

Urban and Regional economic of transition.

Is there a housing shortage? A post-Keynesian economics approach to the financialisation of housing in England

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Abstract: The overwhelming dominance of neoliberal economics has come under question following its failure to understand, let alone predict, the barrage of global financial crises that began in 2007/8. Heterodox economic theories, Post-Keynesian school of thought in particular, have since assumed much greater significance during the last decade as much broader and more encompassing theoretical conceptualisation of economic behaviour is established. Land and property development stands at the centre of these debates due to the fundamental importance of property in providing collateral to the private banking system when money is created. Furthermore, the neoliberal exclusion of the role of debt and financialisation in determining the growth of the global economy has encouraged a fundamental misallocation of resources. The significance of excluding debt has permitted a deep-seated narrative to evolve amongst policy makers, in which the high price of land and homes in most developed countries is indicative of a shortage of supply, whereas it is likely that the role of debt driven demand is a more plausible culprit. This paper explores the role of financialisation and money creation in the UK to better understand the impact of debt upon the presumed shortage of housing supply in England. The unswerving belief of a housing shortage in the UK is beginning to be questioned. Between 2016 and 2018 the UK government substantially reduced its 25-year projections of increased household requirements by some 1.1 million units, reducing annual needs by more than 25% to 159,000 units. The implication of such a substantial and sudden shift in projections will inevitably have a broad impact on urban planning requirements and highlights the usefulness of heterodox economic thought in untangling the complicated transition of urban planning to meet future needs.

Keywords: heterodox economics; financialisation; mortgage debt, house prices

Introduction

Just 20 years after radical government financial deregulation in 1985, the humble Building Society movement became the centrepiece of the 2007 and 2008 global financial crisis in the UK. The most dramatic disruption occurred in mid-September 2008 when long queues formed outside the branches of Northern Rock Bank in the cities and towns of England, the first bank run since 1866.

So what had wrought such devastation across the formerly humble and venerable English Building Society movement with its long and stable history of mortgage provision to the housing market, a history that dates back more than 150 years? In a word the answer is “banking”.

Northern Rock was just one of a former group of building societies which had expanded rapidly into the fast paced world of credit funded banking. Other banks, which had also

previously made the switch from Building Society to bank, like the Bradford & Bingley and the even the bigger Halifax Building Society, also became insolvent in 2008 and were either taken under state control or forced to merge with larger banking institutions.

The introduction of modern banking practices resulted directly from a government policy of wide ranging financial deregulation in the mid 1980's. The deregulation set off a chain reaction of bank created debt, widespread mortgage accessibility and rapidly rising house prices that eventually consumed almost the entire independent mortgage industry. What had once been the centuries old Building Society movement, providing almost the entire mortgage market for house purchases, was destroyed in the financial crisis of 2007/2008.

This paper explores the institutional changes within the mortgage and housing market in England that directly followed that deregulation of the financial sector in 1985 and highlights how strong house price growth is likely the result of those significant institutional changes in the banking system and the process of money creation. The advent of massive growth in mortgage availability necessarily impacted the property market directly through the demand for housing and is likely a major contributor to the substantial rise in the price of house prices over the last 40 years. Despite this financialisation of the property market there is still a predominant narrative throughout industry and government that ignores financial aspects and attributes the cause of high prices to a lack of supply resulting from unnecessarily restrictive planning policy that prevents house building meeting the projected need.

This paper will first review the evidence for a shortage of supply and then review the long-term changes that have occurred in the financing of the property stock in England.

The Housing crisis and the shortage of supply

A common refrain in the British press is that Britain is suffering from a shortage of 300,000 houses a year and that new house building is falling far short of meeting that need (Torrance, 2019). But it is hard to blame the press alone when the source of those headlines comes from the government planning department itself.

In February 2017 the Department for Communities and Local Government published a white paper announcing their housing planning policy called 'Fixing our broken housing market' and the first paragraph stated:

“The housing market in this country is broken, and the cause is very simple: for too long, we haven't built enough homes. Since the 1970s, there have been on average 160,000 new homes

each year in England. The consensus is that we need from 225,000 to 275,000 or more homes per year to keep up with population growth and start to tackle years of under-supply.” (DCLG, 2017,p.9)

A year later in a statement to the Houses of Parliament by the Secretary of State for Housing, Sajid Javid confirmed that the government planned to “deliver 300,000 homes a year in England by the middle of the next decade” (HC Deb 05 March 2018).

