Speech by

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ECONOMIC RECOVERY, THE HOUSING MARKET AND INFLATION

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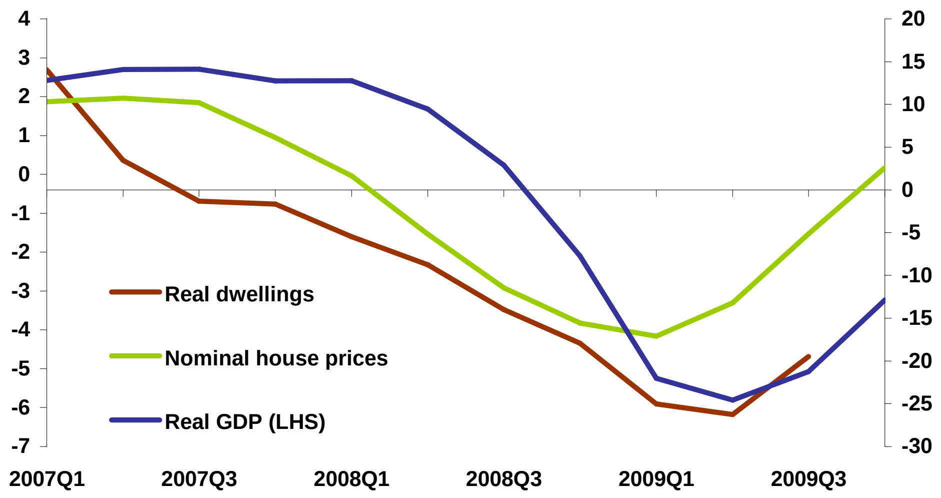
I would like to thank Michael Hume and Abi Hughes for research assistance and I am also grateful for helpful comments from other colleagues. The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

It is a great pleasure to be able to give this keynote address to the British Property Federation Residential Conference. My association with the BPF goes back many years. In the mid-1990s, when I was working at London Business School, I acted as a part-time economic advisor to the Federation, helping with briefings and submissions to the government. The main focus of my work then was the commercial property market, and that remains an area of great interest both for property practitioners and for policy-makers in the current cycle. But as this is a conference dealing with residential property, my comments today will be directed more towards the outlook for the housing market.

Chart 1: GDP and the housing market, 2007-2009
Year-on-year percentage changes



Source: Office for National Statistics, Nationwide, Halifax and Bank calculations

Over the last two years, the UK economy and its housing market have been on a giant roller-coaster, as all the world's major economies have been buffeted by the global financial crisis. Private housing investment in the UK fell by about 30% from mid-2007 to mid-2009. And house prices dropped by over 20% from their peak in Autumn 2007 to their trough last spring. These developments were accompanied by a major recession affecting all sectors of the UK economy. GDP is currently estimated to have dropped by around 6% between early 2008 and mid-2009.

However, the last six to nine months have seen a more positive trend emerging in both the UK economy as a whole and more specifically in the housing market. Indicators of housing market activity have picked up, albeit from very low levels. House prices have bounced back more strongly than many had expected, rising by around 6% in the year to December 2009. At the same time, business and consumer confidence have recovered more broadly. The latest GDP figures released yesterday also showed a return to growth in the final quarter of last year though other indicators – from the labour market, business surveys and measures of retail spending – continue to suggest that recovery started earlier and may have been stronger than the provisional GDP estimates currently suggest.

But this turnaround in the economy as a whole and in the housing market is clouded by great uncertainty about the way that the recovery will develop in the years ahead. So I want to start today by discussing UK recovery prospects, before moving on to address the implications that this could have for two key aspects of the performance of the UK economy – the impact on the housing market, which is clearly of great interest to this conference today, and the implications for inflation, which is a key issue for how the MPC will respond to the recovery in setting interest rates going forward.

Prospects for UK economic recovery

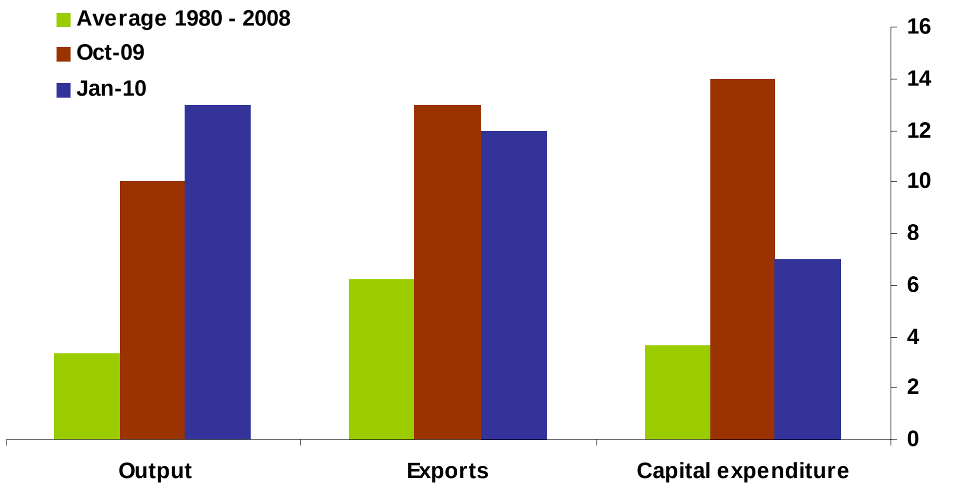
Though we have seen signs of a return to growth in the British economy in recent months, it is very understandable that there is still a lot of nervousness and uncertainty about the future pace of growth. Some of this uncertainty is an inevitable consequence of the fact that we are in the very early stages of the recovery. Indications of a return to growth have only been apparent since the second half of last year. And it is worth recalling that this time last year economic activity was still falling sharply as the global recession deepened and world trade collapsed.

Those who remember the early stages of the 1990s recovery, as I do, will recognise this feeling of nervousness and uncertainty as we were coming out of the previous recession. Indeed, at an equivalent stage of the cycle in the early 1990s, the UK economy did bump along the bottom for about a year, in late 1991 and early 1992, before growth properly resumed in the second half of 1992.[1]

However, in addition to this natural degree of uncertainty which is characteristic of this phase of the cycle, there are two particular headwinds which businesses and economic commentators believe could act as a dampener on recovery.

