The UK economy and monetary policy—looking ahead

Mervyn King, Deputy Governor of the Bank, reviews[1] the outlook for the UK economy, and recent developments in the housing market. He discusses the potential value of house prices as an indicator of economic prospects, but also the difficulties in measuring house prices accurately. He then describes how the members of the Bank's Monetary Policy Committee base their decisions on economic data from month to month, with the common aim of meeting the Government's inflation target; he notes that attempts to classify members as 'hawks' or 'doves' are misguided.

Next Monday—1 June—sees the start of the statutory basis for Britain's new monetary policy regime. An independent Bank of England will, through its Monetary Policy Committee (MPC), set interest rates to achieve an inflation target of 2½%. For over 30 years economic policy in Britain has been bedevilled by inflation and the resulting instability of output and employment. Stability—of both prices and macroeconomic performance more generally—requires a credible commitment to a monetary and fiscal framework embracing low inflation and sustainable public finances. That we now have.

But stability of the economy is not the same as stability of interest rates. Short-term interest rates must go up and down according to the state of the economy if the inflation target is to be met. In contrast, if monetary policy is successful in achieving the inflation target then, precisely because short-term interest rates will have moved over the economic cycle, long-term interest rates will be relatively stable. And, from the perspective of your borrowers, whether on fixed or floating-rate mortgages, what matters is the predictability of the cost of a loan over the life of the mortgage rather than fluctuations, within reason, of monthly payments. Timely movements in short-term interest rates are the means by which both the average cost of a mortgage, and its variability, can be reduced to the minimum necessary to attract loan finance. In so doing we should be able to avoid crisis—and inevitably large—changes of interest rates of the kind that we have seen so often in the past. Indeed, since the inflation target was adopted in October 1992 there have been no changes of interest rates of that kind—all changes were decided at the regular monthly monetary meetings. Moreover, the switch last May to a fixed timetable of meetings for the MPC—with all interest rate decisions announced at 12 noon on the Thursday on which the MPC meeting concludes—was a major step forward in reducing uncertainty in financial markets.

Through the Looking Glass . . .

So if interest rates must be flexible, in which direction are they likely to move next? I wish I could tell you. Inflation, as measured by RPIX, rose to 3.0% in April, compared with 2.6% in March. But that jump largely reflected the Budget changes to excise duties which took effect earlier this year than last. That will drop out of the index in the third quarter of this year when RPIX inflation is likely to fall back towards its target level of 2½%.

However, this relatively optimistic short-term outlook reflects an extraordinarily benign inflation environment. The combination of a strong exchange rate (still about 25% above its level of August 1996), a 20% fall in dollar oil prices over the past year, and an average fall of 9.5% in other commodity prices, is holding down retail price inflation. Domestically generated inflation is significantly higher than RPIX inflation. As the one-off effects of the rise in sterling wear off over the course of the next year or so—as indeed they will unless sterling appreciates further—inflation will start to rise above the target unless domestically generated inflation declines.

In the long run, domestically generated inflation is likely to be close to the rate of increase of unit labour costs. At present unit labour costs are rising at about 3½% a year. The earnings figures released earlier this month—which showed that average earnings in the economy grew by 4.9% and in the private sector by no less than 5.6%—were undoubtedly disappointing. It is too soon to judge how far they reflect the impact of higher bonuses this year than last. In any event, to hit the inflation target those rates of earnings growth will have to fall back.

These high levels of earnings growth are not the underlying cause of inflationary pressure; they are a symptom of a tight labour market. Equally, the prospects for earnings growth depend critically on the future path of output and on inflation expectations. The MPC's central projection in the May *Inflation Report* is that the pace of output growth will slow. But a slowdown in economic growth is not, in itself, sufficient to hit the inflation target. The central issue for monetary policy is whether total nominal demand will slow sufficiently quickly to prevent retail price inflation rising when the favourable effects of a high exchange rate and lower commodity prices wear off.

(1) At the Building Societies Annual Conference in Bournemouth on 27 May 1998.

The extent to which domestic demand growth slows down is crucial. At present, we are relying on a sharp deterioration in the trade balance to keep output growth down to levels that do not lead to rising inflationary pressure. But in the longer run, domestic demand growth must fall from its present rate of 3½%–4% to something closer to trend. During 1997 as a whole, consumption grew by 5%. That growth rate is already moderating. And the MPC's central projection is for a further slowdown in domestic demand during this year. That is likely to be brought about by a combination of the fiscal and monetary tightening that has been put in place over the past year or so. But there are real uncertainties. There is a risk that consumption may prove stubbornly buoyant. Real personal disposable income increased by 4.2% last year, and the ratio of net financial wealth of households to their income reached an all-time high of over three. Those factors will support consumption. The latest retail sales figures provide some comfort with volume growth below that in the middle of last year when consumption was stimulated by windfall gains, predominantly from the conversion of building societies.

