BANK OF ENGLAND

Speech

All Along the Watchtower

Speech given by

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It is difficult to overstate the strategic and historic importance of Dover. As the closest point to mainland Europe, it is considered by many to be the gateway to the United Kingdom. Dover Castle has formed a defensive stronghold for over two thousand years. And its high ground provides the site for one of the tallest military Roman structures in Europe – a lighthouse that for many years provided guidance for ships crossing the Channel. It's little wonder that some historians describe Dover as a 'watchtower', given the favourable vantage point it afforded the Roman commanders of the day.

Although the UK economy faces rather different potential perils to those encountered by Dover in years gone by, the need for vigilance is just as pressing. The UK economy is currently grappling with the combined challenge of an exceptional surge in food and energy prices and, as underlined by the events of the past week or so, a period of intense strain within financial and credit markets. The adjustment to higher commodity prices and to a more sustainable financial system will be painful, characterised by a period of broadly flat output and high inflation.

This process of adjustment is also fraught with uncertainty, with significant risks to both sides of the inflation outlook. To the upside, the period of temporarily high inflation may prompt an upward drift in medium-term inflation expectations that could lead to more persistent wage and price pressures. On the downside, the reductions in households' purchasing power associated with the increase in food and energy prices and the tightening in credit conditions may lead to a deeper and more prolonged slowdown. That might result in a significant widening in the margin of spare capacity in the economy, which could cause CPI inflation to undershoot materially the 2% inflation target.

The scale of the risks around the outlook for inflation is illustrated by a comparison of the MPC's most recent projections in the August *Inflation Report* with those contained in previous *Reports* (Chart 1). In recent years, the MPC has tended to attach a relatively high probability to inflation turning out reasonably close to the 2% target a few years ahead and a correspondingly low probability to inflation outcomes further away from target. But at the time of the August *Report*, the Committee judged that – based on the assumption that Bank Rate followed a path implied by market interest rates – it was more likely than not that inflation would turn out more than one-half of a percentage point away from target after two years, with significant probabilities attached to inflation being either markedly above or below target.

Central bankers are prone to talk about the uncertainty around the economic outlook. I fear that this may sound like we are complaining about the difficulty of our jobs or, worse still, that we are trying to make our excuses early. Neither is meant to be the case. Rather, it is meant to convey the fact that the information underlying our policy decisions is inevitably incomplete – an issue that you too deal with in your businesses – and that there is a need to continually update our view of the emerging economic risks and adjust policy accordingly.

In that spirit, I thought I would describe the view from my 'watchtower', concerning two of the key uncertainties affecting the economic landscape. I will start by considering the risk that deteriorating housing market conditions pose to the outlook for consumer spending. I will then discuss the risk that the current period of high inflation may cause inflation expectations to become less firmly anchored.

House prices and consumer spending

Housing market conditions have weakened markedly over the course of this year. Activity, on some measures, has fallen to the lowest level in more than three decades. And house prices are around 12% off last autumn's peak, according to the main lenders' indices. A range of indicators point to further weakness in the months ahead.

It is important, though, to put these developments into context. Prior to the recent falls, house prices had risen at an exceptional rate. They had roughly trebled in the period since the MPC's inception in 1997. By last autumn, house prices stood some 50% above their long-run average relative to earnings.

Some of that remarkable rise in house prices reflects factors that are likely to persist. For example, the move to much lower average rates of inflation than seen in the 1970s and 1980s is likely to have raised the demand for loans, given that the initial burden of debt-servicing tends to decline with inflation. Real returns on alternative, less risky assets (such as government bonds) remain low, increasing the relative attractiveness of investment in housing. And over the past few decades, demographic changes have boosted the demand for housing relative to the rather inelastic supply of new housing. But some of the other factors that boosted house prices – such as increased availability of credit, especially for borrowers with little or no deposit – have not persisted.

A further period of housing market adjustment therefore appears in prospect, as house prices fall to a more sustainable level relative to earnings. I recognise that this process of adjustment will be painful for many households. It will also be painful for many businesses, especially those – such as housebuilders and estate agents – that are most directly dependent on the health of the housing market. However, in order to achieve the inflation target, the main focus of the Monetary Policy Committee has to be on the implications of the weakening housing market for the wider economy, not on the housing market itself.

