Inside Money: The Cost of Living

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THIS IS A TRANSCRIPT OF THE LONGER REPEATED VERSION

CURWEN: Hello and welcome to Inside Money. This week's subject is something which affects every family in the land, right in the wallet – it determines the value of the money we earn and spend. It is - inflation – the rate at which prices are rising. Controlling inflation is the job of the Bank of England. It has to try and keep the official measure of inflation close to the target rate, of two percent. But in March this year – for the first time in a decade – the Bank failed to do that.

NEWS READER: The official measure of inflation has risen to its highest level since it was formulated more than 10 years ago - forcing the Bank of England to write a letter of explanation to the Chancellor, and adding to the pressure for another rise in interest rates.

CURWEN: Inflation had gone up, partly because of higher prices for gas, electricity and food. The Bank of England has one simple tool – some would call it a blunt instrument - to try to keep inflation on track, and that's moving interest rates up, or down, or keeping them stable. And the base rate did rise again, in May, and earlier this month. That took interest rates to 5.75 per cent, the highest level for six years because of the Bank's continuing concerns about inflation.

SOUND OF MACHINERY

CURWEN: Those worries are shared by Radio 4 listener Adam Potter

POTTER: This we have here is the mounting press, if you can imagine it's the size of the microwave…

CURWEN: He runs a small engineering firm in Stockton on Tees.

POTTER: We actually use the mounting press to mount the sample in Bakelite which we then view under the microscrope

CURWEN: It provides services to the oil and gas industry, including diagnosing why bits of equipment fail. Since he set up the firm four years ago, Adam's found that running it has got increasingly expensive.

POTTER: The main constituent of those costs - about 60% or so - are wages. So obviously that has a big implication for us. In essence we have to increase our prices - we have no choice. When you're then setting prices for next year, what you then have to do is think about whether or not you'll be having price rises continually again. Actually it makes business planning much more difficult because you're continually battling with the buffeting of increasing prices all the time.

CURWEN: He's not just concerned about inflation as an employer, but as an individual too. Adam is not a home-owner; he rents a house. So he's not had the rising mortgage bills many millions of us have experienced. But he has seen his income squeezed by higher household expenses.

POTTER: I've got to heat the house, I've got to eat and I've got to pay my council tax. And it seems as though all the prices that are rising are the prices that we have no discretion over whether or not we spend. And all I've got to do is just look at how much money I've got left at the end of the month, and that is a sure sign that prices are increasing much more than what the government says they are doing.

CURWEN: So Adam Potter joined us at Inside Money, to try to find out whether his fears about inflation were justified.

POTTER: I'd certainly like to know a little bit more about who actually sets the target and what's in this official rate. And also I would like to say well, is it the right target, and fundamentally it boils down to, is the Bank of England actually keeping inflation under control?

CURWEN: Our current system of controlling inflation was set up ten years ago – when the Bank of England was given the freedom to set interest rates by the incoming Chancellor Gordon Brown. The Bank's primary job would be to keep inflation close to a target the Government would choose. This framework, which has been widely regarded as successful, involves monthly meetings of the nine members of the Bank's Monetary Policy Committee. They pore over the latest evidence on the economy, and then vote on whether to change interest rates. Adam was curious about these all-important meetings. The minutes are made public, and closely scrutinised, because interest rates are a ticklish topic which can move the financial markets. For that reason, interviews with the most powerful member of the committee, are rare indeed. But we were lucky. Adam I'm delighted to tell you that I'm about to take you into the Bank of England to meet the Governor Mervyn King.

POTTER: This is fantastic, I'm really interested to hear what he's got to say

CURWEN: There would be, of course, things the Governor could not discuss – he couldn't give Adam any indication of what might happen next to interest rates; that's too sensitive an issue. But he could give our listener a unique insight into the way the bank approaches its job.

KING: Adam Potter I presume?

POTTER: Hello Governor, pleasure to meet you

KING: Very nice to meet you too. Welcome to the Bank. Right, let's sit down

CURWEN: The first thing on Adam's mind was the inflation target the Bank has to work with – it is known as the Consumer Prices Index, or CPI. One of the most controversial aspects of this target is that it doesn't include mortgage costs, often the biggest outgoing for many households.

POTTER: There's lots of different ways to actually measure inflation and you use one of them: CPI. Why do you use that particular measure?

