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# Fibs, damned fibs and the UK's national accounts

## Trying to make sense of the GDP figures for the first half of 1995

**According to the national accounts, domestic demand grew at almost a 6% annualised rate in the second quarter!**

As usual, Britain's economists are having great difficulty forecasting the past. Several features of the second quarter (Q2) national accounts, published on 21st August, are puzzling. The first surprise is that net exports (i.e., exports minus imports) fell between Q1 and Q2 by £1.3b., the equivalent of about 1% of quarterly GDP. (All figures here and below are seasonally adjusted, in 1990 prices.) The deterioration in net exports looks odd when compared with the optimistic noises coming at the same time from British exporters. At any rate, one consequence is that the increase in GDP depended on a surge in domestic demand. Indeed, domestic demand allegedly went up by 1.4%, implying an annualised rate of almost 6% or virtual boom. This simply defies belief. There was very little evidence "in the real world" which was consistent with a 6% annualised growth rate in UK domestic demand between end-March and end-June 1995.

**.... but much of this was due to stockbuilding,**

The second curiosity is the extent to which the growth in domestic demand supposedly relied on stockbuilding. Of the £2.0b. total increase in domestic demand between Q1 and Q2, £1.2b. was due to domestic final sales and £0.8b. to the increase in stockbuilding. Stockbuilding is in fact estimated to have been rather high for several quarters, amounting to £4.4b. in the year to Q2 1995 compared with £1.1b. in the year to Q2 1994. Some increase in stockbuilding was to be expected, as companies initially were rather slow to adjust production to signs of reviving orders and sales during 1993 and early 1994. But the level of stockbuilding in Q2 1995 is again surprising, even though it fits the survey evidence better than the poor export performance. If the official estimate is right, parts of the economy are now rather over-stocked and late 1995 could see a stocks shake-out, with price cuts "to clear the shelves".

**which may be followed by a stocks shake-out**

The Q2 1995 GDP numbers will be revised. About that there can be no doubt. On past form, the revisions could be substantial. Thus, the latest numbers for Q2 1994 are radically different from those published a year ago, showing domestic demand up by £2.2b. from Q1 1994 instead of the originally-estimated £0.9b. A reasonable guess is that the official statisticians will decide that they over-estimated price increases on exports in early 1995 and therefore under-estimated export volumes. Survey evidence continues to suggest that export-oriented manufacturing is doing better than the retail trade and the construction industry. But, despite all the uncertainties, a message is beginning to emerge for monetary policy. If late 1995 does see a stocks shake-out, and if the reports from retailers and construction companies are even half-right, the authorities may have to think about cutting interest rates, not raising them.

Professor Tim Congdon

31st August, 1995

# Summary of paper on

## 'The condition of the British financial system, late 1995'

**Purpose of the paper**

It is now almost a year since UK interest rates began to increase. The purpose of this paper is to consider the effects of the rise in interest rates on the balance-sheet strength of the banking system and the main sectors of the economy.

### Main points

* **In late 1994 and early 1995 the Bank of England raised interest rates in three steps, with clearing bank base rates going up from 5 1/4% on 12th September to 6 3/4% on 3rd February. The move to dearer money occurred despite evidence of continuing weakness in the personal sector's balance sheet.**

* **The corporate sector's financial position is quite strong (see p. 12), while the banking system - with retentions boosted by a big rise in profits - appears to be rather over-capitalised. The over-capitalisation will be exaggerated by the de-mutualisation of building societies. (See p. 11.)**

* **Balance-sheet problems remain concentrated in the personal sector and stem, in particular, from the behaviour of the housing market. 1995 will be the sixth year in a row in which the change in house prices is less than the mortgage rate. (See p. 6.)**

* **The rise in interest rates since last autumn was followed by a higher level of personal bankruptcies and mortgage repossessions in early 1995. (See the comments to the charts on p. 4 and p. 7.) The ratio of mortgage debt to the value of the housing stock is at an all-time high and the demand for mortgages is weakening. (See p. 7.)**

* **But the over-capitalised banking system has slashed margins on corporate loans, helping to stimulate takeover activity and leading to higher lending growth in early 1995. (See p. 9.) Despite the problems in the housing market, the economy is not about to enter a recession.**

This paper was written by Professor Tim Congdon, with help from Rob Miller and Stewart Robertson.

# The condition of the British financial system, late 1995

## Contrasts in balance-sheet strength between the personal sector and the rest of the economy

**Recovery in financial system since late 1992,**

Back in October 1992 the *Gerrard & National Monthly Economic Review* surveyed the balance-sheet position of the different sectors of the economy and reviewed the capital strength of the banking system. Its main conclusions were that the financial system was extremely weak and that a drastic change in macroeconomic policy was needed. Happily, the pound's departure from the European exchange rate mechanism on 16th September paved the way for a large drop in interest rates, from 10% to to a low of 5 1/4% on 8th February 1994. The housing market improved, commercial property recovered (see p. 5 of this study) and the banks' incurred lower levels of bad debt (see p. 8). By early 1994 the corporate sector and the banking system were well on the road to recovery. Monetary growth had plunged from high double-digit rates of growth in the late 1980s to single-digit rates of growth in 1991, causing many of the balance-sheet strains. But it stabilised in late 1991 and 1992, and remained at about 5% a year until late 1994.

**but the personal sector's balance sheet remains very strained**

The October 1992 exercise was repeated in October 1993 and October 1994. The current issue of the *Monthly Economic Review* is on the same lines. The main features are much as in October last year, when the verdict was "clear signs of recuperation, but housing remains a problem". However, there is one clear difference, that the rise in interest rates since last September has reversed the progress towards lower levels of mortgage repossessions and personal bankruptcies that had been achieved since late 1992. (See p. 4.) The reversal is striking. The underlying cause is that the change in house prices remains beneath the mortgage rate (see p. 6), which makes it difficult for people to reduce their mortgage debt relative to the value of the houses they own (see p. 7). Until the housing market revives, fears of a large rise in interest rates will prove misplaced.

