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About the role of barking in monetary policy

Is the silence on M4 significant?

Silence on UK money growth

The newspapers have stopped reporting UK money supply data. They still refer to money supply growth in the Eurozone, where the European Central Bank has a quasi-target for M3, but in the UK they ignore it. Even the pack of City economic commentators has stopped barking about the subject. Is there any significance in this?

But low money supply growth is necessary for low inflation

Inflation targets replaced money supply targets in the early 1990s. But the Bank of England still devotes much space in its *Inflation Report* and other publications to money supply data. No one who has studied the matter doubts that in the long run money growth and inflation are related, as indeed are monetary contraction and deflation. So it remains necessary to assess the rate of money growth consistent with the 2 1/2% inflation target. Over the last 25 years the ratio of money to GDP has been rising, typically by about 2% a year. The reasons for the rise are disputed, but they will probably be less powerful in future than they have been in the past. If the trend rise in the ratio of money to GDP is judged to be 1/2% - 1% a year from now on, and if the assumed underlying growth rate of output is 2 1/2%, then the trend rate of money growth needed to keep inflation at 2 1/2% is 5% - 6% a year. (A little leeway might be allowed around this figure, depending on circumstances.) What, then, is the current rate of annual rate of M4 growth? The answer is that in the year to July M4 rose by 5.7%, while in the previous three months the annual growth rates were 5.9%, 6.0% and 6.0% respectively. The reason that the dog is not barking is that there is nothing to bark about. For the time being money growth is consistent with the inflation target. That is that.

and M4 growth was only 5.7% in the year to July

Unusual pattern of mortgage boom being accompanied by moderate money growth,

However, there are some interesting puzzles about recent monetary developments. Perhaps the most interesting is the combination at present of a mortgage boom and only moderate money supply growth. For most of the last 30 years mortgage booms have been accompanied by rapid money growth and soaring house prices have been part of general asset price excess. Why is this time different? The main answer is that, while the banks have been able to expand their mortgage assets rapidly, corporate loan demand has been weak. In the year to July M4 lending to households, much of it for mortgages, advanced by 8.6%, whereas lending to companies rose by 4.7% and lending to financial institutions fell by 1.3%. If lending to companies and financial institutions had grown at the same rate as to households, banks' balance sheets would have been larger and M4 growth higher. The sluggishness of corporate loan demand is striking against the background of the lowest interest rates for over a generation. The monetary situation could change radically in 2003 if corporate loan demand were to revive. Companies' keenness to reduce their bank debt is partly a reaction to the excesses of the late 1990s, with phone companies in particular having to de-gear their balance sheets as they throw out the too bullish revenue forecasts of 1998 and 1999. By contrast, lending to property companies is booming, rising by 21.0% in the year to the second quarter.

which may not last

Professor Tim Congdon **30th August, 2002**

Summary of paper on

How long can the mortgage boom last?

Purpose of the paper

Two years ago the *Monthly Economic Review* argued that the UK mortgage market may grow more slowly than the rest of the economy in the first two decades of the 21st century. On the evidence of 2000-02 that conclusion seems wrong. Mortgage lending has boomed. But a deeper analysis of the relevant issues suggests that the earlier gloomy prognosis may still be the correct one. Recent experience may reflect cyclical rather than structural influences.

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, but it has recovered sharply since 1999 and has been especially strong over the last two years. (See p. 7.)**

* **The ratio of mortgage debt to housing wealth soared in the early 1990s and is still high by historical standards. Unsustainably rapid house price inflation has helped push the ratio down in recent years but cannot be relied upon to do so indefinitely. (See p. 8.)**

* **Although household sector liabilities have risen steeply relative to income, low interest rates have reduced the debt burden. Low "income gearing" is an offset to high "capital gearing". (See p. 9.)**

* **Tax incentives encouraged mortgage borrowing in the past, but now no longer exist. Their disappearance should make the household sector more reluctant to hold mortgage debt. (See p. 10.)**

* **The rate of household formation is not expected to provide any additional stimulus to mortgage demand in coming years. Higher immigration may help, but its influence is not certain. (See p. 11.)**

* **Demographic influences on mortgage demand will be adverse over the next 20 to 30 years. The number of people in the key first-time buyer age bracket is now declining, a marked contrast to the experience of the 1960s, 1970s and 1980s. (See p. 12.)**

This paper was written by Stewart Robertson.

How long can the mortgage boom last?

Current rapid growth of mortgage credit may be cyclical rather than structural

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

...but mortgage borrowing has boomed over the last two years

The July 2000 *Monthly Economic Review* posed the question "Has the UK mortgage market gone ex-growth?" The experience of the last two years has appeared to provide a clear answer. In July 2000 mortgage credit growth was running at an annual rate of a little over 8%. That had drifted up to 9% by July last year and to an astonishing 11.8% in the year to July 2002. Over the two-year period the outstanding stock of mortgage debt is estimated to have risen by well over £100b. from £514b. to £634b. On the face of it, the conclusion reached two years ago - that the mortgage market would struggle to grow as fast as the rest of the economy - has been emphatically wrong. Judged solely on the facts from the last two years, the analysis must have been flawed. But is that really the correct view to take? The reasons for the performance of the mortgage market since July 2000 are interesting in themselves. And it must be emphasised that the conclusions reached previously referred to the medium term. The purpose of the current paper is to re-visit the earlier analysis, up-date it if necessary and ask the revised question in the title above.

