ECONOMIC PERSPECTIVE 2

THE SCOTTISH HOUSING MARKET: PAST, PRESENT AND PROSPECTS

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1. Summary

This paper examines the recent performance, current state and future prospects of the Scottish housing market. The current Scottish owner occupation level at 54% is on a par with much of the rest of Europe. There is no apparent direct relationship between economic success and high owner occupation levels. Average Scottish house prices over the last 7 years have increased at a rate slightly faster than the Retail Price Index (RPI) but have moved upwards in line with the trend in average earnings.

Although the total volume of housing market transactions has fallen since peak levels in the mid eighties, the decline has been much less than for the rest of the UK. Current Scottish levels are estimated to be 7% ahead of the '82 value. First time buyers are still apparent in the market place accounting for around 50% of transactions. Since '85, the Scottish housing market has shown clear signs of continued sustainability with the average house price to average earnings ratio (the P/E ratio) never exceeding 3.0 since '85. The comparable figure for the UK reached an all time high of 5.0 in quarter 2 '89.

Negative equity is not an important factor in the Scottish housing market only accounting for 0.01% of the value of the housing stock as at quarter 1 '93. Part of the sustainability of the market is due to Scottish savings habits. Scots are currently saving around 19% of personal disposable income compared to a South East of England figure of 9%. Housing costs as a percentage of total household expenditure in Scotland are around 15% compared to a UK figure of around 19%. Areas of the UK like Scotland, which are not highly indebted, have suffered less in recession.

Potential first time buyers are predicted to decrease up to '97 both in actual numbers and in percentage of the total population. However, the average household size is predicted to decrease resulting in an increase in total Scottish households up to the year 2005. Percentage owner occupation is expected to reach 64% by 2000. The number of residential sales in 2000 is expected to increase by 23% compared to the '92 level. Prospects for the Scottish housing market are positive.

2. The International Context

The assumption that high levels of owner occupation are associated with economic success is flawed. Diagram 1 lists owner occupation levels for eight countries. While a relatively poor country such as Bangladesh enjoys an owner occupation level of 90%, an affluent country, like Switzerland, shows an owner occupation level of only 30%. Scotland, at 54%, is in the middle of the range while England at 69% is higher than average.

The diagram clearly shows that a high level of owner occupation by itself is no recipe for economic success. The extent to which the housing market dominated the UK economy in the '80s is now more clearly understood. At the height of the housing boom in the late eighties, mortgage interest tax relief pumped a subsidy of around £8bn at 1991-92 prices (CSO 1993a) into the value of assets. The phenomenon of equity withdrawal (money withdrawn after a housing transaction and not reinvested in housing) was estimated by MacLennan and Gibb (1993b) at £22bn in '88. This sum added to existing levels of consumption which outstripped the productive capacity of the economy.

Financial deregulation provided a further stimulus which ended in an unsustainable boom, an unwelcome bout of high inflation and the current, twin economic deficits. A sober assessment of the housing boom and bust of the '80s leads to the conclusion that a stable housing market is not only desirable but is a pre-condition for a more sustainable and less volatile economic performance in the future. (Maclennan and Gibb 1993b). Scotland's current level of owner occupation and its avoidance of the housing market problems of the '80s must be seen in this economic context.

In actual terms, Scottish property prices are not out of line with other European centres. Diagram 2 compares the prices of a domestic property in an area near to the centre of six capital cities. The most expensive is Tokyo, at an average of £860,000. New York is next followed by Paris and London. Edinburgh and Madrid come in at around £120,000. These comparisons are difficult to make since no two properties are identical. However, they illustrate the general point that Scottish property prices are broadly in line with other European countries.

Averages must be treated with caution. Even inside a city, there are distinct local markets. In Scottish terms, the housing market in Aberdeen has always displayed much more volatility than other Scottish cities. Dependence on the fortunes of the oil industry give Aberdeen a volatility not seen elsewhere.

In analysing and interpreting averages of all kinds, it is important to realise that the trends in the figures are at least as significant as the actual values themselves. Examination of these trends and of important external influences lead to an understanding of the fundamental forces driving the housing market. These fundamentals, of which demographic trends are the most important, are much more influential in the long term than factors such as mortgage rates which often fluctuate rapidly.

3. Recent Trends

Diagram 3 shows average house prices, earnings and the RPI from quarter 1 '86 to quarter 2 '93. Over the period shown, average house prices have increased by around 67% compared to increases in the RPI of 50% and 71% in average earnings. There is no evidence from these figures of a boom or bust housing market in Scotland. Average prices have not moved greatly out of line with average earnings or the RPI.

Diagram 4 examines the volume of housing transactions in England and Wales and in Scotland over the period '82 - '92. The England and Wales figures are produced by the Inland Revenue and chart the progress of the housing boom. The peak occurred in '88 with the volume of housing transactions 39% up on the '82 figure. The extent of the housing market slump is clearly shown with a '92 transaction level down 28% on the '82 value. The '88 peak figure occurred at a time when income tax rates were cut, equity withdrawal was at its peak, mortgage interest relief was based on people rather than on property thus allowing multi-person tax relief and financial deregulation allowed the rapid accumulation of consumer debt.

Comparable Scottish figures for residential sales are much harder to find. The index shown in diagram 4 is an estimate produced from building society mortgage transaction levels for the years '82-'88 inclusive and from the number of residential sales recorded through the Register of Sasines for the years '89-'92. The Scottish experience shows high levels of transactions being achieved in the years '86 and '88 at 29% and 31% respectively above the '82 level. However, the decline in sales has been much less dramatic than in other parts of the UK. The figure for '92 is still 7% ahead of the '82 figure.

In '92, Scottish transactions represented 12% of the England and Wales figure compared to the much lower figure of 7% in the peak year of '88 illustrating the decline in the housing market in the South East of England. The diagram provides clear evidence that the Scottish housing market is radically different from its Southern neighbour.

The strength of the Scottish housing market in the last four years has not been widely appreciated. Banks have taken an increasing market share which is not shown in reported transaction volumes by building societies. This is a major change in the housing market.

The importance of the first time buyer to the housing market has been widely recognised. Diagram 5 shows the percentage of all transactions by first time buyers from quarter 1 '85 to quarter 3 '93. These figures are produced from the TSB Scottish House Price Monitor which is based on TSB Bank Scotland mortgage transactions. Around half of all mortgage transactions is attributed to first time buyers over the years.

The first time buyer percentage from quarter 4 '86 to quarter 1 '88 was significantly higher than for the rest of the period indicating that Scotland was not immune from the housing boom experienced in that period. Confidence among first time buyers apparently dropped during the latter part of '91 and the beginning of '92 but has since been restored to more normal levels in the latter part of '92 and throughout '93. Current results from the Scottish House Price Monitor confirm this position.

4. Sustainability

Sustainability of house prices can be measured by the ratio of average house price to average earnings - the P/E ratio. The P/E ratio is shown for Scotland and the UK for quarter 1 '85 to quarter 2 '93 in diagram 6. From a value of 2.6 in quarter 1 of '85, the figure for quarter 2 '93 was 2.8. A peak was reached in quarter 4 '91 of 3.0. The UK figures reveal the extent of the housing boom experienced in the late '80s. From a starting value in quarter 1 '85 of 3.5, the P/E ratio for the UK reached a peak of 5.0 in quarter 2 '89. The current value for quarter 2 '93 is 3.4. The data show the unsustainable rise in the UK P/E ratio in the late '80s but also provides clear evidence of the constant level of the P/E ratio in Scotland over the eight and three quarter years shown. Current P/E levels for both the UK and Scotland are considered sustainable.

The emergence of the phenomenon known as negative equity where borrowings exceed the value of property has been widely reported and discussed since its emergence in the late '80s. It can be viewed as a measure of the degree of imbalance of the housing market. Diagram 7 reproduces figures reported by the Bank of England on the extent of negative equity in different parts of the UK. Negative equity is expressed as a percentage of the value of the housing stock measured in quarter 1 '93.

The extent of the problem is evident in the South East of England where negative equity represents 2.12% of the total value of housing stock. The South West follows with a figure of 1.59%, Greater London at 1.49% and then there is a dramatic fall to low levels of 0.24% for the West Midlands, 0.15% for Yorks and Humberside, 0.13% for the North West and the lowest value of all is attributed to Scotland at 0.01%. Thus, Scotland's negative equity is estimated as 0.01% of the value of its housing stock as at quarter 1 '93. As at December 31 '91, only 0.77% of Scottish mortgages were six months or more in arrears compared to a UK figure of 2.81%. Based on these figures, negative equity is not a Scottish problem.

Diagram 8 shows the percentage of total household expenditure attributed to housing for the years '75/'76 to '90/'91 for the UK and Scotland. In '75/'76, 10.9% of Scottish household expenditure was expended on housing compared to a UK figure of 14.1%. By '90/'91, this had risen to 15.4% for Scotland and 18.7% for the UK. Although both Scotland and the UK show an increasing percentage of total household expenditure attributable to housing, the actual figures do not indicate a serious problem. Moreover, the Scottish level has been constantly and significantly less than the UK figure by around 3 or 4 percentage points.

