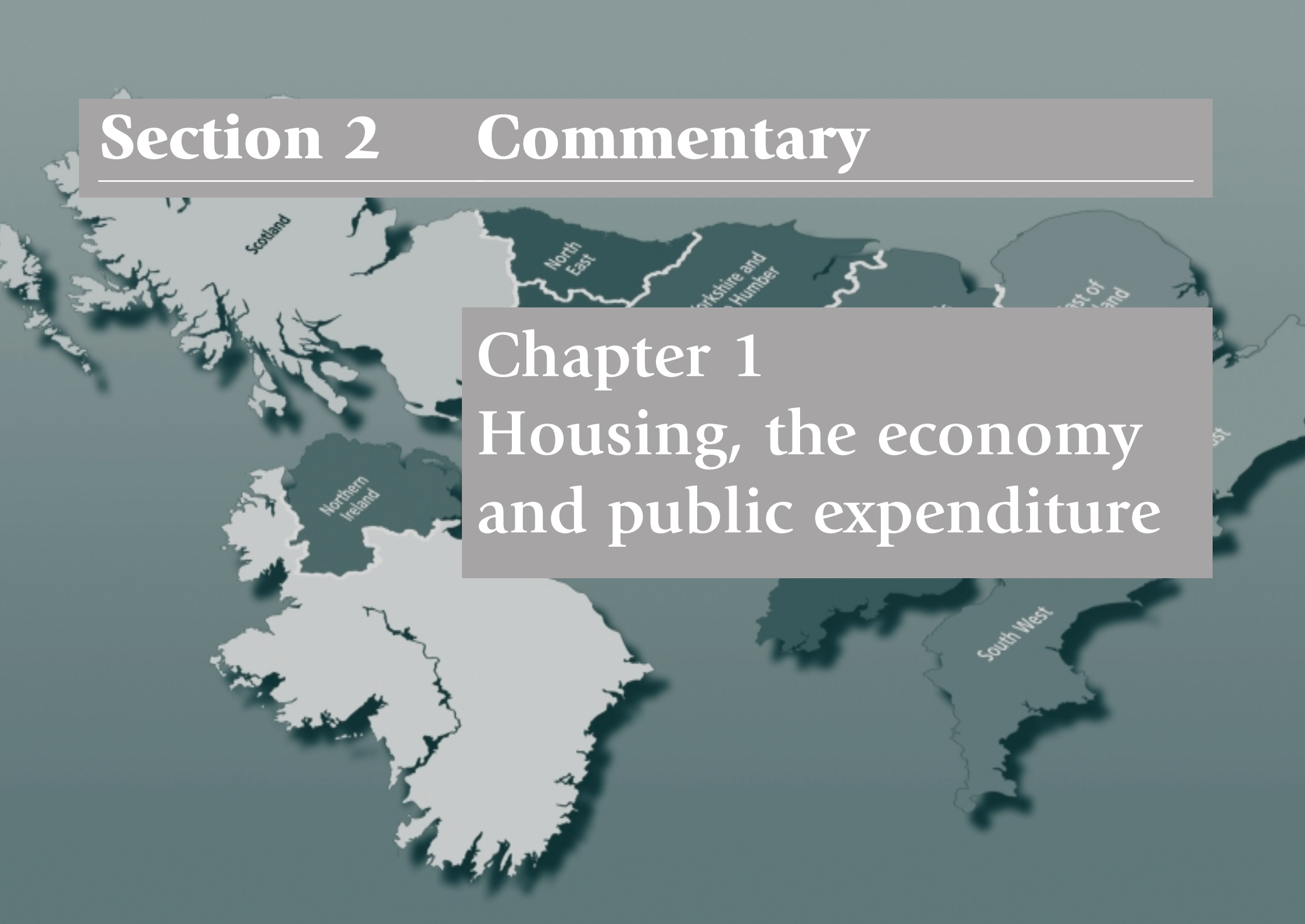
Section 2 Commentary



Chapter 1
Housing, the economy and public expenditure

Housing markets and equity withdrawal

The continuing strong rise in house prices in 2003 (Compendium Table 46) brought in its train a new record level of equity withdrawal. Not only did it rise in cash terms, from £45.6 billion in 2002 to £60.8 billion in 2003 (Compendium Table 7), it rose as a proportion of total consumer spending to 8.77 per cent, eclipsing the 6.98 per cent level seen at the peak of the last housing market boom in 1988 (Figure 2.1.1).