KING: Well the simple answer is that the government has set CPI as the target for the Bank of England. It's a broad measure of the increase of prices of a very big basket of different commodities that families right across Britain buy. I'm sure that if we tried to measure your inflation rate, Adam, compared with mine, because we buy different kinds of things, we would get a different measure of inflation. What matters is that you have an average measure across the economy as a whole, not the measure of inflation of any one person or even group of people. But some things cause particular difficulty. Housing is one. If you rent a house and pay rent, that will be included in the index. If you're an owner occupier, the costs of owning your own home are not included in the present index. Council tax - that's not in the index CPI either.

POTTER: There's some goods in the CPI that I must buy - for example energy, petrol and food - and there's other items that I have discretion over whether I buy them or not. How is this taken into account in the CPI?

KING The CPI does not distinguish between goods that you feel you have to buy, and goods that you feel are more discretionary in your words. The fact that prices may rise by more for the things that you feel are necessities certainly affects your feeling about your standard of living, but it's not really relevant to the question of whether prices on average are moving up or down.

POTTER: It seems surprising that the cost of housing isn't included in the CPI.

KING: It is surprising, you're right, and in the index that we used to use, housing was included. Now CPI is meant to be an index which is constructed in the same manner in all European countries and so far the European statisticians have not worked out a way of how they can calculate the cost of housing in a way that can be done uniformly across Europe. And for that reason it's not in this harmonised European index. I wish it did include housing, but it doesn't - at least at present. Maybe one day it will.

POTTER: So do you actually look at what's happening in the housing market?

KING: The housing market inevitably is an important piece of information about our decisions on interest rates. It tells us what is happening in both the asset market, which is the prices at which houses are sold, but it also tells us a lot about whether households may be feeling optimistic, and willing to spend money in the future on other goods and services.

CURWEN: Mervyn King wouldn't be drawn further, on the MPC's thinking about the housing market. In the past he has issued warnings about the risk of falls in house prices. But what about Adam's biggest area of concern – rising wage levels which, in the case of his own firm, had led him to increase his prices?

POTTER: I mean certainly as somebody who is running a business, something on my mind is how much I have to pay my staff. How much attention do you actually pay to wage levels when you set rates?

KING: Well the rate at which wages are increasing across the country as a whole, the average, is an important ingredient in our discussions and you will see that referred to in the minutes of our meetings. Every month we produce a pretty detailed record of the discussion of that meeting. We explain what factors entered our decision. You can go onto the Internet, Adam, and read our discussion and see whether you agree with it or not.

CURWEN: Again, the Governor wasn't giving any real clues about the relative importance of indicators such as wages to the MPC. Its members must weigh up thousands of pieces of often conflicting evidence, and that can lead to disagreement. When it comes to voting on interest rates, the committee is sometimes split. It can even mean the highly-respected Governor himself ends up on the losing side. That's seen as a rather unsettling event – he's been outvoted twice now, most recently in May this year, and Adam wanted to ask Mervyn King more about the dynamics of the meetings.

POTTER: Does it get heated if committee members disagree?

KING: No, it doesn't get heated. Of course people do have different judgments about what's the right level of interest rates, and it's that interplay between the different members of the committee that helps everyone make up their mind more productively, and I think this is a great strength to our system. It's a genuine - I think - spirit of intellectual enquiry, if that isn't too pompous a phrase, where people sit round as a group trying to work out what is happening in the economy and what's the right bank rate that we should set to keep the economy on track to meet our target.

POTTER: And you can be outvoted. How does that feel?

KING: I don't think it feels that different, to be honest, from any other meeting. I mean it's never been an issue on the committee itself. Each person has one vote, and over a long period of time everybody at some time or another will be in the minority. But we accept that in the long run the majority view is likely to give you on average the best decisions, the best prescription for the economy.

CURWEN: Meeting Mervyn King had been a unique experience. What was our listener's verdict?

POTTER: What an opportunity to go and meet one of the most influential people in the British economy. It's really good to know the depth of thought that goes into how these guys go about making their decisions. It's something that I've never really ever appreciated before.

CURWEN: Adam had been struck by what Mervyn King had to say about the housing market – that he wished the official inflation target, the CPI, did include housing costs. As a nation we owe more a trillion pounds in mortgage debt, and many of us have seen mortgage payments rising, as interest rates have gone up. And yet that's not reflected in the Bank's target measure. So is inflation higher than it's painted? Someone who's worried about the property market is leading economist Roger Bootle, who's famous for successfully predicting in 1990 that the UK was about to experience a decade of low inflation. He's also famous for forecasting falls in house prices, which have so far failed to materialise. Like many economists, he thinks the MPC has done a good job, but he does have misgivings.