Three reasons for the gloomy prognosis

There were three strands to the analysis presented two years ago that, when combined, suggested that the mortgage market in the first few decades of the 21st century would be very different from the one that existed in the 1960s, 1970s and 1980s. The first was that at the end of the 1990s homeowners were heavily indebted and that this would tend to constrain the future growth of mortgage lending. Specifically, the ratio of mortgage debt to the value of the housing stock was extremely high by the standards of the previous 30 years. The second was that much of the buoyancy of the housing and mortgage markets in the past could be explained by the generous tax relief granted on mortgage interest payments. Tax incentives were such that effective (i.e., post-tax) mortgage rates throughout the 1970s and 1980s were extremely low and consistently lower than annual house price rises. There are now no tax advantages to mortgage borrowing at all, which should imply that the level of debt (relative to value) with which homeowners are comfortable would be lower than in the past. The final argument was that the pool of potential first-time buyers will be shrinking in the first two decades of the present century, a sharp contrast to the experience of the 1970s and 1980s. Between 1970 and 2000 first-time buyers accounted for 85% of all new mortgage lending.

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

The experience of the last few years suggests that these three influences have not had any noticeable effect on the mortgage market or, at the very least, that their impact is not yet being felt. So what went wrong with the analysis and what is the outlook now? The cornerstone of the argument presented earlier was that debt was too high relative to housing wealth. With house price inflation seemingly constrained by the Government's 2½% retail price inflation target, the only way for the ratio to fall was for mortgage lending to grow more slowly. Two things have happened over the last two years that have affected this conclusion. In one sense the outcome has been as predicted. The debt:value ratio peaked at 35.8% in 1995 but fell steadily over the next five years and has certainly declined significantly further so far in 2002. The surprise has been that it has been the manner in which the adjustment has taken place. Rather than slow growth of mortgage debt, it has been rapid house price inflation that has done the job. Over the last five years the average annual rate of house price increase has been an astonishing 12.6%. In 2001 house prices rose by 14% and, according to the latest figures from the Nationwide and Halifax, prices have risen in the last year by well over 20%. These trends have boosted the value of the housing stock massively and have allowed the continued fall in the debt:value ratio to be reconciled with very strong rates of mortgage lending growth. The key point is whether these trends can continue and the clear conclusion must be that they cannot.

Rapid house price inflation has reduced capital gearing...

Over the very long-run house prices have tended to grow in line with earnings. The generally accepted view is that wage inflation of around 4.5% is consistent with the official retail price inflation target of 2.5%. In other words, the sustainable long-run rate of house price inflation cannot be much higher than 5%. More fundamentally, there is considerable evidence that the house market at present is overheating. The ratio of house prices to average earnings is currently about 4.5 (and still rising steeply) compared with a long-run average of 3.6. That sort of figure has only been seen twice before over the last 50 years. Once in 1974 and, more recently, at the end of the "Lawson boom" in 1989. Both occasions were followed by much weaker housing markets. The imbalance was greatest in the late 1980s when the ratio briefly reached 5 (and was significantly higher in the usual hotspots of London and the south-east). A period of much lower house price rises - and possibly falling prices - seems inevitable. But it does not look imminent, and that brings us to the second crucial influence of recent years.

...but 20%+ rates of house price increase are unsustainable

Low interest rates have stimulated the mortgage boom

The main explanation for the present housing boom is fairly clear. Base rates of 4% - the lowest since the 1960s - have stimulated credit demand hugely. There is little doubt that if the Bank of England paid attention only to the UK's domestic economy, interest rates today would be much higher. But the Bank has faced a severe dilemma over much of the last five or six years. Consumer demand has been buoyant, due in substantial part to the strength of the housing market, but the manufacturing sector has experienced recession and the global slowdown has hit exports hard. The compromise that the Bank has been forced to accept has been to allow the housing market and consumption spending to surge ahead (by keeping interest rates low) and to provide some respite for the weaker parts of the economy. Low interest rates mean that regular mortgage payments are much easier to finance. Affordability is good, in other words. According to the *Housing Market Report*, first-year mortgage interest payments as a proportion of average (single person) income is currently less than 25%. When interest rates were ramped up in 1988 and 1989 this proportion reached 64%. Little wonder that the house market crashed, mortgage arrears mounted and repossessions soared. But there seem little likelihood of interest rates doubling (or worse) today. Income gearing (the ratio of interest payments to disposable income) is extremely low by the standards of the last 30 years or so. So although capital gearing remains high, the low-interest rate environment means that income gearing is low. Average mortgage rates of less than 6% have reduced the burden of debt considerably and that appears to be the dominant influence on mortgage demand at present.

Once house price inflation slows, high capital gearing will restrain mortgage demand

However, some care needs to be taken in this area. It is not simply the case that low income gearing means that high income gearing is not important any more. While it is true that low interest rates have made high capital gearing less onerous, it is also true that capital gearing has fallen and continues to fall. With mortgage credit currently growing at annual rates of 10%-12%, the ratio will only drop further if house price inflation exceeds these rates. (The influence on the value of the total housing stock from additions through housing investment is not considered here. Its impact is negligible compared with the effect of re-valuations from changes in house prices.) A decline in house price inflation to below 10% does not look likely until some time in 2003, but most commentators seem to expect it to slow to a sustainable rate - presumably around 5% - by the end of next year. If that happens, then double-digit mortgage growth can no longer be reconciled with a continuing fall in the ratio of debt to housing values. If capital gearing is an important influence, as asserted here, then mortgage demand would then have to slow sharply.

Demograhic influences will be adverse over the next 30 years

Two final points need to be made. First, the adverse demographic influence on medium-term mortgage demand that were described two years ago remain in place. New projections from the World Bank show that the numbers of people in the key first-time buyer age bracket (20 to 39) are expected to decline steadily over the next 30 years, with most of this effect being felt in the current decade. Recent data from the Council of Mortgage Lenders (CML) highlighted that proportion of loans accounted for by first-time buyers slipped well below 40% in 2002. Throughout the 1970s, 1980s and even the first half of the 1990s this proportion was routinely over 60% and often much higher. Cyclically-low interest rates are currently encouraging existing homeowners to extract equity from their housing wealth via new, larger loans and this trend is helping to support overall mortgage lending growth. But the structural adverse influence from demograhic trends will be felt over a much longer period of time. One unknown in this area concerns immigration. The Government has recently relaxed immigration laws to attract more workers to the UK. The majority of these will be young and the numbers involved could be sufficient to offset some of the negative effect outlined above.