**Excess capital in the banking system may stimulate more corporate deals**

However, the higher interest rates have had little adverse impact on companies or the banking system. Industrial and commercial companies are running an exceptionally large financial surplus and have a very healthy ratio of money holdings to their bank borrowings. (See p. 12.) With fixed investment in many industries still deterred by weak consumer spending, this financial surplus looks set to continue and companies have embarked on more takeovers. They have been encouraged in this by a sharp drop in margins on bank loans, a reflection of an emerging excess of capital in the banking system. The excess of capital will be aggravated by the de-mutualisation of building societies, since the former building societies' reserves can now be deployed to support all sorts of lending and not mortgages alone. (See p. 11.)

# Bankruptcies and failures

## Personal bankruptcies may remain high for some time

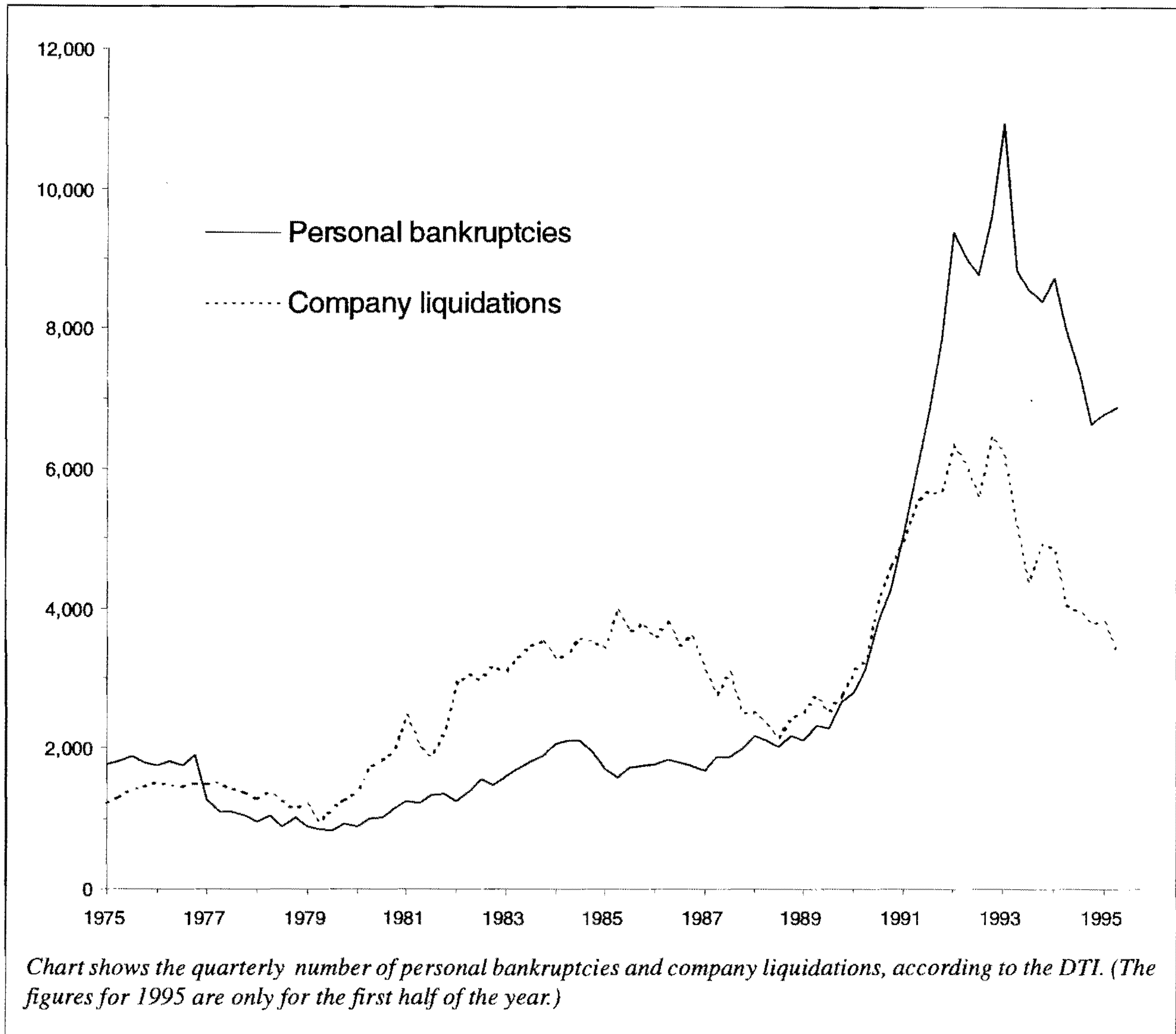
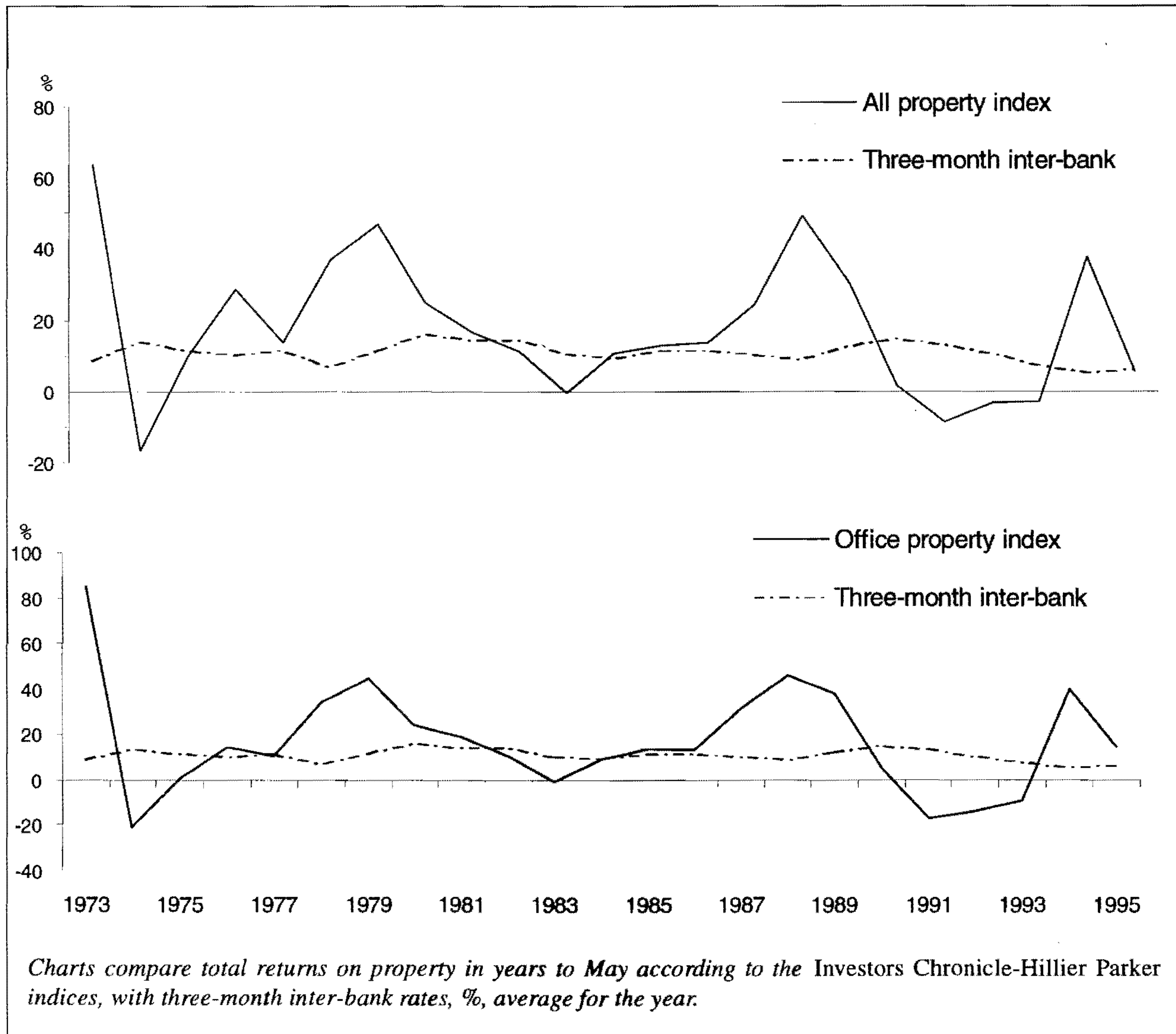