The first is the balance sheet adjustment taking place in the financial sector, and in particular within banks. Unlike previous post-war UK recessions, this one was driven by a financial crisis precipitated by risky lending, particularly in the property sector. This is affecting the attitude of banks towards lending in the upswing, as they seek to repair the damage to their balance sheets from past losses.

Chart 2: External finance as a constraint
Percentage of manufacturers



Note: Weighted percentage of respondents reporting credit or finance as a limiting factor
Source: CBI Quarterly Industrial Trends survey

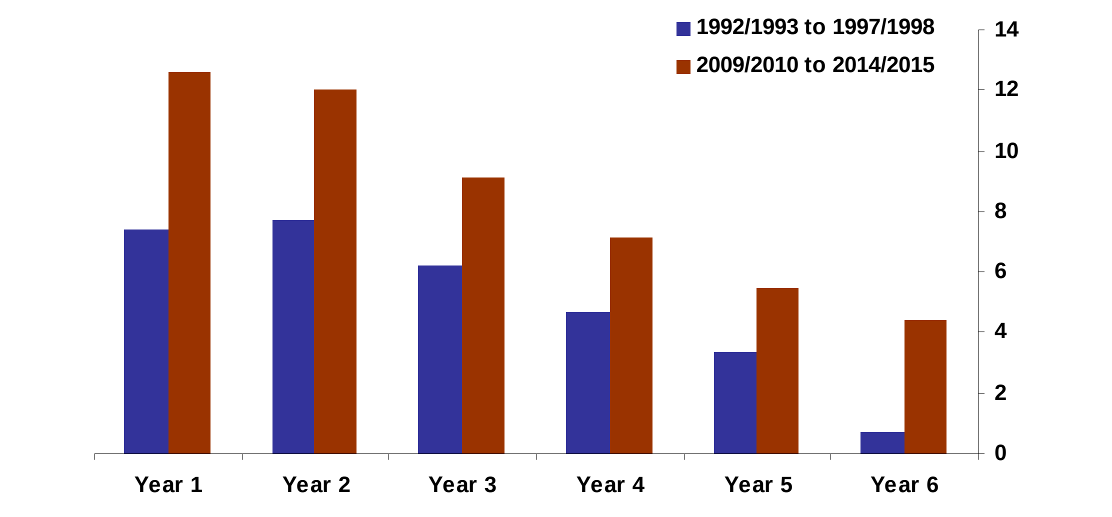
These constraints in the banking system are affecting the availability of finance, to both households and business. Business surveys, such as the long-established CBI Industrial Trends Survey, show unusually high proportions of companies reporting that lack of availability of finance is constraining investment, output and exports, as Chart 2 shows. Over time, as the financial health of the banking sector improves, we

[1] It is also worth observing that initial estimates of growth were very weak throughout 1992. Subsequent data revisions show that growth in the second half was quite healthy, with GDP rising by over 1% over two quarters

should see a "new normality" establish itself in terms of bank lending. But though constraints on finance should ease as the macroeconomic climate gradually improves and bank balance sheets are strengthened, we should not expect a return to the cavalier attitudes to risk seen in the mid-2000s, at the peak of the global credit boom.

However, if this headwind from the financial sector eases over the coming years another one may be gathering force. The UK economy is likely to face another drag to demand as the government seeks to rebalance its finances, and cut the very large public deficit which has emerged over the recession. In one sense, we have been here before as there are parallels between the process of fiscal consolidation projected for the next five years and the deficit reductions achieved in the 1990s recovery. As Chart 3 shows, the scale of reduction in public borrowing projected in the latest Pre-Budget Report is similar to the fiscal tightening experienced in the mid-1990s.

Chart 3: Public sector deficits, 1990s and 2010s
Public sector net borrowing, percent of GDP



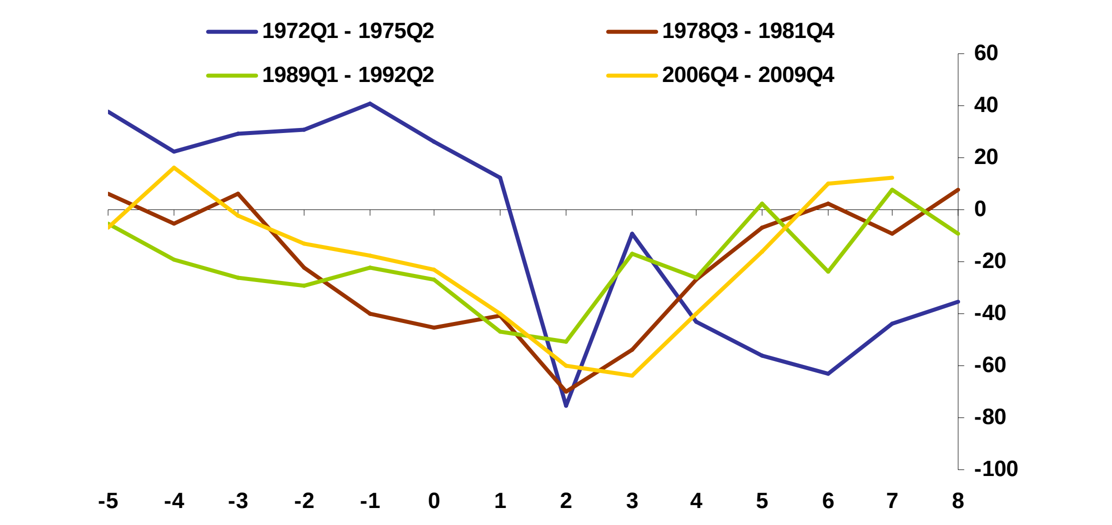
Source: HM Treasury

This 1990s rebalancing was accompanied by reasonably healthy growth, driven by private sector demand – which should give us some encouragement that the same can happen this time around. However, the public finances are starting from a larger deficit position than at the start of the last recovery. There is a risk that fiscal policy is tightened more aggressively after the election – or that the sheer scale of the deficit acts as a bigger drag on private spending, because of the fear of future tax rises and/or spending cuts. However, these concerns should not be overplayed. It is the growth of activity and spending in the private sector which will ultimately determine the pace of recovery in the UK economy over the next 3-5 years. A key challenge for policy-makers is to ensure that this private sector engine of growth can play its full part in driving the economy forward as the public sector rebalances its finances.

