BANK OF ENGLAND

Speech

Some Current Issues in UK Monetary Policy

Speech given by

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Good afternoon. The world economy now appears to be experiencing a broad recovery from the synchronised downturn that started in 2000. The UK economy weathered that storm better than most, though how much of that was down to luck and how much to judgment others should decide! In any case the immediate economic outlook appears brighter than it has done for a while. But the job of a central banker is to be on the look out for rain even on a cloudless day, and today I want to touch on some of the issues that have recently been occupying us on the MPC.

One issue which has attracted considerable public attention recently is the potential threat posed by high levels of consumer debt, with headlines about the stock of household debt approaching £1 trillion and talk of a debt "time bomb". Caricaturing this view just slightly, the economy has been kept afloat during the last few years only because households, encouraged by the inflated value of their property, low interest rates and an easy supply of credit, have borrowed in order to finance a consumption binge. But that debt will eventually have to be repaid, at which point consumer spending will slow sharply and the economy will slip into recession.

The reality is somewhat different. While gross household debt has risen from about 90% of annual personal disposable income in 1998 to about 120% today, the household savings rate has not been *unusually* low – in fact it is less than two percentage points below its post-1963 average. And a measure of the savings ratio that corrects for the loss in real wealth induced by inflation[1] is actually one and a half percentage points above its post-1963 average (see Chart 1[2]).

So how does this all fit together? At the aggregate level, the answer is that the household debt build-up has been primarily associated with asset accumulation rather than borrowing in order to finance current consumption. In particular, the acquisition of household financial assets (as a share of household income) has broadly risen in line with the acquisition of liabilities over the past five years, so that the ratio of

[1] Income as measured in the National Accounts includes nominal net interest receipts, but from an economic perspective one should include only *real* net interest receipts, i.e. allowing for the fact that the real value of assets and liabilities that are fixed in cash terms falls as prices rise.
[2] Even if the periods of unexpectedly high inflation in 1974-76 and 1979-81 are excluded, it is still one percentage point above the post-1963 average.

financial assets net of liabilities to income is about the same today as it was in the mid-1990s (see Chart 2[3]). That is largely a by-product of developments in the housing market. Faced with higher house prices, a lower initial debt-servicing burden as a result of lower interest rates, and an increased availability of mortgage finance, first-time buyers and those trading up the housing chain have been both willing and able to take out larger mortgages, thus adding to the upward pressure on house prices. But on the other side of the market, last-time sellers and those trading down the housing chain have been investing the housing equity thereby released into financial assets rather than spending it immediately. In essence, higher house prices have induced a transfer of lifetime wealth from younger generations to their parents. Moreover, even if house prices were to stop rising tomorrow, the debt-income ratio would continue growing for many years until all of the housing stock had turned over[4].

How does that affect the macroeconomic outlook? Since, in the aggregate, the higher debt has been broadly matched by higher financial assets, it is not obvious that it has any impact. But, if highly-indebted individuals respond more strongly to, say, falls in income than do individuals with less debt, then the debt build-up could increase the responsiveness of aggregate demand to adverse shocks. And if indebted individuals respond more strongly to a rise in their interest payments than do savers to a corresponding rise in their interest receipts, the impact of monetary policy on demand may also be affected. Differences in the behaviour of households are therefore key to generating a scenario in which the high levels of household debt have an impact on the economy. But this is a much more subtle mechanism than is usually envisaged in popular discussion of the debt "time bomb".

None of this is to deny that *some* households may have been borrowing primarily in order to consume and that *some* households may have over-extended themselves. For example, with regard to unsecured debt, we know from a recent Bank survey[5] that a significant fraction of low income households find servicing their debts difficult and could be particularly vulnerable in the event of higher unemployment or a significant

[3] The increase in the second half of the Nineties followed by the sharp fall in the Noughties reflects the swings in equity prices.
[4] See Rob Hamilton "Trends in households' aggregate secured debt", *Bank of England Quarterly Bulletin*, Autumn 2003.
[5] See Merxe Tudela and Garry Young "The distribution of unsecured debt in the United Kingdom: survey evidence", *Bank of England Quarterly Bulletin*, Winter 2003.

increase in interest rates. But these households account for only a small fraction of consumers' expenditure and so do not represent a threat to the overall macroeconomic outlook, though the problems for the individuals affected are, of course, real and acute.