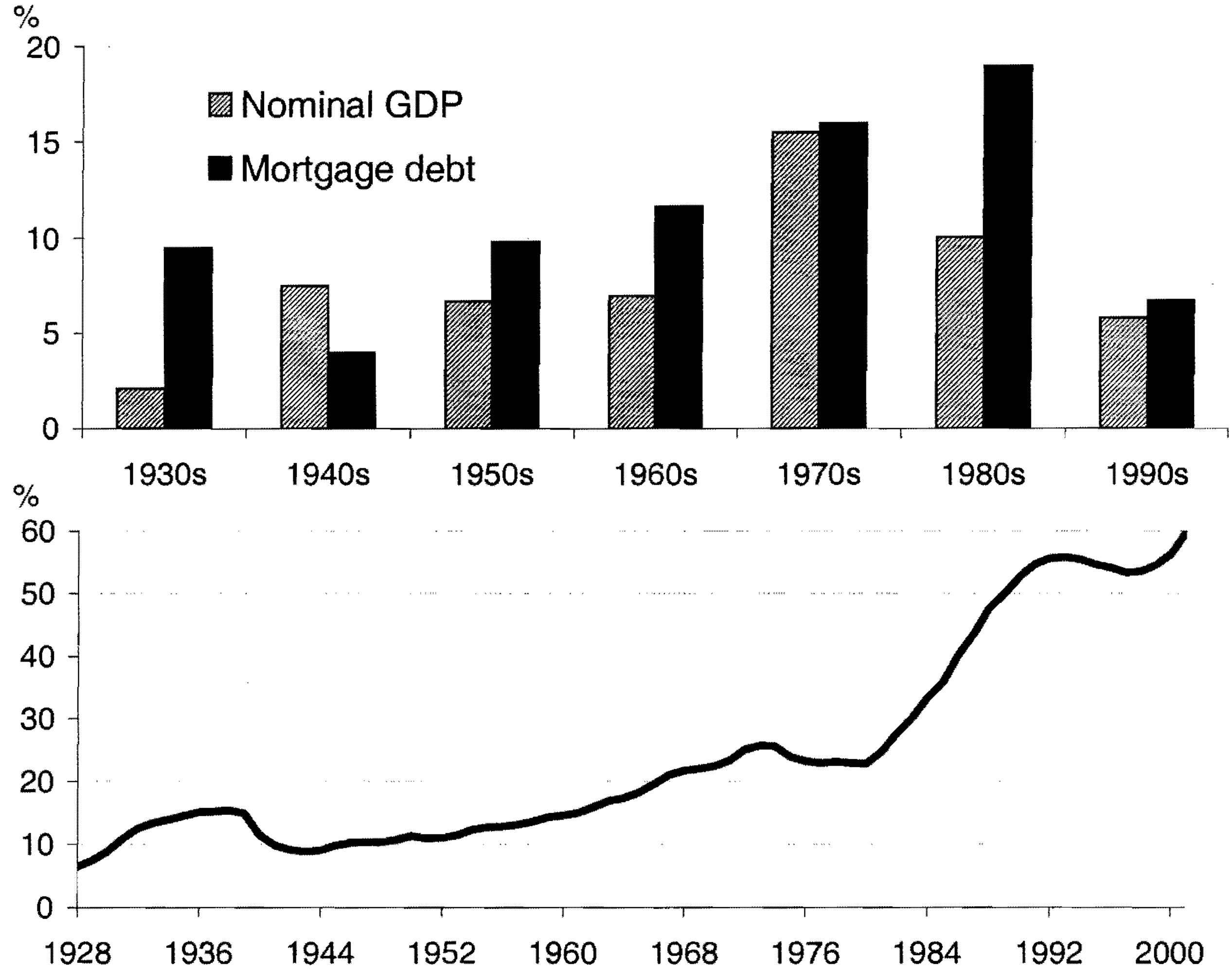
Downward pressure on mortgage margins set to continue

Lastly, competition among mortgage lenders has intensified over the last decade. The British Banking system is well-capitalised and keen to grow its balance sheet and mortgages make up about half of total assets. Although mortgage demand has been strong, competition has driven margins down relentlessly. Mortgage volumes may have been satisfacory, but profits have almost certainly not been. If demand for mortgage funds were to slow sharply over the next 20 years, the pressure on margins would simply become even greater.

The mortgage market in the long run

The mortgage market is growing faster than GDP again

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.



