LOMBARD STREET RESEARCH

Monthly Economic Review

No. 133, July 2000

Contents | Page no.

Commentary on the economic situation 1

Research paper -

Has the UK mortgage market gone ex-growth? 3

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Lombard Street Research Ltd.
Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0207 337 2975
Fax: 0207 337 2999
e-mail: lsr@lombard-st.co.uk
www.lombard-st.co.uk

Boom-bust returns to public spending

Mr. Brown's plans will force growth of private spending to slow

Public expenditure is both on transfer payments and on goods and services,

Commentary on Mr. Brown's Comprehensive Spending Review has overlooked a fundamental distinction. Public expenditure is of two kinds, on transfer payments and on goods and services. In the case of transfer payments (mostly pensions and welfare benefits), the state levies taxes and hands over the money to the population. This process does not in itself imply any pressure on the nation's resources. Public expenditure on goods and services is quite different. It is on the products (the medical equipment, the school textbooks, the navy frigates) and the labour (the doctors and nurses, the teachers, the sailors) who create the "goods and services" provided by the state. It therefore does involve pressure on the nation's resources.

with only expenditure on goods and services absorbing the nation's resources

In any economy total demand is the sum of private and public expenditure, where "public expenditure" is to be understood solely in this second sense, as expenditure on goods and services. After the privatization of the utilities in the 1980s, public expenditure in the UK has become predominantly by "general government". Between 1992 and 1999 private sector spending in the UK rose in real terms by just over 4% a year, while general government spending on goods and services went up by a mere 1/2% a year; between 1997 and 1999 private spending grew - again in real terms - by 5% a year, while general government spending increased by slightly under 2% a year. Evidently, in the mid- and late 1990s demand from the UK's private sector - for consumption, business investment and investment in the housing stock - moved ahead faster than the trend growth rate of output, usually put at 2 1/4% - 2 1/2% a year. This "excess growth" was accommodated without inflation, partly by a squeeze on public expenditure and partly by a rather long period (from early 1997 onwards) of imports rising faster than exports.

Big boom in private spending in the late 1990s,

Of course, the discrepancy between export and import growth led to a large deficit on external trade. According to the national accounts, the gap between exports and imports (in constant 1995 prices) widened from 0.5% of gross domestic product in the first quarter of 1997 to 4.9% of GDP in Q1 2000. This gap cannot keep on increasing indefinitely. Assume - for the sake of argument - that from now on exports and imports grow at the same rate. Assume also that at present national output is roughly in line with trend. To avoid future inflation risks the rate of increase in domestic demand has to be about the same as the trend rate of output growth. The Comprehensive Spending Review signals that public expenditure *on goods and services* is to expand at an annual rate of 5% for three years. *It follows that the growth rate of private spending has to be cut from 5% a year in the two years to 1999 to under 2% year in the three years from early 2000.* Have the Treasury and Mr. Brown noticed this? And has the Bank of England wondered what it may mean for interest rates?

which cannot in future be maintained because of planned surge in public spending and the UK's unduly large external deficit

Professor Tim Congdon 26th July, 2000

Summary of paper on

Has the UK mortgage market gone "ex-growth"?

Purpose of the paper

For the sixty years until 1989 the UK mortgage market grew faster - and usually much faster - than the rest of the economy. The purpose of this paper is to argue that this will not be the case in the next ten or fifteen years. The housing boom and bust of the late 1980s and early 1990s changed things fundamentally. Although mortgage lending growth has picked up a little in the last few years, the recovery is likely to be short-lived.

Main points

* **The mortgage market in the UK has generally grown more quickly than the rest of the economy over the last 70 years. (See p. 6.)**

* **The slump in the housing market in the late 1980s and early 1990s led to a collpase in mortgage credit growth. In the 1990s as a whole, the mortgage market grew in line with nominal GDP. (See p. 7.)**

* **Largely as a result of housing boom-bust, the UK household sector remains overborrowed. The ratio of mortgage debt to the value of the housing stock is still very high by past standards. (See p. 8.)**

* **Tax relief on mortgage interest payments was reduced steadily in the 1990s and was finally abolished in April 2000. Throughout the 1970s and 1980s, the tax incentives available go a long way towards explaining the buoyancy of mortgage borrowing. (See pp. 9-10.)**

* **Demographic influences on mortgage borrowing are likely to be adverse over the next 20 or 30 years. The rate of household formation is not increasing, while the number in the key first-time buyer age brackets is expected to decline sharply. (See pp.11-12.)**

* **Weak mortgage demand over the medium run would be a problem in itself for UK lenders. But it is made worse at present as the UK banking system is so well-capitalised. The combination suggests that intense margin pressure will continue and may get more severe over the next decade.**

* **Mortgage lending did grow faster than GDP in 1998 and 1999, but this could be reconciled with a fall in the ratio of mortgage debt to the value of the housing stock only because of unsustainably high house price increases.**

This paper was written by Stewart Robertson.

Has the UK mortgage market gone "ex-growth"?

The demand for mortgage credit will weaken markedly over the next decade

Earlier analysis suggested that medium-term prospects for UK mortgage lenders were bleak...

...although mortgage lending rose robustly in 1998 and 1999

In early 1998 Lombard Street Research wrote a management report, published by the *Financial Times*, that proposed that the UK mortgage had gone "ex-growth". This description was not meant to imply that net mortgage lending would not increase at all in the future. Rather, it suggested a sharp contrast between the last 20 or 30 years and the future. Whereas historically mortgage lending grew faster than GDP, in coming years it would grow more slowly. Indeed, in economic downturns it may well be the case that the mortgage market would struggle to grow at all. The purpose of this paper is to update the analysis undertaken two years ago, acknowledging recent developments. Broadly speaking, 1998 and 1999 were reasonable years for UK mortgage lenders, with the stock of mortgage debt rising by 5.8% and 8.3% respectively, both comfortably above the comparable increases in nominal GDP. Was there something wrong with the earlier analysis or does the medium-term outlook remain difficult for mortgage lenders? Despite the modest recovery in mortgage lending growth in the last two years, the rest of the paper will outline the reasons for believing that the previous conclusions stand. The recent upturn has been a cyclical revival, not a structural recovery.

