
Trends in the global economy

*The **Governor** discusses⁽¹⁾ the impact on the provision of housing finance of recent trends in the world economy—both in approaches to economic management and the revolution in financial services. There is now widespread agreement that monetary policy should be directed to achieving and maintaining permanently low inflation. If that succeeds, the demand for housing as a hedge against inflation should decline, so that real house prices may tend to rise more slowly over time; by moderating the economic cycle, it should also lead to greater stability in these prices. On the microeconomic side, the **Governor** discusses the formidable challenges presented to financial institutions—and to their regulators—by the continuing process of competition and innovation.*

I have been asked to contribute some thoughts on trends in the global economy and what they might imply for housing finance. I will comment on two broad trends in the global economy which seem to me to have an important bearing. I will speak first about current approaches to economic management, and in particular about the worldwide efforts to achieve greater price stability. And then I will discuss some of the implications of the continuing global financial services revolution.

Economic management

Let me begin then with some observations on current approaches to economic management.

If you look back over a longish period of, say, 10 to 15 years or more, you can, I think, see a distinct change in many countries—all around the world—in their approach to economic management, with the emphasis generally moving away from government intervention. Of course, the radical shift away from central planning in the countries of the former Soviet Union or Eastern Europe is a dramatic example of this. But it goes much wider. In a whole range of both industrial and industrialising countries, the emphasis before was on short-term demand management, with both monetary and fiscal policy directed to managing the short-term trade-off between growth and employment on the one hand, and inflation and external imbalance on the other.

Now, the emphasis generally tends to be on providing a stable medium and long-term macroeconomic environment. Monetary policy is typically allotted the specific task of achieving and maintaining permanently low inflation, while overall fiscal policy is increasingly concerned with budgetary consolidation and maintaining sustainable levels of public sector debt. Then, macroeconomic policy was typically supported by direct administrative controls of various kinds, and also by specific taxes and subsidies on particular forms of activity; whereas now the trend is towards deregulation and fiscal neutrality, with increasing

recognition of the possible economic costs that need to be weighed alongside the social benefits of various forms of intervention. Then, it was widely accepted that there should be direct public sector involvement across a range of microeconomic activities; whereas the tendency now is to transfer many such activities to the private sector through various forms of privatisation, or for the public sector to undertake them in conjunction with private sector finance and management.

Now I do not suggest that we have all suddenly discovered the Holy Grail—a single blueprint for policy that is of universal application. Individual countries start from different positions and their policy approaches, of course, reflect differences in their national circumstances and different social priorities. Nevertheless, to varying degrees certainly, I suspect that most of you will recognise a shift of emphasis in the general direction I have described.

Now, to the extent that this is true, your business—the business of housing finance—is likely to be particularly affected in all sorts of ways, because housing and the provision of housing finance have typically in the past enjoyed very considerable government support reflecting the special social importance attaching to them. Deregulation—including, particularly, deregulation of financial services—may, for example, radically change the financial environment within which you operate, increasing competition on both sides of your balance sheet from other financial intermediaries or new instruments or techniques. I will return to this question when I come on to my second main theme—the continuing revolution in financial services.

Privatisation, in its broadest sense, may substantially change the balance between public and private sector housing. In the United Kingdom, for example, the sale of publicly owned houses to their occupants since 1980 has increased the proportion of the total housing stock that is owner-occupied by nearly 10% to some 67%; and private

(1) In a speech on 12 September to the World Congress of the International Union of Housing Finance Institutions in London.

finance these days accounts for roughly 40% of the funding available to housing associations, which are the main providers of social housing. Such trends could certainly have important implications for you. So too would any reduction in tax or other incentives to homeownership, whether as a result of changing social priorities or of overall budgetary restraint.

What I should like to focus on are the effects on the housing market and on housing finance of the current approach to monetary policy. This, as I say, is nearly everywhere now directed to achieving and maintaining permanently low inflation—not simply as an end in itself, but as a means to the ultimate objective of steady and sustainable economic growth over the medium and longer term—as a means, in other words, of moderating what have in the past been exaggerated fluctuations in the economic cycle. If we can indeed achieve greater stability in this broad sense, then this could radically change the environment in which you have to operate—especially those of you from countries, such as the United Kingdom, with a history of relatively high and variable inflation.