*Chart shows the quarterly number of personal bankruptcies and company liquidations, according to the DTI. (The figures for 1995 are only for the first half of the year.)*

Personal bankruptcies have fallen from their peak of almost 37,000 in 1992, but are continuing to run at historically high levels. The remarkable rise in the last five years is attributable to the depressed housing market where falling house prices have battered households' balance sheets. Having dropped to an annualised equivalent of 26,400 in the fourth quarter of 1994, bankruptcies actually rose slightly in each of the next two quarters. These small increases are probably due to the three interest rate rises since September last year. Repossessions were higher in the first half of 1995 than in the previous six months. On the corporate front the news is more favourable, with failures now down to levels comparable with the 1980s. Unlike households, companies have repaired their balance sheets successfully in the 1990s.

# The state of the commercial property market

## Total returns continue to be held back by over-supply




*Charts compare total returns on property in years to May according to the* Investors Chronicle-Hillier Parker *indices, with three-month inter-bank rates, %, average for the year.*

As many commercial property purchases are financed by borrowing, the relationship between total returns and interest rates is crucial. Between 1990 and 1993 short term interest rates exceded total returns which were negative in three out of the four years. Many property companies went bankrupt and banks, which had lent heavily to the property sector, incurred substantial bad debts. In the year to May 1994 the performance was much better with total returns close to 40%. Much of the improvement was due not to higher rents but to a surge in capital values which seems to have ended. Returns since mid-1994 have dipped sharply and prospects for sustained rental growth continue to be limited by over-supply of space. The outlook for property remains unexciting, but the crisis is over.

