



BANK OF ENGLAND

Speech

Financial Instability and UK Monetary Policy

Speech given by

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Introduction

One topic much discussed by economists at present is why so many industrialised economies have experienced greater stability in economic growth and inflation over the past decade or more. In the UK, this comparative stability has prevailed since the adoption of inflation targeting. In the present circumstances, it is relevant to recall that during this period there has, however, been a series of significant shocks in financial markets – and today we are in the midst of another.

While these past financial shocks have had some macroeconomic effects - for example the US economy slowed sharply in 2001/02 during the period of equity market weakness - these have been relatively limited. There has not been a major recession in either the US or the EU in the past decade, and in the UK there has not been a quarter of negative growth since the second quarter of 1992. Following Bank of England independence in 1997, the inflation rate has also been surprisingly stable. Only in one month, March 2007, did it move more than 1 percentage point away from the Government's target. This is despite a series of shocks external to the UK, including in addition to financial market disruptions the large rise in oil prices (and more recently other commodity prices) since 2004. While all of these events have posed some risks to stability, it remains the case that beyond the short term, it is domestic monetary policy which will determine domestic inflation, despite international developments.

Ahead of the recent financial market turbulence, the economic situation was strong, both at the global level and in the UK. The world economy had been growing at an annual rate of around 5% since 2004, and even in UK trade-weighted terms, which puts less weight on the fast-growing Asian countries, by between 3% and 4%. In the euro area, after a period of rather sluggish growth, the pace of expansion has recently picked up to broadly around 3%. In the UK, after a short-lived slowdown in early 2005, there have been seven quarters of unusually steady growth at around 0.8% according to the latest ONS estimates. And according to the Bank's internal estimates, growth has speeded up a little from this pace in recent quarters. Encouragingly, this growth has not been especially dependent on household spending, which has been growing at a similar rate to the whole economy, whilst business investment in 2006 grew much more strongly.

But alongside this strong global and domestic economic momentum, there were also potential sources of fragility. In particular, there were long-standing concerns about the scale of the US current account deficit, which has averaged 5.5% of US GDP over the past five years. Much commentary has focused on how this might unwind, with considerable discussion of the likelihood of very significant dollar devaluation.¹ In fact the US dollar in September 2007 was, in trade-weighted terms, down 30% from its peak in early 2002. The other main area of concern has been around the low interest rate environment in major OECD countries since 2001, which, combined with other factors such as greater confidence in economic stability, has led to a reduction in risk premia, and a sharp rise in many asset prices. In consequence, both the OECD and the IMF have raised concerns about unsustainably high levels of house prices in several economies.² And the rapid pace of global demand growth since 2004 has produced upward pressure on commodity prices. Industrial metals prices were up by 111%³ in the first half of October from their level in January 2004. Over the same period, the Brent sterling oil price was up by 126% in sterling terms, and has risen further over the past week.

Today I will consider two issues relevant to the present debate about what the impact of financial disruption might be, against this background. The first is what could be learnt from past episodes about the reliability of the early responses of forecasters and business surveys. The second discusses potential risks for the UK housing market.

Recent financial disruption

The causes of the financial disruption which started in early August, and the course of the turbulence, have been thoroughly described elsewhere⁴. While the recent considerable volatility in many asset, money and currency markets has eased in some markets, this volatile period is not yet over. It may be useful to remind ourselves where some of the key financial prices are presently, compared with pre-August levels. Compared with the end of July, at close-of-business on October 19, three-month LIBOR was around 0.5

¹ For example, Obstfeld and Rogoff (2004)

² See OECD (2005) and IMF (2007)

³ *Economist* metals index (which includes nickel, tin, copper, lead and aluminium) converted into sterling using market exchange rates.

⁴ For example, the Governor's speech at the Northern Ireland Chamber of Commerce, 9 October 2007.

percentage points above the expected policy rate implied by sterling overnight interest rate swaps, having at times over the last two months been more than 1 percentage point above. Ten-year risk-free rates were 4.6%, the same as they were at end-July, though having peaked at 4.8% in late September. Spreads on sterling non-investment grade corporate bonds are 83 basis points higher, but again this is well below the peak levels in mid-September. Sterling's effective exchange rate has weakened by 2.5% over the period, having fallen by 3.3% against the euro, but risen slightly against the US dollar. The FTSE All-Share was unchanged on end-July at the end of last week, but remains volatile. While conditions remain uncertain, it is worth noting that the fall in the exchange rate will tend to support growth and push up on inflation.