Diagram 9 shows the savings ratio for the South East of England and Scotland from quarter 1 '82 to quarter 4 '93. The figure shown is savings as a percentage of personal disposable income. For almost the entire time series, the Scottish savings ratio has been at a considerably higher level than the South East of England confirming the greater propensity to consume in the South East of England. The only period where the Scottish savings ratio was less than the South East of England occurred in late '88/early '89. The savings ratio for the South East of England had plummeted in '87 to a low of 3.0 in quarter 3. This figure began to increase as the housing boom ended and recession commenced.

Scotland was later into the recession and so an increase in the savings ratio did not commence until almost a year later. The current level of the savings ratio for Scotland is around 19%. The South East figure is currently around 9% - around half of the Scottish figure. Given the state of the UK economy at present, there is a fine balancing act required. A recovery from recession based on an increase in investment and exports is preferred. However, the recovery from recession is mainly coming from an increase in consumer spending.

Any large increase in consumer spending will lead to a problem on the trade balance given the low productive capacity and weakness of the manufacturing base evident in the UK economy. Since the recovery is almost entirely dependent on consumption and consumer spending, the task facing the Chancellor is to keep consumer spending at a high enough level to continue the recovery but at a low enough level to avoid too severe a problem on the balance of payments. However, a lowering of the Scottish saving ratio might well encourage the Scottish economy given that Scotland's manufacturing base is in a healthier state than the rest of the UK and remains more export orientated.

Empirical evidence of the important effect of the level of consumer debt on the overall behaviour of the economy has emerged from a study by King (1993). Diagram 10 shows the results of the analysis. The period '88 to '90 has been examined for seven areas of the UK. The seven areas were classified according to two criteria. The first was the percentage rise in real household expenditure over the period '88 - '90 and the second was the debt to income ratio over that period. The seven areas fell into two major categories.

The South West, Greater London and the South East of England fell into the high debt and low percentage rise in expenditure group while the North West, West Midlands, Scotland and Yorkshire and Humberside fell into the low debt and high percentage rise in real household expenditure group. The areas with low debt levels increased real household expenditure faster (recovered from recession) than the high debt areas.

The analysis illustrates the constraining effect on recovery from recession of a high level of consumer debt. In '90, UK personal sector debt was well over 100% of personal disposable income compared to less than 50% in '82 (Peat 1993). The importance of a sustainable housing market and sustainable levels of consumer debt is shown by this analysis. Scotland does not appear to have a problem in either of these areas.

5. Future Prospects

In considering future prospects for housing markets, references are often made to factors such as mortgage rates, sentiment, unemployment levels and overall economic prospects. There is little empirical evidence of the effects of these factors. Property developers have always pointed to the importance of population projections to estimate demand for housing. The technique has proved remarkably strong: the current soft housing market in the South East of England was forecast 30 years ago in a demographic study by the National Institute of Economic & Social Research.

The forces that affect demand for new housing also govern prices in the used house market. Weak population growth results in soft prices. House prices soften when the rate of household formation slows. Therefore, the prospects for the Scottish housing market are best discussed from a demographic starting point. Mention has already been made of the importance of the first time buyer to the housing market. No strict definition of a first time buyer is available but this paper uses the description employed by the Bank of England in a recent paper.

First time buyers are estimated using the group of persons aged between 25-29 years. Diagram 11 shows the numbers of persons aged between 25 and 29 years from '89 through to '97. As at '93, the number of persons aged between 25 and 29 years old is 410,389. This figure is set to decline to 377,535 in '97 - a fall of 8%. The line on Diagram 11 also shows persons aged between 25 and 29 years old as a percentage of the total population. In '93 this was estimated at 8.1%. This is forecast to fall in '97 to 7.5%. These figures are taken from the General Register Office for Scotland (1991). Based on this chart, the number of potential first time buyers is set to decline in Scotland over the next few years with a negative effect on the demand for houses.

However, there are other trends creating an influence in the opposite direction. Diagram 12 shows the average household size in Scotland from '87 projected to 2005. The '87 figure is 2.58. This falls to 2.29 in 2005 - a decline of 11%. Various social and economic factors account for this fall including the increase in one parent families, the increase in the rate of divorce and the increasing ageing of the Scottish population.

The net result of these trends is illustrated in diagram 13 which shows the total number of households in Scotland from '87 - 2005. In '87, the total number of households was 1,949,850. This is predicted to increase to 2,134,760 by the year 2005 - an increase of 9.5%.

Percentage owner occupation increased by 1.6% per annum between '82 to '92. In order to estimate future sales levels in the market, owner occupation has been assumed to increase by 1.25 percentage points per annum over the period to 2005. This is a conservative estimate based on the assumption that as the actual level of owner occupation rises, the rate of increase slows. Using these figures, the percentage owner occupation in Scotland is estimated to rise to 63.8% by the year 2000. This trend is illustrated in diagram 13. Diagram 14 shows the number of owner occupied households increasing steadily to 1,342,837 in the year 2000.

For the years '89 to '92, the number of residential sales was, on average, 12.88% of owner occupied stock. This translates into a residential move, on average, every 7.8 years. In order to estimate the future level of residential sales, a conservative estimate of turnover of 12% of owner occupied stock has been used. Based on these estimates, the total number of residential sales is therefore estimated to increase by 23% comparing the year 2000 to '92. See diagram 15.

The negative effects of the decline in the number of first time buyers is more than offset by demographic trends such as the decrease in the average size of household and the increase in the percentage owner occupied. Policy factors such as the recent reduction in mortgage interest tax relief and possible encouragement of the private rented sector, although present, are considered to be small when compared to demographic effects.

A forecast of the Scottish housing market level, size and volume would require another paper on this subject alone. This paper only provides an introduction to the topic but attempts to highlight the major factors affecting the market.

6. Conclusions

The Scottish housing market has avoided the boom and bust associated with the South East of England during the '80s and '90s. This has had beneficial effects for the Scottish economy allowing a later entry into recession and an easier recovery. There is little evidence of any imbalance in the market with almost zero levels of negative equity and a low level of mortgage repossessions.

The available empirical evidence points to the Scottish housing market continuing at sustainable prices and showing a substantial increase in activity. Future prospects for the Scottish housing market depend on demographic trends such as the downwards change in average size of household.

Some of these effects act in opposite directions but the net effect is for an increase of 23% in the number of residential sales in Scotland up to the year 2000 compared to the '92 level. Scottish house prices are forecast to increase in line with earnings.

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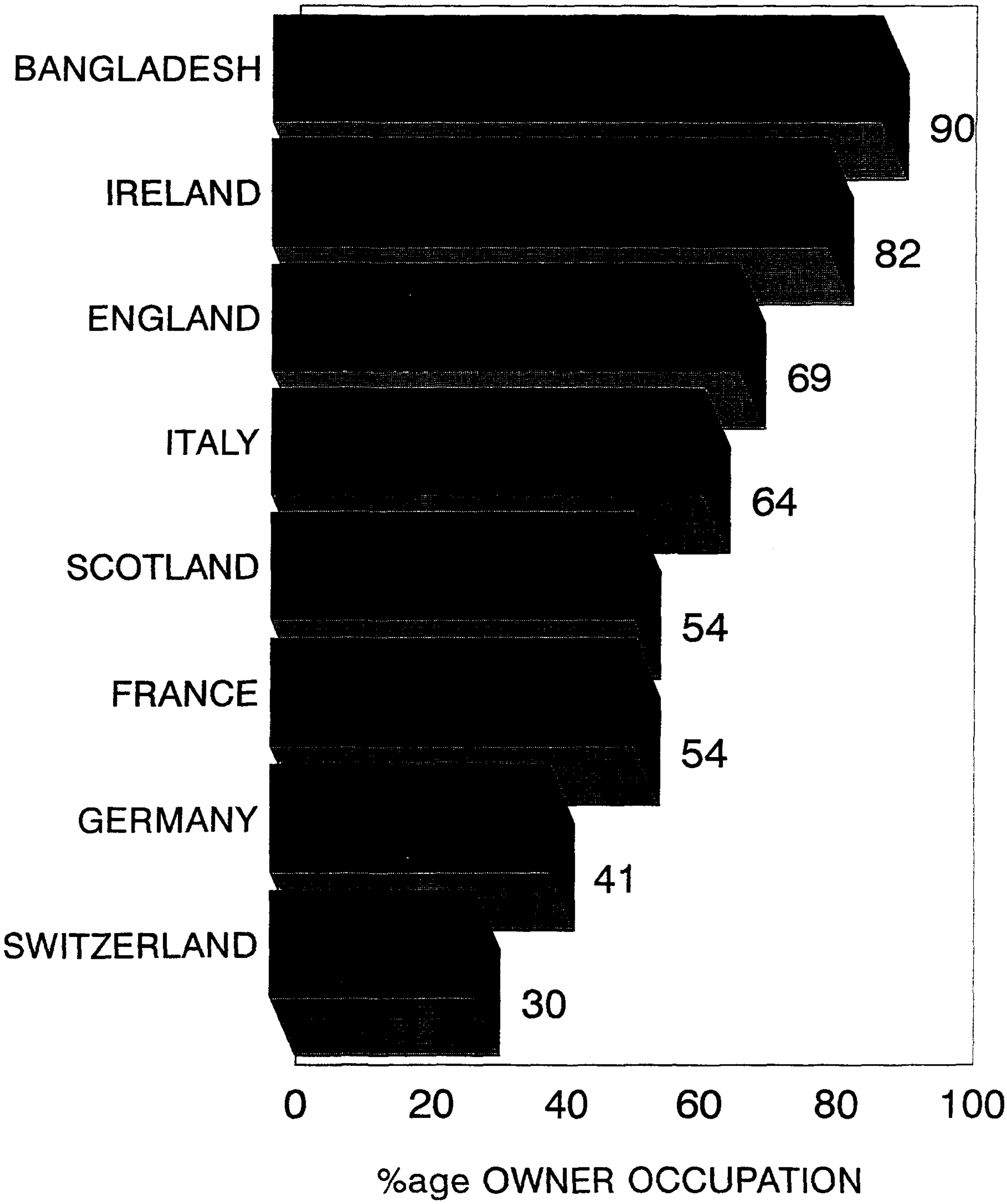
Diagram 1