Highs and lows in house prices

In the past, domestic demand has been sensitive to developments in the housing market. In the late 1980s house prices increased by 40% in two years, while consumption rose by over 9%. Borrowing using housing as collateral—so-called 'equity withdrawal'—amounted to almost 50% of the increase in consumption over that period. The impact of rises in house prices on consumption—which is cause and which is effect—remains hotly contested by economists. A rise in house prices leads not only to an increase in wealth but also to an increase in the cost of housing services. Or, to put it another way, if the price of your home goes up, you will not be able to spend more on other things if you wish to carry on living in your home. So it is not at all clear that changes in house prices will in fact have a significant impact on household spending.

Perhaps of greater importance is the role which house prices play in signalling consumer confidence about the future. In common with other assets, such as equities, house prices can respond quickly to news about future economic prospects. And house prices and consumer confidence do seem to be closely correlated. So house prices may be a leading indicator of sentiment about the economy and hence of consumption and domestic demand. But, just like equities, house prices also reflect changes in real interest rates. Since long-term real interest rates have fallen from over 3½% to below 3% over the past year, it is not surprising that house, and other asset, prices have risen.

Precisely because housing is an asset, its price is more volatile than most goods and services in the retail price index. As such, it is important to look at house price levels as well as at their rates of change. Although house prices have been rising quite rapidly over the past couple of years, they returned to the peak reached in the late 1980s only at the end of last year, and exceeded it for the first time in the first quarter of this year. That, of course, followed the sharp fall in house prices in the early 1990s—house prices fell by over 10% between 1990 and the end of 1992.

For most families, apart from future earnings and pensions, their wealth is dominated by one asset and one liability. The asset is their home and the liability is the mortgage on it. But the difference between these two is sensitive to the state of the economy. In a low-inflation world, house prices are likely to rise and fall whereas the mortgage liability is fixed in money terms. This mismatch has the potential to create large swings in household net worth which may well exacerbate fluctuations in demand and output. The upside consequence was seen in the consumption boom of the 1980s, and the opposite was evident in the bust of the early 1990s when falls in house prices meant that as many as 1½ million families had negative net equity resulting in higher precautionary saving and lower consumption.

The forward-looking information contained in house prices underlines the importance the MPC attaches to measuring them accurately. The recent divergence between the rates of house price inflation implied by the Halifax and the Nationwide indices is both puzzling and unfortunate. The rates of house price inflation recorded by the two indices began to diverge at the beginning of 1997. The most recently published data suggest that house prices, as measured by the Nationwide index, rose by 12% in the year to April 1998, whereas, according to the Halifax index, they rose by only 5.6%. Gross household wealth in the year to April 1998 rose by £80 billion more according to the Nationwide than the Halifax index. Such differences matter in our assessment of the economy.

The Bank of England, together with representatives from the Halifax and Nationwide and from the Department of Environment, Transport and the Regions (DETR), has spent a great deal of time and effort trying to understand the cause of this divergence and to assess what is really happening to house prices.

The answer to the first question—what accounts for the divergence?—remains largely a mystery. The Bank's preferred explanation, reached I have to admit via a process of elimination of other plausible explanations rather than by the existence of incontrovertible evidence, is that the divergence reflects the way in which house prices are 'mix-adjusted' to take account of the different characteristics of the houses bought and sold in any one month. Changes in the relative composition of the loan portfolios of the Halifax and the Nationwide over the last year or so are likely to have magnified this effect.

To answer the second question—what is really happening to house prices?—the Bank has developed an alternative measure of house price inflation using data from the Land Registry. These data have the advantage that they cover nearly all housing transactions in England and Wales and so are more comprehensive than the data used by either the Halifax or the Nationwide. However, the Bank estimate is far from ideal. The published Land Registry data are not

mix-adjusted. And, although the Bank staff do apply a simple mix adjustment to take account of the basic type of property bought and sold and the county in which the property is located, it is less sophisticated than that used by either the Halifax or Nationwide.