In judging the significance of these events for monetary policy, the key questions are: how far prospects for the US economy have changed, how this will impact on the rest of the world, how severe and durable any tightening of credit conditions for business and for households will prove to be, and whether there will be any negative effects on confidence more generally.

With regard to the US economy, many forecasters have revised down their growth projections - for example the *Consensus Economics*⁵ forecast for 2008 is now 2.4%, down 0.4 percentage points since July. But considering the scale of this revision does not enable a full judgment to be made about the impact on the global economy. While the effect via trade flows may be estimated from past experience, the more important impact on the UK may well be transmitted through global financial markets, although the effects on businesses and households are not easy to assess.

Forecast and business survey responses to past episodes

In considering the medium-term impact of financial market disruption, one question is whether there is any tendency for the initial reactions in terms of business confidence and investment intentions to be over-gloomy, relative to the actual outcome. If this were true, it would argue for some caution in interpreting business survey data over the next few months.

⁵ *Consensus Economics* publish regular averages of the major economic forecasting groups

Why might there be an undue impact on sentiment? One possible reason would be if, in previous periods of financial disruption, economic forecasts have been revised down too far initially, and these forecast revisions had then led businesses to be unduly pessimistic. Looking back at the history of the forecast averages produced by *Consensus Economics*, this appears to be only partially true. Following the ERM crisis in 1992, for example, forecasts for the UK growth were initially revised down for 1993, but the eventual outcome was stronger than the pre-crisis projection (due in large part to the easing of monetary conditions, see Chart 2). On the other hand, for Germany it was several months before forecasts recognised the extent of weakness for 1993, when GDP declined by 0.8%.

In the wake of the events of 9/11, world GDP growth forecasts for 2002 were revised down sharply, but the eventual outcome was well above the 1.1% forecast made at the end of 2001. This was mainly due to better-than-expected growth in the US. In the UK, the initial downward revision was broadly correct, and in Germany the growth outturn was in fact weaker than suggested by the initial downward revision.

The only episode which convincingly bears out the story of initial over-pessimism is the Russian default and associated collapse of LTCM in the early autumn of 1998. This triggered sharp downward revisions for the UK, Germany and the world economy – for both the UK and the world these were far too pessimistic⁶. And in the US, where projections were not revised down, the final outcome for 1999 was much higher than expected in late 1998.

Of course, this look at history is subject to many reservations. Most obviously, policy may have reacted more or less strongly than forecasters expected, or other unanticipated events will have affected the outcome.

⁶ Although the data for the UK in 1998/99 published at the time was considerably weaker than the latest published outturn.

Looking at the response of business surveys to financial crises, a number of periods since 1992 have been considered (Chart 1)⁷. These were Sterling's departure from the ERM in 1992, the Barings' collapse in 1995, the Asian crisis in 1997/98, the collapse of LTCM in 1998 and the events of 9/11.

Taking business confidence and investment intentions (Charts 3-4), for both manufacturing and services, the two episodes linked with the largest deterioration in survey results were the collapse of LTCM and 9/11.

The sharp falloff in business confidence around the LTCM episode, most apparent in the CBI manufacturing survey, was not linked to a subsequent major decline in GDP at least in present estimates of the data (Chart 5). However, manufacturing output growth did ease back in 1999, although rather less sharply than the CBI survey indicated. Business investment growth declined very markedly in 1999, but much of this reflected adjustment following the surge in investment in 1998, due to concerns ahead of the millennium about possible software problems.

Post 9/11, GDP did however indeed weaken, and business investment was also subsequently weak. While GDP growth had been slowing ahead of this event, as indicated above downward forecast revisions for the UK in late 2001 proved broadly correct, and business surveys reflected this change of view.

For both forecasts and business surveys, perhaps unsurprisingly, the broad conclusion is that there is no uniform tendency for the initial reaction to financial disruptions to be unjustified declines in sentiment. In any case, so far in this episode, there is little sign of survey weakness, for example the latest British Chambers of Commerce *Quarterly Economic Survey* suggested that business confidence and investment intentions were in fact little changed in the third quarter of 2007.