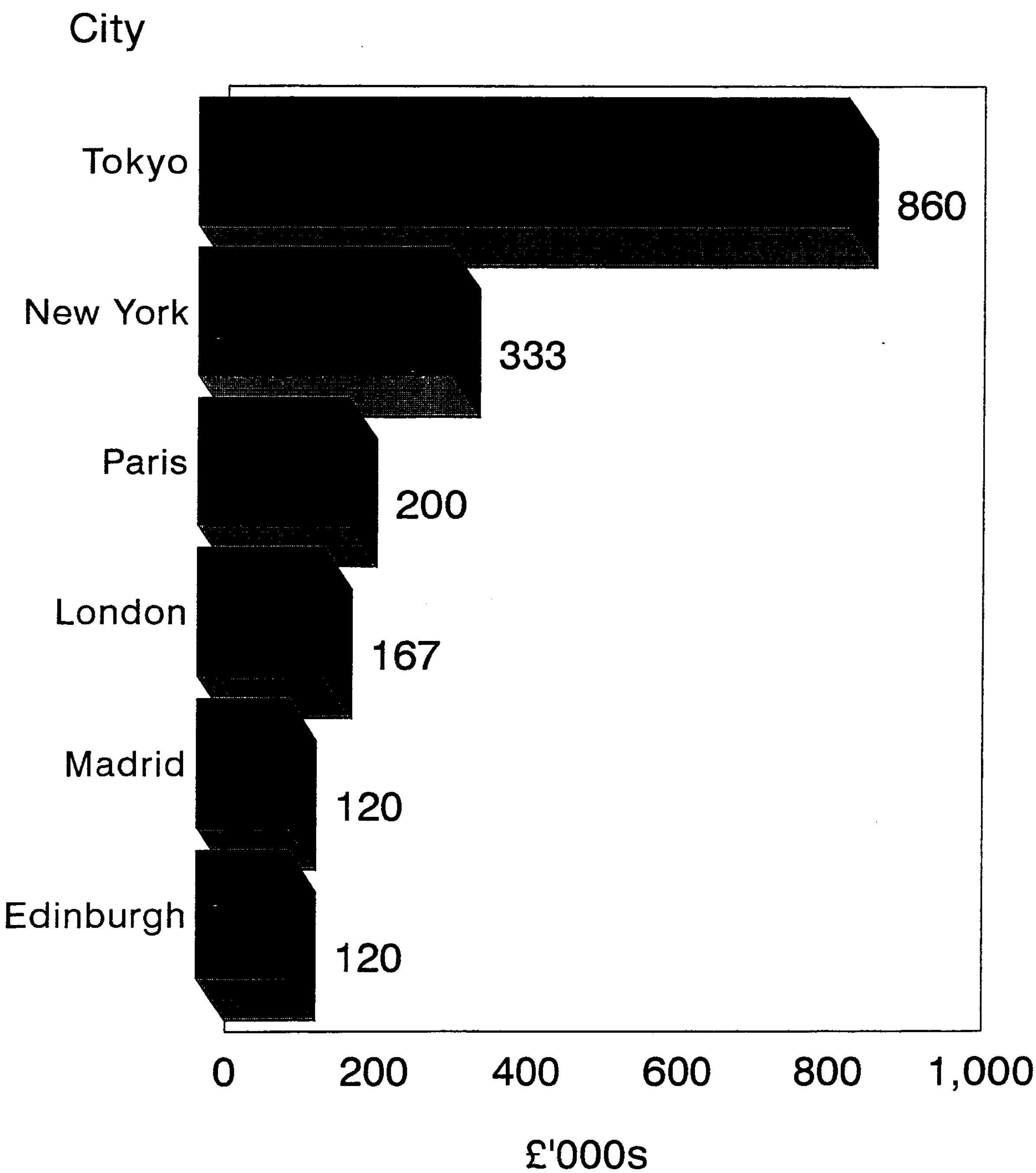
OWNER OCCUPATION LEVELS



Source: Economist (1993), Scottish Office (1993b), CML (1993).

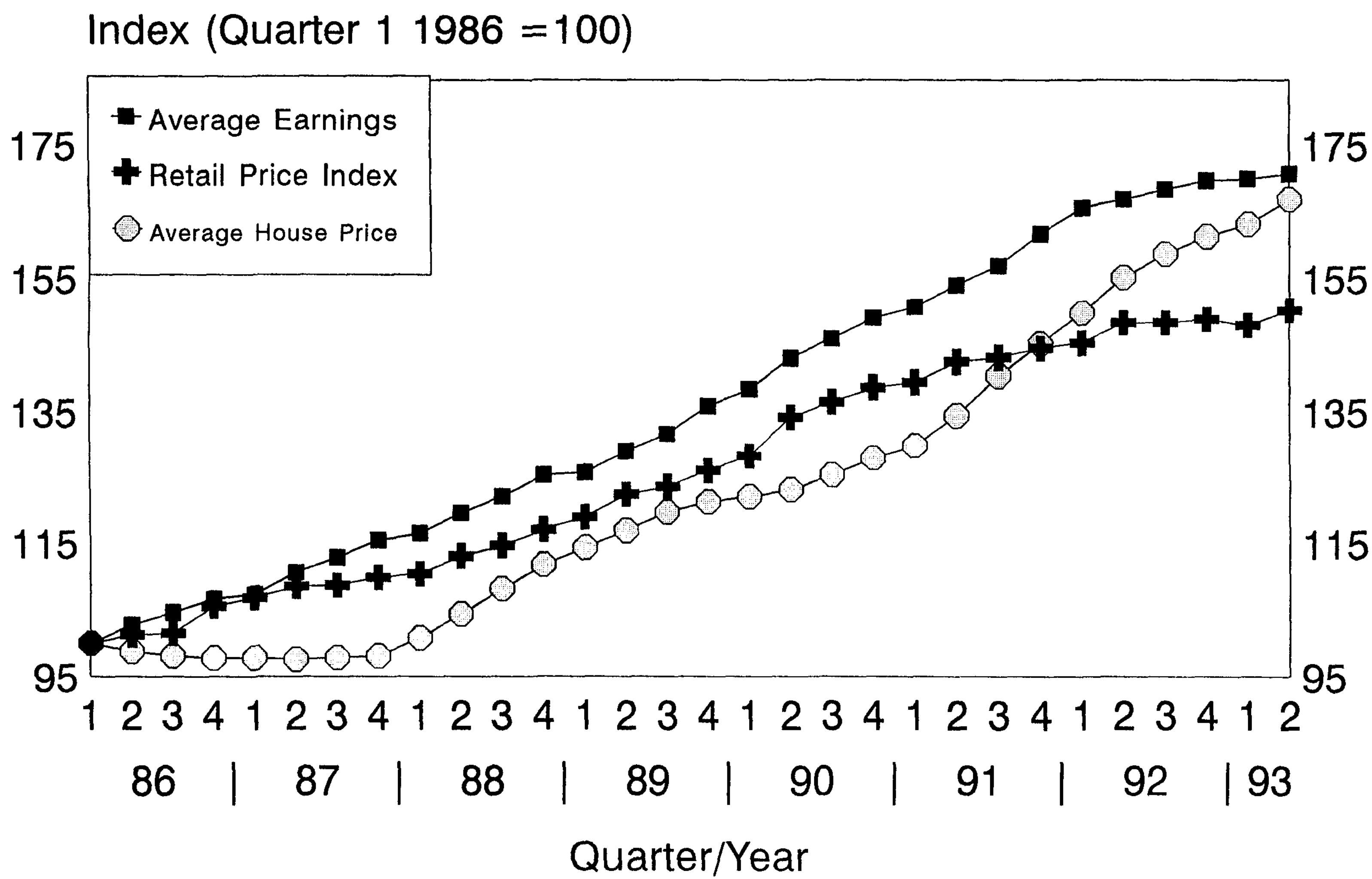
Diagram 2

CAPITAL CITY PROPERTY PRICES
(CITY CENTRE PROPERTIES)



Source: Economist (1993).