In that regard, what implications might the weakness of the housing market have for consumer spending?[1] The relationship between house prices and consumer spending is complicated and varies across different groups within society. For some households, a fall in house prices represents an erosion of the equity that they have accumulated in their homes and so may lead them to cut back on their spending as they seek to build up other types of savings. However, for other households, such as those looking to move to a larger property, a fall in house prices represents a welcome shift to more affordable housing and may free up funds for other types of spending.

For society as a whole, a change in house prices in itself does not significantly affect our well being. The stock of housing still exists, providing the same housing services as before. In the jargon used by economists, there is no significant aggregate wealth effect associated with a change in house prices. Some households gain, others lose.[2]

Even so, consumption spending and house prices have often moved together in the past (Chart 2). In large part, this co-movement reflects the fact that consumer spending and house prices are influenced by the same economic factors. For example, if the income that households expect to earn in the future were to increase, that would lead them to demand both more consumer goods and services and more housing services. Given the relatively inelastic supply of new housing, this would most likely lead to a rise in house prices, as well as to a rise in consumer spending. Likewise, a change in the general availability of credit would be likely to exert a similar influence on consumer spending and the demand for housing. This co-movement is akin to the similar patterns observed in the demand for turkeys and Christmas trees. One does not cause the other; rather they are both responding to a common driver.

The importance of such common drivers in accounting for movements in consumption spending and house prices varies according to the economic circumstances of the time. For example, in the boom and bust of the late 1980s and early 1990s, income expectations appeared to play a key role. Marked movements in consumer spending and house prices were accompanied by similar fluctuations in a variety of indicators of expected income. And, tellingly, the spending of renters appeared to move in tandem with house prices – even though they did not own a home (Chart 3).[3] In contrast, the rapid house price gains earlier this decade were not accompanied by correspondingly rapid gains in consumer spending. In this instance, the various indicators of income expectations remained relatively stable (Chart 4).

Over the next year or two, it seems quite likely that the co-movement between consumer spending and house prices will reassert itself. Real take-home pay appears to have been broadly flat in the first half of this year and measures of households' near-term income expectations have softened. Added to that, credit conditions faced by many households have tightened – in some cases, considerably so – as a result of the strains in financial and credit markets over the past year. These common influences will put downward pressure on both consumer spending and house prices.

Over and above the influence of these common factors, it is likely that the deterioration in the housing market will amplify the impact of the tighter credit conditions on consumer spending. For example, some households wish to borrow funds to finance spending. For those households, the ongoing falls in house prices reduce the amount of collateral against which they can borrow. Other households may wish to have some savings set aside as a precaution against unforeseen events, such as illness or redundancy. Although this saving can take the form of housing equity, tighter credit conditions restrict access to this equity at the same time as falls in house prices diminish the overall amount of housing equity. That is likely to encourage households to limit current spending in order to build up other forms of precautionary saving, such as bank deposits.[4]

The deterioration in the housing market is also likely to impact banks' balance sheets, leading them to tighten further the supply of credit. This type of so-called 'adverse feedback loop' – in which a deterioration in the housing market and in the wider economy impinges on banks' balance sheets and their ability to lend, which then in turn feeds back on to economic activity – already appears to be operating to some extent. A key risk to the economic outlook is the possibility that this feedback loop intensifies, leading both to a marked reduction in the willingness of banks to lend and to a significant weakening in consumer (and business) spending. The next Bank of England Quarterly Credit Conditions survey, which will be published in a fortnight's time, will provide further evidence on the extent to which this risk is crystallising.

Looking ahead, my most likely scenario is one in which consumer spending is very subdued in the near term, weighed down by the same factors that are contributing to the weakness in the housing market – the reductions in households' purchasing power and the tightening in credit conditions. I then expect spending to recover gradually, as the squeeze on real take-home pay eases. But there is a risk that the continuing adjustment of the housing market amplifies the impact of the tighter credit conditions by more than I expect, resulting in a protracted period of weak consumption spending. That poses a downside risk to the outlook for demand and hence for inflation.

Inflation expectations

The second risk that I wanted to touch upon relates to the implications that the current period of high inflation may have for generalised wage and price pressures in the economy.

As you know, consumer price inflation has increased sharply over the course of this year. CPI inflation increased from 2.1% last December to 4.7% in August, and it is likely to rise further in the next month or two, not withstanding the recent declines in oil prices. In an accounting sense, this pickup in inflation has been driven by increases in food and energy prices. Of the rise in CPI inflation since December, more than two percentage points are due to increased contributions from these items. In addition to these global price developments, the recent depreciation of sterling – by some 15% since its peak last summer – is pushing up on the rate of import price inflation faced by UK firms and households.

