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Speech

Six Months on the MPC: A Reflection on Monetary Policy

Speech given by

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Six months on the MPC: a reflection on monetary policy

Thank you for inviting me to speak to you here today. Last week I voted on the appropriate level of UK interest rates for the sixth time since my term on the Monetary Policy Committee began in June. Today I thought I might take the opportunity to reflect on my first six months.

In many ways it is a very technical and narrow job. The monetary policy arena in which policymakers can have influence, by alterations in interest rates and the quantity of money, is the general price level and its rate of change, i.e. the rate of inflation. In some respects the central bank's monetary policy role is even narrower in the UK than in some other countries because the rate of inflation which the Monetary Policy Committee targets is set, quite properly, by the democratically elected government and not by the Committee itself. The Committee has no discretion over the choice of target. And to avoid any confusion the Government also defines the measure of inflation that is to be targeted. Although the target is confirmed each year by the Chancellor, since its inception in 1997 the Committee has been charged with keeping the inflation rate of the Retail Price Index excluding mortgage interest payments (RPIX) at 2½%: no more, no less. The low and symmetric target indicates that deflation, or falling prices, is as undesirable as significant inflation.

There are lots of things over which monetary policy has no influence. Many that might be judged to come within the economic sphere are outside the realm of monetary policy. To attempt to do more than affect the overall price level would jeopardise the substantial achievements of the inflation targeting regime which were eloquently set out by Deputy Governor Mervyn King in his recent speech. Monetary policy can do nothing about relative prices. And nor should it. Not only are the limited instruments at the disposal of the authorities unsuited to the task of controlling individual prices but the central bank should not interfere in market functioning which leads to an efficient allocation of resources. The MPC is not running a command economy. If there are issues of market failure, when the market price is not economically efficient because it does not fully reflect the costs and benefits to society, they can be addressed by the appropriate fiscal, regulatory or other authority,

not the monetary authority. The MPC should be only interested in individual prices in the economy to the extent that they affect the overall level of demand and supply, and hence inflation. Where the overall price level is increasing only modestly it is likely that the movements in relative prices one would expect in a dynamic economy will lead to some prices falling.

Monetary policy works via its influence on aggregate demand and, in the long-run, it determines only the nominal value of goods and services, that is, the general price level. When inflation expectations are in line with the target, the role of the MPC is to ensure that monetary policy is set so that demand in the economy is running in line with supply capacity. This will keep inflation constant and avoid unexpected inflation or deflation.

For much of the last 2 years monetary policy has supported domestic demand to offset weak global economic conditions and keep overall demand growing at a rate consistent with hitting the inflation target. Externally exposed sectors of the economy have done relatively less well and those serving the domestic economy, in particular the UK consumer, have performed rather better. While we recognise that this has been difficult for some sectors, the MPC can not address sectoral, regional or industrial difficulties without putting achievement of the inflation target in jeopardy.

By the time my appointment to the Committee was announced in April it appeared likely that this policy of supporting domestic demand would soon have run its course. I expected that, as demand from the external and public sectors picked up, interest rates would have had to be raised to slow consumer spending and keep overall demand growing in line with supply. That did not happen as financial markets and the prospects for the major economies took a turn for the worse in mid to late summer.

Now things look somewhat brighter, leading to a degree of cautious optimism about the future. Financial markets have steadied over the autumn, prospects for world growth have recovered, and the UK economy, having stagnated around the turn of last year, is now growing back at around trend. Excluding the volatile agriculture, mining and utilities sectors the economy grew by 1.0% in the third quarter of this year, up

from 0.3% in the second quarter, and zero in the first. Recent data are likely to have been influenced by the impact of the timing of Easter and the two Jubilee Bank Holidays this year, but such an acceleration in growth appears consistent with an improvement in underlying activity.

On the expenditure side, consumers' expenditure has been robust, up 0.8% in the third quarter, in line with high levels of optimism and boosted by strong borrowing. Consumers' confidence in their own financial position is close to record levels while the balance of those considering it a good time to make major purchases has been on a rising trend and in November was at its highest level since July 1988. Together with a rapid growth in borrowing this suggests that the outlook is for spending to remain strong in the near term. Government spending has also been growing strongly, up by 3.2% in the year to the third quarter. Public sector and consumer demand has been more than sufficient to offset the negative impact of falling business investment and net trade, which has made a negative contribution to growth in each of the last 6 years.