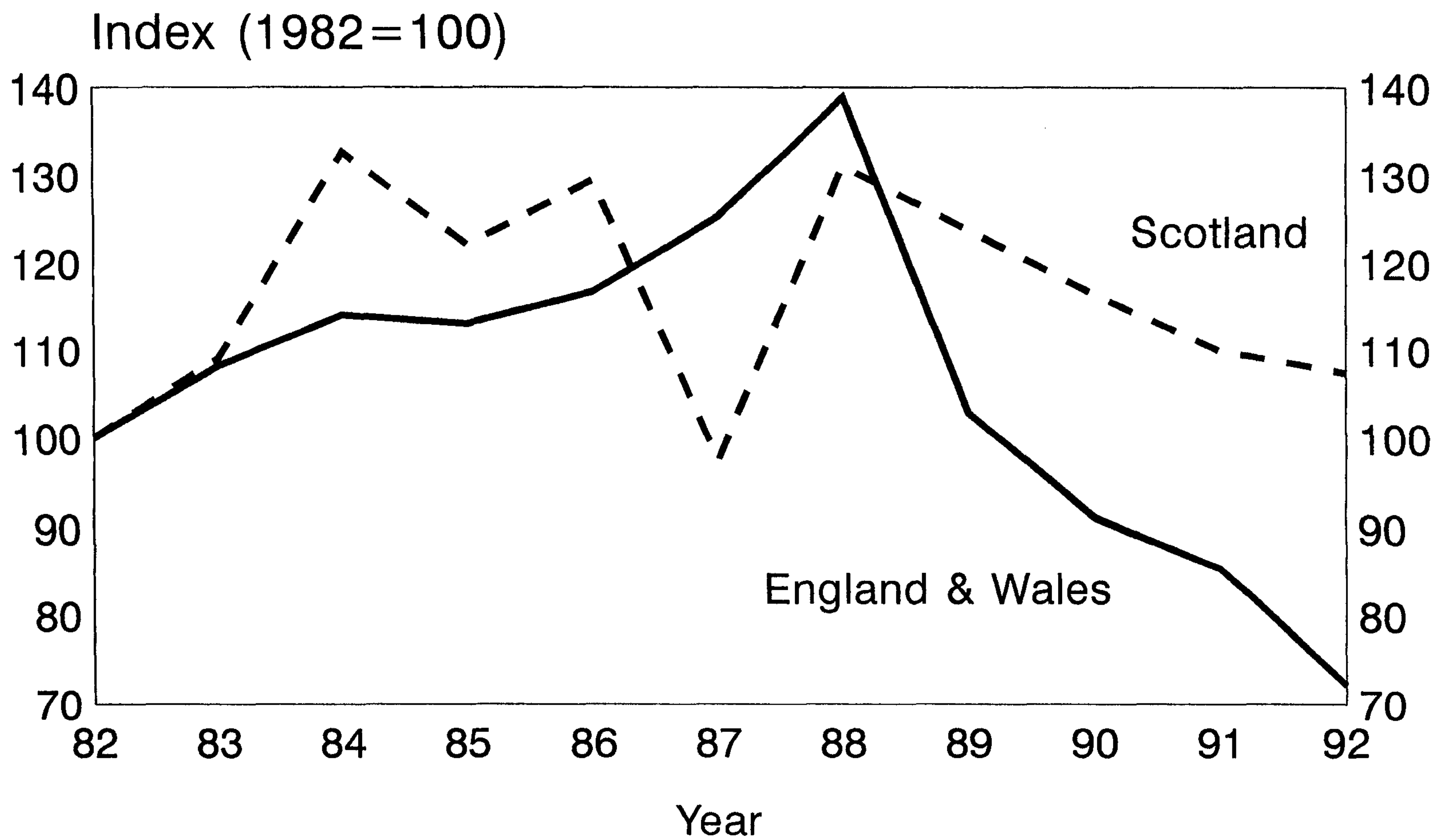
Diagram 3 Average House Price, Earnings & the RPI 1986-93



Source: Department of Employment (1993), TSB (1993).

Diagram 4

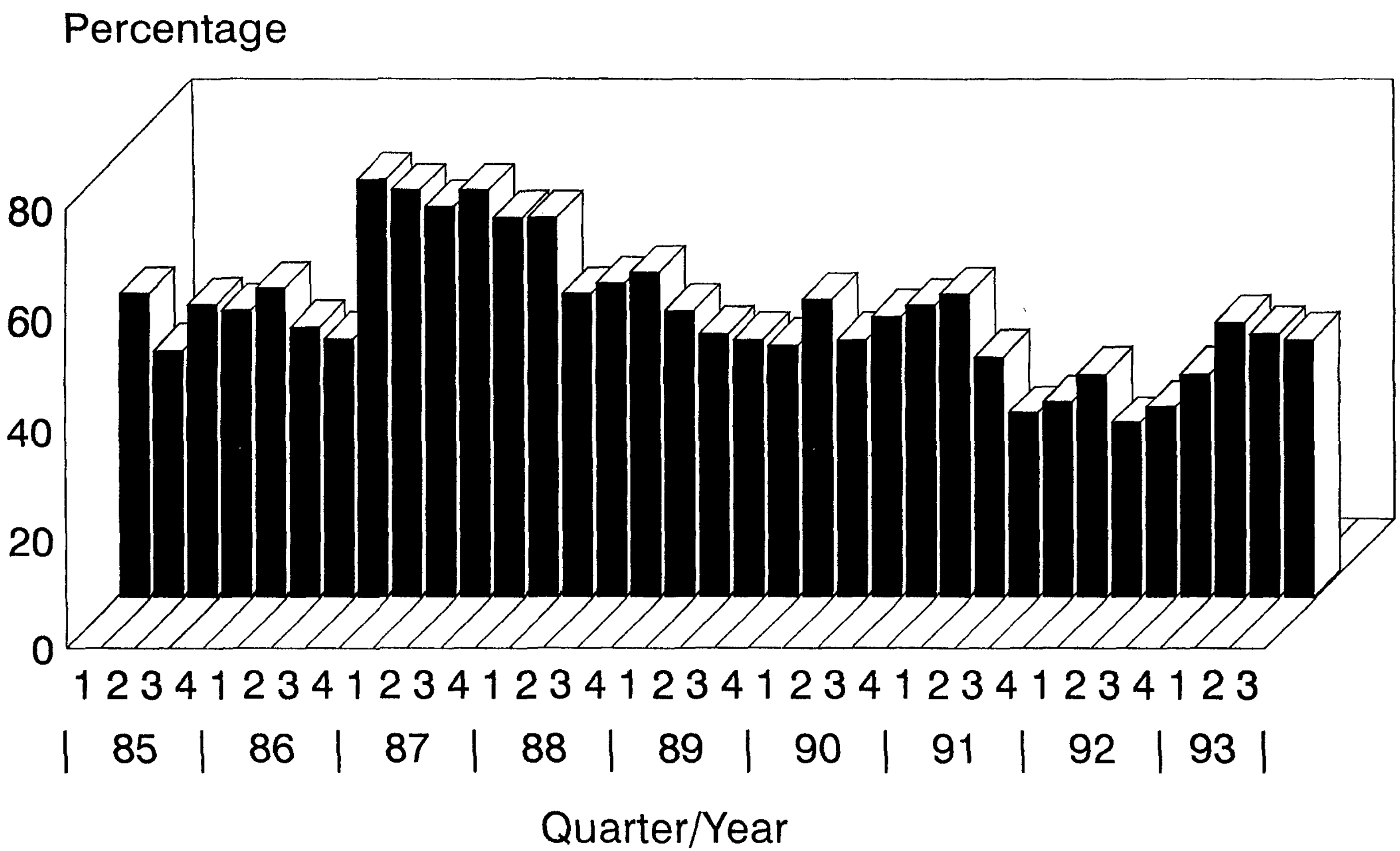
Housing Transaction Volumes



Source:Inland Revenue (1993), Scottish Office (1993b), Pitticas (1993).

