The Politics of Inflation Management

Matthew Watson

Published in the *Political Quarterly*, 74 (3), 2003, 285-297.

The Politics of Inflation Management

I. Introduction

An unanticipated and almost wholly unexpected coincidence of economic events occurred in Britain in July 2002. Taken together, these raise serious questions about the stated rationale that has guided the conduct of British macroeconomic policy for at least a generation. Yet they remained entirely unremarked upon in the financial and broadsheet press.

On Monday, 15th July, the FTSE 100 index fell below 4,000 for the first time in 5½ years, a full 43% below its peak of 6,950.6 reached on 30th December 1999. Before the London Stock Exchange opened for trading the next morning on Tuesday 16th July, the Treasury announced the latest figures for the Retail Price Index measure of underlying inflation in Britain, which had fallen to an annual equivalent of 1.5%. This was the lowest figure on record since the Treasury first began to collect systematic Retail Price Index data amidst the inflationary experience of the early 1970s. Moreover, this was not merely a one-off, a statistical blip. At the time of the announcement, inflation in Britain had been below the Chancellor's 2.5% target rate for all but two months of the previous three years.[1]

So, why is this particular coincidence of events of such significance? To answer this question, it is necessary to look back at the strategy deployed by the Labour Party in its efforts to win the 1997 General Election. In particular, we must revisit the extent to which it sought to capture for itself a reputation for governing 'competence' – which, in economic terms, it understood solely as a reputation for counter-inflationary credibility.

Labour acted as if the stock market were the primary arbiter of the Party's reputation in this respect. Any evidence of falling share prices on the expectation of a Labour victory was assumed to signify market concern about the strength of the Party's counter-inflationary commitments. Or, as proved to be the case, rapid increases in the value of the stock market in the immediate pre-election period, coupled with the general feeling that Labour would win, were taken to indicate that the markets were now unconcerned about the likely inflation performance of a Labour Government. Low inflation and governing 'competence' were thus elided, with the stock market cast as judge of whether the prevailing inflation rate constituted evidence of a competent government.

Moreover, this understanding of the relationship between stock markets and governments, which vested all sense of power in the former, was by no means confined to the British Labour Party. It had also become commonplace within the academic literature to argue that markets had acquired a virtual veto over government policy. It was assumed that the veto was enacted at those moments where co-ordinated selling expressed the markets' disapproval with governments who prioritised other policy goals over that of containing inflation. However, it is precisely such an assumption – namely, that share prices vary inversely, and *automatically*, with the markets' inflationary expectations – which last July's coincidence of events did so much to contradict. At that time, the London futures market was trading at prices which suggested that investors were expecting little upward pressure on inflation for the following six months and, as such, little upward pressure on primary interest rates, which stood at a 38-year low of 4%.[2] Yet this did nothing to arrest the prevailing slide in share prices. Indeed, the slide continued in the months following July 2002. On March 12th, 2003, a 4.8% fall in the value of the index took the FTSE 100 back below 50% of its 1999 peak. It closed that day at 3,287.0, almost 53% off its peak.[3]

Two points follow. Firstly, it is clear from the foregoing that there is no simple technical fix for running a modern economy, whereby suppressed inflationary expectations lead to low interest rates, which in turn lead to opportunities for expanded wealth, as reflected in ever-rising share prices delivered by a satisfied stock market. As a consequence, and contrary to the actions of successive British Governments over the past twenty years, the politics of inflation management cannot be reduced to a simple technical question of creating an appropriate institutional framework for suppressing inflationary expectations. There is more to governing 'competence' than merely delivering low headline inflation rates. Secondly, the experience of inflation must be viewed as a distributional, and therefore highly political, issue. While the headline rate of inflation has been both historically low and stable in Britain for some time now, the headline figure masks divergent price trajectories across different sectors of the economy. Stable, and even falling, prices in some sectors exist alongside rapidly rising prices in other sectors. The decision to allow certain assets to experience rapid price inflation within a generally benign inflationary environment should be understood as an integral feature of the Government's wider political strategy.

