation on housing development in the West Midlands during the recent house price boom. Rising house prices and deteriorating affordability far outstripped modestly rising housing completions after 2001. This confirms that increasing land supply is an extremely inefficient means of making houses more affordable, if it has any bearing at all.

S4 The National Housing and Planning Advice Unit (NHPAU) has assessed the impacts on affordability of a variety of levels of house building in England and in all regions including the West Midlands (in a publication in October 2007). These include the Government's house building target rate of 240,000 annually in England, and 270,000 annually (the extra being built in southern regions). They all use the Government's preferred measure of affordability ratio of house prices to incomes, both at the lower quartile level. Under all scenarios, the NHPAU anticipated that affordability would deteriorate to 2016. This deterioration would be less marked if housing were concentrated in the southern regions of England or if larger (4-bedroom) houses were built.

S5 The NHPAU's results are sensitive to its assumptions, e.g. on earnings growth, mortgage interest rates and household growth. The NHPAU therefore prefaced its *Advice to the Minister* (June 2008) by testing scenarios on the means by which affordability could be stabilised at 2007 levels (7.25 nationally). In the West Midlands, affordability could be returned to just below its 2007 level by an annual building rate of 19,000 by 2008-26 (increasing output to 19,600 by 2016 and then sustaining this level for a further 10 years). This is 18% higher than the peak regional output rate achieved in 2007. Even this would achieve an affordability ratio of at best 6.04 in 2026, so achieving a much smaller ratio, nearer to the 3.0-3.5 at which borrowers might obtain a mortgage without a deposit, would require still larger amounts of construction than this.

S6 The NHPAU also developed a demographic model, using the Government's 2004-based household projections, alongside its affordability model. For the upper end of the proposed range of house building, the NHPAU added to the household projections allowances for items such as meeting the backlog of unmet need, second homes and an allowance for vacancy in the emerging stock. This calculated an annual requirement for 22,600 houses in the region each year from 2008 to 2026 (24,300 annually from 2016 onwards). This is much higher than the figure produced by the affordability analysis, and is the one proposed by the NHPAU. As the lower end of the NHPAU's proposed range is set by Government policy (to deliver 240,000 houses annually by 2016), it is apparent that in the West Midlands the NHPAU's affordability analysis is not significant at all in its *Advice to the Minister* on regional housing supply rates.

S7 The most effective means of improving affordability around England, according to the NHPAU, involve prioritising the construction in high demand areas, particularly in the southern regions. This would involve major changes to the patterns of inter-regional migration, the merit or otherwise of which the NHPAU does not address. Predictable impacts would be on demand for infrastructure (wasting investment in some areas and requiring extra in others), realignment of employment away from the areas which need it most, damage to already weak housing markets, deterioration in the north-south divide, social change, and damage to environments long-protected by planning policies. There would be special problems of applying to the Housing Market Pathfinder Areas the NHPAU approach of increasing housing provision as a means of reducing house prices. The Pathfinder Areas are aiming for stronger housing markets with rising prices, which depends on housing supply being controlled in adjacent areas. This is the opposite of the NHPAU approach, which is likely to entrench vacancy and deprivation, discourage regeneration, and divert wealth and investment out of the Pathfinder Areas.

S8 The housing boom and the recent housing market crash reflect badly on the approach to housing affordability taken by the NHPAU. House prices became enormously overvalued in relation to incomes, not because of significant supply side shortages as assumed by the NHPAU, but due to very low interest rates and remarkably generous lending. The housing market, including affordability ratios, has been dominated by demand side controls, yet the NHPAU assumes that supply side interventions sustained for the next twenty years are the means by which affordability problems should be resolved. If the supply of land had virtually nothing to do with the house price boom or the house price crash, as was the case, then seeking solutions to house price issues by increasing land supply through the planning system, as the NHPAU does, seems a seriously misplaced enterprise.

S9 The over-valuation of housing in the boom included a speculative element accounting for perhaps as much as one fifth of house prices according to the International Monetary Fund or even one third according to Morgan Stanley bank. If an important part of house price rises was due to speculation, not – as NHPAU believed – all of it being due to rising demand in an environment of constrained housing supply, then the remedy of increased land supply cannot be reliable. In our view the NHPAU approach has been broken at its root. In any event there will be no return in the foreseeable future to the affordability patterns modelled by the NHPAU, as the Prime Minister and Financial Services Authority have committed themselves to more prudent lending rules in future. It is therefore difficult to see any circumstances in which the NHPAU affordability model would serve any purpose.

## **1 The Brief**

1.1 The purpose of this study is to explore the implications for housing market affordability in the West Midlands Region of the report *Affordability Targets: Implications for Housing Supply* (Meen et al, 2005) – the ‘Reading’ report – and its accompanying model. This has underpinned the advice provided by the National Housing and Planning Advice Unit on the number of dwellings to be provided in the West Midlands. The implications of the NHPAU advice for housing supply and affordability in the region are examined.

1.2 In particular the analysis is required to explore:

- i) the implications of the findings set out in the Reading report, based on the scenarios addressed by the economic modelling tool, for housing development and consequent impacts on affordability in the West Midlands;
- ii) how the theoretical scenarios outlined in the model compare with observed actual changes in house prices, housebuilding activity and land availability and other relevant factors for future spatial planning for the West Midlands;
- iii) the implications of the NHPAU housing provision figures for affordability in the West Midlands, in the context of the figures provided by the NHPAU for all of the English Regions, distinguishing, if possible, between short term, medium term and long term (up to 2026) time periods;
- iv) how the NHPAU figures compare with household projections and the implications of any disparity, in particular for issues such as demand for housing (as opposed to housing need), household formation, migration, second home ownership, vacancies and low demand areas (with particular attention to the two Housing Market Renewal Pathfinders in the Region);
- v) the available evidence that observed rises in house prices are, or are not, the result of a house price “bubble” (i.e. inflated prices as a result of buoyancy in the market and purchaser confidence), and the implications of ‘normalisation’ of the housing market for the NHPAU provision/affordability assumptions if a “bubble” has in fact occurred.

1.3 This study addresses each of these detailed issues in turn, but opens with a brief review of the background to the Reading report and thus the assumptions made by the NHPAU.

## **2 Market housing affordability: a review of the birth of an idea**

### Kate Barker's 'Review of Housing Supply'

2.1 Kate Barker started the controversy over the role of the planning system in influencing market housing affordability when in March 2004 she focused her *Review of Housing Supply: Final Report – Recommendations* on affordability as one of her key issues. She considered that the evidence of declining affordability was clear, citing evidence that only 37% of new households could afford to buy in 2002, compared to 46% of new households in the late 1980s. Her Chart 1.2 tracked national affordability (of mean dwelling price to mean income) over the years, showing that for former occupiers affordability had deteriorated to 3.7 (from 3.1 in 1996) and for first time buyers to a new high rate of 3.3 (from 2.5 in 1996)<sup>1</sup>. She clearly felt that these affordability ratios merited serious corrective action.

2.2 Affordability of market housing was at the heart of her concern. She considered that real house prices could only be brought down in the long term by a sustained increase in housing supply, thereby making homes more affordable (and reducing price volatility in the housing market). Furthermore, “Central to achieving change is the recommendation to allocate more land for development” (Summary paragraph 22). Her recommendations included amongst others:

- Recommendation 1 that “Government should establish a market affordability goal. This goal should be incorporated into the Public Service Agreement framework to reflect housing as a national priority.”
- Recommendation 5 opened with “Each region, through the Regional Planning Body (RPB) should set its own target to improve affordability. Taken together, the regional targets should be consistent with the Government target (recommendation 1), although individual regional targets will differ.”
- Recommendation 6 wanted a strong and independent Regional Planning Executive responsible inter alia for “providing public advice to [merged RPBs and Regional Housing Boards] on housing numbers and allocation of housing within the region in order to aim to achieve the region’s market affordability target”, and also for “signalling the need for a review of the RSS where the market was not functioning well and the affordability target was unlikely to be met”.
- Recommendation 7 wanted a revised Planning Policy Guidance note 3 *Housing* to be based on principles which included “Application of market information and signals, including house prices and house price growth and market affordability in decisions made about the scale and distribution of housing targets”.

2.3 Unfortunately, she made two fundamental errors in her assessment. One was in respect of the way the housing market works and the other was in respect of how the planning system works.

### A conceptual error in the housing market

2.4 Kate Barker failed to report that building houses is an extraordinarily inefficient way of bringing down their price. On her own figures, the annual real (inflation-adjusted)

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<sup>1</sup> At the ratio of lower quartile house prices to lower quartile earnings, affordability rates for all purchasers were 4.72 in 2002, compared with 3.65 in 1997.

price increase in houses at the time she wrote was 2.4% annually based on the construction of 145,000 houses planned by the Government annually, but if the building rate rose to 245,000 annually (the extra entirely in the private sector) then the real price increase would drop to 1.1% annually. With real incomes rising at 1.8% per annum, this would imply some modest improvement in housing affordability. Very large house building rates would therefore be needed to effect only less rapid house price growth, and a small reduction in affordability would also be achieved. However, the predicted reductions in affordability from sustained high levels of house building would be achieved at far slower rates than affordability had deteriorated during the house price boom.

2.5 Meanwhile, the Barker review chose to neglect ‘demand side’ issues, notably that the ability and willingness of prospective owners to pay and to borrow money are far more significant determinants of price. There had been some discussion of this within The Treasury at the time of her review. A report on *Housing, consumption and EMU* had argued:

“Recent housing market performance in the UK can partly be attributed to the significant reduction in interest rates in the early 1990s, and specifically the sharp fall in rates since the end of 1998. Despite a 50% increase in real house prices since the end of 1998, typical monthly mortgage interest payments as a per cent of household incomes have fallen over the period” (HM Treasury, 2003, paragraph D10).

The direction of causation is important: each household can afford a particular rate of mortgage repayment, so if the interest rate comes down they can spend more on the house, and house prices rise. The rise in house prices was specifically because interest rates dropped. If interest rates had not declined so much, the mortgage repayments to sustain the observed house price increases would simply not have been affordable; and those price rises would not have happened.

2.6 Prices were therefore rising at the time of the Barker review not so much because of the constraints on supply which she assumed, but primarily because of the increasing enthusiasm of financial institutions to lend money to buyers, and of buyers to borrow the cheaper loans on offer. These enthusiasms were reflected in larger proportions of the value of homes offered during the housing boom (rising sometimes to 120% rather than requiring a deposit) and larger multiples of borrowers’ incomes (rising sometimes to 5.5 times income rather than the more traditionally prudent 3.0-3.5 times income), all achieved by offering money, initially at least, at very low rates of repayment.

2.7 Kate Barker’s idea for reducing house prices, and improving affordability, was essentially to over-supply the market with houses so comprehensively that there would always be a significant surplus of homes available in the market, in effect creating universal ‘low demand’, notably in high price areas. The scenario noted above, of providing 100,000 dwellings annually for many years above the rate currently planned, would soon result in the dwelling supply greatly exceeding the number of households to occupy them (as indicated by the Government’s household projections). Furthermore, Kate Barker wanted to focus supply preferentially on areas which were market hot-spots, because the greatest benefits for improving affordability were identified as being achievable in the highest-priced locations.

2.8 She did not explore the wider desirability of such a course, e.g. that:

- in some places there might be no known limit to demand;
- some urban areas could be hollowed out by population out-migration;
- major increases in local supply in high pressure areas would reduce outmigration and expand inward migration, gravitating people principally from north to south;
- the social and environmental consequences of such changes could destroy decades of efforts to regenerate poorer urban areas and to protect nationally and locally cherished environments (this she specifically omitted: see paragraph 1.34 of her final report).