The turnaround in the UK economy and the return to modest expansion over the second half of last year provide grounds for encouragement about the resilience of the private sector. As I have visited businesses round the country through this recession, I have been struck by the way most companies have developed strategies to cope with the very abrupt downturn they have faced – both in terms of taking the short-term actions necessary to deal with a sharp drop in demand, and their commitment to keeping vital capacity and skills in place for when the upturn comes. In particular, businesses appear keen to maintain the resources of skilled labour in which they have invested for many years, perhaps recognising the error of shedding labour too rapidly in earlier recessions.

I take this resilience as a sign of medium-term confidence in the health and vitality of British business, and a very encouraging sign for the UK economy to sustain an upturn. In a recent newspaper interview, I described it as the "bouncebackability" of British business.[2]

Chart 4: CBI business confidence
Percentage balance of manufacturers, 0 = cyclical peak in output



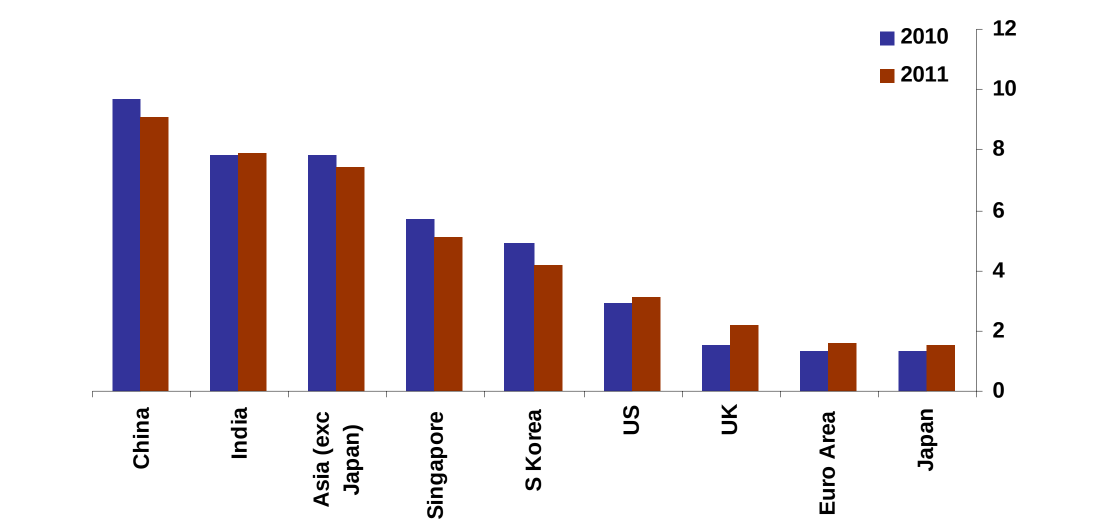
Note: The percentage balance of firms more optimistic about the economic situation minus the percentage less optimistic
Source: CBI Quarterly Industrial Trends survey

[2] "Bouncebackability" was a term coined in a football context by former Crystal Palace manager, Iain Dowie, in 2004.

We can see this in the measures of confidence recorded by business surveys. The CBI Industrial Trends Survey of manufacturing firms is the longest running series of business confidence, which has tracked industrial sentiment through all four major postwar recessions. As Chart 4 shows, business confidence was hit harder in the early stages of the recession than in previous postwar recessions. But the recent responses from the Survey show stronger readings on this business confidence measure than we saw at an equivalent point in the cycle in the mid-70s, early-80s and early-90s recoveries.

Alongside these signs of business resilience and confidence, there are two other potential supports to the recovery, to counter the headwinds from the financial sector and a consolidation of public finances. The first is from the international economy. In my time on the MPC, I have been struck how heavily influenced the UK economy has been by global economic prospects. This partly reflects the traditional trade multipliers – through which rising export activity boosts growth in manufacturing and in tradable services. But it also reflects other channels of influence from the global economy. The UK is a centre of activity for many international businesses, and is very open to flows of international investment. Our financial system is also very international, and the City of London is one of the largest financial centres in the world.

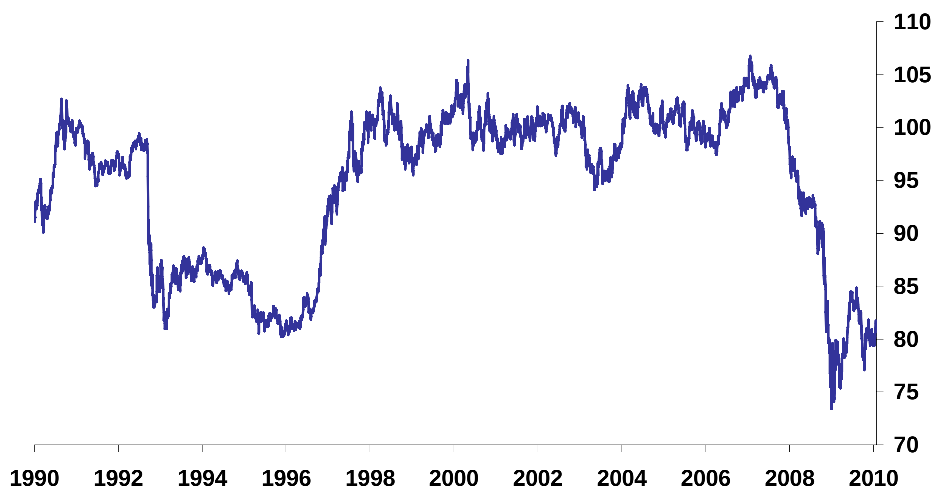
Chart 5: International growth forecasts, 2010 and 2011
Annual percentage change in real GDP



Source: January 2010 Consensus forecast

The turnaround in the international economy over the last nine months has been particularly impressive. As Chart 5 shows, this has been driven particularly strongly by Asian economies, which are projected to continue to grow robustly through this year and next. The US economy is also projected to grow at around 3% in 2010 and 2011, around its average growth rate over the last thirty years.[3] The Euro area, which is the UK's major export market, is not currently forecast to grow particularly strongly over the next couple of years. But here, the British economy has another source of advantage – a competitive exchange rate.

