



BANK OF ENGLAND

Speech

Policy Dilemmas

Speech given by

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Good evening.

It is a great pleasure for me to have been invited to give this speech tonight. Many of you will be aware that this is where I grew up and opportunities to return are welcome – not least in order to replenish my supplies of oatcakes. Indeed, the item of most interest to me last week on the Today programme was the debate on the oatcake shop. It is however nearly thirty years since I last lived here - years of great economic change. I moved away just before the recession of the early 1980s, which took claimant count unemployment in Stoke-on-Trent to 15,500 in 1983. Since then, unemployment has fluctuated strongly, with the claimant count falling to 5,500 in 1989, and then rising again to 12,500 three years later.

Today unemployment is just 4,000, or 2.8% on the claimant count. 17.5% of jobs are in manufacturing, well above the UK average of 11%, but down from over 30% in 1995. However, the service sector has been growing strongly, adding 1,500 jobs annually on average over the past 10 years. Alongside this expansion, regeneration is now underway in several parts of the City, and I know there is a real determination to build long-term success.

The Monetary Policy Committee (MPC) plays a major role in providing the right economic background to enable this success. We all learned in the 1970s and 1980s that allowing inflation to be high and unstable ultimately brought all the economic and social costs associated with significant downturns. Since inflation targeting was adopted in 1992, the UK's annual growth rate has not fallen below 1.5%. This period of growth stability, combined with an inflation rate which has so far only once since 1997 moved more than 1 percent away from the Government's target, has enabled the MPC to build the credibility of the target, and widespread support for an independent central bank.

But, as Committee members have frequently stressed, there are limits to what we can achieve. Shocks inevitably occur which drive the economy away from the path of steady growth and low inflation for a time. At present we are faced with a number of significant shocks, most notably the ongoing uncertain conditions in credit markets, rising oil and commodity prices and a sharp fall in the exchange rate.

As these various shocks play out in the domestic economy, it is highly likely that for a period output growth, and more particularly inflation, will prove volatile. The perceived uncertainty resulting from this volatility may well be reinforced by the varying outlook for the components of demand.

This evening I will set out how and why the balance of growth in the economy is likely to be changing, look at downside risks to the overall rate of output growth (particularly from the credit and property markets), consider upside risks to inflation and finally draw these themes together with some reflections on the balance of risks.

Changing balance of economic growth

Over the past decade, overall growth in the economy averaged an annual 2.9%¹, household consumption growth was 3.3%, business investment growth 5.8% and net trade made an average negative contribution of 0.5 percentage points. Unemployment declined from 7.1% in 1997 to 5.5% in 2007 (on the ILO measure).

This pattern of economic growth was unlikely to continue indefinitely. A particular vulnerability is the worsening external trade position on goods and services, which was being offset by an overall favourable rate of return on UK investment abroad relative to that on UK foreign-owned investment. Latest data suggest that the latter has been eroded – the current account deficit for the first three quarters of 2007 averaged 4.9% of GDP. This, together with the recent sharp fall in the exchange rate, suggests that an adjustment of the economy towards exports growth outstripping imports, should now be in prospect. This means that exports should be supported despite slowing overseas demand, if the decline in the exchange rate were to be sustained. In turn this would tend to support business investment.

At the same time, household debt rose rapidly. For many households their asset holdings have also increased, due in large part to the nominal 211% rise in house prices since 1997, with the house-price/earnings ratio almost doubling. While the sustainable house-price/earnings ratio has probably risen over this period, even taking

¹ Average growth rates from Q1 1997 to Q3 2007.

into account the fall in long-term real interest rates and easing in credit conditions (until the recent past) the scale of this increase is difficult to justify.