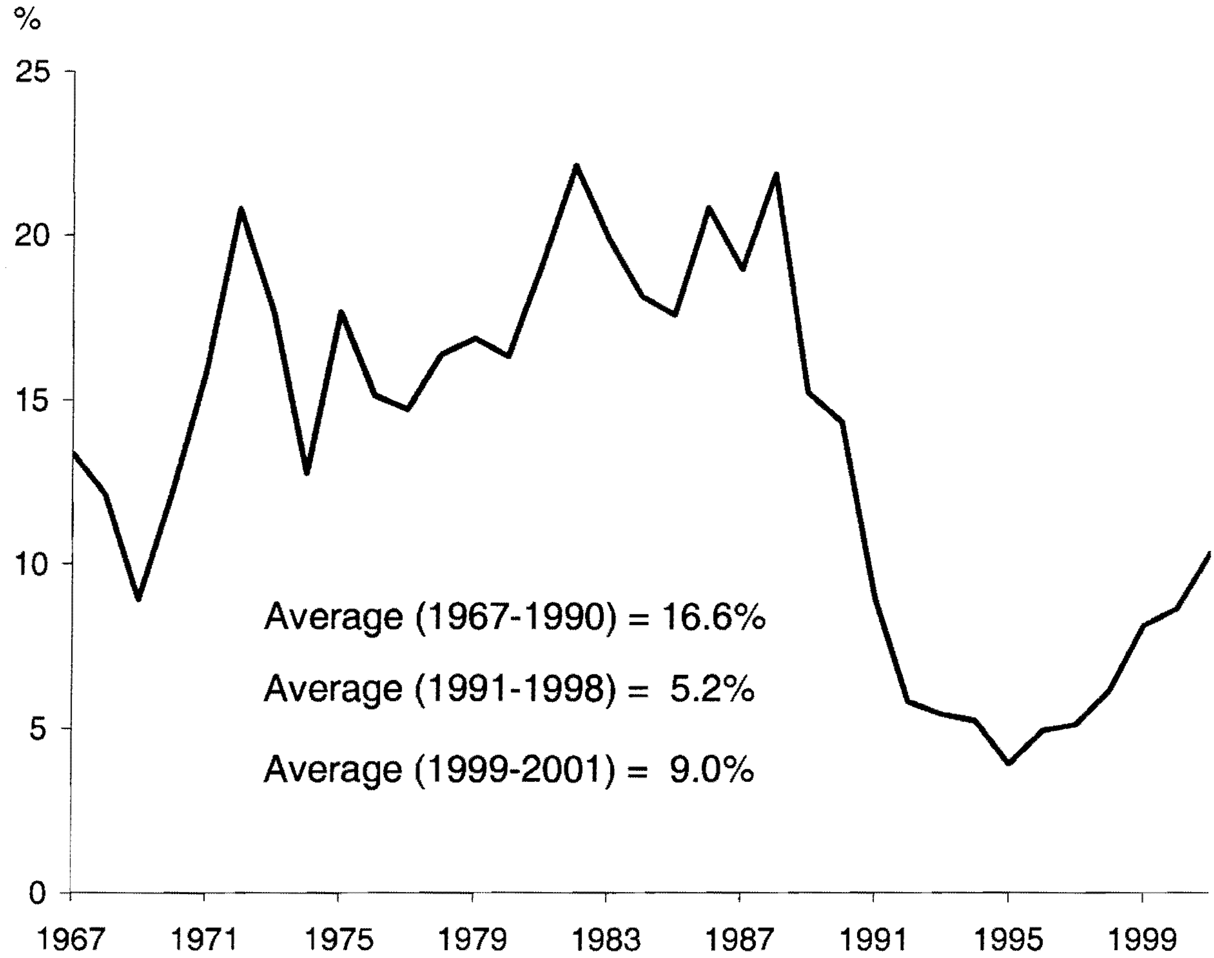
Sources: Building Societies Association, National Statistics, British Historical Statistics (Mitchell)

Between the end of the war and 1974 mortgage debt grew steadily as a proportion of GDP. After a brief decline in the second half of the 1970s the upward trend was resumed, only now it was much stronger. De-regulation of the banking sector and the drive towards greater home ownership stimulated mortgage demand greatly throughout the 1980s. Small wonder, then, that UK banks and building societies devoted much of their resources to growing their mortgage businesses. Unfortunately the legacy of the Lawson boom was an unprecedented period of falling house prices and the misery of negative equity for many new homeowners. Mortgage credit growth collapsed, restrained by soaring repayments. (See p. 7.) From 1994 to 1997 mortgage debt rose more slowly than the economy as a whole, giving the impression that the market may have gone "ex-growth". But since 1999 the pattern of the 1980s has resumed. In the year to June 2002 mortgage credit increased by 11.4%. Nominal GDP growth over the same period was a mere 3.7%.