Diagram 5

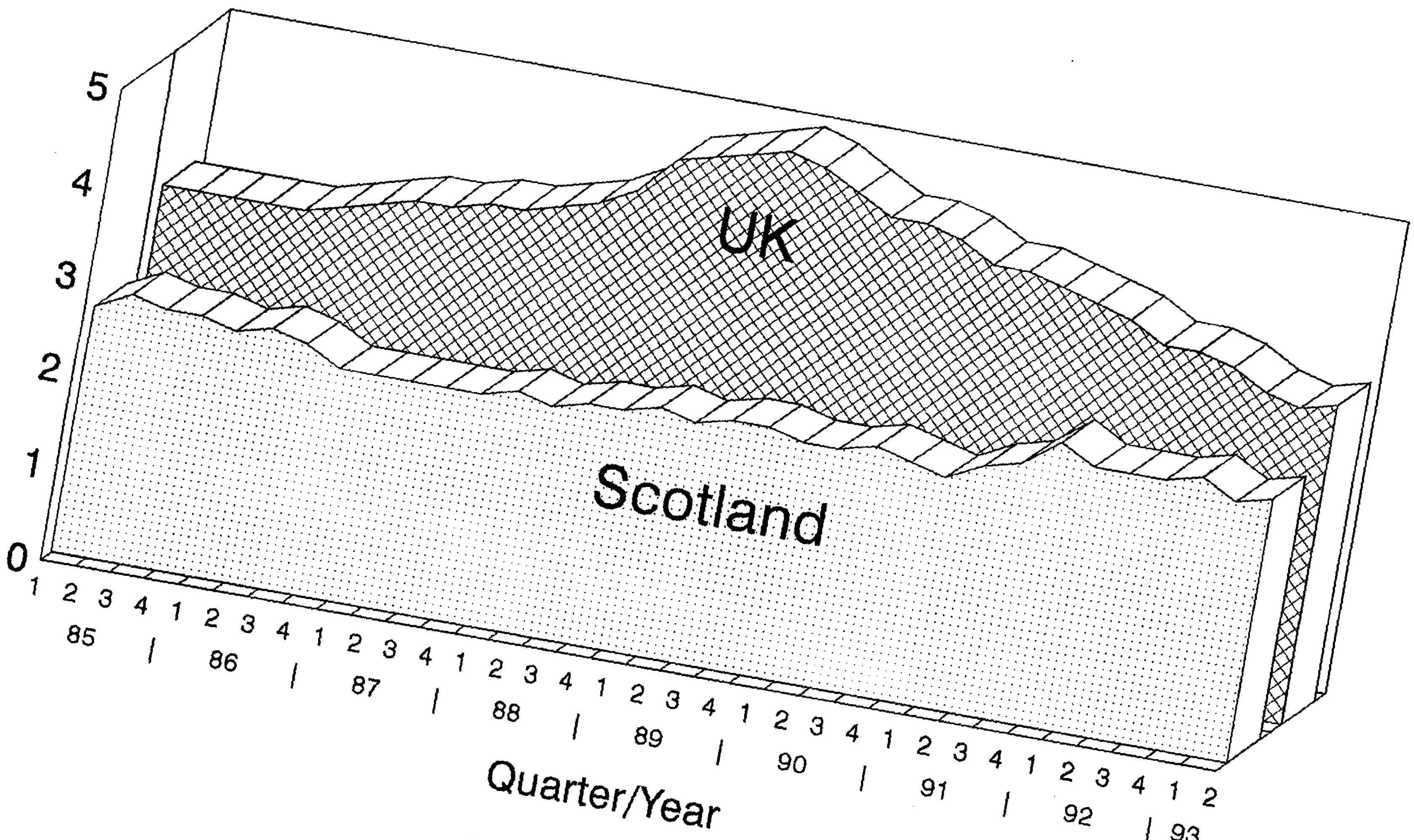
Percentage First Time Buyers



Source: TSB (1993).

