Institute of Fiscal Studies Annual Lecture

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7 July 2008, Bloomberg (London)

The question I wish to address is whether we need to revisit the basic framework of economic policy which has operated, apparently successfully, through a decade now that we face different, and more difficult – indeed dangerous – conditions.

The framework which we have enjoyed – interest rates set independently by the B of E to meet an inflation target; fiscal rules, albeit flexibly applied; an open economy with a floating exchange rage outside the Eurozone – have contributed to stable, sustained economic growth, historically low inflation, falling unemployment and rising employment. All that is now at risk. Changing economic circumstances and political pressures are bringing calls for a re-examination of the policy framework. **We have seen a re-emergence of powerful cyclical factors – in credit and housing markets and potentially in economic activity; a deep crisis within the banking system; the economic challenges posed by commodity price boom including a third oil shock; and political uncertainty including a possible change of government**.

Theories and Ideas

Before moving on the practical policy issues let me reflect briefly on the theoretical underpinnings of policy. The unfamiliar and alarming inevitably brings forward a search for new theories. George Soros has written about a 'new paradigm' and proposed a -Theory of Reflexivity[1]. I, for one, am sceptical about the need new theories, let alone for a Theory of Reflexivity. I see nothing so far which isn't already embedded in the history of economic ideas.

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[1] George Soros, *The new Paradigm for Financial Markets*, (Public Affairs, 2008)

Keynes noted in the General Theory that "practical men are usually the slaves of some defunct economist"[2]. Keynes himself was, on this measure, a slave owner of some substance. Post-war economic policy makers from the 50s to the 70s – Macmillan and Heath; Wilson, Jenkins and Healey – all operated within a broadly Keynesian perspective: that an essential task of government was to manage aggregate demand so as to sustain growth in economic activity and maintain full employment. It was a philosophy born out of a major economic crisis. Having been taught economics by Keynes' Cambridge disciples – Kahn, Joan Robinson, Kaldor, Meade and others – I guess I also come from that tradition. It has sometimes felt as if we were dinosaurs, struggling to survive amongst the hot-blooded, furry, mammals of the monetarist era. **But much of the Keynesian tradition of thought remains, not least the underlying neo-Keynesian model of the Bank of England in which aggregate demand is the main transmission mechanism feeding interest rate changes into the economy.** Indeed, there is a new danger that some of the important insights of the furry mammals are being overlooked. Too little attention has been paid to the dangers of rapid credit expansion which, as the Austrian economists would have warned, has fuelled a boom and bust cycle in asset markets.

Another powerful piece of theory which underlies what policy makers do is based on 'rational expectations'. Theories of 'rational expectations' led to a belief in the importance of policy credibility that led, in turn, to the importance of central bank independence in setting short-term interest rates in pursuit of inflation targets, for which Prescott and Kydland received their Nobel Prize; and to a belief in credible fiscal rules to maintain sustainable long term bond yields. **The Labour Government's macroeconomic policy, set out in the first year in office, and largely unchanged since, has been built on these foundations.** Now, with a slowing economy and a simultaneous spurt in inflation there are some awkward new challenges for the policy framework.

[2] J.M. Keynes, *General Theory of Employment, Interest and Money*, (London: Macmillan, 1936), Chapter 4

A further important and related strand in the policy thinking derives from the standard, neoclassical economic theory which assumes rational behaviour by consumers and firms: the "efficient markets hypothesis". Markets, it is said, are always correctly priced and move in a "random walk" towards "equilibrium" with prices incorporating known information. This rather abstract point has become highly relevant in practice since it led policy makers to disregard important developments in financial markets. The growth of a financial **bubble, centring on property values, was assumed to be simply a rational reflection of long term supply and demand balances in the housing market. By definition, markets could not depart from correct valuations for long periods of time or in a major way. There was no 'bubble'. That is, until it became clear, in the wake of the 'credit crunch', that there was. (Fig 1)**

In searching for a better understanding of these recent phenomena I go back, first, to a seriously defunct economist: J S Mill. Mill's concept of the business cycle was based on a theory of irrational expectations. He describes five "calamitous" periods of "frenzy" between 1784 and 1826 in all of which "prices at length rise to such a height as to induce a considerable number of bidders to think of realising. Then commences the fall of prices… A general alarm ensues and an end is put for the time being to all dealings upon credit: many persons are thus deprived of their usual accommodation and are unable to continue their business."[3] **He describes, almost two centuries ago, the current subprime crisis and its credit crunch aftermath**.

Separately, Mill also anticipated another major problem with which we are currently grappling: "the exchange values of manufactured articles compared with the products of agriculture and mines have, as population and industry advance, a certain and decided tendency to fall…" He may not have anticipated China's role in driving down manufacturing prices, and the

[3] JS Mill, _Paper Currency and Commercial Distress_ reported in JM Robson _Collected Works of John Stuart Mill: essays in Economics and Society_, (Toronto: Routledge, 1967), pp. 75-76

specifics of the oil market, but he was the first major environmental economist who worried about resource constraints in growth.