It is difficult to establish the exact origin of the 300,000 number but it is likely derived from the projected growth in the number of households for the whole of the United Kingdom (UK) published by the renamed Ministry of Housing, Communities and Local Government (MHCLG) and is approximately in line with their projections for England from 2014 (MHCLG, 2018). Given that England has a population of some 85% of the UK total, a figure of 300,000 may derive from that. Other studies also suggested similar projections for household formation. In 2004, the government commissioned a wide-ranging study of housing supply (Barker, 2004, p5.). Barker estimated that 245-260,000 new homes would be needed to prevent rising house prices in England. A further widely quoted study (Holman, 2013) with revised estimates for annual household formation, estimated that from 2011 to 2031 there would be a need for 240,000 new households each year. Current government policy as laid out in the National Planning Policy Framework (NPPF) was updated in February 2019 and emphasises in particular, government guidance on how planning permissions are to be granted to meet housing needs (MHCLG, 2019) and it appears that household projections from 2014 data are the basis for this guidance. The household formation projections from MHCLG are therefore a crucial input to the entire planning policy in England.

Current UK planning policy for household development.

Unfortunately, the history of projecting the formation of new households for a planning horizon one or two decades ahead was not straightforward. The key determinants for the growth of new households are

1. *Population projections, births and deaths*
2. *Migration.*
3. *Average household size, by persons.*

Population projections are provided by the Office for National Statistics (ONS) and are periodically revised. They are subject to considerable revisions as shown in the Table 1

Table 1. Historical Population Projections for England (millions of persons)

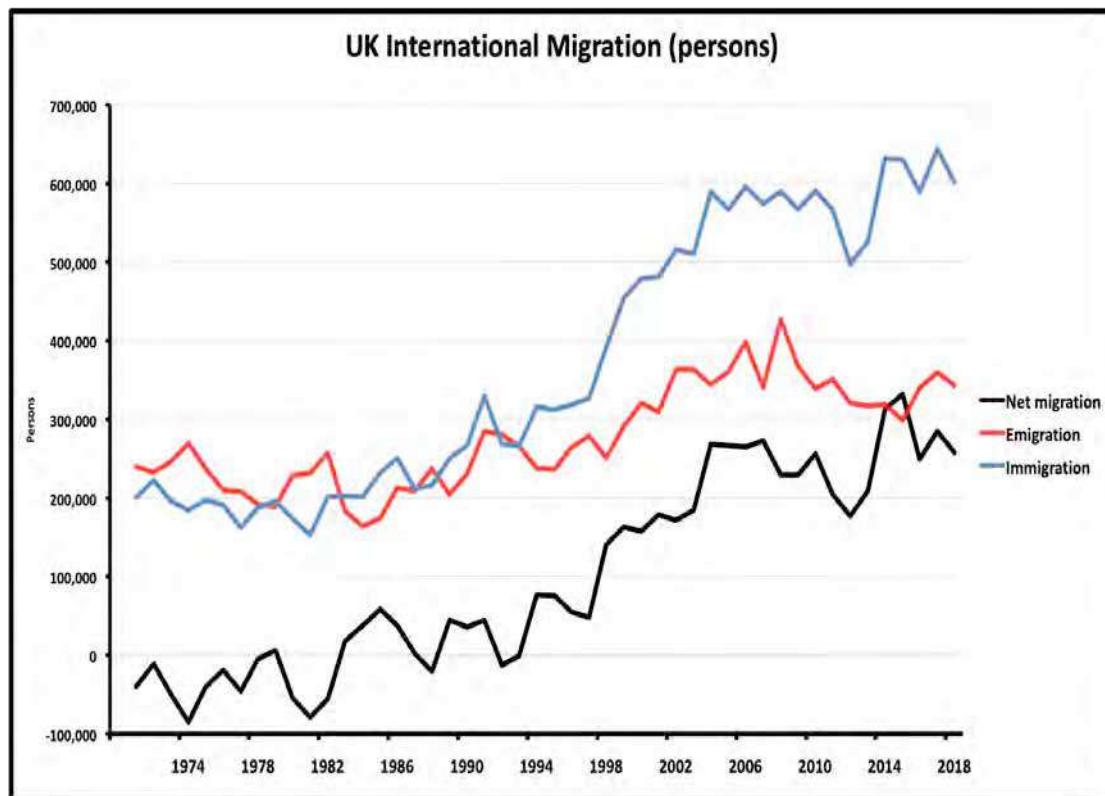
Year	2008 based survey	2014 based survey	2016 based survey
2011	52.5		
2016	54.8	55.2	55.2
2021	56.8	57.2	57.0
2026	58.7	59.1	58.5
2031	60.3	60.8	59.8
2036		62.4	60.9

Source: ONS (2019) Table 401 and earlier versions.

The most recent figures from the 2016 based survey show a reduction in the projected population for the year 2036 of 1.5 million persons against the previous 2014 based survey just 2 years earlier. This reduction reflects a significant narrowing of the birth/ death rate, as life expectancy is currently estimated to grow less quickly than previously thought.