The central projection of the Committee's November *Inflation Report* was for robust consumer demand to push annual GDP growth up to a little above trend early next year. Growth then settles back, as a deceleration of household spending offsets a recovery in external demand, higher public expenditure and a modest pick-up in business investment. In the central projection, inflation rises above the 2.5% target by the end of this year, reflecting the impact of higher oil prices than a year earlier and an unusually high contribution from housing depreciation. It remains at that higher level for most of next year, and then drops a little below target as those influences unwind, subsequently edging back up to target as the two-year horizon approaches

Although the central projection of output at trend and inflation close to target is a monetary policy maker's dream, the reality feels far less comfortable, with significant risks in either direction. In what follows I offer reflections on some current issues that are relevant to the risks in the context of the role and limits of monetary policy.

On Deflation

The risk of “deflation” emerging in several major economies is being widely discussed. With inflation and interest rates low in many economies, we cannot afford to be complacent but must be alive to the downside risks. Indeed in the context of the November *Inflation Report* forecasting round the Committee explored various scenarios which might result in weaker growth and inflation in both the US and Germany and assessed the likely impact of these scenarios on the UK over the forecasting horizon. These were described in the risks to the central projection described in the November *Inflation Report*.

However, although the Committee will continue to monitor the evolution of the risks going forward, there are several reasons for thinking that some of the worst case deflation scenarios that some external commentators have painted are not a real prospect, at least not on the basis of currently available information. My colleague on the MPC, Charlie Bean, outlined some in his recent speech to the Emmanuel Society. I would like to add another. First we should remember that falling prices are not always a bad thing. Sometimes they are the fruit of supply and productivity improvements and lead to an improvement in welfare as real purchasing power is increased. “Deflation”, the possibility of which alarms many commentators, is a more insidious beast where purchases are postponed in anticipation of lower prices; nominal interest rates fall to zero but cannot be reduced below, leaving real rates too high to stimulate demand; and the real value of debts rises, redistributing wealth from debtor to creditor. During such a pernicious deflation nominal demand falls.

Among the major economies the main historic episodes of pernicious deflation have been the depression of the 1930s and Japan over the last five years, although the former episode was far more pronounced than the latter. In both episodes falling nominal demand was accompanied by and preceded by very weak monetary growth. During the 1920s, from the cyclical economic trough in July 1921 to the peak in August 1929, growth of the US money stock had averaged 4.6% per annum. Policy was tightened in early 1928 in an attempt to curb the strong stock market¹ and from

¹ Friedman and Schwartz, 1963 and Cecchetti, 1997.

April 1928 the money stock declined. In the five years to April 1933 the stock of both the M1 and M2 monetary aggregates fell around 30%. In Japan, there was a sharp slowdown in the annual growth rate of broad money (M2 plus CDs) from double-digit rates of growth in 1990 to around zero in 1992, since which time broad money has grown only sluggishly, averaging under 3% per annum.

By contrast broad money growth in the major economies is currently strong, with the exception of Japan. Indeed it has accelerated. Annual IMF data for the advanced economies show broad money growth picking up from 5.1% in 2000 to 8.7% last year. US broad money growth slowed significantly in the early summer this year but is now growing at around a 9% annualised rate². UK M4 growth has been growing around a 7% rate² since mid summer. In the euro zone, the annual growth rate of broad money (M3) has been in excess of 7% this year after having picked up substantially in the previous year. It is unlikely that growth rates of this magnitude would be consistent with declining activity in nominal terms unless there was a sharp and very unusual fall in the velocity of circulation of money. Of course that does not rule out falling prices, but these would have to be accompanied by strong real economic growth rates for nominal growth to be positive: a benign rather than malign deflation.

Both in the 1930s depression³ and in Japan more recently weak money growth has been accompanied by a weak banking system and a failure of financial intermediation. During the stock market declines of the summer I was concerned that a similar pattern might emerge elsewhere. I am pleased to say it has not, and there is little sign that it will. There has been no major bank failure and little evidence of constraints on credit growth. UK M4 lending was up nearly 10% in the year to October. Within the total both the household and corporate components have been accelerating. US credit growth that had been weak earlier in the year is now running at a 6% annual rate. Moreover companies' access to capital markets does not seem to have been impaired by recent developments. Capital issuance by UK companies has been robust. In the third quarter total external finance raised by private non-financial companies was the highest for over a year and monthly data showed a further pick up

² 3 month annualised rate

³ Bernanke, 1983

in October. To the extent that credit growth has been slow (for instance for US corporate and industrial loans) this appears to reflect weak demand for credit to a greater extent than any supply limitations.