BOOTLE: I still very much believe that inflation is going to be low by comparison to what we've experienced in the past. I wrote a book many moons ago called 'The Death of Inflation' in which I argued it would be low. No way am I recanting on that. However, I think you know we are in a phase when it clearly has moved up a bit and the danger is it could move up a bit further. I'm not talking you know 9 or 10%, but it's not inconceivable that it could get to 4.

POTTER: Do you think the Bank of the England pays enough attention to the strength of the housing market?

BOOTLE: It's difficult to know really what they really think, you see, because in some ways they're in a bit of a bind over this issue, as indeed are some independent commentators. A number of people with egg on their face over this, including the Bank of England. Because don't forget the Governor did warn about the housing market. It then bounced back and it looked as though his warnings were really rather silly. I suspect, therefore, that the bank is probably - and certainly the Governor - is more concerned about house prices than he's willing to let on.

CURWEN: And indeed you have warned in the past that house prices might fall.

BOOTLE: I have and of course I was wrong - so far. Tricky business, house prices, of course as an economist you have to get used to the idea of being wrong, it's an occupational hazard, and I was wrong in a big way. Well, I say so far. A lot depends on how things pan out at the moment. You know if you can imagine Mervyn King going to bed at night saying his prayers, what would he be asking the Almighty for? I think it would be a gentle slowdown in the housing market, which over a period of years brought back a state of normality without disturbing the overall position of the economy. He's not going to get that by the way.

POTTER: Does that mean that maybe we should actually have housing costs in our official inflation figure?

BOOTLE: Well this is a really very deep and tricky issue. A lot of people I think don't have faith in the official measure - the CPI. You see I think a system under which we have - let's assume - a bonkers environment in which house prices at one point are going up by 10, 12, 15% that they have been recently. Then let's assume we go into a period where house prices fall. I think the human and economic cost of that instability in house prices is going to be enormous - all sorts of people whose lives are going to be profoundly affected by it. Meanwhile the CPI inflation may have done next to nothing. My own view is that there's a mis-specification of the target and actually it would be better if the Bank of England were aiming to maintain stability more generally, and in that regard I would think house prices were supremely important.

POTTER: One question is what is the right level for interest rates? I mean is 5.75% the right level?

BOOTLE: I think rates have been much too low. I'm on record as saying I think they'll get to 6, and I have a sneaking feeling that they're going to go higher than that. 7% is not impossible, but I would guess that 7% would cause mayhem in the housing market quite apart from anything else. But I wouldn't be at all surprised to find them going to 6½%.

CURWEN: We'd heard criticism, then, of the Bank's CPI inflation target, and suggestions that interest rates hadn't been raised far enough. Adam's original concern had been about wages. It seems the CPI measure has shortcomings in this area too, because most pay negotiators in the UK don't use the CPI; unions argue it is not a realistic measure of workers' cost of living, just because it doesn't include mortgage bills. In fact, average wages have been rising, more sharply than that official target rate of two per cent. Ken Mulkearn is the editor of the influential Pay Report from the research company Incomes Data Services. When we met him, Adam asked whether wage increases are feeding the flames of inflation.

MULKEARN: In some ways it's a chicken and egg question, the whole thorny issue of whether wage prices cause inflation or inflation causes wage prices. Inflation has only risen - and not to very high levels, it must be remembered - over the last four or five months. And it's had an effect. Our measure of the level of wage settlements ticked up from 3% at the end of 2006 to 3.5% in the first month of 2007 and it stayed there.

POTTER Certainly in my sector we're seeing pay rises of I mean really 5% is your starter, we've got rates up to 10% easily, depending on what your specialist skills are.

MULKEARN: Yeah absolutely, Adam. That doesn't surprise me at all. In sectors like yours where skills are often in short supply, we've seen that employers are prepared to pay a premium. But the question as to whether they'll then cause employers to pass on those wage increases in the form of higher prices, I think is a really good question I'd like to put to you. You know whenever you raise wages, does that mean then that you'll try and recoup your costs by raising the prices that you charge to your customers?

POTTER: Well certainly with my company, because wages are a very significant percentage cost of running the business, we do actually and certainly this year have passed on those increase in costs to our clients. So very much so.

MULKEARN: I think it's interesting and in many ways it does answer my question. And I think what it means is that if inflation were to significantly increase and if workers were then to try and maintain their living standards, you might then begin to see a knock on effect in terms of further inflation. What I would say though is that in terms of the recent rises in inflation that we've seen - and they have been modest - the extent to which they've been driven by increases in UK labour costs, I would say is fairly doubtful.