Of possibly greater significance for consumption prospects is the evolution of house prices, which have almost doubled relative to earnings since 1996. The value of housing wealth affects consumption because it allows households to borrow more easily and at lower rates than on unsecured borrowing. And, to the extent that high rates of house price inflation are associated with higher levels of activity in the housing market, more house moves imply more expenditure on housing-related durables, such as furniture and white goods. While there are a variety of reasons why the equilibrium house-price-to-earnings ratio might be higher now than in the past[6], there is considerable uncertainty about what ratio is sustainable. Moreover, to the extent that house prices are overvalued relative to earnings, it is also uncertain how drawn out any adjustment to a sustainable ratio will be: there could be a sharp correction to house prices, but equally house prices could just stagnate for a while until earnings catch up. Previous sharp corrections to the level of house prices have typically been preceded by a substantial tightening of monetary policy – usually to curb excessive inflation – and coincided with a substantial increase in unemployment. On the other hand, a "soft landing" is entirely possible if the economic conjuncture remains benign. That, for instance, was exactly how the adjustment occurred during the second half of the 1950s. But we simply do not know how things will unfold – only time will tell.

Of course, the household sector is not the only source of uncertainty the MPC faces. Even though the global economy has been strengthening, doubts remain about the momentum of the recovery in the euro area. Further ahead, there is considerable uncertainty about how the twin US fiscal and current account deficits will correct and the consequent implications for exchange rates, including Sterling. And there is the ever-present threat of terrorism and disruptions to the supply of oil. But, overall, prospects still look brighter than for a while.

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[6] See e.g. *Inflation Report*, May 2004 pp.43-44.

It is against this improving background that the Committee has, since last November, been gradually reducing the monetary stimulus that had been introduced to offset the impact of the global slowdown. A key vehicle for both making and explaining our decisions is the assessment of economic prospects contained in our quarterly *Inflation Report*. The *Report* contains projections for inflation and growth conditioned on the assumption that official interest rates remain unchanged and on the alternative assumption that rates follow a path implied by the financial markets. Projections conditioned on either assumption can be used to illustrate the Committee's assessment of economic prospects – they are like two photographs of an object taken from slightly different vantage points. But the usefulness of the information contained in those two photographs depends on the starting value of interest rates. If interest rates are significantly different from their "normal" level – as has been the case recently – the assumption that they will remain unchanged over the forecast period becomes less plausible and the behaviour of inflation and growth towards, and beyond, our normal two-year forecast horizon under the constant interest rate assumption can start to appear peculiar. The constant-interest-rate photograph is accurate, but not so helpful in portraying economic prospects.

That is evident in the inflation projections from the February *Report* (Charts 3 and 4), which I have mechanically extended into a third year to make the point clearer[7]. It can be seen that inflation moves sharply above the target by the third year under the constant interest rate assumption (Chart 3). That is because official interest rates are assumed to be held low despite the building inflationary pressures. In contrast, the market's expectation of official interest rates represents more plausible behaviour on the part of MPC, leading to a better-behaved projection in which the central projection for inflation settles around the target (Chart 4).

In our own deliberations we have increasingly found ourselves referring to the projection based on market rates. A key issue facing us recently has been how quickly to reduce the monetary stimulus injected earlier, and discussion of the merits of alternative strategies is facilitated by comparison against a benchmark with rising,

[7] The MPC did not agree projections for the third year.

rather than constant, interest rates. And, for similar reasons, we have found that the explanation of our policy decision is more straightforward when reference is made to the projection based on market rates. For, as Chart 3 demonstrates, if official interest rates are unusually low, but likely to rise back to normal as activity and inflation pick up, then the central projection under constant interest rates should be expected to *overshoot* the target. By contrast, if the profile implied by market interest rates represents a plausible expectation for the future path of official rates it should settle around it, as in Chart 4. Accordingly, in future *Inflation Reports* we will place the primary emphasis on the projection based on market rates, rather than that based on constant interest rates as hitherto.

In deciding how quickly to reduce the policy stimulus implied by very low interest rates, there are a number of factors that need to be weighed against each other. First, and foremost, is the question of how quickly the economy is gathering momentum with the consequent implications for inflationary pressure in the medium term. That judgment is, of course, embodied in our projections and with inflationary pressures building only slowly, a gradual withdrawal of the stimulus is appropriate. Second, uncertainty about the reaction of house prices and of the response of highly indebted households to higher interest rates also suggests a cautious approach.