Other factors behind the economic changes of the last decade or so were also likely to come to an end at some point. In particular this applies to the fall in the rate of unemployment consistent with stable inflation, and the decline in real long-term interest rates (Chart 1). These trends tended to support higher levels of household borrowing, and may have come to an end at the same time as real household income growth is being squeezed. Households might well have extrapolated the strong trend in average real labour income growth during the early years of the MPC (until around 2004) as being permanent. Since then, real incomes have grown less strongly, and as this is now likely to persist for a time, households may be revising down their income expectations - and household spending may slow further as savings are increased. Together with the impact of tighter credit conditions, this accounts for the weakness in consumer spending expected in the Bank's latest *Inflation Report*.²

Expectations of rebalancing are also reflected in equity price movements by sector. Equity prices overall were perhaps surprisingly resilient in the autumn of 2007. But as the financial market turmoil has proved prolonged, and it has become clear that the central banks are not able and/or willing to offset the whole impact of credit tightening on output, equity markets have both weakened and become more volatile.

By the end of last week, since the turmoil began in early August, the Standard and Poors 500 in the US had fallen by 10%, and the UK FTSE All-Share by 10.5%. Some sectors had performed more strongly – for example in the UK oil, gas and utilities sector had risen slightly over the whole period, while basic materials were up by 28%. While the industrial sector had fallen by 15%, the financial sector had been particularly weak, down 23% and consumer services down 19%. Property had performed poorly, with the real estate sector down 22% and the housebuilders sector down 47%.

² Bank of England (2008).

Downside risks to growth and inflation

With a variety of shocks affecting the economy, it is unsurprising that there is also a wide range of risks. On the downside, the risk I believe to be of most concern is around the interplay between the property market and the financial sector resulting from the credit turmoil. There are clear signs of a marked weakening in both the commercial and residential property markets. Commercial property prices fell by 12% in the second half of 2007, and latest data from the major lenders suggest that house prices declined slightly over the three months to January.

While the outlook for house prices is always highly uncertain, it is likely that prices will decline in the short-term relative to earnings, and falls in nominal terms cannot be ruled out. An added uncertainty is whether consumers might respond proportionately more to downside news on house prices than to upside. There is only one recent study of which I am aware that investigates such asymmetric behaviour in the UK.³ This concludes that there was no significant tendency for spending to respond more to falling house prices than to rising. Indeed, to the extent that the large rise in house prices over the past decade has resulted in high levels of housing equity, there should be ample opportunity to borrow against housing equity for many even if house prices were to fall – in general the level of housing equity may be more important than the direction of change in house prices. It is worth noting that it has been calculated, on a very pessimistic assumption of a fall in house prices of 15%, that only 5% of mortgagors (around 2% of total households) would find themselves in negative equity (Chart 2)⁴. The constraint in present circumstances is more likely to be whether or not lenders are willing to meet the demand for borrowing.

More important risks relate to the effects of the credit market tightening, including the risk that some less high quality borrowers reaching the end of two year fixed-rate mortgages during 2008 may find that they have to re-finance onto the much higher standard variable rate. The impact of this could be very significant for those households, but should not be so for the economy as a whole.

³ Disney, Gathergood and Henley (2007).

⁴ The calculations in Chart 2 are based on the 2007 NMG Survey reported by Waldron and Young (2007).

The most significant, but less likely, downside risks are those associated with the linkages between the financial sector and the property market. A prolongation of the present difficulties in accessing wholesale funds could restrict the quantity of mortgage lending during 2008. In this case the mortgage market could become less competitive and more expensive, feeding back into a decline in the housing market, somewhat lower consumer spending, and also into lenders' balance sheets, reducing lending capacity further. A similar risk exists with regard to commercial property and the balance sheets of both borrowers and lenders. If these risks were to crystallise to any great extent, there would be clear potential for much weaker output growth as reduced credit availability would adversely affect both consumption and companies' ability to invest. This would also tend to result in lower inflation in the medium term than the MPC's present central projection. It is for this reason that the MPC will continue to monitor property and financial markets closely.