Mortgage credit growth has boomed since 1999

Volumes may have recovered, but profits probably haven't

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



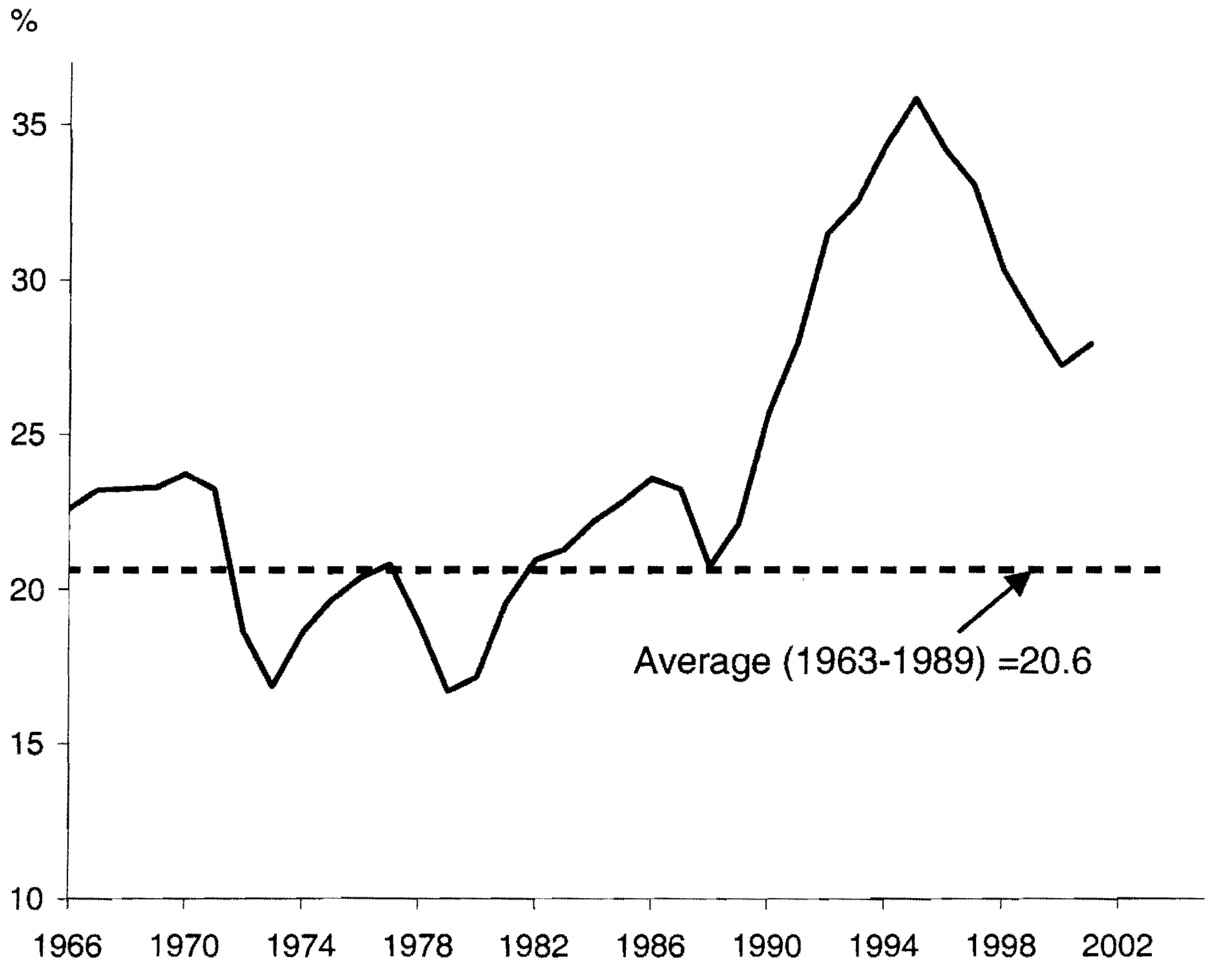
Source: National Statistics

The collapse in mortgage credit growth in the 1990s was followed by an extended period of modest increases. The recession of 1990-92 left most UK banks badly damaged - bad debts averaged 75% of net income between 1989 and 1993 - and restricted asset growth because of shortages of capital. But balance sheet health was soon restored, helped by lower interest rates after the UK's exit from the ERM in September 1992. Weak mortgage demand in the mid-1990s was then met by over-supply from the banking sector. The inevitable result was severe pressure on margins. Over the last three years mortgage demand has revived, stimulated primarily by the lowest borrowing costs since the 1960s. But the banking sector has remained well-capitalised and profitability within the mortgage market has fallen significantly in recent years. This trend has also not been helped by the entry into the market of several new, non-traditional lenders, and is further threatened by the likelihood of stricter regulation of the mortgage market.

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.