The boost given to consumer spending by that high level of equity withdrawal, which has continued into the first half of 2004, contributed to the rise in economic growth in 2003 (Compendium Table 1), and the fall in unemployment on both ILO and claimant measures (Compendium Table 4).

However, it also contributed to a rise in inflation that has now seen the Bank of England increase base rates five times in less than twelve months, in quarter point steps from 3.5 per cent in October 2003 to 4.75 per cent in August 2004.

Meanwhile, overall personal borrowing, including mortgage borrowing, has now (in mid 2004) crossed the £1 trillion threshold. Of that amount, £827 billion was lending secured on dwellings, up from £774 billion at the end of 2003 (Compendium Table 5).

Uncertainty and volatility

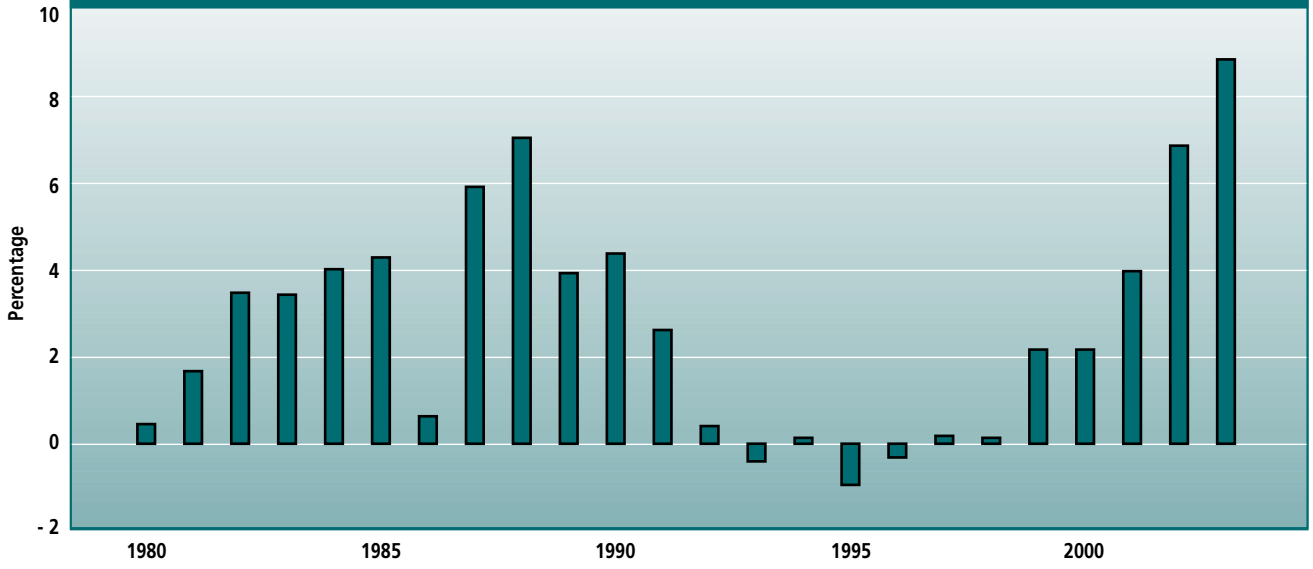
As ever, many of the economic uncertainties ahead that potentially threaten the stability of the UK economy are located around the world. As well as uncertainties about the sustainability of the US economy after the presidential elections, there are inevitable concerns about the supply and price of oil. Much of that arises from the immediate worries about political and military instability in the middle east, but in the longer run the rapid economic development of the Chinese economy is beginning to add a new dynamic, increasing the demand for oil.

Apart from those global concerns, this year the management of the domestic economy poses difficult questions, both for the Chancellor and the Bank of England Monetary Policy Committee (MPC). The critical question for the MPC is how does it meet its inflation targets without tipping the economy into a housing market collapse and recession of the kind experienced in the early 1990s.

While the MPC has increased interest rates in a series of gentle quarter point rises these are nonetheless substantial given the low starting point of 3.5 per cent. Already base rates have increased by just over a third during the last year, and two more quarter point rises would translate that into a fifty per cent rise, that would be the effective equivalent of the rise from 10 per cent to 15 per cent in the bank rate over 15 months between July 1988 and October 1989.

