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DAILY COMMENTARY

DISSECTING THE NICKELL ARGUMENT

As expected, the MPC duly left rates unchanged today, but it is unlikely to have been a unanimous decision. Whether Mr Nickell was a lone dove remains to be seen, but the emphasis on output gaps and short term growth prospects within this camp is somewhat worrying. The Royal Society of Economics is right to warn of the dangers posed by taking such a narrow view of what should drive interest rates. The MPC should be taking a longer perspective. The role of borrowing and house prices is given insufficient weight in Mr Nickell's assessment. It matters not, it seems, that debt burdens are set to hit yet another record high this year. Playing down the role of housing and borrowing in driving the economic cycle is short-termist, and merely increases the secular risks that debt deflation will eventually take hold.

Debt Matters

In his address to the BoE's South East and East Anglia Agency on 31st January 2006, MPC dove Stephen Nickell made a valiant attempt to defend his decision to vote for rate cuts at the last two meetings. It is a fair assumption that Mr Nickell will have voted to reduce the cost of borrowing today, even though rates were left unchanged. In the narrow context of the BoE's remit set out by Chancellor Gordon Brown in 1997, the points made in the paper "Monetary Policy, Demand and Inflation" are not unreasonable. A cursory glance at the UK's output gap might well suggest there was room for a rate cut in the coming months. While growth did improve in the final quarter of 2005, Mr Nickell expressed some doubts over how far the recovery would claw back some of the ground lost from last year's slowdown. And in some sense, the disappointing manufacturing production numbers for December, combined with the downward revisions for earlier months, might vindicate this line of argument. While the service sector was strong in Q4, the underperforming manufacturing sector is acting as a considerable drag on growth, and may continue to do so.

Rising unemployment has also provided a strong indication that growth was not running at its full potential. The pace of hiring did improve last year, notably in the private sector. Employment growth actually accelerated a touch last year, with the total number of jobs expanding by an average 1.1% y/y in the first ten months of 2005, compared to 1.0% y/y in 2004. But the claimant count measure of unemployment has risen for eleven consecutive months, by a cumulative 95,300. The slightly more erratic ILO measure has also climbed by 89,000 since January 2005. The steady influx of migrant workers is one obvious factor behind this, and may have accelerated the potential growth path. The renewed attempts to reform disability benefits - currently claimed by 2.6m recipients - could also contribute over the longer term to faster growth in the available labour force.

Mr Nickell certainly makes a good case for his policy stance in pure output gap terms. However, one has to question whether that is always the most appropriate framework. For one, the best leading indicators of growth strongly suggest consumer spending will firm a touch in the coming months. If growth was close to trend in Q4, with GDP rising by an annualised 2.6% even as manufacturing contracted, there is a chance that the economy will be expanding slightly above trend in the first half of 2006. Mr Nickell is right - that may not be enough to immediately reverse the output lost following the housing slowdown. But equally, the role of borrowing and housing in driving consumption growth is only briefly acknowledged, just as it was downplayed in 2004 ("Household Debt, House Prices and Consumption Growth", September 14th 2004). On that occasion, it was suggested that "debt accumulation appears not to be closely related to household consumption growth". Events since suggest otherwise.

And therein lies the difficulty with Mr Nickell's argument. Instead of the property cycle, Mr

GFC Economics
Coborn House, 3 Coborn Road, London E3 2DA
Tel. 020 8981 8085 Fax. 0870 056 1693
graham.turner@gfceconomics.com - rupert.thompson@gfceconomics.com