Almost throughout the industrial world, housing has been a very reliable investment over a long period. Although subject to cyclical ups and downs, *real* house prices in the G7 countries, for example, rose by over 1½% a year on average during the 1970s and 1980s. In *nominal* terms, they increased almost without interruption at an average annual rate of no less than 8¾%. In the second half of the 1980s, real house prices in the G7 countries rose by over 5% a year, and nominal house prices by nearly 9%.

The United Kingdom was not untypical, although house prices in this country generally rose more rapidly than elsewhere—by 2½% a year in real terms from 1970–92, and by over 9% a year in real terms from 1985–90. The comparable nominal house price increases were 12½% and nearly 15%—and only twice in the last 50 years have nominal house prices actually declined in the United Kingdom (in the early 1950s and in the last three years).

The behaviour of real house prices is presumably to be explained in terms of steadily rising demand for owner-occupied housing coupled with a relatively inelastic supply of new houses associated, in some countries, with a limited supply of land. The demand resulted from a combination of demographics and rising real incomes, as well as from tax incentives and increasing availability of mortgage finance. But it was boosted to varying degrees too by the perception that houses were not just somewhere to live, but also a way to make money in an inflationary world. A large part—about half—of all personal financial wealth in the United Kingdom is accounted for by net housing wealth, accumulated by purchasing a rapidly-appreciating real asset with debt fixed in nominal terms. And the same is true in most other G7 countries (apart from the United States, where net housing wealth is only about one fifth of total personal wealth).

In these circumstances, housing was not only an attractive asset to the purchaser and mortgage borrower, it was also very attractive security for the mortgage lender.

What happens then if we *do* achieve greater long-term economic and price stability?

To a greater or lesser degree, most of the factors explaining the rising trend in real house prices will probably continue to apply. The main exception is that the demand for housing as a financial asset—as a hedge against inflation—should decline, so that overall real house prices may tend to rise more slowly over time.

And if we succeed in moderating the economic cycle real house prices should also become more stable. There should be less erratic demand for houses, where before buyers were sucked into the market by the prospect of rising prices during the boom phase, only to find they had difficulty in servicing their debt when interest rates had to be pushed sharply upwards to bring the economy back under control. Even so, because housing demand tends to be particularly sensitive to expectations, and because the supply of housing is likely to remain inelastic, at least in the short term, real house prices may still be more variable than other prices. And in an environment of general price stability, that could mean that falls in *nominal* house prices become somewhat more common than they have been in the past.

Greater economic and price stability should also make for less financial uncertainty—and for that reason to lower overall real interest rates as the uncertainty premium is reduced; and it may affect the form of mortgage finance, with more emphasis on fixed interest rates rather than variable rates, for example. Such trends too may help to improve the capacity of borrowers to service their loans.

Moving to a more stable, low-inflation environment can involve difficult problems of transition—which, as we are still seeing in this country, can be acutely painful for both mortgage borrowers and lenders. But it clearly also raises longer-term questions for you about the nature of your business: whether, or to what extent, it is appropriate to concentrate asset portfolios on housing, for example; questions about appropriate loan-to-value ratios or earnings multiples; and questions about the appropriate forms of housing finance. I can only say that I am very glad that my role in these proceedings is to identify the questions rather than provide the answers!

The financial services revolution

Let me turn now to my second theme—the continuing global financial services revolution—and I choose those words with care because, even though I have lived with the process here at the heart of it, in the City of London, for the past 15 years and more, I am still constantly amazed at the extent and pace of change in the financial services industry, and by the fact that it goes on and on, with wave after wave of innovation.

From my perspective, it is a self-sustaining, interactive process, with a number of distinct elements feeding on each other. Advances in information technology are an important part of it, but they facilitate innovation and encourage competition, which in turn generate the demand for further advances in technology. Innovation and competition, and the new financial instruments and techniques they create, lead to new forms of financial intermediation and increasing overlaps between previously distinct types of intermediation. This complicates financial regulation, which has typically been structured on the basis of established distinctions between financial institutions and instruments, but which becomes increasingly difficult to apply in the same form as those distinctions erode. Deregulation—or re-regulation along broader, functional lines—whether as a practical inevitability in this sense, or because it is regarded as desirable in principle, in turn encourages further innovation and competition, and so on.

