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UK Household Rebalancing

In the latest National Institute Economic Review, published tomorrow, Dr. Angus Armstrong, Director of Macroeconomic Research at NIESR, examines the process of household rebalancing. There is broad agreement that prior to the crisis households increased borrowing and house prices rose sharply. Yet there are important differences in the interpretation of these trends. The OBR points out that the rise in household borrowing has been matched by a rise in financial assets and so they play-down the need for rebalancing and forecast the ratio of household debt to income will rise each year over the forecast period.

The decline in global real interest rates clearly provided a favourable backdrop for borrowing. Angus Armstrong suggests that the rise in households’ income inequality may have been an additional cause for the emergence of imbalances. In the years prior to the crisis income inequality widened which does not appear to have been matched by wider consumption inequality. For total consumption to even rise in line with income this requires more saving to be intermediated from the high to low income households. High income households must save more and low income households must borrow more.

This insight offers four benefits in terms of explaining the Great Recession over the standard decline in real interest rates argument: (a) it explains the observed differences in saving behaviour across income groups, (b) it explains why the volume of financial flows was well in excess of output growth, (c) it is consistent with the innovations in mortgage market finance which connected lower income borrowers with higher income savers, and (d) it explains why this process would eventually lead to greater financial risk taking.

The official (OBR) assessment is entirely consistent when looking at aggregate level data. Our concern is that this masks important distributional consequences between households. When the solvency condition of borrowers is questioned the absolute size of credits and debits is of first order significance and not just the net position. Just as in Japan the aggregate net asset figures can be very misleading. The link between inequality and debt deflation has lead to parallels being drawn in the US between the Great Depression and this Great Recession.

Prospects for the household sector are very different depending on which segment of the sector one considers. The Bank of England's mortgage repayment data show no sign of any increase in repayment behaviour. According to the FSA between 5-8% of mortgages could be subject to forbearance. This has a familiar ring of the zombie firms in Japan which were insolvent but the banks would not close to avoid crystallising a loss. If this gamble-for-recovery does not pay-off the result may be a very low activity equilibrium in the housing market in certain parts of the country.

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