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Worries about UK inflation

Annual rate of RPIX inflation may edge above 3% this year

Last year's expectations were for inflation under 1 1/2% - putting pressure on Bank of England to cut interest rates

Last year the Bank of England was under constant pressure from the media to cut interest rates. A widely-held expectation was that the annual rate of RPIX inflation would drop beneath 1 1/2%, requiring the Governor to write to the Chancellor of the Exchequer to explain why the target had been undershot by more than the allowed 1% margin. (RPIX is the "retail price index excluding mortgage interest costs". The official inflation target is an annual increase of 2 1/2% in RPIX, with a 1% margin either side.) After the surprise increase in the annual rate of RPIX inflation from 1.9% in December to 2.6% in January, the media pressure has abated. However, the Bank of England has tried to sooth concern about the inflation outlook by saying that changes in particular months are often erratic and not a good guide to the underlying trend.

But now a case can be made for RPIX inflation above 3% in late 2002

Should the Bank of England be so complacent? It is true that part of January's deterioration was due to a large adverse movement in seasonal food prices, but - in fact - most of the volatile influences (notably from oil and petrol prices) have been favourable over the last year. Over the next few months RPIX will suffer from two special items - a large increase in the council tax, rumoured in some newspapers to be as much as 12%, and the return of excise duty increases. (Mr. Brown avoided these last year, partly to placate the lorry drivers.) These two items could add as much as 1/2% to the annual rate of RPIX increase. Utility prices will also be less helpful in 2002 than in 2001, with a big rise in the cost of domestic gas coming through in the first quarter. Moreover, the dramatic fall in the price of second-hand cars in 2001 - a once-for-all event which reflected the withdrawal of the car industry's "block exemption" - will not be repeated.

and even higher figures if the imbalances in the economy are resolved by a fall in the exchange rate

When all the recognisable special factors are brought together, there are grounds for suggesting that the annual rate of RPIX inflation may edge above 3% later this year. But the exercise of totting up known significant price changes needs to be supplemented by a more fundamental review of the causes of inflation. Here the Bank of England has a difficult problem. Its key decision-makers have spent much of the last two years warning about the unsustainable imbalances in the UK economy. The essence of these imbalances is that for over five years domestic demand has grown faster both than actual output and any plausible view of trend output growth. The gap between demand and output has been covered by a massive decrease in "net exports" (i.e., imports have grown faster than exports). All historical precedents show that such phases of falling net exports have to be followed by phases of increasing net exports (i.e., exports growing faster than imports), to keep the UK's foreign creditors happy. But in 2003 and 2004 (and perhaps even in late 2002) the required swing in export behaviour will not happen unless the pound falls on the foreign exchanges, and any fall in the pound will make it more likely that RPIX inflation exceeds 3% or even 3 1/2%.

Professor Tim Congdon **27th February 2002**

Summary of paper on "Much ado about MEW"

Purpose of the paper

Anxiety about excessive debt and borrowing has been one feature of recent media reporting of the economy. In particular, it has been argued that the boom in mortgage lending has allowed people to take too much equity out of their housing wealth. The research paper asks whether this is really so.

Main points

* **Mortgage borrowing enables people to withdraw equity from the housing stock and so to finance consumption. Such "mortgage equity withdrawal" (or MEW) is sometimes said to be an important influence on the current strength of consumption.**

* **The Bank of England clearly regards MEW as an interesting and useful concept, and presents its estimates of the phenomenon on its website.**

* **MEW describes a process whereby the incurral of debt to acquire an asset enables households to spend above their income. Such spending may appear to be an "exogenous" injection of demand into the circular flow of income.**

* **But the circular flow of income is a poor description of the determination of spending. For example, households can finance spending by running down their money holdings or selling assets in order to finance consumption.**

* **Equity withdrawal can take place from any asset holding. (The holder has simply to sell the asset and use the proceeds for consumption.) Such notions as "securities borrowing equity withdrawal" and "antiques credit equity withdrawal" are perfectly viable at a theoretical level.**

* **MEW has contributed to improved analysis of the housing market, but its significance for macroeconomic outcomes has been overstated. The keenness of Bank of England economists' to incorporate MEW into a "credit channel" is another sign of their difficulty in recognising the truly important relationships between money, wealth and national income.**

This paper was written by Professor Tim Congdon, with help from Mr. Jonathan Randall in the preparation of the charts.

Much ado about MEW

How do money and credit relate to housing wealth and consumer expenditure?

Are people borrowing too much to finance their spending?

The buoyancy of consumer spending in the UK in late 2001 and so far in 2002 has stimulated anxious media comment about excessive debt. A typical line of argument is as follows. "People are spending above their incomes. As in the late 1980s the rise in debt reflects this over-spending and is dangerous. When people realize that they have incurred too much debt, they will cut back on spending. Consumption will then grow more slowly or perhaps even fall, aggravating the weakness in the economy."

The concept of mortgage equity withdrawal (or MEW)

This set of ideas has been complemented by analysis of "mortgage equity withdrawal" at the Bank of England and elsewhere. The dominant form of personal debt in the UK, as in most industrial countries, is mortgage lending. Mortgage borrowing appears to be for the purpose of buying a house, but in recent decades net mortgage lending has been larger - sometimes much larger - than investment in housing. The excess of borrowing over housing investment represents "equity withdrawn" from the housing market and enables people to spend above their incomes to consume. The extent of MEW may therefore appear important in the wider discussion of the over-spending that is alleged to accompany debt incurral.

Estimates of MEW can be very complex,

(Note that in this context the phrase "investment in housing" means gross domestic fixed capital formation in residential buildings plus an estimate of refurbishment and improvement costs. In other words, it measures the resources used in building and improving houses. It should be differentiated sharply from the value of the sales proceeds of all houses, including existing houses. Allowance also has to be made for household sector purchases of council houses. The correct method of calculating MEW is a matter of great theological difficulty among housing market economists and and can become extremely complicated. See the Council of Mortgage Lenders, Technical Report no. 35, *Housing and Mortgage Equity Withdrawal, and their Component Flows.*)

but the Bank of England has provided analysts with an easily accessed MEW series in its website

The Bank of England has become sufficiently interested in the subject that its website presents detailed estimates of MEW as far back as 1970. Indeed, these estimates are given as prominent a hypertext link in the statistical section of the website as the signpost to the main page of *Monetary and Financial Statistics*, which contains the monetary data usually regarded as the staple of central bank research. The Bank of England's work is of course rigorous and analytical, and avoids naive homilies about over-spending. Nevertheless, the Bank's economists see a connection between MEW and consumer spending, and newspaper commentators may be tempted to criticise MEW as one form - perhaps even the main form - of irresponsible personal financial behaviour in the UK today.