My argument proceeds in two stages along these lines. I focus primarily on the way in which Labour has built a large part of its future electoral prospects on being able to target specific constituencies, who have become wealthier on the back of Government policies that have led to buoyant share and house prices. This strategy was eminently successful in 2001, as it delivered the material conditions that underpinned the Party's second successive election victory. It is in these markets in particular that asset price inflation exceeded the general inflationary trend during the first term of the Blair Government. This, I suggest, is no mere coincidence. Rather, it has been a deliberate part of Government strategy, intended to maintain its appeal to the new voters it captured in such large numbers in 1997. The significance of last July's economic events should therefore be apparent. While the Government continues to run a macroeconomic policy geared to the successful suppression of the headline rate of inflation, this no longer appears to be tied so closely to an ensuing increase in the material well-being of its target constituencies via ever higher prices on the stock market. This does not mean that the Government's electoral strategy has become entirely self-defeating, although it does point to the possibility of contradictory tendencies within its economic policy. I review that possibility, concluding that the politics of inflation management in Britain remain amenable to more progressive forms of political mobilisation – but only so long as Labour liberates itself from understanding economic governing 'competence' solely in terms of delivering a low headline inflation rate.

II. Inflation Management: The Orthodox View

Perhaps the most notable theme of the academic literature on the 1997 General Election in Britain concerns the lack of competition over the direction of future economic policy.[4] Indeed, for most commentators, Labour's electoral success appeared to be linked to its prior political success in defusing such competition by treating economic policy merely as a matter of competence. In relation to one of the most frequently asked questions of the campaign, 'Who's trusted most on the economy?', virtually all the opinion poll data pointed to the Labour Party. Furthermore, this was a distinctively 'New' Labour phenomenon. While Labour held a narrow lead amongst all voters on the issue of perceived economic competence, amongst *new* Labour voters that lead was 4:1. The party's attempts to redefine the way in which it was seen by the electorate clearly resonated most strongly amongst its target constituencies of potential floating voters. Here we see a party with a carefully constructed policy programme pitched directly at a pre-targeted social group whose support was deemed essential.

The important thing to note in this respect was that Conservative failure of macroeconomic management was made a matter of technical competence rather than one of ideology. The crux of Labour's attempt to prove that it was technically competent to run the economy came in its enthusiastic endorsement of the prevailing 'sound money' orthodoxy. In simpler language, this meant being seen to be tough on inflation.

Justification for adopting such a stance was forthcoming at this time from the academic literature. Driven by the perception that globalisation was changing the power relationship between financial markets and governments to the detriment of the latter, it was widely assumed that the scope of feasible economic policy had been significantly reduced. Globalisation is conventionally linked to a substantial increase in feasible exit options for capital, as investors are more able than ever before to take advantage of market opportunities, wherever in the world they arise. Investors who disapprove of the government's policy priorities are considered likely to register their disapproval by re-locating an increasing amount of their assets overseas. Capital is assumed to hold the upper hand in its relationship with the state, irrespective of the condition of globalisation, in that it is only through the successful reproduction of the capital accumulation process that the successful reproduction of the state can be ensured.[5] Add to this the empowering effect of globalisation for capital and it tends to be further assumed that investors are able to impose their policy preferences on governments in a way which governments are simply not at liberty to reciprocate.