The situation with regard to Germany is a little different since the German economy constitutes a region of the euro currency area and does not have its own currency. There are several reasons to expect that German inflation will continue to run below that of the euro area as a whole. First, it is possible that Germany entered monetary union with an overvalued real exchange rate vis-à-vis its partners and now needs to regain competitiveness. Within the single currency that can only be achieved by lower relative inflation. Second, productivity catch up will lead to faster inflation in many of the other countries. Since the European Central Bank (ECB) seeks to keep inflation for the euro area as a whole at 2% or lower, in accordance with its definition of price stability, it is therefore possible that Germany will at times experience periods of very low or even falling prices. However prices in Germany are unlikely to fall very far without provoking a policy response from the ECB as that would most likely be accompanied by overall euro area inflation falling well below 2%. Germany has a weight of around 30% within the overall Harmonised Index of Consumer Prices (HICP) for the euro zone. For example, if German prices were to fall by 2% a year, the remainder of the euro area would need to be experiencing an average inflation rate of close to 4% in order for overall inflation to register 2%. That would imply an inflation differential between the highest and lowest inflating countries in excess of 6 percentage points. However research by Canzoneri et al cited in Charlie Bean's recent speech, suggests that productivity differences mean that inflation rates for individual countries within the euro area are unlikely to diverge by more than about 2-2.5 percentage points over the medium term. This suggests that a policy response from the ECB should prevent a deflationary spiral developing in Germany.

On house prices

UK house prices have been rising at an extraordinarily rapid rate of late, in the region of 25 to 30% over the last year. The buoyant housing market has had a direct impact on consumer demand and on inflation. Not only has the rising value of housing equity made households feel wealthier and provided an offset to falling share prices,

but households' ability to borrow against housing equity more cheaply than other forms of consumer borrowing has boosted household debt and supported consumption. In the second quarter mortgage equity withdrawal supplemented personal disposable income by around 6%. The annual growth of lending secured on residential property was 12.8% in October, the highest rate since 1990 Q4.

The housing market has been an integral part of the mechanism by which easier monetary policy has boosted consumer demand in the UK and offset weak growth overseas. It has thus necessarily had an impact on the Committee's decision making. Developments in the housing market may well continue to be an important factor for some time. The recent rate of increase in house prices is not sustainable and, as house price inflation slows so too will the boost to consumption from that source, though perhaps with a lag. The Committee's central projection is for house price inflation to slow soon, with prices becoming broadly stable after two years, but there are significant risks. The longer the recent exceptional rate of house price inflation continues, the more abrupt the ultimate slowdown of house prices and consumption might be. But to say that the Committee pays attention to the relationship between the housing market, consumption, borrowing and inflation in reaching its decisions certainly does not mean that it seeks to manage the housing market directly.

I have said that monetary policy has no role with regard to relative price movements, except in so far as they impact overall demand, supply and inflation. But should monetary policy take an interest in house prices that goes beyond this? There are two major problems with seeking to interfere directly with the housing market. The first is that it requires a view on the "correct" level of house prices and, associated with this, the appropriate level of household debt.

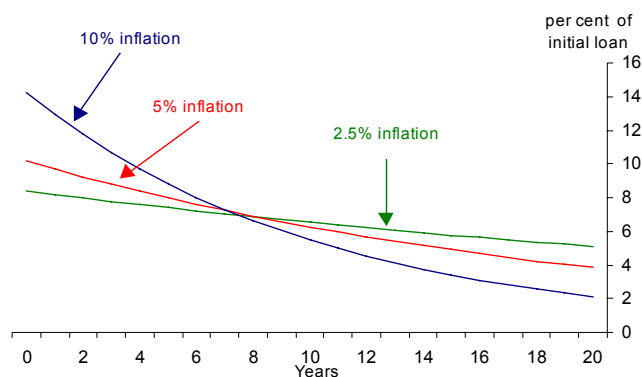
The supply of houses in the UK has long been constrained by land shortages and planning restrictions but has recently been growing very slowly, even by UK standards. The number of new homes built in Great Britain last year at 162,000 was at its lowest for 54 years. Excluding the war years and immediate aftermath⁴ fewer new homes were built than at any time since 1924. Any increase in demand for

⁴ 1940-1947

housing services will thus push up prices. Demand for housing services is likely to be a positive function of household formation and of income (though whether it moves more or less than proportionately with income is unclear) and a negative function of the cost of housing (affordability). To the extent that it is possible for house owners to extract equity the demand for housing will also be a positive function of expected future house prices⁵. All of these factors have been supportive of demand. The number of households has increased by 170,000 a year on average over the last 10 years. Real after tax labour incomes have been rising strongly and unemployment has fallen. And it is likely that expected house prices have risen along with actual prices, but, to the extent that houses have been bought on the expectation of future capital gains, prices could be vulnerable to a change in expectations.