The rise in commodity, energy and import prices reflects a change in these prices relative to the prices of other goods and services. A change in relative prices cannot, in itself, lead to a persistent increase in inflation. For inflation to increase persistently, other prices and costs must begin to rise at a faster rate. By setting interest rates appropriately, the MPC can prevent this from happening. That underpins the MPC's central view that, if food and energy prices stabilise, inflation will fall back sharply in 2009. To mangle a well known phrase: persistent inflation is always and everywhere a monetary policy phenomenon.

The risk, however, is that this period of temporarily high inflation affects households' and businesses' expectations about future rates of inflation, and that these expectations become embedded in wage and price setting processes. By their very nature, the inflation expectations of households and firms are difficult to assess and their relationship with wages and prices is imprecise. But I, and my colleagues on the Monetary Policy Committee, cannot wait and see whether the high rates of inflation today feed into persistent wage and price pressures. By then, it would be too late – a deep and painful economic slowdown would most likely be required in order to return inflation to target, as the sorry history of the UK economy through much of the 1970s and 1980s illustrates only too well. Instead, it is important to closely monitor the many imperfect measures of inflation expectations available and assess the signal they may contain about generalised inflationary pressures.[5]

Over the past year, measures of near-term expectations for inflation have increased (Chart 5).[6] But this in itself need not be a matter for concern: the MPC's expectations for CPI inflation a year ahead have also risen over this period (Chart 6). What would be a matter for concern, however, is if households and firms expected those higher rates of inflation to persist into the medium term, rather than falling back reasonably sharply as the MPC anticipates.

The persistence of the rise in inflation expectations depends critically on how households and firms form these expectations. Some are likely to take a wide range of information into account when forming a view of the likely path of inflation. Like the MPC, they may recognize the recent contributions from global food and energy prices and take note that the prices of other goods and services remain relatively stable. They might understand that it's not always possible for inflation to remain at target at all times, given the lags between interest rate changes and their impact on the economy. And they would (hopefully) retain full confidence in the MPC's ability and determination to bring inflation back to target.

Other firms and households are likely to have neither the time nor the inclination to form their views about future inflation in such detail. Rather, they may adopt a simple rule-of-thumb that has performed well in the past and that is less costly and time-consuming to calculate.[7] Two such guides that might be used are either that inflation in the future will be similar to current rates of inflation or, alternatively, that inflation in the medium-term will be close to the MPC's inflation target.

These rules-of-thumb have very different implications for the economy in the current environment. If individuals and companies assume that the current high rates of inflation are likely to persist, this would increase the risk of a generalised increase in price and wage pressures. Firms would have greater confidence in their ability to pass on cost increases to their final prices without losing market share. And employees would demand higher wage increases in order to maintain their living standards. In order to meet the inflation target in the medium term, the MPC in this case would face the difficult challenge of 'correcting' these expectations, both through our communications and through the demonstration of our determination to bring inflation back to the target. The task faced by the Committee would be much reduced if inflation were expected to be close to target, on average, in the future.

However, the success of the MPC in keeping inflation stable and close to the target means that both of these rules-of-thumb would have predicted actual inflation quite well over the past decade or so. This suggests that the behaviour of the economy in the past would have been quite similar irrespective of which of these rules had been used. As such, it is difficult to distinguish between these different rules-of-thumb – and indeed between the use of other approaches to forming inflation expectations (including the more information-intensive approach) – by looking at the recent behaviour of the economy.

In gauging the likely persistence of the rise in inflation expectations, we therefore have to look at other information. The Bank of England/GfK NOP survey, for example, not only asks households about their expectations of near-term inflation, it also asks about their perceptions of current inflation. In the past, there has been a close correspondence between survey respondents' perceptions and expectations (Chart 7). And, earlier this year, almost half of the respondents reported that their past perceptions of inflation played a 'very important' role in forming their inflation expectations.[8] But in the most recent survey published last week, there were some signs of an increasing gap between perceptions and expectations (Chart 8). This suggests that, when forming their views about future inflation, at least some households aren't simply extrapolating from past rises in inflation.

