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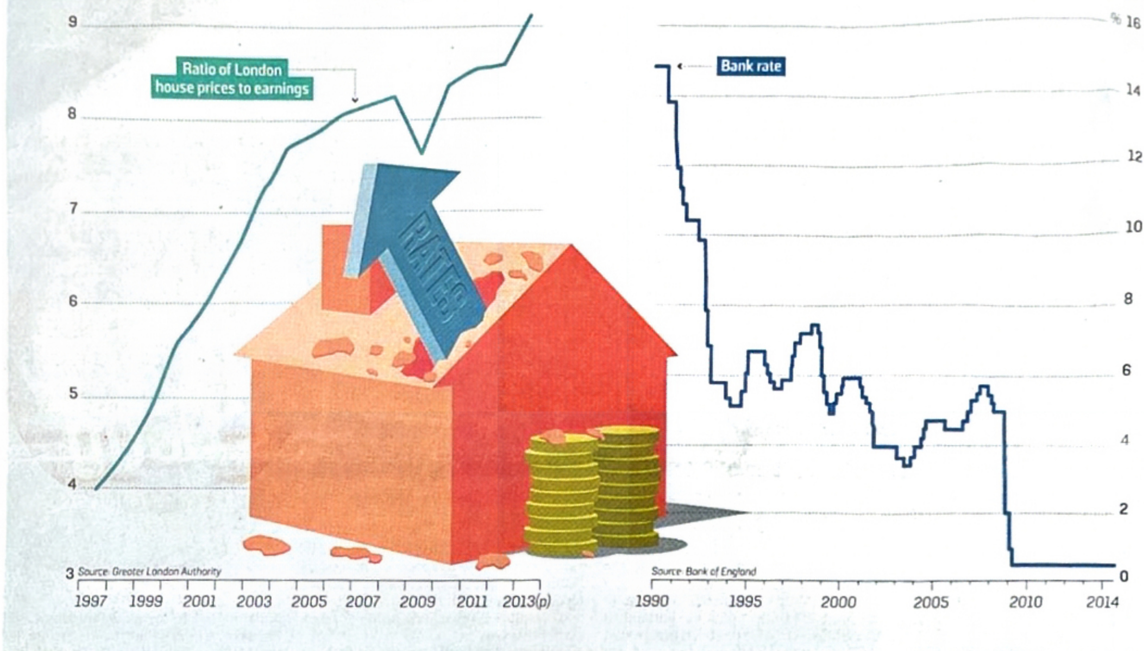
Monetary policy alone can't stop rising house prices ... ... so how high will interest rates have to go?



Let's take it easy on the road to high interest rates

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ECONOMIC OUTLOOK

When will interest rates rise, and how will the economy cope when they do? This was the central story at the end of a week that saw the first disagreement in more than three years on the nine-member Bank of England monetary policy committee. Two voted for an imminent increase. Although this has happened before without policy changing, this time an interest rate rise seems not too far away.

Many might feel that a rate increase is long overdue. After all, a Bank rate of 0.5% seems low for an economy that seems set to grow by almost 3.5%. Yet, it is not as simple as that.

Despite recovery, the economy is only back to its pre-crisis level and inflation of 1.6% is below the Bank's 2% target. Indeed, the Bank's minutes released last Wednesday suggested many reasons not to tighten just yet, low inflation being just one of them.

Moreover, as Mark Carney, the Bank governor, made clear at the previous week's press conference, it has needed interest rates this low for the economy to get back to the level it is at now. So, by implication, one can't conclude that the present growth rate merits higher interest rates.

In recent years, the vulnerability of the economy has clearly favoured keeping rates low, despite recovery. Now the risks are changing and the policy issues are when to increase, and by how much. But there is still much uncertainty, such as how much slack there is before the economy hits bottlenecks and inflation starts to rise. Or how the still-high levels of personal borrowing will affect people as interest rates rise.

This suggests the need to tread carefully. One lesson of recent years is that the formal macroeconomic models often used by economists failed not only to predict the crisis but, just as important, were unable to explain what was happening as the crisis unfolded.

Also, such models tend not to capture fully substantial changes in the economic environment, such as the rise of India and China, or even what has been taking place within the UK as a result of credit growth, or even because of the supply-side reforms of the 1980s.

