# Re-balancing the UK economy

## IoD 2004 forecast

## Key points

- The IoD's latest forecasts show the UK economy is expected to re-balance in 2004, but not in a dramatic way. Household consumption will slow without crashing, whilst business investment is set to accelerate, but more slowly than in previous upturns. Household consumption is forecast to rise by 1.8% in 2004 with business investment growing by 3.5%.
- The IoD's new debt 'Top-up' model of consumer behaviour explains conceptually, at the individual level, how households have become overextended in recent years.
- Aggregate data shows that contrary to received wisdom, total debt servicing costs are very high by historic standards.
- The debt 'Top-up' model, together with total debt servicing costs, suggest the UK economy can be re-balanced with only a modest rise in interest rates. The IoD forecasts that base rates will peak at a maximum 4.5% or less, in 2004.

## 1 Introduction

UK GDP growth is picking up. GDP rose by 2.9% at an annualised rate in the third quarter. Growth in domestic demand was even stronger, rising at a 4% annualised rate. Given the Bank of England's view that there was little spare capacity in the UK economy – a small output gap – the latest figures displaying above trend growth lend support to the decision to raise interest rates.

The small output gap and above trend growth was not the only consideration in the Bank of England's decision. There was a parallel aim to bring about a re-balancing of the UK economy.

So how is the re-balancing process expected to work? There are two dimensions to this process. First, the UK economy needs to experience a reduction in the growth rate of household consumption and an increase in the growth rate of business investment. The share of household consumption in GDP needs to stabilise or decline whilst the share of business investment increases. Second, there needs to be a re-distribution of growth between the domestic and overseas sectors – an improvement in net exports.

With total household debt heading towards £1 trillion there were obvious concerns as to the de-stabilising effect this might have, with the risk of a pronounced boom-bust in the economic cycle over the 2004-05 period.

Many economic questions remain as yet unanswered. Have households displayed the same mistaken financial exuberance, which characterised equity markets during the dot-com boom? Is the UK economy now vulnerable to negative debt dynamics? Will much larger than expected interest rate rises be required over the coming year? In other words, will household consumption slow too sharply, or not at all?

In the wake of the interest rate rise to 3.75% a number of stylised scenarios can be foreseen over the 2004-05 period:

- Scenario 1: Modest interest rate rises – peaking at 4.5% or less – bring about a re-balancing of the economy in 2004.
- Scenario 2: Modest interest rate rises – peaking at 4.5% or less – bring about a sharper slowdown in the economy. Interest rates begin to fall in the second half of 2004.
- Scenario 3: Modest interest rate rises in the first half of 2004 fail to slow economic growth and bring about a re-balancing of the economy. Interest rates continue to rise, reaching 5% or more by the end of 2004. Re-balancing of the economy shifts into 2005.
- Scenario 4: Interest rates rise above 5% in early 2005 and trigger a sharp slowdown in household consumption.

**TABLE 1 UK GDP GROWTH – STYLISED SCENARIOS**

| Scenario | 2004 GDP % (yr-on-yr) | 2005 GDP % (yr-on-yr) |
|---|---|---|
| Scenario 1 | 2.6% | 2.5% |
| Scenario 2 | 2.0% | 2.6% |
| Scenario 3 | 2.8% | 2.2% |
| Scenario 4 | 3.0% | 1.5% |

This paper will argue that the first scenario is the most likely outcome. The IoD believes that a crash in consumption can be avoided and that the UK economy can achieve a successful re-balancing with a rise in interest rates to 4.5% or less.

Central to this view is the IoD's new 'Top-up' model of consumer behaviour, which explains conceptually, at the individual level, how households have become overextended in recent years. This analysis is reinforced by aggregate data showing that contrary to received wisdom, total debt servicing costs are very high.

We will now examine the consumption forces, which suggest a successful re-balancing can be achieved:

- Debt top-up behaviour – a new conceptual model.
- Total debt service costs – aggregate data.
- Recent household consumption growth.

## 2 Debt top-up behaviour

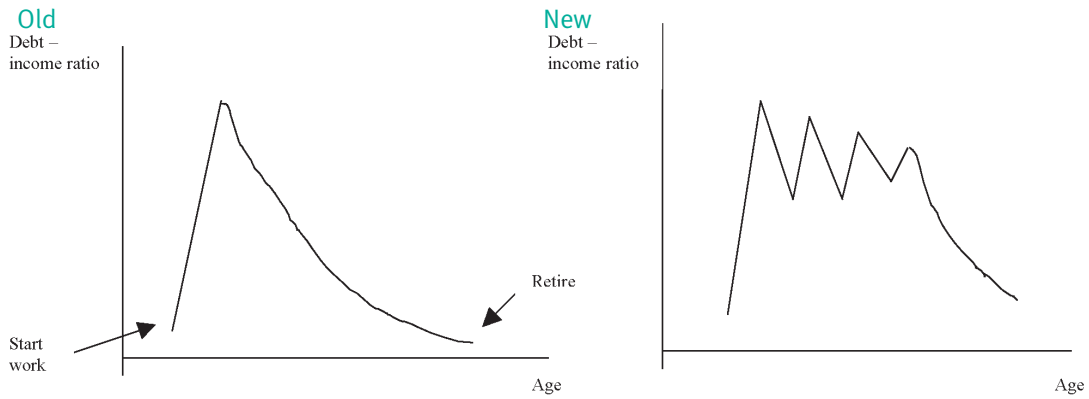
The IoD's debt top-up model of consumer behaviour illustrates how the temptations of the 'High Street' may have interacted with low interest rates over recent years:

