

Section 2 Commentary



Chapter 1 Housing, the economy and public expenditure

Economic and housing market uncertainty

The uncertain prospects for the housing market in 2008 are discussed in Commentary Chapter 3. This in turn throws shadows over the economic prospects in the coming year. Much will depend on whether – and when – the Bank of England Monetary Policy Committee (MPC) feels that inflationary pressures are sufficiently under control that it can make further reductions in interest rates, following the quarter point reduction in December 2007.

While the MPC has consistently factored the housing market into its deliberations, despite working to a target inflation measure that does not include housing costs (see Commentary Chapter 1 in the 2003/04 edition of the *Review*), it also needs to take account of other factors across the economy as a whole, such as the inflationary pressures from high

oil prices. It cannot therefore automatically reduce interest rates just because of concerns about the potential extent of a downturn in the housing market.

In the meantime, those uncertainties have already led the government to slightly reduce its forecast for economic growth over the next few years. The 2007 Budget forecast (Compendium Table 11) was for GDP growth of 2½-3 per cent in 2008 and 2009. The forecast in the October 2007 Pre Budget Report reduced the 2008 forecast to 2-2½ per cent growth; but left the 2009 forecast unchanged. The key component in the moderated forecast is expectations of slower growth in consumer spending.

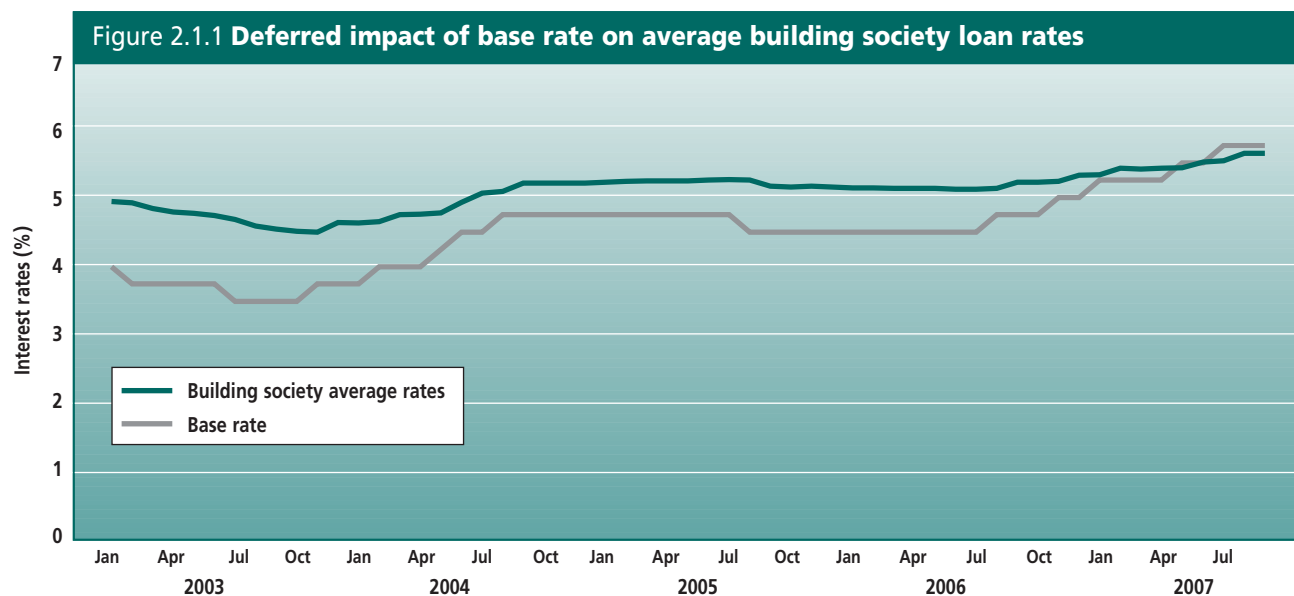
The housing market will contribute to that slow down in a number of more or less predictable ways. The MPC increases in base rates over the last two years

have increased mortgage costs for existing home-buyers, and thus reduced the net disposable income available to them for consumer spending. This impact has, however, been deferred – and moderated – both by the short time delays in bank and building society decisions in response to base rate changes, but more significantly by the delayed impact on households with fixed rate mortgages, who only face a change in their mortgage costs once their fixed term has come to an end.