Diagram 6

Price to Earnings Ratio



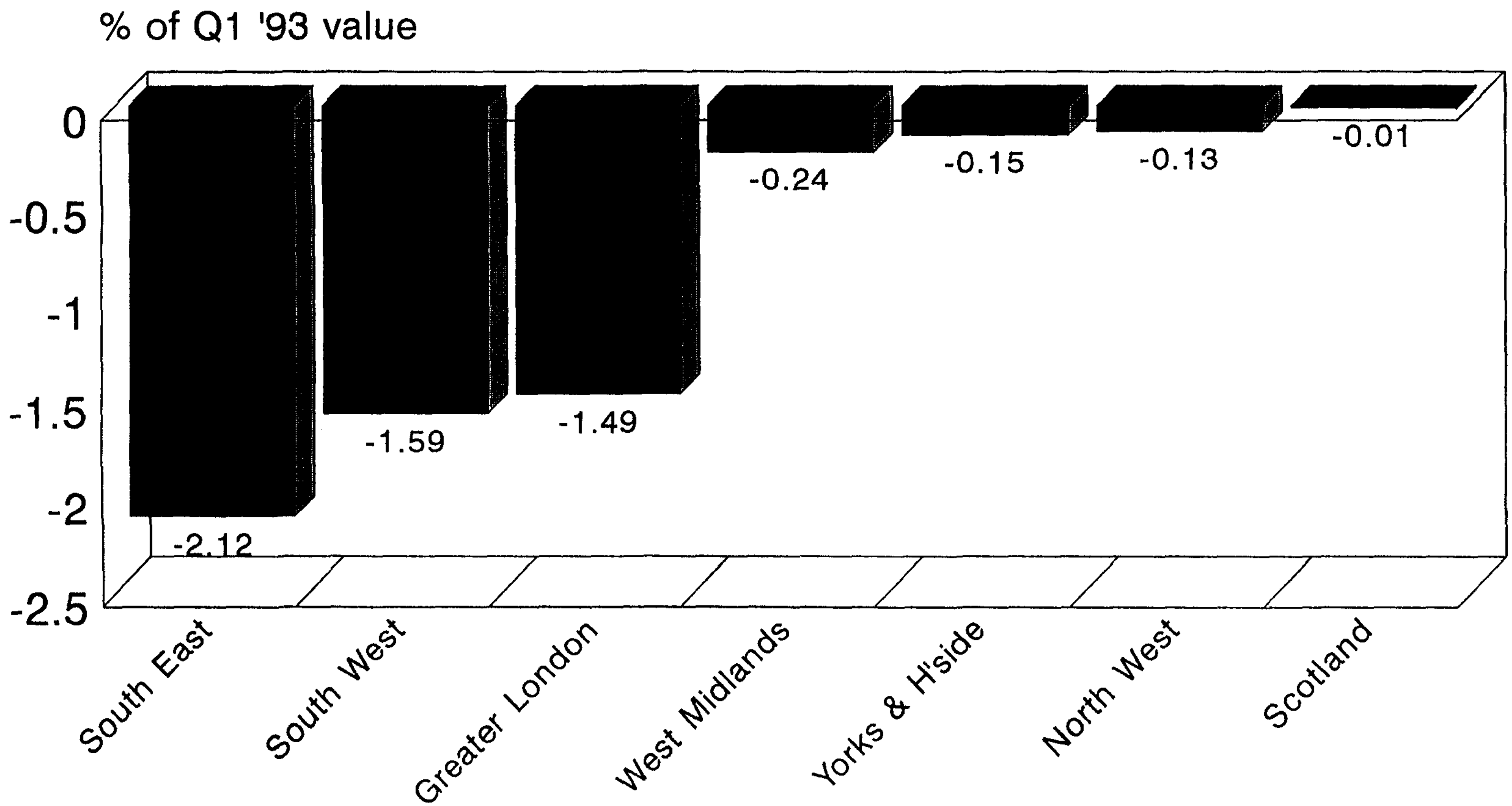
Note: TSB quarters used for TSB data

Source: Halifax (1993), TSB (

Diagram 7

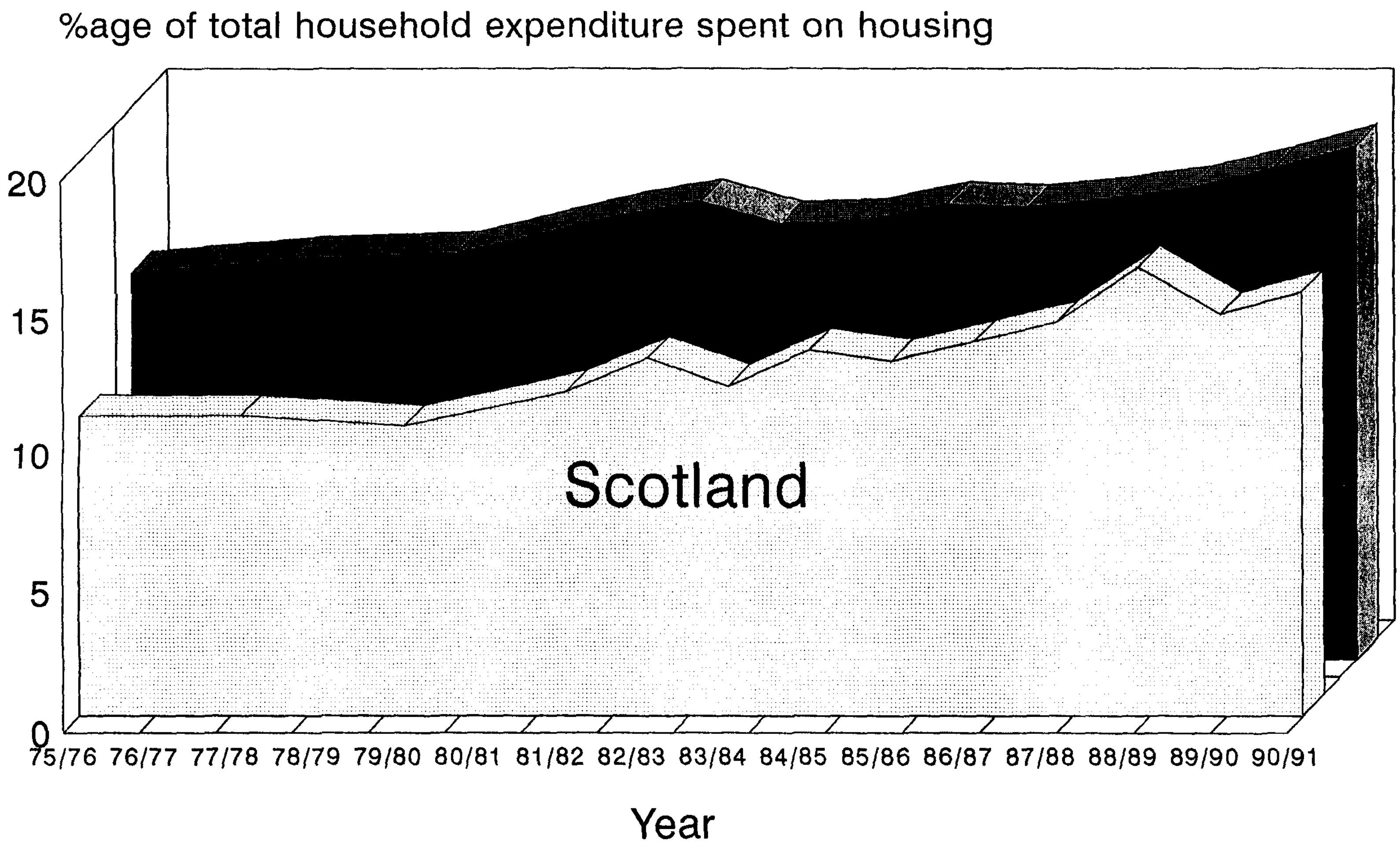
UK NEGATIVE EQUITY

(as % of value of housing stock Q1 1993)



Source: King (1993).

Diagram 8 PATTERN OF HOUSEHOLD EXPENDITURE

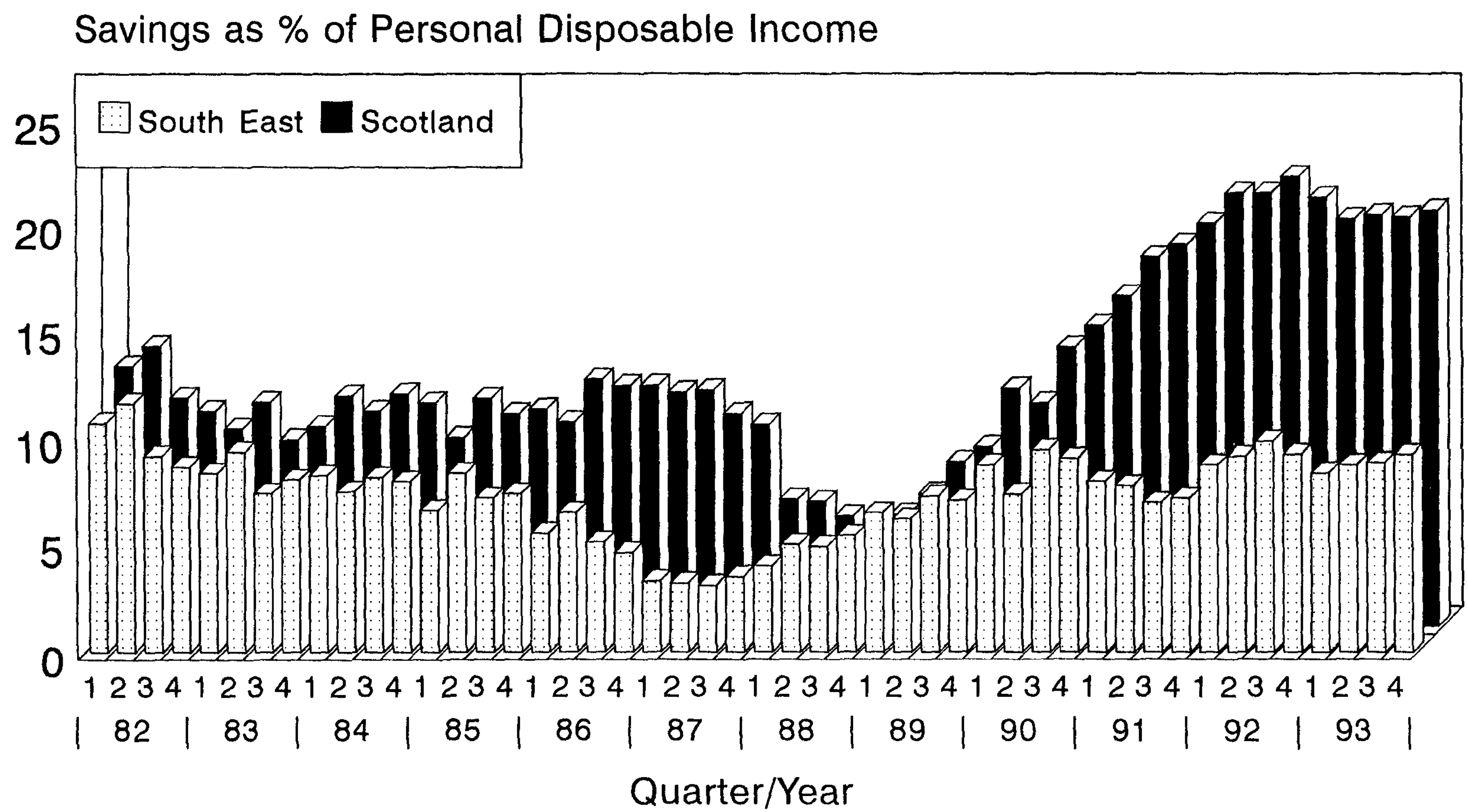


Source: Scottish Office (1993a).

Diagram 9

SAVINGS RATIO

(Q182 - Q493)