But against these two factors, two other considerations point to a somewhat sharper withdrawal of the stimulus. First, although our job is to target 2% inflation "at all times", getting inflation back up to target quickly by engineering a short-lived boom and then slamming on the brakes to prevent inflation overshooting is not very sensible. Rather – as required by the Chancellor's *Remit* – we are also seeking to achieve stability in the trajectories for output growth and employment. Generating a smooth growth profile thus suggests tightening earlier rather than later. And, second, worries that excessively high house price inflation in the present raises the probability of a sharp correction in the future – with the attendant risk of a sharp reduction in demand and a subsequent undershoot of the inflation target – points to a tighter policy in the near term in order to moderate the overvaluation in house prices[8].

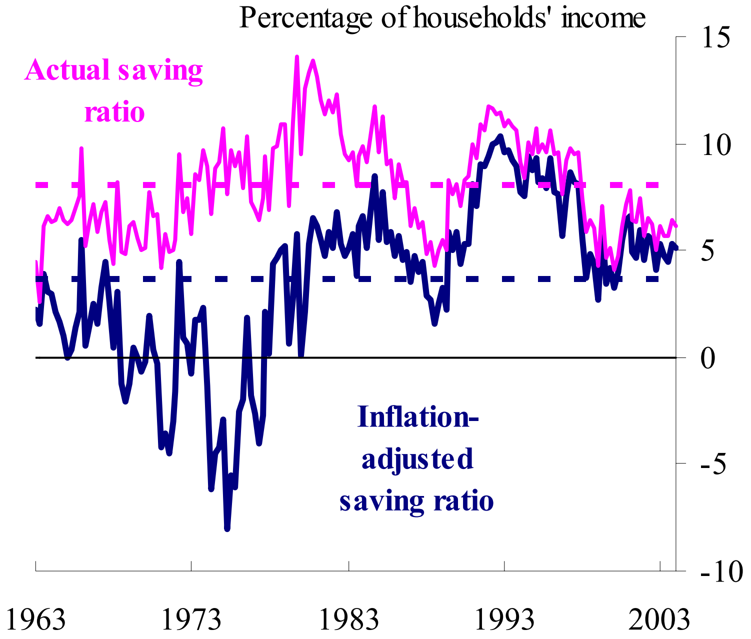
[8] For further discussion, see Charles Bean, "Asset Prices, Financial Imbalances and Monetary Policy: Are Inflation Targets Enough?" in *Asset Prices and Monetary Policy*, eds. A. Richards and T. Robinson, Reserve Bank of Australia, Sydney, 2003.

Some commentators have suggested that what is needed is a sharp increase in interest rates in order to "bring consumers to their senses". Aside from the fact that there is no empirical evidence to suggest that a single large increase in rates is more effective than two smaller increases, we are in any case not in the business of trying to clobber the consumer. Rather, we are seeking to engineer a modest slowing in consumer spending growth in order to make room for an increase in investment and exports as business conditions improve here and abroad.

Where are interest rates likely to settle? That depends on the level of the "neutral" real rate of interest, corresponding to the rate of interest that, loosely speaking, obtains when output is at potential and the economy is growing at its trend rate. But the neutral rate of interest is not a constant and instead varies over time, being affected by factors such as domestic and foreign savings rates, fiscal policies and rates of productivity growth. As a result, although the neutral rate provides a conceptual framework for thought, it cannot be pinned down with any confidence and so is not very helpful in deciding the precise level of interest rates. Instead one is forced back to something more akin to trial and error, as if rates are set too low, inflation will tend to pick up and *vice versa*.

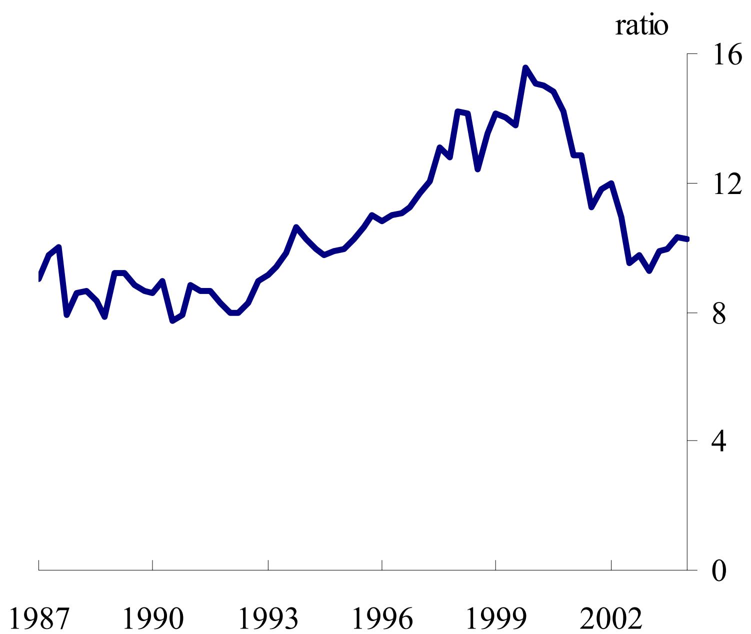
Let me conclude by noting that there are many other important issues affecting the outlook for the UK economy that I have not even touched on. The impact of the continuing competitive pressures wrought by the emergence of China and India, and the likelihood of a US-style surge in productivity here are but two of the more obvious. And I have no doubt that the future will bring further unexpected challenges. The last decade has been one of extraordinary macroeconomic stability in the United Kingdom. The MPC cannot guarantee that that stability will continue over the next decade, but you can be sure that we will be doing our best to make it so.