# The state of the housing market

## 1. The relationship between house price changes and the mortgage rate

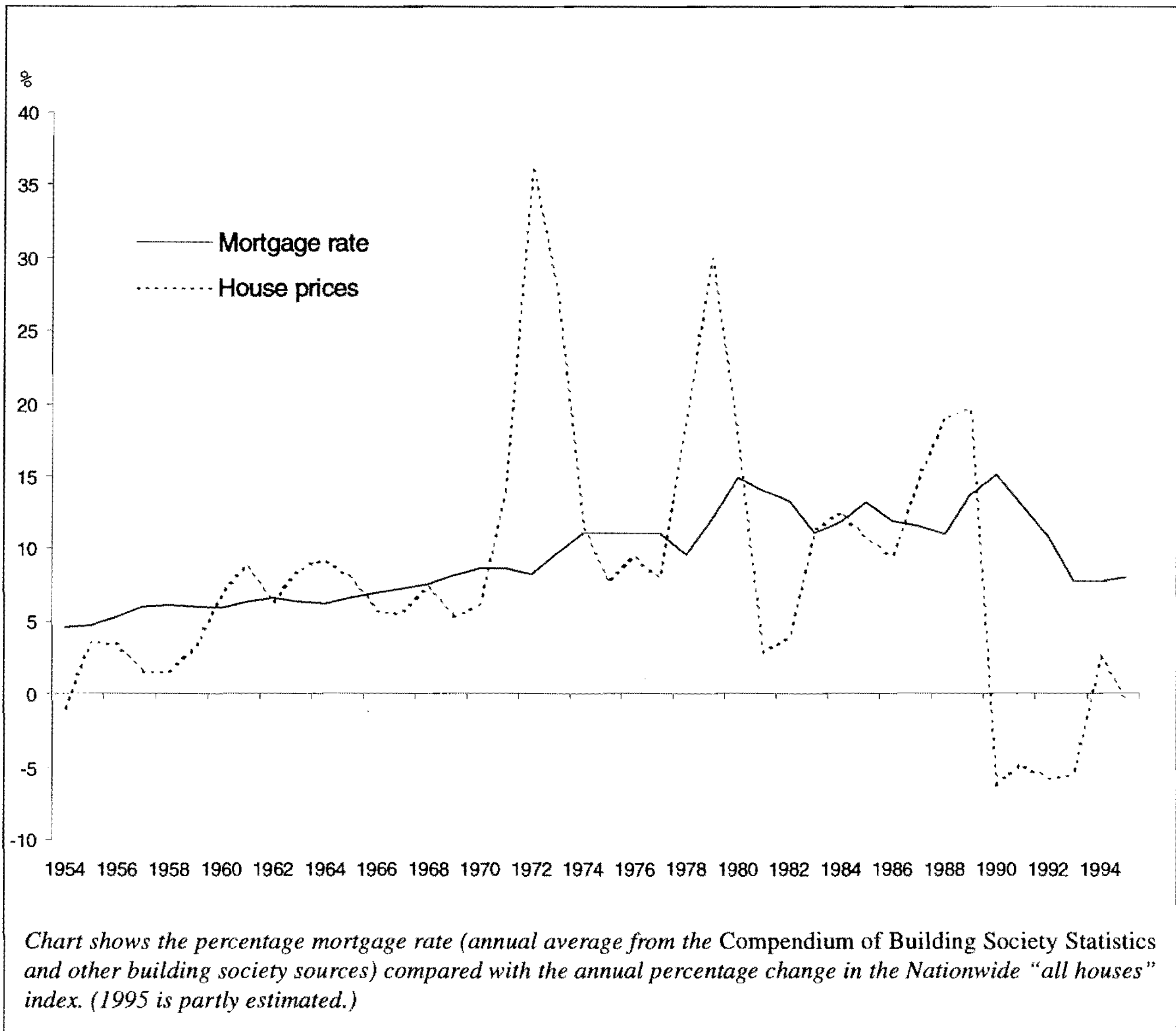
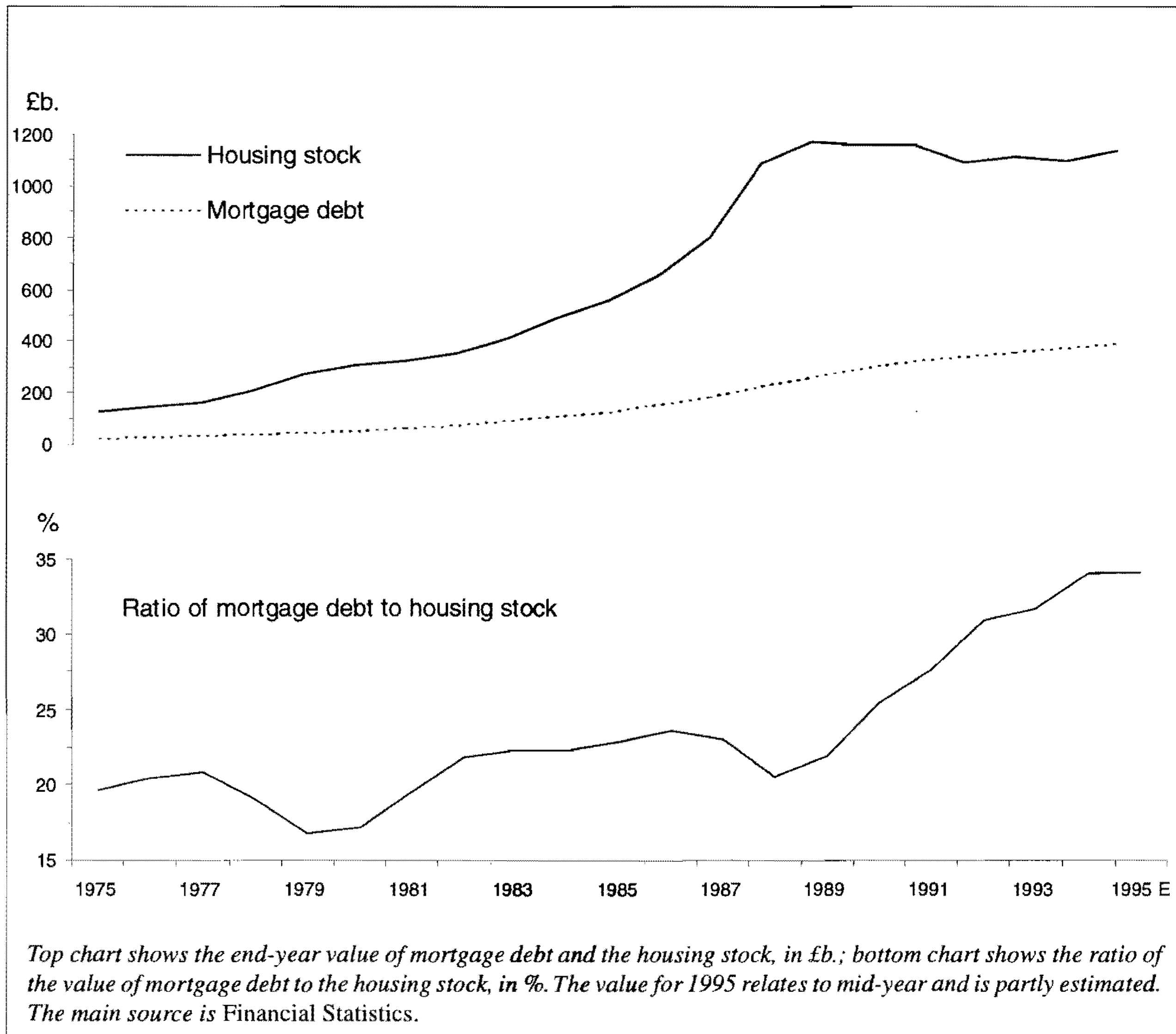



*Chart shows the percentage mortgage rate (annual average from the* Compendium of Building Society Statistics *and other building society sources) compared with the annual percentage change in the Nationwide "all houses" index. (1995 is partly estimated.)*

Apart from the small revival seen in late 1993 and early 1994 house prices have now been falling for almost five years, an unprecedented occurence in the post-war period. Housing wealth represents over 50% of total personal sector wealth, while mortgage debt accounts for almost 75% of total debt. Falling house prices therefore have an immediate impact on the health of households' balance sheets and on their spending patterns. In the late 1980s people were happy to withdraw equity from their homes (via higher mortgage borrowing) in order to finance other spending because house prices were rising. But recently homeowners have injected equity by increasing repayments in an attempt to reduce their indebtedness. The rise in interest rates since September last year has exacerbated the problem.