Is high MEW a sign of excessive borrowing?

The aim of this note is to pre-empt such criticism, by arguing that the significance of MEW has been vastly overstated. The heart of the argument is simple. The UK is a liberal democracy with a free market economy, where the ownership of property is respected as a basic human right. If property ownership means anything, it is that

people should be free to dispose of their assets as they wish. In particular, people should be free to convert accumulated savings into consumption and so to sell any asset with the intention of enjoying the proceeds from the asset sale. "Mortgage equity withdrawal" is nothing very special. It describes a sequence of transactions in which people may convert assets into consumption, but there are many other transaction sequences and many other assets which enable the same conversion to take place. If the media take a relaxed view of these other approaches to financing consumption, they should be indifferent to MEW and indeed to the incurral of debt more generally.

In an economy which recognises private property, short answer is "no"

Economists have been far too excited about MEW,

Further, economists have become far too excited about consumption financed by MEW. They have failed to see that the transactions involved in MEW are only a tiny fraction of all the transactions where people and companies balance immediate consumption against asset ownership (or consumption now against consumption in future.) The newspaper moralists need to be told that there is nothing particularly sinister about MEW and the analysts need to understand that MEW transactions are not uniquely important to macroeconomic outcomes.

perhaps because it seems to provide a source of demand from outside "the circular flow of income"

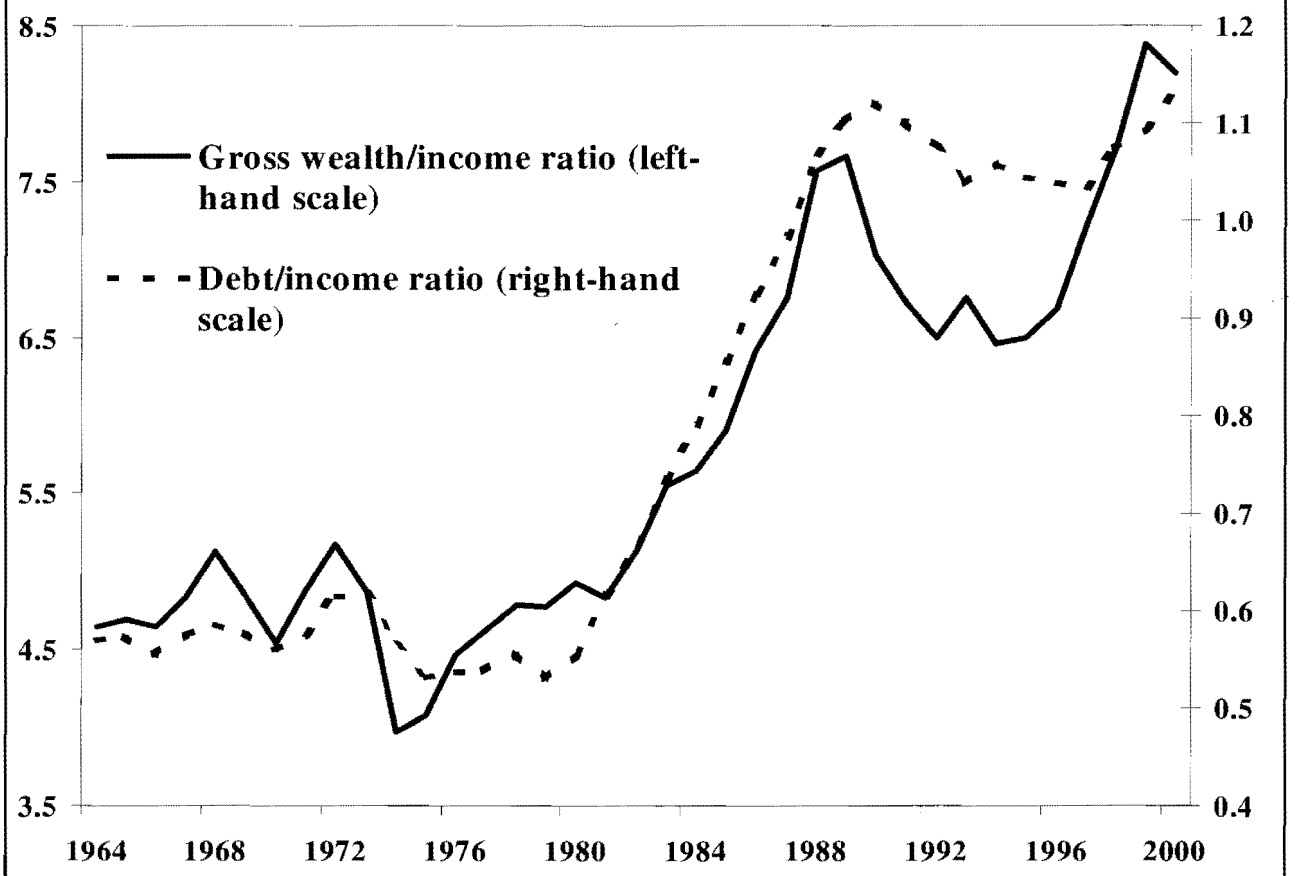
The liveliness of economists' current interest in MEW may stem from the challenge it poses to one of the standard notions of macroeconomics. According to the textbooks, every economy has "a circular flow of income". In one round groups of economic agents (people, companies) receive income and spend it; when the income is spent in the next round, it becomes income for other groups of economic agents; and so on. All the groups of agents taken together comprise the whole economy. So the economy is characterised by a circular flow, in which income and expenditure mutually support each other and circulate endlessly. The circular flow keeps income and expenditure the same period after period, unless demand is injected from (or withdrawn by) an outside or "exogenous" source. Two such sources are taken to be the Government and the rest of the world. So fiscal policy (through changes in tax and public expenditure) and the world economy become the crucial influences on the business cycle.

This account is simplified, but not simplified to the point of caricature, and it is the framework in which many British macroeconomists begin to think about the determination of national income.(1) The circular flow of income explains the phrase "income-expenditure models", which is a standard thumbnail description of the big computer-based models at the Treasury and the National Institute. To anyone brought up to believe in the circular flow of income as an appropriate starting point for macroeconomic analysis, MEW comes as a surprise. The novelty of MEW is that it identifies a familiar sequence of transactions in which consumption is financed not from the previous receipt of income, but from capital transactions made possible by borrowing. So MEW - like fiscal policy and a change in the world economy - seems to be exogenous to the economy, an injection to demand from outside the circular flow of income; it may therefore seem to be very important. MEW is put on an even higher pedestal when econometric exercises identify a good relationship between it and consumer expenditure.