Chart 6: Sterling effective exchange rate
Index 2005 = 100



Source: Bank of England

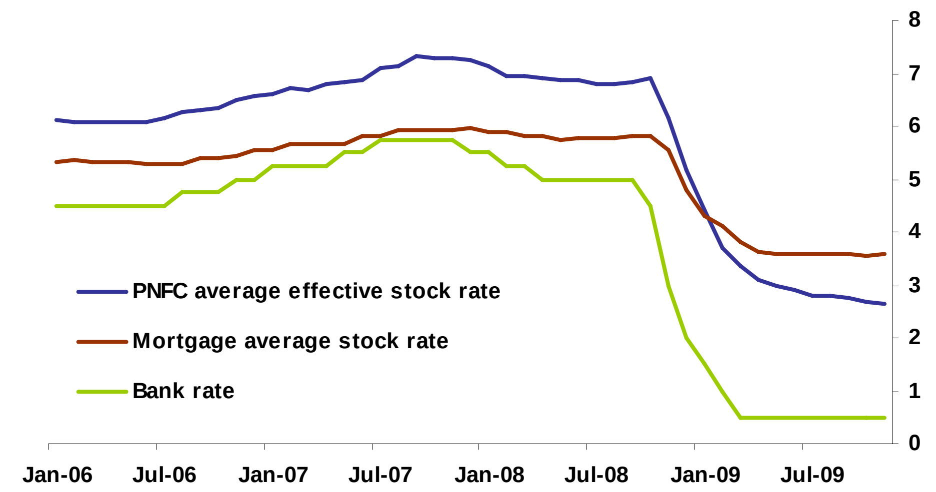
As Chart 6 shows, the effective sterling exchange rate now appears more competitive than it was in the mid-1990s when we last had a period of strong export-led growth. The pound is particularly competitive against the euro – over 20% below its average level in the decade 1999-2008. Until the middle of last year, it was difficult for exporters to capitalise on this advantage, with export markets heavily affected by the global recession. But as export markets have recovered, export confidence has improved and the CBI Industrial Trends Survey now shows the strongest responses on export prospects for the next twelve months since the mid-1990s.[4]

[3] US GDP growth from 1979 to 2008 averaged 2.9%..

[4] The percentage balance of firms reporting optimism about export prospects was +19% in January 2010, up on 16% in October 2009. These were the highest responses since July 1995 (+21%).

These factors – a reasonably robust world economy and a competitive exchange rate – should provide a significant international tailwind to offset some of the other headwinds to recovery. As long as the international economy continues to grow healthily, I believe we should avoid the feared "double-dip" recession. But the pace of recovery is still very uncertain. The UK will also need a reasonably healthy contribution from private sector consumer and investment demand if it is to sustain growth over the recovery

Chart 7: Bank rate and borrowing rates, 2006-9
Percent



Source: Bank of England

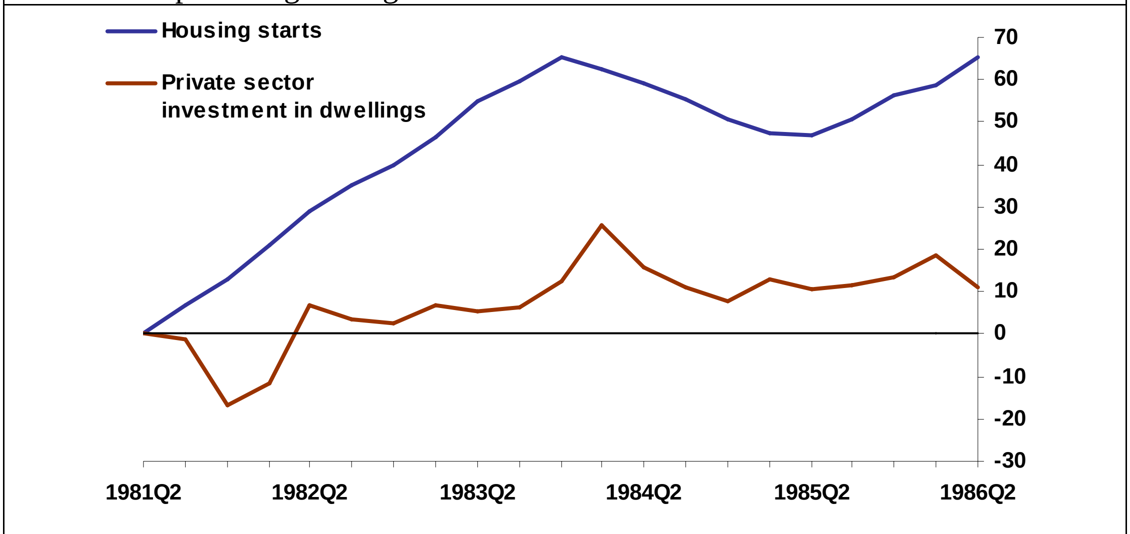
In the UK, as in other countries around the world, monetary policy has been loosened aggressively to support private sector spending. Bank rate has been cut from 5% to 0.5%, which has fed through into lower borrowing costs for businesses and householders, as Chart 7 shows. But set against this, we need to recognise that the problems in the financial sector create an additional headwind to the ability of monetary policy to support demand, as banks seek to widen their margins and are cautious about new lending. The need to counter this headwind was one reason why the MPC embarked on its policy of Quantitative Easing last March. The turnaround in the economy since then suggests that this policy is beginning to have an impact, though we have yet to see its full effect on the level of economic activity.

The combined impact of low interest rates and Quantitative Easing should continue to be supportive of economic growth through 2010, though as the current strains in the financial sector begin to ease, the MPC will need to assess whether monetary policy needs to be so supportive of growth, and whether there are inflationary risks from such a policy. I will come back to this issue shortly. But first, let me discuss some of the implications of the recovery which is in prospect for the housing market.

