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News release

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Credit Conditions and Monetary Policy - Speech by Paul Tucker

In a speech today to the Leeds Financial Services Initiative, Paul Tucker - Executive Director for Markets and a member of the Monetary Policy Committee - discusses the interactions between the financial and real economy and their impact on monetary policy. In particular, he addresses the household and corporate sectors in the US and UK, emphasising the importance of credit conditions as an input to monetary policy.

Commenting on the US, where the outlook is crucial to global prospects, Mr Tucker suggests that the necessary balance sheet adjustment in the corporate sector has made some progress, though a recovery in investment will also depend on improved corporate confidence, following the legacy of the late 1990s. A key question for the global economic outlook is whether US business investment will stage a recovery before US household consumption decelerates. He says the US housing market has been a key factor explaining continued robust consumer spending, partly made possible by the distinctive features of the US mortgage market that have allowed households to refinance their borrowing at lower cost as long-term mortgage rates fell. He adds that, although the US fixed-rate mortgage market has recently played an important role in boosting consumer demand, the ability to prepay adds volatility and complexity to dollar interest rate markets, and makes the effects of monetary policy depend on the rates applying to existing mortgage loans.

Mr Tucker says that, although the UK mortgage market is different, households here have taken advantage of important changes in the availability of finance - such as increased access to fixed-rate mortgage finance, home equity loans, and the fall in consumer credit rates. Together with the low interest rate environment and rising house prices, that has contributed to the increase in borrowing.

Going forward, he asks whether higher borrowing might pose a risk to the economy, potentially complicating monetary policy. Mr Tucker suggests that if household finances have become less volatile than in the past - due to greater macroeconomic stability - then households can probably prudently carry some more debt than in the past. But Mr Tucker underlines the difficulty of "knowing how much is safe, or how much is too much".

Mr Tucker suggests that the extent of the risks facing the economy from higher household borrowing will depend on whether or not households have made borrowing decisions on misperceptions about the future based on their recent experience. He says future real income growth is likely to be lower than it has been

over recent years; and nominal interest rates are currently below their likely long-term average. He says, "Ultimately it depends on individual households, and their lenders, reaching their own view in the light of their particular circumstances". Higher borrowing does mean that households are more vulnerable to economic shocks.

The UK corporate sector has faced different balance sheet pressures from those of the consumer over recent years, with marked differences across sectors. But it is not obvious that these explain persistently weak capital expenditure, which probably owes as much to uncertain global demand and profitability. The MPC expects a gradual recovery in business investment though Mr Tucker sees risks on the downside in the near term but on the upside farther out. For consumer demand, he argues that, relative to the MPC's central projection, there are upside risks in the near-term. In part, that reflects the possibility that households will continue to borrow to shield themselves against decelerating disposable incomes, although that may be dampened by the recent rises in fixed-rate mortgage rates. Given that and what he sees as downside risks to the near-term outlook for the world economy, Mr Tucker concludes that UK monetary policy is "finely poised". Policy is currently rightly supporting demand growth, with interest rates below their likely long-term average level in order to keep inflation on track to meet the 2.5% target.

Key Resources

Credit Conditions and Monetary Policy - Full Speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2003/speech201.pdf