- Myopic consumption smoothing – Economic theory predicts that consumption will be influenced not just by current disposable income (post tax), but also by consumer perceptions of permanent income. For example, a young professional might borrow heavily in their 20s and 30s, confident in the expectation that future income levels will easily meet debt payments – this is called consumption smoothing. The IoD's concept of myopic consumption smoothing focuses on discretionary income (post tax and debt service payments) and the possibility of mistaken expectations of permanent income. This arises when consumers willingly perceive every interest rate fall as a permanent boost to discretionary income – because they are looking for an excuse to spend. Myopic expectations therefore lead to a change in inter-temporal behaviour, which may need to be reversed in the future if the outlook for income and/or interest rates deteriorates, or the accumulation of debt is too large.

- Debt accumulation over the life cycle – Households may be pursuing new behavioural patterns whereby they allocate a set amount of their monthly budget for debt servicing – both mortgage (secured) and credit cards (unsecured) – and if interest rates then fall, debt levels can be increased, whilst maintaining previous monthly debt servicing costs. The concern of the IoD is that UK households do not seem intent on reducing debt burdens but are instead interested in attaining the maximum debt income ratio consistent with affordable debt servicing levels. The conceptual diagram of this 'top-up effect' for an individual in a low inflation environment is shown in Charts 1a and 1b. Chart 1a shows a traditional view of how individuals accumulate debt over the course of the life cycle – borrowing when young, primarily for house purchase and then paying back the debt until retirement. Chart 1b shows what we believe is the contemporary picture, whereby across the age range people aim to maximise debt subject to the affordable debt servicing constraint – the monthly cost of borrowing. This process might be expected to start with people initially adding more to their credit card debt and then over time exploiting growth in house prices to increase mortgage equity withdrawal.

**CHARTS 1A AND 1B**

The Top-up effect – a conceptual diagram over an individual life cycle



If individuals are continually 'topping-up' debt levels across all age groups, one would expect the average debt income ratio for each age cohort to be increasing over time.

Unfortunately debt-income statistics by cohort are not available beyond 2000. However, the British Household Panel Survey (BHPS) does provide comparisons between 1995 and 2000. The BHPS shows that between 1995 and 2000 total debt income ratios by cohort rose for the 55+ age group[1] . Recent years have also seen strong growth in equity release plans for the retired – so-called 'blowing the kids inheritance'. These schemes tend to be either roll-up (whereby homeowners borrow money against their property, without paying interest, and the debt is then paid off at a future date when the property is sold) or reversion plans (whereby homeowners sell their home but are then allowed to remain in the property until death).

The BHPS also shows that unsecured debt-income ratios rose across all age groups. Our strongly held suspicion is that the findings of the next BHPS will show that since 2000 secured debt-income ratios will also have increased owing to the sharp rise in mortgage equity withdrawal in recent years. Unsecured debt-income ratios are expected to have increased further as well.

If top-up behaviour has been a characteristic of UK households over recent years, overall levels of debt servicing should be high. However, the general perception is that they are low, because of historically low interest rates. We now examine the issue of debt servicing costs and whether in reality they are at an historic low.

## 3 Total debt service costs

Basic debt servicing ratios (interest rate-income gearing) are at a historic low when measuring the cost of interest rate servicing. Council of Mortgage Lenders data shows that for the average UK household with a mortgage, the mortgage interest-income gearing ratio is now 14% compared with 34% in 1990. We are paying much lower mortgage interest costs but the size of mortgages are much higher than they used to be. This illustrates the obvious point that consumers need to repay debt. They also have unsecured (credit card, personal loans etc) payments as well. Taking all mortgage and unsecured interest and principal repayments, households with an average mortgage and average levels of unsecured debt are now paying 34% of income in debt servicing costs (17% in interest payments alone).

Recent work by Capital Economics[2] provides strong additional evidence that households are highly geared at the present time.