On the plus side, the Bank of England (and the Treasury) learned important lessons from the last recession, and are now acutely aware of the links between the housing market and the wider

Figure 2.1.1 **Equity withdrawal as a percentage of consumer spending**



economy. That does not, however, remove the inherent volatility of the housing market at turning points in the market cycle, or the uncertainties inherent in dealing with the new phenomena of the buy to let market.

The buy to let market has grown rapidly over the last five years, as mainstream lenders have entered (and supported) a market in which they had previously shown very little interest. Last year alone saw close to a 50 per cent increase in the total number of buy to let mortgages, and at the end of 2003 these now accounted for just over 400,000 dwellings (Compendium Table 55). The 188,000 new buy to let mortgages advanced in 2003 contrast with the sharp fall in the numbers of mortgage advances to first-time buyers in the year, down to 359,000. So in 2003, buy to let landlords represented over a third of new entrants to the private sector housing mortgage market.

With rising interest rates there is an expectation that house price rises will now moderate, and some commentators are already predicting significant falls in house prices over the next year. In practice, the outturn will depend in part on the MPC striking the right balance in its decisions on interest rate changes, and in part on the decisions made by the new buy to let landlords as house price rises ease down.

If buy to let landlords substantially withdraw from the market for additional properties, even if only a small proportion sell off any of the properties they have purchased in the last few years, this would have a significant impact on the market. In this scenario there is every possibility of house prices falling, with the accompanying reappearance of negative equity. In that event equity withdrawal could be expected to fall away sharply, with a knock on effect on consumer spending.

While the MPC would like to see some easing in consumer spending to reduce inflationary pressures, the difficulty is in managing the volatility and unpredictability of the relationship between the housing market and consumer spending. If it precipitates too sharp a reduction in consumer spending this could undermine forecasts of future economic growth, and the Chancellor's hope of funding continued real increases in public spending while keeping within the self imposed discipline of his 'golden rules' on public spending and borrowing.

An easing of the housing market, and with it consumer spending, remains the most likely outcome in the coming months, however it will nonetheless present the MPC with the most difficult decisions they have had to make since they were passed the responsibility for setting interest rates. It does not help that they are now technically required to make those decisions in relation to inflation targets that do not, in themselves, include any direct measure of house prices (see Commentary Chapter 1 in the 2003/04 edition of the *Review*). The Chancellor, in particular, will be hoping that the MPC comes through this testing period unscathed.

EU Stability Pact breaks

While the slow down in economic growth, and the planned growth in public spending, have seen higher levels of public sector borrowing by the UK government in recent years (Compendium Table 13), it has so far remained within the bounds both of the Chancellor's 'golden rules', and the EU Stability Pact that applies to all the member states that have signed up to Euro membership.

UK borrowing in 2005 is, however, projected to rise to 3.2 per cent of gross domestic product (GDP), which would take it marginally over the 3.0 per cent limit enshrined in the EU Stability Pact for all Euro countries. Of more immediate concern in Europe, is the government borrowing levels of France and Germany, which have exceeded the EU limits since 2002, and are still expected to be over those limits in 2005 (Compendium Table 10). In 2003, government borrowing in France was 4.0 per cent of GDP, and in Germany it was 4.1 per cent.

In theory, the excess borrowing by both France and Germany should have led to the imposition of financial penalties to exert pressure on the individual governments to return to compliance with the Pact. In practice, EU ministers voted not to impose penalties, notwithstanding the provisions in the Pact. Subsequently the European Commission contested that decision in the European Courts, and won a ruling that the EU ministers had acted unlawfully.

The upshot is not, however, that France and Germany are now likely to face the financial

penalties envisaged by the Pact. Rather the Commission and EU ministers are looking at ways to reform the Pact. Reforms to the Pact would also help to remove one of the barriers to potential UK membership of the Euro and, alongside the 2004 budget, the Treasury published a pamphlet essentially advocating that the EU should adopt financial rules structured along the same lines as the Chancellor's 'golden rules'.