Both borrower and lender be

Financial liberalisation associated with increases in debt *and wealth*

Chart shows ratio of the household sector's gross *financial wealth and debt to income.*



Source: National Statistics and Lombard Street Research estimates
Note that a major break in the series occurred in 1987.

Until the 1980s the UK's financial sector was subject to severe restrictions in consumer lending, with banks unable to compete with the building societies in the mortgage market. The restrictions were removed in the early 1980s, leading to a very sharp rise in the ratio of debt to income between 1980 and 1991. This rise was accompanied by statements from City commentators that, because the debt/income ratio was at an all-time high, the next few quarters would see reduced borrowing and less consumer spending. These statements became repetitive, but they were wrong throughout the mid-1980s, and even in 1987 and 1988. The point was that borrowing was invariably to acquire assets (mostly houses) and gross wealth rose at a similar rate to debt until the 1980s. Net wealth (see the chart on p.13) did eventually turn down in 1989 and 1990, as higher interest rates hit house prices, and borrowing and consumption then weakened.

But the circular flow of income is a very misleading idea,

The trouble here is deep-seated. The circular flow of income, despite its convenience in classroom expositions and its regular appearance in examination papers, is not an accurate description of reality. In many ways it is very misleading. In the real world it is just not true than an agent's expenditure on the goods and services being produced in one period is equal to his or her income in the previous period, plus or minus something for tax changes (and an income receipt or payment based on a nation's external trade). The proposition that income and expenditure follow each round in a never-ending flow is bunkum. Individual agents can match expenditure on currently-produced goods and services precisely to their income if they want, but in any period they have four other options,

- to run down or increase their money balances,

- to buy or sell existing tangible assets (such as houses and cars) which last longer than the period in question,

- to buy or sell financial assets (which again last longer than the period in question), and

- to borrow or repay debt.

as agents - both individually and in the aggregate - can finance expenditure above income by reducing money or other asset holdings

At the individual level nominal expenditure is therefore not constrained by current or recent levels of nominal income. The same also applies at the aggregate level. Individuals are constantly buying and selling capital assets at ever-changing prices, and nowadays the volume of transactions in capital assets is a huge multiple of the simultaneous transactions (on "consumption", "investment", "stockbuilding" and so on) which make up the demand components of national income. If - for any reason - individuals want to convert some of their wealth into consumption they can do so at any time, provided they carry out the necessary transactions (i.e., selling shares, selling houses, cashing in insurance policies, redeeming unit trust units). The key practical constraint on consumption expenditure is that each individual has a sufficiently large money balance to pay his or her bills, but - as long as this constraint is met - the value of the transactions which determine national income (i.e., the sum of the Keynesian demand components) could be as large as the value of the capital transactions. At the aggregate level nominal incomes and expenditure in 2002 could therefore be any imaginable fraction or multiple of nominal incomes and expenditure in 2001.

Misleading nature of circular-flow-of-income idea shown by

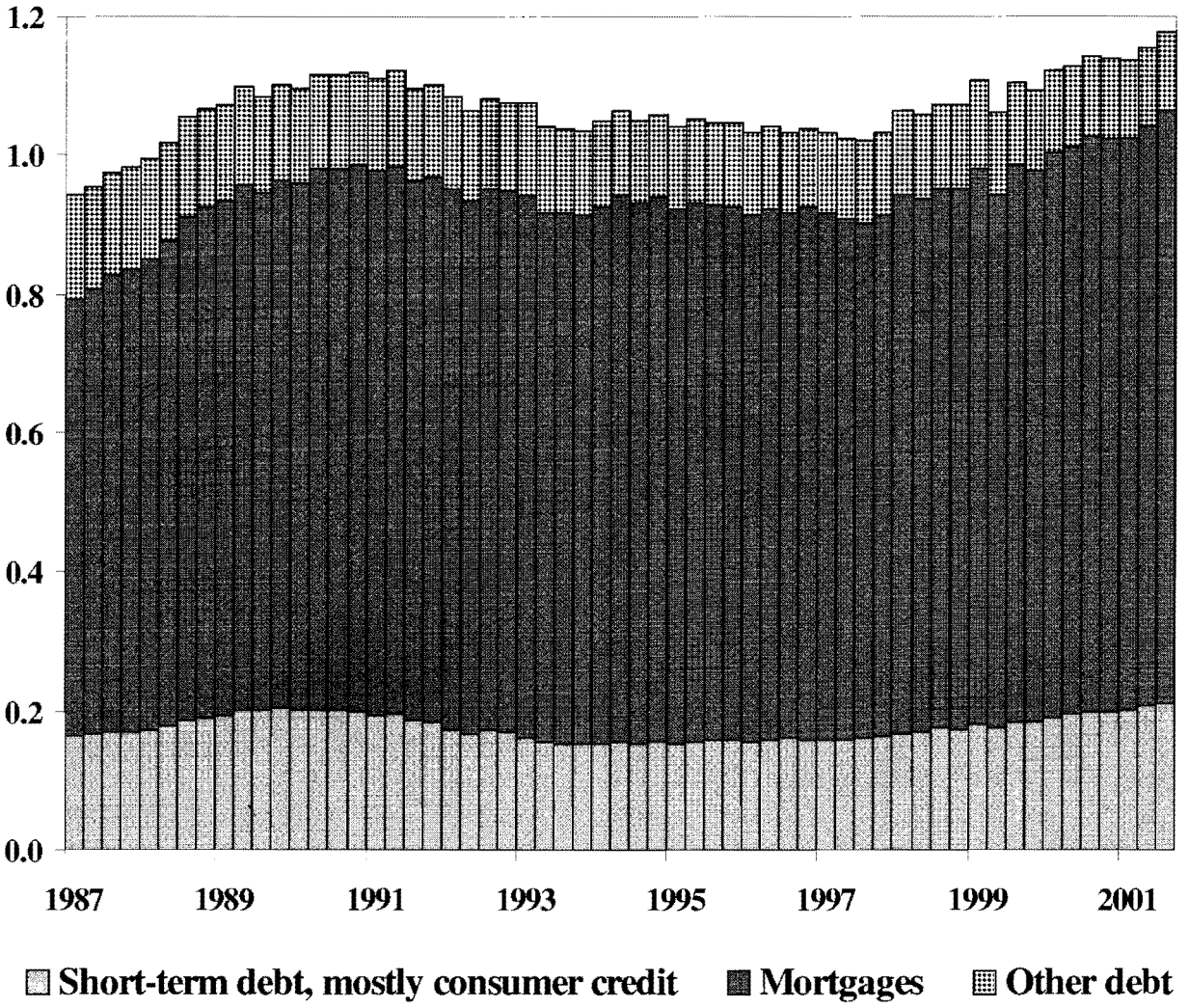
i. hyperinflation,

These propositions may be startling to anyone brought up to regard the circular flow of income as one of the foundations of macroeconomic theory, but there are two compelling demonstrations of their validity. The first is a hyperinflation and the second a massive subscription for new securities. In a hyperinflation it is obvious that nominal incomes in any period are not equal (or even similar) to nominal expenditure in the latest period, and that nominal expenditure in the latest period is not equal or similar to that in the previous past period. The nominal value of both incomes and expenditure are instead exploding upwards, as agents attempt to rid themselves of excess money

Mortgage debt is dominant

Unsecured borrowings small compared with mortgages

Chart shows ratio of different types of debt to household disposable income.