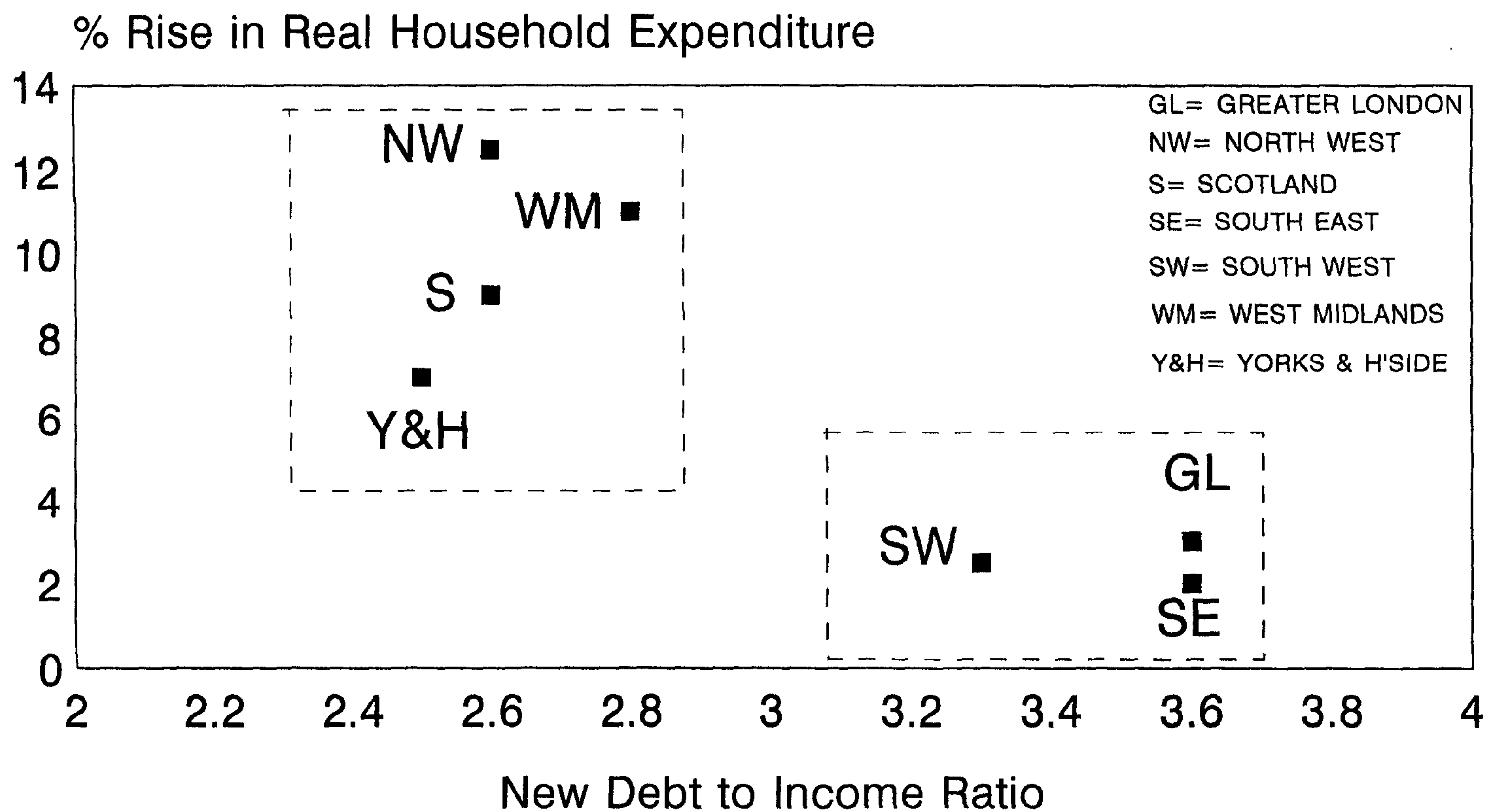


Source: BSL (1993).

Diagram 10

CONSUMPTION AND DEBT

(UK 1988-90)

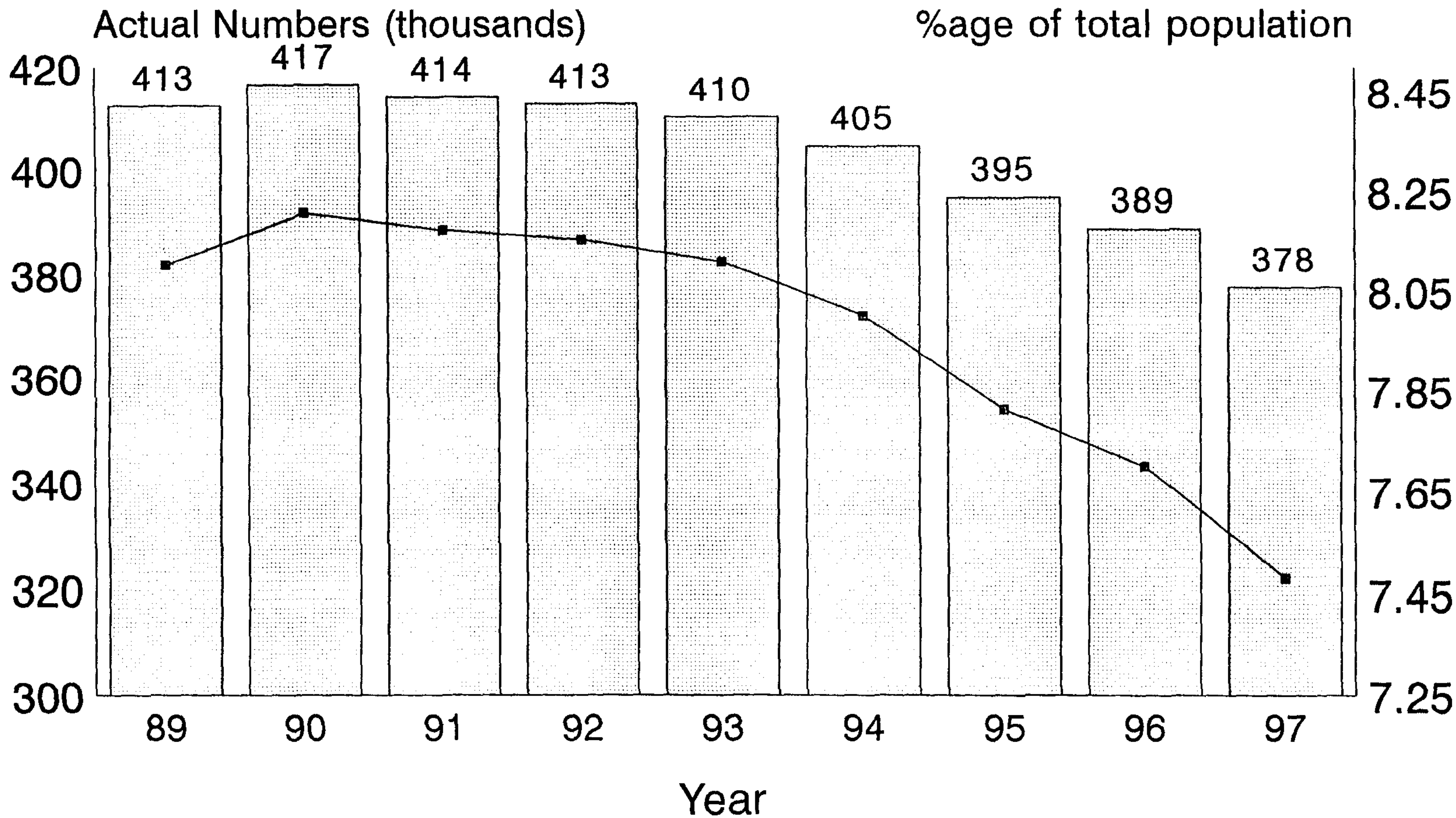


Source: King (1993).

Diagram 11

POTENTIAL FIRST TIME BUYERS

(Projected populations at mid-years by age last birthday)

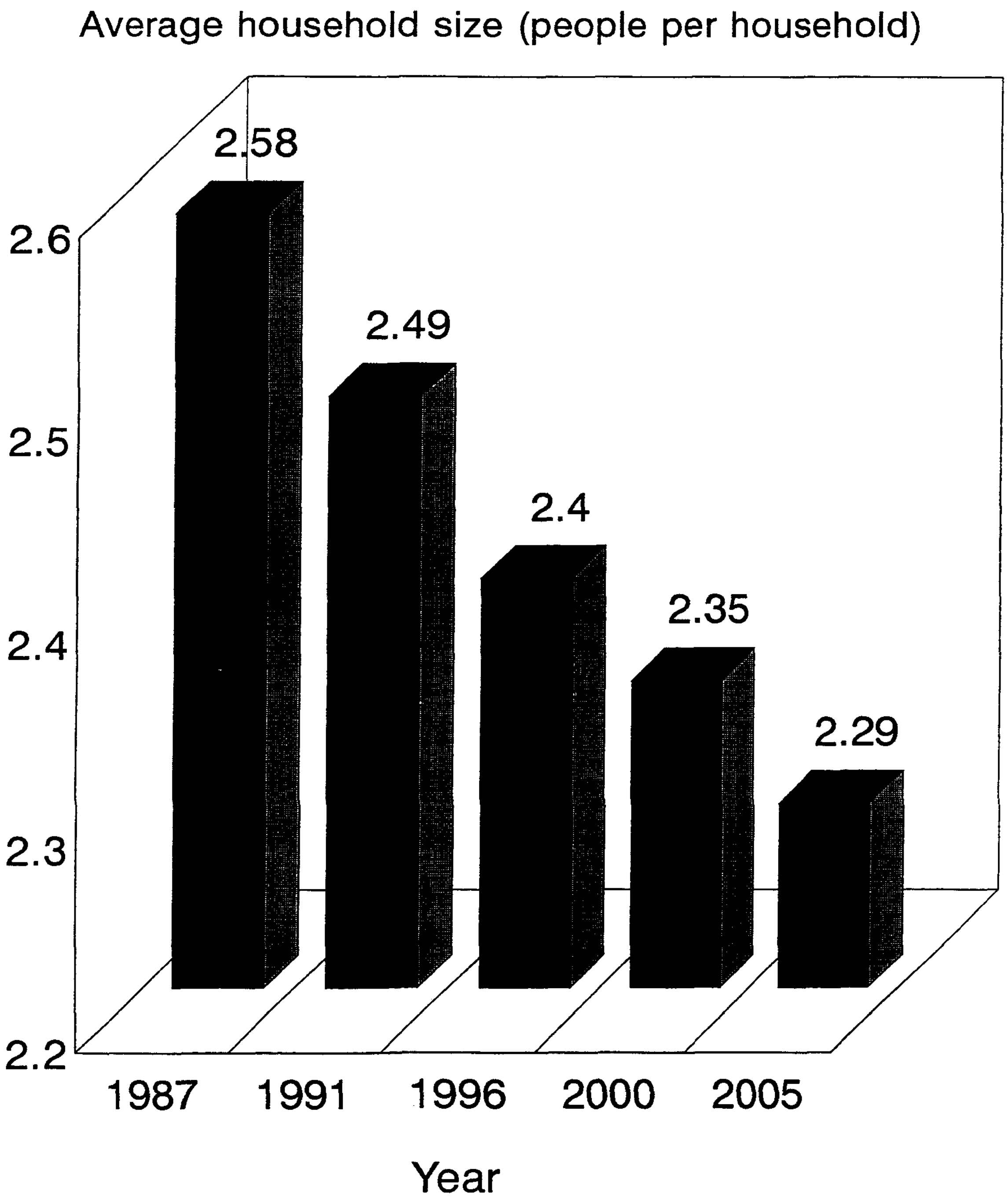


First Time Buyers estimated using persons aged 25-29 years

Source: General Register Office for Scotland (1991).