The housing market

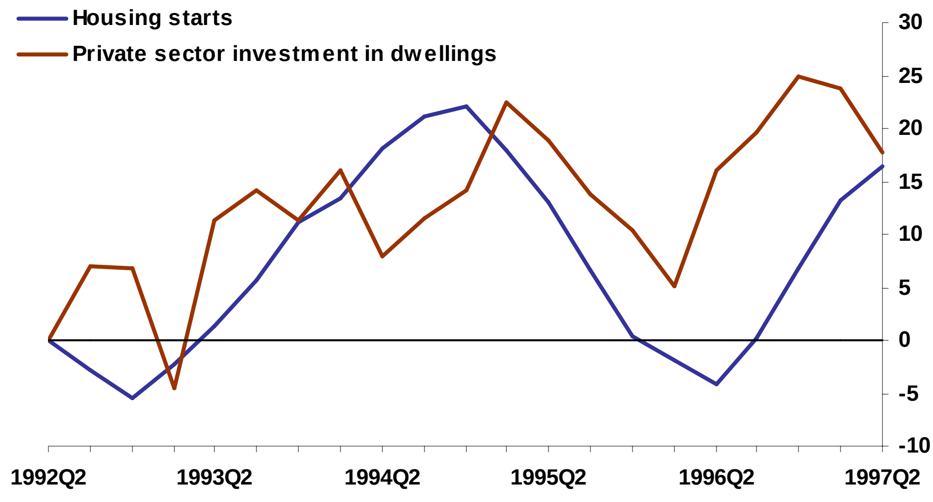
As I have already observed, the housing market has turned around at roughly the same time as the rest of the economy. This does not mean that the housing sector is driving the British economy – which is a commonly held view. Rather, it reflects the fact that a common set of influences have been driving developments both in the housing market and the economy as a whole. Both the housing market and the rest of the economy were depressed by the ongoing "credit crunch" and the shocks to consumer and business confidence associated with the financial market turbulence in the autumn of 2008. The monetary policy and other responses to these shocks have gradually restored confidence, and financial markets have recovered to some extent. As a result, the economy has stabilised and begun to grow again and the housing market has also begun to recover, both in terms of activity and prices.

Chart 8a: Housing starts and private housing investment, 1980s recovery
Cumulative percentage change



Source: Office for National Statistics

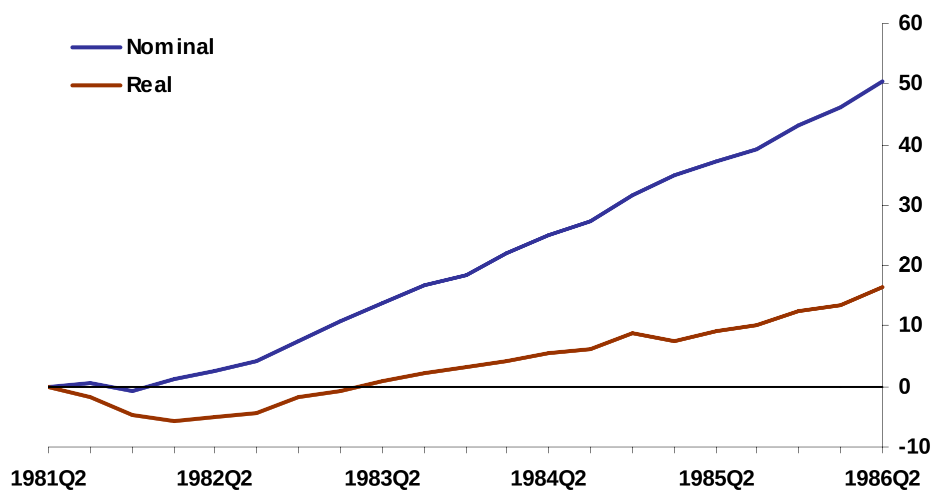
Chart 8b: Housing starts and private housing investment, 1990s recovery
Cumulative percentage change



Source: Office for National Statistics

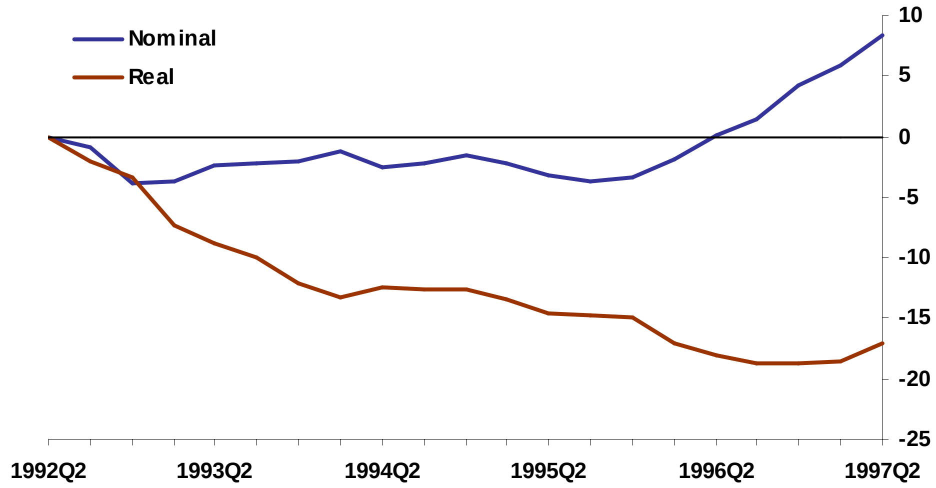
So what is likely to happen next in the UK housing market? Chart 8a and 8b show the experience of previous economic recoveries, in terms of key activity measures – housing starts and new investment in dwellings. Housing investment was relatively slow to recover in both the 1980s and 1990s and the recovery was volatile. Housing starts bounced back much more strongly in the 1980s than the 1990s which reflected the overhang of surplus properties from the late 1980s housing boom which acted as a dampening factor on the housing market through the first half of the 1990s.