Mortgage loans the dominant asset for the UK banking system

Mortgage loans are the most important single type of asset on the balance sheets of UK banks and building societies. At the end of 1999 their total sterling loans to the UK private sector was £888.0b., of which mortgages accounted for £448.9b. or just over half. Mortgage lending was more than double all lending to mainstream private, non-financial corporations, which amounted to £199.9b. Prospects for the UK mortgage market are therefore fundamental to the British banking system. The outlook for housing finance will affect the rate of growth of UK retail banks and building societies, and the structure of their expansion. It will also be a basic determinant of their profitability.

Mortgage market in the UK has been a growth industry for several decades...

In any forward-looking analysis of a market, a reasonable assumption is that the future will be like the past. The main argument in this paper is that, in the case of the UK mortgage market, the future (i.e., the next 10 or 20 years) will be very different from the experience of the last 60 or 70 years and from that in the 1970s and 1980s in particular. In the 40 years to the early 1990s mortgage lending grew consistently faster - and often much faster - than national income. In other words, the mortgage industry was, emphatically, a "growth" industry. In such an environment the logical strategy was for UK lending institutions (i.e., building societies and banks) to assign capital to the development of mortgage business rather than to other types of business.

...but will grow much more slowly in the future

The modest recovery in mortgage lending growth over the last two years is likely to be short-lived. Over the next two decades or so the mortgage market will probably grow at a slower rate than national income. If the increase in nominal GDP is constrained by the Government's committment to a 2½% inflation target, the the stock of mortgage loans will in the future increase at an

annual rate of less than 5%. In recession years it may not rise at all.

1. UK homeowners became heavily indebted in the early 1990s...

Three main reasons for the altered outlook can be highlighted. All are long-term in nature, so cannot change quickly. First, the legacy from the unprecedented events in the UK housing market between 1989 and 1995 (when national house prices fell in total by about 25%) is still being felt. In short, British homeowners still suffer from a significant debt overhang. The ratio of mortgage debt to the value of the housing stock (or to the value of home equity) is still extremely high by past standards. The ratio averaged just over 20% between 1963 and 1989, but surged to almost 35% by the end of 1995 as house values plummeted.

...and despite some improvement in the last two years...

It is fundamental to the subsequent analysis that borrowers will wish to reduce this ratio back to a more satisfactory level. Two years ago it had been anticipated that house price inflation would not return to double-digit rates. Clearly, the ratio of debt to value can only fall if mortgage debt grows more slowly than the prevailing rate of house price inflation. (This conclusion ignores the complication of net additions to the housing stock.) It followed that mortgage lending growth was unlikely to rise above, perhaps, 4% or 5%. In the event, the conclusion that the ratio would fall was correct, but the process by which it happened was surprising. It was true that over-indebtedness encouraged higher repayments for most of the 1990s and that this in itself restrained the overall growth of mortgage debt. But in 1998 and 1999 the return of national house price inflation of 15% or more was the crucial influence in reducing the debt-to-value ratio. Indeed, house price inflation was so fast that the ratio could fall despite a resumption of significantly higher new mortgage lending growth.

...they still are

Nevertheless, at the end of 1999 the ratio was still close to 28%, well above the average of around 20% in the 1960s, 1970s and 1980s. Although house price inflation is still running at a rapid annual rate (9.3% according to the Halifax and 15.1% according to the Nationwide), it seems clear that the peak in house price inflation has passed. Indeed, house prices have fallen in four of the last five months on Halifax data, while hot-spots such as London and the south-east have cooled noticeably. The most likely scenario now is that national house price inflation falls back over the next year or so to a sustainable rate of perhaps 5% to 6%. In such circumstances, rapid rises in housing values will no longer help to drive the debt-to-value ratio down further. The burden of adjustment will return to the rate of increase in mortgage debt which must therefore rise by less than 5% a year in the future if the ratio is to return to a more normal range.

2. Mortgage debt is no longer tax-efficient

Moreover, there are good reasons for believing that the 20% ratio that is claimed to be "normal" or "sustainable" is, in fact too high and that mortgage borrowers will wish to reduce debt further relative the the value of the housing assets it supports. Throughout the 1970s and 1980s tax relief was available on mortgage interest payments. The system of relief was so generous that it went far to explaining the buoyancy of mortgage borrowing across the two decades. Much is made of the alleged "lowness" of mortgage rates today. But effective post-tax

mortgage rates (which today are, of course, equal to actual rates since mortgage interest tax relief has now been abolished) are similar to those that prevailed in much of the 1970s and 1980s. Indeed, for higher rate taxpayers, effective mortgage rates are undoubtedly higher today. The net result was that was that, in the past, borrowers had a clear incentive to maximise mortgage debt subject to the tax relief limits (which did not really begin to bite until the second half of the 1980s). As long as house prices rose by, say, 3% or 4% a year - a rate of increase which they invariably exceeded by some margin - net wealth increased steadily. The abolition of mortgage interest tax relief has removed all such incentives and is a further encouragement towards debt repayment. The impact of its disappearance has probably yet to be felt. Until April this year there was at least some tax relief for holding some mortgage debt.

3. The pool of potential first-time buyers will fall dramatically over the next two decades

Throughout the 1990s the combination of over-indebtedness and the gradual erosion of tax relief encouraged mortgage repayments from existing borrowers. Almost the entire growth of the stock of mortgage debt in the decade was due to loans to first-time buyers. Unsurprisingly, lenders have concentrated their marketing efforts on this group. They continue to do so today, with mortgage deals that cannot be profitable. But right at the time when those in their 20s and 30s become so crucial, there will be less of them. In the 1960s, the total number in these age groups was rising ay an average of 50,000 a year. In the 1970s the comparable figure was over 100,000, while in the 1980s it was close to 150,000 a year. The 1990s saw an average reduction of 50,000 a year, but the real change comes in the decade just started, when the pool will fall by an average of almost 200,000 a year.