There are considerable merits in the Chancellor's approach, in that it provides for greater flexibility in levels of annual borrowing over the economic cycle provided that the total level of government debt remains at prudent levels. In some respects, however, the UK approach is more restrictive than the EU approach. The UK rules, for example, set a limit on total net public sector debt of 40 per cent, while the EU rules set a limit based on total general government gross debt of 60 per cent.

Even allowing for the distinction between net and gross debt, the UK limits are inherently more restrictive. More significant, not least from the perspective of housing policy, is the distinction between the public sector measure of debt applied by the UK, and the general government debt measure applied by the EU. It is rather extraordinary that the HM Treasury document does not allude to this distinction once in its 40 page pamphlet.

The UK government debt measure includes borrowing by government owned trading bodies in the 'public corporate' sector; the EU measure relates only to central and local government debt, and does not include the debts of public corporations. While the UK now has few stand alone public corporations, following the privitisation measures over the last few decades, in this context council housing is accounted for as part of the public corporate sector, rather than as part of local government. This is essentially because council housing is a trading activity. It does not need to be legally separate from the council for it to be accounted for as part of the public corporate sector, as indeed it is in the UK National Accounts. In the jargon, council housing constitutes a 'quasi corporation'.

Another EU ruling has now held that UK housing associations must now be considered as public sector bodies for the purposes of EU procurement rules. This ruling is based not so much on the level of public sector funding provided to housing associations, as on the extent of the regulatory powers over associations held by the Housing Corporation in England (and its equivalents in the rest of the UK). The ruling essentially argues that the scope and degree of that regulation by a government quango brings associations into the public corporate sector, and thus makes them subject to the EU legislation on public sector procurement.

While in the rest of the European Union this ruling would only have any practical significance in terms of the procurement requirements, in the UK it raises the issue of the treatment of housing association borrowing in the UK National Accounts. There would be some logic if, following the EU ruling, housing association borrowing would also sit in the public sector, and thus count against the Chancellor's 'golden rules'.

It will, however, be a matter for the Office for National Statistics to review the application of the National Accounts' categorisations in the light of the EU ruling on procurement. If they do follow the EU ruling this will clearly have far reaching implications for UK housing policy, and some of the possible options are considered further in Commentary Chapter 4.

Labour market trends

The latest national and regional labour market projections by the Institute for Employment Research at the University of Warwick have now been published, covering the period 2002–2012. These projections provide an important resource for the development of housing and regeneration policies at both the regional and local level. Those policies need to understand the dynamics of economic and labour market change, just as much as the impact of demographic trends and changing household preferences.

Table 2.1.1 shows that the trends toward increased female and increased part-time working are projected to continue over the decade, alongside a decline in male full-time employment and male self-employment.

These changes are related to a projected continuing decline in the primary, utility and manufacturing sectors of the economy, while growth is focused within the distribution, business and service sectors. In occupational terms there is an increase in managerial, professional, sales and service employment, set against a decline in elementary, skilled trade and administrative and clerical employment, as shown in Table 2.1.2.

The projected regional levels of employment, and changes over the years from 1992 to 2002 and 2002 to 2012 are shown in Table 2.1.3. It is notable that employment growth is expected to be much slower over the coming decade in all parts of the UK, with the sole exception of the North East. This is linked to broader projections of the UK unemployment rate rising from 2.5 per cent to 3.0 per cent in 2012, while the economic activity rate (among the working age population) is also projected to marginally decline from 78.5 per cent to 78.2 per cent by 2012.

These three tables just scratch at the surface of the wealth of more detailed sectoral and regional projections contained in the national and regional reports.

Public spending

The government spending plans set out in the 2004 budget, and the related HM Treasury Public Expenditure volume, reflect the increased provisions made in the 2002 Spending Review. They also set the framework for the 2004 Spending Review completed in the summer.

Table 2.1.1 **Male and female employment 2002–2012**

Thousands

	Full-time	Part-time	Self-employed	Total
2002				
Male	**11,064**	**1,916**	**2,561**	**15,541**
Female	**6,686**	**6,145**	**964**	**13,795**
Total	**17,751**	**8,061**	**3,525**	**29,336**
2012				
Male	**11,013**	**2,423**	**2,383**	**15,819**
Female	**7,018**	**6,853**	**967**	**14,839**
Total	**18,031**	**9,276**	**3,350**	**30,658**
Change 2002–2012				
Male	**- 51**	**507**	**- 178**	**278**
Female	**332**	**708**	**3**	**1,044**
Total	**280**	**1,215**	**- 175**	**1,322**

Source: Working Futures: National Report.