There are also a small number of more direct measures of medium-term inflation expectations. Some of these measures paint a relatively comforting picture. For example, surveys of professional economists suggest that these expectations have remained relatively stable. Measures of inflation expectations derived from financial market instruments (suitably adjusted) have also remained reasonably steady. But the message from household surveys is more mixed. The Barclays Basix survey of households in August reported that the rate of inflation expected to prevail in five years is just as high as that expected one to two years ahead. By contrast, the YouGov/Citigroup survey in August indicated that inflation expectations for the medium term were materially lower than for the near term, and that the medium-term measure had fallen to its lowest level in a year (Chart 9).

Amid such conflicting signals, I remain alert to the possibility that the current period of high inflation may cause inflation expectations to become less firmly anchored.

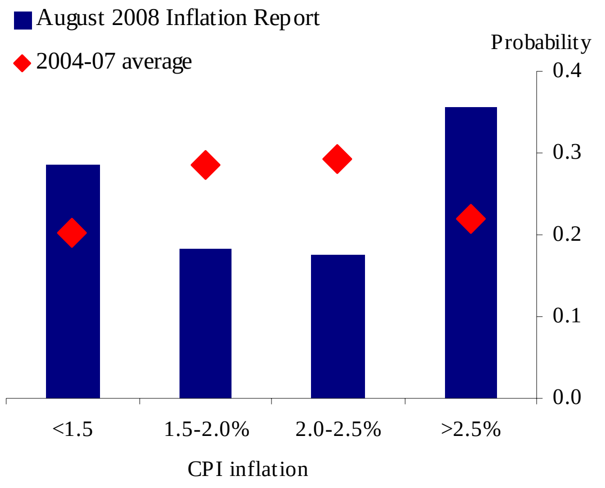
Conclusions

The UK economy is experiencing a painful adjustment, as it responds to the twin global shocks affecting oil and other commodity prices and the supply of credit. We are likely to have to go through a period of broadly flat output and relatively high inflation. It is important, however, to retain some perspective. In due course, inflation will return to target and growth will resume. A return to the remarkable stability of the past decade may not be in prospect. But neither is a return to the boom and bust of earlier years (Charts 10 and 11).

The Monetary Policy Committee will do whatever it takes to return inflation to target. And in assessing the appropriate stance of policy, the Committee will continue to take full account of the substantial risks to both sides of the inflation outlook. Today, I have tried to explain my view on two of those risks. On the downside, I have highlighted the potential impact that deteriorating housing market conditions may play in amplifying the impact of tightening credit conditions on consumer spending. On the upside, I have emphasised the risk that the current period of elevated inflation could lead to an increase in generalised wage and price pressures, necessitating a deep and painful slowdown in order to bring inflation back to target.

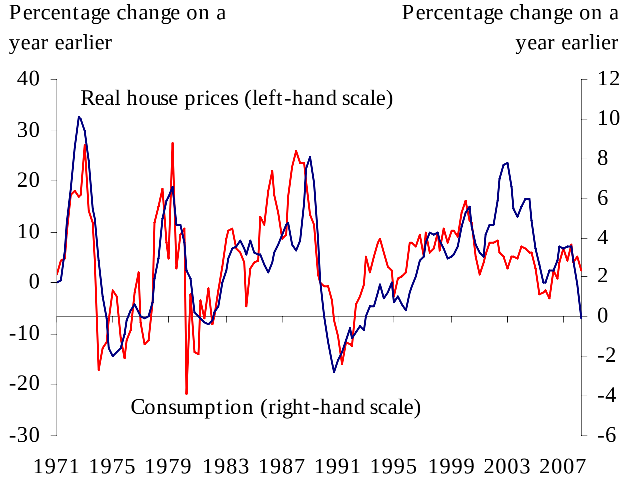
My own view is that these risks are at present finely balanced, which is why I voted to maintain Bank Rate at 5.0% at the September MPC meeting a fortnight ago. But as the economic environment changes, so too can the balance of risks. It is therefore crucial for the MPC to understand as quickly and fully as possible how economic conditions are evolving. Assisting in this endeavour will be the Bank of England's network of 12 regional agencies and their 8,000 business contacts across the United Kingdom. All along the watchtower – somewhat fittingly on this, the anniversary of the passing of Jimi Hendrix[9] – our regional Agents will be speaking to and learning from their discussions with businesses like yours.