2.9 Nor did she properly examine whether her proposed course of action was feasible. For example:

- no explanation was given as to why house builders would wish to flood the market with their product in order to depress their own sale prices;
- observations were not offered on who would purchase these properties;
- if the new homes were not to stand empty (and it must be assumed that builders would only construct them with a real prospect of sales), the type and location of existing occupied homes becoming vacant instead was not stated;
- with the house building industry struggling to meet demand in the boom, the deliverability of major growth – perhaps over half as many houses again – was questionable<sup>2</sup>.

2.10 Kate Barker presented her recommendations as if there was no other way to tackle affordability in market housing other than by sustaining a huge building programme in excess of household projections. While this was clearly wrong, it was also extremely challenging in terms of its desirability for reasons not associated with affordability, and in any event most unlikely to be practicable.

#### *A conceptual error in the contribution of planning to house prices*

2.11 Prior to her study, Kate Barker had by her own admission no real understanding of the planning system. She identified that the house building industry did not appear to be responding to rising house prices as thoroughly as might have been expected. House building rates around 2001 and 2002 were remarkably low by historic standards and showed only modest increases in output through the period of a rising market. However, she erroneously believed that a shortage of land (due to planning constraints) was preventing the construction of the additional homes she thought ought to have been forthcoming. “A key factor underlying the lack of supply and responsiveness is an inadequate supply of developable land” (paragraph 1.6). This was purely an assumption on her part. Despite her claimed desire for an evidence base in planning policy, there is no review whatsoever of land availability in either her Interim or Final Reports. That assumption has been shown to be wrong: most places have ample amounts of land available, which rose rather than declined in the housing boom. Also, house building

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<sup>2</sup> She did comment, though, that building a yet further 100,000 houses annually (i.e. 345,000pa in total), to achieve zero house price growth, would be impractical: “It is doubtful that the housebuilding industry, given capacity constraints, would prove able to build to these numbers in the foreseeable future”, paragraph 1.42).

rates and affordability can be shown in any event not to be tied to land supply<sup>3</sup>. We conclude that it is an extraordinary failing of the Barker Review to make so fundamental an error, and quite inexplicable that such emphasis should be placed in her recommendations on planning solutions (i.e. land releases) to housing affordability problems.

### The Government response

2.12 The Government accepted with enthusiasm Kate Barker's recommendations on the issues outlined above. It accommodated the central assumption that forcing local authorities to allocate more land for housing, in locations favoured by the market, would enable the house building industry to raise its output and thereby make houses more affordable. The underlying assumption here is that the market would be able to sort out house price problems if planning interfered less: meeting unbridled market demand, wherever it was, should be facilitated.

2.13 The rhetoric of Government publications and Ministerial statements changed to put more emphasis on affordability. This was now seen as a severe problem in the housing market, and the release of land through the planning system viewed as the solution to tackle this. This was an argument in the consultation paper *Planning for Housing Provision* (CLG, July 2005), and became a repeated theme in pronouncements by the Planning Minister, Yvette Cooper.

2.14 The Government set about implementing Kate Barker's main recommendations. As a result:

- PPG3 was amended in a new Planning Policy Statement 3 *Housing*, abandoning the sequential approach to land release (brownfields first) in favour of allocating substantially greater quantities of land for building; this was coupled with the abolition of phasing, the discounting of windfall sites towards allocations in most circumstances, and the discarding of a capacity-based approach to future urban provision.
- Making housing more affordable became a planning objective for the first time, set out in PPS3.
- The National Housing and Planning Advice Unit (NHPAU) was set up, notably to drive concern about affordability through the planning system, especially at the regional level.
- An affordability target was set in PSA Delivery Agreement 20 (October 2007) to "Increase long term housing supply and affordability".
- The Government commissioned research from a group of economists to establish targets for housing affordability, which would in turn shape the work of the NHPAU. This is explored in the next section in response to the first issue in the Brief.

2.15 We conclude that, as remarkable as the bad advice from Kate Barker was, the Government's wholesale acceptance of it was even more extraordinary. The planning system simply became the whipping boy for the difficulties of access to housing (particularly for first time buyers) in a booming market. The Government put in place a

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<sup>3</sup> See Green Balance, (2007), *Planning for housing affordability: why providing more land for housebuilding will not reduce house prices*, CPRE, London.

series of planning policy and practical measures which set out to achieve an outcome – improved affordability – for which there was no demonstrated connection with the planning system.

### **3 The ‘Reading’ report and its implications for the West Midlands**

*Explore the implications of the findings set out in the Reading report, based on the scenarios addressed by the economic modelling tool, for housing development and consequent impacts on affordability in the West Midlands.*

3.1 A group of economists led by Professor Geoffrey Meen of the University of Reading was commissioned by the Government to put flesh on the bones of the relationship between increasing housing supply and reducing house prices (to improve affordability). Their study *Affordability Targets: Implications for Housing Supply* was published in December 2005 with the Chancellor’s Pre-Budget Report. This had the aim of allowing affordability targets to be translated into regional housing provision targets. Central to this work was an econometric model – the Reading model – outlining the relationship between housing supply and affordability at the regional level, and some of the other knock-on consequences through the housing market arising from increasing housing supply. The Government has supported further work to update and improve the model, with revisions published in December 2008 on *Recent Developments in the Communities and Local Government Affordability Model* by Geoffrey Meen et al (CLG, dated June 2008). These changes have been assessed for the present study but not described specifically. The report concludes that “the differences [from the earlier model] are not dramatic and large increases in construction are still needed to induce major improvements in affordability” (page 64).

3.2 The Reading model took as its base case the rate of housing supply planned for in Regional Planning Guidance (as at 2004), plus an additional 200,000 houses over 10 years (20,000pa) which the Government had recently added to that by identifying four major growth areas. The housing supply scenarios which the study modelled were those previously used for illustrative purposes by Kate Barker: additions of 20,000, 70,000 and 120,000 dwellings annually. Each of those scenarios was reduced by the Government’s extra 20,000pa to produce scenarios of 50,000 and 100,000. An additional ‘low’ option of 25,000 was also modelled. Each of the additional supplies modelled was assumed to apply for 10 years (2007-2016) after which the extra supply would cease.

3.3 The trend in affordability to 2016 was modelled for the base case. The model anticipated that earnings would generally rise marginally faster than house prices over the period 2004-2016, so affordability would fractionally improve by the end of the period. However, this was not a straight-line trend: the model assumed that house prices would grow distinctly more slowly than earnings for the first two or three years of the period, so affordability would improve noticeably before deteriorating again gradually to 2016. In the West Midlands, annual average growth 2004-2016 was modelled to be 4.5% for house prices and 5.1% for earnings. (Nationally, the figures were 5.0% and 5.1% respectively.) This suggested that on a business-as-usual scenario affordability would improve in the West Midlands: the lower quartile house price to earnings ratio would improve from 5.91 in 2004 to 5.52 in 2016 (Table 8). However, this would be no great achievement: both figures were higher than the affordability ratio had been in any other previous year since the data were first collected in 1997.

3.4 In modelling the impacts of three different rates of additional house building on house prices, the Reading model also explored the effects of (particularly) two other

variants. First, the growth in housing supply was distributed around England in three different ways:

- all the extra construction takes place in the four southern regions (South East, London, East and South West);
- all the extra construction takes place in the four southern regions and in the East Midlands and West Midlands (though the exact amounts in each region are not stated in the main report);
- construction is spread over all nine regions.

Second, two versions of the model were run, assuming two different rates at which the market would respond to the increase in housing supply. One version took into account the effect of ‘flows’ – the short term additions to stock – and showed a more rapid response in house prices than did the other version which modelled only the impact of changing the total ‘stock’ of housing. Due to time lags, house price adjustments continued to take place after 2016, particularly in the stock-only version of the model.

3.5 Table I shows the modelled effect of the various alternative assumptions on house price affordability in 2016, in the West Midlands and for England as a whole. These ratios are all at the lower quartiles of both house prices and full-time earnings. (Confusingly, the ‘base case’ affordability in 2016 changes according to whether the ‘flow’ version or the ‘stock’ version of the model is used.) The impact of the ‘low’ scenario – 25,000 extra houses annually – has been omitted from the table.

Table I

Affordability ratios in 2016 under various scenarios, compared with 2002 and 2004

Region	2002*	2004**	2016 base	<i>All in South</i>	<i>All in South &amp; Midlands</i>	<i>In all regions</i>	<b>All in South</b>	<b>All in South &amp; Midlands</b>	<b>In all regions</b>
WM (v1)	4.42	5.91	5.66	<i>5.40</i>	<i>5.19</i>	<i>5.27</i>	<b>5.16</b>	<b>4.79</b>	<b>4.93</b>
England (v1)	4.72	6.23	6.24	<i>5.78</i>	<i>5.79</i>	<i>5.79</i>	<b>5.36</b>	<b>5.38</b>	<b>5.39</b>
WM (v2)	4.42	5.91	5.52	<i>5.25</i>	<i>5.22</i>	<i>5.30</i>	<b>5.00</b>	<b>4.95</b>	<b>5.09</b>
England (v2)	4.72	6.23	6.18	<i>5.78</i>	<i>5.85</i>	<i>5.91</i>	<b>5.42</b>	<b>5.55</b>	<b>5.66</b>

Notes

Version 1: these rows include ‘flow’ responses to housing supply as well as ‘stock’ responses.

Version 2: these rows include ‘stock’ responses to housing supply only.

Figures in italic show the impact of building an extra 50,000 houses annually for 10 years.

Figures in bold show the impact of building an extra 100,000 houses annually for 10 years.

\* Actual affordability ratios.

\*\* Affordability ratios assumed in the model. The actual affordability ratios in 2004 were 6.27 in England and 5.95 in the West Midlands. Actual figures turned out to be slightly higher in most regions (and never lower) than those modelled.

Source: CLG Live Table 536, and *Affordability Targets: Implications for Housing Supply*, 2005, Tables 11, 12a and 12b.

3.6 Table I shows that building extra houses does improve affordability. Affordability ratios were lower in all cases than would otherwise have been expected in 2016 on the basis of not building the extra houses. The Reading report concluded that this evidence showed: “Large increases in construction do have significant effects on affordability, measured in terms of the ratio of lower quartile house prices to incomes. But the increases in construction have to be large. Furthermore, the improvements in affordability are permanent, reflecting the increase in supply” (page 48). Also apparent is

that building extra houses exclusively in the four southern regions does have affordability benefits in the West Midlands and elsewhere in England.

3.7 The report’s own conclusions, however, are by no means the most striking. By far the most obvious point is how inefficient is new housing supply in reducing house prices. Building one million more houses in England than currently planned, in only ten years, would have remarkably little effect in reducing house prices and affordability: anticipated affordability would at best be 5.36 in England rather than 6.24 by 2016. In the West Midlands, on the most optimistic assumptions about where to build the million houses, affordability might decline from 5.66 to 4.79 (but it might be stay as high as 5.16). The outcome would still be affordability levels higher (worse) than prevailed in 2002, only two years before the base year. Given that affordability was expected to decline slightly from its 2004 level by itself, without building any extra houses, the failure of building one million houses even to match 2002 affordability is clearly lamentable.

3.8 Had a longer time series been taken, back to 1997, the impact of building one million homes can clearly be shown not to be the dominant force explaining affordability. Table II shows that achieving a lower quartile affordability ratio in the range 4.76 to 5.16 would not reduce them to anything like the lower levels they had been only a few years beforehand.

Table II  
Affordability ratios in the West Midlands 1997-2004 (at lower quartiles)

<u>Year</u>	<u>Affordability ratio</u>
1997	3.47
1998	3.49
1999	3.56
2000	3.62
2001	3.88
2002	4.42
2003	4.98
2004	*5.91

\* Modelled ratio as starting point for Reading model calculations: actual ratio was 5.95.  
Source: CLG Live Table 576.

