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Highlights in this issue:

- Household consumption supported UK growth in recent years – but will it last?
- The early 1990's house price crash had significant adverse effects on the economy – could this happen again?
- Have the links between house price growth and consumption changed?

UK household consumption (Part 2): buoyed by house prices?

*By Richard Salt and John Macdonald**

Summary

This is the second in a two-part issue of the ECFIN Country Focus looking at household consumption in the UK. Given the strong house price inflation of recent years, and historical links between house prices and consumption in the UK, this Country Focus asks if there are likely to be significant negative wealth effects from a period of falling house price growth – particularly given the UK's painful experience in the early 1990s, when a house price crash coincided with a deep recession?

This note finds some evidence that historic links between house price growth and consumption appear weak in the current cycle, suggesting that the risks to the wider economy from a fall in house prices are lower than might have been expected. Some structural factors have been at work – but coincident developments in other variables may have helped offset, and potentially disguise, some wealth effects.

Equally, wider real economy developments should help to support consumption going forward, even if house price growth slows, or reverses. Risks remain, particularly in the exposure of some lower-income groups – but together with the finding in the previous note that the current debt burden seems largely manageable, the risks to the wider economy appear smaller than often assumed.

Developments in household consumption

Household consumption has provided a firm contribution to UK growth over recent years and, together with government consumption expenditure, more than offset weak investment and external demand since the beginning of the decade. This note assesses the links between house prices and household consumption – but begins with a brief analysis of recent consumption growth.

Household consumption growth has been firm…

Between 1996 and 2000, household consumption growth in real terms was above its long-run average of just over 2.6% per year, peaking at over 4% in both 1999 and 2000 (see Chart 1). This appears relatively lacklustre when compared to the second half of the 1980s, when household consumption growth peaked at an annual rate of 6.6% in 1986, before falling by almost 1% in 1991. Consumption growth has tended to be more stable in recent years, remaining closer to its long-run average. Most recently, consumption slowed to 2.4% in 2003, and is expected to reach 3.3% in 2004, according to the Commission Services' autumn forecast. Notwithstanding the relatively benign consumption growth of recent years, the apparent correlation

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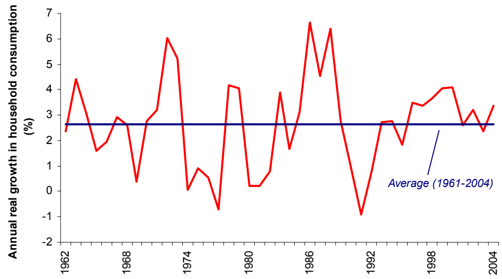
between generally firm consumption growth and recent rapid growth in house prices has raised the possibility not only that house buyers may have overstretched themselves by taking on excessive levels of debt to finance property (see the first part of this *ECFIN Country Focus*), but also that associated wealth effects have provided a boost to consumption that will not be sustained as prices moderate.

…but not strong in historical perspective

1. Real household consumption



Source: AMECO

This is particularly relevant because of the experiences of the UK economy around 15 years ago, when a house price boom, and subsequent bust, became associated with a sharp recession.[1] This concluding note examines the links between house prices and consumption, noting some evidence that the historically close relationship between the two is less apparent in recent years. Moreover, the likely impact on consumption from a period of slow house price growth, or even falls, appears likely to be more muted than often believed.

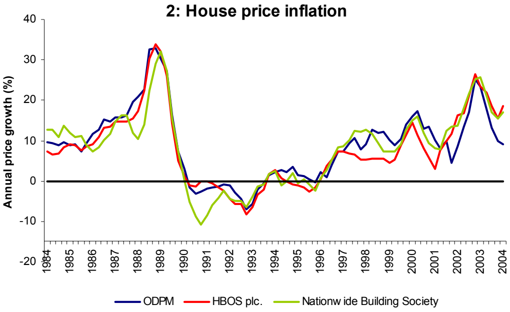
Even so, recent experience casts a long shadow

Drawing on rapid house price growth...

Recent years have seen a marked pickup in annual house price growth - as shown in Chart 2, which illustrates the three most widely quoted measures of house prices in the UK. While growth has not matched the peak of the late 1980s (34% in late 1988), the rise has been sustained since early 1996, before moderating in more recent data. The ratio of house prices to disposable income is at its highest level for 15 years, and is now approaching the 1989 peak of around 13 times average incomes – the average over the last 20 years is roughly 9 times average disposable income.

