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Highlights in this issue:

- **Household consumption supported UK growth in recent years – but will it last?**
- **Household debt relative to GDP is at record levels**
- **Interest rates have risen 125 basis points within a year**
- **But households appear less vulnerable than in the early 1990s**

UK household consumption (Part 1): built on a debt mountain?

*By Richard Salt and John Macdonald**

Summary

This is the first of a two-part issue of the ECFIN Country Focus looking at household consumption in the UK. The UK economy survived the global slowdown of recent years relatively well in comparison with many other industrialised economies, its performance underpinned by firm consumption growth for both the household and public sectors - the former supported by a period of rapidly rising house prices and facilitated by growth in household debt. With the Bank of England having raised interest rates to dampen emerging inflationary pressures, this Country Focus assesses the possible threat to consumption from the accumulated burden of debt.

The note argues that despite the much larger levels of debt now observed, the UK is significantly less vulnerable to higher interest rates and debt servicing costs than it was in the major recession in the early 1990s, and any house price falls would seem unlikely to cause a repeat of the debt problems then experienced. Risks remain, however, particularly in the exposure of some lower-income households – though continued strength in the UK's labour market should mean that the wider economy is likely to be insulated from any adverse effects arising from this exposure.

The second and concluding part of this issue will provide a companion analysis, analysing the impact of house prices on consumption via wealth channels.

Once Bitten, Twice Shy…

Many commentators have made a link between generally firm consumption growth in the UK and the significant growth in household debt. This has led to concerns that the UK's consumer-led growth during the recent slowdown will be at the cost of future growth as households rebuild their balance sheets. In addition, strong growth in house prices may have encouraged consumption through wealth effects, but with the risk that some house buyers may have overstretched themselves by taking on excessive levels of debt to finance property acquisition.

Household debt has reached record levels

With total household debt having risen to record levels exceeding £1 trillion earlier this summer (roughly 90% of GDP) this note examines its nature and impact. The level of household debt is of concern to many, given the experience of the UK economy around 15 years ago, when a house price boom and subsequent bust contributed significantly to a sharp recession. To put the current debate into context, it is worth briefly recapping what happened then.

*** Directorate for the Economies of the Member States.**

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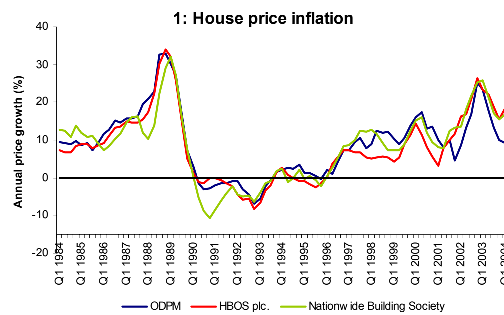
1990 and all that...

The last house price boom was in the late 1980s…

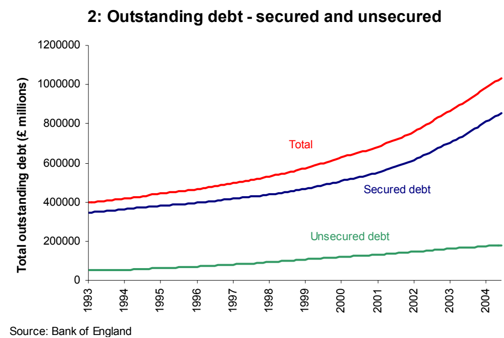
…followed by a bust and a two-year recession

During the late 1980s, in a period of rapid growth leading up to the recession of the early 90s (which lasted from the third quarter of 1990 into 1992), the level of household debt in the UK rose significantly, fuelled by a rapid increase in house prices that forced buyers to assume ever larger mortgage debts. As the economy began to slow, the UK experienced a widespread crash in property prices. With many buyers having overstretched themselves financially, the recession became characterised in many people's minds by the problems in the housing market. The problem of "negative equity", where the values of outstanding loans exceeded the value of their property, left many households unable to finance their mortgage comfortably, but simultaneously unable to secure further credit (see Davis 1995 for an overview) - and unable to sell their property in order to ease the financial burden.

