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Separating Fact from Fiction: Household Balance Sheets and the Economic Outlook - Speech by Spencer Dale

In a speech given today to the Exeter Chamber of Commerce in Exeter, Spencer Dale - Chief Economist and Executive Director for Monetary Analysis and Statistics - discusses household balance sheets and how their past deterioration might influence behaviour in the period ahead.

Spencer Dale begins by noting that "the economy appears to have turned". In a technical sense, the recession does appear to be coming to an end. But he states that we are only just starting along the road to recovery. In order to meet the inflation target a sustained period of robust growth is required to bring the level of activity better into balance with the supply capacity of the economy. "It is a recovery in levels of output and employment that matters, not just a return to positive growth". He envisages that progress could be hindered by a number of headwinds, including tight credit conditions, the need for a rebalancing of international trade flows and the extent to which households need to rebuild their balance sheets. It is this third factor on which Spencer Dale focuses in this speech.

He starts by noting that a consumption boom is often presumed to have preceded the bust. But consumer expenditure did not grow rapidly in this century prior to the onset of the financial crisis. There is little evidence of a debt-fuelled consumption boom.

But given the increase in household debt is not a myth, where did it all go? The answer he suggests lies in the housing market. "Debts were accumulated to pay for the housing that had become so much more expensive." But much of the rise in household debt was matched by an increase in financial assets through "a huge redistribution of wealth between different households".

He believes this episode provides two important lessons. "First, any analysis of the increase in household debt over the past decade has to pay equal attention to the record accumulation of financial assets." "Second, changes in house prices do not result in significant changes in aggregate household wealth". But that does not mean changes in house prices can not have significant implications for the macroeconomy, through collateral and distributional effects.

Spencer Dale considers the possibility that attempts by households to repair their balance sheets could weigh on the recovery. However, he argues that just observing standard measures of household balance sheets may be misleading. This is because as they are normally measured, household balance sheets suffer from a 'missing' asset - human capital - and a 'missing' liability - future housing costs. He goes on to explain that any falls in human capital as a result of the recession would "likely be significantly less than the falls seen in financial wealth". And that declines in house prices would be offset in future by "the benefits of more affordable housing". As such, Spencer Dale concludes that "the pressure on households to repair their balance sheets might be exaggerated".

Spencer Dale finishes by explaining why he voted for £175 billion of asset purchases in August. The "decision came down to an assessment of the risks of doing too much versus the risks of doing too little". He placed considerable weight on both risks and thought that they were best balanced by an expansion of the programme to £175 billion.

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech403.pdf