3.9 Improvements in affordability are of course welcome. However, the actual level of affordability deserves more attention. The best outcome modelled for the West Midlands would be a ratio of 4.79 by 2016. Prudent lenders and borrowers have historically considered that mortgages of 3.0-3.5 times income are repayable on a sustainable basis, but that is far short of 4.79 times income. Even with the huge volume of extra building, houses would still not be affordable to any household without a very substantial deposit. Most first time buyers would be as unable to obtain a mortgage at an affordability rate of 4.79 as they would be if it remained at 5.52 or 5.66 (the modelled base figures for 2016).

3.10 Finally, with the benefit of hindsight, the economic downturn and the recent remarkable reduction in house building rates have now shown that in the ten years to 2007 a housing market bubble inflated and then burst. Unfortunately, the Reading model

was built on the assumption that there was no housing bubble in progress at the time. Now that we know there was (see section 7), and the input data was reflecting expectations of rising prices rather than an equilibrium market, the model is in many respects void. The Reading report explained its position as follows:

“...our model suggests that the market is currently not far from equilibrium and a major house price adjustment is not required. The strong growth in prices relative to incomes in recent years is a function of low levels of nominal interest rates. Although the adjustment to a low nominal interest rate environment is now probably over, unless large increases in nominal interest rates occur, there is little reason (in our view) to expect a major crash. In other words, the projections do not take the view that past house price growth is a bubble. Of course, if this view turns out to be incorrect – and house price forecasting is subject to large errors – then, perversely, meeting future affordability targets becomes easier” (page 33).

3.11 The final point in this commentary, that raising interest rates makes meeting affordability targets easier, is a point taken up elsewhere in the report: “since house prices are sensitive to interest rate changes, this illustrates one of the problems of targets set in terms of price to income ratios. The easiest way of meeting this target is to raise interest rates. But this is hardly the required outcome” (page 43). The highly significant point being recognised here is that achieving affordability improvements is easier on the demand side than on the supply side – but the construction of the model and the effort of the entire report is devoted to supply side solutions.

3.12 We conclude that the Reading model has demonstrated that extraordinarily large amounts of extra house building, additional to those already planned, would bring down house prices and affordability ratios. However, this would be by only very modest amounts, and far less and far slower than the rates by which those ratios rose during the house price boom which ended in 2007. Building additional houses, even in vast numbers, would make little difference to access to home ownership for prospective purchasers without a large deposit. Building houses is clearly an extremely inefficient way of reducing house prices and improving affordability. Furthermore, the Reading report tacitly accepts that demand side influences, notably interest rates, can have a bigger impact. Unfortunately, the model was developed on the assumption that the housing market was in equilibrium in 2004 and not an inflating bubble: now that this has been shown by events to be wrong, the value of the entire model must be called into question.

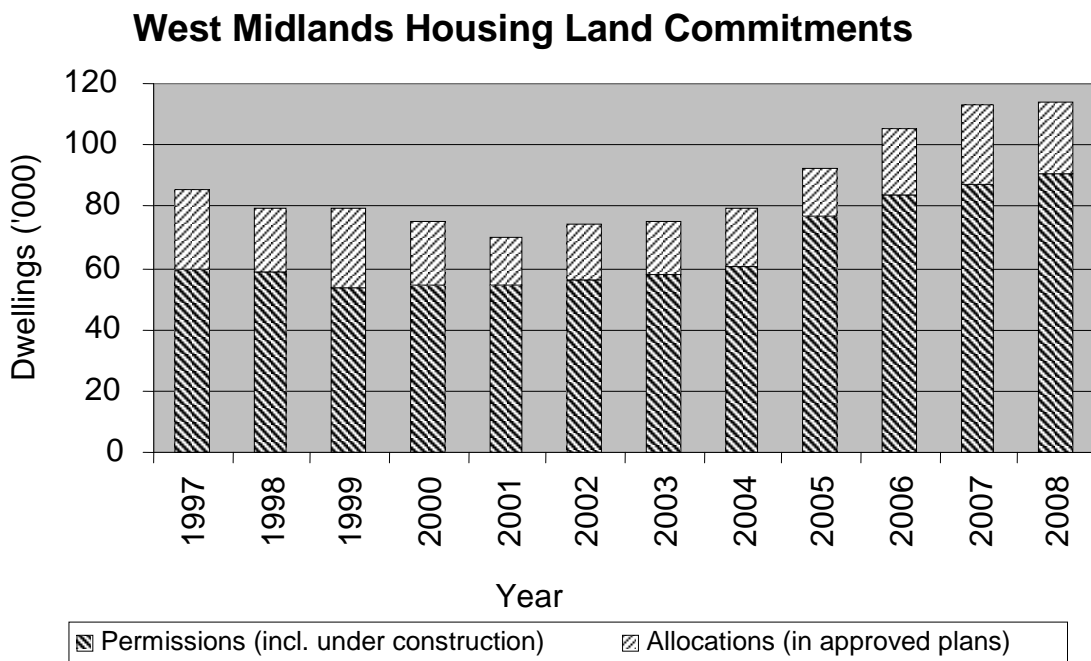
3.13 These findings all apply as much in the West Midlands as they do to England as a whole. The only specific point for the region is that the model suggests that concentrating all the additional house building in the four southern regions of England would still produce affordability benefits in the West Midlands due to a ripple effect; in one version of the model this would even be more effective than spreading the houses around the Midlands or the whole country. This assumes, of course, that the southern regions of England can be prevailed upon to supply the requisite number of houses.

## 4 Planning and the housing market in the West Midlands

*Explore how the theoretical scenarios outlined in the model compare with observed actual changes in house prices, housebuilding activity and land availability and other relevant factors for future spatial planning for the West Midlands.*

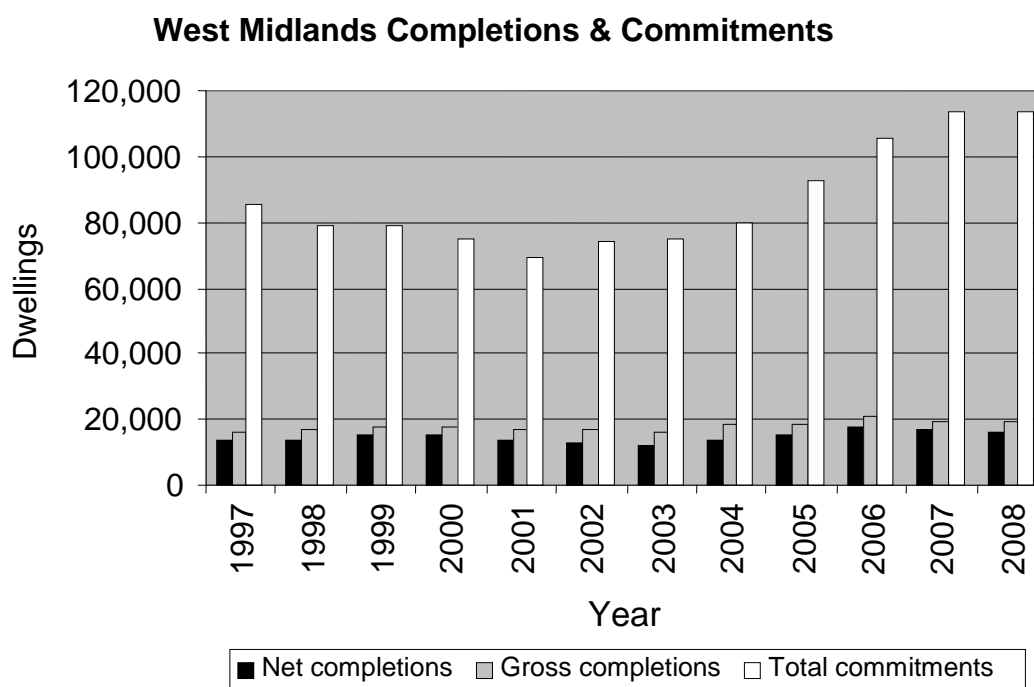
4.1 This section outlines trends in the housing market in the West Midlands since 1997 and the parallel trends in housing land supply. It examines the extent to which in the West Midlands the NHPAU model is observed in practice, regarding the relationship between housing development and house prices/affordability on the one hand and land supply through the planning system on the other.

4.2 Housing land supply takes two main forms: planning permissions and commitments. Planning permissions include both dwellings under construction (but not completed) and those permissions not yet implemented. Commitments take a number of forms, but firm commitments comprise allocations in approved development plans. These are shown in the figure below (all at April).



4.3 The figure shows that the planning permissions available were reasonably constant from 1997 to 2004 (in the range 54-60,000 dwellings) and then increased gradually to 91,000 by 2008. Land allocations in plans fluctuated but were usually broadly in proportion to remaining planning permissions. Land supply has been rising steadily since 2002, particularly in respect of full planning permissions. With over 60% growth in overall land supply in the seven years to 2008, the response of the planning system to enable an increased supply of housing is clear. This is just the kind of change which the NHPAU is seeking as a means of tackling house price affordability. The figure below shows how the building industry responded, by charting all these commitments together against numbers of dwellings completed (net and gross). Commitments are at

April in the year indicated, completions in the 12 months to April that year. Completions are from data supplied by local authorities in the region<sup>4</sup>.

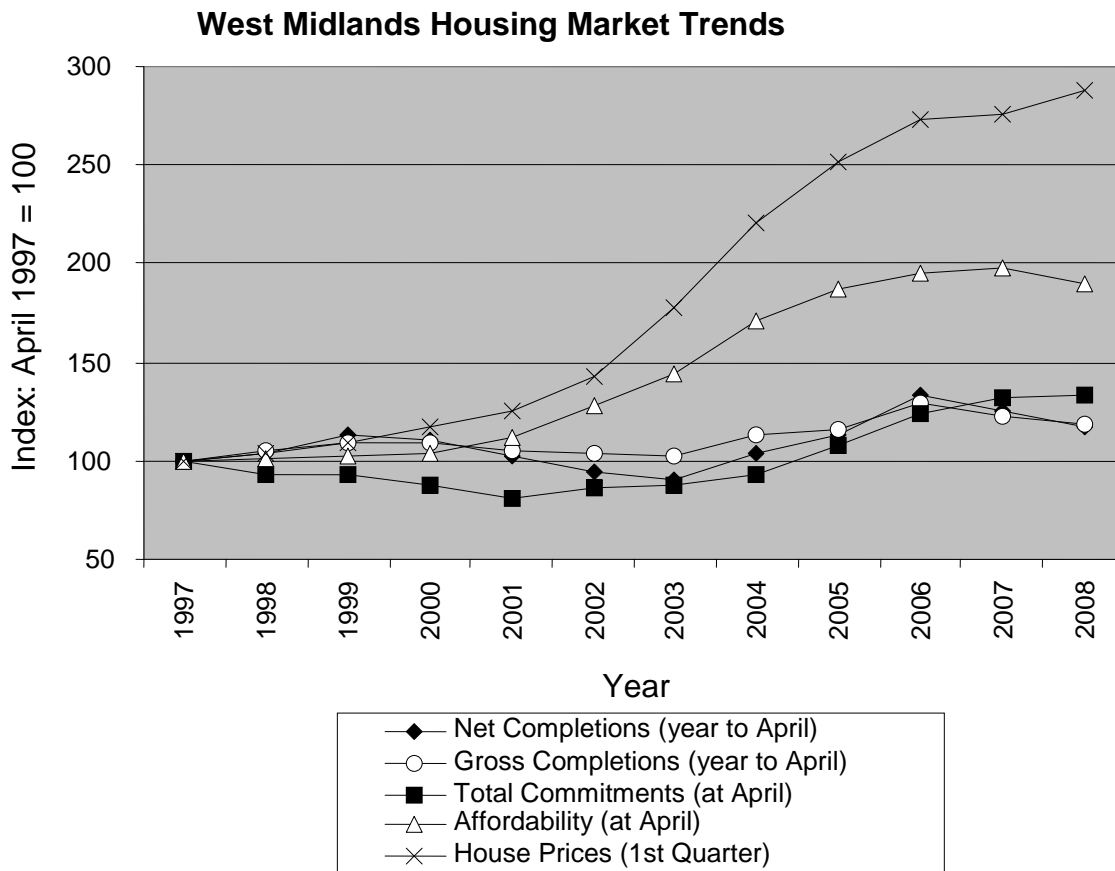


4.4 The chart shows that there was never less than 5 years' supply of housing land in the West Midlands from 2002 onwards at the net completion rate at the time. Gross completions maintained a reasonably consistent rate over the study period, in the range 16,000-20,600. Allowing for demolitions, the net completions were more varied, in the range 12,000-18,000. However, modest growth in housing supply is apparent from the turn of the century, though land supply grew much more strongly in the same period. The trends in completions and commitments were closest in the short period between the lowest number of completions (gross and net) in 2002-03 and the peak year of completions in 2005-06. Between just these three years, gross completions rose by 26%, net completions by 47% and commitments by 41%. For all other periods the relationship between land supply and completions was much weaker.