Factoring large risks into the monthly policy decisions is not easy. In some instances, such as a sharp fall in exchange rate, the MPC is likely to have sufficient time after the risk has emerged to offset the consequences, as the inflation response feeds through only over a period. However, if credit tightening were to prove more severe than in the MPC's present central projection, leading to a significant fall in lending to households and companies, this could prompt a further decline in property values. The consequent adverse impact on growth could prove difficult to turn around quickly, potentially resulting in a protracted period of low output growth and below-target inflation. This would argue for giving this risk some weight in decisions now.

This would be consistent with the MPC's remit which invites us, subject to achieving the Government's target for inflation, to support the Government's objectives for growth and employment. There are circumstances in which undue volatility in growth, either up or down, should be avoided, provided (a vital proviso) this seems likely to prove consistent with achieving the inflation target over the medium-term. While there is no long-run trade-off between growth and inflation, in the short term there may be choices between different paths for the economy. The aim is to strike the right balance between limiting the social and economic costs associated with output volatility, given the overriding goal of ensuring that inflation does not move away from target for a prolonged period.

Upward risks to inflation

Unfortunately, the strong upward inflation pressures in the UK today make it difficult to argue for large reductions in Bank Rate to reduce this downward risk. Higher global prices, particularly for energy and food, are still feeding through the supply chain, amply illustrated by the sharp rises in producer price inflation in January, both for input and output prices. Including the estimated impact of the announced rises in domestic energy bills, CPI inflation is expected to be considerably above the 2% target for much of the rest of 2008. There is little that monetary policy can now do to dampen this peak. In addition, the fall in the sterling exchange rate, down over 8% since just before the credit market turmoil began in August 2007, will, if sustained, tend to push up on consumer prices throughout the forecast period as importers and their customers adjust.

A period of above-target inflation, driven primarily by global factors, is not necessarily a concern. Indeed, the rise in CPI inflation last year was weathered successfully, in so far as neither pay settlements nor average earnings picked up to the same extent. Will a second year of squeeze on real earnings produce greater upward pay pressure? There is not, as yet, very much evidence on this year's pay round. The Bank's Agents survey on pay around the turn of the year was reassuring, and did not suggest that inflation would put particularly strong upward pressure on pay in 2008. And there is a background of greater economic uncertainty which may limit pay pressures as wage bargainers become more concerned about employment prospects. The GfK consumer confidence survey suggests that households are not very confident in the future of the economy - even though they remain reasonably confident about their own situation. Unemployment has been quite stable in recent months and employment has picked up, but the trend in business surveys for future employment has generally been down over the last quarter.

However, it is not clear what rate of increase in average earnings would give rise to concern in present circumstances. A figure of 4.5% is often cited in this context – for example a comment in the latest Institute for Fiscal Studies Green Budget: “The Bank of England believes that pay increases of around 4.5% across the whole economy

would be consistent with the inflation target.”⁵ This figure, which was cited in a number of *Inflation Reports* in 1997 and 1998, was certainly never intended to be a guide for every situation, but rather a rough guide to what average earnings increase over a longer period would be consistent with achieving the inflation target, assuming that annual productivity growth remained close to 2%⁶. Within this average, individual settlements will of course reflect the particular conditions of demand and supply.

In the short term, variations in productivity growth and in other costs need to be taken into account. At present, increases in energy and other imported costs imply less scope for labour cost increases, and therefore suggests that wage inflation needs to be lower than average for a period relative to inflation, and possibly also in money terms, to be consistent with the inflation target in the medium term.

The immediate outlook for wages is only part of a wider concern about the overall picture for UK inflation expectations. The central projection in the latest *Inflation Report* makes it clear it is more likely than not that over this summer CPI inflation will reach the level where an open letter from the Governor will be triggered for only the second time. Not too much significance should be attached to this. When the MPC was first established, it was suggested, on the basis of recent past experience, that these open letters would be quite frequent⁷. In fact, there were few large supply side shocks in the first decade of the MPC, and inflation was kept within one per cent either side of the target in all but one month. But the recent sequence of shocks stemming from oil and commodity prices, and the exchange rate, inevitably leads to greater short-term inflation volatility. Open letters may well become more frequent. Indeed, were energy prices to fall back sharply in the next twelve months, there would be a risk of an open letter because CPI inflation is too far below target.