As a result, many forecasts were caught out in terms of how firms behaved in recent years. Instead of sacking staff, as was widely feared in 2008, workers were kept on and wages took the hit. Now, the unemployment rate is falling, but the large number on zero-hour contracts or in part-time work suggests that there is still ample slack in the labour market.

It is not just here that there are such challenges for policymakers. A similar debate on interest rates is currently taking place in America over the timing of their first rate increase. This weekend there is an annual gathering of central bankers at Jackson Hole in Wyoming, with the topic being "Re-evaluating labour market dynamics".

Over the years there has been a significant evolution of macroeconomic policy in the West. Before the 2008 financial crisis, policy in America was referred to as the three Ts: being timely, targeted and temporary. This apt analogy also fitted well with what was happening in the UK.

After the financial crisis, there was an attempt to co-ordinate policies as all western economies faced similar risks. Policy became the three Ss: synchronised, sizeable and successful. Synchronised, as countries acted together. Sizeable, as huge amounts were thrown at the problem. Successful, in the sense that a depression was avoided.

Then, monetary policy became the shock absorber, taking on more of the heavy lifting needed to keep the economy on its feet. Monetary policy could be described by the three Us: unlimited, unclear and unknown. Unlimited, as the Bank of England pumped in huge amounts of money. Unclear, as to how to measure its success. Unknown, in terms of the longer-term repercussions of keeping interest rates so low for so long and in how to exit easily from such a policy.

That is where we are now. It is complicated further by the new powers given to the Bank's financial policy committee. This has created a more complex policy environment. No longer is it just the relationship between monetary and fiscal policy that matters in the UK. A tough fiscal stance adds to the pressure on the Bank not to tighten too much.

Instead, in coming years we will need to focus more on the relationship between micro-prudential policy, macro-prudential policy and monetary policy: MIP, MAP and MOP. In short, interest rates are only part of the Bank's policy toolkit.

Although inflation is low, house price inflation is a worry. The last thing we want is for the economy to recover, only to run into the same problems as in the past, where every boom and bust in the housing market has led to a boom and bust in the economy itself.

The chart shows the high ratio of house prices to earnings in London. The answer lies mainly in building new homes, to take the pressure off prices and rents. Even though the capital is experiencing the highest number of private housing units being built this year than in any year since the early 1980s, the reality is that this is having to make up for the lack of building over many decades, plus rapid population growth. But this is a nationwide, not just a London problem, and it takes time for new housing to become available.

This is not a problem the Bank can solve, yet the focus is on how it can help to curb housing demand, without hitting the wider economy. Already MIP and MAP appear to be having an impact in taking some heat out of the housing market in recent months, making banks think twice about how much they lend, and to whom. It makes sense for the Bank of England to be sure how these measures are working before it raises rates too far.

The regulatory pendulum has swung from one extreme of too little to the other of too much. The full consequences of this may only become clear as the recovery continues. It also ties in with the fact that in the past the UK economy has become overly dependent on bank lending, far more so than America, where firms rely on the capital markets to raise finance. Recently, the Bank of England released a discussion paper about the leverage ratio. Perhaps we need to focus as much on a target for this as on that for the inflation rate, ensuring that policy remains even-handed to address downside as well as upside risks as the economy grows.

Carney has been consistent in saying that interest rates will stay low, rise gradually and peak at a low level. I agree with the first two of these, that rates should not rise yet and should increase only gradually, but I think that when they eventually peak they need to do so at a high level. That, however, may be five years away.

Despite the problems in the eurozone, there is every likelihood that the world economy will grow solidly in coming years. The chart shows the movement of UK base rate in recent cycles. In the years before the crisis, one lesson was not that rates fell too much, but that in the good times they did not rise high enough.

Thus, when interest rates begin to increase next year, it will be important to manage expectations, and that is half the battle. To really get across to people that rates will rise gradually, I think the Bank should opt for increasing rates in small steps of 0.125% and see how the economy copes.

Dr Gerard Lyons is chief economic adviser to Boris Johnson, the mayor of London. His new book, The Consolations of Economics, is published by Faber & Faber