Diagram 12

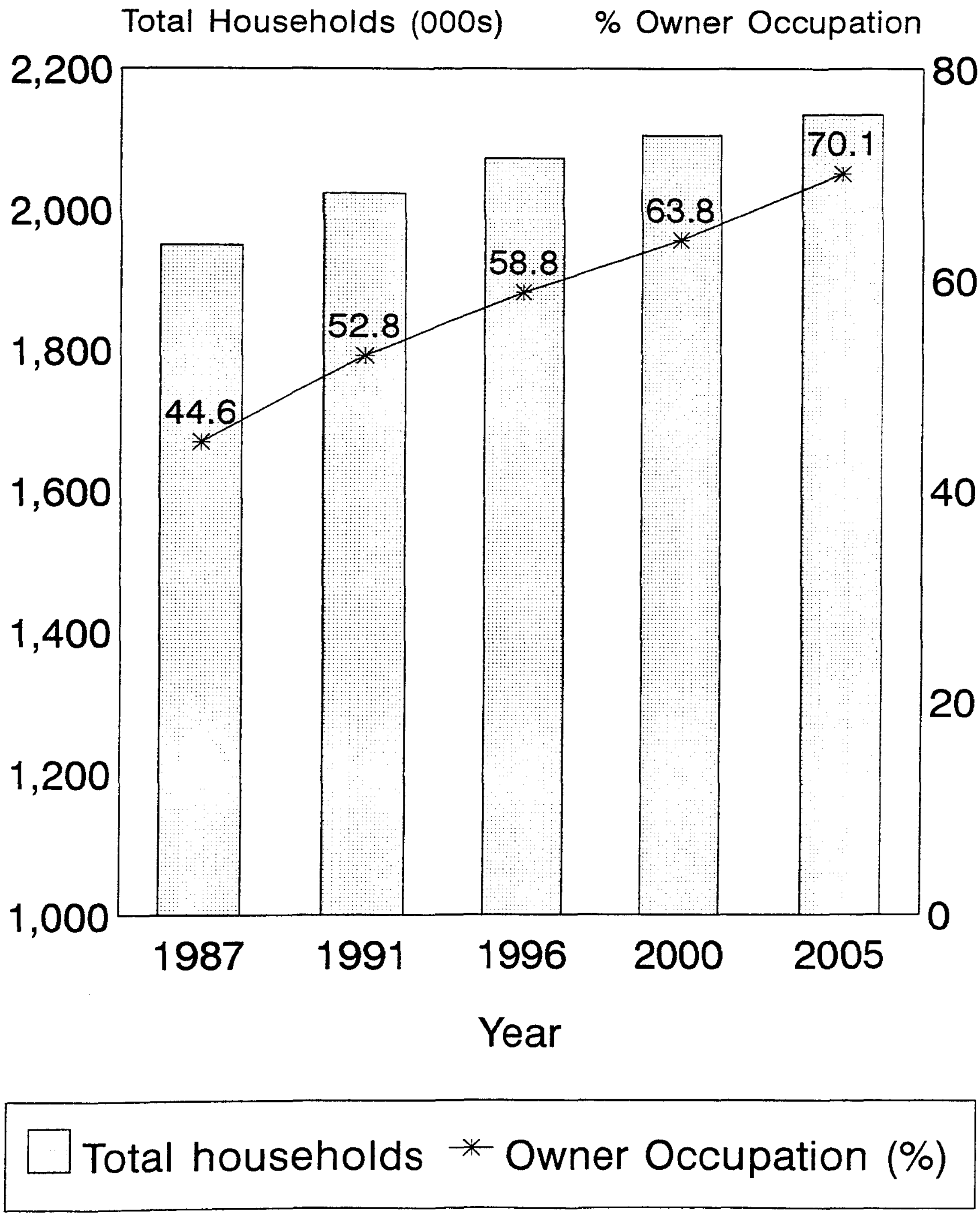
Scottish Household Size (1987-2005)



Source: Scottish Office (1992).

Diagram 13

Scottish Housing Market (1987-2005)



Source: Scottish Office (1992).

Diagram 14

Owner Occupied Households (1987-2005)

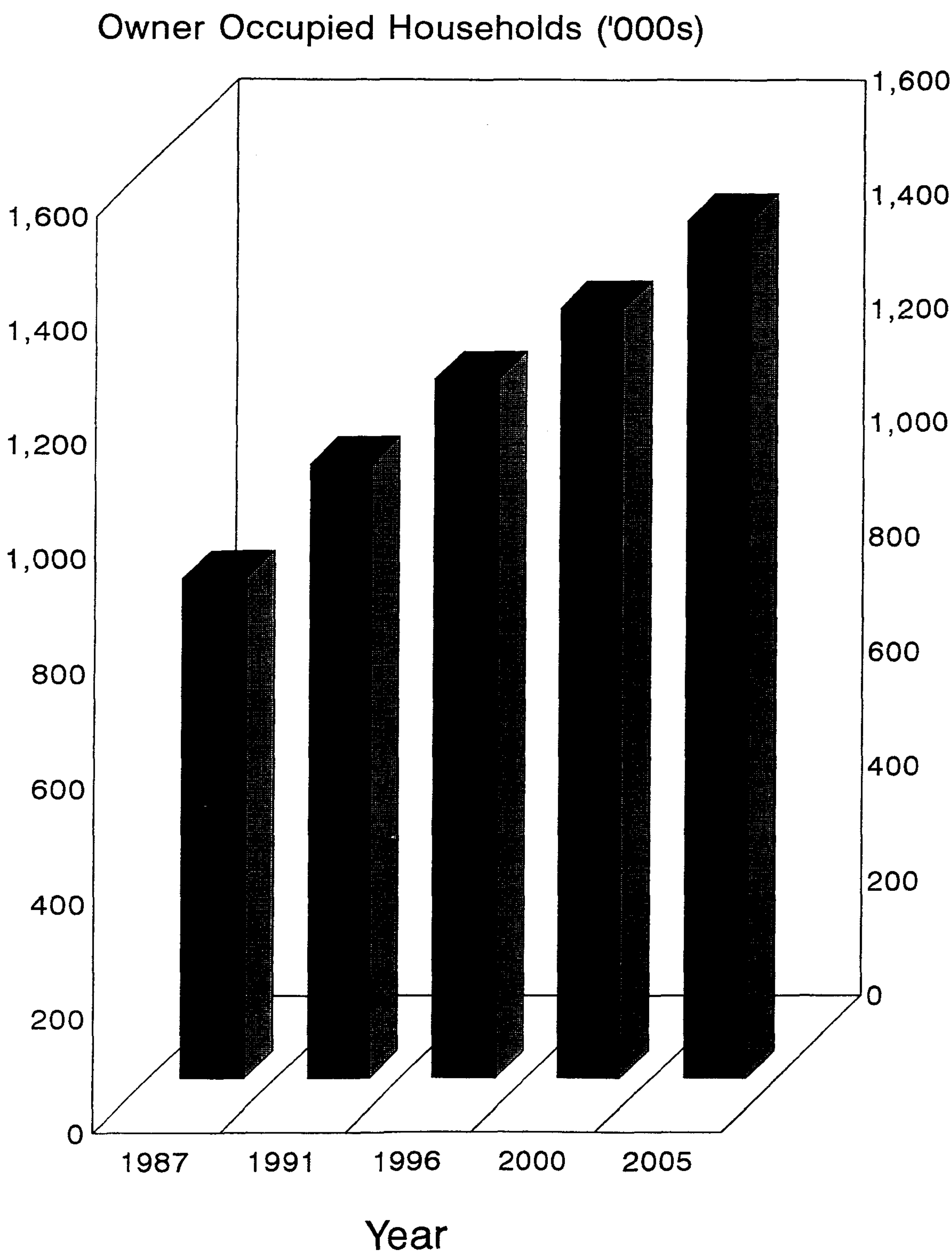


Diagram 15

Residential Sales
(1991-2005)