So I would not want to claim in any way that we at the Bank have found the true measure of house price inflation. Rather, the Bank estimate was developed in the spirit of trying to give some guidance to the members of the MPC on the relative weights that they should attach to the conflicting pictures painted by the Halifax and Nationwide indices. The house price index constructed by the DETR is also helpful in this respect. That index has the advantage that it is constructed using a more complete method for adjusting for the mix of houses transacted than the Bank estimate, but it is based on only a small sample—approximately 5%—of mortgage-backed transactions.

The Bank estimate suggests that house prices increased by 9% in the year to 1997 Q4, compared with 6.9% measured by Halifax and 12.9% by Nationwide. The Bank estimate is broadly consistent with the DETR index, which shows a 7.9% increase over the same period. But further work is required on this issue which is of importance to us all.

'Divided we stand, united we fall'

That brings me to the MPC and the prospect for interest rates. The transparency of the new process means that the debate about monetary policy within the MPC is explained clearly to the world at large. Hence the reasons why monetary policy is so finely balanced are, I believe, now widely understood.

But it is not just the policy debate which is now more transparent. The voting record of each individual member of the MPC is in the public domain. There is a good reason for this. Disclosure is an incentive for individuals to cast their vote for the policy most likely to hit the government's inflation target. I have little doubt that the prospect of having to defend one's voting record in public makes individual members of the MPC well aware of their responsibilities. There can be no hiding behind the coat-tails of the chairman, nor disowning a decision subsequently by claiming to have argued against a position adopted by consensus. Transparency should improve both the quality of decisions and the accountability of Committee members.

But there is an additional point which is fundamental to the role of the MPC. Its purpose is to take technical decisions about the level of short-term interest rates. When the issue is one of technical judgment it is better to rely on the collective wisdom of nine people than the views of only one individual. I have noticed that the highest in the land often rely on teams of doctors whereas you and I have only one. Of course, it is often tempting to take comfort from the great confidence with which any one doctor proclaims his or her diagnosis. But the evidence suggests that in difficult cases reasonable experts can interpret the evidence in different ways. Rather than take comfort from one self-confident view, which I would find difficult to challenge, I would like to know where the balance of professional opinion lies. That is why in the case of essentially technical judgments it is sensible to rely upon collective wisdom, and there are other areas in which we do precisely that. The Law Lords, for example, reach their decisions by aggregating individual judgments, and the same is true in the United States Supreme Court. The MPC is based on the same principle. For such a system to work it is crucial that the individual members of the MPC give their best judgment and do not try to reach an artificial consensus.

When policy is clearly off-track, as in the spring of last year, it is not difficult to reach unanimous decisions, as the Committee did through 1997. But when policy is finely balanced, disagreements about the precise level of interest rate are not only likely but an indication that policy is broadly on-track. That is why the motto of the MPC should perhaps be 'divided we stand, united we fall'.

Some commentators have been unable to resist labelling members of the Committee as either 'hawks' or 'doves'. There is a fundamental problem with this labelling. It makes no sense in the new system to describe individuals as hawks or doves. Each member of the Committee has the same inflation target. Unlike some other central banks, MPC members cannot entertain closet views about the attractions or dangers of slightly higher or lower inflation. Their task—to which they will be held personally accountable—is to hit the Government's inflation target. So members of the Committee vote on interest rates according to the economic data, which change from month to month, and the analysis of those data. No one takes a position that higher interest rates are a good or a bad thing out of principle. If you drove past an infant school at 40 mph, you might well be described as driving dangerously fast. But if you drove at 40 mph on a motorway, you might well be described as driving dangerously slowly. Actions must be judged in the light of the circumstances. In terms of monetary policy, that means that the positions which members of the MPC take on interest rates will change over time according to the way the economy evolves. But if interest rates themselves cannot be predicted, because they depend on changing economic data, what should be predictable is the way MPC members respond to those data. A predictable 'policy reaction function', to use the jargon, should, over time, diminish the interest which market commentators take in the meetings of the MPC and direct interest to what is happening in the economy.

So, as the voting record shows, it is seriously misleading to think of the MPC in terms of fixed camps of hawks and doves. As circumstances change, it is easy to imagine that the hawks shall be doves and the doves shall be hawks. And, over a five-year period, since each member of the

MPC is trying to hit the same inflation target, I predict that it will be impossible to distinguish between doves and hawks. What will the commentators call us then? If Britain either has or is about to join Monetary Union, then the birds may have flown the nest. But if the MPC is still setting interest rates in Britain, then I hope that we shall be seen as a group that is tediously predictable, sometimes raising interest rates, sometimes cutting them, but always moving in response to the economic data in order to hit the inflation target.