Capital Economics have constructed an aggregate measure of total income gearing, incorporating

[1] A recent Prudential survey (reported in The Sunday Telegraph, 24th August 2003) found that 750,000 people over the age of 65 have aggregated personal debts of £1.1 billion (excluding mortgages). The average unsecured debt per individual was found to be 71% higher than in 1996. One in three pensioners now has a credit card compared with one in four in 1999.

[2] Gearing up for a household borrowing slowdown, UK Economics Focus, Capital Economics, 26th November 2003.

all interest, mortgage interest, regular mortgage repayments, endowment redemption payments and unsecured repayments. This shows that whilst income gearing measured using interest costs is just 7% of household income, when debt repayments are included this rises to 15% and 20% if endowment redemption payments are included. Capital Economics has estimated that:

*"Whereas income gearing on just interest payments measures is less than half its early 1990s level, on both of the wider measures, it is almost at the levels reached in the last boom/bust … the amount of their income that households are paying to service their record levels of debt is not far off the peak in the late 1980s. This is despite the fact that interest rates have only just started to rise from a 48 year low."*

We are now faced with the turn in the interest rate cycle with higher interest rates needing to be paid on record levels of outstanding debt. Capital Economics have estimated what would happen if debt continued to rise at recent growth rates and interest rates increase by a further 1%, 2% and 3% respectively. Their conclusions are:

- A 1% rise in interest rates takes income gearing to just over 24% – its previous peak in 1988.
- A 2% rise would result in households paying just over a quarter of their income in debt.
- A 3% rise would raise this figure to 28%.

This aggregate analysis clearly supports the IoD's stylised top-up model and our hypothesis that households are close to their affordable limit in terms of total debt servicing costs. The conceptual analysis and aggregate data support the IoD's hypothesis that household consumption can be slowed relatively easily. However, our conclusions depart with those of certain commentators in that we believe a crash in consumption can be avoided.

## *Will there be a crash in consumption?*

Consumption has risen sharply as a proportion of GDP in the UK over recent years and cannot realistically be expected to continue to rise at current rates. Between 1997 and 2003 household consumption increased from 61% to 65% of GDP. This increase is measured at constant prices, which is slightly misleading, because over the period falling import prices for PCs and other items – and due to the exchange rate – has meant that at current prices the consumption share has only risen from 62% to 63% over the same period. Despite this caveat, it is clear that the Bank of England wants to bring about a re-balancing of the economy. The MPC is obviously worried that if left unchecked, household borrowing and consumption will continue apace and de-stabilise the economy.

According to the Bank of England, secured mortgage debt has increased from 76% to 96% of household income over the 1997-2003 period. The stock of unsecured mortgage debt has increased to 22% of household income in 2003 – attributable to a combination of easier availability of credit and/or falling unsecured borrowing costs.

The increase in the secured debt ratio is probably due to a combination of cyclical and structural influences. The primary structural explanation is long-term growth in owner occupation. Cyclical factors relate to the low interest rate environment, the boom in house prices and the associated

explosion in mortgage equity release to more than 6% of disposable income over the past year. Despite the surge in debt levels to date, there is good reason to believe that this process will not necessarily end in tears:

- Nominal versus real measures of consumption – Recent growth in household consumption looks less excessive when measured in nominal as opposed to real, terms. Does this mean that the risk of a sharp retrenchment in household consumption is low? The IoD's view is yes, but with certain qualifications attached. First, similar observations regarding the difference between real and nominal measures could have been made at the end of the 1980s, and this did not prevent a subsequent sharp retrenchment in household spending. Second, the relative strength of real household spending has been facilitated by the relative weakness of the prices of goods and services purchased by households compared with those in the rest of the economy. Certain commentators[3] have been prominent in arguing that "this weakness could soon come to an end as a lower exchange rate worsens the terms of trade and the upward pressure on prices in the public sector fades".

- Structural changes in debt – Growth in fixed rate mortgages may mean that traditional econometric models are misleading as to the effects of variable interest rate changes on the economy. Moreover, financial services providers are enabling unsecured debt to become secured debt and thereby reducing the spread over base rates. Other forms of credit consolidation are also possible, such as continual shifts in credit card balances to take advantage of zero interest rates on transfers.

- Measurement issues – The debt ratio is misleading as a measure of economic exposure. The numerator is the sum of total debt, whilst the denominator is the sum of all incomes i.e. those with and without debt. A better measure would show the ratio of total debt to the total incomes of those in debt. Such a measure[4] is only available up until 2001, but does show that over the 1995-2001 period the secured debt to income ratio for mortgage holders increased from 1.24 to 1.25 – at a time when the standard debt income ratio rose much faster. There can be little doubt that the adjusted debt income ratio will have increased since 2001, at the very least because of the growth in mortgage equity release in recent years.

- Housing equity – The growth in equity release has not been alarming when measured against retained housing wealth. Bank of England estimates show that because of the growth in house prices over recent years, undrawn housing equity has actually increased from 65% to 77% of housing wealth over the 1996-2003 period.