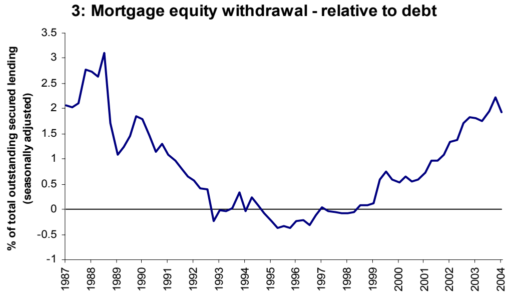
House price growth has been significant…

2: House price inflation



Source: Office of the Deputy Prime Minister (ODPM)

3: Mortgage equity withdrawal - relative to debt



Source: Bank of England

Rapid house price growth has encouraged a rise in mortgage equity withdrawal (MEW) as households adjust their portfolio gearing in response to higher property values. Broadly defined, MEW is borrowing secured on housing, but not invested in it, thereby releasing funds that might be consumed.[2] HM Treasury (2003) find that MEW is more widely observed in the UK than in many other EU countries, reflecting a liquid housing market (with a high volume of housing transactions), relatively low transaction costs, and (perhaps most fundamentally) the strong upward trend in real house prices. They also find evidence that the UK's rate of mortgage equity withdrawal is partially explained by the greater level of financial deregulation that has been implemented relative to some other EU countries – a key ingredient for delivering competitive mortgage markets from which households can benefit. Indeed, MEW has picked up sharply in recent years – both in volume terms and relative to total outstanding debt, MEW has grown rapidly, particularly over the last 5 years. In volume terms, MEW greatly exceeds the levels of the late 1980s. Relative to outstanding secured lending, however, as shown in Chart 3, it remains below the peaks of 1998; it has recently begun to moderate.

…encouraging households to capitalise on higher property values

The recent moderation is likely to reflect a combination of the cumulative 125 basis points monetary policy tightening over the last 12 months (increasing debt servicing costs), and the slowing in house price growth observed in recent data. House price falls, if they were to emerge, would act as a further brake because it would reduce the quantity of equity available for households to draw upon.

Many think house prices are above their fair value

While a number of observers argue that UK house prices are above their equilibrium level, the variety of methodologies employed inevitably means there is less agreement on the scale of overvaluation:

- Buchanan and Fiotakis (2004), for example, estimated that, as of July 2004, UK house prices were some 15% above values that would be suggested by fundamentals;
- The IMF (2004) estimate that the figure may be 30-35%, closer to a Barrell at al (2004) estimate of around 30%.

Moreover, even if it were possible to agree on a level of overvaluation, the pace of any adjustment is also unknown. A very mild adjustment, based on slow growth in prices rather than falls, would clearly have less impact than a rapid correction.

Wealth effects and consumption

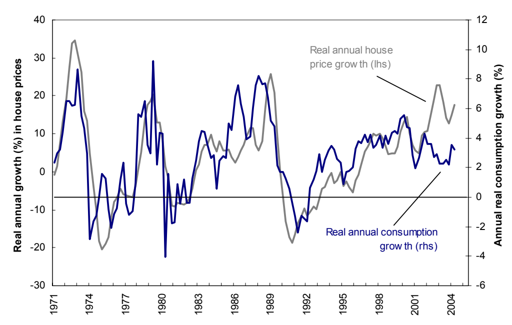
Household consumption might be expected to slow as house prices decelerate…

Rising MEW provides a source of finance for household consumption; but has it been used in this way? More broadly, does a slowdown in the housing market mean lower consumption through wealth effects? We assess whether a link can be identified between house price growth and consumption patterns in recent years.

Somewhat contrary to expectation, it is hard to establish a clear link between the growth in house prices and consumption. Chart 4, reproduced from the Bank of England (2004), shows that over the last three years, the historically close link between house price growth and consumption in the UK appears, at first sight, to have broken down. Specifically, consumption has actually been lower than would generally be suggested by the level of house price inflation.

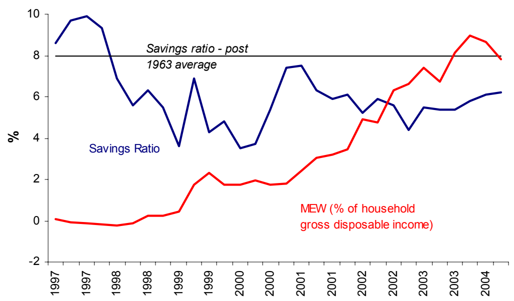
…but the link between household consumption and house prices seems to have weakened in recent years

