GILT-EDGED

The outlook hinges on domestic credit control

By the year-end the British economy faces the prospect of a further large deterioration in the current-account deficit, a sizeable depreciation of sterling and successive hikes in interest rates.

Despite last week's half-point rise in base rates, the Government's aim of non-inflationary growth is being seriously undermined by the relentless strength of consumer spending. This spending is seeping into increased demand for imports, and will eventually lead to higher imported inflation as sterling weakens.

Consumer spending accounts for about two thirds of domestic demand, and there appears to be little reason to expect a sharp slowdown in its strong growth. Unless the authorities are relying on a sudden slowdown in spending, they need to act quickly in order to minimize the problems likely to occur. But what policy can the authorities adopt?

It is clear that, in addition to the large boost to disposable income arising out of earnings growth, individuals are dissaving and borrowing in large amounts.

The majority of borrowing has been linked to loans for house purchases, which would appear to point to the personal sector accumulating liabilities in order to build up their stock of assets. Such "investment" by the personal sector should not have detrimental consequences, unless the value of assets, especially housing, falls.

Of more immediate concern, however, is the evidence to suggest there have been substantial leakages into personal consumption. On this front, the continuing trend for total new lending for house purchases to exceed net additions to the housing stock should be viewed with some concern. In 1986, this excess reached £15.3 billion, more than double the £6.9 billion seen in 1983.

While the rise in house prices and inheritance of properties can account for some of this discrepancy, people are now also taking out mortgages larger in size than the property purchased. Some of this money will be saved or redirected towards other assets, representing an allocative change in the personal sector's balance sheet, but a large proportion is seeping into consumption. Set against this is the fact that although consumer credit represents only 15 per cent of personal sector borrowing, it, too, has grown by a large amount in recent years, reaching £6 billion in 1987.

Wide availability of credit and borrowing facilities is important for the efficient working of a leading economy, allowing wider choice to individuals in timing spending and saving decisions. The problem for the authorities, however, is that the personal sector is borrowing for current consumption when domestic demand is already strong.

A tighter fiscal stance would appear necessary. However, expenditure cuts are slow to implement and would appear difficult to justify in the face of buoyant government revenues; increases in taxes would not even be considered. Instead, monetary policy looks set to carry on being used to fine-tune the economy, but here the authorities are using one policy instrument to control both the exchange rate and domestic credit growth. The immediate aim for the authorities should be to dampen down spending and encourage more saving.

The Treasury, in its evidence to the Treasury and Civil Service Committee after the Budget, pointed to "a significant role for interest rates in the determination of the demand for credit." It is our view that consumer borrowing, including credit demand, is not very sensitive to small movements in interest rates, as the huge consumer credit card APRs would testify.

Using interest rates to control credit does not appear to be the right solution. It highlights the problem of not having enough instruments to control the necessary targets. If the authorities are relying solely on interest-rate movements as the weapon to control credit demand, it may need a very large increase in interest rates to have a significant impact.

The required size of the increase in interest rates would undermine confidence about the outlook for the economy and reduce domestic economy activity. A risk is that the large hike in interest rates needed would affect export competitiveness by making sterling a short-term speculative buy, and could result in a fall in house prices. This would not be favourable.

It would appear that it is not interest-rate movements themselves that are capable of controlling credit. Rather it is by influencing economic activity first, and hence reducing the growth in personal incomes, that higher interest rates reduce the demand for credit. The early 1980s highlighted the inadequacies of such a policy.

What is clearly needed is for the authorities to send a sharp signal to the personal sector that spending must slow. This policy must also be one that does not undermine the longer-term aim of boosting investment and the productive potential of the economy. This necessary policy reaction by the authorities should be viewed as the cost of implementing a Budget that boosted domestic demand too much.

One clear and effective way to achieve this is to introduce controls on credit, as well as limiting leakages from the housing market. For instance, limits could be put on how much can be borrowed, or interest payments on credit could be taxed. Individuals should also not be allowed to obtain mortgages greater in value than the property being purchased.

While controls on credit may be anathema to Tory philosophy, the corner in which government policy finds itself means a pragmatic approach may be needed.

If such an initiative were implemented, it would have a restraining influence on spending, alleviating problems on the current account, and prevent interest rates from rising substantially. This is the best chance of sustaining balanced economic growth. Without such an initiative to calm spending, the outlook points to further economic problems and much higher gilt yields.

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