The constraints on feasible policies are thought to be particularly pronounced whenever governments, or even prospective governments, reveal progressive political aspirations in their proposals for the economy. Set in such a context, an obvious contrast is to be made between the reactions of the financial markets to the possibility of Labour victories in the General Elections of 1992 and 1997. During the four weeks of the 1992 campaign, for instance, the headline FTSE-100 index of leading shares recorded a points loss equivalent to 7% of the market's value. The most substantial losses in that period came in the immediate aftermath of opinion polls that showed a strong Labour lead. This reflected the fact that those shares whose underlying values were considered most susceptible to a change of government experienced a percentage fall which ran well into double digits. By contrast, no similar cluster of 'vulnerable' shares emerged during the course of Labour's surge to victory five years later. The FTSE's upward trajectory at that time was entirely undisturbed by the prospect of a Blair Government.[6] This was largely due to there being no group of shares whose underlying values were considered susceptible to a change of government, and this in turn was primarily because a change of government was not thought likely to lead to a change of animating vision for government policy. Labour's erstwhile progressive political aspirations did not cause concern amongst the financial markets in 1997 as they had in 1992, because the Party's leaders had used the intervening period to extricate themselves from such aspirations.

However, my concern here is to caution against an unequivocal acceptance of this reading of events. For, such a reading overlooks an important element of the politics of inflation management. Taken to its logical conclusion, it suggests that the politics of inflation reduce simply to the search for efficient institutions to guide the conduct of policy. Specifically, it is founded on the assumption that there is an inflationary bias originating within the political process, and that there is a technical fix for such a bias. Inflationary outcomes are thought of as the product of institutionally 'inefficient' policies: provide the correct institutional framework for overcoming such inefficiency and positive results will follow, both in terms of superior inflation performance and subsequent increases in personal wealth.[7]

Yet it is precisely such assumptions that last July's coincidence of economic events did so much to undermine. The Chancellor moved with haste in the immediate aftermath of the 1997 General Election to provide an institutional framework suited to the task of sustaining counter-inflationary credibility. Primarily as the result of his decision, taken within a week of coming to power, to cede operational independence to the Bank of England, the historic differential on long-term interest rates between Britain and other major European economies has fallen to zero – indeed, according to the Chancellor's latest budget speech, beyond zero.[8] No clearer comment could be forthcoming from the financial community about the perceived strength of the Government's counter-inflationary framework. However, for much of the period since July 2002, the FTSE-100 index has been trading below the level that the Blair Government inherited when it first entered office in May 1997. Despite the market's rapid increase in value amidst all the excitement generated by expectations of a 'new economy' in 1999, all that additional value – and, therefore, wealth – has subsequently been lost again (see diagram 1). Average wealth holdings in Britain, as secured through the value of stock market investments, are now no higher than they were six years ago. This is *despite* all the Government's efforts to introduce an institutional framework consistent with improved inflationary performance.

[Insert diagram 1 about here – Source: calculated from Thomson Datastream figures.]

This is important for three entirely different reasons. Firstly, it tells us much about the character of the upward movement in share prices experienced in the late 1990s. Looking solely at the level of the headline index, it appeared that an increasing amount of capital had been pumped into the market as a whole, to keep it afloat with excess demand, which in turn served to inflate existing prices. Investors seemed to be acting as if the broad range of market risks and returns had been shifted in the direction of a new lower-risk equilibrium – one consistent with suppressed inflationary expectations. However, on closer inspection, this proves not to be the case. Behind the overall increase in the value of the market index in the period 1997-

1999, stock market investors appeared to be operating to two distinct logics.[9] On the one hand, for established firms without digital prospects, price to earnings ratios were forced down as investors demanded good news on profits as a sign that operating costs could be more than adequately recovered through the product market. For these firms, there was no evidence at all that investors had reconfigured their perceptions of the risk/return structure of the market to reflect suppressed long-term inflationary expectations. Here, the Government's putative success in establishing counter-inflationary credibility had no effect on the performance of the stock market. On the other hand, for 'new economy' firms with digital prospects, price to earnings ratios rocketed to historic highs as investors overlooked adverse profits warnings and accepted that costs could be recovered through the capital market. But, once again, this is not evidence that the risk/return structure of the market had shifted in line with lower levels of expected inflation. It is merely evidence of a sector-specific share price bubble pushing the overall market index temporarily, albeit significantly, above trend (see diagram 2).

[Insert diagram 2 about here – Source: calculated from Thomson Datastream figures.]