The deferred impact of base rate decisions on average building society rates for all their home loans is shown in Figure 2.1.1. This clearly shows the lagged impact of the recent rise in base rates on existing borrowers, and it is particularly notable that between August and September 2007 average building society rates were lower than base rate. While the December quarter point reduction in base rate (to 5.5 per cent) will ease the upward pressures, average building society rates will continue to rise under the deferred impact of the increases in base rate earlier in the year.

Indeed unless the MPC makes further base rates reductions early in 2008, the great majority of home-buyers coming to the end of a fixed rate term for their mortgage will still face the prospects of a hike in their mortgage costs going forward.

In contrast, the impact of base rates on the costs of new mortgages is far more immediate, and the five quarter point rises in base rate between August 2006 and July 2007 clearly impacted on affordability, and the future prospects for house prices. Following those



risers house prices have now stabilised, or even begun to fall, by the end of 2007. The single quarter point reduction in December 2007 will begin to ease those pressures, but on its own its effect will be limited, particularly bearing in mind the impact of the Northern Rock episode on market confidence.

Stable or falling house prices can also be expected to trigger a downturn in levels of equity withdrawal, and thus reduce another potential source of funding for consumer spending. Figure 2.1.2 (and Compendium Table 7) shows that equity withdrawal rose in 2006, to some £58 billion, representing some 7.3 per cent of annual consumer spending in the year. Bank of England quarterly figures show that equity withdrawal had already begun to fall back in the first half of 2007, and that downward trend is

certain to continue into 2008. (For a more extended discussion of equity withdrawal see Commentary Chapter 1 in the 2005/06 edition of the *Review*.)

In the years it has been operating, the MPC has been widely judged to have been – with its single interest rate instrument – highly successful in managing to sustain a growing low inflation economy. There can, however, be little doubt that the decisions it makes in the early months of 2008 will be among the most difficult it has had to make since its inception.

Public spending

The moderated forecast for economic growth in 2008 added to the constraints on the government's expenditure plans for the years 2008/09 to 2010/11, set out in the October comprehensive spending

review, which this year was combined with the Pre Budget Report. The consequent housing expenditure plans for England are outlined in the Contemporary issues Chapter 3 *All Plans Ahead*, and the housing budgets set by the devolved administrations in Scotland and Wales are set out in Commentary Chapter 4.

The overall expenditure plans as set out in the 2007 Budget, and related documents, are included in the usual way in the main body of tables in the Compendium. They are supplemented in this chapter by the equivalent tables drawn from the comprehensive spending review.

Table 2.1.1 sets out the total resource and capital budgets, both as cash sums and as a percentage of Gross Domestic Product (GDP). This table supercedes Table 12c in the main compendium (from the 2007 Budget Report), and takes the projections forward another year to 2012/13.

Table 2.1.1 shows a slight increase in projected capital investment in the years ahead compared to those in the 2007 Budget report, with gross investment (net of asset sales but not depreciation) rising to £66 billion per annum in 2012/13, compared to £48 billion in 2007/08. Underlying those figures is an assumed £1.8 billion per annum receipts from sales of council housing. With right to buy sales receipts declining (Compendium Table 60), primarily as a result of the cash limits on maximum discounts, there must be some question about that assumption.