The real concern is whether this renewed bout of inflation well above target could spark off a lasting rise in inflation expectations that posed a serious risk to keeping

⁵ IFS Green Budget 2008.

⁶ For details on the impact of the change in inflation target on this estimate see Nickell (2003).

⁷ Bean (1998) suggests inflation would deviate from target by more than the 1pp required to trigger an open letter more than 40% of the time.

CPI inflation on target. If this occurred, it could be very costly to reverse. Certainly at the moment many of the short-term indicators are worrying – household inflation expectations in the Bank’s own survey rose in late 2007, and picked up quite sharply in the Citigroup survey in early 2008. Business surveys also indicate that short-term expectations for output prices are unusually strong - for example the Chartered Institute of Purchasing Survey for the services sector shows price expectations the fourth highest since the survey began.

These indicators are probably not very informative about where inflation will settle in the medium-term. They can be volatile – for example services price expectations dropped back quite sharply during 2007. But household inflation expectations remained high in late 2007 despite the fallback in CPI, possibly influenced by inflation remaining high as measured by the RPI. If that is the case, they may fall back later this year. In 2001, inflation perceptions from the GfK survey fell back quite sharply with RPI inflation, although this has not invariably occurred (Chart 3). And RPI inflation could weaken relative to CPI in 2008 if house prices were to remain weak. Nevertheless, the strength of short-term upward inflation pressures indicates a very real risk that those involved in price and wage setting may persistently have inflation expectations too high to be consistent with the CPI target.

Conclusions on the balance of risks

It may have been inevitable that the largely favourable economic backdrop to monetary policy of the first ten years would not prove permanent, but the precise combination of shocks experienced since August 2007 was obviously unexpected. Today I have discussed the likelihood that the near term outlook is for a rather different balance of growth in the economy than the recent past, with consequently varying pressures on the companies represented here. Such a re-balancing is not unexpected or unwelcome – but as last week’s *Inflation Report* made clear, it is likely to take place within the context of an overall sharp slowdown in output growth.

Policy decisions at present are unusually dependent on judgements about risks to the central projection. Monetary policy is not able to prevent either the short-term inflation peak, or arguably do very much to improve financial markets liquidity and credit supply. So our judgements are about offsetting the potential effects of these

developments on medium-term inflation, in the context that the risks of an outturn considerably above or below target in the medium term are both unusually high. My chief concern is the significant possibility of a large downside risk to growth, and therefore to inflation, as the impact of the credit tightening works through the economy. I rate this a little higher than a large upside risk to inflation over the medium-term from dislodging inflation expectations on the upside. And the change in credit conditions themselves means that any given level of Bank Rate is somewhat more restrictive. However, while this might suggest an immediate case for lowering interest rates further, it is not compelling. After all, at the end of 2007 the level of activity in the economy was still judged to be a little above trend – and the slowdown, which the MPC thought necessary last August to keep inflation at target, has only just got underway. At the same time, the upward inflation pressures have continued to build and over the next few months it is likely to be higher inflation, not slower growth, which is the dominant story in the data.

In addition, despite the warning signals from credit conditions surveys, the overall tone of the economic data so far is still quite positive. Beyond the property markets, there are no clear signs of a downturn. Retail sales may have been weak in December, but a full picture of consumer resilience around the turn of the year is not yet available. And a more positive forward scenario can be painted. If the US economy responds positively and quickly to the policy stimulus there, then alongside continued robust growth in Asia, this might help to improve financial market confidence and produce an outcome for growth stronger than the central projection.