## 2. Mortgage debt and the housing stock

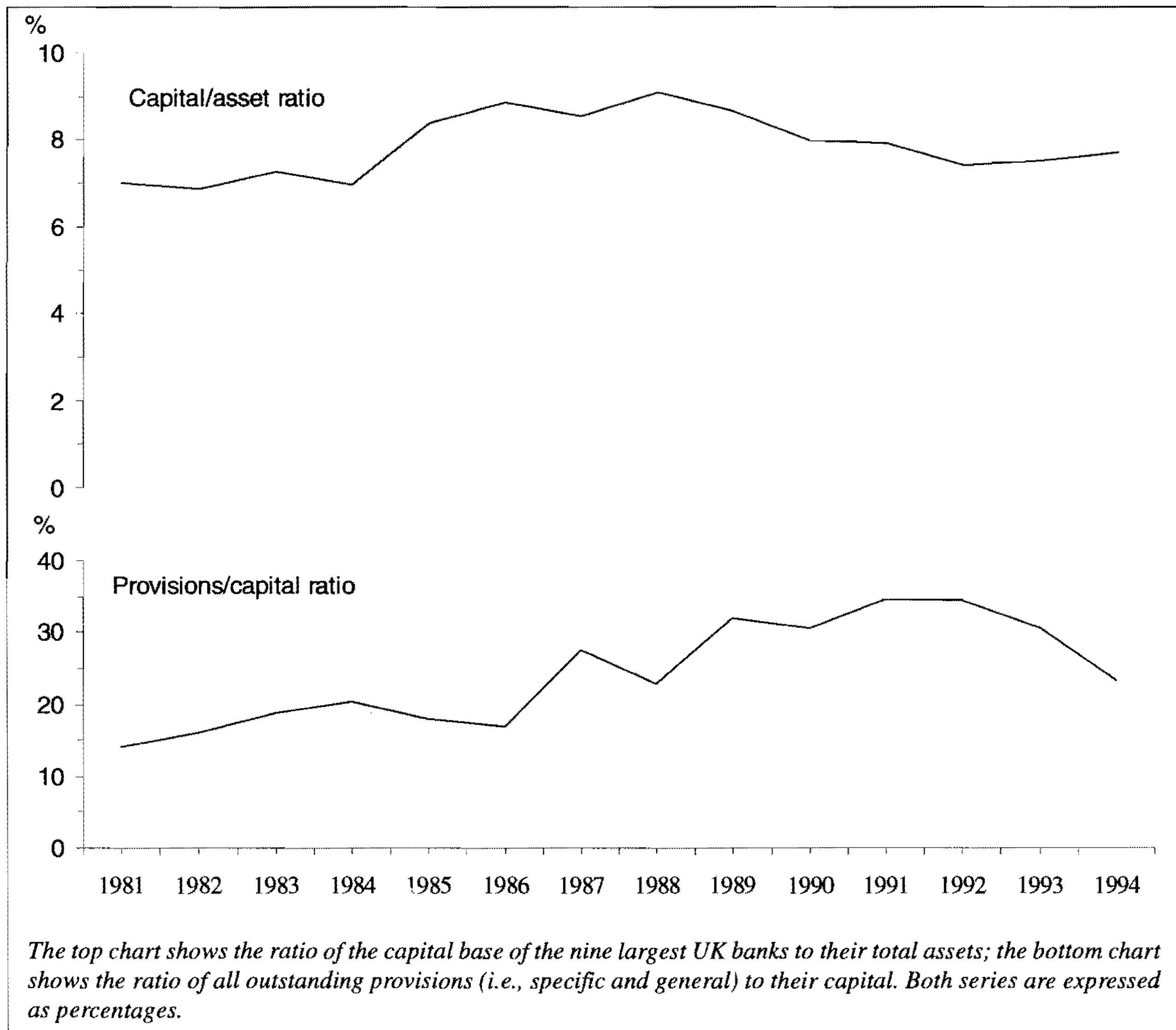



*Top chart shows the end-year value of mortgage debt and the housing stock, in £b.; bottom chart shows the ratio of the value of mortgage debt to the housing stock, in %. The value for 1995 relates to mid-year and is partly estimated. The main source is* Financial Statistics.

Average house prices across the UK were 15% lower in July this year than at their peak five years ago, according to the Nationwide index. But, as mortgage debt has continued to rise, the ratio of debt to the value of the housing stock increased from just over 20% in 1988 to an estimated 34% by mid-1995. This trend is totally different to the experience in the 30 years to 1990 when the ratio tended to fluctuate around 20%. It does much to explain the persistent absence of the "feel-good" factor amongst consumers. Those affected most obviously are households with negative equity (estimated at over one million). Mortgage debt is currently rising much more slowly than in the past as existing borrowers continue to repay debt. But unless house prices begin to rise sharply the ratio of mortgage debt to home equity will remain high.

# The condition of the banking system

## 1. Banks are no longer constrained by capital




*The top chart shows the ratio of the capital base of the nine largest UK banks to their total assets; the bottom chart shows the ratio of all outstanding provisions (i.e., specific and general) to their capital. Both series are expressed as percentages.*

The capital/asset ratio of the major British banks at the end of 1994, at 7 3/4%, is back in line with its level at the beginning of the 1990s. Gross income in 1994 of £29.1b. was broadly the same as in 1993, but pre-tax profits jumped to £8.1b. from £5b. and retentions doubled to £3.2b., or 10.4% of combined shareholders funds of £30.8b. at end 1994, as a result of a 40% cut in net provisions. It is possible that provisions may be cut further in 1995 given the improvement in company balance sheets that has occurred over the last two years. The clear implication is that the major British banks are in a position to expand their balance sheets aggressively. However, with the personal sector's balance sheet strained by excessive mortgage debt, the demand for credit may be subdued over the next year or two. Banks are increasingly over-capitalised and margins on corporate loans are being cut.

