PROPERTY BOOM BUILDS ON A SWAMP OF DEBT

Credit is out of control - which is why the base rate will be raised this week

Larry Elliott, economics editor - Monday November 6th 2006 - The Guardian

Here are some snippets of news from last week. Abbey says it will offer mortgages of up to five times single or dual income. A survey shows that repayments on home loans now consume more than half the weekly budget of the average family. One of Britain's leading economists says there is a 36% chance that house prices will fall by 2010. The governor of the Bank of England says he finds the current level of house prices hard to explain. A record number of people are going bust.

What does this tell us? Do I really need to spell it out? It tells us that debt in this country is out of control; it tells us that thrift is no longer regarded as a virtue by consumers who want it all and want it all now; it tells us that lenders are acting in an irresponsible and short-sighted manner; it shows us that the housing market is riding for a fall; and it shows us that interest rates will quite rightly be raised this week.

The housing market, as Graham Turner of GFC Economics pointed out, is "spinning out of control". There is no evidence as yet that the quarter-point increase in interest rates in August has had the slightest impact on a property market that has plenty of money to lend, but it is perhaps symbolic, Turner notes, that Abbey sustained big losses in the dotcom bust six years ago. There's always something that provides a whopping great clue that the top of the market is imminent; Britain's second biggest lender deciding to offer such big multiples of earnings may well be it.

The lenders say that they conduct the most rigorous checks into the credit worthiness of borrowers. But if they really are being ultra-careful, it's somewhat strange that they initiated 34,626 possession actions in the third quarter of this year (before the August rate rise had any effect) and that this was the highest total since the housing market was at rock bottom in 1993. It also sits oddly with the record number of personal insolvencies, up 55% in the year and certain comfortably to top 100,000 this year.

Though it is true that individuals have a choice in whether to take on debt and thus can't escape their share of the responsibility when debts go bad, the insolvency data fits with a picture of the aggressive marketing of debt that is part and parcel of the modern go-getting, profit-maximising, shareholder value-dominated lending organisations.

One wonders whether, in the days when Abbey was the staid old mutually owned Abbey National, the people in charge would have felt comfortable about such extravagant lending practices. Somehow I doubt it.

Vincent Cable, the Liberal Democrats' Treasury spokesman, was right to call Abbey's new mortgages "very alarming" and right again when he noted: "With interest rates, unemployment and council tax all rising, it is likely that these irresponsible lending practices will lead to financial disaster for many people."

Dangerous game

In the short term, though, loosening the criteria for lending helps sustain economic growth. Last week's survey of the service sector was strong, helped in no small part by the huge industry that has grown up in the high street to finance secured and unsecured debt. Yet in the longer term, lenders are playing a dangerous game. They may think that the Bank will conclude after looking at the mountain of debt, the stuttering US economy and the rising pound that it is too risky to pull the interest-rate trigger. But it is the closest thing to a sure-fire bet that rates will go up on Thursday, and the City believes that the Bank has at least one other bullet in the chamber ready to be fired in the new year.

Mervyn King was at pains to stress when giving evidence to the House of Lords last week that the Bank does not target house prices but the Bank's monetary policy committee certainly pays a lot of attention to asset prices. In his evidence, the governor also made it clear that he was uncomfortable about the fact that the measure of inflation used by the government to set interest rates excluded housing costs. On this measure, the consumer prices index, the inflation rate is 2.4%; when measured by the retail price index, which does include mortgage repayments, inflation is 3.6% and is likely to edge closer to 4% when interest rates go up this week.

Now, if you are a borrower with a hefty mortgage that is gobbling up more than half your income, you will probably think the RPI is a more accurate guide to the increase in your cost of living (and, even then, probably an underestimate). When it comes to negotiating pay deals, therefore, you will want a rise that uses the RPI as a benchmark. The prospect that pay bargainers will seek compensation for rising mortgage costs (and dearer energy and rising taxes) is something that concerns the Bank.

Unsustainable

By any traditional yardstick, property is over-valued. Some eminent economists believe that there have been structural changes to the market that mean prices are sustainable at current levels. Work published by John Hawksworth of PriceWaterhouseCoopers last week took issue with this analysis. While doubting that property was over-valued by 30%, which is what the traditional models would show, Hawksworth used sophisticated probability techniques to conclude the market was perhaps 15% above fair value. As a result, he said, there was a greater than one in three chance of prices falling over the next four years.

That is a risk that will grow bigger and bigger if house prices continue to grow faster than earnings. First-time buyers are having to stretch themselves to the limit to get a foot on the property ladder, and without first-time buyers the market tends to seize up.

Although borrowers have yet to respond to August's quarter-point rise in rates, the overall level of indebtedness makes borrowers sensitive to even relatively minor increases in borrowing costs. King would be well advised to deliver a strongly worded warning about the dangers of those seduced by the lure of easy credit in an environment where interest rates are going up. If that warning is not heeded, new borrowers would have only themselves to blame.

Guardian Unlimited Money