STIR Capital LLP

Robie Uniacke Letter to Mervyn King
Bank of England Governor, 2004

November 15th 2004

Dear Governor,

What prompts me to write to you today is the recent inflation report the Bank published on the 10th of November and in particular the "blue box" on page 12 & 13 entitled **House Prices and Consumer Spending**. Inserting explanatory boxes on certain issues is I am aware a popular and often useful practice engaged in by a number of central banks, I am equally aware of the limitations of this format when compared to a full research piece. Nonetheless this section is in my view an extremely poorly conducted and presented piece of research, an observation that in itself would not particularly be of concern were it not for the highly questionable conclusion that was not only drawn from the suspect research but then inserted into a number of other areas of the report and furthermore appears to carry some weight in the minds of the MPC.

Without writing a full research piece of my own, my objections are as follows. I am not arguing with the graphic representation of the relationship between **Real House Prices** and the **Chained Volume Measure of Consumption** depicted in Chart A. My problem lies with the insertion of Chart B (Correlation between **Annual Real House Price Inflation** and **Annual Consumption Growth**.) the choice of a **Rolling Ten year Correlation Coefficient** and the information that the graphs are purported to convey.

Let us say you reduce the Correlation to a **Rolling 5 year Correlation Coefficient**, from a visual perspective initially, which is after all the point of showing a graph, two things which are hidden in your chosen graph, would be immediately clear. First it would illustrate that the correlation has tended to deteriorate as **Real Annual House Price Inflation** has moved beyond 10% and second it would show the bank and other readers that the correlation moves close to 1 in times of **Falling Real Annual House Price Inflation**. In short had I been faced with a chart of a **Rolling 5 year Correlation Coefficient** the conclusion I would have fairly quickly drawn was that the correlation between house prices and consumption is readily explained by the shape of the curve, which represents the **Declining Marginal Utility of Wealth**.

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Furthermore if we ignore the **Rolling Ten year Correlation Coefficient** and examine the correlation over fixed time frames of rising or falling **Annual Real House Price Inflation** the evidence against the conclusion of the piece would appear to be even more compelling.

Taking the following snapshots of the data:

Period	Real HP Inflation Falling/Rising	Correlation with Consumption
Q1 1974-Q1 1977	Falling	-0.89
Q1 1978-Q1 1980	Rising	-0.98
Q1 1980-Q1 1982	Falling	0.96
Q1 1983-Q1 1989	Rising	-0.02
Q1 1989-Q1 1991	Falling	0.91
Q1 1992-Q1 1996	Falling	0.79
Q1 1997-Q1 2004	Rising	-0.19

- The overall period Q11989-Q1 1996 displayed a correlation of 0.79 the data above is broken into two phases to illustrate the extremely strong correlation in the initial phase of this decline, consistent with the Marginal Utility of Wealth Curve.

In short, contrary to what was illustratively implied by the **Rolling Ten-year Correlation Coefficient** depicted in Graph B the current collapse in correlation is normal rather than exceptional, for there has been no significant positive correlation between **Rising Real House Price Inflation** and **Consumption** in the last 30 years. But more importantly, the correlation between **Falling Real House Price Inflation** and **Consumption** in the last 20 years has been highly significant and persistent. It will not surprise you that I therefore take strong issue with the conclusion of this section of the report, namely, "*The association between house prices and consumer spending has weakened in recent years. That MPC judges that it is likely to be less strong in the future too – spending growth is therefore expected to ease only moderately despite a sharp slowing in house price inflation".*

The second half of the piece entitled "**Why Might the Association Have Changed**?" feels like a bit of a shot in the dark, which suffers terminally from the lack of point and counterpoint analysis. The report's attempt to explain the change relies on an examination of the relationship between the **Share of Durable Expenditure in Consumption** and **Real House Prices.** There is a prima facie logic to this in an environment of equity withdrawal, a point that is made, however there is nothing in this chart to suggest that a connection exists and I note that there is no attempt to overlay a rolling correlation on this relationship. Indeed an examination of the relationship between the **Share of Durable Spending in Consumption** and **Housing Market Transactions** or **Permanent Dwellings Completed**, reveals a much stronger statistical correlation on top of the measurements being intuitively more compelling. Had the report focused on the relationships above, the proposition of the report: "*more recently, the durables spending share has remained close to its long-run average, while house price inflation picked up markedly. This could suggest that income expectations have been broadly stable and credit constraints less binding than in the past"* would have been unthinkable. Instead it would have likely concluded: "*more recently, the durables spending share has remained close to its long-run average, while house price inflation picked up markedly. This is likely the result of the supply inelasticity in the housing market and* *the steady decline in annual housing transactions since the late 1980s and tells us nothing about income expectations"*

This letter is mainly concerned with the shortcomings of the research surrounding the "issue" and I am happy to note that the bank draws attention to the risks associated with the "conclusions" under **Risks to the Central Projection** and in the **Opening Remarks**. That said I remain concerned by the conclusions.

Given the statement; "*the MPC believes that there is a risk of a sharper correction to house price inflation than is implied by the central projection"*, the relationship that your piece sought to explain becomes critical; later in the same paragraph the report states; "*There is a risk that the MPC has underestimated the potential downward impact on consumption from a sharp slowing in house price inflation"*. If this conclusion was based on the flimsy piece of research we have been presented with, then the underestimation of that risk has serious implications for the central projection of GDP and the current level of interest rates.

Whether I have merely highlighted the hazard of truncated research insertions in a publication like this or whether I have drawn out an important example of a "statistical lie" I will leave it for you to judge. I look forward to your comments.

Yours sincerely,

R. Uniacke

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