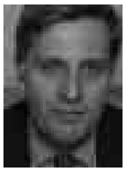


IT IS EASY TO FORGET HOW UNUSUAL THE LAST FEW YEARS HAVE BEEN FOR THE ECONOMY. GDP GROWTH HAD BEEN UNDERWRITTEN BY A STRONG HOUSING MARKET AND A SUBSTANTIAL BOOST FROM PUBLIC SPENDING. THE FIRST IS WELL KNOWN, THE HELP PROVIDED BY PUBLIC SPENDING IS, ARGUES **DAVID OWEN,** LESS WELL UNDERSTOOD.

The best is past

Regardless of the extent to which fiscal policy may be tightened in coming budgets, we are definitely past the best as far as the boost to GDP from public spending is concerned. For much of the last few years the boost to GDP from general government consumption and investment was at least 1% a year (see *Figure 1*). And this was during a period when the economy was only growing around trend (close to 2.5%). So, effectively almost half the growth in the economy was courtesy of Gordon Brown.

Moreover, Gordon Brown opened the floodgates in 1999 pretty much at the same time as the corporate sector was getting its own house in order. The history of the five years prior to 1999 was one of public sector employment in decline, and earnings growth in the public sector being less than that of the private sector. That trend went into reverse in 1999. Between Q1 1999 and Q1 2005, public sector employment grew by around 625,000, the majority in health and education. Moreover, government statisticians revised up their estimate of the total numbers employed in the public sector by between 100,000 and 200,000 a year since 1997.

There was also an important regional dimension to the story, with much of the largesse from public spending helping boost economic activity in the regions outside London and the South East. These were the parts of the country where the housing market at the time was still relatively affordable. Unemployment in these regions fell significantly and house prices there rose relatively quickly. Before too long, house prices in London no longer appeared expensive compared to those in the rest of the country. Arguably, more by luck than judgement Gordon Brown kept the momentum of recovery going, at a time when the corporate sector was stepping back from the plate.

But, this is all largely history. Public spending in the UK is not set to be cut – Gordon Brown's fiscal policy rules are sufficiently flexible to make that unnecessary. But the latest plans are based on no further increase in current spending by government as a share of GDP. Public sector investment is set to grow significantly, but this will do much less to help the housing market and consumer than a further rapid rise in numbers employed by government.

RISK AVERSE CORPORATES This puts much more onus on the corporate sector to take up the baton again. However, to date companies in the UK have been averse to spending the cash

Figure 1. Boost to UK GDP from public spending

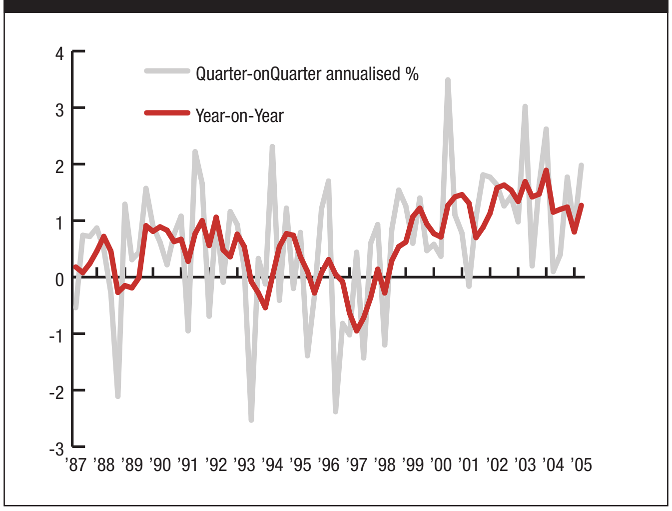
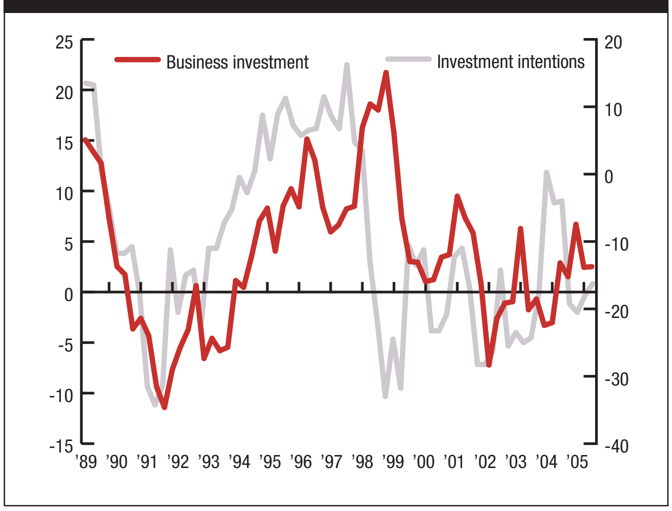


Figure 2. CBI investment intentions vs business investment in UK



mountain that they have built up on their balance sheets and move back into so-called financial deficit again. A risk-averse corporate sector is not just an isolated UK phenomenon, but can be seen in other countries as well.