4.5 Across the study period, completion rates did not respond strongly to the supply of land available through the planning system. Indeed a more likely scenario is that, in times of greater housing demand, planning authorities in the region have been able to bring forward an increased supply of land. Either way, with a land supply sufficient for at least five years' building, and rising land allocations available since 2001 (despite the increase in house building), it is clear that an insufficiency of land cannot be held to be the limitation on housing development in the West Midlands during the recent house price boom.

<sup>4</sup> Local authority completions data are invariably substantially greater than completions recorded in official Government records (e.g. CLG Live Table 217). Even allowing for conversions and changes of use, which are included in the planning data but excluded from the CLG data, the differences are largely explained by the much weaker recording mechanisms used by the Government.

4.6 Trends in housing land supply and completions can be set against house prices and the affordability of market housing. Differences in units of measurement can be overcome by indexing the trends from the start of the study period in April 1997. The trends are indicated in the following figure.



4.7 The figure shows how the housing boom affected the West Midlands. House prices at the lower quartile level nearly trebled between 1997 and 2008, and doubled between 2002 and 2008. Housing market affordability rose (i.e. deteriorated), so that homes were only half as affordable in 2007 as they had been in 1997 (at the lower quartile level). Rising house prices and deteriorating affordability far outstripped modestly rising housing completions after 2001. This was despite land supply increasing more quickly than completions. The findings for the region confirm that increasing land supply as a means of increasing housing output, in turn as a means of making housing more affordable, is extremely inefficient. Indeed there is no evidence from the graph that this sequence of principles functions at all.

## **5 Improving affordability in the West Midlands on the NHPAU model: a review**

*Explore the implications of the NHPAU housing provision figures for affordability in the West Midlands, in the context of the figures provided by the NHPAU for all of the English Regions, distinguishing, if possible, between short term, medium term and long term (up to 2026) time periods.*

5.1 The NHPAU has issued two reports which identify the consequences for affordability in the West Midlands of different levels of housing provision. These are *Developing a target range for the supply of new homes across England*, October 2007, and *Meeting the housing requirements of an aspiring and growing nation: taking the medium and long-term view – Advice to the Minister about the housing supply range to be tested by Regional Planning Authorities*, June 2008 (abbreviated hereafter as ‘Advice to the Minister’).

### NHPAU report, October 2007

5.2 This NHPAU report *Developing a target range for the supply of new homes across England* started from the perspective of calculating the future affordability of homes by region according to a variety of assumptions about the level of house building. In each case, affordability was expressed as the ratio of house prices to earnings at the lower quartile level. Input levels of house building were fed into the Reading model to produce affordability measures. The assumed house building rates were those specified in, amongst others:

- published RPG housing levels (Table 2);
- housing levels at the latest available stage of emerging RSSs (Table 3);
- the Government target of 240,000 homes by 2016<sup>5</sup> (Table 8);
- with Growth Points & Eco-Towns as part of 240,000 homes (Table 13);
- 270,000 homes annually by 2016, the extra in southern regions (Table 15).

Some variants on these tables were offered, distributing extra house building amongst the regions in a variety of ways.

5.3 The four main tables noted above are reproduced below. In each case, they project affordability in 2007, 2016 and 2026, and are therefore all directly comparable with each other.

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<sup>5</sup> Distributed by region in proportion to the 2004-based household projections. The targets were specified in the Government’s Housing Green Paper of July 2007: *Homes for the Future: More Affordable, More Sustainable*.

**Table III**

**Illustrative impact of RSS housing plans on housing market affordability, by region**

Region	Current RSS plans – annual average net additions to 2016	Lower quartile house price to earnings ratio – point estimates		
		2007	2016	2026
North East	6,988	5.3	5.8	7.4
North West	23,111	5.6	6.2	8.0
Yorkshire & Humber	21,442	6.0	6.2	8.0
West Midlands	16,167	6.7	7.3	9.2
East Midlands	20,418	6.5	6.9	8.9
East England	26,830	7.7	9.2	11.3
London	30,500	9.0	9.9	11.0
South East	32,000	8.4	10.1	12.4
South West	23,612	8.5	10.2	12.9
<b>England</b>	<b>201,068</b>	<b>7.1</b>	<b>8.0</b>	<b>10.0</b>

Source: Table 3 in NHPAU, October 2007, *Developing a target range for the supply of new homes across England*.

**Table IV**

**Illustrative impact of HMG housing target on market affordability, by region – distribution according to the 2004-based household projections**

Region	240k distributed according to projected household growth		Lower quartile house price to earnings ratio – point estimates		
	Average annual net additions to 2016	Annual supply by 2016	2007	2016	2026
North East	7,986	8,613	5.3	5.7	6.8
North West	25,382	28,396	5.6	6.1	7.5
Yorkshire & Humber	23,367	26,116	6.0	6.1	7.5
West Midlands	19,654	20,351	6.7	7.1	8.7
East Midlands	21,407	22,407	6.5	6.8	8.5
East England	27,354	28,238	7.7	9.1	10.9
London	34,902	40,917	9.0	9.7	10.4
South East	35,031	36,234	8.4	9.9	11.9
South West	25,952	28,728	8.5	10.1	12.1
<b>England</b>	<b>221,035</b>	<b>240,000</b>	<b>7.1</b>	<b>7.9</b>	<b>9.5</b>

Source: Table 8 in NHPAU, October 2007, *Developing a target range for the supply of new homes across England*.

Table V

Illustrative impact of HMG housing target on market affordability, by region – distribution of growth above RSS plans is policy led

Region	Policy driven growth		Lower quartile house price to earnings ratio – point estimates		
	Average annual net additions to 2016	Annual supply by 2016	2007	2016	2026
North East	7,964	8,566	5.3	5.7	6.8
North West	26,985	31,978	5.6	6.1	7.4
Yorkshire & Humber	25,086	29,946	6.0	6.1	7.3
West Midlands	19,106	19,265	6.7	7.1	8.7
East Midlands	22,115	23,829	6.5	6.8	8.4
East England	28,654	31,129	7.7	9.0	10.8
London	30,175	30,500	9.0	9.9	10.9
South East	35,667	37,516	8.4	9.9	11.9
South West	25,283	27,272	8.5	10.1	12.3
<b>England</b>	<b>221,036</b>	<b>240,000</b>	<b>7.1</b>	<b>7.9</b>	<b>9.5</b>

Source: Table 13 in NHPAU, October 2007, *Developing a target range for the supply of new homes across England*.

Table VI

Illustrative impact of building 270,000 homes on market affordability, by region – distribution of growth above RSS plans across southern regions

Region	Focus growth in least affordable regions (270k) – Average annual net additions to 2016	Lower quartile house price to earnings ratio – point estimates		
		2007	2016	2026
North East	7,006	5.3	5.6	6.0
North West	23,730	5.6	5.9	6.5
Yorkshire & Humber	22,107	6.0	6.1	6.8
West Midlands	17,308	6.7	7.0	7.6
East Midlands	21,136	6.5	6.7	7.3
East England	35,886	7.7	8.5	8.8
London	31,159	9.0	9.9	10.5
South East	45,152	8.4	9.4	9.6
South West	32,630	8.5	9.5	9.8
<b>England</b>	<b>236,113</b>	<b>7.1</b>	<b>7.7</b>	<b>8.2</b>

Source: Table 15 in NHPAU, October 2007, *Developing a target range for the supply of new homes across England*.

5.4 The most striking feature of all the tables, both nationally and in the West Midlands, is that the assumed level of house building is insufficient to prevent affordability continuing to deteriorate between 2007 and 2016 and further deteriorate to 2026. Even with the construction of 270,000 houses annually by 2016, affordability would deteriorate nationally from 7.1 in 2007 to 7.7 in 2016 and 8.2 in 2026, while affordability in the West Midlands would deteriorate from 6.7 in 2007 to 7.0 in 2016 and 7.6 in 2026. That level of house building is of course well in excess of current practice, emerging planning policy, the 2004-based household projections and current Government policy.

5.5 The obvious implication from the NHPAU results is that on current supply patterns distinctly more than 270,000 dwellings would have to be built annually to achieve stabilisation of affordability. The October 2007 report does not discuss what this level might be, but does address two other contributory means for reducing affordability: varying the location of the extra homes and varying their size/type.

5.6 First, the NHPAU suggests that housing development could be concentrated in the southern regions, as this is where house prices are greatest and the most impact on affordability can be achieved by building additional houses. Various scenarios are considered. For example, the Government's policy of providing 240,000 dwellings by 2016 is distributed (a) according to the Government's household projections (Table 8) and then (b) with growth above RSS levels distributed around the SE, SW and EE regions only (Table 11). Nationally this achieves a small affordability improvement: both have affordability ratios of 7.1 in 2007, but by 2016 affordability is 7.9 under (a) but 7.8 under (b), and by 2026, 9.5 under (a) but 9.1 under (b). Interestingly, affordability also fractionally improves in the West Midlands, even though the additional housing would be built elsewhere: the regional ratio of 6.7 in 2007 remains equal under both scenarios at 7.1 in 2016, but by 2026 is 8.4 under scenario (b) rather than 8.7 under scenario (a). Nonetheless, in all cases, affordability continues to deteriorate.

5.7 Second, the type of market housing which might best contribute to greater stability is assessed briefly. Taking the Government policy level of building 240,000 homes annually, Tables 13 suggested that nationally affordability would deteriorate from 7.1 in 2007 to 7.9 in 2016 and 9.5 in 2026. This assumes that dwelling sizes and types currently constructed continue to be constructed in future, and provides the baseline for analysis.

5.8 The variant explored is the effect of building 'bigger and better' houses on market affordability. This concludes that building the same number of houses, 240,000 annually, but with a bias towards 4-bedroomed properties, would comparatively improve affordability (though continuing to deteriorate in absolute terms): from 7.1 in 2007 to 7.8 in 2016 (instead of 7.9) and 9.1 in 2026 (instead of 9.5) (Tables 13 and 17 compared). The idea that building bigger (and therefore more expensive) houses compared with current output will make them more affordable is counter-intuitive, but that is what the model predicts. The NHPAU explains the logic of its argument as follows:

“4.62. A distribution of new supply that better caters for future demand – including crucially from existing homeowners – will have a more significant impact on affordability. An undersupply of larger homes means higher prices at this level and increased competition for properties at lower levels in the chain from those unable to move up, thus increasing price pressure here as well.”

5.9 Finally, the October 2007 report raises the question of how affordability might be stabilised or improved, given that none of its main options would achieve anything near to that outcome. It concludes that raising the supply of dwellings to 270,000 annually by 2016 would be needed, but that 70% of the total would need to be supplied in London, the South East, the South West and the East of England (paragraph 4.58).

5.10 The practical implications of this should be appreciated. 70% of 270,000 in the four southern regions compares with:

- 55% there if the distribution is in proportion to the household projections but at the lower level of 240,000 dwellings annually by 2016 (Table 8); and
- 60% there in the NHPAU’s earlier option for providing 270,000 dwellings by 2016 if extra dwellings, above RSS rates, were focused on the southern regions (Table 15).