Secondly, the headline rate of inflation may be a somewhat misleading figure. Certainly, without disaggregation, it tells us very little about the overall performance of the British economy. Moreover, so long as the Government continues to target solely the headline rate, and so long as it continues to seek political capital for its current 'competence' in this endeavour, the impression remains that the politics of inflation management is a purely technical exercise. However, focusing only on the headline rate allows divergent price trajectories in different sectors of the economy to be overlooked. It diverts attention away from the Government's decision to allow certain sectors of the economy to experience significant price inflation, at the same time as introducing an institutional framework for inflation control that has led other sectors of the economy to experience price *deflation*. It is necessary to look beyond the headline rate of inflation to understand more about the current distribution of inflationary tendencies within the British economy. As a result, it is also necessary to treat the politics of inflation management as a distributional issue.

Thirdly, when the politics of inflation management are recast in this way, it becomes clear that the material basis of Labour's previously successful electoral strategy looks increasingly fragile. Its strategy for re-election has been to combine a strict targeting of a historically low headline inflation rate with rapid price rises in the two sectors of the economy in which most of the recent increases in personal and household wealth have been concentrated. These two sectors revolve around the stock and the housing market. However, with share prices currently subdued, this leaves only the housing market to provide increases in personal wealth and, as a consequence, that electoral holy grail for any Government, the 'feel-good factor'. Yet, the current trajectory of house price rises serves merely to exclude an increasing number of people from investing in property, and subsequently sharing in the additional wealth that is created by ever higher property prices. This provides a qualitative limit to the number of people that Labour is likely to be able to incorporate into its currently successful electoral strategy.

The remainder of the article focuses on points two and three above.

III. The Distributional Consequences of Contemporary Inflation Management

The academic literature is awash with the suggestion that 'market sensitive' policies of low inflation are now a functional necessity for the management of modern capitalist economies. However, much less time has been expended on analysing the implications of increased 'market sensitivity' for the distribution of wealth and power within society. It is clear that financial markets have a significant impact on the way in which society is organised, as the allocation of credit through financial markets is the *sine qua non* of distributional politics. Financial markets have their most direct impact on the social distribution of wealth in Britain through their ability either to enable or to constrain access to investments in shares and property.[10]

The social basis of 'market sensitivity' therefore incorporates those who own their homes and those who have private investment plans concentrated in shares. The Government's innovations to create an institutional framework for delivering counter-inflationary credibility, and in particular its decision to cede operational independence to the Bank of England, operate directly in the interests of these people. Central bank independence provides not only an institutional guarantor of orthodox monetary policies, *but also a political guarantor that the interests of a particular sector of society will be inscribed at the heart of the policy-making process*. For those with insufficient savings to be able to invest in either the stock or the housing market, the Government's institutional framework for monetary policy provides a further constraint preventing them from sharing in the expansion in wealth that forms the material basis of Labour's continuing appeal to the electorate.

For these people, any sense of enhanced material well-being is tied to the rewards that they can expect through the labour market. Yet, if we disaggregate recent headline inflation figures by sector, there is bad news for those whose future well-being is linked solely to likely wage increases. The July 16th announcement of a fall in the annual headline rate of inflation to 1.5% masked two very different trends. The Office for National Statistics data on which the Treasury's announcement was based showed inflation in the services sector to be running at 4.5%. By contrast, the goods sector was experiencing price *deflation*, with a reduction in the price of goods of 1.6%. The 6.1 percentage point difference in the rate of inflation between goods and services represented another record high.[11]

The prospect of wage rises within a goods sector experiencing price deflation appears bleak. Firms can only finance higher wage payments in such circumstances should they be willing to sanction significant reductions in earnings. However, the currently subdued state of the stock market makes this an unlikely strategy of corporate governance. As part of the process of winding down the share price bubble of the late 1990s, investors have acted to force the market's price to earnings ratio more closely into line with the historic average. Firms that announce expected reductions in earnings to a market of this nature will tend to trigger further losses in the value of their share price. As a result, it is much more likely that they will adopt an austere attitude within the wage bargaining process. Consequently, in such circumstances, the scope for enhancing the sense of material well-being through wage rises appears to be severely restricted. Thus, price trends within the goods sector serve to reinforce the divide between those who have access to expanded wealth opportunities within the stock and housing markets and those who do not. 'New'

Labour's Britain contains very definite patterns of inclusion into, and exclusion from, the Government's economic strategy.

