

**February 19, 2006 Sunday**  
First Edition

**SECTION:** BUSINESS; Pg. 9

**HEADLINE:** If house price rises were made of straw, would spending fall through the floor?

**BYLINE:** Hamish McRae

**BODY:**

There was a sudden jolt last week to the "steady as she goes" perception of the UK economy.

Just a day after the Bank of England had published its Inflation Report, which suggested the economy would pick up a bit more speed through this year, came news of a slump in retail sales in January. Year-on-year, the rate of increase in sales fell from 4.3 per cent in December to just 1.3 per cent. With prices falling in the shops, this means, in money terms, that we are spending hardly any more now than we were a year ago.

This has had an impact on interest rate expectations, for now the markets reckon that the Bank will be forced to cut by the summer. It also has implications for the Chancellor, now only just over a month way from his Budget. In the view of the Bank, one of the main reasons for the slowing in the growth of consumption is the rising tax burden.

There are three ways you can look at all this. One is to wonder how relevant retail figures still are. Sales are falling as a proportion of consumption and are now only about one-third of the total. That is partly a result of people shopping online but more because of the gradual shift away from buying things and towards buying services, itself a function of a relative shift in prices.

There is a further point here: the very bad January figures followed quite a strong December. Maybe people simply took advantage of the proliferation of pre-Christmas sales to shop earlier than in previous years. You can see in the left-hand graph both the fall-off in sales and the way in which the overall price of goods has been declining for several years.

The next way to look at it is to see trends in retail sales as largely a function of movements in house prices. The link is well known. When people move house, they both buy more kit for the home and take out a slightly larger mortgage than they need - to use the money to fund other purchases. That makes sense because you can borrow at a much lower rate on a mortgage than you can on a credit card, though that has not stopped credit card debt soaring too. The UK has more plastic debt than the rest of Europe put together.

On that basis, consumption should recover. Not only have house prices started to rise again but mortgage applications have shot up, as the next graph shows. So

maybe the expectation of a summer recovery in consumption is sensible after all.

There is a third way to look at the numbers and one which I think will come more to the fore in the next two or three years. This is the extent to which people will be happy to spend less of their earnings on private consumption and more on public goods and on savings.

In recent years, there has been a tendency for the proportion of national income that we consume to creep upwards. In addition, the amount we save (or fail to save) is quite closely linked to house prices. When prices are rising, we save less, and vice-versa, as the third graph shows. But in the past five years there has also been a tendency for public spending to creep upwards too, with the fiscal deficit now about 3.5 per cent of GDP.

While the Government has been able to move from a surplus to a deficit, this has disguised the impact of increased public spending on consumption. So people have not yet had to confront this issue. They have been prepared to cut back their savings but have faced only modest increases in the overall tax burden. That cannot be sustained for ever. What happens next?

The best study I have found on all this is a new paper, "UK house prices, consumption and GDP in a global context", by Andrew Farlow of Oriel College, Oxford (not yet published but available at [www.economics.ox.ac.uk](http://www.economics.ox.ac.uk)). It looks in-depth at this relationship between house prices and consumption and also at the implications for public borrowing. Why the last? Well, because debts run up by a government are ultimately debts of British people. Mr Farlow argues that there are three explanations for the global housing boom: low interest rates, greater economic stability, and a global housing bubble. The main explanation, he says, is provided by the third of these.

The trouble here is that housing bubbles (unlike other investment bubbles) do not generate an increase in income-generating assets. Yes, if people rent out property, they make money. They may also benefit from the rise in prices. But this is mainly a question of redistributing wealth - housing as a form of consumption.

Unfortunately, Mr Farlow notes, "politicians like bubbles, too. They love the feel good factor bubbles generate [while they last] and the badge of approval seemingly bestowed on macro-economic policy [even if quite the reverse is going on], and they even become bubble participants themselves."

No names, no pack drill but you could apply this criticism to a person whose address starts with "No 11". The big danger here is that if people have over-invested in housing at the cost, for example, of saving for pensions, then were house prices to fall they would have to compensate for their past errors. So people would increase their savings, particularly for their pensions, and cut consumption just as the economy softened. The further twist is that if they start cutting their spending, government revenues fall, so the government also has to compensate, again just at the wrong time.

All this sounds a bit glum. I don't think we inevitably face a housing crash, with a consequent sharp fall in consumption, though it would be mad not to acknowledge the possibility. It is more likely that we will have a long period - say, four years - of relatively small rises in living standards. People will pare back their borrowing a bit,

save rather more for their pensions, hold down any growth in their consumption. The Government will do the same, with increases in spending levelling off (as the Chancellor plans) and a gradual start made on correcting the budget deficit.

What we had in those January retail sales figures was therefore a bit of a taste of things to come. Sales may well recover a bit in the next couple of months but the glory days of consumption rising by 4 per cent a year are over. The huge surge of public spending is over too. And we will see, in the Budget on 22 March, how Gordon Brown responds to this cooler climate.

We may face a long period of small rises in living standards.

Those January retail figures were a taste of things to come.