And there is no place to hide. Although the process may have started in the more highly developed financial markets, affecting initially the more sophisticated wholesale transactions, it has spread—and continues to spread—into all areas of financial services activity, including the retail sectors. And no country can easily stand aside from it all for very long, even if it wished to, because wholesale financial activity that cannot be undertaken at home can increasingly easily be undertaken abroad—to the ultimate detriment of the local financial community. And once the process begins, it spreads remorselessly to other sectors.

Now there is good news and bad news for all of us in all of this—for both users of financial services and for you, the providers of such services. It is mostly bad news, I have to say, for the hapless financial regulators!

The good news for the users of financial services is that they are given access to a whole array of new services, on more competitive terms, from which they can choose those which most closely meet their needs. Businesses, for example, can now—if they choose to do so—protect themselves against virtually any kind of financial risk to an extent that was unimagined only a decade or so ago. And retail customers everywhere have access to an enormously greater range of deposit and investment products, payments and settlements media, and credit facilities. This includes, of course an enormously increased range of mortgage facilities, distinguished by their repayment terms, their interest rates, currency of denomination and so on, and offered by an increasing variety of lenders—from traditional specialists in housing finance, to banks and insurance companies and new types of centralised mortgage lenders—all competing more and more vigorously both among and between themselves.

The bad news for the customers is that they have more, and more difficult, decisions to make as to which products to use, how to use them and who to deal with. There have been some spectacular stories of non-financial businesses,

whether intentionally or not, taking on financial risks and coming to grief. And there has been a growing number of incidents in which users of retail financial services have incurred financial losses on products which they did not fully understand.

This is bad news for financial regulators. The public looks increasingly to them for protection as the financial world becomes more complex. But by the same token, that growing complexity makes it increasingly difficult to monitor and maintain the expected high standards of business behaviour and financial prudence. These conflicting pressures tend to lead to a situation in which financial intermediaries are freer than before to undertake a wide range of activities in a variety of instruments, but subject to increasingly intrusive functional rules.

There is good news and bad news, too, for financial service providers. They generally now have almost boundless opportunities to extend the range of the services they offer, on or off balance sheets—subject, of course, to legal and regulatory constraints; and they have vastly increased opportunities also for own-account activities. In either case, they can use these new opportunities to limit the risks in their core activities, through diversification into new activities or investments, or using the new instruments available for hedging, for example; or they can take on additional risk.

But, of course, these opportunities are available to financial intermediaries *generally*, not just to particular intermediaries or particular types of intermediary. The effect is to intensify direct commercial pressure both within and across financial services sectors. This provides an increasing incentive to hold down costs. It creates increasing pressure to manage and control risks—including risks arising elsewhere in the financial system or in relation to counterparties. And it generates an increasing need to price services properly in relation to costs and risk, including the elimination of cross-subsidisation of one group of customer at the expense of others—for example borrowers at the expense of depositors. Increased competition tends, too, to erode the scope for collective agreements, for example on interest rates or other terms on which particular financial services are provided; and it tends to erode the scope for mutual support within particular financial services sectors.

I imagine that most of you will already have been faced with many of these difficult issues—and I am sure that, if you have not already done so, then you soon will! Choices cannot be avoided in a rapidly evolving situation: to stick to one's last and do nothing beyond traditional business is not necessarily an option; indeed it *could* prove fatal if the market-place moves on around you. But so too, of course, could ill-considered moves into new and unfamiliar territory. And no-one can make those choices for you—they can only be made at the level of the particular institution in the light of its local situation, wherever that happens to be. There is no stock answer.

If it is any comfort to you, I can say that the problems relating to risk and instability in financial institutions confronting financial regulators are at least as difficult. They must have regard to the risks to the stability of the financial system as a whole, as it evolves, as well as to the stability of individual intermediaries. And they must pursue these objectives without imposing unreasonable regulatory costs, or unnecessarily inhibiting innovation or distorting competition, which could take away much of the potential benefit of open markets to the wider economy. Happily, to some considerable degree, their interests and those of the businesses they regulate run in the same direction. Financial regulation can therefore help to reduce the risks you face.

But it cannot be said often enough that it cannot eliminate them altogether.

Where then, Mr Chairman, does all that take us? What I have said—in perhaps an over-elaborate way—is that, given the way the world is going, you all face some formidable challenges. I hope that I have been able to throw some light on the nature of some of those challenges. In any event, I wish you all every possible success in coming to terms with them. I do so not simply as a politeness. I am very conscious that the more successful you are in your endeavours, the easier things will be for those of us involved in financial regulation!