Table 2.1.2 **Employment by occupational category 1982–2012**

Thousands

Occupational categories	1982	1992	2002	2012	Percentage Change 1982–2012
Managers and senior officials	**2,698**	**3,336**	**4,349**	**4,934**	**82.9**
Professional	**2,003**	**2,501**	**3,305**	**4,008**	**100.1**
Associate professional and technical	**2,406**	**3,023**	**4,121**	**4,895**	**103.4**
Administrative, clerical and secretarial	**3,895**	**4,205**	**3,857**	**3,434**	**- 11.8**
Skilled trades	**4,289**	**3,901**	**3,341**	**2,801**	**- 34.7**
Personal service	**925**	**1,310**	**2,147**	**2,894**	**212.9**
Sales and customer service	**1,527**	**1,784**	**2,334**	**2,732**	**78.9**
Transport and machine operatives	**2,981**	**2,591**	**2,473**	**2,225**	**-25.4**
Elementary occupations	**4,463**	**3,989**	**3,409**	**2,735**	**- 38.7**
Total	**25,186**	**26,639**	**29,336**	**30,658**	**21.7**

Source: Working Futures: National Report.

Table 2.1.3 **Employment by region 1982–2012**

Thousands

Region	1982	1992	2002	2012	Percentage change 1982–1992	1992–2002	2002–2012
South East	3,157	3,618	4,179	4,491	14.6	15.5	7.5
East of England	2,070	2,319	2,614	2,803	12.0	12.7	7.2
London	4,037	3,824	4,490	4,777	- 5.3	17.4	6.4
South West	1,891	2,181	2,470	2,590	15.3	13.3	4.9
Yorkshire & The Humber	2,095	2,207	2,313	2,404	5.3	4.8	3.9
West Midlands	2,289	2,388	2,554	2,649	4.3	7.0	3.7
East Midlands	1,705	1,838	1,972	2,042	7.8	7.3	3.5
North West	2,957	3,000	3,194	3,280	1.5	6.5	2.7
North East	1,062	1,070	1,045	1,054	0.8	- 2.3	0.9
England	21,264	22,444	24,832	26,091	5.5	10.6	5.1
Northern Ireland	570	629	752	776	10.4	19.6	3.2
Wales	1,106	1,184	1,241	1,265	7.1	4.8	1.9
Scotland	2,246	2,383	2,511	2,526	6.1	5.4	0.6
United Kingdom	25,186	26,639	29,336	30,658	5.8	10.1	4.5

Source: Working Futures: National Report.

Total government spending is set to continue rising in real terms, and by 2007/08 it is projected to represent 42.3 per cent of GDP. While this represents a significant increase since1999/00, when it was just 37.4 per cent of GDP, it is still lower than the level that prevailed under the previous government between 1991/92 and 1995/96.

The overall increase in Departmental Expenditure Limits over the period to 2007/08 are set out in Table 2.1.4. The annual increase in the ODPM budget (of which the greater majority is for housing) over the three years to is 3.3 per cent, compared to an average of 4.2 per cent. However, very few departments receive a greater rate of increase than ODPM other than Health (6.9 per cent per annum) and Education (5.9 per cent per annum).

'Total Managed Expenditure', and the component elements of 'Annually Managed Expenditure' are set out in Table 2.1.5. Tables 2.1.4 and 2.1.5 effectively update and extend the information set out in Tables 16a & 16b in the main compendium.

If the government's projections for economic growth remain on course public spending will continue to meet the Chancellor's 'golden rules'. Year on year borrowing over the economic cycle will remain a little below the level of net of investment, and total public sector net debt is now forecast to rise to 36.5 per cent by 2007/08, some way below the Chancellor's self imposed 40 per cent limit. Those forecasts could, however, be undermined if the MPC decisions on interest rates end the housing market cycle in a 'hard' rather than a 'soft' landing.

References

The Stability and Growth Pact: A Discussion Paper, HM Treasury, 2004.

R.Wilson, K. Homenidou and A. Dickerson, *Working Futures: New Projections of Occupational Employment by Sector and Region, 2002-2012*, Volumes 1 & 2, Institute for Employment Research, University of Warwick.