Mill was arguably the first of a succession of great economists who focussed on the problem of economic cycles which, after a decade of apparent stability, preoccupies us again. (Fig 2) A decade ago Gordon Brown talked of "no more boom and bust", an assertion which, for **hubris, now ranks alongside Canute's instructions to the tides to retreat and Mao's edict that all sparrows should be eliminated**. **The classical economists of the 19th Century understood in a way that many of our contemporaries have denied or forgotten that capitalist economies are prone to boom and bust. After Mill, Marshall built a theory of cycles based on the economics and psychology of irrational expectations.**[4] As he saw it, credit expansion interacts with speculative demand and market confidence and what later were described as multiplier and accelerator effects to create booms which contain the seeds of their subsequent bust. By coincidence, Marshall, like Mill, was extraordinarily percipient about today's world, preoccupied with the problem of managing a mature economy against a challenging international backdrop; in his case it was the problem of new economic powers (then Germany and the USA rather than China and India) creating additional competitive pressures and demand for raw materials. That is not a surprising insight since economists in the Victorian era were concerned, as we are, with the economic consequences of globalisation, in trade and financial markets, and with shifts in relative prices at a global level.

There have, of course, been many theoretical and policy refinements in the decades since. In particular, Pigou, Patinkin and others have explained the link between asset market inflation and deflation and household behaviour; **the so-called 'wealth effect'**: the transmission mechanism which links asset bubbles to real economic activity. **Hyman Minsky in the 1980s argued for stabilising an unstable financial sector**

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[4] Alfred Marshall, *The Enemies of Industry*, (London: MacMillan, 1985)

through counter cyclical regulation.[5] It is useful to remind ourselves that the problems we currently face are not fundamentally new, and defunct, rather unfashionable, economists have grappled with them before.

Against that background **I want to raise the question of how our economic policy framework should respond to the two big simultaneous policy challenges. The first is how to deal with major asset bubbles and what it is that happens when they burst** (John Kay, in a recent essay, has noted that there is no word in the economic dictionary for the opposite of a bubble – perhaps a revealing omission). **The second is how, simultaneously, to manage a big, externally induced, shift in relative prices**.

Bubbles and Cycles

In the current policy framework cycles are explicitly built into the fiscal framework though these are assumed to be – modest – fluctuations around trend growth in output. Although economic policy makers were obviously aware of market volatility this was – implicitly – assumed to be a microeconomic problem for particular markets rather than a systematic economy-wide phenomenon.

Yet both ancient and modern economic history is littered with examples of major 'bubbles' which had far reaching economic consequences. John Calverley of Amex, who deserves recognition for having spotted the significance of the bubble in the UK housing market four to five years ago, has produced a well rounded historical account of 'bubbles' (I should add that my own, more politicised, warnings which started at around the same time, were, partly, informed by his book *Bubbles and How to Survive Them*[6)]. **From the Tulip Mania in the 1630s and the South Sea Bubble in 1720, there were cycles of frenzied lending asset inflation and then default and collapse**. Throughout the 19th Century these centred mainly on emerging markets, railways and commodities[7]. **The Wall St Crash of 1929 had enormous**

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[5] Hyman Minsky, *Stabilising and Unstable Economy*, (1986)
[6] John Calverley, *Bubbles and How to Survive Them*, (Nicholas Beasley and Amex, 2004)
[7] Charles Kindelberger, *Manias, Panics and Crashes*, (Basic Books, 1978)

ramifications, of course, and it is perhaps a fortunate accident of history that Mr Ben Bernanke of the Fed kept alive institutional memory of it through his PhD thesis.

In the last quarter century we have experience several others – the Japanese bubble in land and property prices in the 1980s; the UK and Scandinavian housing bubbles in the late 1980s (and the preceding UK housing bubble in the 1970's); Latin American syndicated sovereign lending; the **Asian 'Tigers' bubble in the mid 1990s; and the dot.com bubble of the late 1990s**. In each case, a surge in asset prices continued to extraordinary levels, stimulating confidence in consumer spending and/or business investment until a crash led to reduced investment and spending via negative wealth effect. Except in the case of Japan, which was largely disregarded as a somewhat weird exception, the impact was relatively mild and short-lived and, even in Japan, led to stagnation rather than slump which, for an affluent society, did not seem excessively worrying. **Wider, global economic consequences from the most recent troubles – the dot.com bubble and the Asian crisis – were mitigated by aggressively expansionary monetary policies by the Fed. These apparent successes and folk memories of the consequences of conservative monetary inactivity in the wake of the Great Crash led to emergence of new orthodoxy as articulated and practised by Alan Greenspan: that asset bubbles are difficult to identify, and cannot be anticipated and prevented by policy makers; that they should be allowed to burst naturally; but that any deflationary aftermath can then be countered, reactively, by active, aggressive interest rate cutting (and expansionary fiscal policy). The apparent success of this approach led to Mr Greenspan achieving the secular world's equivalent of canonisation.**