It is tempting to draw parallels with the current situation. Annual house price inflation has picked up markedly (see Chart 1), and while rates of growth have yet to match the peak of the late 1980s (reaching 34% in late 1988), the ratio of house prices to disposable income is now approaching the levels of the late 1980s.



Source: Office of the Deputy Prime Minister (ODPM)



Source: Bank of England

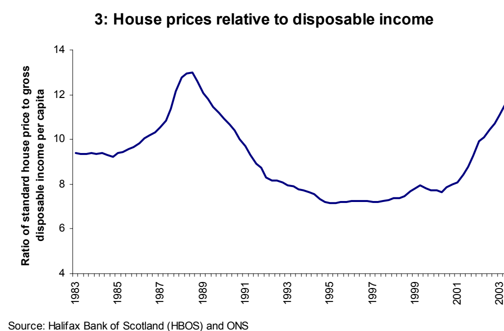
Equally, outstanding levels of household debt have picked up in another development similar to the late 1980's. Outstanding debt grew from around 76% of household disposable income in 1987 to reach 95% in 1990. In contrast, debt reached around 130% of household disposable income in 2004.

Most of the increase in debt in recent years has been secured on property (see Chart 2), a development consistent with rising house prices. Unsecured debt (including consumer credit), while increasing, has grown at a lower, steadier rate over the last decade.

Debt secured on property – grabbing the headlines…

The majority of new debt is secured…

The increase in secured debt is closely linked to house price developments, and households have taken on higher levels of debt to finance house purchases. The median mortgage advance relative to applicant's salary has been on an upward trend for over 20 years, and has grown rapidly over the last five. For property owners, rising prices have encouraged a rise in mortgage equity withdrawal (MEW) – borrowing secured on housing, but not invested in it, thereby releasing funds for reinvestment or consumption.[1]



Source: Halifax Bank of Scotland (HBOS) and ONS

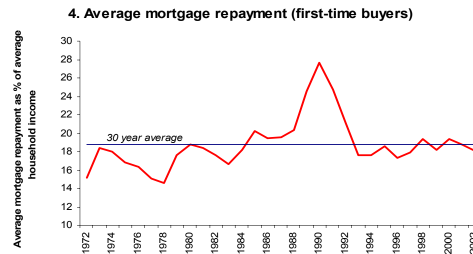
Chart 3 shows how house prices have risen relative to disposable income in recent years, to close to late-1980s levels. Income multipliers (the

…and mortgages appear larger relative to incomes

value of mortgage advance relative to applicant's salary) have been on an upward trend for the last 25 years, for both existing home-owners and first-time buyers – reaching an average of 3-times salary for first-time buyers in the second quarter of 2004, well above the 1990 peak of 2.34-times salary. However, two factors suggest that the current high level of debt does not present as serious a risk as in 1990.

But lower interest rates have lowered mortgage servicing costs…

The first is that **mortgage servicing costs are markedly lower now**. The generally low interest rate climate evident in many industrialised economies, has been embedded by two other factors – financial market liberalisation, which has helped engender a relatively competitive market for financial services (including mortgages) in the UK and a series of improvements to the UK's macroeconomic framework, including the operational independence given to the Bank of England in 1997 – that have helped interest rates fall to historically low levels (the autumn 2003 rate of 3.5% had not occurred in the UK since 1955). Rates peaked at 6% in the last period of tightening (in 2000), in contrast with 1989, when the government raised interest rates to 15% to cool an overheating economy. The mean mortgage repayment for a first-time buyer is close to its 30-year average (Chart 4), and well below the rates observed in 1990.