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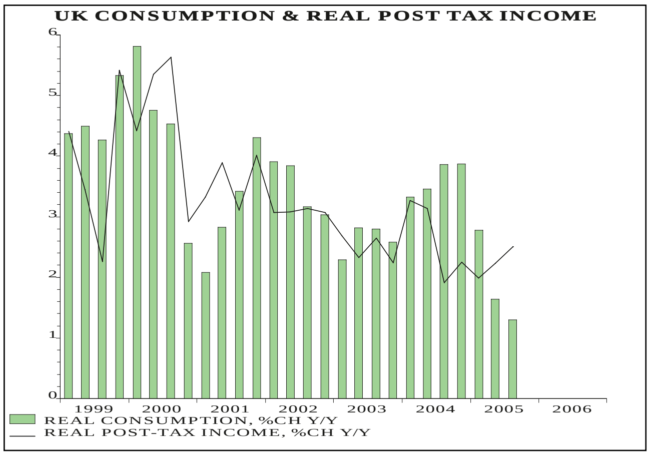
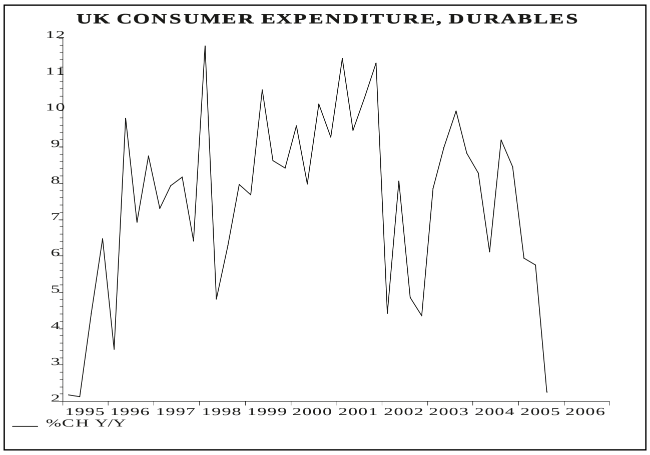
Nickell blames the impact of higher fuel charges in squeezing real take home pay for last year's slowdown. He also points to the role of fiscal drag in lowering disposable incomes. In both cases, it is true that higher than expected headline inflation and the indexation of tax bands to prices rather than wages left their mark in 2004. There was a particularly large increase in 'current taxes on income' in Q3 of that year, which rose 4.2% q/q and a hefty 9.4% y/y. This helped to push the annual growth rate in post-tax incomes down, but it has since bounced back. However, it is not clear whether this explains the slowdown in consumer expenditure as claimed. The first chart is an attempt to recreate the Nickell argument. It shows there has been quite a lag between post-tax incomes and real consumption over the past two years or so. Post-tax incomes actually peaked in Q1 2004. Consumption growth did not peak until a year later (see chart). Similarly, post-tax incomes troughed in Q3 2004, but in annual terms, consumption growth continued to slow for a year. A lag of one year is not perhaps that unreasonable, but the much closer and timely relationship between retail sales and mortgage approvals suggests that the housing market was a far bigger factor in slowing the economy.



Indeed, the low-point for retail sales was in Q1 2005, which more or less coincided with the trough in the housing market. Mortgage approvals hit their low in November 2004, and the time lag between that particular data series and retail sales has reliably been three months. Retail sales reached a nadir in February 2005, falling 2.4% on a 3m/3m annualised basis, before recovering swiftly. The breakdown of the GDP consumption numbers also strongly indicates that the property cycle was key. The downturn in spending has been concentrated in goods. Spending on durables was up 2.3% y/y in Q3, compared to 9.2% y/y a year earlier, a decline clearly related to the housing market. Consumption for services, by contrast, accelerated from 1.2% y/y to 2.0% y/y over the corresponding period. That may reflect the pick-up in real incomes. But the net result of these countervailing forces has been softer consumption, indicating the housing factor more than outweighed the income effect.



All this matters, since it suggests looking at monetary policy simply in terms of output gaps can overlook the important dynamics within the property market. Indeed, mortgage approvals have been indisputably strong in recent months. It is still hard to believe house prices are likely to accelerate by anything close to the pace witnessed in 2003, for example. This morning's release of the Halifax price index for January is a case in point. Last month's fall of 0.4% m/m implies the 6-month annualised rate has slipped from 11.0% to 9.4%. The 3-month annualised rate has dropped from a high of 14.1% last September to 6.5%. Nevertheless, reports that gazumping has made an unwelcome return in the high-end of the London and SE market certainly underlines the upside risks to property prices from record financial industry payouts. The current spurt in prices could yet prove to be the final hurrah, before the long bear market finally sets in. However, cutting rates now to help close some notional output gap - in itself created by the excessive accumulation of debt - would ultimately prove counterproductive.