



BANK OF ENGLAND

Speech

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Speech given by

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The views expressed here are personal and should not be interpreted as those of the Bank of England or other members of the Monetary Policy Committee.

I am very pleased to have been invited to speak here tonight - three years on from my previous appearance at this dinner. That was the day before my appointment to the Monetary Policy Committee was announced, and now I have just been re-appointed for a further three years. So it's a good opportunity to reflect on one or two of the developments in the economy over the recent past, and on the challenges the MPC seems likely to face over the next three years.

The economic environment has perhaps been less varied than your choice of venue – from the National Railway Museum in York to this football stadium in Bradford. It is perhaps not the most tactful time to dwell on the fortunes of Bradford City, although I will reluctantly point out that there may be chance of a win this Saturday when my favourite team Stoke City comes to visit, as Stoke has not won away from home against Bradford since October 1990.

When I joined in 2001, the MPC had been setting interest rates for four years, and had established a high degree of credibility in the financial markets and widespread support for its approach in the business community. However, there are few, if any, periods when there is nothing to worry about in the economic situation, and back in 2001 these worries were generally expressed in terms of concerns about imbalances in the UK. In particular it was argued that these imbalances included the contrasting fortunes of the consumer and the corporate sectors. It was, and is, not clear that imbalances in the economy should necessarily be thought of as problems, but worry about the potential severe pressure on manufacturing industry, due in part to the sustained period of sterling strength, was largely justified. For example, in February 2001 an article in the Guardian suggested 'This has been the age-old problem for the UK economy. Too much consumer spending and insufficient investment has led to over-heating...' The CBI in May 2001 argued that 'the current imbalances in the economy are likely to persist next year. This will maintain pressure on exporters and hold back the growth of manufacturing output'.

Given these concerns, how far is it the case that the past few years have proved an unusually tough time for the UK corporate sector? Not surprisingly, there has been a mixed picture across sectors. Total output of the economy rose by over 5% from the end of 2000 to the fourth quarter of 2003. Over the same period, manufacturing

output fell by more than 5%, and service sector output rose by over 7%. Even within manufacturing there are sharply contrasting fortunes - textiles output fell by 16% in the early 2000s (and indeed is just 68% of its level in 1995), while the chemicals sector has grown by about 7%.

Output data, while probably the key indicator, is only part of the story, with profitability and investment also important symptoms of a sector's health. Looking at net rates of return according to ONS statistics, these weakened in the late 1990s for both manufacturing and service companies. For manufacturing, at 6.7%, the rate of return in 2001 was the lowest since 1992. For the service sector, net rates of return peaked at 18.3% in the third quarter of 1998 before declining sharply to 14.0% in the fourth quarter of 2001. But both sectors have since experienced an encouraging pick-up - indeed the latest estimate for the rate of return in manufacturing was up to 8.6% at the end of 2003, the best for four years.

Similarly, business investment, which in mid-2003 had declined by around 7% from its peak in late 2000, has subsequently shown signs of recovery. In particular, manufacturing investment, which fell sharply by almost 12% in 2002, declined less steeply in 2003, and on the latest estimates rose by over 5% in Q4 from Q3.

Business survey data in early 2004, including and perhaps especially CBI data, points to a continued improvement in business conditions. This has raised some puzzles, especially with regard to manufacturing output, where early estimates for January and February paint a much weaker picture of the sector. Consequently it seems right to temper optimism about the pace of industrial recovery, especially in the light of sterling's renewed strength since the end of 2003. Nevertheless, even though export orders, according to the CBI manufacturing survey, have fallen back in April, they remain above the levels of the past six years. And more broadly, intentions surveys suggest the strengthening of investment discussed above is set to continue.

This recent cycle has been rather muted by comparison with the major economic swings in the early 1980s and early 1990s. The principal downward pressures stemmed from a series of negative external shocks – the appreciation and sustained strength of sterling, the uncertainties following the Russian default in 1998, the

unwinding of impact of the high-tech cycle on the US equity market and the global uncertainties associated with the events around the Iraq war. The MPC's actions have been generally successful in offsetting the impact of these shocks on the UK economy, such that for the whole economy the level of output has not declined very far below its probable trend level.

So whilst the last few years may not have been easy ones for some of you, the UK has clearly weathered the storms relatively well, and today many indicators suggest companies believe that the future looks bright. The Bank's February forecast central projection anticipated above-trend growth over the next year.

The external outlook is very favourable, with the world economy forecast to experience its strongest year of growth since 2000, although some uncertainties remain. And, while a year or so ago there were some big downside risks causing major concern (such as the persistent weakness of global equity markets, and to a lesser extent worries about deflation) these more acute risks have faded over the horizon. In terms of the impact on the UK, however, the relatively sluggish outlook for growth in the EU and the recent appreciation of sterling means that the support for growth from export prospects may be somewhat muted.

It is probably not much of a surprise that I am suggesting the key uncertainties facing us today stem from the domestic economy, in contrast to the recent past. These chiefly revolve around the outlook for the UK consumer in the light of a household debt-to-income ratio at its highest since a comparable series started in 1987, and a house price/earnings ratio a little above the peak reached in the last cycle. However, the fact that these ratios are at unusual levels does not necessarily mean that this is a source of risk, nor that any risk is automatically large enough to require an unusual policy response.