## 2. But credit growth has been distorted by takeover activity

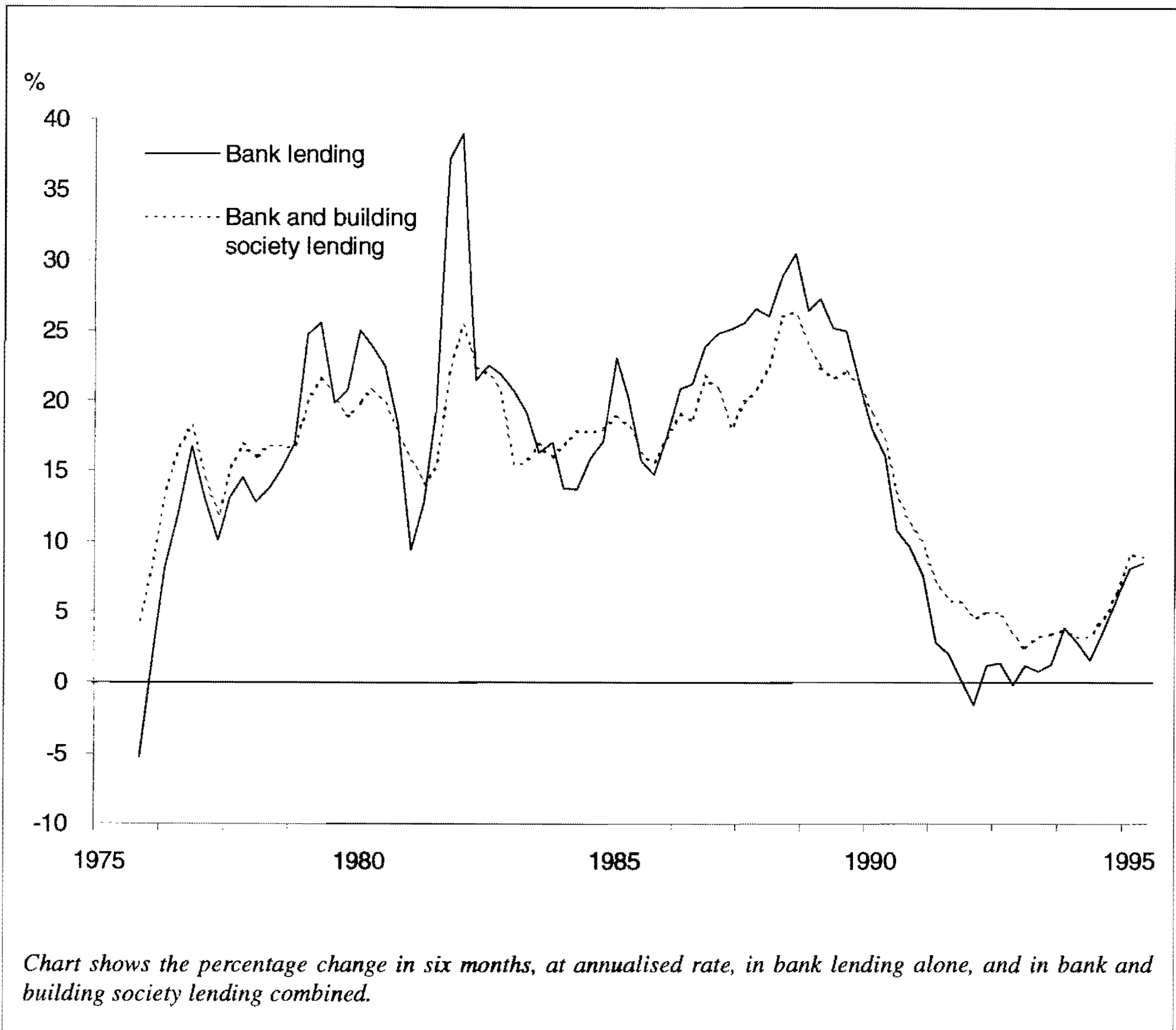
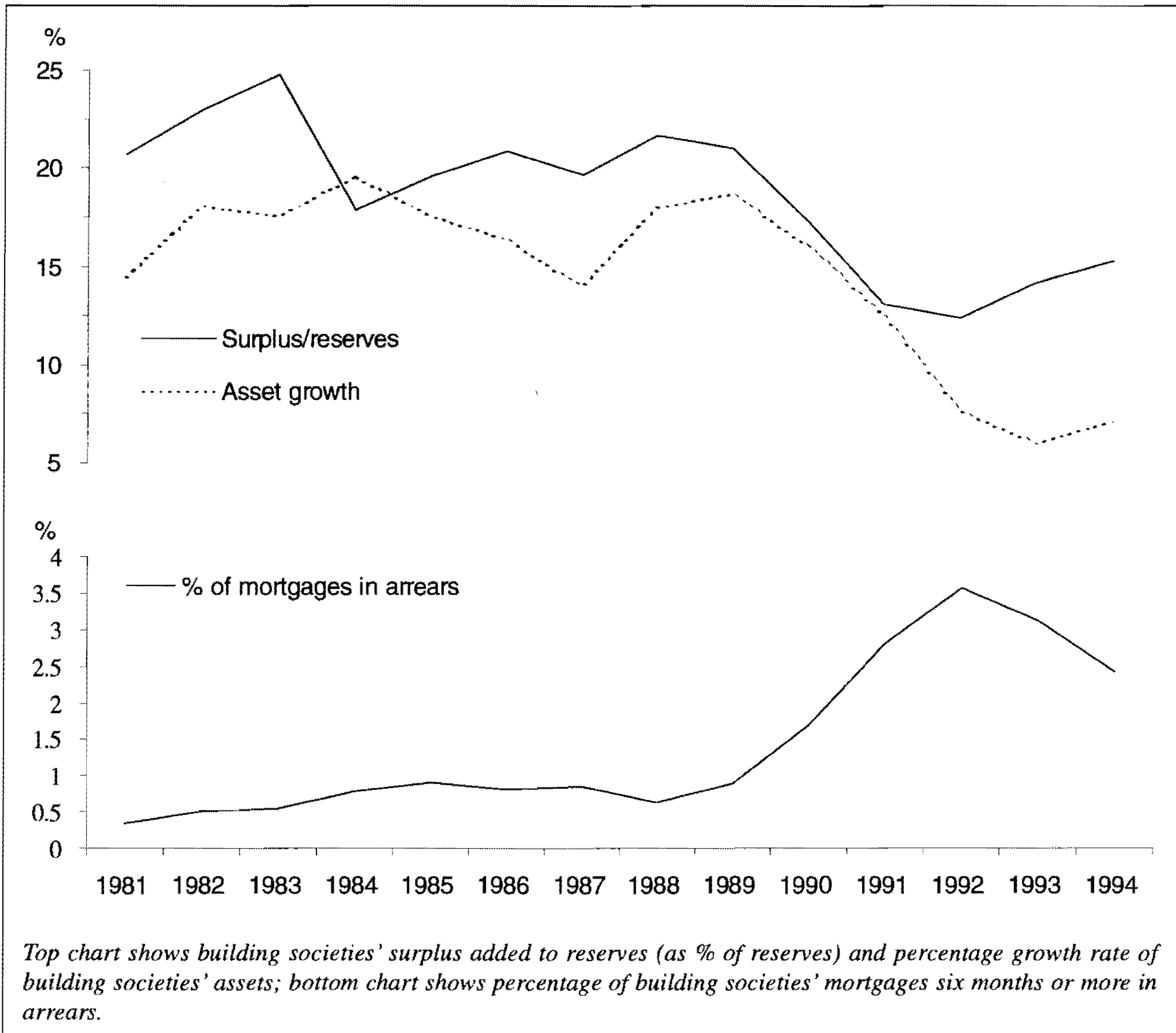