CURWEN: So you're saying there isn't a simple equation between wages rising and inflation as a whole rising?

MULKEARN: I think that's right. I mean there's often a kind of mythology around wages and inflation so that wage rises are either referred to as inflation busting, on the one hand, or benign on the other and there often isn't a language to describe the in-between situation, you know the reality that's often more complex.

POTTER: Should the Bank of England actually be worried about high wage inflation?

MULKEARN: At the moment probably not. I think on balance, it's probably something that the economy can cope with. Now I know I don't necessarily speak for you, Adam, I know that business can be tough, but what we're hearing from a lot of larger companies is that things have been good over the past period, and therefore, in as much as the cost of living has increased that little bit, and employees are looking to peg their wage rises against that, employers are prepared to say "Sure, that's fine, the budget can stretch, here you go".

CURWEN: Adam's fears about a wage-price spiral had been partly defused

POTTER: Certainly in our case we are passing on wage increases onto our clients but that's not the case at all in the economy as a whole. With companies making a higher amount of profit, they are capable of actually absorbing those wage increases and therefore not contributing to inflation at all. So it's a much more complicated picture than what I first originally thought.

CURWEN: Some reassurance then for Adam. But there was another economic indicator to look at, that's got some academics very worried indeed. It is the rather arcane and seldom-reported issue of money supply. It may sound deeply technical; it is certainly a source of contention. Money supply figures give us a snapshot of the billions of pounds flowing around the UK economy, in the form of notes and coins as well as all the money churning in and out of our bank accounts, and that's boosted by increased amounts of borrowing. Some experts think the faster the flows increase, put baldly, the greater the risk that inflation will rise. One group of economists became extremely concerned when it emerged that money supply, by one measure, is growing at more than 13 per cent a year. They sent an open letter to Mervyn King, expressing their worries in April. The group was led by Professor Tim Congdon of the London School of Economics. He met Adam to explain his concerns.

POTTER: So what is the risk if money supply keeps on increasing?

CONGDON: Let's go back over the last 30 years. We had two big episodes of rapid monetary growth. One was in the early '70s when the total of money, all these bank deposits, grew at about 25% a year for a couple of years. And then again in the late '80s when for a period, money growth was about 15, 20% a year. Initially there was a big increase in the price of shares, of houses and so on. But then eventually there were booms in the economy and then there was increase in the price of goods in the shops, big pay increases and we had a bust. So this is very important to the economy. If we want to avoid a boom-bust cycle, then we must prevent these excessive excesses in money growth happening again.

POTTER: Do you think the Bank of England is actually paying enough attention to the increase of money supply?

CONGDON: No I don't. I have immense respect for Mervyn King and, on the whole, I think over the last ten years the MPC has done on average a fantastic job. But the Bank of England has a tradition of not paying that much attention to these money supply numbers. For example in the boom of the early '70s and again the boom in the late '80s, they tended to pooh-pooh the significance of these figures. They were wrong. They've moved a bit towards recognising the importance of money. But in my view not enough.

CURWEN: But the Bank of England has been given a target by the government and that target is the CPI - it's not money supply.

CONGDON: That's correct and obviously the ultimate target is inflation. I think my fear is that they'll keep on having increases in the consumer price index that are above target. They then have to raise interest rates more than they thought and so then there's a period of asset price weakness in 2008 and 2009.

CURWEN: And by asset weakness you mean a collapse in house prices, possibly in share prices too?

CONGDON: Yes. I don't want to get too dramatic, but a period of two or three years in which house prices, maybe they don't collapse, but just go sideways, share prices fall, that kind of thing.

POTTER: So if interest rates would need to rise in order to fix the money supply problem, what would be the right level?

CONGDON: Suppose that this boom gets out of control, and suppose inflation moves up towards say 5 or 6%. And people come to expect that in the future and they come to expect house prices to keep on rising at 10% a year. Then the interest rate may need to rise to 8%, and that means mortgage rates at 9½%. Now you may think that this is a horror comic or something. But in the 1980s base rates averaged 12%. We sometimes had base rates of 15% with the associated mortgage rates by the way. Look, I don't think we're going to get there, and I hope not, but if this boom gets out of control, that's the kind of number to be thinking about. That's why it's so important to act early, to pre-empt this sort of problem and I think I'm expecting the peak in the cycle to be somewhere between 6 and 6½%.

CURWEN: But even 6 or 6½% will be very painful for people with mortgages and debts.

CONGDON: Yes. And that's why it's important to nip these booms in the bud.