Chart 1: Probability of different CPI inflation outcomes two years ahead[(a)]



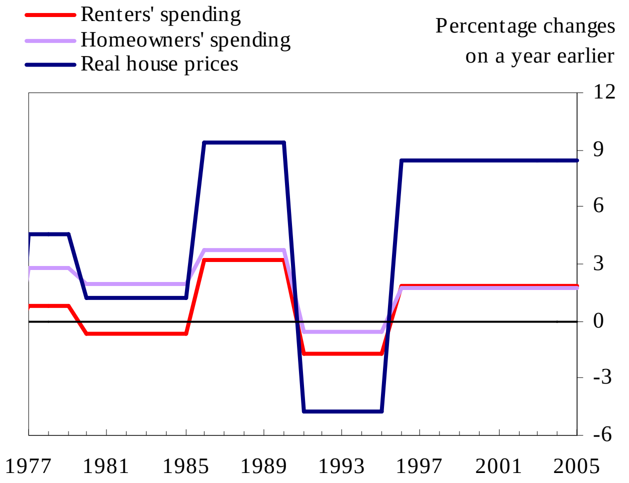
Source: Bank of England.
(a) Projections conditioned on market interest rates.

Chart 2: Real house prices and consumer spending[(a)]



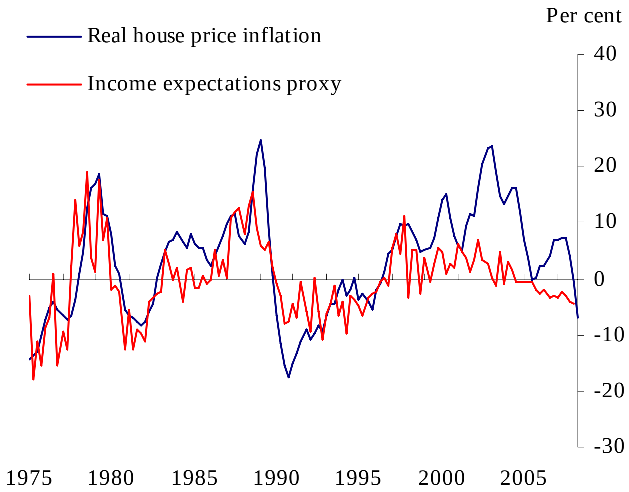
Sources: Nationwide and ONS.
(a) Nationwide house price index deflated by the consumer expenditure deflator.

Chart 3: Real house prices and the consumer spending of renters and homeowners[(a)]



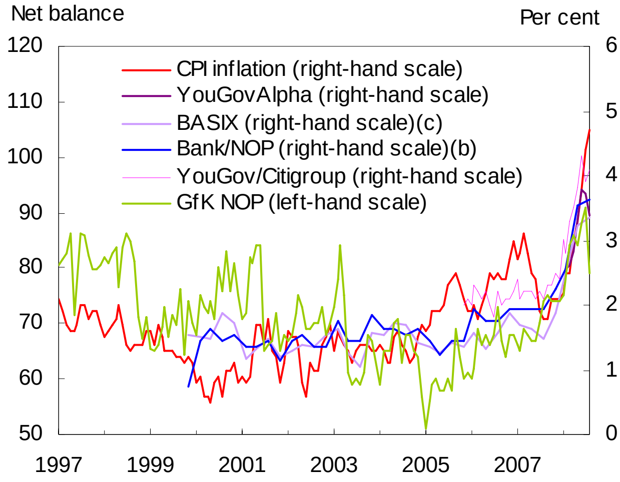
Sources: Attanasio et al (2005), Bank of England and the ONS Family Expenditure Survey.
(a) In order to smooth year-on-year fluctuations, annual data are averaged over periods of relatively high or low growth in consumer spending (per capita).

Chart 4: Real house price inflation and a simple proxy for income expectations[(a)]



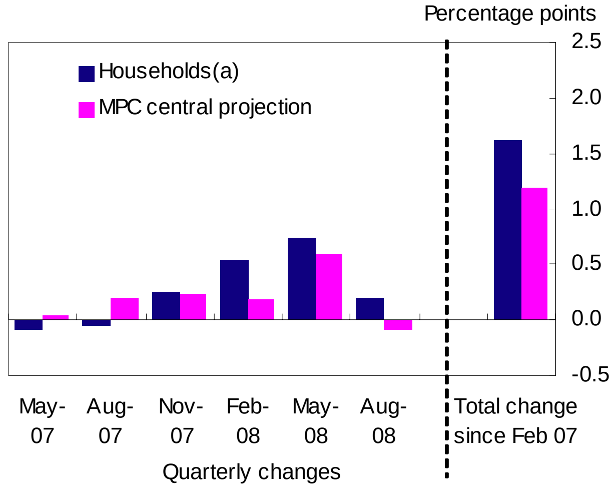
Sources: Bank of England, GfK NOP, Nationwide and ONS.
(a) Four-quarter rate of real house price inflation and a proxy for income expectations. The latter is based on real post-tax labour income growth, the share of durable spending in total nominal consumption and the GfK consumer confidence balance. For further details, see Benito et al (2006).