*Chart shows the percentage change in six months, at annualised rate, in bank lending alone, and in bank and building society lending combined.*

There are good reasons to doubt whether the acceleration in lending seen during the first half of this year will be maintained. The recovery in credit growth is due in part to the impact of takeover activity and in particular the Glaxo-Wellcome deal, which added £6b. to M4 lending in the first half. Credit growth has been further boosted by the takeover of the Cheltenham & Gloucester building society by Lloyds Bank. However, lending secured on dwellings, which accounts for a little over 50% of outstanding loans to the non-bank private sector, remains weak. Moreover, leading indicators of future demand for mortgage finance suggest it is weakening. Unless corporate borrowing to finance takeovers continues, it is likely that credit growth will slow sharply.

# Trends in the building society movement

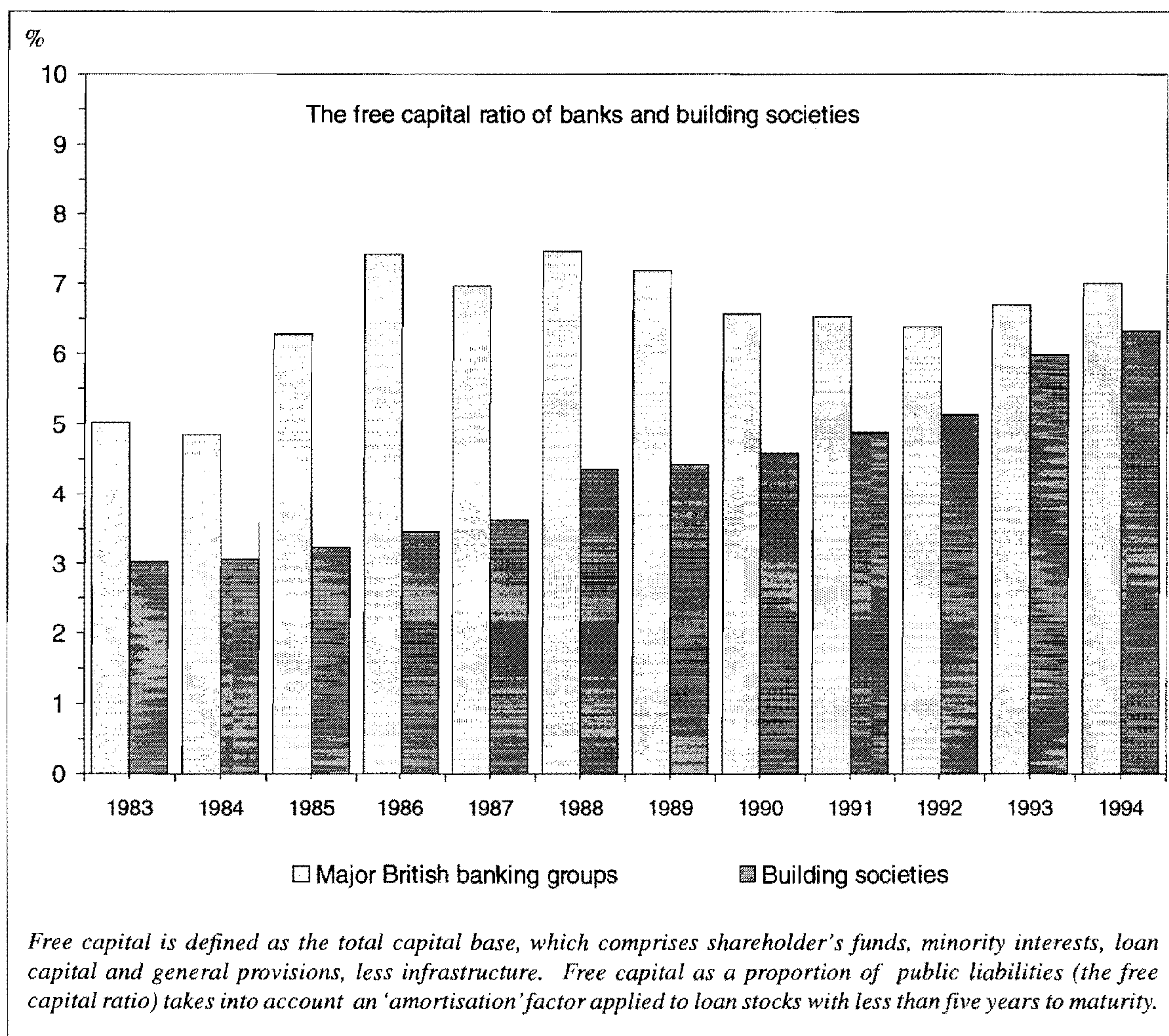
## 1. Building societies are in a position to expand their balance sheets




*Top chart shows building societies' surplus added to reserves (as % of reserves) and percentage growth rate of building societies' assets; bottom chart shows percentage of building societies' mortgages six months or more in arrears.*

Building societies' surplus (i.e., their profits) increased in 1994, rising as a proportion of reserves (i.e., capital) to 15 1/4% from 14.2 % in 1993 and 12.3% in 1992. Asset growth also picked up, but remains very modest compared with the 1970s and 1980s. The ratio of reserves to assets has increased as a consequence so that building societies are now in a position to expand their balance sheets. The rise in the surplus is a reflection of reduced bad debt provisions as the housing market stabilises, the percentage of mortgages six months or more in arrears having fallen to less than 2 1/2% in 1994 from over 3% in 1993. However, personal sector balance sheets are still under strain from excessive levels of debt and demand for mortgages is likely to remain weak. Building societies are therefore accumulating capital, while demand for their product remains subdued.