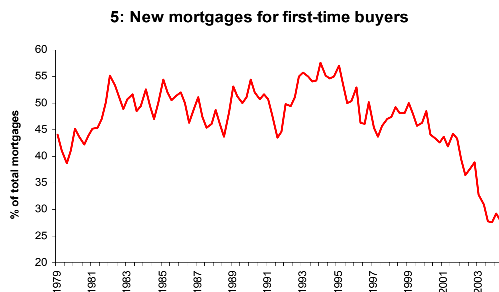


Source: Office of the Deputy Prime Minister
Note: calculated on the basis of the average advance, after tax relief, on a repayment mortgage.

The corollary of a low interest, low inflation environment is that the real value of debt does not decline so rapidly (see, for example, Debelle 2004), implying that while initial payments may be lower, real repayments are higher over longer periods than in a high-inflation environment. Nonetheless, lower interest rates, by reducing this "front-loading" effect, remove a credit constraint early in the mortgage (see Barker 2003). Indeed, HM Treasury (2004) finds evidence that some borrowers, particularly first-time buyers, "attach overwhelming weight to the initial monthly repayment on mortgages" (p. 6), which may even suggest that *to a degree*, lower mortgage costs have helped drive house prices higher.

…and some traditionally vulnerable groups have not been prominent among the debt-accumulators

The second is that **mortgage applicants, and new advances, look very different** than in the late 1980s. First-time buyers are assumed to be the most vulnerable group to higher mortgage costs since they tend to have fewer assets (including household equity), and take on slightly greater loans relative to income than existing home owners. However, first-time buyers are clearly less prominent this time around – the proportion of first-time buyers has fallen to only 29% of new loan recipients in the first quarter of 2004, compared with 54% in 1990 (Chart 5). This would suggest that, in contrast with the 1980s, the accumulation of debt is increasingly being assumed by existing home owners through re-mortgaging, which has increased markedly. There has also been a clear increase in buy-to-let mortgages, used to finance the purchase of property for rental. Although there is the potential for substantial variation in burdens among households (as noted by Nickell 2002), other data suggest that key groups are not as vulnerable in their exposure to secured debt as in the previous slowdown. For example, data show that mortgage arrears are at low levels, and that there has been no marked pickup in claims made on mortgage payment protection policies.



Source: Council of Mortgage Lenders

Smaller, but no less dangerous. The case of unsecured debt…

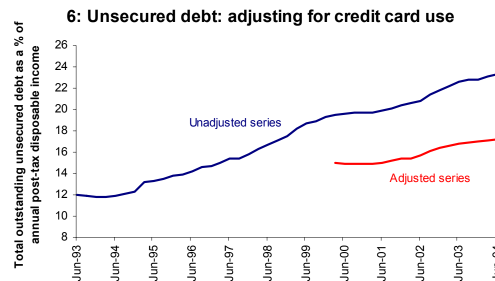
Unsecured debt forms a significantly smaller share of the total debt burden than secured debt, and has been rising at a slower rate in recent years. Even over the last 5 years, the rate of increase in the level of outstanding unsecured debt has

Though smaller, unsecured debt has also risen sharply

been relatively steady, marking a significant difference with secured debt, where rapid growth has been a particular feature of the last 3-4 years. Outstanding unsecured debt has risen from just under 16% of household disposable income at end-1997 to over 23% by early 2004 – though changes in the financial sophistication of consumers may be playing some role if, for example, consumer credit (at low or zero interest rates) is used to manage cash flow over short periods.

This is particularly relevant for credit-card borrowing, which can be very short-term. The Association for Payment Clearing Services estimates that in a typical billing cycle, 54% of credit card holders *always* repay their full balance each month, while a further 11% *usually* do. More significantly, the 54% who pay off their entire balance account for 77% of all credit card expenditure, with a further 8% incurred by those who *usually* pay off their entire balance – suggesting that up to 85% of credit card debt is repaid in full each month, and is effectively used in place of cash. We estimate that this effect alone would reduce the effective level of unsecured debt from around 89% of GDP to around 66% – see Chart 6.[2]