The Greenspan Doctrine has also permeated British economic thinking in the Treasury and the Bank of England. The success in heading off recession in 2000/1 was attributed not only to the monetary policy framework itself but to timely interest rate cuts on the Greenspan model. In 2003/4 some of us started to worry out loud that the expansion of

credit was feeding worrying levels of personal debt secured against what appeared to be an unsustainable boom in house prices comparable to that in the early 1970s and late 1980s. (Fig 3 Fig 4) Considerable intellectual firepower was deployed to shoot down this heterodox view. Steve Nickell wrote an article in the Bank of England Quarterly Bulletin seeking to show that levels of household debt were not exceptional or problematic[8.] Indeed, the prevailing view – **expressed most strongly by Kate Barker in her report to the Treasury – was that rising house prices were not cyclical, let alone a 'bubble', but a product of 'real' demand and supply factors: demographic factors on the demand side and planning restrictions on the supply side[9].** Other serious analysts reinforced that conclusion; John Muellbauer's Oxford model of the housing market suggested, even recently, that all but a small fraction of the boom in house prices could be explained by the model's 'real' explanatory variables (which did, however, include a proxy for the availability of credit in liberalised markets). **Suffice it to say that there has been no consensus around the existence of a bubble. But that is the nature of economic policy debate and it is clear with hindsight that there was a bubble.**

For those of us who have argued for the existence of a residential property bubble for the last three to four years, **the evidence was of several kinds**: rapidly rising prices; high expectations of further increases; overvaluation compared to historic averages; overvaluation in relation to plausible, reasonable returns on capital for given levels of inflation and risk; a major rise in lending and, as a corollary, increases in indebtedness and a falling household saving rate. Some of these factors can be clearly seen at work in the UK:

- **Cumulatively very major real term increases in house prices since the nadir of the 1990s:** over 130% in the UK; over 80% in Spain; around 100% in Netherlands and 100% in the USA. Even taking into

[8] Stephen Nickell, 'Household debt, house prices and consumption growth', _Bank of England Quarterly Bulletin_, Autumn, pages 383–89, (2004)
[9] Kate Barker, _Delivering Stability: Securing our Future Housing Needs_, (Treasury, March 2004)

account the fact that prices were generally depressed in the mid 1990s, they have been unusually high ***(Fig 5)***

- **Comparing prices to earnings around an average for the last five decades suggest that, at the peak of the market, it was around 50% overvalued**. ***(Fig 6) (Fig 7)*** The IMF, which took account of a variety of a factors which may have changed the base of comparison from the average, concluded that overvaluation was around 30%

- **Studies of the ratio of house prices to rents have indicated that there has been substantial overvaluation**

- There is plenty of anecdotal evidence that the market has been stimulated by high expectations of future increases from 'pension refugees' looking for big capital gains and popular journalism – on TV and in the press – feeding expectations. The absence of any counterweight, reminding investors of the cyclical nature of the business, was probably important too.

If there is, indeed, a domestic property bubble, **its significance depends on the impact on the rest of the economy.** That, in turn, depends on the magnitude of the bubble. **A Goldman Sachs study of 29 bursting housing bubbles over the last 30 years in different countries suggested that an average 'real' fall was 27% spread over 4½ years (albeit with nominal falls less because of inflation)** [10]**. For the UK, the two main housing recessions involved falls of 34% and 30% each over around 4 years. The current downturn starts from a higher overvaluation and has a lower rate of inflation which suggests that the fall could be bigger and/or longer.**

[10] Goldman Sachs, *Global Economics Weekly*, April 2003

As the bubble bursts its transmission effects are several. **First, there is** the **direct impact on construction**.[11] **There is a lot of evidence at present that house construction in the UK is slowing rapidly with reports of projects being stopped in mid-construction.** The leading residential building contractors are teetering on the edge of bankruptcy with the inevitable loss of their long term capacity. New residential construction accounts for only 1.2% of GDP but its effects are compounded by second round effects of spending on household fittings and furnishings. **Second there are wealth effects on spending particularly those recent buyers who slide from net wealth to negative equity. *(Fig 8)* It is roughly estimated that a 30% house price fall would drag 2.5 to 3m families into negative equity** who might be expected to respond by cutting spending and increasing savings[11]. And, in addition, falling house prices reduces the scope for, and willingness to engage in, equity withdrawal and the spending which flows from it equity withdrawals. **All this would matter less if interest rates could be cut to offset any deflationary effects, but in the current conjuncture of inflation in goods and services and deflation in asset prices, the Bank of England has to give priority to its inflation mandate.**

The Bank of England which is, and has been, the crucial player has been strangely ambiguous in its approach to this problem. The Governor of the Bank of England warned in June 2004 that house prices were too high and could fall. Yet despite this warning, and the fact that prices continued to rise, the warnings have since been muted. Interest rates have both increased and decreased over that period sending no clear or consistent signal and the MPC has been at pains to point out that its remit does not include asset markets, except indirectly through wealth effects which bear upon inflation in goods land services.