- Debt wealth ratios – The ratio of total debt to total assets is relatively close to the average of the past two decades. Wealth is now being underpinned by: (1) Housing market ripple effects extending north across the country. (2) The rise in the stock market in 2003 has led to double digit growth in net financial wealth. On some calculations the net wealth to income ratio may be close to the all time peak recorded in 2000. As a result, positive wealth effects on consumption remain strong.

[3] Real or nominal, imbalances are a major concern, UK Economic Focus, Capital Economics, 23rd October 2003.

[4] Available from the British Household Panel Survey.

- Net acquisition of financial assets – Net acquisition of financial assets actually rose from 0.2% to 1.2% of household income between 1998 and 2003Q1. In aggregate, households have been expanding both the liability and asset sides of their balance sheet. What is unclear from the data is the extent of any mismatch i.e. debt accumulation concentrated in certain households and asset accumulation in others.

- Disposable income growth – The slowdown in household consumption growth seen in 2003 may well be explained – in part – by slower growth in incomes. Annual growth in real household disposable income slowed to 1.4% in 2003Q2 from a 2.9% average over the post 1995 period. However, continued growth in public sector pay and employment provides support to household disposable income.

- Savings ratio – The household savings ratio has been relatively stable over recent years, ranging from 6.7% in 2001 to 4.8% in 2003Q2. At current levels the savings ratio does not suggest a sudden upward shift as a result of a swing towards precautionary behaviour on the part of consumers. The inflation adjusted savings ratio is not low by historical standards. The Bank of England argues that since the mid-1990s income volatility has been lower, and this may have helped to reduce consumer perceptions of future income uncertainty – such as at times of rising unemployment and falling household income. If so, this would have led to a reduction in the desired savings ratio. In other words, macroeconomic stability may have permitted lower levels of saving and higher levels of debt. Of course, if these improved expectations prove to be false, households could swiftly revise down their expectations and raise the level of desired savings rate.

- Dutch disease – The Dutch economy experienced a large rise in household debt in the 1990s and a subsequent sharp economic slowdown. However, part of the severity of the Dutch slowdown could be attributed to a loss of control over interest rate policy within the euro, and an inability to set monetary policy appropriate for domestic economic conditions. Unlike the Netherlands we still have control of monetary policy and could therefore reduce interest rates if the economy begins to slow too fast.

- Tax hikes – The deterioration in the public finances risks further tax rises which then squeeze disposable income growth. However, on balance the Chancellor can probably avoid tax increases in 2004 and still satisfy his fiscal policy Golden Rule.

Despite this relatively optimistic assessment, it would be foolish to ignore potential downside risks. Two potential risks stand out:

- Exogenous shocks – Such shocks could take various forms and might include an act of mega-terrorism. Danger would arise if a future economic shock triggered a sharp adjustment in employment levels as a result of an anticipated and/or realised deterioration in corporate finances. In such an environment of rising unemployment, debt income ratios would also begin to rise even if total outstanding debt remained constant. This in turn could result in a swift upward movement in the savings ratio.

- Real house prices – Throughout the post-war period the peak in the house price cycle has been followed subsequently by a fall in real house prices. If this tendency were to be repeated there would be a clear risk of falls in nominal house prices – given that general inflation is so low.

## 3 Recent household consumption growth

Household consumption growth has clearly weakened already in 2003, having grown by 4.5% in 2000, 3.1% in 2001 and 3.6% in 2002. Thus far in 2003, household consumption has grown by 2.8% (yr-on-yr) in Q1, 2.4% (yr-on-yr) in Q2 and 2.5% (yr-on-yr) in Q3. In other words, households were already beginning to bring their spending under control, before the rise in interest rates.

## 4 The outlook for business investment

The IoD has recently published a major study on the business investment outlook in the UK[5]. This report concluded that despite an improvement in corporate finances over the 2002-03 period, economic uncertainty and historically high levels of gearing (including pension fund deficits) have provided companies with an incentive to postpone or delay investment. Rebounding stock markets have helped corporate gearing, but levels remain high by historic standards.

Latest third quarter figures show overall business investment remained weak. However, corporate liquidity is not a constraint on investment and recent growth in unused corporate credit facilities suggests borrowing will pick-up over the coming months[6]. When combined with the level of corporate surplus, improved corporate confidence and the influence of the IT replacement cycle, our conclusion is that business investment is set to recover.

The IoD argues that business investment will accelerate in 2004, but there will not be a strong cyclical recovery in business investment. The IoD forecasts business investment growth of 3.5% next year.

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*December 2003*

[5] Uncertainty, uncertainty, uncertainty – the outlook for UK business investment, Graeme Leach, IoD Policy Paper, August 2003

[6] Source: Higher interest rates and corporate borrowing, Lombard Street Research, 3rd December 2003.