Chart 9a: Real and nominal house prices, 1980s recovery
Cumulative percentage change



Source: Office for National Statistics

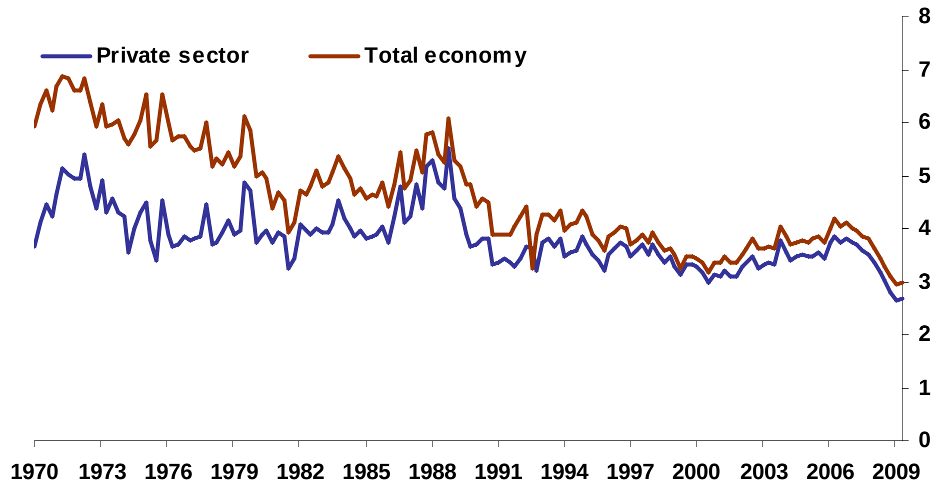
Chart 9b: Real and nominal house prices, 1990s recovery
Cumulative percentage change



Source: Office for National Statistics

House price trends – shown in Charts 9a and 9b – also reflect this contrast between the two previous housing market recoveries. Whereas house prices recovered relative to inflation in the early 1980s, the first half of the 1990s saw real house prices continuing to fall before stabilising around 15% below their level at the start of the recovery. These differences suggest that the degree of imbalance in the housing market is an important factor influencing the performance of the housing sector over the recovery, both in terms of activity levels and prices. .

Chart 10: Housing investment
Real investment in dwellings, percent of GDP



Source: Office for National Statistics

In terms of the balance of demand and supply in residential property, most of the evidence suggests that the current position is closer to the early 1980s situation than the early 1990s. The long-run trend in housing investment in relation to GDP, shown in Chart 10, also supports this view. Unlike the late 1980s, there was no big spike in housing investment in the mid-2000s, and housebuilders were quick to cut back on activity as they saw the downturn coming, heeding the lessons from the previous cycle. Indeed, this has taken the level of investment in new dwellings to a historically low level, both in terms of private housing and whole economy investment.

So the underlying forces – in terms of the balance of demand and supply – are likely to be more positive for house prices and investment than in the last recovery in the early 1990s, which may help to account for the bounce in house prices we have seen over the last year. In the short-term, the problems in the banking system are likely to continue to act as a dampener on the growth of housing demand. However, if the pressures in the banking system ease over the next couple of years, there could be scope for a much stronger recovery in the housing market, especially if interest rates remain low and monetary conditions remain as relaxed as they are at present. So a key issue for future housing market prospects is how monetary policy evolves, which is the issue to which I will now turn.

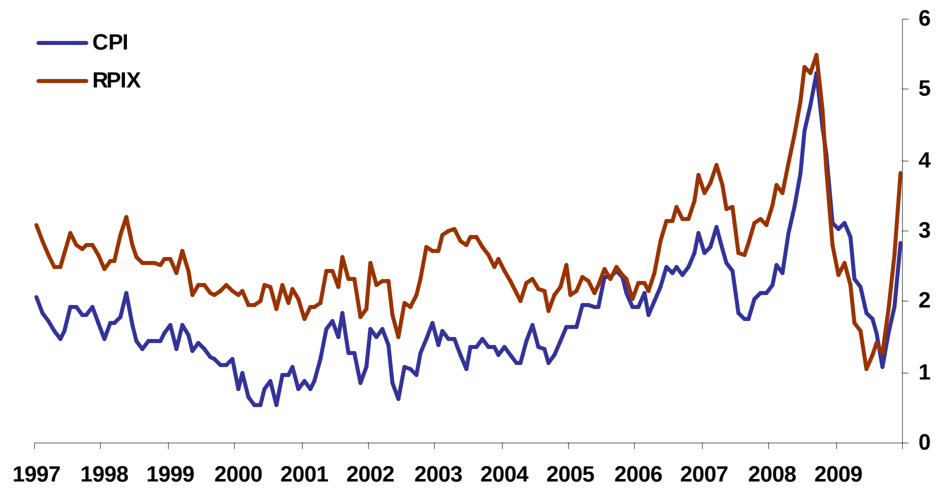
Inflation prospects and monetary policy

The Bank of England Monetary Policy Committee takes its decisions in relation to an inflation target – currently a 2% annual increase in the consumer prices index (CPI). In my view this remains a sensible framework for UK monetary policy, and one which has provided the most stable platform for economic growth in the UK since the collapse of the Bretton Woods system in the early 1970s which brought to an end the long expansion of the 1950s and 1960s.

Inflation targeting does not solve all known economic ills. As we have discovered, we are still vulnerable to global economic volatility from the financial system and from energy and commodity price fluctuations on world markets. But it is not clear that a different monetary policy regime would have shielded us better from these shocks, and there is little in the experience from other countries to suggest that.

Perhaps the most important lesson from the recent financial crisis is that a sound framework for monetary policy should do what it says on the tin – keep a check on inflation over the medium-term and prevent sustained deflation. In a small, open economy like the UK, monetary policy should not be and cannot be an antidote to all sources of economic volatility, particularly when these economic fluctuations are driven by global economic factors.