Nor is there any indication that the authorities took much account of how an asset boom and burst might worsen financial instability. The FSA

[11] Based on estimates of Sandy Chen, Panmure Gordon

warned from time to time about levels of debt but gave no indication that it was concerned about the health of lending institutions. The instability which arrived with a vengeance in the late summer last year was attributed to an external 'credit crunch' caused by a financial intermediation starting the USA. Even when the Northern Rock was engulfed in a bank run and was faced with a prolonged crisis leading to nationalisation, at no stage was it ever acknowledged that it was anything other than a liquidity problem; the Bank, the FSA and the Government all insisted that Northern Rock (like other mortgage lenders) had a sound UK mortgage book and was not in difficulty because of exposure to the UK domestic property market or its lending practices. It is only within the last few weeks that there has been a slow, painful realisation that other banks, not just Northern Rock, might have a solvency problem arising from bad loans in a falling housing market.

Surely it would now be better for British macroeconomic policy to incorporate explicitly some acknowledgement that 'bubbles' have major economic consequences, and that there is a case for, first, trying to analyse and monitor these cyclical phenomena in key markets, notably domestic property, and, secondly, trying to counter them. To the extent that the matter is currently under discussion, it is in an environment where the monetary and regulatory authorities appear to be seriously rattled and are reduced to reacting to events, There remains, **implicitly, an acceptance of the, laissez faire, 'Greenspan Doctrine' that nothing much can be done other than to clean up after the mess.**

But it is because the Bank, the FSA and the Government failed to acknowledge and think about the problem of cyclical bubbles that they were psychologically and intellectually unprepared to deal with the aftermath. It is one thing to confront honestly the existence of bubbles in markets like housing and to conclude that the best policy response is simply to let them burst; it is another **to be in a state of denial about the problem**. The UK response seems to have been closer to the latter than the former**. It is perhaps not too cynical a view to suggest denial**

suited all the parties involved. The Government was content to let the public enjoy the collective euphoria of a property bubble. The FSA had neither the inclination nor the intellectual self confidence to challenge the insistence of the banks that a lending boom was all for the best in the best of all possible worlds. And the Bank of England was happy to hide behind its narrow mandate rather than pick a fight with the government, the banks, the regulator and millions of house owners basking in the illusory warmth of a property bubble.

(Fig 9)

The Greenspan Doctrine, and its British derivative, has a lot to answer for. By creating the impression that the authorities will not intervene to prick bubbles, because it is too difficult, but will intervene to step in to mop up the consequences there is a systematic bias towards interest rate cutting – and thus to inflation and to the creation of new bubbles – and towards moral hazard in respect of irresponsible lending (and borrowing). There is, furthermore, an assumption that governments can be relied upon to bale out financial institutions with the consequent costs to the taxpayer: a point we reached with the decision of Alistair Darling to rescue Northern Rock. **And while recession may have been avoided in the wake of the dot.com boom and bust it now threatens to arrive in the wake of the current bubble, on a serious scale**. ***(Fig 10)***

What can be done? It has to be acknowledged from the outset that there are bound to be problems of measurement and that policy is likely to be limited to 'leaning against the wind' rather than precise calibration. The issue is whether it is possible to improve on the status quo. I make several suggestions, none of them original but none yet accepted as official policy:

1. **The remit of the Bank of England should include a capacity to monitor and evaluate, and warn about, the potential problems caused by cycles in those major markets prone to**

destabilising 'bubbles', notably housing. **I don't pretend for moment that this task is easy.** Having spent considerable time and effort unsuccessfully trying to find the holy grail of a predictable cycle in oil refining and oil tanker construction, I am painfully aware of the problems. **But similar problems face the Monetary Policy Committee in making judgements about cyclical variations in aggregate demand and output in relation to trend for the purposes of interest rate setting.** Conventions such as the output gap and the Taylor Rule, designed to judge the stage of the overall economic cycle suggest the necessity for, and feasibility of, establishing rough measures of this kind.