Sources: National Statistics and Lombard Street Research estimates

A favourite media tactic is to demonize consumer borrowing as "bought with plastic", "all on tick" or something of the sort. In fact, credit card borrowing is small compared with other kinds of consumer debt. At the end of the third quarter 2001 the stock of credit card borrowings was £39.6b., out of total consumer credit of £135.7b. The stock of loans secured on dwellings - at £577.2b. - was over four times the size of all consumer credit and almost 15 times larger than credit card debt. (At any one time the household sector has large unpaid bills owing the utilities, phone companies and so on, which are creditor items for other sectors in the economy and appear here under "Other debt".) The dominant messages from this chart are twofold, that most debt is secured against housing (and in that sense is highly responsible), and that the debt total is fairly stable relative to income (which again suggests stable, responsible behaviour).

balances. It is the relationship between the quantity of money on the one hand and income and expenditure on the other that captures the reality of the economic situation, not the relationship between income and expenditure in successive periods.

and ii. heavy subscriptions for popular securities issues

Subscriptions for popular new securities issues demonstrate again the pivotal role of the quantity of money. Sometimes - particularly at moments of market mania - a new issue is made of a security regarded as hugely attractive by the public and financial institutions. The price is set "too low" and market participants expect that the price in the after-market will be well ahead of the issue price. The level of applications quickly reaches and exceeds all the available stock, and investors realise that they will be "scaled down" (i.e., they will receive only a proportion of the shares for which they subscribe). In order to maximize the quantity of shares they receive, they apply for a high multiple of the shares they expect to pay for. What is the constraint on this activity? The answer is that - as any instruction against a bank deposit would be valid payment - the aggregate value of applications for a popular share issue could be equal to the entire money supply. Since the money supply, on the broad definitions, is in most countries similar to annual GDP the value of applications in one share issue may be larger than a nation's quarterly or even six-monthly GDP. (Telecom share issues in Hong Kong during the bubble of the late 1990s are an example.) Evidently, the scale of payments of this type has no direction connection with recent levels of national income or expenditure. But a payment that would be valid in a share subscription would be equally valid paying for groceries and a hotel bill. To repeat, at the aggregate level nominal incomes and expenditure in 2002 could - in theory - be any imaginable fraction or multiple of nominal incomes and expenditure in 2001.

Equity withdrawal from non-housing asset pools is taking place all the time

These remarks may help in understanding why the importance of MEW has been exaggerated. The point is that equity withdrawal can be made from any asset. It is perfectly possible for a wealthy investor to sell some of his securities and to spend the proceeds on the goods and services which form part of "national expenditure" (i.e., consumption, investment and so on). Such behaviour might be seen as an individual example of "securities equity withdrawal". Another example would be for a wealthy businesswoman who owns a chain of fashion shops to sell them to a quoted retailer for a large capital sum, and then to spend some of the capital sum on goods and services. This could be called "equity withdrawal from unquoted business wealth". Another case would be for an old family short of income to sell part of its antique collection at auction, perhaps with the intention of using the proceeds to pay for improvements to the estate and additions to the wine cellar. This would be "antiques equity withdrawal".

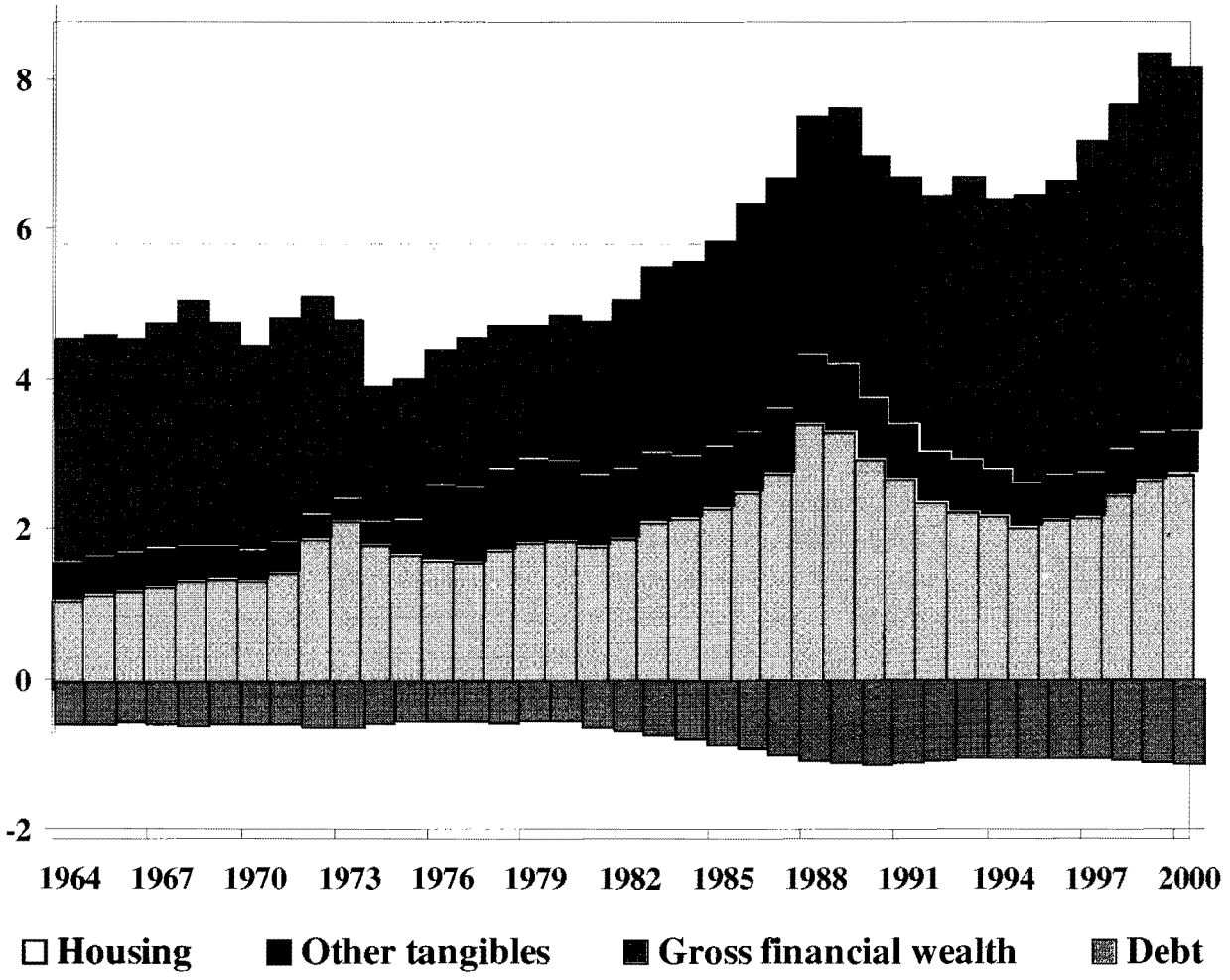
Easy to propose such notions as "securities equity withdrawal"

