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The Great 2003-2005 Crash in Britain's Housing Market

At the end of 1988, I had a chat with my wife. I told her we must sell our house. Look at these graphs, I said. House prices are going to fall.

Perhaps not surprisingly, as nobody at that point could remember a time when British house prices had dropped, and she (correctly) was dubious of economists' forecasts, she found my logic unimpressive. So she declined to sell. By the autumn of 1989, our house had lost about 20% of its value, and there was to be worse to come. Fortunately, we had sold, at that stage, because I had taken a job with a United States university. This episode, however, made an impression on family and acquaintances, because my forecast had seemed to them so implausible.

I think we are about to go through the great housing crash of 2003-2005. This crash will feel worse, in my opinion, than the one at the end of the 1980s.

I advise you to sell your house, and move into rented accommodation. After that, put as much money as you dare into the stock market. If that high level of shares keeps you awake at night, then sell shares down to sleeping point, and keep the rest in cash.

I am serious. However, in real life it is of course not so easy, and one could take the view, as with a pension portfolio, that housing will go up and go down, and that one should just stay fully invested. For some people, that is a defensible position.

The best indicator of what will happen in the housing market is the ratio of prices to incomes. In Great Britain, the long-run ratio of the average price of a home to the average person's earnings is about 4. In other words, if the typical Briton gets a wage of approximately 25,000 pounds, then the sustainable typical house price in this country is around 100,000 pounds.

That sustainable ratio is a bit higher in London and the South East, and a bit lower elsewhere, but this is the broad-brush number.

Unfortunately, we are now considerably above that. British house prices have currently reached a ratio of 5 times the average level of earnings.

I believe that house prices will continue to rise about 5% or a little more until next summer, 2003. Then I expect British house prices to fall by around 30%.

One way to understand this is simply to look at the numbers and to study history. Another is to use pure logic. Both, however, point to the same conclusion. Sell now.

As in most markets, when things get over-valued, the decline in prices does not merely return to long run par value. It overshoots downwards. When people start selling, they get carried away, and go too far down. The same happens in the upwards direction, of course. To use jargon, ‘bubbles’ happen on the way up and the way down.

It is useful to look at the stock market, and to compare that with the housing market. The value of shares is dictated, at bottom, by people’s confidence in the future. More precisely, the price that traders are willing to pay for a share like Rolls Royce or LastMinute.Com is fixed by their deep-down views about the degree of prosperity to come in the British economy. The price of shares tells us about confidence in the future.

The same has to be true in the housing market. Both shares and homes are assets. They are valuable because they will be worth something in the future.

This takes us to an inescapable fact that seems not to have been made in public debate. It does not make sense for the stock market to be valued below its long-run trend while housing is valued above its long-run trend. Because both are assets, that cannot be sustained. It is not an equilibrium, one might say. Either people are confident about the future, in which case both houses and shares should be worth a lot, or they are not confident, in which case the prices of both shares and houses should be low.

The current over-valuation of house prices in our nation is being driven by low interest rates and a lack of logic by purchasers. Buyers have mistaken low interest rates as a sign that houses are, in some sense, cheap. But that is a very serious illusion. Just because my repayments today are lower than under high inflation and high interest rates does not mean, in a true sense, that my home is now less expensive. A 40,000 pound BMW is not cheaper in a world where interest rates are low, nor dearer in a world where interest rates are high. The price is the price. And it is the same with houses.

Britain's housing crash will probably come about something like this. In late Spring of 2003, it will begin to be recognised that house prices have stopped rising. People will cease being such enthusiastic purchasers. Those who rushed into buy-to-let properties will begin to sell them. House prices will crumble, just a little. Then by late summer of 2003, confidence in housing will go. Prices will crumble more. At that point, newspapers will take up the cause. Headlines will appear: house prices fell 8% last year.

Panic will then set in.