2. **It should be part of the remit of the Monetary Policy Committee to focus on major asset markets when setting interest rates. This is not a new idea. Irving Fisher, back in 1911 argued for a broad index of prices including shares, bonds and property as well as goods and services.**[12] The theoretical case is should include the prices of future consumption (assets) as well as current prices. There is however a practical problem of not confusing the MPC remit with multiple objectives. There is only one policy instrument and the MPC cannot, therefore, coherently have more than one policy objective which should remain the current, symmetrical inflation target, looking 18 to 24 months ahead. **If it were possible, the inflation objective would be based on a measure of inflation which also includes house prices as Fisher argued a century ago. Such an indicator would have suggested that interest rates were too low in the growth of the asset bubble, which would have slowed growth, but could be cut now**.

(Fig 11)

[12] Irving Fisher, *The Purchasing Power of Money*, (1911)

How can this be done? There is first, a need for a satisfactory inflation measure. There is a reluctance to revert to the RPI which includes mortgage costs since policy then becomes circular: increasing interest rates to reduce inflation automatically increases inflation via the interest component of the RPI. The other means of incorporating housing costs is via the rental component but that is a poor measure of house prices and may move in the opposite direction. **There is essentially a choice of two options: one is to readopt a flawed measure, the RPI, which captures house prices only imperfectly (housing costs are currently rising while prices are falling)**. **The other is to have separate measures of housing prices sitting alongside the inflation target. There is no unique or definitive indicator of a 'bubble' but the relationship between rents and prices and the ratio of prices to earnings are key indicators. This approach appears to have been the approach in Sweden where the Central Bank deliberately undershot its inflation target in the 2004-6 period because of worries about a property 'bubble' (with some success). Critics argue that such subtlety creates more opaque and confusing monetary policy which risks undermining credibility since no one is entirely sure what policy is and how it can be assessed. At the present time, policy would be particularly difficult since housing deflation is producing calls for interest rate cuts and general inflation suggests the need for interest rate increases. The dilemma would, however, have been less acute now if the dangers of the housing 'bubble' had been recognised and acted upon sooner. And the resolution of the dilemma almost certainly lies in accepting that a degree of housing deflation needs to occur in any event for wider social reasons, of affordability, leaving current priority clearly with combating rising inflation. On balance, the Swedish model of referring specifically to property markets in the setting interest rates seems the most sensible of the options on offer. Sushil Wadhwani, a former**

member of the MPC has described how this would work in the UK[13]. I believe we should adopt it.

3. **There is also growing support for the idea that, in response to the analysis of cycles discussed above, regulatory measures should be used in a counter-cyclical manner. Basel capital adequacy rules already require banks to hold capital as a prudential measure. In principle these rules can be applied flexibly to tighten capital requirements against mortgage lending at a time of housing boom with off-setting relaxation in a period of slump**. It **can** be seen from the current position how useful such countercyclical activity might be. Banks are struggling to meet capital adequacy requirements at the same time as mobilising capital to offset their losses from bad loans, adding further to the contraction of lending. **I have argued for this change for several years and Goodhart and Persaud have given some analytical rigour to the proposal**.

   In principle it should also be possible to apply property taxes in a countercyclical manner. **Stamp duty already operates counter cyclically since falling house prices lead to lower duty paid and lower rates.** However, unfortunately, Britain does not have a national tax based on current property values, of the kind operating in Denmark, based on annual revaluations. **One useful counter cyclical measure would be to shift the tax base of business rates to land values – including unused land – increasing the cost of holding land banks in booms but easing the burden in slumps which are transmitted to land prices.**

4. **Just as the top of the cycle is extended by speculative investment demand, the bottom of the cycle is made more extreme by distress selling from families who can no longer**

[13] Sushil Wadhwani, *Should Monetary Policy Respond to Asset Price Bubbles? Revisiting the Debate, Revisiting the Debate*, (Speech to Suerf Colloquium, Munich, June 2008)

service their mortgages and are forced into the repossession process. In the current downsizing there is already evidence of a big increase in repossession orders – the first stage in the process. *(Fig 12)* Interest rates are rising, because the breakdown in financial intermediation during the credit crunch has disrupted the transmission of interest rate cuts. This is pushing many heavily extended borrowers over the edge, even though there is no significant unemployment. If recession gathers momentum the number of defaults, and repossessions, will escalate. The Government should intervene to regulate the repossession process along the lines of current industry best practice. Repossession could not be stopped in all cases – there has to be some sanction against wilful default – but it would help if all lenders, not just the virtuous few, were required to refer the case to a source of adequate financial advice and to offer occupiers a range of financing options including shared ownership and rent back.