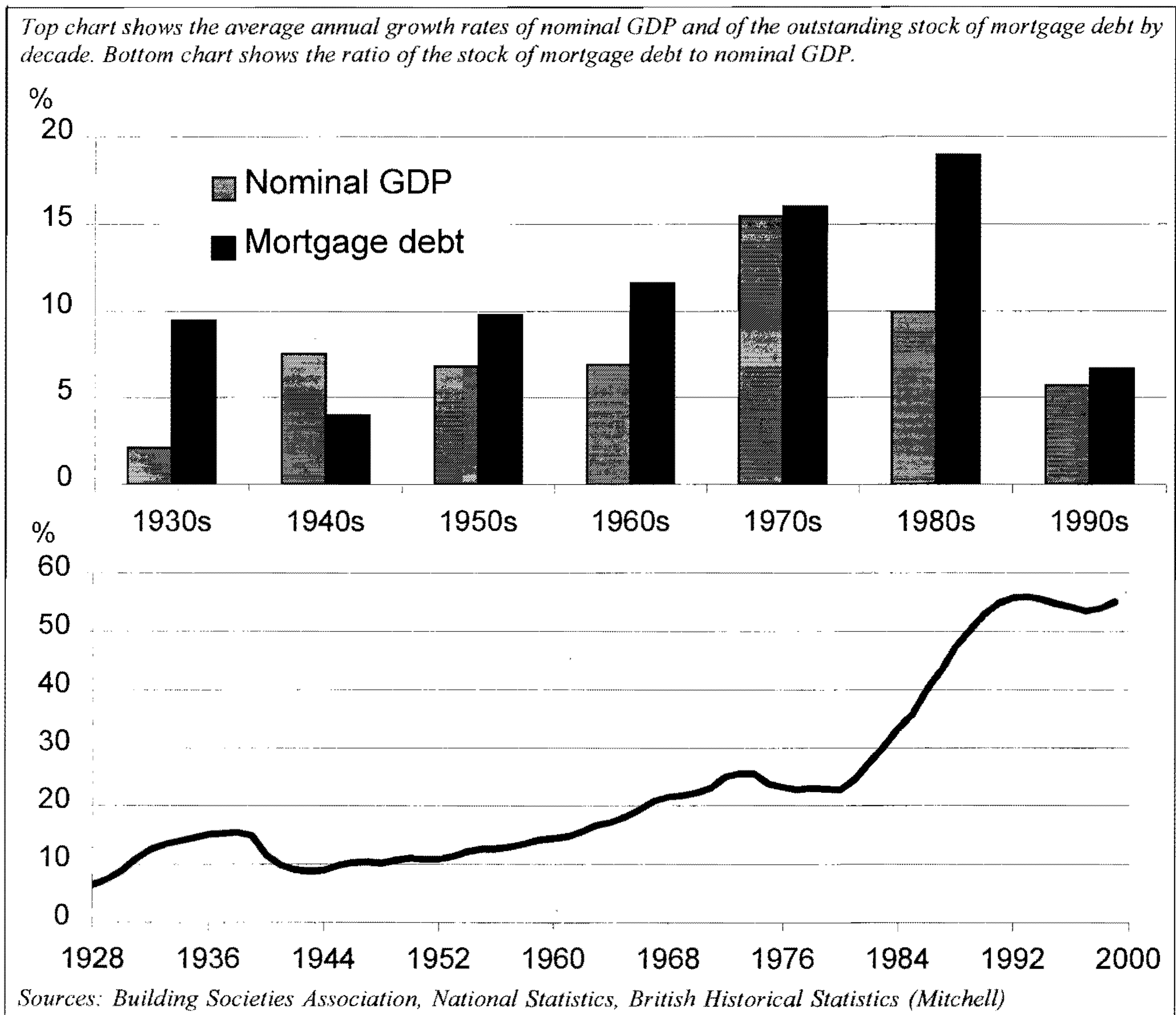
The combination of weak demand and over-supply can mean only one thing...even more severe margin pressure

Whereas the demand for mortgages will increase much more slowly than in the past, the potential supply of mortgage credit is being boosted by the abundance of capital in the UK banking system as well as from new entrants to the mortgage market. Despite share buybacks and rising dividends, mainstream mortgage lenders continue to increase their equity capital base by around 10% a year. To utilise capital effectively, they will wish to expand their assets - including their mortgage assets - at a similar rate.

By implication, the demand for mortgage credit and the supply of capital to housing finance are on collision course. What will give? The obvious answer must be further, unremitting downward pressure on margins. Until now, intense competition has been largely confined to the new borrower market. But the recent initiative from HSBC - a 1% reduction in its variable rate - is only the latest indication that competition is spreading back into the wider market. UK lenders can probably no longer rely on inertia among existing borrowers. Those institutions that base their expansion strategies on the UK mortgage market over the next ten years or so will not perform as well as those who are prepared to diversify and develop alternative lines of business.

The mortgage market in the long run

The mortgage market has usually grown faster than the rest of the economy



Top chart shows the average annual growth rates of nominal GDP and of the outstanding stock of mortgage debt by decade. Bottom chart shows the ratio of the stock of mortgage debt to nominal GDP.