Migration projections are very difficult to establish. As Chart 1 below shows, net migration was small and slightly negative until the mid 1990's when it began to rise significantly.

Chart 1.

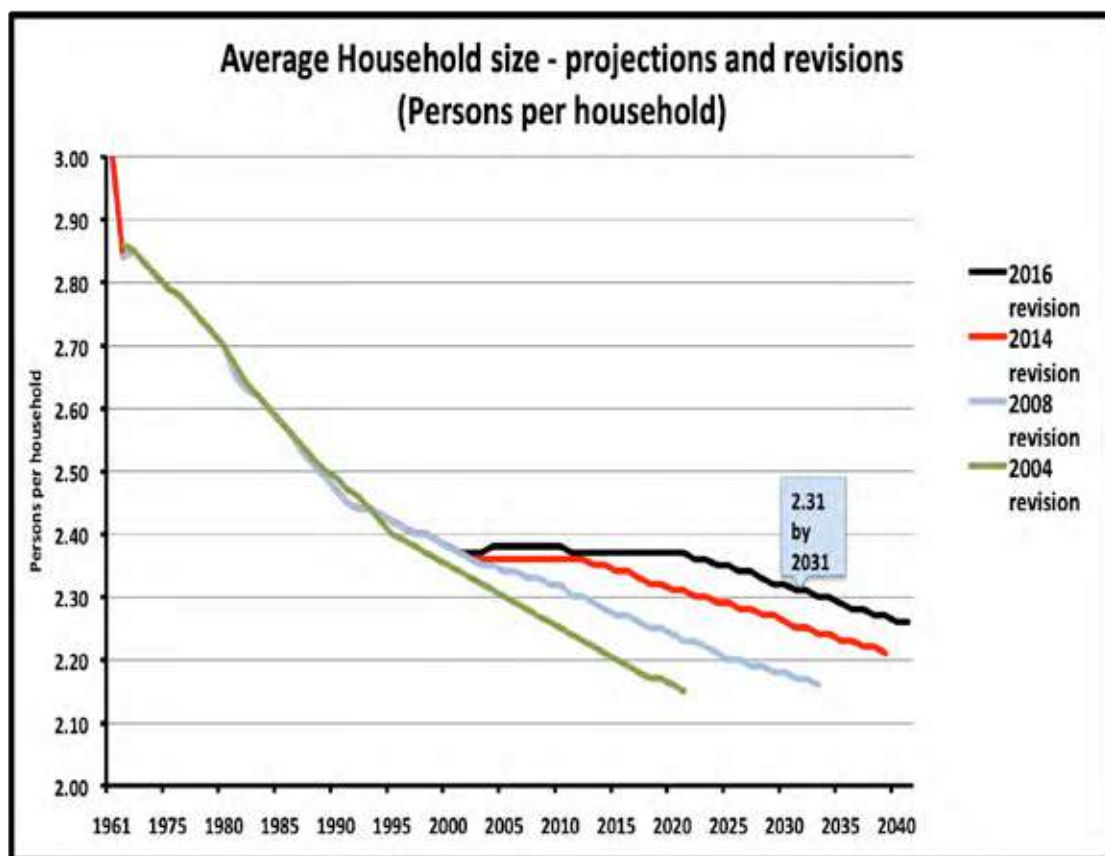


Source: ONS (2018) Table 2.04.

The total numbers of migrants clearly has a direct bearing on projected household formations but when the level of migration is higher, it also has an impact on average household size because newly arrived migrants are less likely to form single family homes. The tendency in the government statistics has been to overstate the growth of the natural population death/birth rate and to underestimate the growth in migration. To some extent the revisions to these two variables offset each other.

Chart 2 shows the long-term trends and revisions for projected average household size in England by number of persons.

Chart 2.