The proposed scale of supply implies building 150,000 houses more by 2016 than in the Government’s target for 2 million new homes by that date, and 270,000 more by 2020 than in the Government’s target for 3 million new homes by that date (paragraph 4.51). Building 70% of them in the four southern regions would imply remarkably high building rates in those areas. If each of the four took its share in proportion to the 2004-based household projections, each region would typically be obliged to build 46% more houses than expected in its emerging RSS. In the South East, for instance, the expectation would be to build nearly 47,000 dwellings annually, well above the level proposed by any participant at the Examination-in-Public of the Strategy and greatly above the 32,000 annually recommended by the Panel.

5.11 We conclude that the steps required to stabilise affordability at a ratio of 7.1 are so extreme as to have no credibility in the real world. The NHPAU’s October 2007 report is a theoretical exercise in the application of a model which, obviously, produces most implausible results. The idea of building 270,000 houses more than the Government’s target of 3 million by 2020 is clearly unreal. So too is the proposition that 70% of the total should be in the four southern regions, necessitating nearly half as much building again as is already emerging in RSSs. It is also important to appreciate that an affordability ratio of 7.1, the outcome of this astonishing building programme, is itself widely viewed as a most undesirably high ratio and nearly twice the ratio ten years earlier. The package as a whole is a theoretical exercise of no practical use.

NHPAU report, June 2008

5.12 The NHPAU report *Meeting the housing requirements of an aspiring and growing nation: taking the medium and long-term view – Advice to the Minister about the housing supply range to be tested by Regional Planning Authorities* aims to mesh the Unit’s main work on market housing affordability with demographic data. The information is used in combination to generate recommendations on future house building rates for which provision should be made through the planning system.

a) Affordability analysis

5.13 The affordability analysis in the June 2008 report develops the NHPAU’s earlier work by focusing on various alternative means of stabilising market housing affordability. In October 2007, the Government had published a Public Service Agreement addressing the issue of affordability: *PSA Delivery Agreement 20: Increase long term housing supply and affordability* set out an intention that the ratio of lower quartile house prices to incomes should be stabilised nationally at 7.25 (its level in April 2007). This provided a clear context for the NHPAU’s studies.

5.14 In view of the finding in the NHPAU’s October 2007 report that achieving the emerging housing supply plans in Regional Spatial Strategies would cause affordability to deteriorate to 8.6 by 2026, stabilising affordability would clearly require additional house building. The Reading affordability model (with ‘baseline’ assumptions) was run to

identify how much extra would be required. This filled in a gap left in the NHPAU's October 2007 report. Table 3 in the report concludes that stabilising affordability in all regions by 2026 would require the construction nationally of:

- over 306,000 dwellings annually 2008-2026;
- 335,000 dwellings annually 2016-2026;
- total net additions between 2008 and 2026 of 5,821,669 dwellings.

On a 'business as usual' basis, this level of housing construction would clearly far eclipse the Government's policy for building to rise to 240,000pa by 2016, by nearly 100,000 extra each year.

5.15 NHPAU ran dozens of alternative scenarios through the model to test the sensitivity of the results to the various assumptions (notably on nominal income growth, mortgage interest rates, population & household growth, and the regional distribution (& timing) of housing development). The Unit's preferred assumptions held inflation at an assumed 2.5%, but differed from the baseline in various ways (paragraphs 62-63):

- nominal earnings were assumed to grow at 4%pa rather than 5%pa;
- mortgage interest rates were assumed to be 6.25% instead of 5.75%;
- development was focused more on regions where affordability is worst.

This package would stabilise affordability in the southern regions and improve it slightly elsewhere by 2026, comfortably achieving PSA 20 levels. On this basis, Table 5 in the report would require the construction nationally of:

- 257,000 dwellings annually 2008-2026;
- 273,000 dwellings annually 2016-2026;
- total net additions between 2008 and 2026 of 4,884,016 dwellings.

5.16 The options in the study highlight the considerable sensitivity of the results to modest changes in the assumptions. For example, almost a million fewer dwellings by 2026 would be required under the preferred scenario compared with using the model's baseline assumptions. Beyond this, the dwelling requirements fall further if more 'bigger and better' homes are built (Table 6). The scenarios quoted in the NHPAU's main report can be compared with the assumptions in the original Reading report, which were for 5.1% annual growth in nominal incomes and 5.25% mortgage rates to 2016 (Table 7 and page 34). The original Reading model would therefore have argued the need for still higher housing construction figures than in Table 3 in the NHPAU Advice.

5.17 The NHPAU's preferred level of development for affordability purposes implies the construction nationally of nearly 250,000 more houses by 2020 than the Government's target of 3 million by that date (calculated from Table 5). In the West Midlands, the rate of net completions would be required to rise from an actual quantity of 16,812 in 2007 (NHPAU assumed 16,300) to 19,800 by 2016; that level would then be sustained for the following ten years to 2026. The 2016-2026 proposed rate would be 18% above the region's peak output year of 2007.

5.18 Affordability in the West Midlands would improve under the NHPAU's preferred scenario, dropping to 6.04 in 2026 at the lower quartile level compared with 6.30 in 2007 (as modelled by NHPAU, Table 5). Actual affordability in 2007 turned out to be 6.88, so there is some question whether the proposed amounts of house building could reduce the ratio to 6.04 by 2026. These outcomes depend significantly on the achievement of a massively higher rate of house building in the southern regions of England than is currently achieved or intended. Also, the stabilisation of affordability in the West

Midlands at 6.04 should not be viewed as an especially great achievement: it was this level as recently as 2004; in April 2002 it had been 4.42; and in April 1997 it had been 3.47.

5.19 In conclusion, this review of the NHPAU's affordability analysis and preferred option has examined the building requirements to stabilise affordability. It has shown that the Government's target level of affordability in market housing in the West Midlands could be achieved if house building increased to, and was sustained at, a level 18% higher than the regional peak output in 2007. While an 18% increase in output may appear as a challenging but conceptually not excessive idea, it is based on a false premise. That level of building, according to the affordability model used by the NHPAU, would at best return affordability from its 2007 ratio to its 2004 ratio, preventing the deterioration in affordability otherwise modelled to arise by 2026. Such a large increase in housing output to achieve little better than a 'standstill' outcome appears wholly unrealistic. That lack of reality is made worse by:

- far greater deterioration in affordability having occurred in recent years than is proposed to be corrected by new building in line with the model;
- the level of housing supply would be implausible for the industry to build;
- the resulting house prices would still not be 'affordable' on any reasonable understanding of the term: few would view PSA 20's national target of 7.25 as affordable, or its somewhat lower component in the West Midlands (6.88 in 2007).

5.20 Also highly significant in the NHPAU's affordability analysis is the assumed geographical spread of development to achieve the Government's national and regional affordability targets. According to the NHPAU, the rate of housing supply needed to stabilise affordability in the West Midlands would require regional construction at a level 18% above the regional peak output in 2007. However, this stabilisation would only be achieved if at the same time the rate of housing supply in the four southern regions substantially increased. This would be particularly marked in South East England, where the annual rate of supply from 2016 would need to rise to 53,800 houses, spectacularly greater than any level of housing planned or even contemplated in that region (see paragraph 5.10 above). If the southern regions, particularly the South East, were unable to provide this amount of housing supply – as seems highly likely – the implications for the West Midlands would be enormous. Housing supply in the West Midlands would then need to rise greatly above the previously calculated level, simply to stabilise affordability. The NHPAU anticipated this possibility. In its Technical Appendix A to its *Advice to the Minister*, it observed:

“We also consider it necessary to ask the question: what if regions in the south are unable to deliver the level of housing indicated by the baseline model as being required to stabilise affordability? This will not only have an impact on affordability in southern regions. In the absence of the same level of supply in the south driving the ripple effect, it will also mean that supply levels in the midlands and the north will need to increase to stabilise affordability in those regions” (paragraph A50).

5.21 The NHPAU modelled the impact by setting 'maximum' constraints for each of the four southern regions: 38,100 in the East of England, 38,600 in London, 42,400 in the South East and 35,100 in the South West. These were based on their demographic

estimates of locally arising needs, but even so are still substantially greater than currently planned supply rates. The NHPAU then ran various scenarios through the model, constrained to these limits in the south. The one most comparable to the baseline run of the model is Run 3D, which assumes the same real earnings growth (1.5%) and the same mortgage interest rate (6.25%) for the whole period. The impact of the supply limits in the southern regions is to require the supply in the West Midlands to rise from 19,800 annually to over 26,600 annually from 2016 (see page 55). This would stabilise affordability in the West Midlands at the target ratio of 6.30 by 2026, though nationally affordability in 2026 would rise to 7.49, just short of the 7.25 target. Not only would the national affordability target therefore not be achieved, but output in the West Midlands would have to be sustained at a rate 58% higher than the peak output achieved in 2007. Just like the original proposals for flooding the southern regions with houses, this seems impractical too.

5.22 Also instructive are the scenarios which the NHPAU has not pursued. For example, the original Reading report also examined various scenarios, in which the ‘Kate Barker high’ option (an extra 100,000 dwellings per annum) would result in an national affordability ratio of perhaps 5.36 by 2016 and even the base case ratio (without any additional rate of house building) would be ‘only’ 6.24 by 2016. Under the proposals from NHPAU in June 2008, affordability ratios would still be far above the rates which had caused Kate Barker such concern and prompted her drastic recommendations in 2004. Nowhere in the Technical Appendices to the June 2008 report can be found runs of the model where the objective was to achieve more demanding affordability ratios. Had it set a target ratio of, for instance, 3.47 (the 1997 ratio in the West Midlands) the resulting housing requirements would have been massively bigger even than the proposed numbers. The runs of the model have avoided demonstrating the reality that, according to the Reading model, unbelievably high rates of house building would be required to reinstate the affordability ratios achieved only a few years ago.

b) Demographic analysis

5.23 The NHPAU in its June 2008 report takes as its demographic starting point the Government’s Revised 2004-based household projections published in February 2008. These are properly explained as trend-based projections of household growth based on current trends in migration, mortality, fertility, etc. They are not policies, and the Unit recommends that they should be used “with appropriate adjustment” to ensure that the Government’s targets (i.e. for 240,000 additional dwellings annually by 2016 and 3 million in the period 2007-20) are satisfied (paragraph 79). Its Table 7 suggests a regional distribution which does this (though it confuses households and dwellings).

5.24 Converting households into dwelling requirements is notoriously difficult, as small changes in key assumptions have big impacts on implied dwelling needs. Nonetheless, the NHPAU argues the case for three additional allowances on top of the additional households, annually between 2008 and 2026:

- provision to clear the backlog of unmet need by 2026 (27,500 dwellings nationally, of which 3,300 should be in the West Midlands)<sup>6</sup> (paragraphs 82-86);

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<sup>6</sup> This backlog includes a significant and controversial allowance for single people allegedly priced out of the private market, as measured by changes in one-person and multi-person households and by changes in non-dependent children living with their parents (see para. 84).

- allowance for second homes (2,870 dwellings nationally, of which 190 should be in the West Midlands) (paragraphs 87-91);
- allowance for vacancies in the new stock (7,280 dwellings nationally, of which 680 should be in the West Midlands) (paragraphs 92-95).

These add each year 37,650 nationally of which 4,170 should be in the West Midlands. These are added to the household projections but redistributed in Table 10 to plateau in 2016 (recognising that an immediate leap in output is impractical). On this basis, the demographic requirement in the West Midlands is raised by 4,400 annually by 2016 above the Revised 2004-based household projections.

5.25 The implications of the NHPAU’s demographic assessments are set out in Table 10, on a basis comparable to its affordability proposals. Nationally there would be a need to build:

- 260,900 dwellings annually 2008-2026 on average;
- 277,300 dwellings annually 2016-2026.

