

Housing market effects on the economy

This evidence briefing is aimed at policymakers working with the financial sector and the effect of the housing market on the economy. As a result of this research the model can be used to better understand drivers and fluctuations in the housing market, and to predict long-term aggregate consumption and quarterly stock market returns in the UK and the United States.

Key findings

- Stricter limitations on land development result in less residential building, which tends to push up rental and purchase prices.
- Availability of land for residential development is more important than availability of capital in determining house price trends, especially in built-up urban and metropolitan areas.
- Where land availability is the important factor in the rate of house building, there is greater sensitivity of house prices and rents to the availability of jobs and world interest rates.
- People saving to buy a house in a market with less abundant land need larger down payments relative to their income. They take longer to save up and so buy a house later in life - resulting in lower homeownership rates.
- Relaxing borrowing constraints has little impact on housing prices (house purchase and rentals), but does increase homeownership rates.



- As a general rule, when house prices rise, house buyers such as young worker-tenants lose out, whereas house sellers such as retiree homeowners make gains.

The research was carried out by social scientists at the Financial Markets Group, the London School of Economics. The researchers developed a mathematical model to investigate how house prices, the overall economy and wealth distribution react to changes in technology and financial conditions.

The model was used to analyse the effects of policies on home ownership-rates, house prices and aggregate consumption fluctuations, the impact of land availability on the housing market, the housing decisions made by people at different stages in their lives, and the impact of market fluctuations on standard of living and welfare.

The findings show that changes in financing constraints have only limited effects on house prices. Tenants or credit-constrained home owners are relatively poor, so the effect of relaxing the borrowing constraint on house prices is simply absorbed by the conversion of rental housing into private housing. An increase in house prices leads to a redistribution of wealth from relatively poor tenants to rich unconstrained home owners. The wealth effect of house prices on consumption is negligible, as the positive wealth effect of the unconstrained home owners is offset by a negative wealth effect of the relatively poor renters.

In conclusion

The research illustrates how constraints on the supply of land, for instance through zoning restrictions, can have major implications for household welfare through their effect on house prices and individual home ownership.

The model can be used to better understand drivers and fluctuations in the housing market, and determine the component of house prices that is affected by market bubbles.

Potential policy measures include:

- **Financial:** A focus on the housing market, as changes in housing wealth have a persistent effect on both stock market returns and aggregate consumption.
- **Transport:** An emphasis on improved commuter systems to alleviate constraints in land availability.
- **Planning:** Increased ability to build taller buildings in areas with high economic activity and/or high population density.

Brief description of the research

The project 'Home Ownership, Housing Collateral and Aggregate Fluctuations' was funded by the ESRC and led by Dr. (now Professor) Alex Michaelides of the Financial Markets Group, London School of Economics.

The research shows the effect of policies such as greater financial flexibility on homeownership rates, house prices and consumption, and how constraints on the supply of land affects house prices. A mathematical model developed as part of the research project can be used to better understand drivers and fluctuations in the housing market.

Further information

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