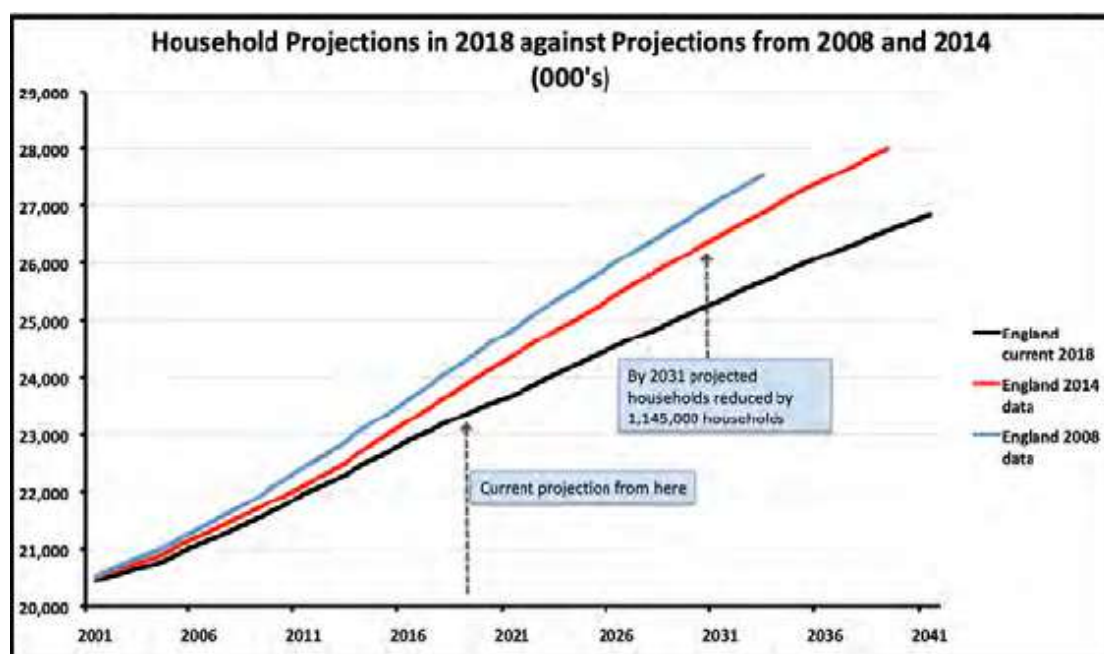


Source: ONS (2018a) Table 401.

Average household size estimates have been significantly revised since 2008, when it was believed that household size would continue to reduce following the pattern of the preceding 20 years. More recent data tends to confirm that the historical fall in household size is flattening out and has remained static at 2.37 persons per household for almost 20 years.

The consequence of these substantial revisions to the major determinants of new household formations is shown in Chart 3.

Chart 3.



Source: ONS (2018a) Table 401

The steady reduction in the estimates for the projections of household formation is striking. For example, the projection published in July 2016 and based on 2014 data (drawn in red on Chart 3) showed projected households for 2031 at 26.5 million. The household stock for 2016 is given as 23.6 million, implying a requirement for 193,000 new houses per year. But the most recent publication in December 2018, based on data from 2016 (drawn in black), projects household numbers at 25.35 million for the year 2031, or 1.1 million less households than were projected just 2 years earlier. The most recent numbers imply a requirement for some 164,000 new households each year, almost 18% less than that projected just 2 years earlier; significantly below the headline figures of 240,000 -265,000 discussed above.

The National Planning Policy Framework (NPPF) appears to be based on statistics derived from data from 2014 and earlier and does not appear to be adjusted for recent reductions in household projections just described. Nonetheless, the emphasis within NPPF guidance on

building more houses is having some effect. Data for the actual number of new household completions are rising. Table 2 shows the number of net additional dwelling for each of the last 10 years.

Table 2. Housing Completions in England (net additional dwellings)

Year	Net additional dwellings
2006-07	193,080
2007-08	200,300
2008-09	157,630
2009-10	124,200
2010-11	117,700
2011-12	128,160
2012-13	118,540
2013-14	130,340
2014-15	155,080
2015-16	163,940
2016-17	183,570
2017-18	195,290

Source: MHCLG, (2018) Table 120

Following the financial crisis in 2007/2008, household completions fell sharply from just above 200,000 dwelling to a low of 117,700 in the preceding 3 years, a fall of more than 40%. It is understandable that at that level of new completions there was growing concern about a shortage of supply across the entire housing market and it was against this background that the UK government began forming its agenda to radically overhaul the planning policy towards building more houses. Table 2 shows a steady recovery in annual housing completions since the nadir in 2010/11. The latest figure for 2017/18 shows completions rising to levels last seen in the boom days just before the financial crisis. Commentary in the British press continues to highlight that the government is still well below its objective of providing 240,000 to 265,000 new dwellings each year for England (NAO, 2019). But it is noteworthy that the most recent data shown in Chart 5 has annual requirements projected at 164,000 each year, if that is so then the actual supply of housing is currently exceeding need

by more than 25,000 dwellings each year. If completions continue to accelerate, England could be facing a glut of housing in the next few years.

Are High House Prices the cause of the crisis?

