

# Housing, consumption and EMU

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EMU study



HM TREASURY

# EXECUTIVE SUMMARY

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**1** This EMU study informs the assessment of the convergence test – the first of the Government's five economic tests for determining whether adoption of the euro would be in the UK's economic interest: *“Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?”*. It considers in detail a particular, and important, structural aspect of the transmission mechanism of monetary policy: the housing market. The transmission mechanism as a whole is the subject of the EMU study by HM Treasury *EMU and the monetary transmission mechanism*.

**2** There are four structural aspects of housing markets which could potentially lead to differences in the interest rate sensitivity of UK and euro area households, and to differences in the sensitivity of consumption to housing wealth:

- house price trends: differences in long-run growth rates or in house price cycles may affect household consumption;
- mortgage markets: the level of mortgage debt and the nature of mortgage interest rates, in particular whether they are variable or fixed, will affect households' interest rate sensitivity;
- housing tenure: high levels of owner occupation, as compared to private or social renting, are likely to increase the impact of changes in housing wealth on consumption; and
- mortgage equity withdrawal: the ability of households to withdraw equity from housing is important in determining the impact of changes in housing wealth on consumption.

**3** This study considers evidence on differences in these structures across the UK and the euro area, and considers the implications for households' interest rate sensitivity and consumption.

## **Context: the UK housing market**

**4** Strong cycles in the housing market have been a striking feature of British economic life over the past three decades. Most recently, in 2002, house prices rose strongly, and the state of the housing market, and its influence on households' spending, was an important consideration in the Monetary Policy Committee's decisions about interest rates. The nature of the UK housing market, and its link to households' spending decisions, motivates close investigation of the possible effects if the UK were to adopt the single currency. Interest rate decisions taken by the European Central Bank would be determined by developments in the euro area as a whole rather than being exclusively focused on UK conditions, as they are under the UK's current monetary framework. If households' spending is significantly more sensitive to interest rate changes in the UK than in the euro area as a whole, a common monetary policy could induce some relative instability in the UK housing market and households' spending.

**5** Since 1999, consumption growth has been rapid in the UK, partly due to strong growth in housing wealth. Over the same period, Ireland and Spain were the only euro area countries to have experienced above trend consumption growth, despite lower official interest rates in the euro area than in the UK. This raises the possibility that growth in house prices may be less strong in the large euro area countries, or that the link with consumption may be weaker.

**House prices 6** House price behaviour in the UK has differed from the euro area average in the past, though there has been a wide variety of experience across Europe. The UK has seen a rise in real house prices over the long term of around 2½ per cent a year. This is double that in France and Italy, while in Germany real house prices have hardly changed. Among the larger countries, only Spain has seen real house prices increase at a comparable rate to the UK. Faster house price growth has made housing a better investment asset in the UK. Insofar as the gains can be accessed, this has increased the wealth of homeowners available for consumption.

**7** The volatility of UK house prices has tended to be more marked than in France and Germany. But UK volatility has not been unusual compared with other European countries, many of which have also experienced significant house price cycles. However, where house price cycles have occurred, there is no evidence that they have been synchronised. Rather they appear to have been generated by local conditions.

**8** The differing behaviour of house prices reflects both supply and demand factors. A number of studies suggest that the responsiveness of housing supply to demand pressures is particularly low in the UK. Certainly the UK has, on average, invested a relatively low proportion of its national income in housing compared to other EU countries since 1960. A low supply response would help to explain the much stronger upward trend in real house prices in the UK. It would also tend to accentuate house price volatility – increased supply should help to check house price rises when demand for housing expands.

**Mortgage markets 9** There are some key differences in mortgage markets across Europe which bear on the issue of the sensitivity of households' disposable income to interest rate changes. Owner occupation itself, at 70 per cent, is not very different in the UK from the EU average. It is, however, significantly higher than in Germany and France, although lower than in Spain.

**10** The level of mortgage debt tells a rather different story. Mortgage debt in the UK, at 60 per cent of GDP, is well above the EU average and exceeded only in Denmark and the Netherlands. Mortgage debt is much lower in France and Italy. Perhaps surprisingly, in the light of its low level of owner occupation and stable real house prices, German mortgage debt is similar to that of the UK – the explanation of this apparent paradox lies in fact that there are mortgages held by householders who are private landlords. The high level of mortgage debt in the UK suggests that household income after mortgage payments is likely to be more sensitive to interest rate changes than in many other European countries.

**11** Another way in which changes in interest rates may impact differently on household income is through differences in the prevalence of fixed and variable rate mortgages. The rate of interest paid on fixed rate mortgages does not vary with changes in the base rate for the period of the fix, while variable mortgage rates tend to move closely in line with base rates.

**12** On the latest comparable figures, over 60 per cent of new UK mortgages were variable rate and most others were short-term fixed rates of one to five years. In Germany, 80 per cent of mortgages were at long-term fixed rates of over five years, with all the rest at short-term fixed rates. In France, 60 per cent were at long-term fixed rates and nearly all the rest were at short-term fixed rates. Among the larger EU countries, only Italy – where the level of mortgage debt is low – had an appreciable proportion of variable rate mortgages; and then, at around 35 per cent, the figure was almost half that in the UK.