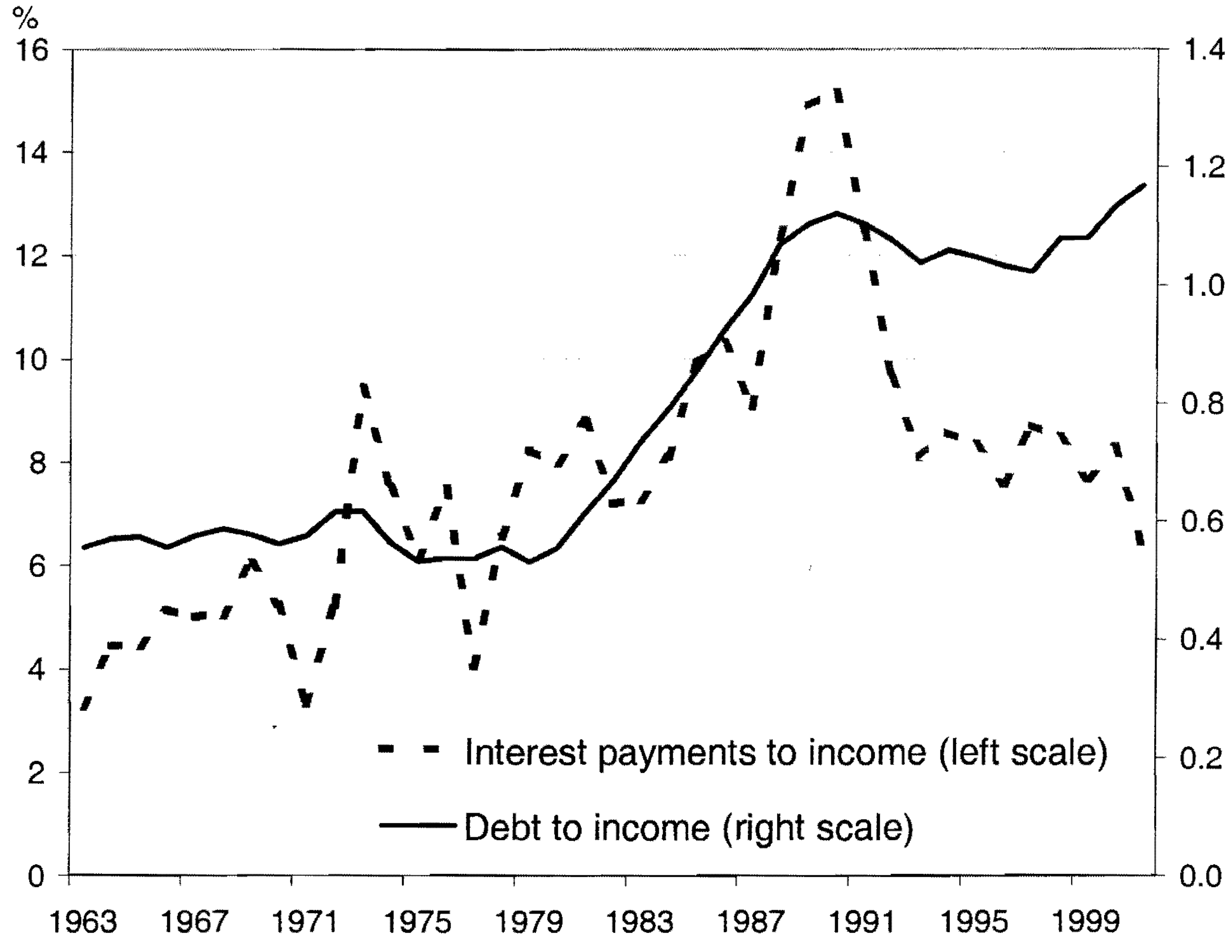
Source: National Statistics

Between 1966 and 1989 the ratio of mortgage debt outstanding to the value of the housing stock (a measure of capital gearing) fluctuated within very narrow bounds. The unprecedented period of falling house prices from mid-1989 until late 1995 caused the ratio to rise sharply. By the mid-1990s it was well over 35% and completely out of line with historical experience. The logical conclusion was that the growth rate of mortgage lending would be held back as borrowers repaid debt - or were reluctant to take on more. And in 1995, 1996 and 1997 that appeared to be what was happening. Mortgage debt grew by just 4.5% a year and house prices recovered, driving the ratio back below 30%. But since 1999 house price inflation has averaged around 15% and this has allowed the continued decline in capital gearing to be reconciled with a strong revival in mortgage borrowing. A key question is whether rapid house price inflation can be relied upon to bring the ratio down further. The current 20%+ rates of house price growth are clearly unsustainable.

Income gearing and affordability

Debt-to-income has risen steeply, but low interest rates have eased the burden

Chart shows the ratios of mortgage debt and of average annual income payments to disposable income