The discussion above has highlighted the difficulty of projecting the future need for housing in England but there is little in the discussion about house prices, even though high house prices are usually cited as the result of a presumed supply crisis. For example, in the foreword to the white paper introducing the governments new planning policy in 2018 the British Prime Minister stated:

“Our broken housing market is one of the greatest barriers to progress in Britain today”

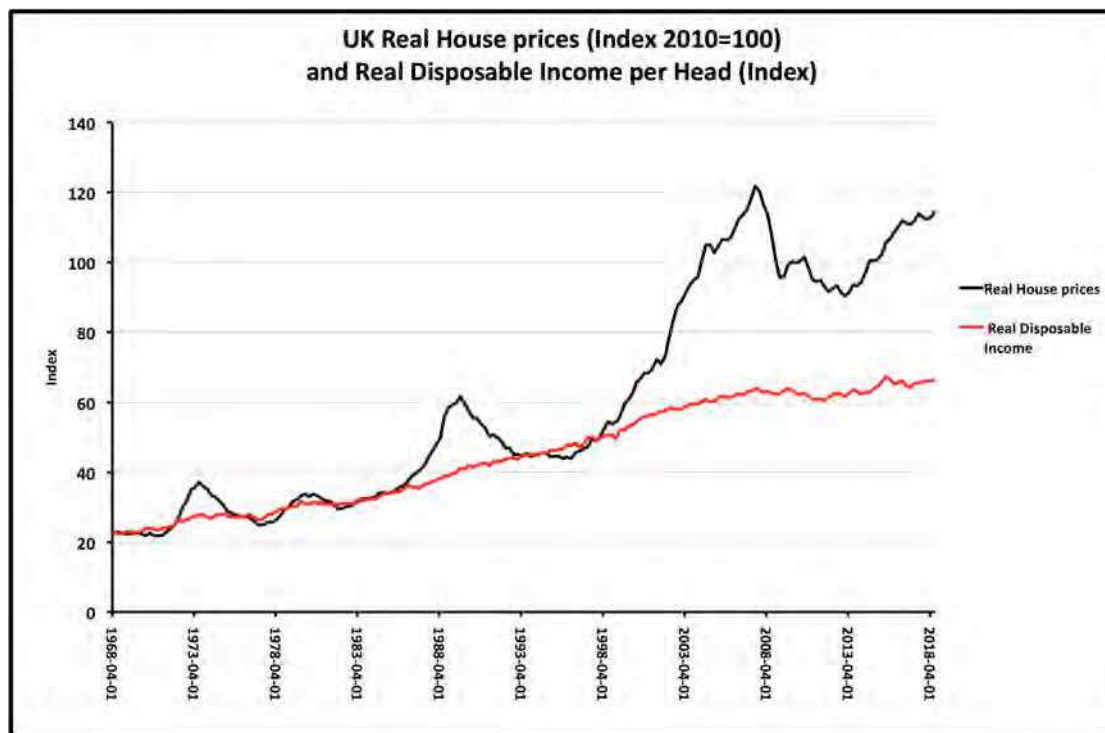
“Today the average house costs almost eight times average earnings – an all-time record.”

“The starting point is to build more homes.”

(MHCLG, 2018)

The rise in house prices is not in doubt. Chart 4 shows the long-term relationship between household disposable income and the average house price in the UK.

Chart 4.



Source: (BIS, 2019); (OECD, 2019); (BoE, 2019)

Chart 4 shows that house prices have increased sharply above incomes. Whilst house prices exhibited periods of volatility in the 1960's and 1970's the tendency was for booms to be followed by busts and with house prices moving back in line with incomes. From the 1990's onwards the rise in prices is much stronger than in previous episodes and the tendency to fall back in line with incomes has not occurred.

Whilst it is intuitively appealing to suppose that the elevated level of house prices reflects a shortage of supply, it is equally possible that the increase is driven by an increasing demand. Mainstream economics has tended to ignore the impact of credit and debt by presuming that debt and loans merely transfer spending power from the lender to the borrower and cancel out in terms of the impact on the real economy. But following the financial crisis in 2008 it became clear that credit and debt were important drivers of activity in the real economy. The theories of heterodox economists that had been largely ignored before the crisis have been given much greater exposure in recent years. Hyman Minsky for example shot to posthumous fame after a life of relative obscurity with his 'financial instability hypothesis' (Minsky, 1992). This theory postulated a very dynamic role for debt, whereby long periods of steady growth in the economy would encourage increasingly speculative investment bubbles endogenous to the financial market. Ultimately, the leverage in the economy becomes so great that it increases fragility in the financial markets, such that any small downturn in the economy would trigger large financial distress. Following Minskys lead more economists began investigating debt and concluded that banks actually did create debt, rather than acting as an intermediary between borrower and lender and concluded that debt was a fundamental driver of the economy (Wray, 2015), (Keen, 2017, Chp4). Even the Bank of England (BoE) confirmed that debt and money is created by primarily by the commercial banks in a groundbreaking article in their Quarterly Review (McLeay et al., 2014).