The Government should also allow, and encourage, social landlords to buy up property which cannot be sold to provide homes for the homeless and others unable to afford or access owner occupation or commercial renting. The stock has become massively depleted in the wake of 'right to buy' – over one and three quarter million have been sold, reducing the social housing stock from 5.5 million in 1979 to 3.9 million today, even after new construction is included. There has been much distress in low income groups both in big cities like London and in rural areas. The Government has set aside a tiny sum for stock acquisition in the Autumn Statement £200 million, which would buy only around 1500 houses. But consideration should now be given to freeing up councils and other RSLs to borrow against their balance sheets to engage in countercyclical buying on a significant scale.

If a programme of this kind could operate on a substantial scale – that could mean 100 times the Government scheme – it would have major advantages beyond meeting social need. First, house builders would receive a cash flow injection from selling properties unsold due to the mortgage famine. There is no case for the taxpayer rescuing individual companies but the costs of losing a large part of our house-building capacity could be substantial. Second, the banking sector would be helped to cope with the credit crunch if it can recycle some of its property loans and this would in turn stimulate new lending.

Since the benefits are obvious why doesn't it happen? During the mid-1990s something along these lines occurred but belatedly. There are currently fears that a multibillion pound acquisition programme would impact negatively with public finances. But there is no reason why it should. We are concerned with an asset transfer, not public spending. RSLs, using their negotiating strengths as almost the only buyer in a distressed market, would be acquiring assets, probably at wholesale prices, which would strengthen rather than weaken balance sheets and provide a guaranteed income stream. Purchases are offset by assets but these are long term assets so there would be an impact Government net debt as currently defined. In practice the government need do no more than lift RSL's borrowing limits though a Central Bank credit line to the Housing Corporation might be necessary also. The RSLs could then use their expertise and local knowledge to manage the transactions. My understanding is that the more entrepreneurial RSLs in cities like Leeds are ready and able to embark on a programme of this kind and are inhibited only by Government conservatism.

(Fig 13)

The 'Imported' Inflation Shock

The recent upsurge in inflation which has caused the Bank of England to miss its 2% CPI target relates primarily, though not exclusively, to an upward movement in world commodity prices especially oil. ***(Fig 14 Fig 15)*** Like the bursting of the housing market bubble, though with very different effects, the spurt of inflation and its prominence are causing some to question the framework of macroeconomic policy which has operated for the last decade.

Perhaps I should acknowledge from the outset the obvious economic point that a rise in commodity prices is a change in relative prices (as against manufacturing and services). It may have its origins in inflationary forces in the world economy and it may fuel inflation but it isn't, in itself, inflation. Nor is it necessarily 'imported' as the Government would have us believe. Oil prices are, indeed, set internationally though the UK is (still) largely self-sufficient in oil, and it was the choice of the Government (which I don't quarrel with) to absorb the economic 'rent' in its revenues rather than to cushion consumers. Some inflationary commodity markets have been substantially influenced by domestic supply and demand factors: dairy products for example. In some cases 'imported inflation' is another way of describing a shift in the international terms of trade; in others there is merely a shift in relative UK prices.

Nor is it clear that the inflationary 'shock' is fundamentally different from the issue of boom and bust cycles described above. **Commodity prices are notoriously cyclical** and at least in several markets there is evidence of a classic hog cycle. A period of depressed prices has led to underinvestment as with metals – and oil – or the withdrawal of land from food cultivation or depletion of herds. Rising demand has hit up against inelastic supply. Prices rocket. Supply will increase. Leading to over supply. Then falling prices. You know the story. **But it is not universally shared**. And there is a reasonable argument that **there has been a fundamental shift in the terms of trade against food and raw material importing countries on account of rapidly growing, industrialising China and India, pushing up against global resource limits.** ***(Fig 16 Fig 17)*** **And, then, superimposed on this**

complex story there is the domestic price impact of currency devaluation sterling haven fallen by 17.5% against the Euro since April 2004. Domestic, sterling prices have risen in part because of this currency adjustment. ***(Fig 18)***

Faced with inflationary pressures or cost increases, which are at least partly imported, there is a debate as to whether the Bank of England should disregard, or at least play down, that element in the inflation figure which derives from international markets and is beyond UK control. Even respected economic commentators from the same journalistic and ideological stable disagree on this point. Sam Brittan makes the case for the standard policy response to a one-off change in relative prices: "the emphasis in counter inflationary policy should shift towards domestically generated inflation (which he defines to include the effects of a depreciating exchange rate)[14.] He admits that an index of domestically generated inflation is difficult to construct but argues that something is better than nothing.