Defenders of the significance of MEW might say that the distinguishing feature of the equity release they analyse in the housing market is that it relies on borrowing. As noted earlier, MEW is calculated as the difference between net mortgage advances and housing investment. But - at a conceptual level - it would be straightforward to add up the bank borrowings intended to finance the purchase of securities and to call that the aggregate amount of "securities borrowing equity withdrawal". (Societies

Debt vs. wealth

Debt is small compared to wealth

Chart shows debt and the main types of wealth as a multiple of annual household disposable income.



Sources: National Statistics and Lombard Street Research estimates

The previous chart showed that debt is stable relative to income and is overwhelmingly secured against residential property. This chart shows that debt is, and always has been, small compared with households' wealth. (This is hardly surprising. Ultimately, only households can own wealth. Companies, financial institutions and the government exist to serve individuals.) However, the relative importance of different types of wealth varies considerably, as the basis of valuation changes. As gross financial wealth is dominated by equities, low share prices meant that in the mid-1970s it was worth less than twice income whereas today it is worth almost five times income. Key messages for the future are that at present both equities and housing are valued highly by past standards, gross wealth is about eight times larger than debt and the strong balance sheet supports above-trend growth in consumption spending.

or even "antiques credit equity withdrawal"

do not invest resources - apart from issuers' fees and transaction costs - in the creation of financial securities. So net securities lending would almost in its entirety allow equity withdrawal.) If the purchasers of antiques were to be financing their purchases by borrowing, then the total of all such borrowings would be the aggregate value of "antiques credit equity withdrawal". (Societies do not invest resources in the creation of antiques, which by definition are not newly-made but an inheritance from the past. Again, a deduction might be made for the auctioneers' fees. At first glance, the idea of borrowing to buy an existing asset may seem unproductive and shocking, but note that most mortgages are to finance the purchase of existing houses, not newly-built ones.)

MEW no more significant for economy than conversions of the equity in other asset pools into consumption

In short, there is nothing particularly special about MEW, where MEW is regarded as the potential addition to consumption made possible by mortgage borrowing and the sale of housing assets. Any act of borrowing and any asset sale can have the same effect, to allow consumption to be larger - perhaps much larger - than current or recent levels of income. Housing or mortgage equity withdrawal is intrinsically no more powerful in its bearing on macroeconomic outcomes than equity withdrawal from quoted securities, antiques and unquoted wealth held by private individuals. Equity withdrawal from all the assets in the personal sector's wealth pool is a never-ending feature of an economy with private property. In individual transactions this withdrawal may sometimes be made possible by individual acts of borrowing, but it is a hallucination to believe that "the nation" is thereby "borrowing". A nation cannot borrow from itself and it can never be in debt to itself, as the borrowings of one set of individuals must be the financial assets of another set of individuals.

Long-run stability of balance sheet ratios is salient feature of wealth statistics

(It must be conceded that the ratio of gross debt to household income may become "too high", in the sense that particular borrowers have difficulty meeting their obligations. But a nation cannot have net debt to itself. In the UK's case the household sector's gross assets are a high multiple of its debts. [See p. 9.]) The striking feature of balance sheet data in the UK - as elsewhere - is the stability is the balance sheet ratios [debt/income, wealth/income] relative to the enormous increases in the nominal values of debt, wealth and incomes over long-run periods. Further, although a nation may have net debt to other countries, international debts are generally small compared with domestic debts and the world as a whole cannot have net debts to Martians.)

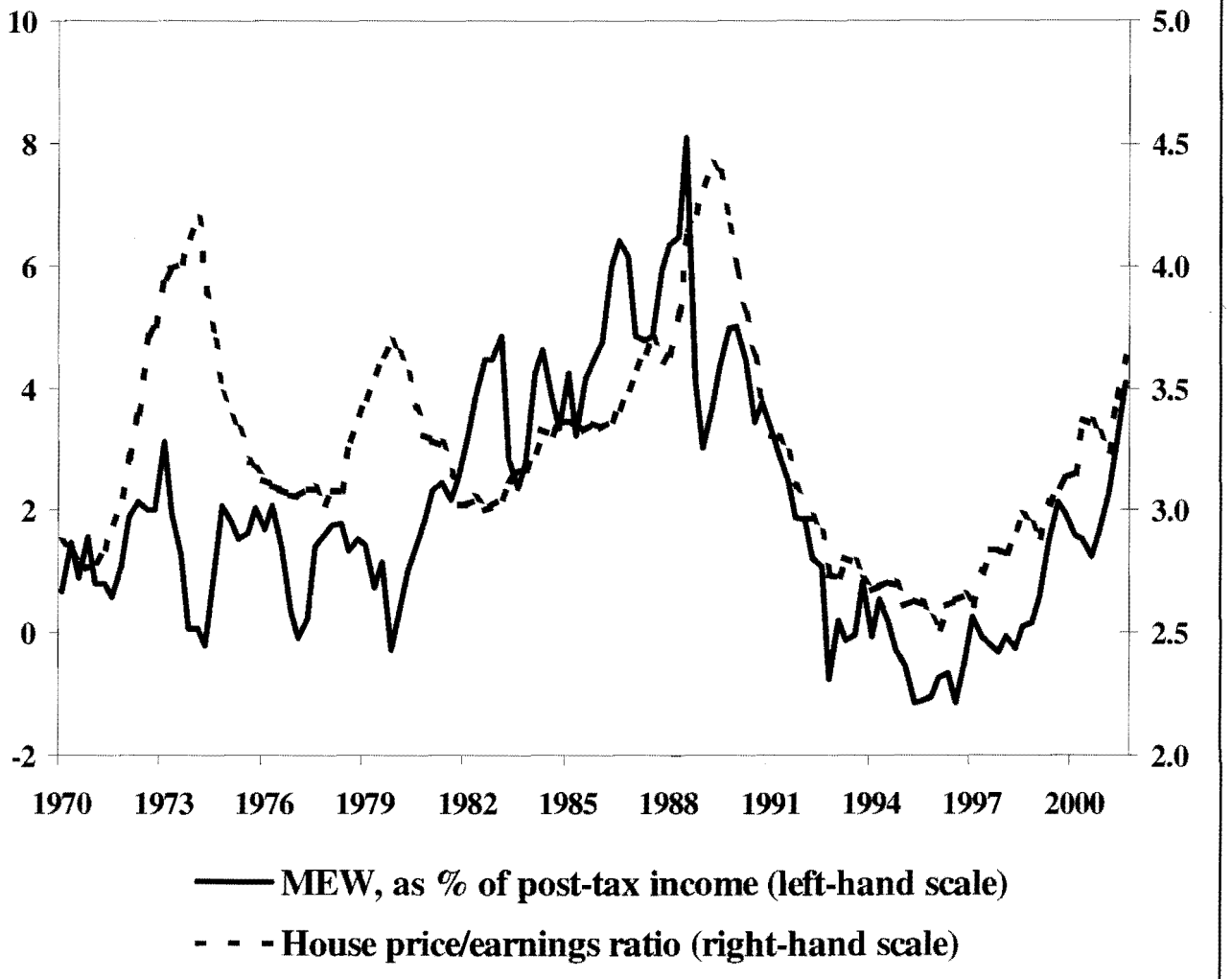
MEW has been a useful concept in analysis of the housing market,

