

## **Monetary Policy Roundtable**

### **Held at the Bank of England, 30 September 2008**

On 30 September, the Bank of England and the Centre for Economic Policy Research jointly hosted a Monetary Policy Roundtable. This was the first in what is expected to become a regular series intended to provide a forum for economists to discuss key issues affecting the design and operation of monetary policy in the United Kingdom. Participants included a range of economists from private sector financial institutions, academia and public sector bodies. There were four discussion topics:

- The prospects for the housing market and consumer spending;
- Oil and other global price pressures;
- Monetary policy considerations at the current juncture;
- Lessons from the financial turmoil for monetary policy.

This note summarises the main points made by participants at the Roundtable. The event was conducted under ‘Chatham House rules’ and, as such, none of the opinions expressed at the meeting are attributed to individuals. *The views expressed in this summary do not represent the views of the Bank of England, the Monetary Policy Committee or the Centre for Economic Policy Research.*

#### **The prospects for the housing market and consumer spending**

House prices had fallen sharply in recent months, but further declines were likely. The relative importance of restrictions in credit supply and falling demand in driving the housing market slowdown was discussed. Gross mortgage lending had slowed less sharply than net lending, suggesting that remortgaging activity had been more resilient. If restricted credit supply was the main driver, then all forms of lending might be expected to fall in a similar way. So weak demand could also be playing a role. Prospects of further price falls might lead buyers to put in very low offers. If sellers were not yet willing to accept such a drop in price, transactions would fall sharply and observed house prices would adjust sluggishly. Some estimates suggested an overall fall in house prices of 20-30% was plausible.

On average, mortgage interest rates on the outstanding stock of mortgages had not changed much over the past year or so. For new mortgages, rising spreads had been partly offset by the decline in Bank Rate, but there was significant differentiation between different types of borrowers. Most of the key drivers in empirical models of house prices were now pointing to further falls; real income growth was weak, credit conditions were tightening and unemployment was increasing (although supply constraints for new homes remained an upside factor for house prices). Rising loan-

to-value ratios could delay any recovery in the housing market if buyers had to save more for their deposit.

A range of channels were identified through which falling house prices might affect aggregate demand. Lower house prices would lead to a slowdown in housebuilding and less housing collateral available for households to borrow against, potentially reducing consumption. Lower housing market activity might also lead to fewer purchases of key household items which were often bought when people moved house. In addition, falling house prices might feed back into tighter credit conditions if banks saw collateral values fall or experienced losses through defaults. A further possible channel was if increases in house prices constituted a 'bubble'. In this case, it was argued that changes in house prices might lead to conventional wealth effects.

Changes in house prices caused some households to gain and other to lose. Those 'long' of housing (households who planned to sell or trade down) would be worse off, while those 'short' of housing (households who were yet to buy or planned to trade up) would be better off. Whether or not these effects netted out in the short run depended on the different marginal propensities to spend out of wealth of the two groups.

Identifying the importance of the various channels through which house prices might affect consumption was difficult. The often strong correlation between house prices and consumption could reflect both variables responding to a common factor, such as income expectations. Nevertheless, incorporating house prices in consumption equations did seem to improve forecasting performance.

### **Oil and other global price pressures**

Rapid increases in commodity prices have been associated with the pick-up in inflation over the past year in the United Kingdom and elsewhere. The discussion in this session focussed on the factors behind these commodity price developments, the outlook for commodity prices, their macroeconomic impact, and the response of monetary policy.

The two key factors contributing to increasing commodity prices since 2003 were the rapid growth in the demand for commodities from fast-growing developing countries and the relatively inelastic supply response, especially in the oil market. The muted oil supply response reflected a number of factors. In non-OPEC countries, production yields had been declining in mature oil fields, the marginal cost of extraction in many new fields was relatively high, and there were significant barriers to entry in a number of countries. As a result, the increase in oil production in non-OPEC countries had not kept pace with the increase in global oil demand, leaving OPEC to fill the gap. OPEC had also not increased oil production significantly in response to the pick-up in

oil demand. In part, this reflected a low margin of spare capacity due to under-investment in exploration and development since the mid-1980s. And in part, it reflected a change in pricing behaviour by OPEC countries.

Views differed as to the eventual level at which oil prices might settle. The sharp increase in volatility of long-dated oil futures prices was highlighted as evidence of increased uncertainty amongst market participants about medium-term prospects for the oil market. Much depended on the outlook for global growth – especially growth in emerging markets, but also in the US, which continued to be the largest energy consumer in the world – and on the long-run price elasticity of demand for commodities. It was noted that US demand for oil had been falling but that demand from emerging market economies remained strong.

In the United Kingdom, rising energy and food prices have pushed up CPI inflation, which had led to a squeeze in real incomes and a slowdown in consumer spending. In the view of some participants, the impact of higher consumer prices had up to now been a more important factor in explaining the economic slowdown in the United Kingdom than the impact of tighter credit conditions. Higher energy prices can put pressure on growth through affecting potential supply, especially in developing countries that specialise in the production of energy-intensive goods.