Over the next few months I will be monitoring credit conditions, including the ability of financial institutions to gain access to finance, asset prices and inflation expectations in order to assess how the likelihood of the different risks is shifting. Judgements about the correct policy response may need to be unusually flexible, with much more uncertainty than normal around the future path of policy rates. This will mean a major challenge in communicating clearly how the evidence is informing our judgements, and how we are responding in order to fulfil our determination to keep inflation on target in the medium-term.

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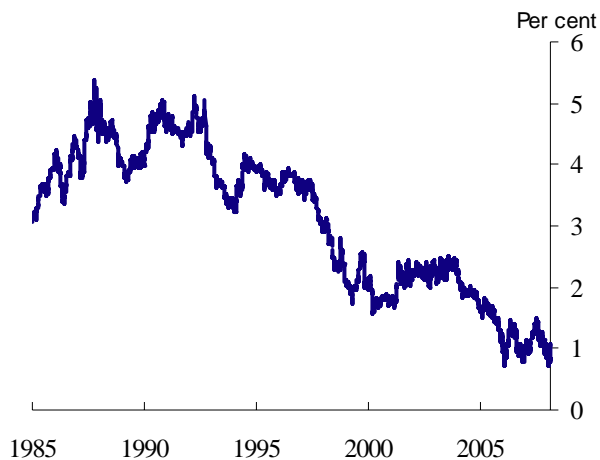
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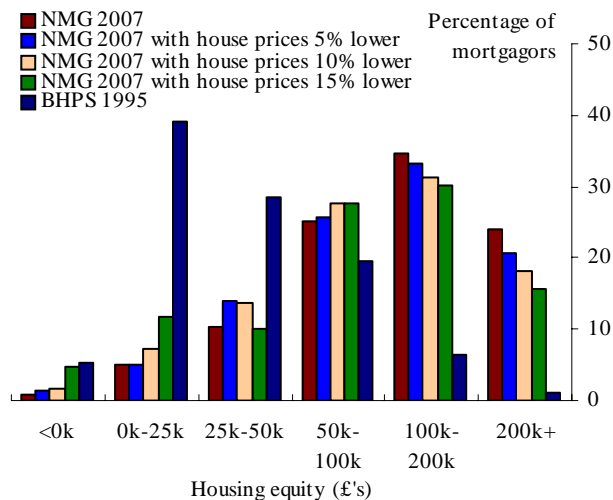
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Chart 1: UK 10-year real forward rates



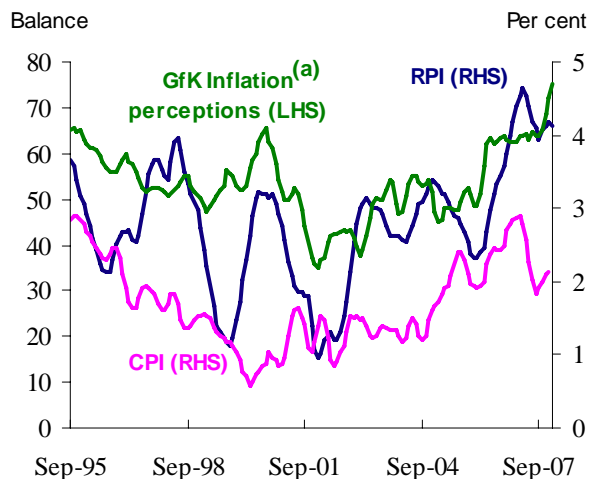
Note: Real forward rates derived from index linked government bonds
Sources: Bloomberg and Bank calculations

Chart 2: Illustrative distribution of housing equity with lower house prices



Sources: BHPS, NMG Research survey and Bank calculations.

Chart 3: Inflation and inflation perceptions



(a) Net balance believing consumer prices to have increased over the past 12 months.

Note: Data show the three-month moving average.
Sources: Bank of England, GfK NOP and ONS