The equivalent figures in the West Midlands would be for building:

- 22,600 dwellings annually 2008-2026 on average;
- 24,300 dwellings annually 2016-2026.

These dwelling requirements are higher in the West Midlands than those generated by the NHPAU’s affordability proposals (which were for 19,800 dwellings annually from 2016 onwards). The demographic proposals represent a 45% increase by 2016 from the peak output year of 16,812 in 2007. The implications for the three southern regions outside London are reversed from the rest of England: here the affordability proposals would generate greater dwelling requirements than would the demographic proposals.

5.26 The Revised 2004-based household projections from the Government, used by the NHPAU in its modelling work to date, were updated in March 2009 by 2006-based household projections. These revised the household projections upwards. The NHPAU has indicated that it expects to review its assessments in the light of the new household projections. Since 2006 there have been significant change to migration patterns, notably in respect of migration between Eastern Europe and the UK, so the 2006-based household projections – which did not take these into account – should be approached with caution.

5.27 The NHPAU’s treatment of the household projections requires critical evaluation. The demographic proposals particularly embed a selection of difficulties. The critical feature is that for the most part they are not really demographic proposals at all, but the housing delivery policies of the Government (particularly those informing the bottom end of the range). If they were demographic proposals, then the NHPAU would be guilty of treating the household projections as targets, and, in seeking to achieve them, turning the projections into the self-fulfilling prophesies. The lower end of the NHPAU range is therefore essentially the Government’s policy, not demography.

5.28 The Government has specifically set housing delivery levels as a matter of policy well above household projection rates (240,000pa rather than the projected number of households at 223,000pa to 2026) in a deliberate attempt to increase output faster than newly arising need. The NHPAU nonetheless states that “Our recommendation at the present time is that the minimum number of homes to be considered in the next wave of RSSs should be based on the Revised 2004-based Household Projections with appropriate adjustment to ensure that the Government’s targets are satisfied” (paragraph 79). In our view these cannot be the same entity. Table 7 shows the NHPAU’s ‘minimum’

requirement including a column which refers to housing supplies at an ‘annual average to 2026’ which reflects the household projections. However, the other columns (on the building rate at 2016 and net additions to 2016 and to 2020) are contrived.

5.29 To generate the upper end of its national demographic range, the NHPAU has added-in an extra 37,650 dwellings annually for England as a whole to reflect the additional needs it has identified (noted above). In Table 10 these have been correctly added to the household projections to be supplied annually to 2026 (260,900), but the means of calculating cumulative totals to 2016 and 2020 is unclear (not assisted by changing the base year from 2007 to 2008).

c) Synthesis of affordability and demographic analyses

5.30 The NHPAU report of June 2008 marshals its affordability and demographic analyses, putting forward ‘supply ranges’ for the period 2008-2026. The bottom of the range figures are tied to satisfying the Government’s housing delivery targets (240,000 dwellings per annum by 2016, 2 million additional dwellings 2007-2016 and 3 million 2007-2020). The upper end of the range is offered in two ways:

- demographically, reflecting the Revised 2004-based household projections, and taking into account the backlog of unmet need, second homes & vacancies; and
- in terms of affordability, to achieve stability nationally at the PSA 20 rate.

5.31 The more challenging upper-end objective varies between the regions, with demography requiring greater building in the Midlands and North, and affordability requiring greater building in the South. The NHPAU recommendation to Ministers is simply to take whichever regional upper end of the range is more challenging, thereby ensuring that each region secures both demographic and affordability objectives by 2026 (paragraph 114).

5.32 In the West Midlands, the lower end of the range is set by Government policy for housing supply and the upper end of the range is set by demographic projections. The NHPAU’s affordability modelling therefore plays no formal role in the *Advice to the Minister* on the level of house building appropriate for the region. However, if the southern regions of England, and especially the South East, fail to supply spectacularly large numbers of dwellings, then the requirement in the West Midlands needed to meet affordability targets would be far higher than currently proposed. If supply in the southern regions was constrained in the manner the NHPAU’s considers (even this being much greater than currently achieved or planned), the requirements in the West Midlands for affordability purposes, at around 26,600 annually from 2016, would then exceed the requirements for demographic purposes, at 24,300 annually from 2016.

5.33 With affordability dictating the upper end of the NHPAU’s range in some regions and demography dictating it in others, the NHPAU’s *Advice to the Minister* may give a broad impression of some comparability between the two measures. This is misleading. It arises because the affordability proposals are of little merit. A national target of an affordability ratio of 7.25, with regional variations, is remarkably high and undemanding. Had a more realistic target been set, noting that Kate Barker had been concerned when the lower quartile affordability ratio was 4.72 (see paragraph 2.1 and footnote 1 above), the number of dwellings required to be built to achieve such an outcome would have been very substantially higher. Housing requirements to meet the affordability targets in each

region would then have been comprehensively far in excess of the figures to address demographic projections.

5.34 There is every likelihood that the affordability target of 7.25 has already been met: the recent fall in house prices (about 20% since their mid-2007 peak) should have seen to that, and the figures published in due course will demonstrate this. We will not have to wait until 2016, let alone 2026, to fulfil the PSA 20 objective, and we certainly will not have to build mind-bogglingly large numbers of houses to achieve it. A drop in credit supply (coupled with a loss in buyer confidence) has had a much greater and virtually instantaneous impact on affordability – much simpler than a building programme to supply more houses each year for 20 years than there are households to occupy them.

5.35 We conclude that neither the affordability nor the demographic elements of the *Advice to the Minister* from the NHPAU should be relied upon, either nationally or in the West Midlands. The affordability advice is a function of the remarkably inept assumptions fed into the Reading model, while the demographic advice relies on controversially high estimates of the backlog of unmet need.

## 6 Identifying needs and demands: who would the NHPAU proposals house?

*Explore how the NHPAU figures compare with household projections and the implications of any disparity, in particular for issues such as demand for housing (as opposed to housing need), household formation, migration, second home ownership, vacancies and low demand areas (with particular attention to the two Housing Market Renewal Pathfinders in the Region).*

6.1 NHPAU's assessment of household projections (compared with housing requirements to meet affordability objectives) was reviewed briefly under issue 3 above (based on the NHPAU's *Advice to the Minister* in July 2008). This included a commentary on demographic aspects of household formation, second home ownership and vacancies. While most of that analysis concerned total household formation and total dwelling requirements, this section focuses on the balance between provision in the market and social sectors and on the varying housing markets around the West Midlands.

### The balance between market and subsidised housing in the NHPAU approach

6.2 The affordability model used by the NHPAU is fundamentally a model of the private housing market, where additional housing supply reduces the ratio of house price to income. The limited evaluation of the needs for housing which cannot be met by the market (because households cannot afford to buy) is therefore not surprising. The NHPAU has organised its *Advice to the Minister* around the housing targets set in the Housing Green Paper *Homes for the Future: More Affordable, More Sustainable* (July 2007), which assumed that as a minimum total housing provision would be 240,000 dwellings annually (by 2016) of which 70,000 would be affordable (i.e. sub-market and subsidised in some way) by 2010-11. This approach is broadly consistent with the assumptions in the original Reading model<sup>7</sup>.

6.3 In England, 45,000 homes annually would be social rented out of the total 70,000 affordable. As new housing construction increases, the NHPAU would increase the number of social rented homes to 50,000pa and then hold this constant thereafter (in line with the Government's goal of 50,000 new social homes a year in the next spending review). The provision specifically of social rented housing in the NHPAU model in England and in the West Midlands would be as set out in Table VII below

Table VII

Social rented housing provision assumed in the NHPAU model (annual numbers)

Year	2008	2009	2010	2011-12	2013-31
West Midlands	1,753	2,150	2,546	2,943	3,270
England	26,806	32,870	38,935	45,000	50,000

Source: NHPAU

6.4 Meanwhile, it can be said with confidence that the 'additional dwellings' (*Advice to the Minister*, June 2008), on top of the household projections, for which NHPAU

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<sup>7</sup> The Reading model stated that specifically for the dwellings in the 'already planned' level of house building, for the base case, it assumes 30% affordable housing at all times, except for 50% in London (page 32).

makes an allowance in its demographic calculations dated June 2008, will be split by tenure as follows:

- backlog of unmet need: 100% in the subsidised sector: 3,300 homes per year in the West Midlands 2008-2026 (Table 8);
- 3% vacancy in the new stock (paragraph 95): 680 per year in the West Midlands (Table 9), distributed pro rata by sector;
- second homes: 190 per year in the West Midlands, 100% in the private sector (Table 9).

6.5 In addition to this, the NHPAU model conceptualises housing markets with improved (i.e. reduced) affordability in which households unable to access the market are increasingly able to do so as the affordability ratio declines. The impact of this process is dampened, however, because the principal beneficiaries of improved affordability through additional housing provision are identified by the Reading model as existing households already housed (who would be able to access greater space), more than households who are not currently housed adequately (Meen et al, *Affordability Targets: Implications for Housing Supply*, December 2005, pps. 27-28). In practice, however, none of the scenarios under active consideration by NHPAU involve significant improvements to affordability beyond those targeted in PSA20 (i.e. the position in 2007), so the degree to which households will be 'priced in' to the market can be assumed to be negligible.

#### Inter-regional migration

6.6 The NHPAU has run various assumptions through its affordability model based on different regional distributions of additional house building. All regions are interrelated on each individual run of the model. Some of the runs envisage very large numbers of houses being built in the southern regions of England, with the clear implication that these regions will not only satisfy demands arising from projected household growth locally, but may well dampen outmigration to other regions and attract more inward migrants. Major change could be expected to the current pattern of inter-regional migration in such cases. However, the migration implications are not reported by NHPAU. The balance of dwelling take-up is not stated between interregional migration, increased vacancy in the stock (whether in high-build regions due to over-supply, or low-build regions due to more outmigration to high-build regions<sup>8</sup>), or increased consumption of additional housing.

6.7 The migration information is vitally important. There may well be a mismatch between the consequences of migration in terms of improving affordability and the consequences of migration in terms of everything else. For instance, building very large numbers of extra houses in specified locations would necessitate the construction of the infrastructure to follow them: not just schools, roads and health centres but possibly reservoirs and railway stations. This could be needed while at the same time investment already made in areas expected to lose population is not then used efficiently. Major building programmes in high price areas, already under development pressure, could

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<sup>8</sup> NHPAU notes in its *Advice to the Minister* (page 22 footnote) an unpublished report from Reading University which found that the Reading model simulated an increase in vacancy rates for England rising from 3.4% to between 3.8 and 5.9% (mean = 4.5%) by 2016 if an extra 100,000 dwellings were built annually.

create a new chasm in the north-south divide. Realigning the population would itself change the dynamics of employment provision and other investment priorities in favour of the new areas for growth. All of this could have major social and environmental effects as well as demographic and economic ones. While this may all be immaterial to the single purpose of the NHPAU in addressing affordability, it is hugely important for place-making and regional planning. The assumption should not be made that, even if the proposed changes to the migration pattern were desirable for affordability (which we doubt in any event), they should necessarily prevail over many other reasonable and interrelated objectives for sound regional and subregional planning.

### Low demand and the Housing Market Pathfinder Areas

6.8 When there is a significant surplus of dwellings over households in an area of weak economic activity, there is a risk of a downward spiral in the local housing market which entrenches that 'low demand'. These areas may show the associated symptoms of high concentrations of difficult to let or sell properties, loss of population, inability to attract new households, neighbourhood decline, and deprivation. Very low house prices can lead to high turnover in the stock, boarded-up property, criminal activity, and an atmosphere of deterioration which encourages those who can to leave. Efforts to improve the housing stock – to break into the downward spiral – have to be handled as part of a wider regeneration programme: otherwise households simply gravitate to the attractive new stock, leaving the worst behind instead and simply move the surplus stock around an area. Likewise, the low demand areas need to be planned alongside surrounding districts: if these provide significant numbers of new houses, then households may gravitate there and entrench the difficulties of the low demand areas.