This is not to deny that MEW plays a useful role in the analysis of the housing market. Economically logical behaviour would be for people to reduce their housing equity when house prices are high and to increase it when house prices are low. It is a simple exercise to compare one of the well-known house price/earnings ratios with the Bank of England's MEW series and to calculate an econometric relationship. (See the chart on p.11 and the econometric appendix on p. 16.) Over the last 20 years the positive relationship between house prices and MEW as a ratio of income is in fact clear and quite impressive. Insofar as MEW is in turn correlated with consumption, some interesting links between asset prices and expenditure have been identified. An important message for early and perhaps mid-2002 is that no early

Housing equity and house prices

Equity withdrawal rises with house prices

Chart compares Bank of England's estimate of mortgage equity withdrawal with Nationwide's house price index



Source: Bank of England, Nationwide and National Statistics

When residential property is expensive (relative to long-run norms), people try to convert part of their housing wealth into consumer goods and other assets; when it is cheap, they postpone consumption or sell other assets, and increase their equity in the housing stock. That is the central and perhaps unsurprising message of this chart. It demonstrates a clear correlation between mortgage equity withdrawal (as a % of income and estimated by the Bank of England) and the house price/earnings ratio. The final date for the chart, the third quarter of 2001, is determined by data availability, but it is well-known that house prices have risen sharply over the last six months. By implication, 2002 will see a high level of mortgage equity withdrawal and buoyant consumption. In fact, changes in house prices typically have much more powerful effects on households' net wealth and consumption than changes in the debt/income ratio.

slowdown in consumers' expenditure is in prospect. On the contrary, the rapid house prices gains of late 2001 and early 2002 imply that consumption will be buoyant in the spring and summer of 2002. (The chart on p. 13 - showing the strength of net wealth at present - supports the conclusion.)

but its wider importance has been exaggerated

The MEW concept has improved understanding of the housing market, personal sector behaviour and consumption since it was introduced in the early 1980s.(2) But its role in cyclical fluctuations must not be overstated. It highlights transactions in which the sale of assets from persons' stock of wealth influences their spending on the goods and services that are currently produced (i.e., that constitute current GDP), particularly their consumption spending. But there are many other transactions sequences, involving different types of wealth, where asset sales (or purchases) feed back to consumption. Analysts need to see all these transactions as part of a wider picture, where economic agents balance their money holdings against other components of wealth and where asset portfolios interact constantly with expenditure. The recent over-emphasis on the role of MEW in macroeconomic analysis - notably at the Bank of England - seems to be a by-product of the undue prominence of the circular-flow-of-income idea in university teaching. It would be much healthier if macroeconomists were not taught this misleading notion in their first-year courses,

Need to reinstate analysis of monetary trends

but were instead made to think from the outset about the ways in which economic agents try to maintain an equilibrium between their money holdings, their assets, their debts and their expenditure.

Notes

(1) Christopher Dow *Major Recessions* (Oxford: Oxford University Press, 1998), p. 38 and p. 43.