In principle, increases in relative prices should wash out of the headline measure of inflation after a while. But there was a risk that persistently higher headline inflation could dislodge inflation expectations away from target, leading to a wage-price spiral. Some participants noted that there was not much evidence of such a spiral having occurred so far in the United Kingdom.

### **Monetary policy considerations at the current juncture**

Discussion in this session centred on: just how difficult the current economic situation was and whether this necessitated a change to the MPC's remit; whether the MPC should adopt 'core' inflation as an intermediate target; and what information could be gleaned from macroeconomic models at the current juncture.

Much of the discussion on the current state of the economy was rather gloomy. A number of speakers argued that the United Kingdom was in the midst of an unprecedented combination of adverse external demand and supply shocks, with the result that the economy was probably already in recession. At the same time, however, CPI inflation was well above the 2% target. Several speakers thought that the rapid deterioration in financial market conditions might well lead to a sharper downturn and in due course an undershoot of the inflation target. These speakers recommended an early (and possibly large) cut in interest rates.

Discussion of whether or not there should be any change to the MPC's remit focussed largely on the advantages and disadvantages of adopting 'core' inflation as an intermediate target and performance indicator. There was a general consensus that it would not be sensible to alter the remit to put more emphasis on growth, as in the US Federal Reserve's 'dual mandate'. There were two arguments put forward for adopting 'core' inflation as an intermediate target variable. First, headline inflation was subject to shocks that were not readily controllable with Bank Rate, such as movements in oil prices. Second, the current remit was vague about the speed with which headline inflation should be brought back to target. This reduced the effectiveness of the framework in anchoring inflation expectations and made it harder to hold the MPC to account for its actions. With 'core' inflation as an intermediate target, it was argued that: the MPC would gain greater clarity; their performance could be measured more easily since changes in Bank Rate more directly influence 'core' inflation; and they would still ultimately achieve the inflation target since 'core' and actual inflation rates moved together in the long run. However, for a number of reasons, other speakers were less supportive. First, households and businesses care about actual, not 'core', inflation—if actual inflation diverged from 'core' inflation for an appreciable length of time, as had been the case recently, the credibility of the monetary policy framework would be strained. Second, the MPC's inflation projections played a similar role to that suggested for 'core' inflation. And third, the current framework had worked well; it was not obvious that this proposal would have affected the MPC's decisions and any change risked damaging the credibility of the framework.

Finally, there was a discussion about the weight one should attach to model estimates of the likely size of the economic downturn given that most models do not explicitly incorporate credit intermediation channels. Opinion here was divided. Some speakers noted that general equilibrium models that did attempt to capture credit market effects pointed to the likelihood of significant depressing effects on growth. But other speakers argued that such models did not fit the data well enough to be usable for policy analysis.

### **Lessons from the financial turmoil for monetary policy**

Much of the discussion in this session centred on how monetary policy should react to what some saw as the pro-cyclicality of liberalised financial systems. Some speakers argued that the current financial turmoil was a product of developments during the 'Great Moderation' period that preceded it. In particular, excessively low policy interest rates, especially in the United States, and inadequate macro-prudential regulation had contributed to: rapid growth in money and credit, falling credit standards, elevated asset prices, low rates of saving and increased global imbalances. If monetary and regulatory policies had leaned against these trends, it would have reduced the extent of the current financial turmoil. This was contrasted with the view,

associated by some participants with the US Federal Reserve, that monetary policy should not try to lean against asset price booms, but should instead be prepared to clean up the fall-out from any subsequent unwinding.

Some speakers noted that leaning against asset price booms was entirely consistent with an inflation targeting framework, as the 'bust' phase would be associated with significant downward pressure on inflation. But it was not clear that monetary policy was the most appropriate instrument for dealing with asset price booms, especially as modest increases in interest rates would do little to restrain an asset price boom and it was not straightforward to identify unsustainable increases in asset prices. A number of speakers suggested that macro-prudential regulation was better suited to leaning against asset price booms, including maximum leverage ratios for lenders and loan-to-value ratios for borrowers. In addition, it was also suggested that regulatory policy should pay attention to the perverse risk-taking incentives that were inherent in some tax and remuneration schemes.

A few speakers felt central banks should more clearly separate their monetary policy operations from their liquidity support operations. It was also suggested that the Swiss National Bank's approach of targeting three-month market interest rates, rather than overnight rates, might usefully be reviewed by other central banks. Among the other lessons were the need for better co-operation between central banks, and between central banks and regulators.

As in the preceding session, there was discussion of whether existing economic models used by central banks were adequate for the analysis of monetary policy in the face of a financial shock. There were calls for macroeconomic models to be developed so as to capture better the role of financial intermediaries in the monetary transmission mechanism.