4: Real house prices and consumption



Source: Nationwide Building Society, Global Insight

5. MEW and the savings ratio

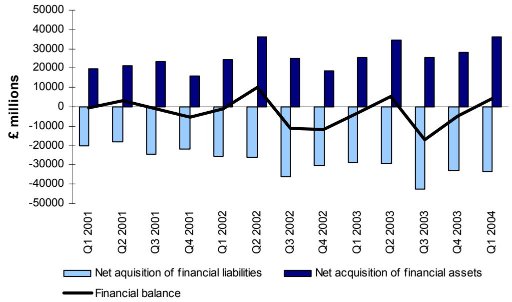


Source: Bank of England, ONS

Barrell et al (2003), however, point out that house prices and housing wealth are not necessarily the same thing; although housing wealth can increase because the value of the housing stock increases (price rises), it can also do so because the stock of housing owned by the private sector rises. They note that during much of the 1980s, there were large transfers of housing stock from the public to the private sector at below market prices (reflecting the sale of publicly-owned housing to sitting tenants), so housing wealth grew even faster than house prices. Disregarding this phenomenon means that analysis will tend to overemphasise the role of house price growth in explaining the consumption developments of the late 1980s.

Rather than comparing house prices with consumption, one further option is to examine the role of MEW more directly (Chart 5). Again contrary to expectation, the savings ratio has not been unusually low, suggesting that a drawing down of wealth from house price growth has not driven consumption unsustainably. Though slightly below its long-term (in this case, post-1963) average, the saving ratio shows no obvious sign of having fallen coincidentally with the sharp rise in MEW over the last five years. Most obviously in 2003, when MEW accounted for over 8% of household disposable income, the savings ratio remained broadly in line with its level over the previous six to seven years. This is despite low and stable levels of unemployment in the UK, which imply less need for precautionary saving.

The withdrawn equity has not all been consumed…



Source: ONS

But if the withdrawal of mortgage equity has not financed consumption, we need to ask what it has been used for. Data on household balance sheet flows in recent years suggest that while households have accumulated net financial liabilities at a rate greatly exceeding that of the late 1980s, this is largely offset by a contemporaneous accumulation of net financial assets. Focusing on the last three years (Chart 6), it becomes evident that while the household sector has moved into net financial deficit in occasional quarters, the tendency is temporary, and there is no sustained period where accumulation of liabilities exceeds that of assets. Recent data show the household sector with a small positive balance. But this does not rule out the possibility of non-negligible differences, across age and income groups, in the accumulation of net assets. Such differences matter because a more polarised distribution of wealth may mean that consumption (at least in low-wealth groups) becomes more sensitive to changes in net assets (see, for example, Davey 2001).

…but used to purchase financial assets

A changing relationship?

Pure Ricardian arguments (see, for example, Miles and Baker 2004) would argue that there is not necessarily a link between house prices and consumption, because forward-looking homeowners do not believe price rises generate an increase in real wealth: those that are moving house know that any increase in house prices is largely offset by an increase in price of any house they subsequently wish to buy; while even those bequeathed property may feel an obligation to compensate their children for the general change in house prices. But households face credit constraints preventing them from borrowing as much in the short-run as they would like – an increase in house prices is likely to ease those constraints because it increases available collateral. Many studies (for example, Henley and Morley 1999) identify a clear positive relationship between house prices and consumption in many countries, while HM Treasury (2003) concludes that the sensitivity of household spending to house prices appears stronger in the UK than in other EU countries.

Structural changes may have weakened wealth effects from house price changes…

However, as argued by Nickell (2004), the relationship between consumption and house prices need not be stable over time. There may be structural changes in the UK that change the long-term relationship. Barrell et al (2003) point out that housing wealth is now relatively less important as a proportion of total income than it was in the late 80s – and the impact of house price falls on consumption should be correspondingly lower:

- Simulations by Barrell et al suggest a 10% fall in house prices would cause consumption to fall by around 1.4% relative to the base level in the year following the shock – around 16% less than after the 1989 shock;
- In contrast, Buchanan and Fiotakis (2004) estimate that a 15% fall, to fair value, would reduce consumption by only 0.6% relative to base.

Noting also that imports now represent a greater proportion of income (thereby shifting more of the adjustment burden overseas) and that the Bank of England would also respond to any shock, Barrell et al estimate that the overall impact on *output* of such a fall would be some 40% lower now than it was in the early 1990s.

There are good reasons to think that the relationship may have weakened...

The Bank of England (2004) gives further reasons why this relationship may have changed: firstly, that due to more widespread availability of credit in recent years, households face looser credit constraints, and that house price rises will therefore have less of an impact on consumption (this is also helped by the lower mortgage rate environment, which eases credit constraints on buyers in the early years of a mortgage); and secondly, that households continue to expect the moderate wage growth of recent years (citing evidence that spending on durables, which tends to be related to income expectations, has not risen markedly). The report notes that the Bank's Monetary Policy Committee expects the relationship to be weaker in future.