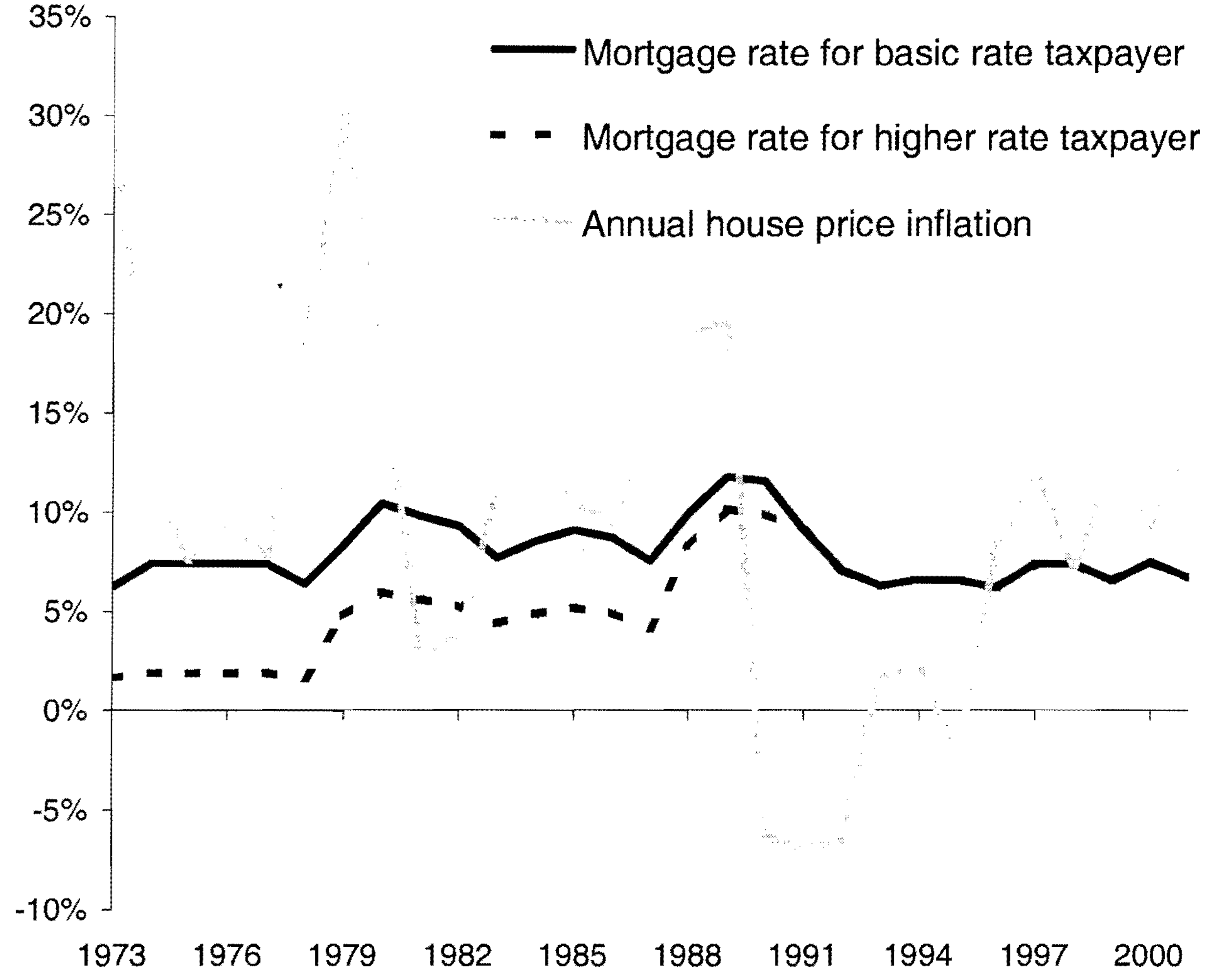
Sources:National Statistics

The 1980s witnessed a huge increase in household indebtedness. The ratio of debt-to-income more than doubled in the decade, while relatively low interest rates until 1988 meant that the burden of debt was not too onerous. Base rates were as low as 7½% in May 1988 but rose to 13% by the end of the year and 15% in late 1989. They remained high until after sterling's ignominious exit from the Exchange Rate Mechanism (ERM) in September 1992, a period that coincided with the worst of house price declines. Interest payments soared as a proportion of income. First-time buyers, who had been encouraged to get on the housing ladder but had borrowed extensively to do so, suffered most. Mortgage debt continued to rise in the early 1990s, although large repayments implied a decline relative to income. More recently, debt-to-income has risen again, but low interest rates have eased the payments burden significantly. How the tension between high capital gearing and low income gearing is resolved will be of vital importance to the pattern of 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



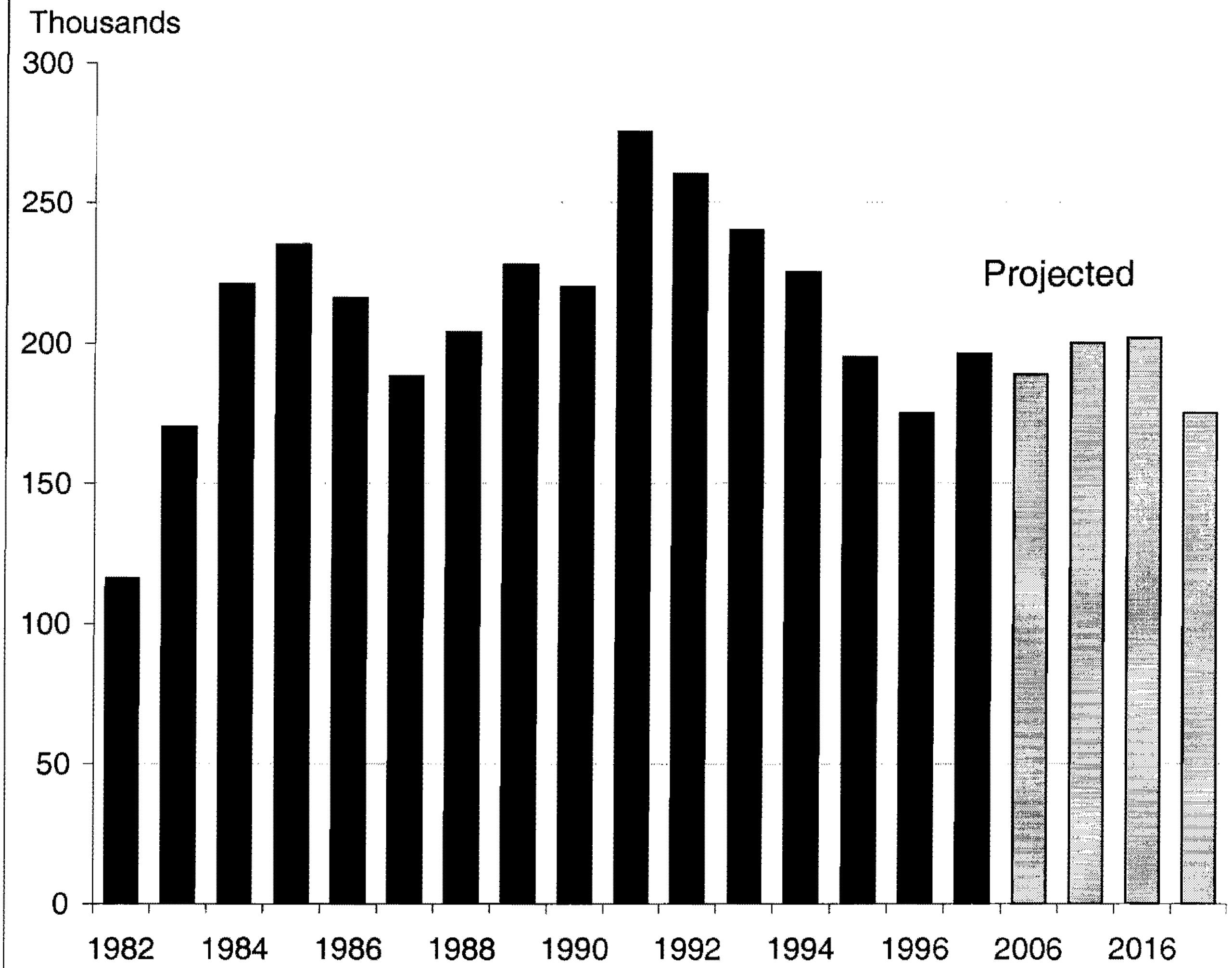
Sources: National Statistics, Inland Revenue, Council of Mortgage Lenders, Nationwide Building Society

Tax privileges on mortgage borrowing no longer exist, but in the past they were a pivotal influence on housing and mortgage markets. With the exception of 1981 and 1982, average house price inflation exceeded the effective post-tax mortgage rate for all borrowers throughout the 1970s and 1980s. The implication was that the huge build up of mortgage debt made sound economic sense. Although financial liabilities rose steeply, the value of assets was increasing even faster, implying that net wealth was always rising. As long as house prices continued to grow at a reasonable pace, maximising mortgage debt subject to the tax relief limits was entirely rational. The housing bust at the end of the 1980s and during the first half of the 1990s changed everything and, unsurprisingly, was followed by a period of more sluggish mortgage debt growth. The removal of tax relief must mean that the "equilibrium" level of mortgage debt (relative to housing wealth) is lower than in the past. Once house price inflation slows - as it must eventually do - mortgage debt could grow much more slowly.