Moreover, the Government's ability to incorporate new constituencies into its economic strategy is further constrained by the current divergent trajectories of the stock and housing markets. As diagram 3 illustrates, the annual average increase in share and house prices in Britain between 1980 and 2002 is very similar. The same cannot be said about the period that has followed the global stock market peak of the first quarter of 2000. In that time, house prices have gone in the opposite direction to share prices, and both have increasingly exceeded their average rate of change since 1980.

[Insert diagram 3 about here – Source: *The Economist* Real House Price Index.]

The impetus for these divergent price trajectories has been the performance of the stock market following the end of the tech-stock bubble. Given the incentives for exploring alternative investments that the depressed nature of share prices has provided, more money has flowed into property. The incentive structure faced by investors has been further skewed towards the housing market by the fact that primary interest rates are at a 38-year low, which in turn has made mortgages historically cheap. Taken together, these factors have combined to make property the investment of choice for an increasing number of those who have sufficient access to credit to enter the housing market in the first place. The result has been a surge in house prices. As diagram 4 shows, average house prices in Britain are two-thirds as high again compared with when the Blair Government came to power in 1997. Moreover, the rate of change in house prices has accelerated markedly in the latter half of that period. According to figures published in *The Economist*'s house-price indices, Britain has the highest house-price inflation anywhere in the world, with an annual average of 20.8% in the year to July 2002.[12] This represents a 13-year high, going back to the time immediately preceding the bursting of the last British housing bubble in the late 1980s.

[Insert diagram 4 about here – Source: *The Economist* Real House Price Index.]

This has created both economic and political problems for the Government. The highly localised nature of the housing market has led to particular geographic pockets of house-price inflation, notably in the South-East of England, but also now in and around other British cities. This in turn creates an obvious impediment to the mobility of labour, which is clearly antithetical to the Government's stated economic preference for labour market flexibility. More and more people, due to the nature of the limited financial rewards that they can expect from their job, find that they are forcibly excluded from favoured sectors of the housing market. This has been explicitly recognised by the Government in its attempts to subsidise property purchases for public sector workers in the London area. Irrespective of the Government's success in this respect, though, such a scheme comes nowhere near tackling the full extent of the political problem it faces. The more that the prevailing trajectory of house prices excludes people from sharing the rewards that are currently available on the property market, the less able the Government is likely to be to forge into a self-reproducing electoral bloc those who rely on investment returns for their enhanced sense of material well-being.

Two possible alternatives present themselves. On the one hand, the Government could attempt to talk down the housing market. However, it could only do this by suggesting that the balance of future interest rate risks is on the up-side.[13] Yet, any indication that interest rates were set to move higher would hit an already depressed stock market, and could very well lead to the paradoxical situation of *increasing* the incentive to concentrate assets in safer investments on the property market, thus leading to still higher house prices. On the other hand, the Government could attempt to talk up the stock market as a means of encouraging investors to move out of property and back into shares. But this would require a definite signal that interest rates were likely to move lower in the future, and it is the cheaper mortgages that have accompanied previous interest rate reductions that has been one of the key determinants of the house-price inflation of the last five years. Again, the actual result could well be the exact opposite of that which was intended.