The economic and financial history of the English mortgage market provides a good example of the impact of the growth of debt, credit and banking leading to fragility in the real economy. A change of institutional financial structures in the mid 1980's when the Building Society movement was drawn in to the world of commercial banking was the start of a very long-term Minsky type business cycle.

The Building Society movement in England

The Building Society movement in England dates back to the middle of the 19th century and evolved from mutual clubs that were formed to provide finance to their members so that they could build themselves houses and homes. Initially the members pooled their savings and

built the homes one by one. When houses had been built for each member the mutual society would be wound down and closed. In time however, the success of these mutual groups in providing finance developed into larger business' and new savers were recruited to take the place of the initial members. In this way some of the mutual groups became more permanent and indeed the word 'permanent' would often be included in their names. In fact the hapless Northern Rock that suffered the collapse and bank run in 2008 was itself the result of the merger of a number of smaller building societies including one called the Northern Counties Permanent Building Society (originally founded in 1850).

The Building Society movement grew steadily over the next one hundred years and established a well-earned reputation for conservative but reliable provision of mortgages to the English property market. Mainly for institutional reasons the mortgage industry in England never attracted competition from the large commercial banks. In part this was due to the retail nature of the mortgage market where large numbers of small short-term savers were required to fund the larger long-term mortgage loans that house purchasers needed. Consequently, the mortgage market remained an almost entirely separate and segregated market from the wider banking industry that funded the larger part of the British economy. So what changed that caused the Building Society movement to become such a large part of the banking crisis in 2007 and 2008? The answer can be found in the substantial liberalisation of banking and finance that occurred in the mid 1980's which was itself the result of economic policy changes brought about by uncontrollable inflation of the previous decade, the 1970's.

Some economic history: free floating exchange rates and the implication for money creation.

In the early 1970's, the global economy had become extremely volatile. In the UK, the government struggled to contain rising inflation, growing unemployment and heavy downwards pressure on its currency, the British Pound. Until 1972 the British Pound had been fixed against the US Dollar under the Breton Woods exchange rate agreement. The US Dollar in turn, under that agreement, was fixed against the price of gold. The widespread economic turbulence of that era witnessed a relentless outflow of gold from the US Treasury, such that the global fixed-exchange regime became unsustainable. Whether by design or necessity the link between the US Dollar and gold was abandoned by President Nixon in July 1971. Thereafter, everything changed. No longer backed with gold its exchange value against other currencies was left to float or sink as determined by the vagaries of the foreign exchange markets. The same applied to all the other developed countries that were a part of that system. The world henceforth was to be conducted with fiat money – money backed solely by government decree.

In many ways this was a much more momentous change than was generally appreciated. In particular this affected the banking industry. Because governments were no longer constrained by maintaining fixed exchange rates for their currencies they were able to explore more flexible methods to control the money system. Quantitative controls on commercial banks balance sheets were removed and monetary policy was directed towards controlling the money supply by using interest rates. Technical operations of banking had mostly been considered an esoteric matter and of little overriding concern for economists. Economic theory always explained banking by what was known as the 'quantity theory of money'. In essence the quantity theory states that commercial banks will create loans in some multiple of their reserves. Reserves are simply funds held on account at the central bank and are used to settle accounts between each other. As for example, when a customer makes a payment to a person with a bank account at a different bank, the two commercial banks have to switch the funds between themselves and will do so via their reserve accounts at the central bank. Beyond holding a prudent level of reserves to enable payments to other banks, any bank is free to offer their remaining customer funds as new loans. Under this mechanism it appears that the amount of reserves in the system will control the total amount of loans that the commercial banks can create and the level of customer deposits in the whole banking system will determine the money supply. However, once fiat currency became a reality in the 1970's and free floating currencies were no longer constrained by fixed rate to either the US Dollar or gold it became apparent to more heterodox economists that bank money creation was not constrained by reserves at all. In reality commercial banks create new money when they grant a new loan to a customer. The loan then becomes a deposit in the banking system. The amount of money in the system is only constrained by the commercial bank that decides whether it believes a customer is a profitable prospect and is prepared to make a loan.

