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News release

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Consumption and Interest Rates - Speech by Professor Timothy Besley

In a discussion meeting held today by the Centre for Economic Policy Research and the Economic and Social Research Council at Chartered Accountants' Hall, Professor Timothy Besley - external member of the Monetary Policy Committee - considers the relationship between interest rates and consumer spending, and the factors that may determine how consumption evolves over the medium term.

Consumer spending comprises 64% of GDP and may provide a good indicator of the strength of the economy. Annual consumption growth has increased over the recent past to an estimated 3.0% in 2007 Q1. How consumers respond to recent monetary tightening is a key judgment in the current policy debate.

Professor Besley argues that there are a number of reasons why short-term disposable income changes explain changes in consumption. Access to credit is one such factor. He urges caution in assessing the link between house prices and consumption growth and cites evidence that "consumption growth of renters is associated with house price growth just as strongly as the consumption growth of owners." But there may be a role for housing collateral in affecting overall credit conditions available to households allowing them greater flexibility to smooth through fluctuations in their disposable income.

Making any assessment of the impact of interest rates on consumption, we need to understand how consumers with mortgages will respond as fixed rate deals unwind. "With rising house prices, they may choose to borrow further to smooth their consumption or they may react abruptly to changes in their disposable income. There is clearly a great deal of uncertainty."

He indicates a broad range of possible impacts upon disposable income from Bank Rate increases in the near term, emphasising "uncertainty over the continued build-up of household debt and the future path of effective interest rates faced by households on this debt." However, there are other uncertainties, including the evolution of household interest income, which will offset some of the negative cash-flow impact highlighted.

Professor Besley comments ".we need to be cautious in reading too much into volatile monthly retail sales data. ...I certainly don't put much weight on the month-on-month variation. They are too easily influenced by weather and other idiosyncratic events. The official data are also prone to revisions.data on overall consumption are generally available with a much greater lag and are equally prone to significant revision."

He concludes, "Overall, it should be clear that reading the trends in consumption in recent months and trying to form a judgement where things are going is fraught with difficulty.It is logical to expect some weakening of consumption growth to reflect the monetary tightening that has taken place. But there is considerable uncertainty about the speed at which this will happen and it could be some time before the data give us a clear picture of the trend."

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2007/speech320.pdf