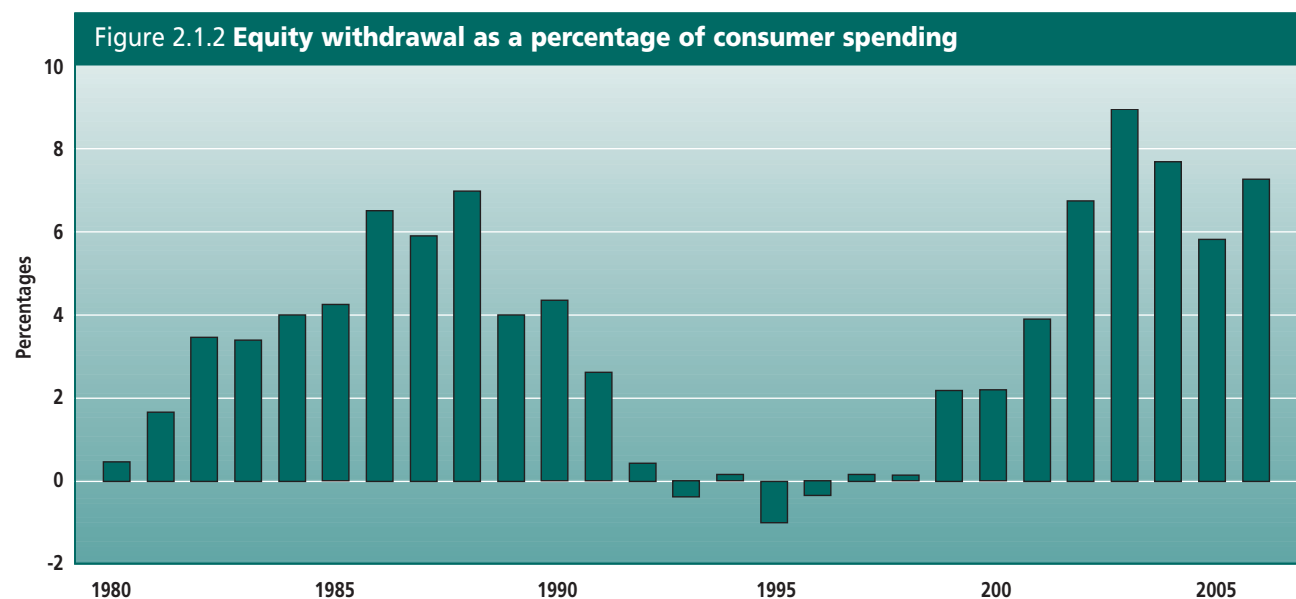


Table 2.1.1 also shows how close the government is to its 'prudential limit' on public sector net debt (PSND); which it has set at 40 per cent of GDP. PSND is set to rise to 38.9 per cent of GDP by the end of 2010/11; before easing back a little to 38.6 per cent by 2012/13. Looked at another way, the government will be within £18 billion of its prudential debt limit in 2010/11; and this is a relative slim margin in unpredictable times.

It should also be noted that PSND is measured against GDP differently to all the other figures in Table 2.1.1. All the other figures are simple

representations of the cash figures as a percentage of GDP for the equivalent financial year. PSND is measured instead on the annual GDP over the year 'centred' on the end of the financial year. While not new this different methodology effectively reduces PSND by around 1 per cent of GDP, compared to the figure that would result if the measure was based on the financial year GDP used to compute all the other figures in the table.

If the government's plans are close to its own self imposed prudential borrowing limits, there is a far more substantial margin relative to the criteria

applied by the EU under the Maastricht Treaty. This provides for a maximum debt level of 60 per cent (for general government gross debt – GGGD). The GGGD figures for the UK run at around 45 per cent over the projected period. In other words, UK borrowing could rise by well over £200 billion before it began to approach the EU maximum level.

While the UK has not signed up to EU monetary union and the Maastricht Treaty, the difference in the borrowing limits between the UK and EU approach indicates just how 'prudential' the UK's own self imposed limits are.

Table 2.1.1 Public sector receipts, budgets and borrowing

	£ billion							Percentage of GDP						
	Outturn 2006/07	Estimate 2007/08	Projections					Outturn 2006/07	Estimate 2007/08	Projections				
			2008/09	2009/10	2010/11	2011/12	2012/13			2008/09	2009/10	2010/11	2011/12	2012/13
Current receipts	519.1	551	581	616	651	686	724	39.2	39.2	39.5	39.7	39.9	40.0	40.2
– Current expenditure	506.6	541	566	593	620	650	681	38.3	38.5	38.5	38.3	38.0	37.9	37.8
– Depreciation	17.2	18	19	20	21	22	24	1.3	1.3	1.3	1.3	1.3	1.3	1.3
= Current budget surplus (deficit)	- 4.7	- 8	- 4	3	9	14	20	- 0.4	- 0.6	- 0.3	0.2	0.6	0.8	1.1
Gross capital investment ¹	43.5	48	51	54	58	61	66	3.3	3.4	3.5	3.5	3.6	3.6	3.7
– Depreciation	17.2	18	19	20	21	22	24	1.3	1.3	1.3	1.3	1.3	1.3	1.3
= Net capital investment	26.3	30	32	34	37	39	42	2.0	2.1	2.2	2.2	2.3	2.3	2.3
Public Sector Net Borrowing	31.0	38	36	31	28	25	23	2.3	2.7	2.4	2.0	1.7	1.5	1.3
General Government Net Borrowing	34.0	41	41	37	34	31	29	2.6	2.9	2.8	2.4	2.1	1.8	1.6
Public Sector Net Debt	500.2	541	580	617	651	682	713	36.7	37.6	38.4	38.8	38.9	38.8	38.6
General Government Gross Debt	574.4	616	658	699	738	774	810	43.4	43.9	44.7	45.1	45.3	45.2	44.9