6: Unsecured debt: adjusting for credit card use

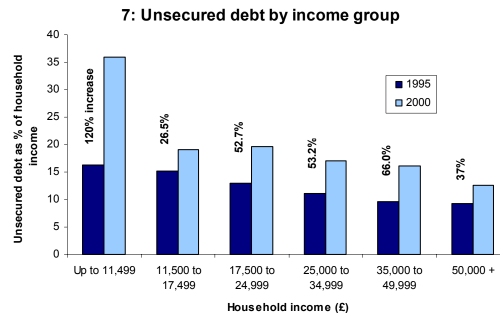


Source: Bank of England, Association for Payment Clearing Services, ONS, DG ECFIN calcs
Note: Assumes that 75% of credit card debt accumulated by individuals who "usually pay off balances in full" is repaid in the first billing period. Modelled from Q12000 only.

Nonetheless, it is difficult to believe that the increase in unsecured credit is entirely due to more sophisticated use of short-term credit. There is evidence of asymmetry in debt burdens across income groups – suggesting that groups most susceptible to changes in interest costs are exposed.

And low-income groups could be vulnerable

7: Unsecured debt by income group



Source: Cox et al (2002)

Cox et al (2002) report data (illustrated in Chart 7) showing that the rapid growth of debt in the second half of the 1990s was disproportionately large among the lowest income groups (at 120% of 1995 levels), even if growth was observed across all income groups. Moreover, the pattern of debt accumulation changed somewhat, with low-income groups looking particularly exposed to an increase in debt servicing costs. Somewhat surprisingly however, more recent research referred to by Tudela and Young (2003) showed that over the subsequent period from 2000 to 2003, unsecured debt relative to income *fell* in many lower-income households, and only rose significantly among higher-income groups – suggesting that the these risks to lower-income households may have fallen.

Evidence exists of some difficulties

Overall, it is difficult to judge the degree of difficulty faced. Some limited evidence may be provided by current levels of personal bankruptcies, which are at record highs after a gentle upward trend through much of the second half of the 1990s. While it is difficult to fully disentangle the effects of the April 2004 Enterprise Act, which simplified the process of declaring personal bankruptcy, this would seem to offer some *prima facie* evidence of some difficulties at the margin.

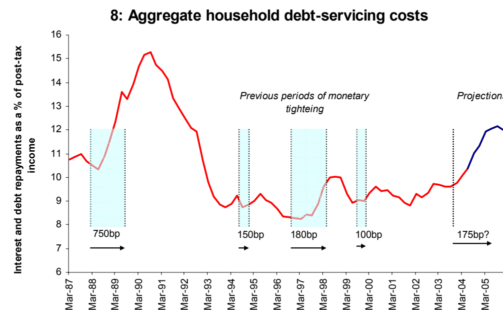
Looking forward…

One concern going forward is if borrowers have (in aggregate) focused too much on the initial affordability of mortgages – which, as noted by Morgan Stanley (2004), could generate greater volatility in the market because short-term interest rates, the key driver of mortgage debt-servicing costs in the UK, are more volatile than long-term rates. But they also note that, unlike for first-time buyers, initial costs are not

the dominant factor for many other (particularly older) buyers. This argues for closer analysis of debt costs and financing.

Aggregate household debt-servicing costs (defined as interest plus capital repayments as a share of income) remain significantly lower than in the early 1990s, and are currently on a par with 1998 levels. Chart 8 shows servicing costs over the last 17 years, and a projection based on the assumption that interest rates rise a further 50 basis points, to 5.25% by spring 2005, before falling slightly in the final quarter of 2005.[3] The chart shows that the increase in debt servicing costs is expected to be larger than in the previous three periods of monetary tightening, and is likely to rise further – but should remain well below levels seen in 1990.[4]

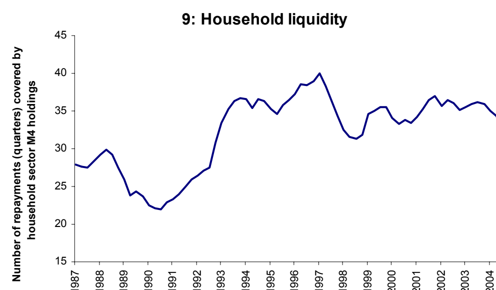
Debt servicing costs look set to remain manageable