Key Reading

Budget 2004, HM Treasury, House of Commons 301, The Stationery Office, 2004.

Public Expenditure, Statistical Analyses 2004, HM Treasury Cm 6201, The Stationery Office, 2004.

2004 Spending Review, HM Treasury Cm 6237, The Stationery Office, 2004.

Economic Outlook 74, OECD, December 2004.

Economic Trends, Office for National Statistics (monthly and annual volumes), The Stationery Office.

Financial Statistics, Office for National Statistics (monthly volumes), The Stationery Office.

A very substantial volume of economic and financial data can now also be accessed from the Office for National Statistics website.

Table 2.1.4 **2004 Spending Review Departmental Expenditure Limits (DEL)**

£ billion

Department	Baseline 2004/05	Baseline 2005/06	Plans 2006/07	Plans 2007/08	Average annual growth rate
Health	71.5	78.5	86.0	94.4	6.9
Local government	43.7	46.2	48.6	51.0	2.6
Defence	29.7	30.8	32.1	33.4	1.4
Education & skills	27.6	31.1	32.9	35.2	5.7
Home Office	12.7	13.2	14.2	14.9	2.7
Transport	10.4	11.0	13.6	12.9	4.5
Work and pensions	8.2	8.3	8.2	8.1	- 2.8
Office of the Deputy Prime Minister	7.0	7.5	7.8	8.4	3.3
Trade & industry	5.0	6.1	6.5	6.6	3.0
Chancellor's departments	4.9	5.2	5.3	5.5	1.1
International development	3.8	4.5	5.0	5.3	9.2
Constitutional affairs	3.4	3.7	3.8	3.9	1.5
Environment, food and rural affairs	3.2	3.3	3.4	3.5	1.2
Cabinet Office	1.9	1.9	2.0	2.1	1.2
Culture, media & sport	1.4	1.5	1.6	1.7	2.3
Foreign & Commonwealth	1.5	1.5	1.6	1.6	1.4
Law Officers' department	0.6	0.6	0.7	0.7	2.9
Scotland	21.3	22.8	24.2	25.5	3.5
Wales	11.0	11.8	12.8	13.6	4.5
Northern Ireland Executive	7.0	7.4	7.9	8.3	3.1
Northern Ireland Office	1.2	1.2	1.2	1.2	
Reserves	1.9	2.7	2.0	2.8	–
Departmental Expenditure Limits	278.7	300.8	321.4	340.5	4.2

Source: 2004 Spending Review, HM Treasury Cm 6237.

Table 2.1.5 **2004 Spending Review: Total Managed Expenditure (TME)**

£ billion

	Plans 2004/05	Plans 2005/06	Plans 2006/07	Plans 2007/08
Departmental Expenditure Limits				
Resource budget	263.9	284.5	302	317.4
Capital budget	26.3	29.1	31.5	34.9
Less depreciation	- 11	- 11.7	- 12.1	- 11.8
Total Departmental Expenditure Limits (A)	279.3	301.9	321.4	340.5
Annually Managed Expenditure				
Social security (benefits)	123.1	127.7	132.9	140.0
Tax credits	13.8	14.3	14.4	14.5
Common Agricultural Policy	2.5	2.5	2.5	2.6
Net public service pensions	0.4	- 0.4	- 0.4	- 0.7
National Lottery	2.0	1.6	1.4	1.3
Non-cash items	28.1	29.7	31.3	33.0
Other departmental expenditure	2.7	2.8	2.6	2.7
Net payments to EC Institutions	2.7	3.7	4.1	4.4
Locally financed expenditure	24.2	26.0	27.9	30.0
Public Corporations own financed capital spending	2.6	2.2	2.1	2.1
Central Government Debt Interest	23.9	25.4	26.5	27.4
AME Margin	1.2	2.0	2.0	3.0
Accounting adjustments	- 19.0	- 18.7	- 19.7	- 20.6
Total All Annually Managed Expenditure (B)	208.3	218.9	227.8	239.5
Total Managed Expenditure (TME) (A+B)	487.6	520.8	549.2	580.0

Source: 2004 Spending Review, HM Treasury Cm 6237.
Notes: All figures are calculated on a resource accounting basis.