⁷ The small spike related to 9/11 in 2001, and the pick-up in 2004 seems unrelated to a specific source of tension

UK household consumption and the housing market

If the initial evidence on businesses suggests some resilience, is there more concern about the household sector? The Credit Conditions Survey published by the Bank of England in September 2007⁸ in fact suggested that, while financial institutions were intending to tighten credit conditions for companies, this was less true for households. To date there is little evidence for most households of adverse effects on lending, although interest rates have risen, often quite sharply, for mortgage lending judged to be riskier. While this will squeeze the finances of some of the households affected, it would not by itself be expected to have a major adverse impact on the macroeconomy. But a more pervasive risk would obviously arise if there were a significant slowdown in the housing market. I stress that this is not my central expectation – the outlook for the housing market, as ever, is highly uncertain and little weight can be attached to any particular scenario.

Much of the rise in UK house prices in recent years can be justified by the lower level of interest rates, the greater stability of the economy and the relatively weak supply response to rising demand. However, the level of house prices now is, on many estimates, above a level explained by these fundamentals,⁹ and therefore somewhat vulnerable to a major change in expectations about future prices. But it is not immediately obvious why the recent developments in financial markets should prove the trigger for such a change. Firstly, a major economic slowdown, with an associated sharp rise in unemployment, is not expected. And secondly, although it is far too early to reach a firm conclusion, the balance of evidence so far on household behaviour is reassuring. There was little deterioration in consumer confidence in September. Retail sales volumes have remained strong throughout in the third quarter, although discounting meant that retail values grew only weakly.

However, there is some evidence that the housing market is slowing from the strength in the first half of 2007. In particular, according to the Royal Institution of Chartered Surveyors (RICS) survey, estate agents have on balance been reporting expectations of falling prices since August. Further, while recent loan approvals data suggest fewer

⁸ Bank of England (2007)

⁹ OECD (2005)

transactions, the sales/stock ratio reported by RICS has remained broadly unchanged since July, as new instructions to sell are also lower. However, there has not yet been firm evidence of a major slowing in house price rises. Although the Halifax index fell in September, both the lenders' indices are often erratic on a monthly basis. The average of these two indices for the third quarter was up 1.3% on the previous quarter, and 10% on the previous year.

A potential source of weakness could be the buy-to let (BTL) market, given a combination of higher interest rates, little change in rents and possibly reduced expectations of price appreciation. New BTL mortgages accounted for 12% of total mortgage lending¹⁰ in the first half of 2007, so a decline in this demand, even if existing BTL owners do not decide to sell, could well dampen the market. Whether this leads to pent-up first-time buyer (FTB) demand, supporting prices, will also depend on expectations. If actual price falls were to become anticipated, prospective FTBs might simply decide to defer their entry into the market, reversing the recent wish to get 'onto the ladder' early. It is the inherent uncertainty about expectations which clouds the outlook.

For monetary policy the important question is what impact any weakness in the housing market would have on demand. Previous experience suggests that changes in house price inflation have more of an effect on household consumption if both are driven by changes in household income expectations. In present circumstances, it is changes in credit conditions which are expected to impact house prices, and in this case a relatively muted response of consumption to changes in house price inflation might be expected. This would mirror the experience of the early years of this decade, when despite very strong house price growth, household consumption growth did not accelerate.

In addition, there may be some impact from a decline in residential investment. It is frequently argued that planning constraints mean that house building in the UK is not very responsive to changes in house price inflation¹¹. While this is clearly true during

¹⁰ Including re-mortgages

¹¹ Barker (2003)

periods of rising prices, developers find it more straightforward to adjust output downward. Indeed, one estimate suggests that the elasticity of supply during a boom is half that during a period of house price weakness.¹²

The last period of significant house price weakness was in the early 1990s, and took place in very different economic circumstances (and also different circumstances for the housing market – for example loan-to value ratios for FTBs are presently 90%, compared to 95% in early 1989). Nevertheless, it may be noted that the total number of private sector housing completions in England fell by 20% between 1989 and 1992. Over the same period residential investment, which had risen above 4.5% of GDP in 1988, declined by 24%.

Over the past five years, residential investment has contributed on average 0.2 percentage points annually to GDP growth. Signs of a potential slowdown in output are already apparent, at least for new build. While housing completions in England in the first half of 2007 were 9% higher than the same period in 2006, housing starts were on the same basis were 10% lower. However, with residential investment accounting for just 3.5% of GDP in 2006, any potential downside here is more limited than in the early 1990s (or in the US, where residential investment was 5.8% of GDP in 2006).