Martin Wolf argues, more persuasively in my view, that the monetary anchor should remain as it is[15]. To do other would give an asymmetrical character to policy, building in an inflationary ratchet. No one argued that the inflation target should be reduced when Britain was importing a negative disinflationary shock through depressed commodity prices and/or falling manufacturing prices on account of China's competitive exports. That benign 'shock' was regarded as a good basis for expansion not for 'pocketing' low inflation. **Moreover, since it is difficult in practice to separate domestic from foreign costs since the latter influences the former**. It does so, not, as was once believed, because there is a mechanical link between rising prices, wages, costs and prices based on rigid 'cost plus' mark-ups **but because of the more subtle working of inflation expectations**. In competitive markets, businesses are more confident that they can raise prices in response to cost pressures if they expect higher

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[14] Samuel Brittan, *When Inflation Comes from Abroad*, (Financial Times, March 28, 2008)
[15] Martin Wolf, *Britain must not cut loose its Anchor*, (Financial Times)

inflation in general and wage earners will pitch their pay claims at a level which maintains their living standards. **In that environment, the Central Bank cannot afford the risk of sacrificing its credibility by accommodating inflation but should tighten monetary policy. I am sure that is right, though monetary tightening is already occurring, rather brutally, through the credit crunch** and it is hardly necessary to superimpose higher interest rates on top of it.

It is difficult to measure inflation expectations at all precisely. Survey data currently suggests that in the UK (as in the Euro area and the USA) **inflation expectations have risen sharply** (in the case of the UK to just over 4%**). Inflation expectations derived from government bond yields have yet to show up in the US and Euro area but predict over 4% inflation in the UK**. **Either way, it is clear that in the UK an inflationary psychology is returning and the credibility of the MPC is now being tested.**

It is worth recalling why inflation matters since, at the first signs of a slowing economy, and particularly rising unemployment, there will soon be calls for "rebalancing" the remit of the Bank of England to emphasise output growth rather than low inflation. UK experience tells us that inflation creates random forms of redistribution of income and wealth, but particularly borrowers at the expense of savers; it also creates business uncertainty and undermines long term investment.

If the aim of policy is to fortify rather than undermine the authorities' capacity for fighting inflation what, if any, are the policy changes which can and should be introduced?

1. It is frequently argued that the current inflation measure – the harmonised Euro area CPI – doesn't reflect 'reality' as experienced by 'average' households or particular groups like pensioners and understates inflation. The logic of this complaint, which is that monetary policy should be fiercer – interest rates higher – is not, however, often what the complainants have in mind. The more

fundamental point is that measures of "headline" inflation – prices or consumer spending deflator – better capture the day to day experience of food and energy prices but is more volatile and likely to lead to more volatile policy than measures of "core" inflation. In my view the issue is not about whether the target measure should change again – preferably not – but whether asset prices, especially housing, are properly considered alongside the inflation measure as in the Swedish model.

Alongside asset market valuations it is important too to incorporate monetary aggregates albeit without the fetishism of the 1980s. The fact that broad money (M4) grew by 12.8% in the financial year 2007/8 was arguably both an early indicator, and a partial cause, of subsequent inflation. Charles Goodhart has commented at the time that "unless the annual growth rates of money and credit fall to appreciably lower levels there is a higher risk of above target inflation in 2008 and even in 2009."[16] The Governor's response has been that these figures reflect the demand for money rather than the supply and interest rates are designed to act upon money demand. In practice it is difficult, if not impossible, to disentangle the two. Nonetheless it is clear that the Bank and the Government missed the significance of credit, and debt-fuelled expansion in recent years which was part of the bubble phenomenon. So credit growth needs careful monitoring.

2. **Beyond the issues of measurement and target definition is a deeper issue of underlying credibility. I am someone who enthusiastically supported the decision to make the Bank of England independent (indeed, I made my maiden speech on the issue, reminding Gordon Brown that my colleagues had got to the same point several years earlier) I worry now that there may not be the same commitment to genuine independence as existed in the first flush of enthusiasm. There is no evidence that the**

[16] Letter to Financial Times. Reported in *Winds of Change*, (Financial Times, May 14 2007)

Chancellor has chosen members of the MPC with an eye to political or philosophical affinity, though it would be desirable to have a term of appointment longer than a parliamentary term to ensure the perception as well as the reality of political independence. There has also been a growing frustration, publicly aired by the Governor, with the "informal" and inefficient way in which appointments are made. It is clear that the process needs to be more professional and transparent.

3. **One of the weaknesses of the macroeconomic framework is that while monetary policy – with a few important quibbles – is credible, fiscal policy emphatically is not**. There has been an ongoing argument about whether the fiscal rules are correctly specified and have been precisely met. **But a more fundamental point made by Hall and Henry is that there is a fundamental mismatch between monetary and fiscal policy[17]. His argument is that the short term flexibility within the fiscal rules (the Golden Rule requiring balance over a cycle – of a decade) has led to major imbalances in the economy, even that the house price boom was made possible by lax fiscal policy (fiscal policy gave a stimulus to the non-traded sector, including housing, while the traded sector was squeezed by an appreciating real exchange rate).** Instead fiscal policy may have been more expansive than the figures suggest because of accounting devices such as PFI/PPP; and that lack of clarity over the cycle has made it even more difficult to coordinate monetary and fiscal policy.