Economic textbooks often start from the assumption of a household sector that is a big saver (in financial surplus) and a corporate sector in financial deficit, i.e investing more than it receives in post-tax incomes. The banking sector and financial markets are seen as channelling the savings of households towards investment projects that offer the best likely future returns (at least that is the hope).

But the history of the last three years is a UK corporate sector in financial surplus, a record period of time for the corporate sector to be a net saver, spending less than it is earning in profits. Meanwhile, far from being in surplus the household sector has been in large deficit, on the back of what had been a booming housing market and a record amount of net mortgage equity withdrawal. (This is the situation where a household obtains a loan secured on a property, but the money raised is not reinvested back into the housing market, rather it is either spent on goods and services or used to acquire financial assets.)

The fact that the corporate sector finances are in relatively good shape significantly reduces the risk of recession. Recessions of the early 1980s and 1990s, for example, were both preceded by a severe deterioration in balance sheets and profits. That is not the situation today. But it is nevertheless disappointing that the corporate sector, for whatever reason, seems loathe to step up its expenditure. Investment intentions remain relatively depressed (see *Figure 2*).

This all brings us back to everyone's favourite subject, the housing market. Everyone may have a view on the outlook for property prices, but it is a subject that even supposed experts seem to have little ability to predict accurately. At a national level, housing may be very expensive when compared to incomes, but if as we expect the Bank of England continues to cut interest rates (to 4% by February next year), then house prices may continue to effectively tread water – having been broadly moving sideways since the middle of last year.

THE DUTCH EXPERIENCE We would draw parallels with the Dutch experience of recent years. Higher interest rates inside EMU brought an end to a housing boom in the Dutch economy in 2000. Subsequent declines in interest rates may have been enough to ward off a housing collapse (at no point did house prices in the Netherlands fall), but they were not enough to kick-start much of a recovery in Dutch house prices. Arguably, this is precisely what we are likely to see here in the UK. Cuts in base rates are needed to prevent the economic situation deteriorating markedly from here; but they should not be seen as sufficient to automatically kick-start a recovery in house prices.

Parallels can also be drawn with another low inflation period in the UK's history, the 1950s, when, following a housing boom, UK property prices effectively trod water for ten years. The example of the 1950s indicates that in a low inflation environment a housing market correction takes longer to occur and the risk of falls in nominal house prices is greater.

In fact, a long-run analysis suggests that last year house prices peaked at a similar level of disposable incomes as in 1948, 1973 and 1988. Worryingly, every subsequent housing market correction entailed a substantial fall in house prices in real terms – in all cases by around 30%. Fifty or so years ago house prices declined in nominal terms in 1949, 1952 and 1953, with the 7.5% decline in house prices recorded in 1953 broadly matching that of 1992.

Executive summary

- **UK GDP growth is set to disappoint over the next few years as there are no plans by the government to increase spending as a share of GDP.**
- **The onus is on the corporate sector to boost the UK economy but it appears unwilling to spend its cash mountain and move back into so-called financial deficit.**
- **House prices are expected to tread water and cut in base rates will stave off a marked deterioration, not provide a kick-start to recovery in house prices.**
- **A strong housing market and a substantial easing of fiscal policy can largely explain the 'dynamic' UK economy of recent years.**

MORTGAGE EQUITY WITHDRAWAL However, the housing market matters more now for the wider economy than was the case 50 years ago. Owner occupation has doubled and net mortgage equity withdrawal was virtually non-existent until financial deregulation occurred in the UK in the 1980s. Moreover, in the 1980s mortgage equity withdrawal only typically occurred when people moved home; financial innovation means that this is no longer the case. In the most recent economic cycle, net mortgage equity withdrawal peaked at a higher level of incomes than was the case in the late 1980s, despite the level of transactions being a lot lower.

But unlike what was seen in the past, mortgage equity withdrawal has increasingly been used in recent years to fund the acquisition of financial assets (probably in large part by older households to fund their retirement). Net mortgage equity withdrawal has already collapsed – an entirely predictable event, given what has happened to house prices. If house prices continue to move sideways, net mortgage equity withdrawal is unlikely to pick up significantly any time soon. This is a further reason to expect consumption to disappoint, since some of the monies withdrawn from the property market would have ended up being spent.

In recent years we have become accustomed to think of the UK economy as very dynamic when compared to many of its European neighbours. It is undoubtedly a flexible economy that has undergone much of the structural reform that is often wished for on the continent. Trend growth in the UK may be higher than say, Germany, but a strong housing market and a substantial easing in fiscal policy go a long way to explain why UK economic growth has tended to outperform since EMU commenced in 1999. Even though recession is likely to be avoided, it would not be so surprising if we now entered a two-to-three year period when UK GDP growth disappointed.

David Owen is a Senior pan-European Economist at investment bank Dresdner Kleinwort Wasserstein.
david.owen@drkw.com
www.drkw.com

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