Conclusions

The disruption in financial markets which started on August 9 has changed the balance of risks around UK economic activity towards the downside. It is not surprising, given the frequently-aired concerns about unduly low risk premia and also worries over an adjustment by the US consumer, that some form of disorderly adjustment has occurred. But the precise course of the events was unexpected, with concerns over the US sub-prime market leading to very widespread uncertainty about the valuations of asset-backed securities, and still causing the markets for these securities to be very limited.

Business surveys are often used as an early indication of how events in financial markets will impact the rest of the economy. But it has been suggested that business surveys,

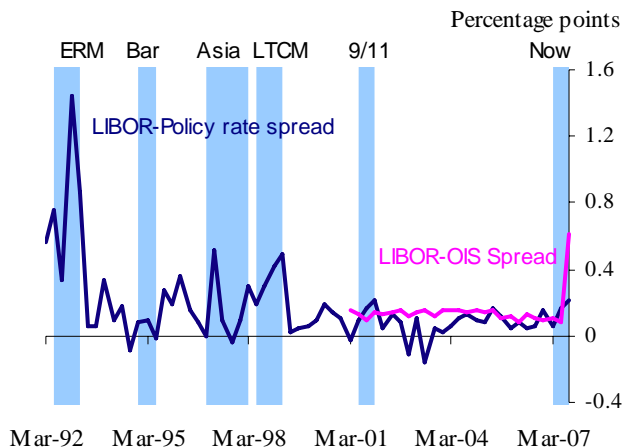
¹² Pryce (1999)

possibly influenced by pessimistic economic forecasts, have in the past been too gloomy in their initial response. Looking back at the previous financial disruptions, however, a more mixed picture emerges. This suggests that business surveys should be given weight in judging the impact of recent events for the wider economy, although the events of autumn 1998 argue for caution if the surveys fall abruptly. In this autumn, however, business survey data overall have not yet shown any marked deterioration.

With regard to the response of the consumer, there is some risk around the behaviour of the housing market, although it is not clear why recent events should prove a trigger which significantly alters previous expectations of continued robust house price growth. And even if there were a major weakening in the housing market, the response of household consumption may be muted, since it is not expected to be linked either to rising unemployment or deterioration in households' income expectations. But the risk of a modest downward effect on output growth from a weakening trend in residential investment should not be ignored.

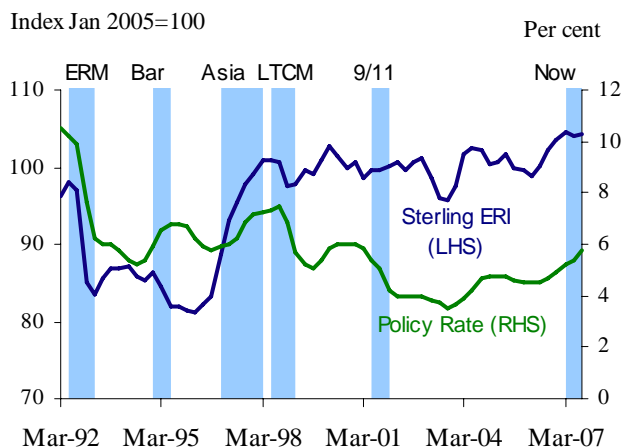
Our key focus remains keeping inflation on track to meet the target in the medium term. The MPC is considering the issues discussed above, alongside other relevant economic trends, to assess how far the previously-robust economic picture is likely to be affected by recent financial market disruption. Not all of the changes since early August imply downward pressure on inflation; for example weaker sterling, if sustained, will tend to push up on prices. And upward pressures from commodity markets, in particular the oil market, remain a concern. In early August, I was concerned that the economic slowdown, which was anticipated following the monetary tightening put into place since August 2006, might not materialise sufficiently to reduce the upward inflation pressures. The evidence from business surveys and housing market indicators will be an important part of my judgement over the next few months about how far the downside risks to the outlook have increased.

Chart 1: Spread between three-month LIBOR and rates implied by sterling overnight interest rate swaps (OIS) and three-month LIBOR (at the start of the quarter) and the UK policy rate (average for the quarter).^{1,2}