Chart 11: Inflation, 1997-2009
Annual percentage change in prices

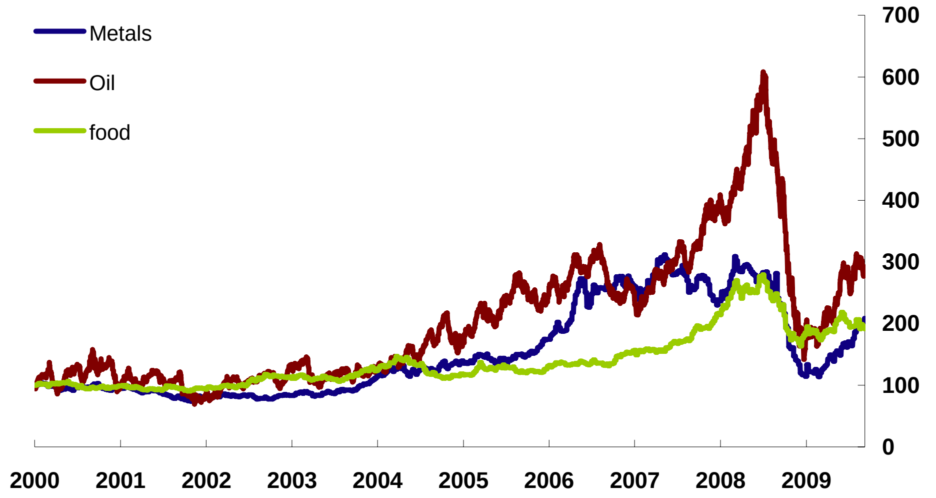


Source: Office for National Statistics

Chart 11 shows the two measures of inflation which the MPC has been tasked with targeting while it has been in existence – RPIX, which was the target variable until 2004, and the Consumer Prices Index, which has been the basis of the inflation targets since then. On both measures, there is a clear break in 2006/7, from the pattern of relative stability which prevailed in the first decade of the MPC regime, and the more erratic moves of inflation we have seen since then. Over the last three years, inflation has been quite volatile, moving as high as 5.2% in the Autumn and then dropping to just over 1% a year later. As we saw last week, CPI inflation has since moved back rapidly above target – ending last year at 2.9%, just short of the level which would trigger an explanatory letter from the Governor to the Chancellor of the Exchequer.

Though there has been some criticism directed recently towards the use of CPI inflation as the basis for our inflation target, it is worth noting that the old RPIX target variable has behaved very similarly. On both measures, inflation has been volatile and above the norms experienced in the first decade of the MPC.

Chart 12: Global energy and commodity prices
Index 1 Jan 2000 = 100



Note: Oil price is Brent forward price for delivery in 10-21 days
Source: Thomson Datastream

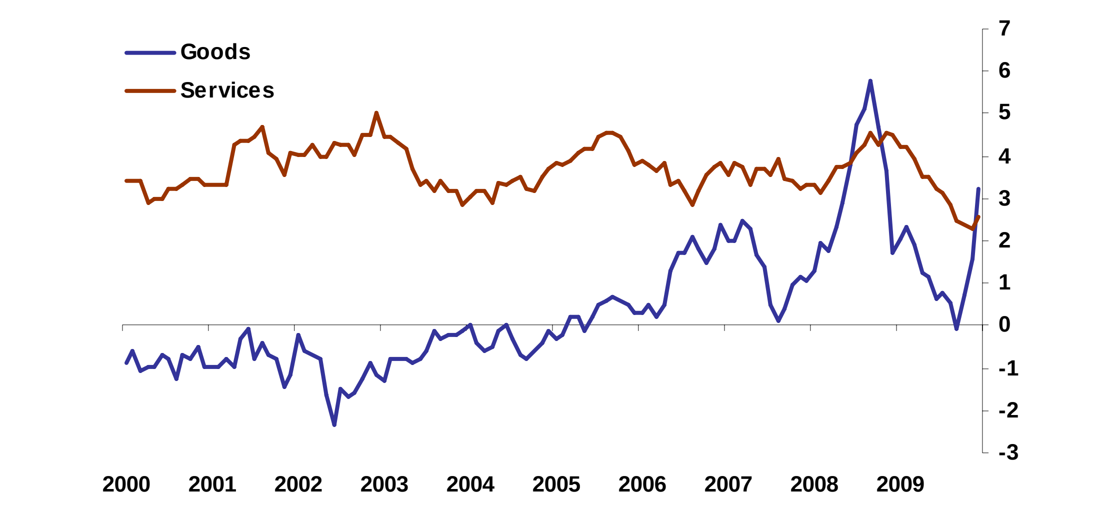
The volatility of inflation is not hard to explain. We have seen exceptional movements in global energy and commodity prices, especially the oil price – which has fluctuated between $40 and $150 over the last couple of years. As I have argued in recent speeches last autumn[5], we could well see continued inflation volatility from this direction. If the world economic recovery continues to gather momentum, there must be a substantial risk that this will be accompanied by further upward pressures on global energy and commodity prices, as we saw in the mid-2000s.

But while the volatility of inflation can be largely explained by global factors, it is not clear that this can fully account for the above-target inflation we have experienced at the same time. Inflation has been, on average, above target for most of the last three years. In twenty-seven of the last thirty-six months, inflation has been above the 2% level – and below target in just nine months. In the wake of the severe recession we have experienced over the last eighteen months, we would normally expect there to be strong downward pressure on inflation. Though we have seen recent evidence of

[5] See, for example Sentance, A (2009) "Energy and environmental challenges in the New Global Economy", Speech to the British Institute of Energy Economics, September.

subdued wage increases, this has not yet fed through into headline measures of inflation. And inflation is likely to be pushed up higher in the early months of this year as the December 2008 VAT cut is reversed.