CURWEN: Tim Congdon had opened Adam's eyes to the whole issue of money supply, suggesting it could even have far-reaching consequences for people struggling to repay mortgages and other debts.

POTTER: Inflation makes headline news, house prices makes headlines news, wages makes headline news but very rare that money supply ever makes headline news, and what Tim was saying was that potentially there is this thing out there that could give us a problem in the future. So there's very much food for thought there.

CURWEN: The issue of the steeply rising money supply figures remains very controversial. Some think it worries the Governor of the Bank of England more than some of his colleagues on the MPC. Our listener Adam Potter, when he met Mervyn King, asked him about its importance.

POTTER: One of the factors I've heard about is how much money is actually flowing around the economy. How significant is that in the committee's discussion about interest rates?

KING: Well since inflation is a fall in the value of money, any increase in the amount of money is clearly important. So these factors do enter into our decisions. But you have to understand why it's happening. It's not enough just to say "oh some number has changed by x%, therefore interest rates must change in turn". You have to go behind the statistics and ask what's the story that's explaining what's going on. And in that sense, what we're doing is a little bit like one of the old spot the ball competitions, where you were given a photograph of the different players in a game and you had to work out where the ball was. And what we have to do is to look at the statistics, which are like the players in the game, and say "what shock could have hit the economy which would explain why retail sales have moved up a little bit or unemployment has moved down a little bit?" So we're engaged in a sort of spot the shock competition where we've got to identify the driving forces in the economy, which will enable us to work out what is likely to happen to inflation in the future.

CURWEN: All along, Adam Potter had been faced with two issues – one was about the very nature of CPI, the official inflation target handed down from the government. If it doesn't address issues such as soaring house prices or money supply, is it really the right target? That's beyond the control of the Bank of England, but the second issue was - how well had the Bank's committee performed, in keeping inflation close to the target level? That was a question for Mervyn King.

CURWEN: Do you think the committee has made the right decisions?

KING: That's for historians to judge. But the track record is pretty good, so if we have made wrong decisions from time to time, there can't have been very many of them and they can't have been that wrong. The Monetary Policy Committee I think was well designed. I think it's been successful for ten years and I see no reason to believe that it cannot be successful for another ten years and decades after that.

CURWEN: Mervyn King's robust defence of his committee still left Adam with questions about the inflation target. He wanted to speak to a government minister, but we were told no one was available for interview. In a statement the Treasury said, since the Monetary Policy Committee was launched, the UK had enjoyed its longest period of low inflation since the late 1960s.

TREASURY STATEMENT: The MPC's objective is straightforward: to maintain price stability, and to support the Government's economic policy. Introducing further targets to the MPC's remit, and complicating this simple objective, risks jeopardising the wide acceptance the current remit enjoys.

CURWEN: Inside Money had given Adam Potter a whirlwind tour of the UK's inflation control system. His worries about rising wages had been partly allayed, but he'd heard calls for a new target structure for the Bank of England, because of concerns about the volatile property market, and a rising tide of money swilling through the economy. There had been gloomy forecasts of falls in house prices and share prices. And, suggestions that interest rates should go up to 6 and a half per cent. Both the Treasury and the Bank of England, had defended the good record of the current system. How did Adam see it?

POTTER: As far as the Treasury is concerned, if it ain't broke, then don't fix it. I think what matters though is not looking back but obviously looking forwards and to say well maybe from what we've heard with the other economists the situation may be changing and really it's much more important now to look forward to understanding whether or not the inflation targeting framework is still indeed the right framework to have. I think what we've learnt is that CPI doesn't really tell the whole story; we've got house price inflation, we've got wage inflation and we've got the increases in money supply. There's a much broader set of figures out there that really tell a much more detailed story I think.

CURWEN: We've heard some fairly dire predictions in the course of the programme. What's your thought about the future?

POTTER: I wouldn't like to have Mervyn King's job. There's so much conflicting data out there. Really, really the task of the Monetary Policy Committee is much, much more complex than I originally thought. My hope is that obviously inflation remains somewhere between 1 and 3%, as is the target, and that interest rates are maintained such to continue that. From a business owner's perspective, managing a business in a high inflation environment is much, much more difficult. So really I'd like things to certainly calm down a little bit. So if that means that interest rates need to rise, then interest rates need to rise. From a personal perspective, obviously if you have debts then it's going to be painful. But fundamentally in the longer term, it's much more important that we have a stable and growing economy. It will be terrible if we lose sight of our target and actually end up with another bust.