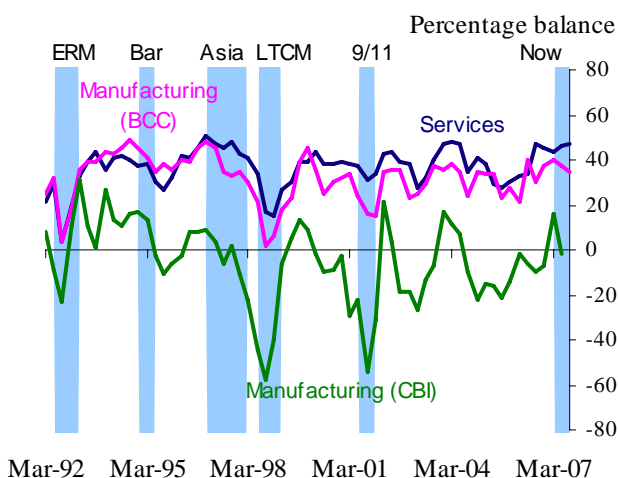
Sources: Bank of England, Wholesale Markets Brokers' Association, and Bloomberg

Chart 2: Sterling ERI and the UK policy rate



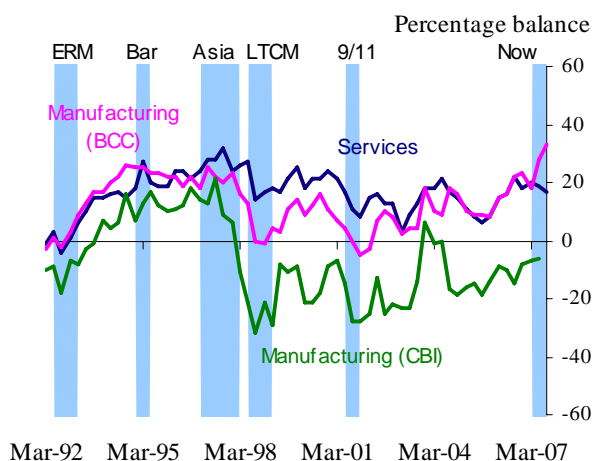
Source: Bank of England

Chart 3: Business confidence



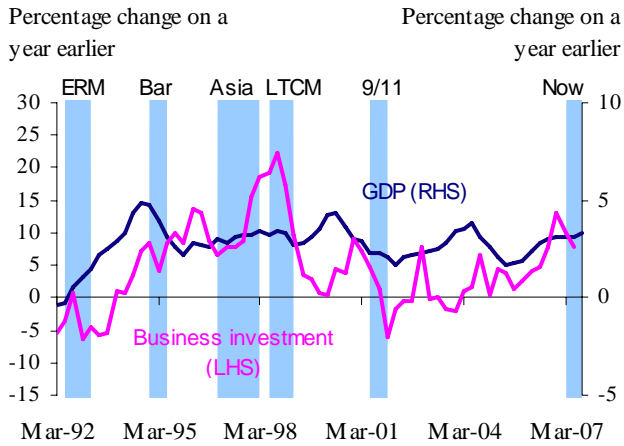
The services and manufacturing (BCC) series show confidence in profitability (over the next 12 months compared to the past 12 months) in the respective sector. The manufacturing (CBI) series shows general business optimism in the manufacturing sector compared to three months previous.
Sources: British Chamber of Commerce (BCC) and Confederation of British Industry (CBI)

Chart 4: Business investment intentions



The services and manufacturing (BCC) series show investment in plant and machinery over the past three months in the respective sector. The manufacturing (CBI) series shows expected investment in plant and machinery over the next 12 months compared to the past 12 months) in the manufacturing sector.
Sources: British Chamber of Commerce (BCC) and Confederation of British Industry (CBI)

Chart 5: GDP and investment outturns



Source: ONS

Notes:

¹Three-month LIBOR rates reflect expectations of monetary policy over the following three months as well as credit and liquidity conditions. To control for changes in monetary policy expectations LIBOR is compared with the average expected policy rate implied by sterling overnight interest rate swaps (OIS) over the same three months. As OIS data is not available prior to 2001 we also show the three-month LIBOR less policy rate spread. LIBOR is measured at the start of the quarter and the policy rate as the average over that quarter, which will be a good approximation to the extent that agents had perfect foresight of the policy rate. However, movements in this series could be due to unexpected movements in policy rates which violate the perfect foresight assumption. As the latest data point for this measure shows LIBOR at the start of the third quarter this series does not yet pick up the recent tightening of liquidity.

²The abbreviations above the charts relate to the episodes of financial disruption surrounding the following events: ERM to the UK's departure of the European Exchange Rate Mechanism, Bar to the failure of Barings Bank, Asia to the Asian crisis, LTCM to the Russian sovereign default and associated collapse of Long Term Capital Management, and 9/11 to the terrorist attacks of 11 September 2001.

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