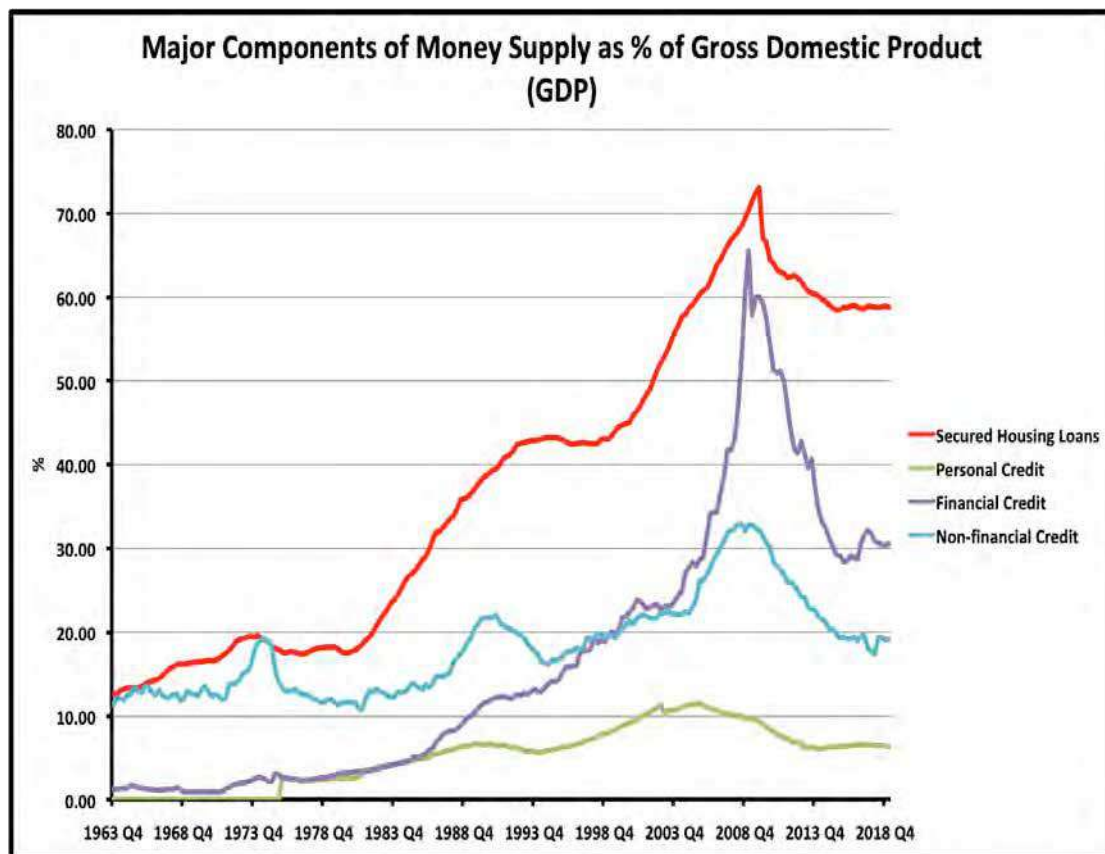
No longer constrained, commercial banks began to look at new markets and began to offer mortgages in competition to the building societies. By the mid 1980's the British government embarked on a very broad liberalisation of the entire financial system, colloquially known as 'big bang'. For the property market the significance of this development was the introduction of a government bill, The Building Societies Act in 1986, allowing the building societies to act like banks and fund their mortgages, not just with savers deposits but, if they so wished, with up to 20 per cent of funds borrowed on the short-term money markets. In effect they had become banks and indeed were permitted to convert to full commercial deposit taking bank status under the new laws, if they wished.

The impact on the mortgage market was dramatic. Availability of mortgages broadened substantially and financial services such as checking accounts and instant access accounts became available to savers in the retail mortgage market.

Very quickly the provision of new mortgages began to outpace almost every other type of loan, far exceeding the growth in commercial business loans or for private loans to consumers. From a banking perspective, property loans have a considerable advantage over other assets because the property behind each mortgage provides very safe collateral that is relatively easy to value. Certainly compared to a small business loans that requires considerable diligence by the lending bank, a residential property loan is a much simpler proposition.

Whereas in the 1960's and early 1970's mortgage finance represented approximately 20% of the total income of the country (or Gross Domestic Product, GDP), some 30 years later this has increased to more than 70% just prior to the financial crisis. The growth and importance of mortgage finance in the overall UK economy is shown in Chart 5.

Chart 5.