## 2. Building societies appear to be over-capitalised




*Free capital is defined as the total capital base, which comprises shareholder's funds, minority interests, loan capital and general provisions, less infrastructure. Free capital as a proportion of public liabilities (the free capital ratio) takes into account an 'amortisation' factor applied to loan stocks with less than five years to maturity.*

Historically, residential mortgage lending was much less risky than most forms of bank lending. Building societies could safely have lower ratios of reserves/ capital to assets than banks and they required lower profit margins on their mortgage books than banks on conventional loan portfolios. Partly for these reasons they grew more quickly than the banks in the 30 years to 1990. However, under regulatory pressure and because of the Basle rules agreed in 1988, the building societies have had to bring their capital adequacy more into line with the banks. With the demand for mortgages now drastically weaker than in the 1980s, they have more capital than they need in their traditional business. This provides a large part of the explanation for the current phase of building society de-mutualisation.

# Company finances

## Healthy corporate balance sheets argue for further takeover activity

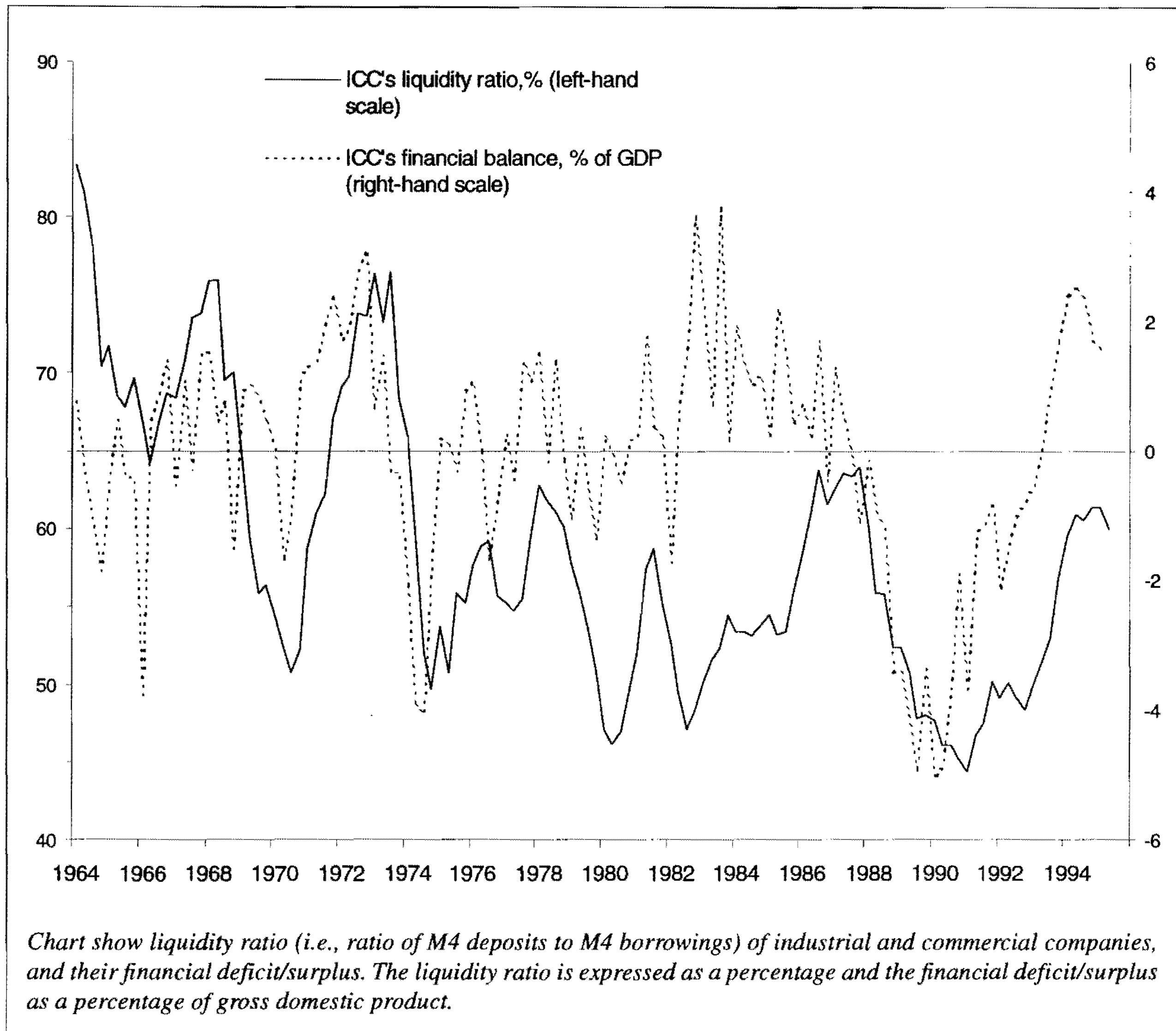



*Chart show liquidity ratio (i.e., ratio of M4 deposits to M4 borrowings) of industrial and commercial companies, and their financial deficit/surplus. The liquidity ratio is expressed as a percentage and the financial deficit/surplus as a percentage of gross domestic product.*

Having recovered completely from the debt-ridden excesses of the late 1980s, company balance sheets currently look extremely healthy. Between mid-1992 and mid-1994 companies repaid over £9b. of loans to banks and building societies, allowing the liquidity ratio to recover from under 50% to over 60%. Borrowing (much of it takeover-related) has since resumed, but the ratio is still significantly above its long-term average of around 55%. With investment remaining relatively subdued during this recovery, the financial surplus of the corporate sector has grown strongly, reaching 2 1/2% of GDP in the middle of last year. The small falls in the last nine months have been due to large increases in stocks, but overall company finances are strong and argue for further takeover activity and increased investment.