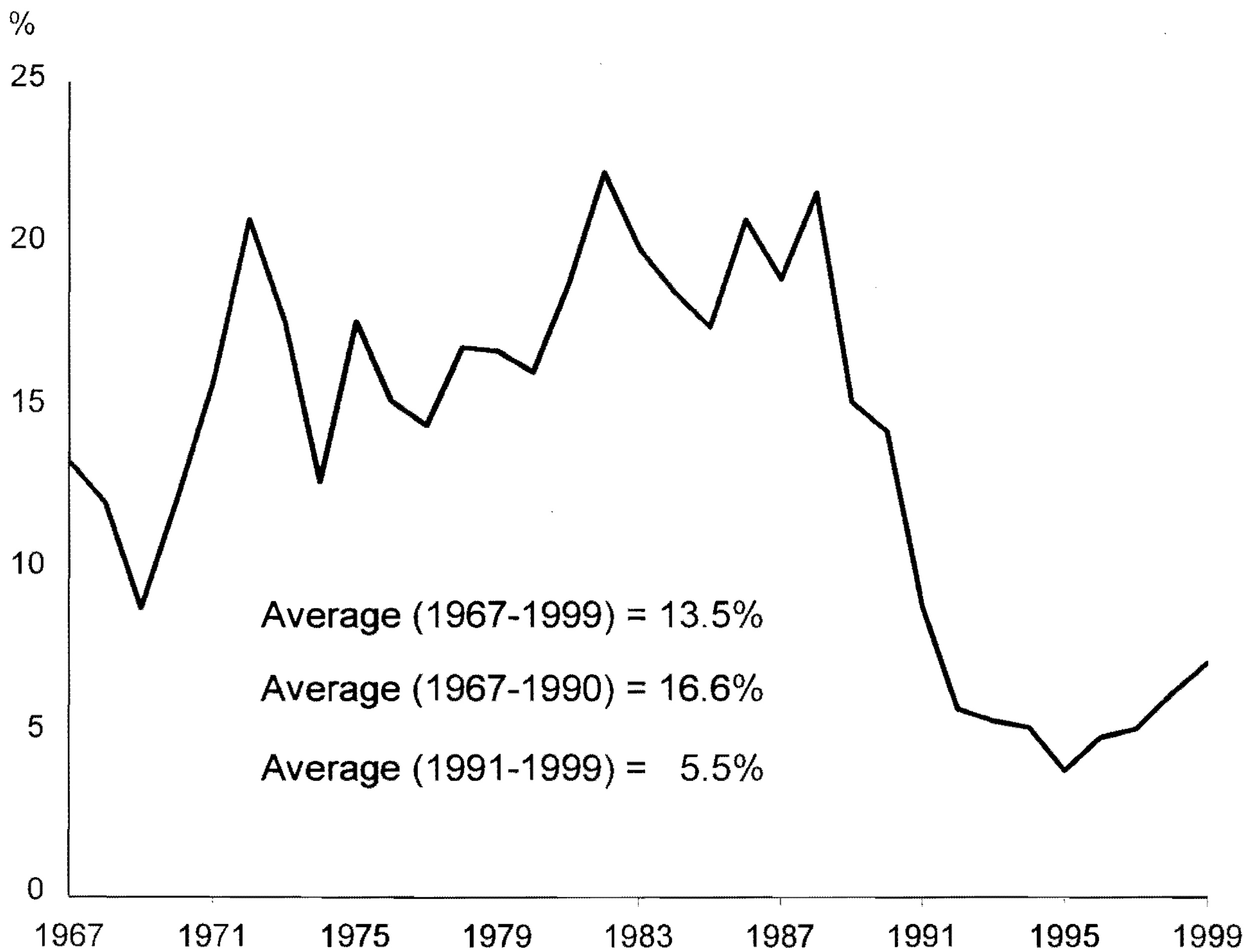
Sources: Building Societies Association, National Statistics, British Historical Statistics (Mitchell)

With the exception of the 1940s, when national output was boosted by the war effort, the mortgage business has grown more quickly then the rest of the economy in each of the last seven decades. Provision of housing finance was, without doubt, a growth industry and it made good sense for UK building societies, and subsequently banks, to devote reserves (or capital in the case of the PLCs) to fund the rapid expansion of their mortgage assets. The increase in owner-occupation is part of the explanation. The proportion of UK households who owned their own home was less than 50% in the late 1960s, but had risen to 55% at the end of the 1970s and over 65% at the end of the 1980s. But it is only inching ahead now, the latest available figure being 68% in 1998. The mortgage market is unlikely to be significantly boosted by higher home ownership in the future.

Mortgage credit growth collapsed in the 1990s

Unprecedented falls in house prices led to a surge in repayments

Chart shows the annual percentage increase in the outstanding stock of mortgage debt



Source: National Statistics

The de-regulation of the banking system in the 1970s and, especially, in the early 1980s provided another boost to the mortgage market. The wide-scale availability of mortgage credit from institutions other than building societies occured at a time when economic policy errors had allowed a full-scale housing boom to develop and certainly contributed to the scale of the bubble. The subsequent plunge in house prices, accompanied for millions by the misery of negative equity, mortgage arrears and repossession, led to a collapse in mortgage credit growth in the early 1990s. The market has recovered a little in recent years, but the revival has probably been cyclical in nature, boosted in particular by very low interest rates. The slower growth of the overall market, along with another clutch of new entrants, has undoubtedly led to a much more competitive environment. The increasing "commoditisation" of the mortgage loan itself has been a further factor, with lenders no longer able to rely as much on customer inertia.

