Goods, assets and houses and why real estate is a bit different

Yolande Barnes says it is important to recognise housing for what it actually is – a complex composite good as well as a financial asset

My twitter feed has seen a few more skirmishes lately in a battle between two camps. Let's call one camp the 'Supplyiters' who believe the housing crisis is down to not building enough housing units for the last 50 years and can be fixed by building a lot more homes. On the other side of the battle ground are the 'Crediteers' who believe expensive housing is down to a surfeit of credit and irresponsible lending. They say restricting mortgage lending and taxing home ownership would dampen demand sufficiently to prevent excess house price inflation in future.

It's tempting to simplify problems and isolate single causes and, in some fields, it may even be a helpful way to find solutions. But I don't think that is the case for housing and especially not housing in London. I have watched a whole succession of governments, commissions, policy think tanks and other experts search for an all-elusive 'single silver bullet' solution to real estate issues over the last 30 years. (I think at least 3 of them came up with the answer "modern methods of construction"). But still Londoners complain (alongside inhabitants of many other global cities) that housing is expensive, inadequate, inaccessible or unavailable for an increasing number of people.

Solving any problem requires an understanding of what the problem actually is. Could it be that we just haven't been thinking about housing in the right way?

Housing is a complex asset, a composite good, which is all at once a commodity, a necessity, a luxury, an investment, a liability, a financial instrument and more. So the key feature of housing is that it is simultaneously a 'good' and an asset.

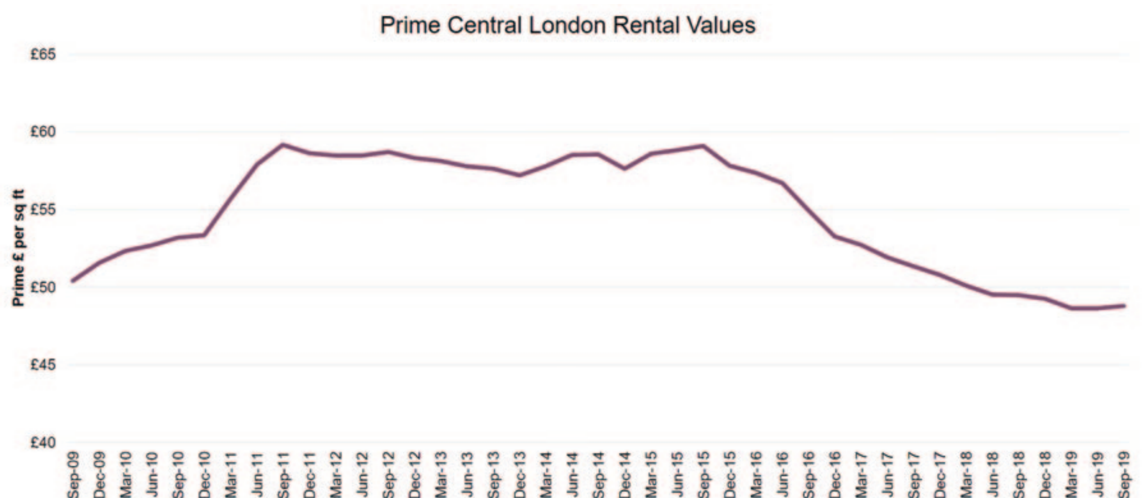
If we think of housing like any other consumer good, a car, a fridge or a pair of trousers, for example then the obvious solution to rising prices must be more supply. The increased and efficient supply of goods like cars, fridges and trousers has demonstrably reduced the price of these items over recent decades - without compromising quality. Why shouldn't the same apply to housing?

This may indeed work to some extent in the case of rented housing, higher supply in a particular location does seem to dampen rents. Renters consume housing purely as a good. They will value a flat or house by its size, amenities and qualities in much the same way as if it were a very large fridge. If there are more and better fridges, sorry flats, available then renters will pick those that are bigger, better, well serviced and cost less to run. Rents will tend to be stable unless l demand rises. On the other hand, if rental supply is constrained, renters will have to pay more for less.