Chart 1: Household savings ratio



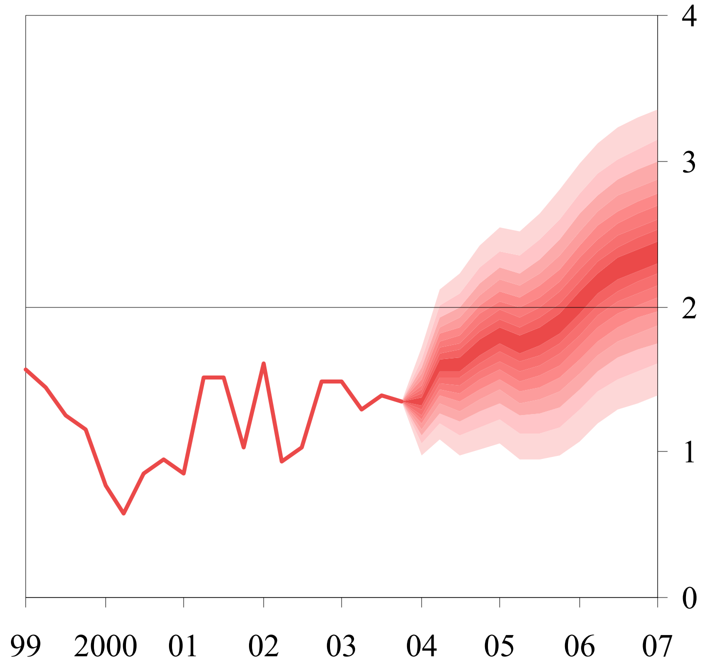
Source: Office for National Statistics and Bank of England

Chart 2: Ratio of household net financial assets to household income



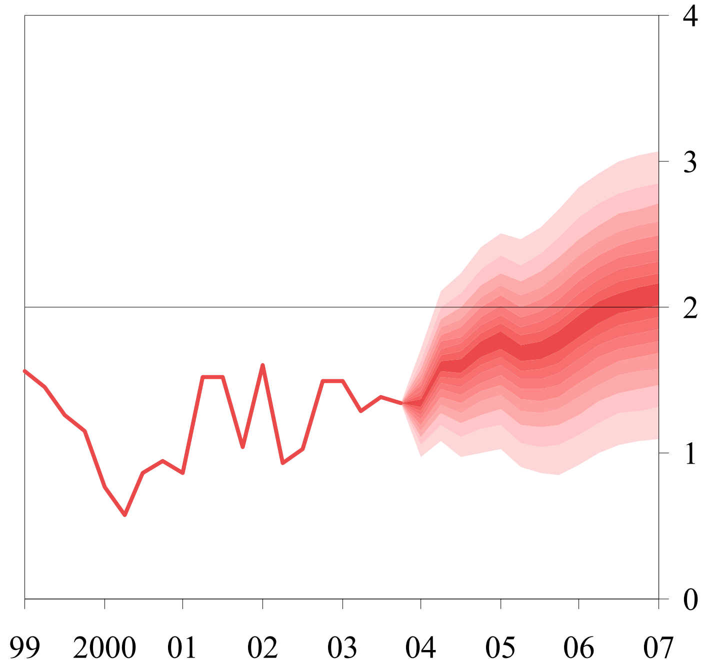
Source: Office for National Statistics

Chart 3: February 2004 CPI projection under constant (4%) interest rates



Source: Bank of England

Chart 4: February 2004 CPI projection under market interest rates



Source: Bank of England

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