CONSUMER CRISIS THE BIG THREAT

IT'S NEITHER THE THREAT OF WAR WITH IRAQ OR ISSUES WITH THE EURO, BUT THE AVERAGE SHOPPER PULLING IN THE PURSE STRINGS THAT COULD HIT THE ECONOMY HARD IN 2003, SAYS **JONATHAN LOYNES.**

This will be another year in which international issues dominate the thoughts of economic commentators and market participants, as well as the newspaper headlines. The recovery (or not) of the global economy, the outcome of the Middle East situation and the Treasury's assessment of the economic tests for UK entry into the single currency are just a few of the issues to be resolved. But the ultimate effect on our economy of all of these developments will depend on something much closer to home – the good old British shopper. Provided that consumers carry on spending at the rate seen over the last five years, then the economy should be able to weather any storm that blows in from across the water. My fear, though, is that this will be the year in which the burden of almost single-handedly propping up the economy becomes too heavy for consumers to bear.

Household spending has grown at an average rate of 4.2% per annum over the last five years. This compares to a long-run average growth rate of 2.8% and an average growth rate for the whole economy in the last five years of 2.5%. Overall, increases in household spending have added 15% to the level of GDP in the last five years. This means that spending has accounted for almost 120% of the total rise in GDP over the period, rather than the 60% to 70%, which would be normal if the economy were expanding in a balanced manner.

MIND THE GAP. But there is a clear limit to how much longer household spending can continue to outpace the overall economy. Looking back through history, household spending and overall GDP have not surprisingly moved closely together over long periods of time. Gaps have occasionally opened up, but they have always closed again subsequently. For the current, unprecedented gap to be closed, household spending would have to grow significantly less quickly than GDP for a period. Assuming that the economy expands at its average growth rate of 2.5%, then to bring it back into line with GDP in five years time, household spending would have to stagnate – a far cry from the rapid expansion of the last five years.

The biggest worry, though, is that the correction comes about more abruptly than this, with potentially de-stabilising effects on the overall economy. The most likely catalyst for such an event would, of course, be a sharp slowdown in the housing market. Granted, such a development does not look imminent on the basis of the latest news. Not only has house price inflation itself continued to accelerate, but mortgage borrowing has hit record highs.

Once again, however, the longer the current strength continues, the more likely it is that some adjustment will eventually arrive. Valuation measures which six months or a year ago were starting to look worrying, now look terrifying. Admittedly, the continued strength of housing in recent months has, on the face of it, lent support to those who argue that measures of price and valuation matter little compared to the cost of financing a house purchase. With interest rates at a 40-year low, debt-servicing costs are still low by historical standards. But interest payments should be low in a low-inflation environment, since their share of household income will not be naturally eroded over time by rising wages to the extent that it will when inflation is high.

LIKELY TRIGGERS. The counter-argument to this, of course, is that it might take years for households to take on board the implications of lower inflation. Moreover, with interest rates unlikely to rise significantly in the foreseeable future, there is no obvious trigger for a housing market slowdown in the meantime. But I draw limited comfort from this. For a start, there are other possible triggers besides higher interest rates. Although the rise in unemployment widely feared a year ago has not yet materialised, this may be down to companies' reluctance to shed staff if a recovery in demand is just around the corner. If economic growth continues to disappoint, then employers may soon wield the axe.

And secondly, I am not in any case convinced that asset price bubbles require an obvious trigger to deflate them. After all, the technology share boom of the late 1990s did not. It just became clear that prices had risen well above the fundamental worth of the asset. And once the belief that prices would keep on rising was replaced by worries that they would fall, the process became self-fulfilling – the classic end to a speculative bubble.

Just how far and how fast house prices will fall is very hard to predict. For the time being, there is probably enough momentum to ensure that prices keep rising in the first half of 2003. Thereafter,

place your bets. Mine is that prices start to fall in the second half, prompting the annual rate of inflation to slow sharply. For the year as a whole, though, prices will still rise by 20% or so compared to 2002. In 2004, however, prices will drop by an average of 5% and by a further 10% in 2005. Altogether, I expect prices to fall by 20% from their peak, and by 10% from current levels. This would bring prices back to the levels seen in the spring of 2002.

STILL DIFFERENT THIS TIME? What might this mean for household spending and the economy as a whole? The relationship between the housing market and the overall economy has been ominously close in the past. Never before has real house price inflation dropped from levels as high as those seen in recent months into negative territory without being accompanied by a recession in the wider economy.

Could things be different this time? In one sense, the signs are not good. The housing market has had a very strong influence on the wider economy on the way up, most obviously via mortgage equity withdrawal. This rose to over £10bn in Q2, the equivalent of 6% of quarterly post-tax income. Altogether, had all of the mortgage equity withdrawal of the last five years been spent, this would explain over a quarter of the total increase in consumer spending over the period.

Both through the direct effects of mortgage equity withdrawal and simply by making people feel wealthier, rising house prices have encouraged households to spend a growing proportion of their income, with the result that the saving ratio has dropped to levels below those seen at the height of the 1980s consumer boom. If house prices were also to fall significantly, this would point to an even sharper rise in saving and hence a sharper drop in spending.

Other factors, however, give more reason for hope that the economy could withstand a sharp housing downturn rather better than in the past. Most importantly, where previous housing slowdowns have often been accompanied by, or indeed prompted by, high and rising interest rates, this time interest rates would already be low and could be cut further. I expect interest rates to drop to 3.5% by the end of this year but they could easily go even lower. This would surely cushion the blow to other forms of consumer activity to some extent.

In addition, there is still a hope that other parts of the economy could offset some of the slowdown in consumer activity. There is a strong likelihood that a slowdown in housing and consumer spending would be accompanied by a sharp drop in the exchange rate, the recent strength of which has coincided with the period of excessive consumption growth. Coupled with some recovery in the global economy, this should help exports to grow more quickly (or at least contract less quickly) than in 2002. Meanwhile, it seems unlikely that investment will fall as fast as it did last year, while government spending should expand strongly. Together, these factors will ultimately facilitate the re-balancing of the economy towards a much more favourable mix of growth.

But they are unlikely to prevent a period of sluggish growth in the meantime. I now expect the UK economy to grow by just 1¾% next year – little faster than in 2002 – and by 2¼% in 2004. Such a performance would still represent a pretty benign end to the house price bubble compared to comparable episodes in the past. But it is a significantly weaker picture than is currently expected by both the policymakers and the markets.

THE VIEW EITHER SIDE. There are, of course, risks to this central view, in both directions. On the downside, the assumption that a sharp slowdown in the housing market would be less damaging for the wider economy than in the past could clearly prove to be too optimistic. Meanwhile, my forecasts assume a relatively sanguine resolution of the Middle East situation. Should the conflict drag on, or lead to further major terrorist attacks in the West, then it would be easy to envisage an even weaker international background than the one we have assumed. This in turn would heighten the economy's dependence on consumers and housing yet further and hence increase the likely size of the adjustment.

On the upside, I could also prove to be too pessimistic about the global economy over the coming months, perhaps because of a quicker and more decisive resolution of the Middle East situation. This would have beneficial effects on business and consumer sentiment, and downward effects on oil prices. This in turn would allow the policymakers to raise interest rates to take some of the steam out of the housing market, thereby increasing the chances of a smoother adjustment. But even this scenario could go awry if the Monetary Policy Committee itself brought on a housing crash by raising interest rates too aggressively. One way or another, a gradual and painless unwinding of the economy's imbalances is becoming harder and harder to envisage.

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