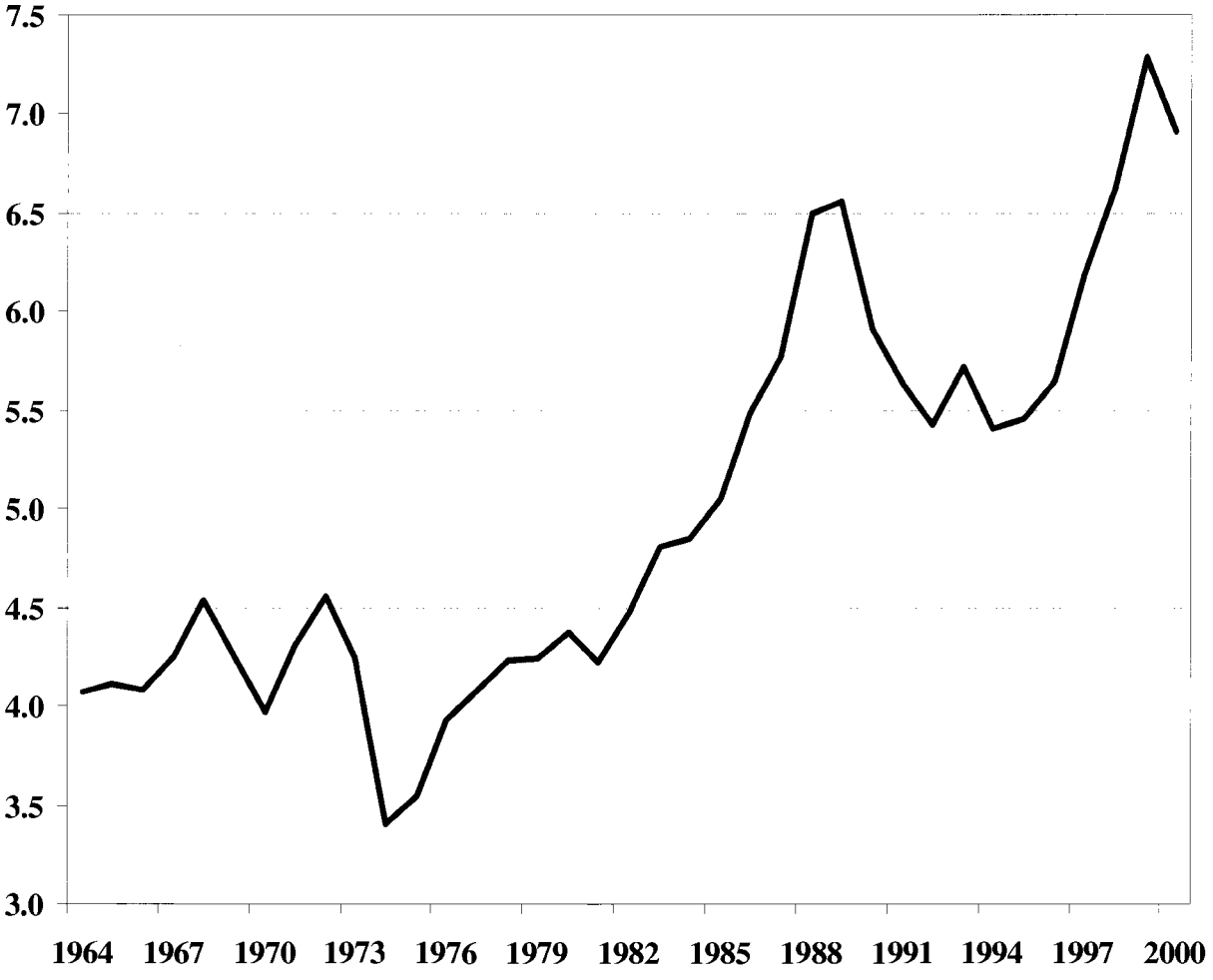
(2) As far as the author is aware, the first use of the phrase "equity withdrawal" (in the context of the UK housing market) and the first estimate of its amount was in a research paper of 4th June 1982 from the stockbroking firm L. Messel & Co. on 'The coming boom in housing credit'. The paper was written by the author and his colleague, Mr. Paul Turnbull. The Messel paper developed and quantified an idea put forward by Dr. David Lomax, the group economic adviser at National Westminster Bank, in the February 1982 issue of the *National Westminster Bank Review*. Dr. Lomax's key sentence was, "The essential point is that apart from mortgage lending used for new construction (new houses or extensions), for transactions costs, and for buying houses from the public sector (council house sales), every penny of net additional credit for house purchase is taken out in equity from the housing market." Dr. Lomax's aim was to refute criticism of the banks for granting supposedly unproductive loans. The Messel analysts obtained figures for advances on new houses and for council house purchase, and for home improvement, and deducted the total of these three items from net mortgage advances to obtain "equity withdrawal". The purpose of the exercise was modest, to explain how the surge in mortgage lending in 1981 and 1982 could be reconciled with the small increases in house prices being recorded at the time. The explanation - as the paper showed - was that the ratio of equity withdrawal to net mortgage advances had been rising.

A paper on 'Mortgage lending and the housing market' appeared (on pp. 390 - 98) in the September 1982 issue of the *Bank of England Quarterly Bulletin*. A section on "The use of

You've never been so rich

But privatisation may be part of the explanation

Chart shows ratio of net wealth to household disposable income (net wealth is gross wealth minus debt)



Sources: National Statistics and Lombard Street Research estimates

This chart is obtained simply by deducting debt from gross wealth in the chart on p.9 and dividing by income. One obvious point is that - despite the debt/income ratio at present being at an all-time high - households' overall balance sheet is healthy. But the contrast between, on the one hand, the 1960s and 1970s, and, on the other, the 1980s and 1990s may be misleading, as it partly reflects the privatisation of assets over the last 20 years. (In a deep sense the UK's citizens always "owned" the nationalized industries and council houses, but this was disguised by their public sector status.) Note that the chart ends in 2000. In 2001 house prices rose by over 10%, while net financial wealth fell slightly because of the weak equity market. Overall the household sector's net wealth today is probably similar relative to income to its end-2000 value. The newspaper worries about over-borrowing have to be seen in this context.

mortgage funds" on pp. 395 - 6 discussed the discrepancy between mortgage lending and housing investment. It referred to "withdrawals of equity" and - following the Lomax article and Messel paper (neither of which it mentioned) - said that, "It must be presumed that a substantial part of net mortgage lending has gone to sustain spending, repay other debt, or increase holdings of financial assets..."

A large literature has subsequently built up around the subject. The latest contribution from the Bank of England's staff, 'Why house prices matter', by Kosuke Aoki, James Proudman and Gertjan Vlieghe, appeared on pp. 460 - 68 of the winter 2001 issue of its *Quarterly Bulletin*. The paper models what it calls "the household credit channel" and refers to a 1999 paper by Bernanke, Gertler and Gilchrist which makes a lot of fuss about the macroeconomic importance of imperfections in credit markets. It claims that "house prices matter because houses can be used as collateral, against which households borrow to finance housing investment and consumption". This statement is simply wrong. House prices matter because they determine the value of the housing stock, because housing equity - whether collateralised or not - can be converted into consumption or other assets, and because the scale of such conversion will depend partly on the value of the housing stock relative to other things. The relationship between house prices and consumption would hold if there were no mortgage borrowing - and hence no use of housing equity for collateral - whatever.

(To repeat, a nation cannot borrow from itself. If external transactions are put to one side, the net sum of all credit transactions in any economy over any time period is nil. Given this rather fundamental problem, a "credit channel" has to work very hard to be relevant to macroeconomic outcomes. It does not matter how large the gross incurral of debt by one set of agents is to other sets of agents; in the aggregate the debts cancel out. There is no obvious evidence of a relationship between the scale of gross credits flows in an economy and major macroeconomic aggregates. [Bernanke, Gertler and their associates have not provided any persuasive statistical material of the right kind.] Of course, when additional credit passes through the banking system, it may create new bank deposits and the extra money in the economy alters the equilibrium level of national income. The long-run relationships between money and nominal national income are well-known and relatively uncontroversial, but this returns the subject to traditional monetary economics.)