The two main concerns raised at present with regard to the present situation are risks from the recent rise in unsecured debt, and risks due to the present condition of the UK housing market. Discussion tends to revolve around the inevitability of a downside risk in the future from reversal of these trends, which is becoming more acute as debt continues to rise. I would like to take this opportunity to discuss briefly,

and in some cases to reiterate, my personal take on both of these, looking at what the scale of the risks might be, and how far it might be difficult to make an appropriate policy response.

Unsecured consumer debt has been rising at an annual average rate of 10.8% over the past 5 years, and the stock of this lending has picked up from 17% to 22% of household incomes. A number of factors are possible explanations for this increase, including greater security of employment prospects in the low unemployment environment, and to a lesser extent a rise in student indebtedness. Unsecured lending rates have also tended to decline, relative to the base rate, over the past few years – for both credit card debt and other unsecured loans, partly as competition among providers has increased. Over the past six months, despite the two quarter point increases in base rates, unsecured rates have generally tended to edge down. All these factors mean that the level of unsecured debt, and the associated benefits for consumers, which is sustainable, has probably risen.

Latest data suggests that the pace of growth of unsecured debt has slackened a little over the past year or so. What would be the consequence if this were to go further, taking the growth rate down from the present 12.5% or thereabouts, to be in line with the growth rate of personal incomes? The key here would be the question of what event triggered the decline. But it seems likely that only in the event of a shock significant enough to bring about a sharp fall in the level of unsecured debt does this aspect of the present situation constitute a severe risk. Such a shock is unlikely to come from monetary policy since, as the interest rates on this debt are relatively high, a large rise in base rates would be required to push up the interest burden from these debts significantly.

There are of course distributional effects. As the Bank's survey at the end of last year indicated, a small group of heavily-indebted and often low income individuals face substantial problems in servicing their debt. But this seems unlikely to pose a big source of macroeconomic risk.

With regard to house prices, it is frequently observed that the growth rate of house prices over the past 2-3 years cannot be sustained. This is of course clearly true over

a long enough period, but in common with many other commentators I have been very surprised by how sustained the period of strong house price growth has proved to be.

Would a slowdown in this growth rate pose a problem? The answer seems to be probably not. While the fan-charts around our central case have implied a range of paths for house prices, the MPC's central forecasts recently have expected a slowdown in house price inflation, and the estimated effect on consumption has not implied any major risk to the economy. Such a trend would also be associated with a slower rate of growth of secured debt, although as a recent article in the Bank's *Quarterly Bulletin* pointed out, the higher level of house prices itself will continue to push the level of secured debt higher as new generations enter the housing market.

More significant is the question of the sustainability of the *level* of house prices. Having spent the last year looking in some detail at the factors related to the UK's housing supply, it might be thought that I am now in a better position to understand what has driven house prices up so far, and how far today's level of prices might now be above a long-run equilibrium level. Regrettably, this is not the case. As with other asset prices (even though housing is not just an asset, but provides a flow of services) it remains highly uncertain what the 'right' level is.

As house prices have risen, it is however increasingly likely that at some point they may fall back, but it is still by no means certain either that they will necessarily fall significantly, or that any decline will be abrupt. Indeed, it is not easy to see what is likely to provoke such a change, although recognition of increasingly stretched affordability for first-time buyers could lead to a shift in house price expectations. A large, abrupt fall would require a monetary policy response, in order to keep inflation from falling below target over the relevant forecast horizon. But given the greater stability of the wider economy this will not necessarily be an unmanageable situation for policy, in most plausible scenarios.

And a flattening out of house prices, or a moderate decline, would more clearly be manageable in policy terms. I do not, therefore, think that the risk of a big house price fall is so critical that it should dominate all the other policy considerations. It is

also perhaps worth noting that the MPC has been urged to act to ‘prick the housing market bubble’ for some time. I am not convinced that the economy would have benefited if we had followed this advice a couple of years ago.

Further, an increase in interest rates, not justified by the inflation outlook but by the desire to hold back house prices in order to lessen this risk, would have carried its own difficulties. Interest rates might well have needed to be raised very sharply, depressing growth. This could have confused the goal of policy, potentially moving inflation expectations away from the Government’s target. In the long-run this would have created further problems for operating monetary policy.

In conclusion, the last few years have seen UK industry and the economy survive a series of external shocks, including sterling strength, without output falling very far below trend. Although manufacturing performance has been very weak, industry now seems to be emerging from this difficult period with improving profitability, rising investment and greater confidence. The focus on risks to the outlook has changed from the external to the domestic economy. In this regard, it is important to be realistic about how far policymakers can hope to understand the risks in asset prices accurately enough to act to offset them. And then the question is how to tackle any risks in a way which is consistent with our remit, such that it can be made clear that it is longer-term risks to the inflation outlook, not house prices per se, which would drive our response. Weighing up these arguments is a critical part of the present policy debate. My own view remains that it is generally better to respond to changes in asset prices as they occur, rather than seek to impose our views of what price level is ‘right’.

References

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