The key conclusion is that, as my colleagues and I have been arguing for some years, there needs to be a much greater degree of independence in the monitoring and assessment of fiscal policy. Credibility has been degraded by the widespread assumption that the Government routinely manipulates its self-

[17] SG Hall and SGB Henry, *An Independent Bank of England: Is That Enough*, (National Institute Economic Review, April 2006), p. 120

assessment of performance to come up with the conclusions it wants. There has been some move to ensure greater independence for the Office of National Statistics and greater integrity for economic statistics. But this is a limited step. While it would not be possible or desirable for an independent body to perform the political task of setting spending and taxation levels, it is both possible and desirable for an independent Fiscal Policy Committee to assess fiscal policy performance and proposals against the Government's own rules and to make recommendations accordingly.

The tricky issue with fiscal policy – which the political parties are studiously avoiding – is what policy should be followed if independent analysis shows that there is a serious drift away from the targets. In the short run, a serious economic downturn would be met by automatic stabilisers – that is a wider deficit. But over the cycle the budget has to balance. The IFS has warned for some years of a small structural deficit. The windfall gains from high oil prices provide some relief. *(Fig 19)* We start from a position where the debt rule has probably been broken. *(Fig 20)* The answer lies in aiming to run a small surplus under the Golden Rule over the cycle. A commitment to an annual surplus of, say, £5 billion a year over the cycle

The public debt rule will undoubtedly be breached because of the Northern Rock acquisition and there will be other major investments and asset purchases required, including the ones I have described above. The golden rule will have to be applied in a way which enables public debt to be repaid and make a public sector contribution to raising the savings rate. The practical consequences – a squeeze in current public spending and possibly a rise in general taxation in the medium term – are not however likely to be embraced warmly by Government or opposition. Perhaps this is the time to face that reality.

4. Macroeconomic stability has been made easier to achieve by macroeconomic policy dating from the 1980s making labour markets more flexible which this Government has largely maintained. This Government's commitment to maintain liberal, outward looking approach to trade and foreign – inward and outward – investment has also helped to keep product and capital markets flexible too. Whatever the excitement generated by party political tribalism it is surely fair to acknowledge that Britain is fortunate to have an unusually high degree of domestic consensus around these issues, unlike the main EU centres, the USA and Japan.

   It is striking that the two main contributors to the current inflationary shock come from two sectors – food and energy – from which the winds of liberalisation have been largely excluded. I am sure I don't need to preach to the converted about the inequities of the CAP but it is alarming how quickly the timidly reformist mood in the EU has been shifted by the likes of President Sarkozy urging a strengthening of trade protection.

   Successive British governments have gone further than almost any other in opening up energy markets to competition and foreign investment. Arguably, there has been a reversion to oligopolistic structures in power generation. But the main problems lie in unliberalised markets especially in the EU. Oil production is also, now, heavily nationalised (in both senses) outside of the main western countries and prone, therefore, to unresponsive, inelastic supply response with the consequences we can see. In these areas Britain's influence is limited though we must continue to make the intellectual case for liberalisation.

Although we cannot predict the future, the combination of the credit crunch in financial institutions, a bursting property bubble and a commodity price shock may well cause a deep and prolonged crisis for

the British economy. The Government is being utterly complacent. It makes sense to prepare for the worst, even if the worst does not materialise. We must retain and strengthen the framework of monetary and fiscal stability but it needs to be adapted to reflect the reality of boom and bust cycles in asset markets and it should be reinforced by timely new interventions like that which I have set out, for strong counter cyclical intervention in the housing market.

Summary of conclusions:

1. Bank of England must retain price stability as its central objective.

2. Price stability must be augmented by measures to monitor and counter volatility in the housing market as the main asset market. The Swedish model of referring to property markets in the setting of interest rates has much to commend it.

3. Pro-cyclical regulation of banking should be replaced by capital adequacy rules which seek to counter the cycle.

4. The repossession process has to be regulated to ensure that industry best practice is the norm and large scale loss of homes avoided.

5. The current adjustment to house prices must run its course to restore affordability. There is nonetheless a strong social case for large scale acquisition of empty, unsold property by social landlords on a scale perhaps 100 times bigger than the current Government proposal.

6. Property taxes have a role in modifying cyclical instability, notably business tax bands on land values.

7. Measures have to be taken to strengthen perception of the independence of the MPC through more professional and transparent appointment processes and appointments longer than the electoral cycle.

8. The monitoring and assessment of fiscal policy must be independent of Government.

9. There is a strong case for a target of a (small) surplus under the Golden Rule under the current cycle to restore public saving and to repay debt.

10. There must be a strong commitment to supporting microeconomic policy in terms of liberalising agriculture and energy markets in the EU.