6.9 The Government established the Housing Market Renewal Programme to tackle such areas, and set up nine Pathfinder Areas. Two of these are in the West Midlands: Birmingham & Sandwell and North Staffordshire. Low demand in North Staffordshire, particularly Stoke-on-Trent, is acute. This city has been losing population for many years, has around 7,000 homes empty for more than 6 months, and has little or no net new demand for housing. Like other Pathfinder areas, a measure of success in regeneration here would be rising house prices, indicating a recovery of buyer interest and a greater commitment to investing in the area's future.

6.10 Independent Government-supported watchdogs which have addressed Housing Market Renewal recently have emphasised, inter alia, the importance of activity in the wider housing market to the success or otherwise of the Pathfinder Areas. The National Audit Office (NAO) in its report *Housing Market Renewal* (November 2007) reiterated a specific reference to the risks identified by the Audit Commission as facing North Staffordshire and some other Pathfinders:

“2.3 The development of pathfinder strategies needs to have close regard to the development of wider regional housing and spatial strategies. Since the programme's announcement in 2002, projections of the level of demand for housing in the North and the Midlands have grown and in its Housing Green Paper *Homes for the Future* the Government announced plans to increase the targets for new homes built in these regions. Failure to align strategies runs the risk of planning decisions being taken that may threaten pathfinders' efforts to restructure their markets. For example, in December 2006 the Audit Commission

highlighted that four pathfinders – South Yorkshire, Merseyside, North Staffordshire, and Newcastle/Gateshead – faced the risk of substantial supply of new homes being built within the wider region that could continue to fuel the migration of people out of the pathfinder areas.”

The Pathfinder bodies were found by the NAO to be generally aware of the need for regional and local alignment of housing policy, and suggested that North Staffordshire was an area where there was some measure of agreement on the case for development restraint in key areas (paragraph 2.4).

6.11 In July 2008 the Public Accounts Committee in the House of Commons published a report on *Housing Market Renewal: Pathfinders*, and concluded (emphasis in original):

“4. **The success of efforts by pathfinders to restructure housing markets in their areas depends on a co-ordinated regional approach to planning housing growth.** Plans to increase targets for numbers of new homes in the North and the Midlands could fuel the migration of people out of pathfinder areas, hindering the impact of pathfinder interventions. The Department should clarify how the Housing Market Renewal Programme is expected to align with regional housing strategies.”

6.12 The Government’s response to the Committee broadly accepted the need in principle for housing policy integration inside and outside the Pathfinder areas<sup>9</sup>, (though there is some question whether the growth strategy can achieve this).

6.13 This agenda is exactly the opposite of the NHPAU’s, which is to reduce house prices and improve housing affordability by raising regional house building targets and building additional homes. Applying these principles in or near the Pathfinder areas would make their problems worse rather than better, and risk tipping marginal housing markets into low demand. The NHPAU ignores low demand. With its model founded on the principle of creating a surplus of dwellings over households, the economically unattractive low demand areas would be the first to feel the pressure of surplus homes and relative decline.

6.14 The NHPAU notes that affordability can be reduced more effectively by building additional houses in high demand areas rather than in weaker housing markets. While this might give the impression that regeneration could continue meanwhile unhindered in Pathfinder areas, the effect of implementing this policy would be very different. Reversing current practice and allowing major housing development in places such as Stratford-upon-Avon (only a few miles from the Birmingham & Sandwell Pathfinder area) would change the dynamics of house building pressure across the whole region. Encouraging building where the market wanted rather than where it would do the most good for the region would immediately cause developers to realign their activities. The limited interest of developers in contributing to market renewal in weak economies would

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<sup>9</sup> “In some cases, market renewal areas are increasingly close to areas experiencing or forecasting growth, and in these circumstances it will be important to bring these development programmes together. This connectivity is reinforced in Government proposals, which encourage local authorities to pursue growth strategically in partnerships across boundaries and ensure that housing and regeneration policies are mutually reinforcing” (paragraph 6).

further decline if not dissolve: these locations would be even less attractive investment locations compared with the more buoyant areas now offered for housing growth. At the same time, public expenditure on associated infrastructure would inevitably be obliged to follow the market, tending to divert funds from the Pathfinder and surrounding areas to the newly expanding areas. The knock-on effects of building in places which until now have been heavily constrained could be expected to be substantial across the whole region.

6.15 An understanding of the forces which create low demand shows clearly that a significant growth in housing supply in locations favoured by the market would worsen rather than ameliorate the problems of weak housing markets in parts of the West Midlands. The singular pursuit of lower affordability ratios using the NHPAU method is not a free lunch. It would exact a potentially enormous price in terms of:

- entrenching vacancy and deprivation in the Pathfinder areas;
- discouraging regeneration;
- swamping economically and physically attractive places with quantities of housing which planning policy has successfully resisted for decades;
- diverting investment in infrastructure from where it is most needed to supporting the new pattern of housing provision.

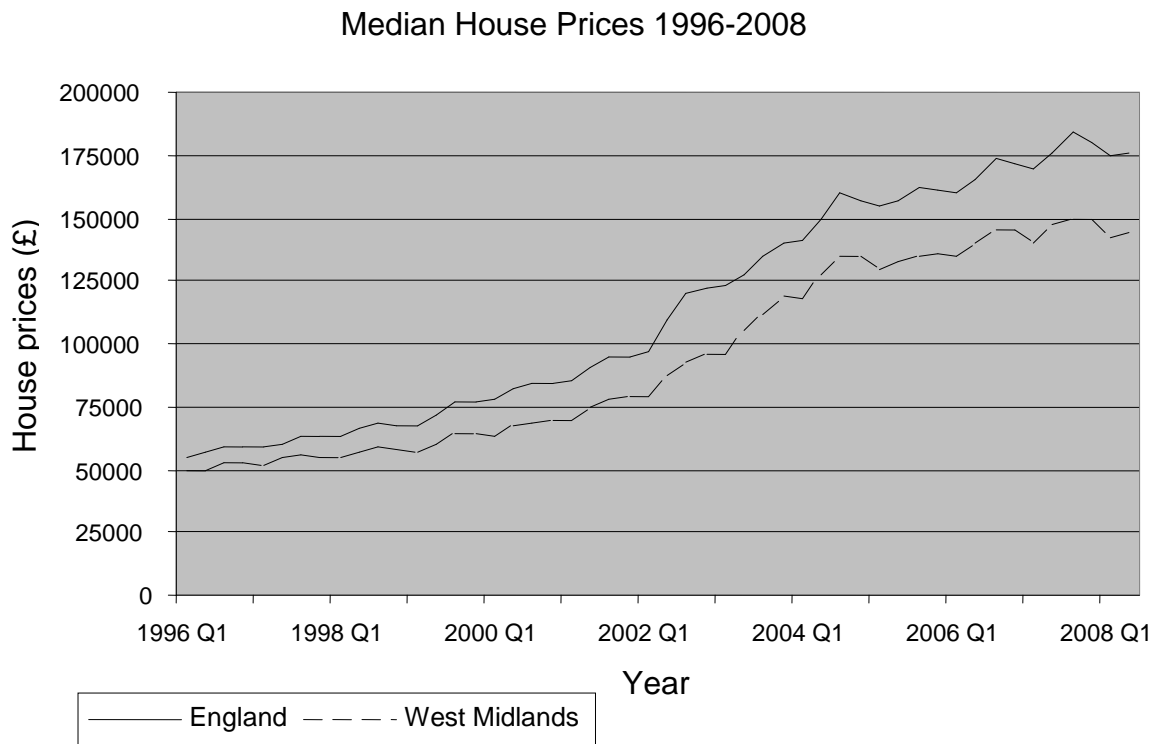
The Government has been warned repeatedly about the critical importance of avoiding stimulating outmigration from housing market areas with low demand, and therefore the importance of a regional approach to housing provision. The priority should be to seek advancement for communities trapped in low demand through regeneration, rather than building large numbers of additional dwellings in or near the worst-affected areas (generally the Pathfinders). The NHPAU, anticipating the opposite mode of operation, could undo years of work in low demand areas and squander the investments already made there.

## 7 The utility of the NHPAU model in current and future housing markets

*Explore the available evidence that observed rises in house prices are, or are not, the result of a house price “bubble” (i.e. inflated prices as a result of buoyancy in the market and purchaser confidence), and the implications of ‘normalisation’ of the housing market for the NHPAU provision/affordability assumptions if a “bubble” has in fact occurred.*

Has there been a house price bubble?

7.1 Whether the housing market has been in a bubble has been debated for many years, including prior to 2007. This brief review of the arguments begins with a chart of house prices in England and the West Midlands, taken quarterly from 1996 at the median level across all dwelling types, from the Land Registry (which records actual prices of dwellings sold). There is widespread agreement that house prices have dropped substantially since the second quarter of 2008 (the last entries on the chart). The Homes and Communities Agency latest *Monthly Housing Market Bulletin* reports the annual declines set out in Table VIII below.



Source: CLG Live Table 582

Table VIII

Annual decline in house prices by agency (basis of calculation varies)

<u>Monitoring agency</u>	<u>House price decline (year to)</u>
Nationwide	16.6% (January 2009)
Halifax	17.2% (January 2009)
Rightmove	9.1% (February 2009)
CLG	10.2% (December 2008)
Land Registry	13.5% (December 2008)
Hometrack	9.4% (January 2009)

Source: Homes and Communities Agency, Housing Market Bulletin, February 2009

7.2 The central issue is whether this information indicates a house price bubble, or a pattern of house prices reflecting other stimuli which, if removed, would cause the housing market to resume its previous course. In other words, was the housing market inflated by rising expectations which became unsustainable, or did the credit crunch undermine, temporarily, a market which was rising in accordance with a normal pattern of supply and demand?

7.3 The case supporting the view that there has been a house price bubble has been argued since before the turn of the millennium. By far the most notable holder of the view that the UK has been in a house price bubble has been the International Monetary Fund. In March 2003 it warned that this could burst at any time with devastating consequences for the wider economy: “domestic demand is being sustained by high and increasing levels of household debt, fuelled by house-price inflation and low interest rates, which increases vulnerability to potential adverse shocks”. In a further warning in September 2004, the IMF argued that house prices were overvalued by as much as 20%, and reiterated two years later that UK house prices were overvalued on any conventional measure. Meanwhile, *The Economist’s* cover story on the housing market on 16 June 2005 considered “the worldwide rise in house prices is the biggest bubble in history.”

7.4 The evidence for this view comes from attempts to distinguish a valuation component of house prices from a debt component. The valuation component compares prices relative to what people can afford, while the debt component measures how indebted households become in buying them (and the accumulated exposure of the banks in lending to them). A study by David Miles, the chief UK economist at Morgan Stanley and author of a review of the mortgage market for the Treasury, was particularly notable. He suggested in November 2006 that one third of the doubling in house prices (and up to a half in some places) in the previous ten years reflected expected future house price inflation. Due to this speculative element he anticipated that “A substantial fall in real house prices is likely at some point in the relatively near future, though it could be one or two years away” (*The Independent*, 23 November 2006). Indicators of stress in the housing market continued to deteriorate in the months following (such as worsening affordability, rising personal debt, riskier mortgage lending, and only weak responses in the market to rising mortgage rates spurred by increases in the Bank of England’s base rate). Nonetheless, the perception of a bubble remained a minority view, with the majority of commentators during 2007 anticipating a market slowdown but not a crash.

7.5 During the housing market upswing, many commentators argued that there was no evidence of a housing market bubble. The stress indicators noted above were viewed as features which the housing market could accommodate, not ones it should not accommodate. The principal arguments focused on ‘the fundamentals’ of supply and demand in the market, which were seen as:

- an insufficient stock of dwellings;
- a poor response of the building industry to rising prices;
- constraints on new housing supply (particularly due to planning);
- numbers of households rising faster than new housing supply;
- mortgages remaining affordable due to low interest rates;
- growing wealth making housing an ever-more valuable commodity.