Debt is high relative to the value of the housing stock

The personal sector remains overborrowed

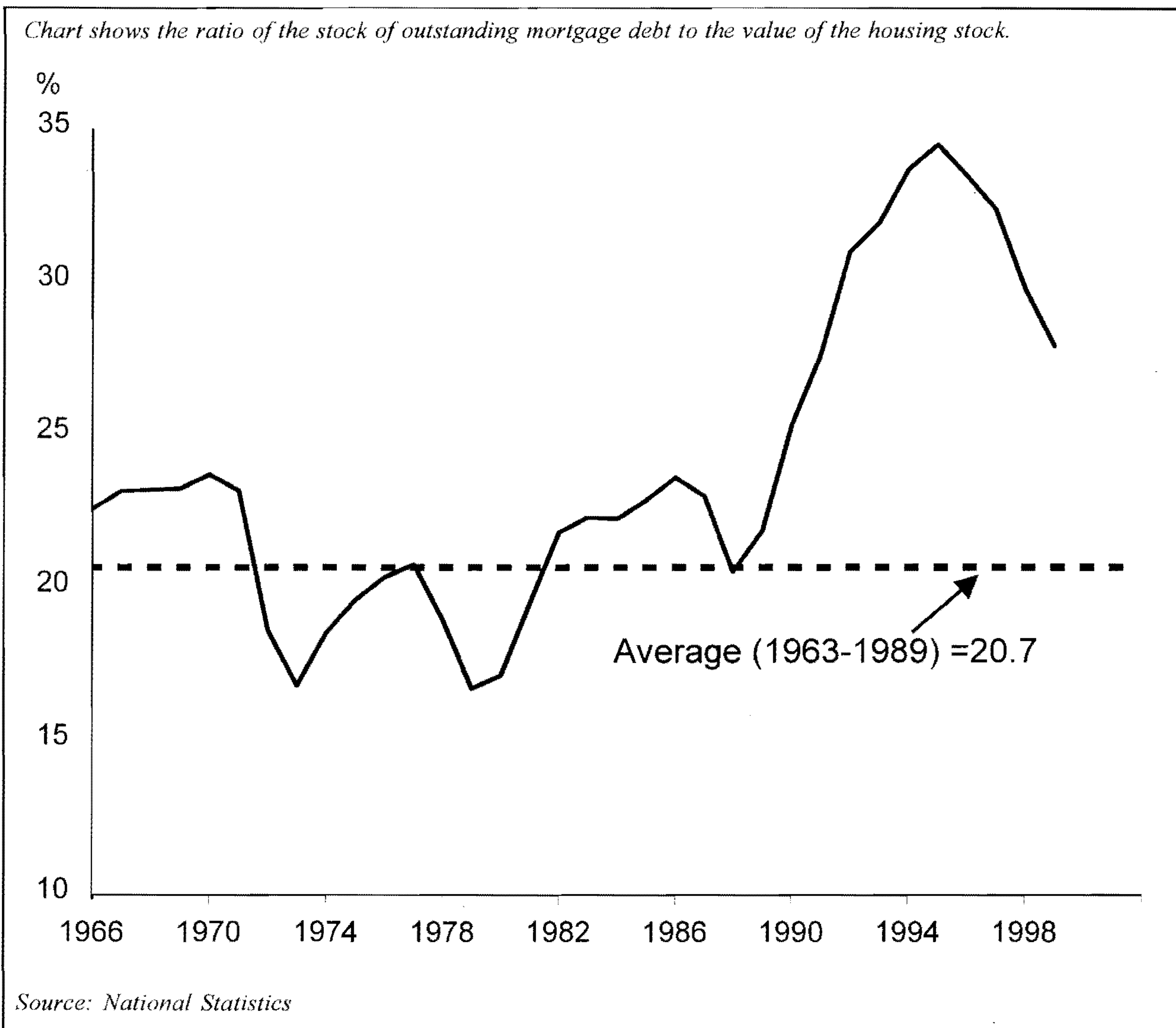


Chart shows the ratio of the stock of outstanding mortgage debt to the value of the housing stock.