The major difficulty for Government policy is that, given the current configuration of prices and earnings within the stock market, few incentives exist for switching the balance of investment portfolios back into shares. At the time of writing, April 2003, both six-month and twelve-month FTSE 100 futures are trading at a level roughly comparable to where the index currently stands, and still below where it was in May 1997.[14] This reflects the fact that most shares in the FTSE 100 index continue to look overvalued in relation to the most recent projections of company earnings. Contrast this to the previous two peaks in the ratio of house prices to personal income. On both such occasions, the price to earnings ratio for shares was significantly below its historic average. This made the stock market cheap in comparison to the housing market, circumstances which are not replicated in Britain today. As *The Economist* concludes, "this means that house prices might continue to rise for a while yet".[15] It also means that an increasing number of potential Labour voters are likely to find themselves excluded from the dynamics of wealth enhancement in the short to medium-term.

If this is not bad enough for the Government to contemplate, then it should also be concerned about the situation of those who have recently purchased property as an addition to their personal wealth. The combination of low inflation and rapidly rising house prices has led to an equally rapid expansion in long-term household debt. Low inflation may result in cheaper mortgages, but cheaper mortgages provide incentives for individuals to borrow more to fund their housebuying, at exactly the time that they are unable to rely on inflation to reduce the long-term value of their debts. The last time that so many households were exposed to so much debt in Britain came during the house-price bubble of the late 1980s. When that bubble burst, there followed a period of rapidly falling house prices, a sharp increase in negative equity, the evaporation of the 'feel-good factor' for a large proportion of the population, and a haemorrhaging of political support for the incumbent government.

From the foregoing, it is clear that there is considerably more to the politics of inflation management than simply the successful targeting of a low headline inflation rate. Indeed, it is necessary to review the entire way in which the Blair Government has attempted to secure for itself a reputation for governing competence. It was certainly electorally expedient in the period surrounding the 1997 General Election for Labour to construct such a reputation on the basis of strict counter-inflationary credibility. Yet, in continuing to follow that path so assiduously in the five years since 1997, unintended consequences of the Government's electoral strategy have become increasingly apparent in the form of systematic imbalances in the structure of the British economy. In turn, these imbalances may prevent the Government from incorporating sufficient numbers into its wider political strategy to enable it to sustain its current electoral ascendancy.

The politics of inflation management in Britain are currently amenable to a variety of different forms of political mobilisation. A more progressive politics of inflation management would challenge the whole basis on which the Government's understanding of ‘competence’ is grounded. The Government claims to be displaying competence whenever the headline rate of inflation is at or below its central target rate of 2.5%. At the same time, however, it chooses to remain silent on the *way* in which such targets are met. Labour has introduced an institutional framework for the conduct of monetary policy that reduces the opportunity to experience enhanced material well-being through rewards from the labour market, while increasing the opportunity to experience enhanced material well-being through rewards from asset markets. This clearly creates a social structure of accumulation that works in the interests of those who are already in the privileged position of having sufficient wealth to access asset markets in the first place.

By contrast, were the Government to understand ‘competence’ in terms of introducing a greater semblance of sectoral balance into the British economy, it may also do much to eliminate the exclusionary political logic of its current method of inflation management. Its first task should be to tackle the deflation in the goods sector, which would relax many of the economic pressures that are currently impacting upon the labour market and preventing higher pay awards. This may well increase the headline rate of inflation – but it would also reduce, in two different ways, the level of household debt that has been generated by the recent, unsustainable, increase in house prices. Firstly, the additional inflation would lessen the real burden of the debt. Secondly, the higher incomes resulting from higher pay awards would lower the ratio of house prices to incomes from its current record high, thus ameliorating the worst excesses of the current house price bubble. At the same time, it would have the added progressive political benefit of recasting the prevailing balance of social forces away from asset holders and towards wage earners.

However, this would all depend on the Government first publicly challenging its existing understanding of economic ‘competence’. As a consequence, it would also mean making a decisive break with one of the cornerstones on which the Party rebuilt itself as ‘New’ Labour. The dilemma can thus be simply stated: prioritise the short-term political fortunes of the Labour Party by continuing to emphasise the Chancellor’s ostensible success in maintaining low headline inflation rates; or prioritise the long-term health of the British economy by seeking to correct its internal imbalances, which have been exacerbated by the strategies that have delivered such counter-inflationary ‘success’.