High-end rentals in London are a very good example of this type of supply and demand pattern at work. Demand for prime central London (PCL) property to rent has, for decades, been a reflection of corporate relocation activity. (When rents are a few thousand pounds a week, you don't rent because owner occupation is inaccessible or unaffordable, you rent because it's expedient and convenient). In this sector, the fundamentals of decreasing demand from this type of housing occupant have shown up as a decade of falling rental prices – at the same time as capital values have soared.

So housing is one area where global competition and efficient manufacturing and supply measures won't shift supply as significantly as they have for cars, fridges and trousers. Real estate is not a normal consumer good – it uses a very expensive, scarce and immovable raw material - namely land. This is particularly the case in cities like London which have been inhabited for centuries and where land is recycled from previous uses >>>

RIGHT: Capital growth in Prime Central London
Source: Savills Research



Professor Yolande Barnes, Bartlett Real Estate Institute at UCL

RIGHT:
Nine Elms Point
New Homes in Lambeth,
Barratt Homes

>>> rather than obtainable (relatively) cheaply from agricultural sources.

It is very difficult, particularly in 'heritage neighbourhoods' to increase the supply of housing as it cannot be increased without simultaneously increasing the supply of land in the demanded location. This means that, in most given locations, land is finite – even where it could be increased marginally through densification. Even if the costs of housing production fall, land prices can still rise. Cheaply produced housing ceases to be cheap if the land it stands on is a scarce and rare commodity. This is particularly the case in London where new build supply is typically high-end and more expensive than the rest of the housing stock.

This leads us to the other component of housing: its value as an asset. Where real estate operates in a near-permanent condition of scarcity, due to land constraints, it is hardly surprising that its price has tended to rise faster than the price of cars, fridges and trousers.

An asset is something that puts money in your pocket. Housing assets can do this in several ways. Most homeowners and investors think in terms of capital growth because for many of them it has been so high over their lifetime. At times, the expectation of future capital growth is sufficient to fuel housing demand over and above the needs of renters, creating booms, busts and bubbles.

These booms are not necessarily reliant on excessive or irresponsible mortgage lending. Prime central London (PCL) provides us with an excellent lesson in this, alongside other top-end markets in global cities. The majority of purchasers in this market do not use credit. Those that do will often do so from personal finance choice, rather than necessity. How come then, these markets have been the first to rise in past cycles and have not been dependent on lax credit in order to do so?

The answer lies in the opportunity cost of capital. Wealthy, cash rich buyers experienced dramatic reductions on cash deposits after 2008 as interest rates fell in the wake of the financial crisis and quantitative easing. Asset price inflation, including real estate, was an inevitable consequence.

So housing is one area where global competition and efficient manufacturing and supply measures won't shift supply as significantly as they have for cars, fridges and trousers. Real estate is not a normal consumer good – it uses a very expensive, scarce and immovable raw material - namely land. This is particularly the case in cities like London which have been inhabited for centuries and where land is recycled from previous uses rather than obtainable (relatively) cheaply from agricultural sources.

But this is due to change. Interest rates cannot fall much further, if at all. Asset price inflation that results from downward yield shift is over. In an era of low and stable interest rates, there can be now capital growth without rental growth. I believe income will be much more important to real estate value in coming decades. Capital values have reached a 'high plateau'.

The size and quality of net income streams will now determine the value of a property. This is true for both landlords and owner occupiers. Owner occupiers will focus on value in terms of imputed rent (that is money not paid to a landlord each month), landlords will be more focussed on actual income received (rather than an estimated rental value). Both will become very focussed on all the running, holding, maintenance and repair costs of real estate over the longer term. Obsolescence and depreciation will become greater concerns for many and could devalue certain types of property.

There is a lot of change and disruption for policy makers to consider in coming years and this makes it all the more important to recognise housing for what it actually is – a complex composite good as well as a financial asset. We won't stand a chance of solving the housing crisis if we don't study, understand and allow for this complexity and also understand the way in which all the components of it interact in different ways at different times.

While it is almost certainly futile to try to stand in the way of the juggernaut that is a good social-media bust-up, my plea is that you don't see the Supplyiters and Crediteers as enemies but rather just two facets of a very complex puzzle. Both can be right in their own way on certain issues but their proposed solutions are fraught with the possibility of unintended consequences if we don't understand the very much bigger and more complex picture. ■