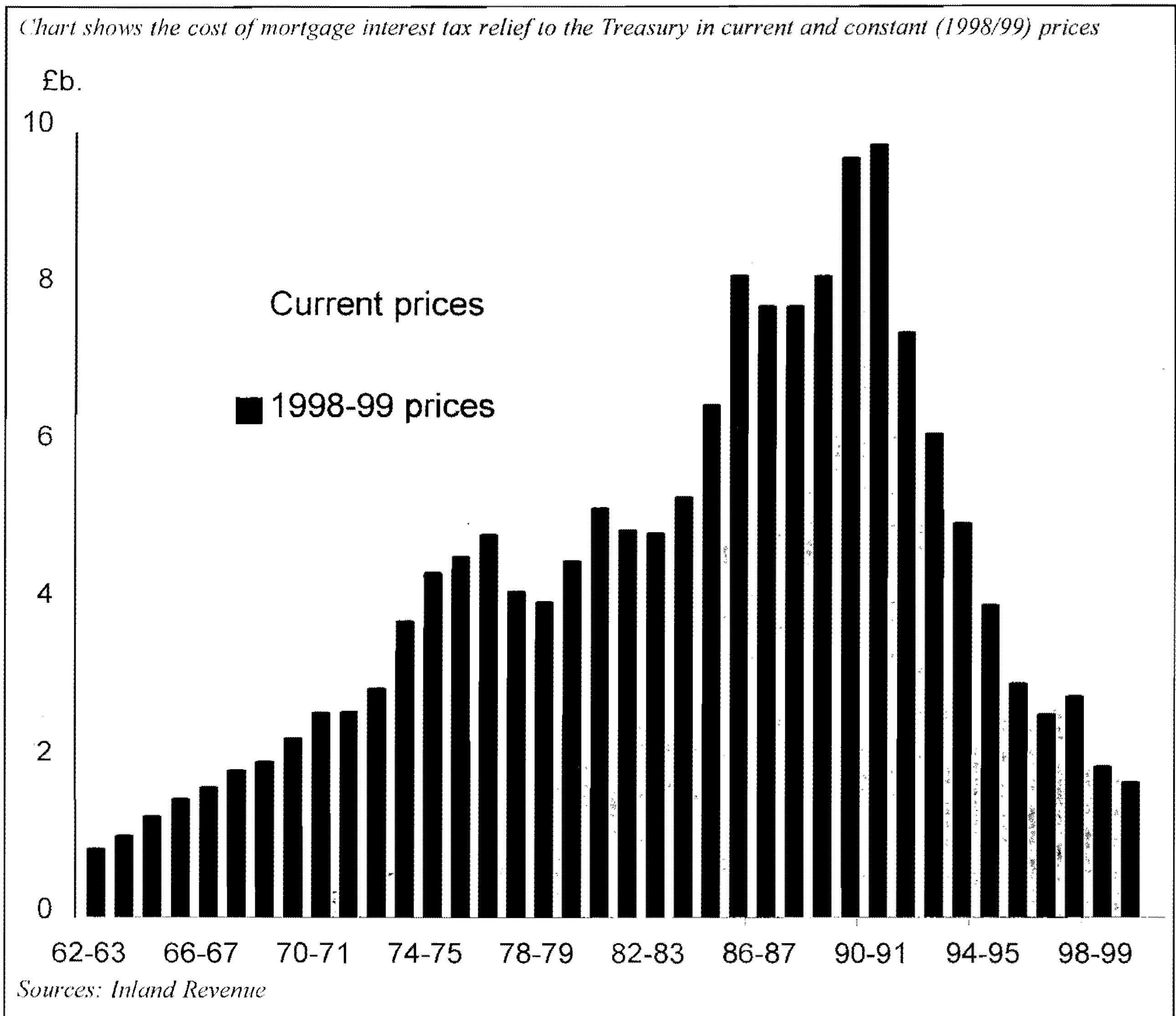
Source: National Statistics

This chart illustrates the cornerstone of the argument that growth prospects for the UK mortgage market are poor. It shows that the unprecedented falls in house values in the early 1990s caused capital gearing for UK homeowners to surge. The ratio of mortgage debt to house values soared out of line with all historical experience. Although rapid house price inflation has helped the ratio decline in the last few years, it cannot be relied upon to do so in the future. The burden of adjustment will move back to the growth rate of outstanding mortgage debt over the coming years and will constrain the overall rate of increase of mortgage lending. It is fundamental to the arguments developed here that homeowners will wish to reduce the ratio further in the future. The view that the low interest rates prevailing at present imply that the debt burden is much lower than in the past is a valid one. But this qualification is probably not sufficient to outweigh the implications of significantly overborrowing among UK households.

Tax relief on mortgage borrowing has been abolished

Tax priveleges eased the burden of mortgage interest considerably in the past

Chart shows the cost of mortgage interest tax relief to the Treasury in current and constant (1998/99) prices



Sources: Inland Revenue

The importance of tax relief on mortgage interest payments on the evolution of the housing and mortgage markets in the 1970s and 1980s cannot be underestimated. Equally, the effects of its disappearance (which was only completed in April this year) will be far-reaching, especially in the light of the starting debt position. During the earlier period the real cost of the relief to the Government rose steadily despite inflation eroding the real value of the £30,000 limit. The explanation is the rapidly-increasing numbers of buyers and the move to positive real interest rates in the 1980s. Indeed, the £30,000 limit for relief was only exceeded by the average advance for the first time in 1988. Moreover, relief was only restricted to the basic tax rate, rather than the borrower's marginal rate, in 1991. The key point is that tax relief eased the burden of borrowing considerably throughout the 1970s and 1980s. The final abolition of tax relief may yet have a significant impact on mortgage borrowing in the future.

