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Lawson should prick the house price bubble and end the spending boom

Economics

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THIS week's rise in bank interest rates was the big one, because it seems finally to have triggered the rise in mortgage rates which is what the Treasury really wanted. An unexpected side effect of the October stock market crash has been the enormous inflows into building societies instead of unit trusts, which has allowed them more leeway to keep down their interest rates even when the banks' rates went up.

This complication is crucial because of the importance of housing borrowing in a consumer boom. Contrary to popular myth, credit-card borrowing is small beer. Even specialist finance houses and stores, though lending some £24 billion at the last count to consumers and up an astonishing 18.4 per cent over the year to May, are only a small part of the market. House purchase loans are worth nearly three quarters of personal debt.

Moreover, there are large leakages out of the housing market. Elderly people trade down, and take some of the equity out of their homes for their retirement. People borrow on mortgage, and buy cars and stereos instead. Some people buy a second home on mortgage, while others sell it and spend the money. Dr Gerard Lyons, of Savory Milln, calculates that only half of total housing loans have been spent on housing between 1983 and 1986 — and the proportion has been falling.

A good house price boom encourages people to borrow and spend more. Thus the rise in housing lending is, directly and indirectly, the main probable culprit for the sharp fall in the savings ratio — the proportion of income saved — to its lowest levels since the 1950s. What happens to housing credit is thus one of the keys to whether Britain's consumer spending boom slows down gracefully, without a nasty crunch as the markets become scared at the prospect of £10 billion current account deficits.

Here, though, the Chancellor has a problem. Even if the rise in mortgage rates is at the top end of the likely range — about 1.75 per cent — it is still not going to be enough to offset the mechanical increase in real incomes due to the budget tax cuts, which began to feed through in the middle of June. Moreover, mortgage rates are still not likely to be back to their level of before the October stock market crash (even though bank base rates now are) because of the post-crash change in the relationship between bank and building society rates. They are far off the 14 per cent rates at the beginning of 1985. Those rates were not enough to stop the house price and credit boom then. Will lower rates be enough now?

Most analysts answer no: the interest rates at which banks lend to each other over the next three months are still higher than base rates, which means that the professionals think that rates are still going up. Moreover, the sensitivity of credit to interest rates is one of the most fiercely controversial areas of economics. The Treasury economists themselves change their views almost as often as the Paris fashions. They are currently relatively optimistic about the effect of interest rates. However, work by economists at the Halifax building society implies that the sensitivity of housing credit to interest rates has roughly halved. Even if the highest price regions now begin to slow down, there is still a lot of house price catching up to do — and hence the possibility of more borrowing and spending.

A central problem is that expectations about the future are crucial, and there is still a lot of optimism about. If you believe that house prices are going to rise by 20 per cent this year and 15 per cent next year — the optimistic view of some housing professionals — then the little matter of 12 per cent or even 14 per cent mortgage rates is unlikely to deter you from borrowing and spending as a part of your gains. However, if you think that prices are grinding to a halt, those interest rates may look rather high. Professor Paish used to say that monetary policy was like pulling a brick towards you across a table with a piece of elastic: nothing happened and then it hit you in the eye.

All of which is a very sound argument for using other policy instruments to cool down the expansion of credit and the economy, quite apart from the particular unsuitability of higher interest rates in present circumstances. The case for a general slowing down of the economy is less convincing than the case for a shift in the pattern of expansion away from consumption and towards investment and exports.

A rise in interest rates in the short run actually helps to worsen the observed inflation rate — a 1 per cent rise in mortgage rates will add 0.4 per cent to the retail price index and push annual inflation to over 5 per cent. It also has an ambiguous effect on the balance of payments deficit because it holds sterling up and make British producers less competitive than they would otherwise be, although it also eventually curbs demand and imports.

The present situation is thus the best argument for not starting from here: in demand terms, the budget was a mistake. If the Chancellor wants to remove some of the burden of slowing down the consumer and credit boom from interest rates, as he should, then these are his options:

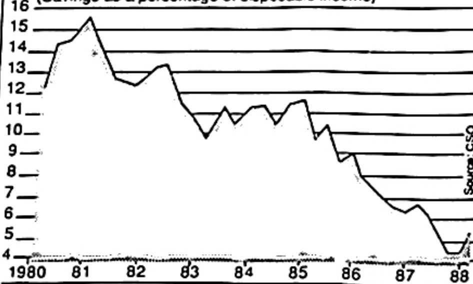
- Tighten fiscal policy. He could use the "regulator" — the law which allows him to vary Value Added Tax and excise duties between budgets by up to a quarter and a tenth respectively. The main snag is that it would look like a panic measure, while also pushing up inflation again. The full rise in VAT of 3¾ per cent would raise £3½ billion at an annual rate, not quite cancelling out the budget's effects but adding nearly 2 per cent to inflation. It would be a recipe for 7 to 8 per cent inflation by the end of the year.
- Tighten fiscal policy by raising income taxes. This would require a mini-budget, and is by far the best economic means of tackling the present imbalance between consumption and the rest of spending. However, it would require the Chancellor to eat too many words to be politically possible.
- Tighten fiscal policy by cutting public spending in a nostalgic "July package". The politics are not attractive since people want more public spending, and would contrast cuts with the March lollipops for higher rate tax payers.
- Introduce direct measures to limit credit. Financial institutions would eventually find ways around old-fashioned administrative guidance. However, it might have the desired effect of pricking the house price and lending bubble, which would then settle down of its own accord. Alternatively, the Bank of England could raise the amount of cash which lending institutions have to deposit with the bank for each extra pound they lend, which would in effect reduce the profitability of their lending or cause a rise in their lending rates. This has the additional advantage, as both the Netherlands and French central banks have recently discovered, of leaving unchanged interest rates charged to businesses which borrow directly on the money markets.
- Try to boost personal savings. The government could attempt to relaunch National Savings by being much more imaginative about their marketing, which would have two effects. It might directly expand savings, while at the same time squeezing the building societies to raise their rates, thereby redressing some of their post-crash advantage. This is tinkering.

There is still, though, no sign that the Chancellor is persuaded of the need for any other policy instrument than interest rates. He takes the view that the government ought not to be intervening to decide who or what should be able to borrow, and professes unconcern about the current account deficit on the grounds that its counterpart is willing private sector investment.

It is, though, a rather selective economic liberalism. The Chancellor accepts the argument for intervening to stop bubbles in the foreign exchange market. Markets do make mistakes. The willing overseas investor may become unwilling and cause a run on the currency. The case for other policy instruments to tackle the credit and spending boom remains strong. Otherwise, the message for interest rates may be: "Up, up and away!"

The savings slump

(Savings as a percentage of disposable income)



Investors depressed by news from Gulf and base rates rise

The markets

THE combination of the grim situation in the Gulf and another half-point increase in

Ranks Hovis sprang to life in the afternoon on revived rumours that the 18.4 per cent Goodman Fielder stake had been sold to Hutchison Whompoa. The shares closed 12p higher at 411p. In dull stores

Granada's jump disappoints City

Rosemary Collins

GRANADA, the television and leisure group, reports interim pre-tax

and management structures. ERG contributed around £4 million to profits in its first three months within Granada, but in the next full year, when rationalisation is complete, annual

flat throughout the high street for at least the past half year and Granada is quietly thankful that its equipment sales are still dwarfed by the hitherto less fashionable rental busi-

other £12.2 million, and business services like computer maintenance earned £4.3 million.

This last division is due to double revenue from computer