Number of households to rise more slowly

No great stimulus to mortgage borrowing from rising household formation

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



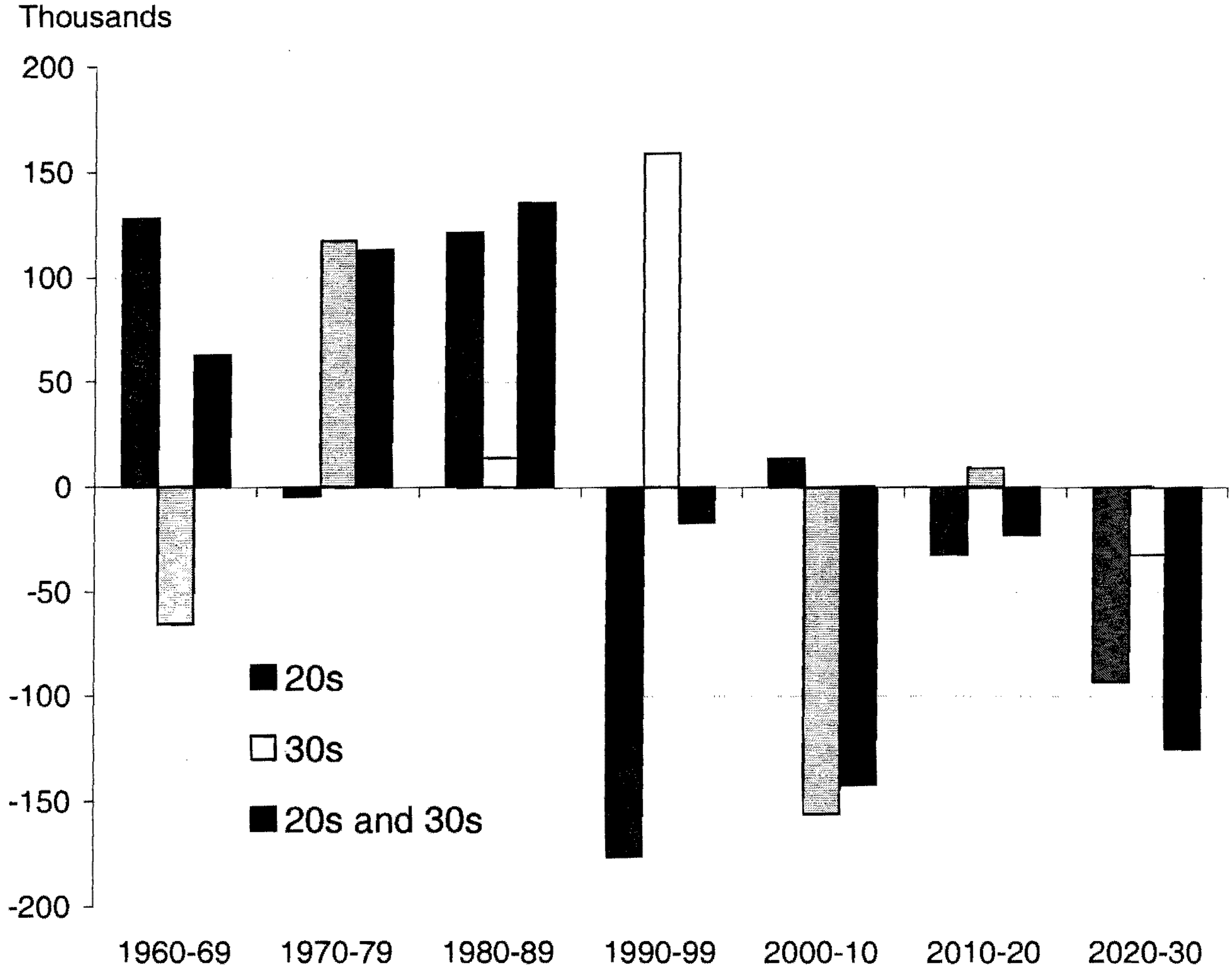
Source: Department for Transport, Local Government and the Regions

Over the last two decades the number of households in the UK has increased by an average of around 200,000 a year. Official projections for the next 20 years show that annual increases a little below this average are to be expected. A common misconception is that the rising proportion of households headed by a single person will mean a significant upturn in the overall rate of household formation. But there will be a major offset from the lower number of those headed by two people. More importantly, adverse demographic trends (see p. 12) imply that the number of people in the age range usually associated with household formation will fall significantly in coming years. It is also worth noting that lone parents and single person households are likely to be more "debt conscious" than most. One favourable influence may be higher immigration into the UK. The Government recently announced an expansion in the number of work permits being granted to 175,000 a year. In the late 1990s the typical annual total was generally between 50,000 and 100,000.

Numbers of first-time buyers is falling

Trends over the next 30 years very different from the 1960s, 1970s and 1980s

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

The first-time buyer (FTB) market is crucial to the major mortgage lenders. Although things are changing a little, inertia still characterises large parts of the mortgage market. Signing up new borrowers is therefore of great importance. Moreover, the overall growth of mortgage debt is dominated by loans to FTBs. Indeed, the rise in repayments following the housing crash meant that between 1992 and 1998 lending to FTBs accounted for over 100% of the net increase. That proportion has dropped to around three-quarters in the last few years as existing borrowers have taken advantage of the lowest mortgage rates for 40 years to withdraw equity from their housing assets. In the 1960s, 1970s and 1980s the numbers of people in the key FTB age bracket (20 to 39) increased steadily. But in the next three decades they will fall sharply, especially over the next ten years. The steep decline in the potential pool of FTBs will be a major adverse influence on the growth of mortgage lending in the first part of the 21st century.