Tax incentives encouraged heavy borrowing in the past

House price inflation exceeded post-tax mortgage rates in the 1970s and 1980s

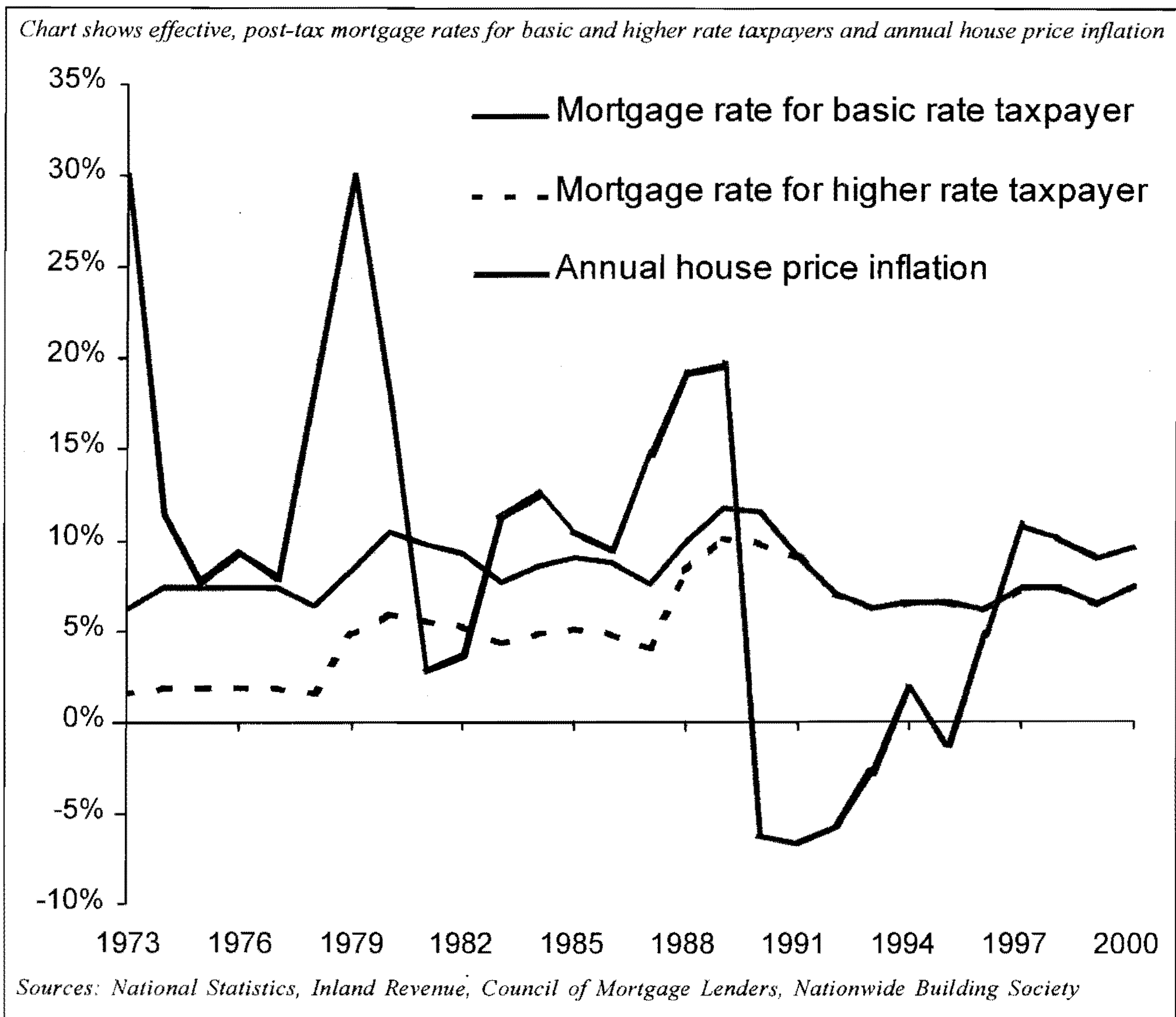


Chart shows effective, post-tax mortgage rates for basic and higher rate taxpayers and annual house price inflation

Sources: National Statistics, Inland Revenue, Council of Mortgage Lenders, Nationwide Building Society

This chart shows that, with one or two exceptions, house price inflation exceeded effective post-tax mortgage rates in every year between 1973 and 1989 for all taxpayers. The implication is that borrowers did not need to worry about increasin their mortgage debt. Indeed, they were foolish not to, because although their liabilities were rising rapidly, the assets that the debt supported was increasing in value even faster. In other words, net wealth was always rising. The most rational approach was therefore to maximise debt subject to the relief limits (which did not begin to bind seriously until the late 1980s) and trade up whenever possible. The contrast today could not be more marked. There are now no tax advantages to mortgage debt at all. The change implies that the level of debt that homeowners will be happy with must be even lower than in the past. The abolition of relief can only encourage more repayments and could mean that the "equilibrium" level of debt relative to house values is below the 20% average previously cited.

Number of households will rise only modestly

Increases in the number of households will be lower over the next 20 years

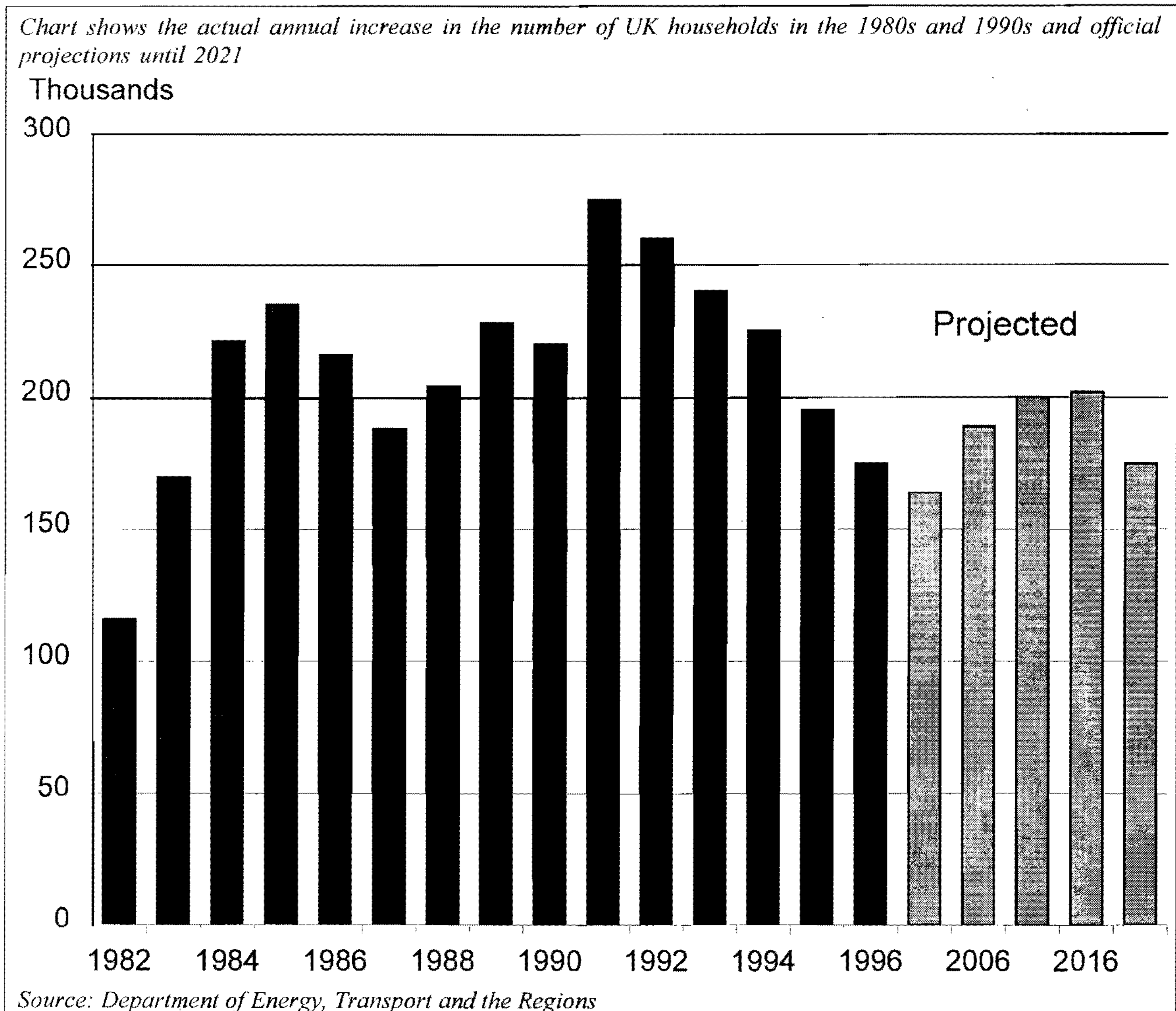


Chart shows the actual annual increase in the number of UK households in the 1980s and 1990s and official projections until 2021