As noted, the Bank of England paper subsumes housing credit inside a supposedly vital "credit channel", providing yet another example of the difficulty that Bank of England economists have integrating money into their macroeconomic analysis. This is not a minor academic debating point. It would be straightforward, at a conceptual level, for all the credit transactions involved in house purchase to take place outside the banking system. Vast amounts of credit could be registered (i.e., gross mortgage lending would be a very high multiple of net mortgage lending) and net mortgage lending could be much higher than housing investment (i.e., MEW would be substantial), and yet there would be no effect on the equilibrium level of national income. The explanation would be that the mortgage lending did not appear or banks' and building societies' balance sheets, and therefore had no effect on bank deposits and the quantity of money. *It is the monetary effect of booming (or collapsing) mortgage credit which is ultimately vital to macroeconomic outcomes.* The Bank of England's failure to understand this argument goes a long way to explain its inglorious role in the Heath-Barber boom of the early 1970s and the Lawson boom of the late 1980s. Apparently its economists still have not learnt the lesson.

Mortgage boom rolls on

2002 will be another record year for mortgage lending

Chart shows quarterly net mortgage lending by all lenders, including specialist intermediaries (which are neither banks nor building societies).

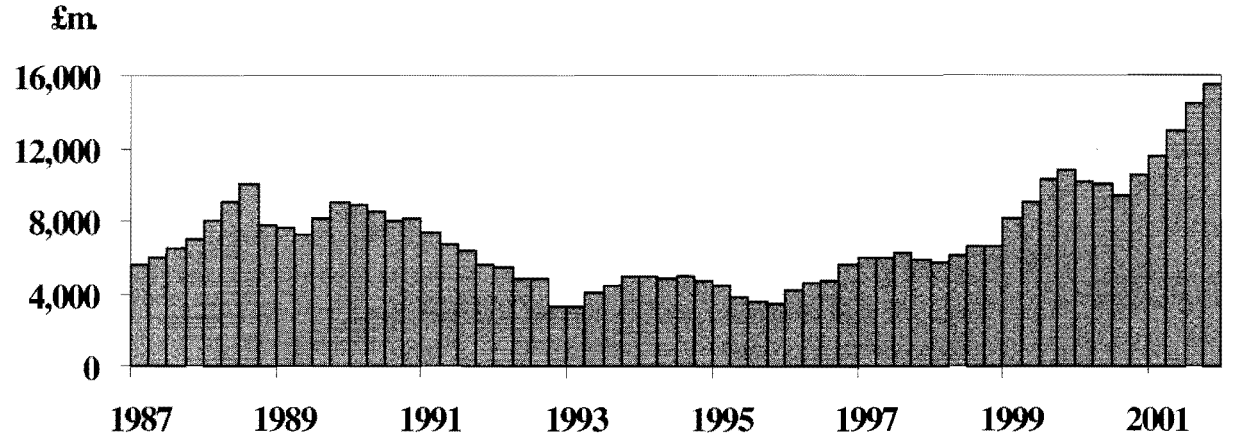
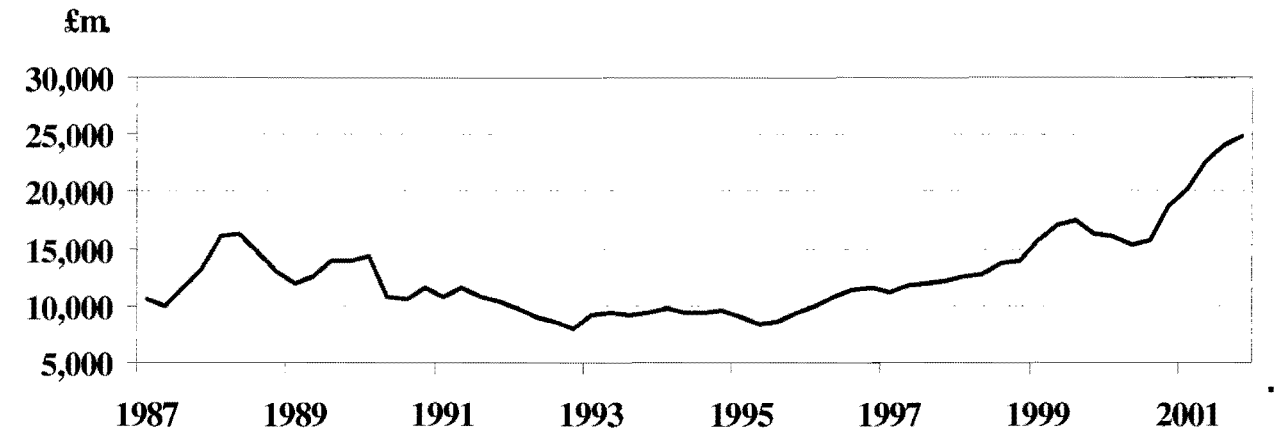


Chart shows quarterly bank and building society new mortgage commitments (in seasonally adjusted, 1987 prices)



Source: Bank of England

The previous charts showed - after the financial liberalisations of the early 1980s - the stability of the debt/income ratio, and even the gross and net wealth-to-income ratios, when compared with the huge increases in the nominal value of wealth over the long run. A possible interpretation is that - at least in part - mortgage debt adjusts to the value of the housing stock rather than vice versa. When excess money growth is accompanied by high asset price inflation, arbitrage between non-housing assets (especially equities) and housing ensures that housing participates in the asset price advances. The ratio of housing wealth to debt increases, and people - keen to enjoy their wealth - then borrow and extract mortgage equity. Obviously, interest rates are also crucial to borrowing decisions. The message has to be that mortgage credit will remain robust in 2002, with net mortgage lending probably reaching another all-time peak of over £60b.

Econometric appendix

The results of regressing MEW on the house-price-to-earnings ratio in the period Q1 1980 to Q3 2001 are shown below. (The data were presented in the chart on p. 11.) The best-fitting equation is

MEW = -9.5 + 3.7 HPER

where MEW is expressed as a %age of households' disposable income and HPER is the house-price-earnings ratio, as based on Nationwide house price index. The significance tests are reproduced below.

The quality of the relationship is surprisingly good. This may have encouraged analysts at the Bank of England and elsewhere to accord MEW a central role in their macroeconomic research. However, the quality of the econometric relationship between the two variables in the 1970s was markedly worse.

SUMMARY OUTPUT

Regression Statistics

Multiple R	0.743
R Square	0.553
Adjusted R Square	0.547
Standard Error	1.488
Observations	87

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	232.722	232.722	105.049	0.000
Residual	85	188.306	2.215		
Total	86	421.028			

	Coefficients	*Standard Error*	*t Stat*	*Lower 95%*	*Upper 95%*
Intercept	-9.499	1.169	-8.126	-11.824	-7.175
X Variable 1	3.693	0.360	10.249	2.977	4.410