Moreover, lower nominal interest rates have reduced the cost of housing services by reducing mortgage interest payments. Households' interest payments are currently just over 7% of personal disposable income, less than half that of 1990. To the extent that this reflects lower inflation rather than lower real interest rates, lower real payments now will be followed by higher real payments in the future as the value of future payments are eroded less rapidly by inflation. Chart 1 shows how the real value of payments falls under different inflation rates with a constant real interest rate.

Chart 1: Effect of inflation on real mortgage repayment schedule



Under which state of the world the consumer will be better off will depend on the rate at which he values current consumption over future consumption, in other words on his own internal rate of discount or time preference. If his real rate of time preference

⁵ This could either be because they are owner-occupiers who are trading down or withdrawing equity through borrowing, or are investors able to realise a capital gain.

is the same as the real rate of interest on the loan then he will be indifferent between the different states, as the net present value of his repayment stream will be the same in each case. But if the real rate of time preference is higher than the real rate of interest on the loan the consumer will be better off with low inflation as the lower early real repayments are more important to him than the lower real repayments later on. In that situation, if the mortgage is flexible, the household may choose to alter its repayments to replicate the repayment schedule of the high inflation case. However it may also be rational to take on a larger mortgage until the net present value of interest payments is the same as in the high inflation case.

Thus while there are several reasons for thinking that the equilibrium house price might have risen this is an area in which there is considerable uncertainty which makes forecasting difficult.

The second problem with seeking to manage house prices is that, even if one had a clear view on the appropriate level of house prices, the MPC only has one instrument (the short run interest rate). It would be unlikely that the interest rate required to hit the inflation target would be equal to that required to control the housing market. As Cecchetti said in relation to the focus of US monetary policy on equity prices in 1928-29:

“if central bankers allow the fluctuations in asset markets to affect their decisions it may distract them from concentrating on some combination of output growth and inflation.”⁶

On Discretion

I have commented on the limits of monetary policy. However, there is one area in which the MPC has some degree of discretion. It is the time frame over which the inflation target is to be met. The MPC's remit is to meet the inflation target at all times but the monetary policy framework enables the MPC to allow inflation to diverge from target in the short term if bringing it back quickly would lead to undesirable volatility in output and inflation. If inflation diverges from target by more than 1 percentage point either way the Governor is required to write a public letter to

the Chancellor explaining the reasons for the deviation, what policy action the Committee is taking to deal with it, the period within which inflation is expected to return to target, and how this meets the Bank's remit. The Chancellor's response to the Governor's letter would depend on the merits of the case at the time and on the prevailing economic circumstances⁶.

It has always been envisaged that it would be in the event of a shock to the economy, more usually a supply shock but also possibly a short-lived demand shock, that the policy discretion offered by the letter writing procedures would come into play. Indeed it is difficult to envisage circumstances other than a supply shock or a short-lived demand shock in which it might be appropriate for the Committee to accept a significant temporary short term deviation of inflation from the target of the magnitude that would invoke the letter writing procedure. In particular, to severely undershoot the target could take chances with deflation.

Conclusion

I have described the job of the MPC as a narrow and technical one limited to controlling changes in the overall price level. In particular I have spoken about areas that are not suited to monetary policy control, such as house prices, and I have argued that the degree of discretion offered by the letter writing process is constrained. I have also discussed deflation. Here my conclusion is rather different. Deflation is a monetary phenomenon and it is quite clearly the job of the monetary policy authorities to prevent a pernicious deflation occurring, for, to use a well-known phrase, "prevention is better than cure". I have given reasons for believing the risk of such deflation is not high currently. But rest assured that, should it threaten, deflation is something that the MPC should, can and, I am sure, will do something about.

⁶ Cecchetti, 1997.

⁷ Note on the Inflation Target and Remit for the MPC, HM Treasury, 13 June 1997

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