…and though risks remain, fears of a collapse in consumption are overstated.

Almost inevitably, other, coincidental factors may also have dampened consumption growth in recent years, clouding a simple analysis of the relationship between house prices and consumption:

- Nickell (2002) notes that strong terms of trade improvements in the late 1990s helped drive real disposable income growth, before slowing in the period since 1999;
- Nominal average earnings growth in the private sector was also well above trend from 1996-2000 (by around 5% a year), but has since been remarkably subdued, given the strengthening labour market over the same period. In 2003, for example, nominal earnings rose by only around 3% in the private sector, the weakest rate on record. With the introduction of an increase in National Insurance Contribution rates (the UK's social insurance tax) in 2003, and significant rises in local taxation, private sector employees saw their real consumption wage fall in 2003 – which should have helped dampen consumption growth relative to the late 1990s.

… but other factors have been affecting household consumption too

One further possibility is to attribute the divergence in house price growth and consumption to equity market developments – the divergence between consumption and house price growth is most marked in 2002, when the sharpest recent falls in UK equity markets took place, implying wealth effects in an opposite direction to those arising from the housing market.[3]

Conclusion

Private consumption has helped underpin UK growth in recent years, leading many to identify two principal risks to future consumption: from higher debt servicing costs, on a historically large debt burden accumulated in recent years; and, from wealth effects associated with a slowing in house price growth, or even price falls.

Households, in aggregate, are relatively well-prepared to deal with their accumulated debt…

The first part of this two-part issue of the *ECFIN Country Focus* found evidence that households, in aggregate, appear well-able to finance a temporary increase in costs, and that debt servicing costs do not currently pose an obvious risk to consumption. Due to improvements in macroeconomic performance in recent years, and a more robust macroeconomic framework, debt servicing costs are markedly below levels observed in the late 1980s, prior to the recession of the early-1990s. But there remain risks to some households and income groups, notably from unsecured debt.

This, second, part of our analysis finds that household consumption, while clearly supportive of the UK's recent firm overall performance, has not been strong by historical standards – and certainly not as strong as might be implied by past relationships with house price growth. While the relationship between house prices and consumption may have weakened, other factors such as low disposable income growth and equity price developments will have contributed to dampening consumption in recent years.

…and there may be a smaller impact on consumption from slower house price growth than many imagine

Perhaps more significantly, there are some reasons to think that structural changes will imply a smaller effect on consumption if house price growth were to slow for a sustained period, or even fall. One promising argument is that households are now less credit-constrained than in the past (particularly in terms of their access to unsecured credit), so house price changes may have less of an overall impact on household's propensity to borrow against housing collateral – the result of a relatively efficient market for credit in the UK, and the lower interest rate environment, which removes a constraint on credit in the early years of a mortgage.

Looking forward, the current recovery in both disposable income and equity markets should bolster household consumption, while the strength of the UK labour market gives confidence that even if some households were to experience difficulties, the risks of wider contagion appear small. Some upward move in the savings ratio is likely in line with weaker house price growth, though not necessarily back to its long-term average. That argues, as in the Commission Services' autumn forecast, for a moderation of consumption in the face of a slowing housing market – but that fears of a collapse are, more than likely, overstated.

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1 A brief discussion of that episode is contained in the first part of this *ECFIN Country Focus.*

2 The Bank of England calculates MEW as the difference between net lending secured on dwellings (plus grants for housing) and households' gross investment in housing. An alternative measure of MEW, derived from individual flows, helps illustrate the way MEW takes place:

- Withdrawals of housing equity: *Last time sales* (seller does not buy new property); *trading down* (seller moves to cheaper property, mortgage is reduced by a smaller amount); *over-mortgaging* (seller moves to more expensive property, mortgage is increased by a larger amount); *remortgaging* (no sale, owner increases mortgage); *second mortgage* (no sale, additional mortgage taken out);
- Injections of housing equity: *First-time purchases* (deposit paid by first-time buyers); *under-mortgaging* (seller moves to more expensive property, mortgage is increased by a smaller amount); *under-remortgaging* (no sale, owner repays and takes out a smaller mortgage); repayments *of mortgage debt* (repayments of mortgage principal, not including remortgaging or sale); *house improvements* (home improvements paid for with unsecured funds).

3 Other factors such as employment, macroeconomic stability etc. are likely to affect underlying consumption behaviour, not least as they can change the perceived need for precautionary saving. The recent Pensions Commission report identifying a shortfall in UK private pension provision highlights another such example, which may yet have long-lasting effects on household consumption and the savings ratio. A full analysis of these issues is beyond the scope of this Country Focus, however.

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