Chart 5: CPI and households' inflation expectations for the year ahead(a)



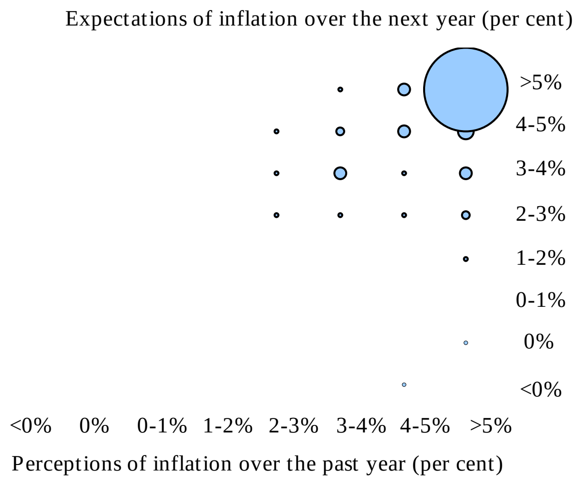
Sources: YouGovAlpha, Bank of England, Barclays Capital, Citigroup, GfK NOP.
(a) The measures show median expected price change over the next twelve months (except Barclays Basix which shows mean expectations and GfK which is the weighted net balance expecting prices to increase). They are scaled to have the same mean as CPI inflation (with the exception of GfK).

Chart 6: Changes in one year ahead inflation expectations



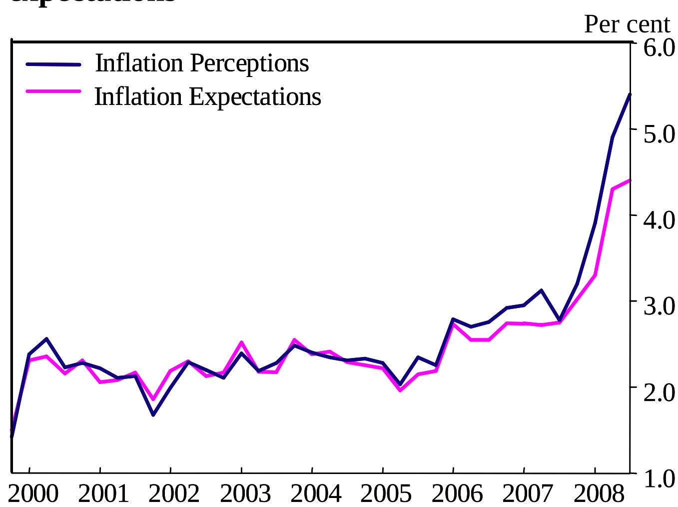
Sources: Bank of England, Barclays Capital, Citigroup, GfK NOP and YouGov.
(a) Average of Bank/NOP, Barclays BASIX and YouGov/Citigroup one year ahead inflation expectations, based on observations most closely comparable to Inflation Report publication dates.

Chart 7: Individual views of inflation perceptions and expectations(a)



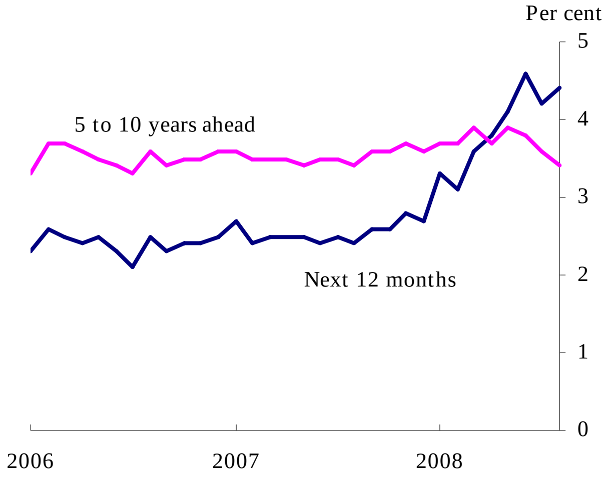
Sources: Bank of England and GfK NOP.
(a) Respondents who answered either question 'no idea' are excluded. The width of each bubble represents the proportion of respondents holding that view.