7.6 Probably chief amongst the supporters of this argument were the Bank of England and the Government. The Bank generally took the view that despite high levels of debt and house price inflation the economy would be well-placed to withstand a drop in house prices, and that fewer borrowers would be badly affected than was the case in the late 1980s. The Government has considered that there is no inconsistency between the rise in the housing market and macroeconomic stability, and that low interest rates made owning a house attractive even at very high prices. In probably the most relevant statement of all, Gordon Brown as Chancellor said in his Budget Statement on 21 March 2007 that “we will never return to the old boom and bust”.

7.7 When the collapse of sub-prime mortgage lending in the USA had become entirely apparent in early 2007, the question arose whether the UK market would be similarly affected. As the credit crunch took hold in the UK and the housing market faltered, commentators revised downwards their expectations for house prices. There was also a certain amount of revisionism, with the language of bursting bubbles becoming much more frequently used, and more attention paid to the unsustainability of earlier price rises. With the passage of time the recession and the housing market crash have become so severe that there is now virtually no talk of the housing market bouncing back quickly: commentators are all talking about recovery over a period of years. Even Ed Balls, the former chief economic adviser to the Treasury, indicated on 9 February 2009 his belief that the economic downturn was worse than in the 1930s and could last for 15 years. It is obvious that there has been a housing boom followed by a housing bust, but not quite universal acceptance that the boom was a speculative bubble which has now burst.

7.8 For its part, the NHPAU has not formally taken a view on whether there has been a house price bubble. However, its approach to the issues has historically suggested that it does not believe there has been one. As previously noted, the Reading model was built on the assumption that there was no housing bubble in progress at the time of its preparation in 2005. The NHPAU has done nothing to question the continuing validity of that assumption. Well after signs of problems had appeared in the UK, the Chairman of the NHPAU (Professor Stephen Nickell) still claimed at its first AGM on 2nd July 2008 that there was no housing market bubble and that he expected the market to rebound to its previous level as soon as the problem of bank lending had passed. The NHPAU’s argument in 2008 was that the underlying buoyancy of market demand and shortage of supply – induced by the planning system – would ensure that there would continue to be an upward pressure on affordability once mortgage lending resumed.

7.9 The implications of these two assumptions – that there was no house price bubble and that the market will bounce back with affordability problems once the supply of credit resumes – require examination, particularly to see how valid the NHPAU approach remains if they are wrong. The two assumptions are related. The stronger the argument that there has been a house price bubble, now bursting, the weaker the argument that house prices (and thus affordability) will return to their pre-2007 levels in the foreseeable future.

What caused the house price crash?

7.10 The boom in house prices was built on debt. The report by Professor Michael Parkinson and his colleagues in a report published by CLG, *The Credit Crunch and Regeneration: Impact and Implications*, January 2009, explains concisely how the credit crunch and the UK housing market interacted (see particularly chapters 1 and 3). The report observes that:

“1.8 Some financial crises – the Stock Market Crash of 1987 – come out of the blue. Others, like the collapse of the dot.com stocks in 2001 are the culmination of pricing bubbles which have been widely, though not universally, expected to burst. The credit crunch clearly belongs in the second category. It has been the product of two factors: inflated house prices, and over-extended credit and leverage in the financial system.

1.9 Inflated house prices and the search for yield in the financial system shared common origins: the equities market collapse of 2001, and the adoption of extremely low interest rates as the main policy tool to stave off economic recession. A loss of confidence in equities while yields on government bonds were extremely low pushed a large flow of capital into “alternative” investments – real estate, private equity, hedge funds and asset backed securities. The resulting rise in the value of these assets coupled with very low interest rates made it very attractive to leverage investments with large amounts of debt.”

7.11 The report goes on to explain how this was reflected in the financing of the housing boom, which had started in about 1996: “Between 2000 and 2007, the top ten mortgage lenders’ reliance on customer deposit funding declined from 72% to 55%. By contrast, overall gross mortgage lending trebled from £119bn to £364bn” (paragraph 3.5). In short, a vast amount of borrowed money found its way into the housing market in a short period of time, and this enabled house prices to rise rapidly. The house price boom was not built on the back of rising quality in the stock, significant shortage of dwellings or any other inherent feature of the housing market. Rather it was driven by a self-reinforcing belief in rising property values which made housing seem a good investment (at least compared with the alternatives).

7.12 When the music stopped and the credit crunch turned off the money supply, the stimuli affecting the housing market also changed drastically. The credit crunch had its origins in foolhardy lending in the United States sub-prime housing market, but quickly affected banks worldwide. House prices fell in the USA, affecting all those banks and investors with a stake in the sector, and created a fear – justified as it turned out – that banks retained assets which were overvalued. Furthermore, other types of asset might also turn out to be over-valued, such as corporate bonds and commercial property. The

loss of confidence by banks in each other caused lending to dry up. Banks tried to restore their balances and severely limited their lending. As Professor Parkinson et al report:

“3.7 The number of mortgage products on offer in the UK dropped from 13,027 in August 2007 to only 3,748 a year later, with average maximum loan-to-value (LTV) ratios falling from 90% to 80%. 100% LTV mortgages have disappeared. Those with poor credit histories have experienced the sharpest rises in mortgage interest rates of 2 to 2.75%, whereas their rates were virtually the same as standard ones the year before.

3.8 There has been a flight to safety in which many potential borrowers are squeezed out altogether until the market settles down again.”

With a looming recession, the debt-fuelled UK housing market quickly became an unwise choice of investment (even to those with money to spend), and the collapse in house prices, once started, became self-reinforcing as non-essential buyers stayed away.

7.13 However, in addition to the credit crunch, there were already indicators before the end of 2007 that the UK housing market had over-reached itself. Professor Parkinson et al observe:

“3.3 Activity in the housing market [in terms of number of mortgage loans] actually peaked in 2006 well before the onset of the credit crunch, because affordability was being weakened by rising house prices and mortgage interest rates which discouraged purchase. Prices continued to increase for some time afterwards, however. They would probably have slowed substantially over the past year even without the credit crunch. But the onset of the credit crunch has greatly intensified the scale of the downswing.”

There may well have been a self-correcting element in the housing market, therefore, with rising prices beginning to discourage purchasers even before the credit crunch. Nonetheless, rising mortgage interest rates and the credit crunch were both demand-side stimuli outwith the housing market. Even if a fraction of the housing market cycle can be explained by internal supply and demand forces, much of the boom and bust has been caused by an oversupply and then a drying up of credit, reinforced by market expectations of rising houses prices in the boom and falling prices in the bust. Noteworthy in this context is that Professor Parkinson et al do not once mention the operation of the land use planning system as having had any bearing on the housing market crash or on the development of its previous boom.

#### Will the housing market return to its condition prior to 2007?

7.14 The lesson of history is that in the housing market cycle prices collapse quickly but build only slowly. This was rightly identified by Professor Parkinson et al, who comment on long-run housing market behaviour:

“3.10 The two major UK house price downswings in the 1970s and 1990s lasted for four years and six years respectively. Both proceeded major general economic recessions and persisted even after general economic conditions improved, particularly in the 1990s. This suggests that, although the current crisis is

different, major housing market downswings can have long-lasting damaging impacts on consumer house price expectations, which delay market revivals.”

This view is entirely logical: lenders are most unlikely to wish to lend for many years on the same basis as currently exposed as unsustainable, and borrowers will be shy of supporting house prices so high that they could risk damaging losses in another market slump of the kind so recently experienced.

7.15 Professor Parkinson et al point out too that the nature and activities of lending institutions is likely to be different:

“7.29 ....whatever the timing of the revival, the mortgage market will look different from what it does today. Many providers have already changed, through retrenchment, takeover or merger. The pure RMBS [Residential Mortgage Backed Securities] funded operators may find it difficult to re-emerge as important players while other types of capital market funding may grow in importance.

7.30 Lender spreads are likely to stay wider than they have been in recent years; risk assessments will be more stringent and expensive; and there will probably be greater risk-based pricing of loans and loan conditions, with greater equity required from some borrowers and higher borrowing costs for such products as larger LTV [Loan To Value] loans. This will obviously impact on house price growth in the future...”.

7.16 It is difficult to see how the housing market over the next ten years could possibly be similar to that over the last ten. The probability of a return to the affordability levels experienced in recent years is therefore minimal.

#### *The implications of boom and bust in the housing market for the NHPAU*

7.17 The explanation of recent housing market experiences reflects badly on the approach to housing affordability taken by the NHPAU. House prices became enormously overvalued in relation to incomes, not because of significant supply side shortages as assumed by the NHPAU, but due to very low interest rates and remarkably generous lending. The housing market, including affordability ratios, has been dominated by demand side controls, yet the NHPAU assumes that supply side interventions sustained for the next twenty years are the means by which affordability problems should be resolved. The house price crash has achieved what the NHPAU set out to do – stabilise housing market affordability – by other means and in a fraction of the time. If the supply of land had virtually nothing to do with the house price boom or the house price crash, as was the case, then seeking solutions to house price issues by increasing land supply through the planning system, as the NHPAU does, seems a seriously misplaced enterprise.

7.18 The over-valuation of housing in the boom included a speculative element. The scale of this element remains to be resolved (e.g. whether it accounted for as much as one fifth of house prices according to the IMF or even one third according to Morgan Stanley bank). Nonetheless, the evidence of speculative activity calls into question the validity of the NHPAU’s approach to affordability based on the Reading model, which assumed no

bubble in its calculations. If an important part of house price rises was due to speculation, not – as NHPAU believed – all of it being due to rising demand in an environment of constrained housing supply, then the remedy of increased land supply cannot be reliable. In our view the NHPAU approach has been broken at its root.

7.19 Even if there has been no bubble, the implications for housing markets in the future would be similar if instead there were changes in the parameters within which the housing market operates. Self-regulation will inevitably induce a more moderate mortgage lending pattern, at least for a while. More importantly, there is little chance that the Government (or indeed the EU) will allow such reckless lending activity to be repeated unchecked: the likelihood is that, when fire-fighting the recession has passed, the Government will turn its hand to introducing measures which limit the chance of excessive indebtedness happening again, including in the housing market.

7.20 The Government has made clear it intends to do this. Already the Prime Minister has stated “We have got to get the balance right between serving home owners better and encouraging responsibility in the housing market. This is a duty on banks and building societies, but we have also asked the Financial Services Authority to look at how in the future we should control new mortgages more than 100% of house value” (*The Observer*, 22 February 2009). Three days later, the Financial Services Authority (FSA) went further than this in oral evidence to the Treasury Select Committee in the House of Commons. The FSA promised “a revolution in approach”, following a review to be completed by the third quarter of 2009. The Chairman, Lord Turner, stated:

“we can see considerable merit both in relation to the defence of consumer interests and in relation to the macroprudential issue about guarding against excessive booms and busts in looking at the issue of mortgage regulation either through the loan-to-value or the loan-to-income route, or some alternative. Just one point in relation to that: if we do that, I do not think we can simply narrow it to the 100% issue. Actually, only about 0.5% of mortgages were ever over 100%. I think the bigger issues might be should we be into 85% or 90% and what do you think about those issues, and those are important issues, they require some thought. We can see a prima facie case for a quite significant shift in the previous philosophy of British regulation in this area” (Q2281, uncorrected transcript).

7.21 A more prudent lending environment would constrain house price rises and affordability problems of the kind witnessed up to 2007. The likelihood is that, whether or not there has been a bubble, the circumstances which gave rise to the affordability patterns modelled by the NHPAU will not return in the foreseeable future. It is therefore difficult to see any circumstances in which the NHPAU affordability model would serve any purpose.

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