Chart 13: Goods and services CPI inflation
Annual percentage change in prices

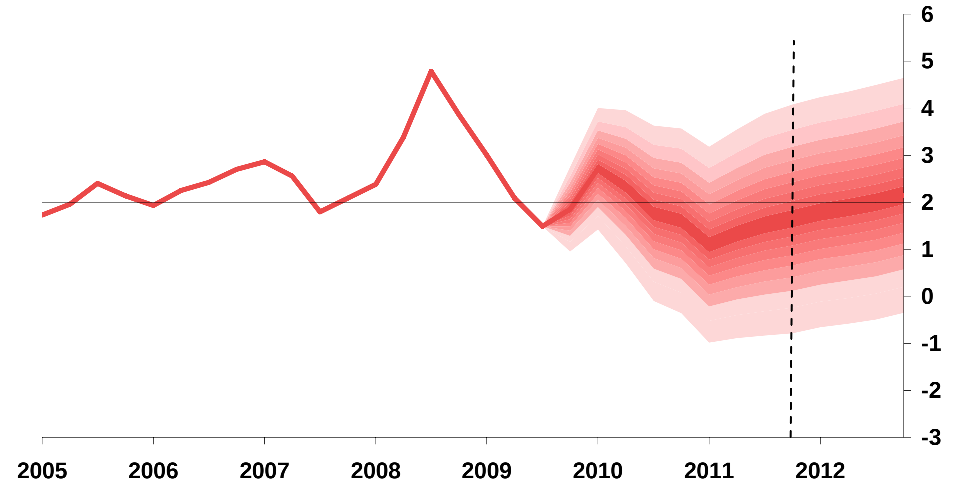


Source: Office for National Statistics

This persistence of inflation most likely reflects the impact of the rising costs of imported goods, following the decline in the exchange rate we have experienced since mid-2007. As Chart 13 shows, the period when inflation was low and stable prior to 2007 saw very different trends in goods and services prices. Services inflation was relatively high and persistently above the 2% inflation target. But overall inflation was held down by the prices of goods which were generally experiencing sub-zero inflation. Global competition was holding down the prices of many manufactured goods – the China effect – and the impact of this in the UK was reinforced by a relatively strong exchange rate.

This balance of forces has now shifted. In current circumstances, we cannot rely on goods deflation to hold down the UK inflation rate – particularly while the impact at sterling's depreciation feeds through. Though services inflation has come down to some extent, reflecting the increase in spare capacity and slower wage growth, it has not dropped enough to keep the overall inflation rate on target. Indeed, services inflation in December was 2.6% – still above the 2% target level. While the combination of above-target services inflation and rising import prices persists, it will be difficult for the MPC to keep inflation on target. Services inflation may therefore need to fall back further if we continue to experience relatively high inflation in goods prices.

Chart 14: CPI inflation projection
Annual percentage change in prices

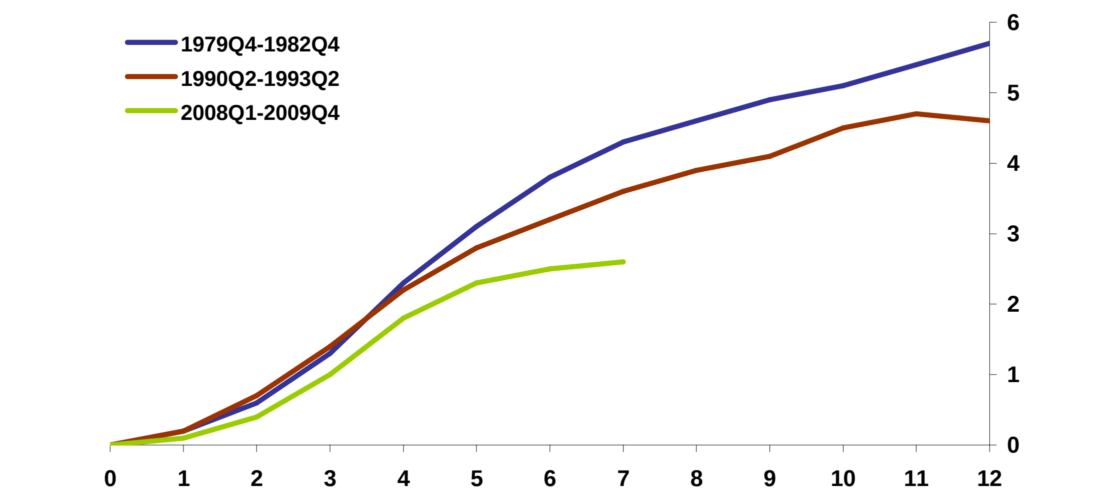


Note: Based on market interest rate expectations and £200 billion of asset purchases
Source: Bank of England *Inflation Report*, November 2009

The Monetary Policy Committee is currently updating its inflation forecast, and the new forecast will be published early next month in the February Inflation Report. Last time we published a forecast, in November, this indicated that the most likely scenario was that the rise in inflation in the early months of this year would prove temporary. Inflation was expected to fall back later this year and in 2011, as some of the one-off factors which had pushed it up – in particular, rising energy prices and VAT – dropped out of the calculation. On the balance of probabilities, that Inflation Report forecast suggested that inflation would then drop below target, as price and cost increases were subdued by spare capacity generated in the recession.

Looking further out, as Chart 14 shows, the November Inflation Report suggested that inflation would begin to move up again as the recovery took hold and the depressing impact of the recession on costs and prices faded. However, there is a large range of uncertainty around the inflation outlook at present. While the resilience of inflation is most likely due to the impact of rising import prices, that is not the only possible explanation. Business surveys suggest that the margin of spare capacity within firms is not as high as we might expect, given the decline in GDP recorded by the official statistics. At the same time, the increase in unemployment we have seen so far over the recession is considerably less than in the last two major recessions, as Chart 15 shows, suggesting that there may be less labour market slack at present than at the equivalent stage of the early 1980s and early 1990s recoveries.

Chart 15: Unemployment in major recessions
Percentage point deviations from unemployment rate at GDP peak



Source: Office for National Statistics and Bank calculations

Note: Claimant count measure of unemployment

While the recovery is in its early stages at present, the MPC has to set monetary policy to influence the inflation outlook over the medium-term – normally a horizon of two to three years. Given the dramatic changes we have seen in the economy over the last two years, this is a very challenging task. But as we go through this year and beyond, we will be accumulating evidence on the pace of the recovery and the way in which the economy is responding to the many potential opposing pressures I have identified.

If the headwinds from the financial crisis and the consolidation of public finances dominate the outlook, the balance of risks to inflation are likely to be to the downside, once the temporary factors currently affecting inflation have dropped out of the equation. But if the tailwind from the global economy, a competitive exchange rate and a recovery in confidence are felt more strongly, then the margin of spare capacity could be eroded more quickly. In that scenario, there will be more upward pressure on inflation, both from domestic price pressures and from the global economy.

Which of these scenarios unfolds will have a critical bearing on the decisions which the MPC must take over the next couple of years – both on the future path of interest rates and on our approach to Quantitative Easing. Through the recession, the MPC has been right to relax monetary policy aggressively to provide support for a recovery which is now emerging. But as the recovery develops, the economic situation will change and the MPC must be ready to adapt its policies to the changing economic situation over the course of the recovery – just as we have done through the recession.