Source: Department of Energy, Transport and the Regions

The "son of baby boom" generation helped boost home ownership in the 1980s. As previous pages have illustrated, the tax system in operation actively encouraged them to borrow, while the Thatcher Government too was keen to expand owner-occupation significantly. Over the next 20 or 30 years population growth in the UK is expected to slow noticeably. The rate of increase of the number of households will not slow as much, but is still expected to be a little slower than in the recent past. Although higher divorce rates and the fact that people are living for longer and doing so in their own homes imply a greater number of total households, this is not sufficient to offset a lower rate of population growth. Moreover, such households are likely to be even more debt-conscious than "average" homeowners. The inescapable conclusion seems to be that mortgage growth will not be stimulated by favourable demographic trends over the next 20 years or so.

Numbers in the first-time buyer age range are declining

Rapid rises in first-time buyers boosted mortgage borrowing in the 70s and 80s

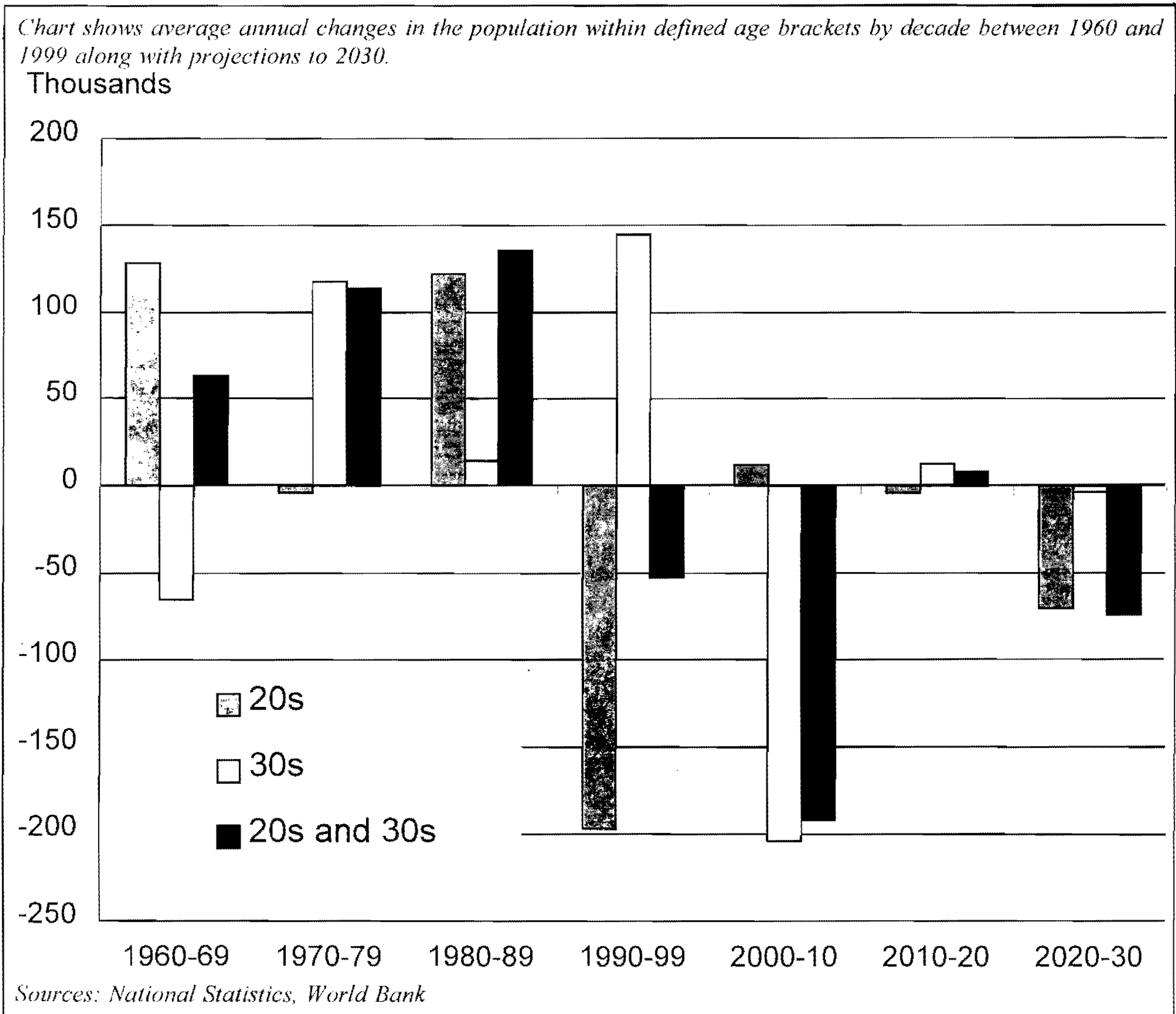


Chart shows average annual changes in the population within defined age brackets by decade between 1960 and 1999 along with projections to 2030.

Sources: National Statistics, World Bank

Throughout the 1990s, virtually all of the increase in the oustanding stock of mortgage debt was accounted for by loans to first-time buyers (FTBs). Indeed, between 1993 and 1998 FTBs accounted for 110% of net mortgage lending. In other words, existing borrowers made net repayments over this period. In the past, successive trading up by homeowners had meant that they too contributed to the overall increase in debt. They did increase their overall borrowings a little in 1999, but by much less than they had done routinely in the 1970s and 1980s. Moreover, last year saw a housing mini-boom. The point is that the FTB market has become crucial to mortgage lenders. But here too, the news is bad. As the chart illustrates, the potential pool of FTBs is expected to decline sharply over the next decade and not recover thereafter. Over the last three decades, and especially in the 1980s, strong increases in the numbers in their 20s and 30s had provided a valuable boost to mortgage demand.