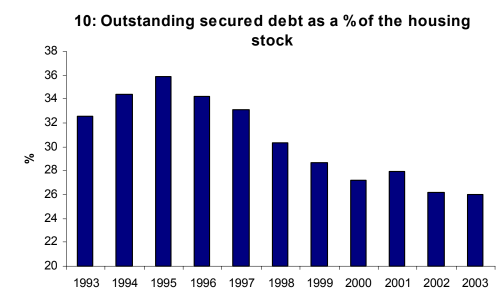


Moreover, it should be borne in mind that this analysis ignores a potential offsetting factor - higher interest rates will increase some households' incomes by increasing the flow of income from financial assets (cash, equities, pensions funds), which represent a significant part of household net worth in the UK.

On a liquidity measure, debt-servicing costs also look manageable. This analysis, shown in chart 9, is a useful guide to households' ability to adjust either to higher debt-servicing costs or to a period of unemployment. Currently, household holdings of broad money (M4) are equivalent to around 32 quarters' (8 years) of current, regular debt-servicing costs – see Chart 9. Though lower than the peak of almost 40 quarters' worth in the first quarter of 1997 and declining recently, the level compares well with historical norms. And most strikingly, liquidity is significantly higher than in the late 1980s, when a declining liquidity ratio *predated* the house price collapse (consistent with the relatively depressed savings ratio in 1988 and 1989).

And household liquidity should help temporary rises in debt costs





In addition, and as noted by Morgan Stanley (2003), the level of *un-drawn* equity is higher than in previous years, which makes the prospect of negative equity more distant. The increase in value of the housing stock has outpaced debt accumulation in recent years. As an overhang from the earlier slowdown, secured debt peaked at just under 36% of private sector housing assets in 1995, and has declined significantly in recent years to around 26% in 2003 (as shown on Chart 10).

Ultimately, the most likely source of any difficulty arising from household debt is related to the disproportionate increase in debt burdens on low-income households that were observed in unsecured debt levels in the 1990s, and which is likely to be present in secured debt also – though without detailed disaggregated data it is difficult to assess the scale of any vulnerability. Either way, continued growth and strong labour market performance would do much to ensure that any difficulties among some households are not transmitted to the wider economy.

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[1] Mortgage Equity Withdrawal (MEW) takes place when the value of new loans secured on property exceeds additional investment in the stock of housing. As house prices have grown rapidly in the UK in recent years, increasing net housing equity, many households have assumed larger mortgage debts without moving house – effectively drawing on the increase in housing wealth to, for example, invest in financial assets, pay off unsecured debts, or fund consumption.

[2] The adjusted data may still overstate the level of effective unsecured credit, because it includes those individuals who repay minimal amounts while they take advantage of introductory zero-rate interest offers.

[3] Interest rates used do not represent a forecast. Projections are based on an approximate rule of thumb that a 100bp rise in interest rates will lead to roughly a 1pp rise in the ratio of interest payments to disposable income; since debt is 130% of household disposable income, a 100bp rise would ordinarily lead to a 1.3pp rise in this ratio, but an adjustment is made to reflect the fact that roughly 25% of UK mortgage stock is at fixed interest rates. Note that the expected impact of monetary tightening would be less than projected here if the rate hike is not fully passed onto borrowers.

[4] The data may not present a completely accurate picture, since they exclude the repayments of principal on unsecured debt. Bank of England research suggests that since 1997, adjusting for this debt would add up to 4 percentage points to debt servicing costs – despite the higher level, however, the profile over time is similar to that shown in the chart. The data also exclude payments made into savings vehicles such as Individual Savings Accounts, for paying off "interest-only" mortgages – these payments appear as savings, rather than debt repayments, in the national accounts.

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.

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