Chart 8: Households' inflation perceptions and expectations(a)



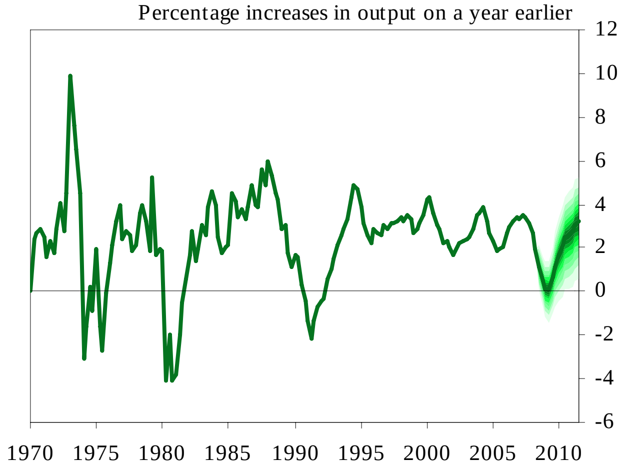
Sources: Bank of England and GfK NOP.
(a) Median measures of perceptions of inflation over the past year and of expectations for the year ahead.

Chart 9: Households' inflation expectations in the near term and medium term(a)



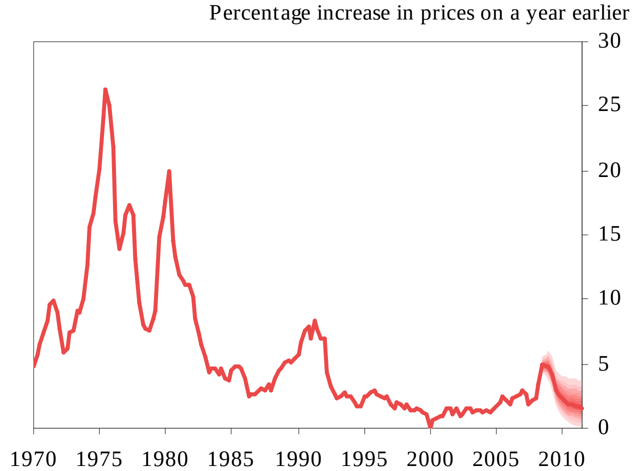
Sources: Citigroup and YouGov.
(a) Median measure. The questions ask about expected changes in prices, but do not refer to a specific inflation index.

Chart 10: GDP projection(a)



Sources: Bank of England and ONS.
(a) August *Inflation Report* projection, based on market interest rate expectations. The probability distribution around Bank estimates of past growth is not shown in this chart.

Chart 11: CPI inflation projection(a)



Sources: Bank of England and ONS.
(a) August *Inflation Report* projection, based on market interest rate expectations. Back data based on an RPI inflation-based proxy between 1970-1975 and historical ONS CPI data from 1976 (for further information, see http://www.statistics.gov.uk/articles/economic_trends/hicp_historical_estimates.pdf).

Endnotes

[1] Other links between property markets and the wider economy are discussed in a box on pages 22-23 of the February 2008 *Inflation Report*.

[2] The redistribution of wealth associated with a fall in house prices might depress aggregate spending if those households who benefit from the change in house prices (typically younger households) respond less than those made worse off (often older households). But this effect is likely to be dampened by factors such as borrowing constraints (which tend to make younger households relatively *more* responsive to changes in house prices) and bequests (which limit the extent to which wealth is redistributed in the first place). See Benito et al (2006) for a fuller discussion.

[3] Attanasio et al (2005).

[4] Benito (2007).

[5] The MPC also considers trends in other nominal variables. See, for example, the discussion in the minutes of the June 2008 MPC meeting, the box on pages 16 and 17 of the August 2008 *Inflation Report*, and the discussion in Tucker (2008). (These are all available at http://www.bankofengland.co.uk/publications/.)

[6] See pages 33-35 of the August *Inflation Report* for further details.

[7] Brazier et al (2006).

[8] Benford and Driver (2008).

[9] It is also almost exactly forty years since Hendrix's version of 'All Along the Watchtower' was first released. The original song was written and recorded by Bob Dylan.

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