**13** The UK's level of mortgage debt and its greater reliance on variable rate mortgages imply that the sensitivity of housing-related interest payments to changes in interest rates is higher in the UK than in any other EU country, and far higher than in the other large EU economies.

### **Mortgage equity withdrawal**

**14** The influence of the housing market on household spending also depends on the extent to which housing wealth can be accessed and, in particular, the extent to which homeowners are able to borrow against their housing wealth (known as mortgage equity withdrawal). The UK now has a liberalised and competitive mortgage market and so do the Scandinavian countries. Both the UK and the Scandinavian countries have seen rapid rises in personal borrowing. In France, the deregulation process started later and has not progressed as far, while in Germany, the mortgage market remains heavily regulated. Mortgage equity withdrawal has been strong in the UK and in Sweden, but negative in France, Germany and Italy. This reflects both the relative ease of achieving mortgage equity withdrawal in the less regulated markets and trends in housing equity itself, largely the result of house price movements. This study includes a case study of the Netherlands which shows that substantial house price movements and associated mortgage equity withdrawal can occur even in a predominantly fixed interest rate environment.

### **Housing wealth and consumption**

**15** Other things equal, differences in housing and mortgage markets between the UK and other EU countries together indicate the potential for greater sensitivity of household spending to interest rate changes in the UK than in the larger euro area countries. The study also considers variations across Europe in the responsiveness of households to changes in interest rates and housing wealth by examining estimated consumption functions. Existing studies of consumption functions are reviewed and some new comparable modelling results by HM Treasury are presented. While the results are not as clear cut as the evidence of structural differences, on balance they support the view that the sensitivity of household spending to housing wealth and house prices is higher in the UK than elsewhere. These consumption function based studies do not consider the link between interest rates and house prices. Other work presented in this study suggests that this link may also be more sensitive in the UK, tending to enhance any response of household spending to interest rates.

### **Could these differences change in EMU?**

**16** This study recognises that past relationships may not be a good guide to what might happen if the UK were to join EMU. Established patterns of behaviour might change sharply, leading to convergence in the interest sensitivity of household spending in the UK and the current euro area. The best place to search for evidence of this kind is in the housing and mortgage markets of those countries which have already adopted the euro. However, there is little sign of significant convergence to date. While nominal mortgage rates have converged, mortgage markets remain segmented, with little tendency for the types of mortgage product available to become more similar across the different countries. While the moves towards a single financial market have made it easier for banks to operate in different countries, this has yet to make much impact at the retail level.

**Conclusions 17** The study seeks to address the question of whether UK households are more interest rate sensitive than the euro area average as a result of differences in housing market structures. It finds that:

- real house price growth has been stronger in the UK than in the larger euro area countries, and the low response of housing supply in the UK appears to be an important reason for this;
- high levels of mortgage debt in the UK, combined with the dominance of variable rate mortgages, implies that the sensitivity of household interest payments to changes in interest rates is higher in the UK than in euro area countries;
- the UK owner occupation rate is well above the levels in Germany and France, although lower than Spain and a number of smaller EU countries;
- the competitive, liberalised mortgage market in the UK makes it easier for households to access their housing wealth than is the case in the larger euro area countries, and UK households have been active in taking advantage of these opportunities, as shown by higher levels of mortgage equity withdrawal; and
- the evidence of the euro area to date suggests little by way of convergence of housing and mortgage markets following EMU membership.

**18** These conclusions are drawn on in the EMU study by HM Treasury *EMU and the monetary transmission mechanism*, which considers the overall interest rate sensitivity of the UK compared to the euro area. That study finds that there are other structural factors, in addition to housing, which may make the UK more interest rate sensitive than euro area economies, but that there are also factors which work in the opposite direction. Overall, it finds that there is more evidence for structural factors that will increase the strength of the transmission mechanism in the UK relative to other countries. While empirical econometric studies at the aggregate level, as reported in *EMU and the monetary transmission mechanism*, do not demonstrate consistently that the UK transmission mechanism stands out, these techniques are not always the best way of considering specific areas which may have special characteristics and particular importance and risk.

**19** This is a key motivation for the current study, which has revealed high sensitivity of incomes after mortgage payments to interest rate changes in the UK and high house price growth and volatility, reflecting to a significant extent the low supply response of house building in the UK. This is a combination which may mean that deviations in UK interest rates from their appropriate level could lead to particularly large swings in the housing market (implying correspondingly large swings in the distribution of wealth between home owners and others) and hence in the wider economy in the UK, while similar deviations would be less problematic in some other EU countries. In EMU, interest rates are set in relation to conditions in the euro area as a whole, rather than in relation to conditions in any individual country. The resulting gap between what is appropriate for the euro area and what would be appropriate nationally could matter more in the UK than elsewhere.

**20** These conclusions are considered further in the convergence test – the first of the Government's five economic tests for EMU entry.