Sources: 2007 Pre-Budget Report and comprehensive spending review.

Note: 1. Gross capital investment is net of receipts from asset sales.

Government spending by departments and functions

The Spending Review provisions for government departments are shown in Table 2.1.2. While overall the rate of growth is a little ahead of inflation, it is also clearly a difficult spending round for a number of departments, and especially those that see a reduction in their cash budgets over the review period. This includes the expenditure limit for the Department for Work and Pensions, although it should be noted that this relates solely to their budget for research and administration. The cost of DWP benefits is part of 'Annually Managed Expenditure' and this is forecast to rise from £139 billion in 2007/08 to £158 billion in 2010/11.

The implications of the comprehensive spending review for housing in England are discussed in the Contemporary issues Chapter 3 *All Plans Ahead*. The post spending review housing budgets in Scotland and Wales are discussed in Commentary Chapter 4.

Key Reading

Budget 2007, HM Treasury, House of Commons 342, The Stationery Office, 2007.

Public Expenditure, Statistical Analyses 2007, HM Treasury Cm 7091, The Stationery Office, 2007.

2007 Pre Budget Report and Comprehensive Spending Review, HM Treasury Cm 7227, The Stationery Office, 2007.

Economic Outlook 80, OECD, December, 2007.

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 2.1.2 Total Managed Expenditure 2006/07 to 2010/11

£ billion

Resource and capital budgets	2006/07 outturn	2007/08 estimate	2008/09 plans	2009/10 plans	2010/11 plans
Departmental Expenditure Limits					
Health	83.6	94.0	98.7	105.4	112.6
Children, schools and families	46.2	50.8	52.9	55.6	59.5
Innovation, universities and skills	16.3	18.0	18.9	19.8	21.0
Defence	40.6	40.3	41.5	43.4	45.6
CLG local government	22.7	22.9	24.8	25.7	26.5
Home Office	8.9	9.4	9.9	10.1	10.5
Justice	8.9	9.6	10.0	10.2	10.1
Transport	13.4	13.3	13.7	14.1	14.8
CLG communities	9.0	9.2	11.4	11.8	12.2
Work and pensions	7.8	7.9	7.7	7.5	7.2
Business, enterprise and regulatory reform	3.3	3.6	3.5	3.4	3.4
International development	5.0	5.3	5.8	6.9	8.0
Environment, food and rural affairs	4.1	3.9	3.9	4.1	4.2
Cabinet Office	2.0	2.2	2.5	2.7	2.9
Culture, media and sport	1.8	2.0	2.6	2.1	2.4
Foreign and Commonwealth Office	2.0	1.9	1.8	1.8	1.8
Law Officers' departments	0.7	0.7	0.7	0.7	0.7
Chancellor's departments	5.3	5.2	5.1	4.9	4.8
Independent bodies	0.8	0.9	0.8	0.9	1.0
Scotland	25.4	26.7	27.6	28.7	30.1
Wales	12.9	14.1	14.6	15.3	16.0
Northern Ireland	9.2	9.8	10.2	10.6	11.0
Modernisation funding	0.0	0.0	0.5	0.4	0.1
Reserves	0.0	2.9	3.2	3.5	3.8
Departmental Expenditure Limits	330.3	355.4	372.4	389.6	409.9
Annually Managed Expenditure	219.8	233.7	245.1	257.1	268.4
Total Managed Expenditure	550.1	589.2	617.4	646.6	678.3

Source: Tables B11 & B13, 2007 Pre Budget Report and comprehensive spending review.