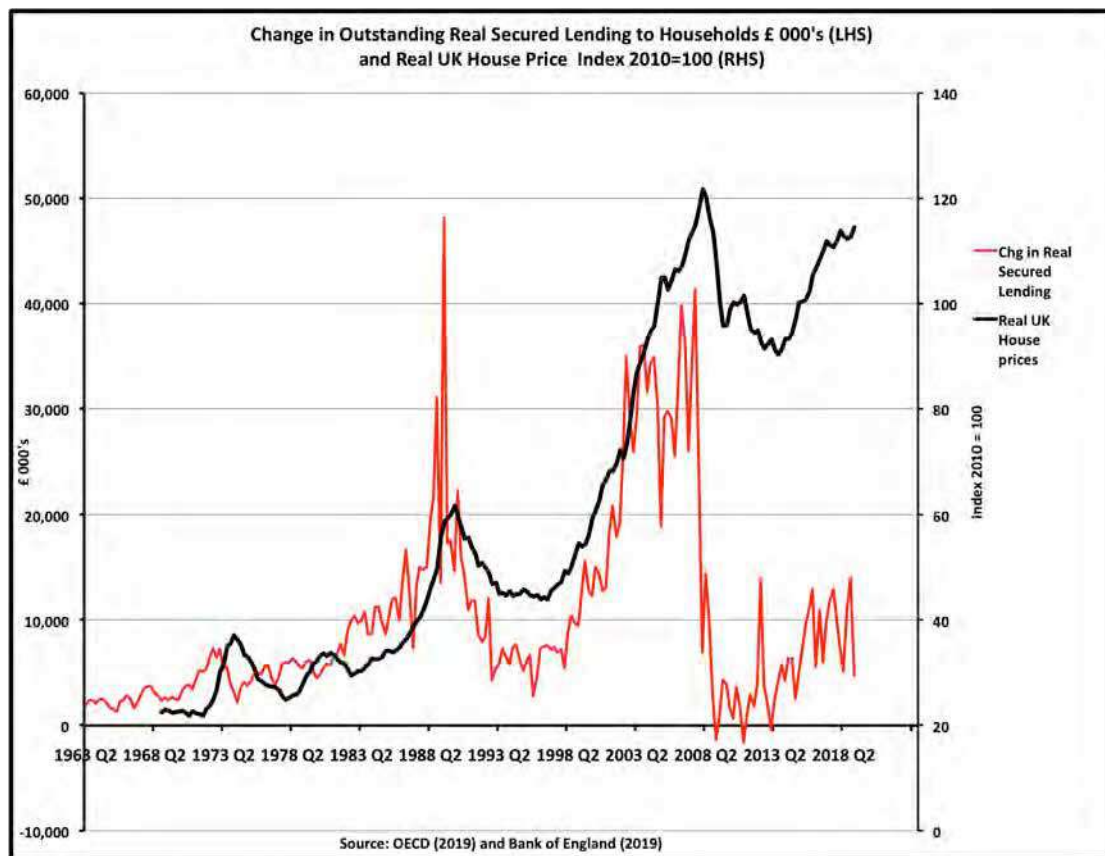
Source: (BoE, 2019b)

The value of the mortgage credit as a percents of Gross Domestic Product(GDP) is shown in red and labelled as “Secured Housing Loans”. The early part of the chart shows mortgage credit representing less than 20 % of the economy

As the banking industry was deregulated in the 1980's and the mortgage market and the Building Society movement was gradually subsumed within the commercial banking business Chart 5 tracks the explosive growth in mortgage credit. By 2007, just before the financial crisis the mortgage market was by far the largest component of the balance sheet of commercial banks. The other fast growing item of the UK money supply was 'financial credit' (shown in Chart 5 in purple) and this includes much of the notorious shadow banking finance that was also a big driver of mortgage credit.

The relationship between the growth of mortgage credit and the price of houses is shown in the chart below.

Chart 6.



Source: (OECD, 2019); (BoE, 2019).

Chart 6 shows that there is a strong relationship between house prices and the change in mortgage credit. Whilst, correlation does not prove causation it would be hard to suppose that without the availability and easy access to billions of pounds of mortgage credit that UK house prices could have been driven so high.

Conclusion.

The housing market in England is in crisis but the crisis is one of high house prices not one of housing availability. Apart from high prices it is far from clear that the crisis is related to a shortage of supply. Much more likely is that the crisis is one of affordability. The growth of mortgage credit over the last 30 - 40 years has been dramatic and now approximates £1,414,763 million. This sum is so big that it represents the largest component of bank credit in the economy. Clearly the cost of holding such a large amount of credit is a substantial burden upon house buyers. Also, following the line of argument of Hyman Minskys instability theory, the accumulation of so much debt must substantially reduce the soundness of the UK economy. The cost of holding that amount of debt is given by multiplying it by interest rates, which have been driven down to extraordinary low levels in order to support outstanding debt. But when the debt is so large it is readily apparent that any significant rise in interest rates would carry a high risk of triggering another financial calamity.

There is also another possibility for triggering a crisis if debt burdens are close to the limits of sustainability. The evidence presented in the first part of this paper indicated that the current supply of new dwellings now exceeds the projected need from growing population and migration. If the government policy of increasing that supply even higher towards their stated target of 250,000 additional dwellings, any resulting pressure on house prices could, ironically, trigger a much more serious financial crisis.

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