IV. Conclusion

Yet, even if the dilemma can be simply stated, the significance of the choice that it implies may be entirely overlooked by the Government. If the Government truly believes its own diagnosis of the circumstances it faced prior to the 1997 General Election, no such choice will be deemed to exist. The construction of a binary opposition between ‘Old’ and ‘New’ Labour by the Party’s managers served to highlight the latter’s acceptance that the range of feasible policy options was heavily constrained in an era of heightened capital mobility and speculative asset pricing. More specifically, ‘New’ Labour presented its policy preferences in a way that mirrored its perception of the inflation preferences of the financial markets.[16]

However, there is reason to believe that the opinions of the financial markets are not the non-negotiable constraint that Labour cited as its principal guide for action in the build-up to the 1997 Election. What is more, that reason comes from Gordon Brown's most recent budget, delivered in April 2003. Much of the contextual discussion contained within the Chancellor's speech focused on the benefits the British economy was enjoying from the credibility that the Government had *already established* in the eyes of the financial markets.[17] If credibility increases the room for manoeuvre and the Chancellor was correct in his claims, then such room already exists. Moreover, to the extent that financial markets express an 'opinion' on a government's macroeconomic performance at all, this is through the price at which assets are traded and their subsequent incorporation into wider investment portfolios. Yet, the only lesson to learn from the movement of prices on the London Stock Exchange during 'New' Labour's tenure in government is their *lack* of correlation with the general performance of the British economy. Nothing at the level of macroeconomic performance can explain the precipitous rise in share prices in the period 1997-1999. Likewise, there was no direct trigger from the real economy to the stock market to explain the depressed state of share prices in the period 2000-2003.

This returns us to the significance of the housing market. It is within the housing market that we find the most profound economic and political pathologies of the imbalances of the current pricing structure of the British economy. This was partially recognised by Gordon Brown in his most recent budget. But his speech suggested that he understood the structure of the British housing market, not as a nascent political problem, but solely as a problem of macroeconomic co-ordination. His sole reference in this respect was that: "most stop-go problems that Britain has suffered in the last fifty years have been led or influenced by the more highly cyclical and often more volatile nature of our housing market".[18]

There is certainly a key difference in the structure of housing finance, as compared with all other European economies, which makes the British housing market particularly susceptible to augmenting and reinforcing the business cycle. The repayment structure of most British mortgages, following a strictly limited period of fixed repayments, varies directly with short-term interest rates (i.e., when interest rates go up, so do mortgage payments). It is this sensitivity of the mortgage rate to the interest rate that makes the British housing market more volatile than elsewhere in Europe, where housing finance is dominated by long-term fixed rate mortgages. As a response, the Chancellor used his April 2003 budget to establish a commission whose task is to review the possibility of developing a market within British housing finance for long-term fixed rate mortgages.

While this measure may help to alleviate some of the economic pathologies of the current structure of the British housing market, it will not arrest its political pathologies. Much of the vitality of the British economy from the mid-1990s has been driven by rapidly rising house prices within the context of falling interest rates. This combination of an increase in the value of houses and a reduction in the cost of mortgage repayments creates what economists call a 'wealth effect'. The impact of the housing market's current 'wealth effect' has been a sharp rise in equity withdrawal, through which homeowners increase their level of borrowing against the value of their house in order to sustain increases in general consumption. The most recent estimates suggest that the additional consumption financed by equity withdrawal since Labour came to power has been responsible for at least a quarter of the increase in GDP in that period.[19]

Significantly, the ‘wealth effect’ also has a close political counterpart, the ‘feel-good factor’. It is through the additional consumption made possible by ‘wealth effects’ that Labour has been able to incorporate more and more people into a winning electoral bloc. Those who have experienced the greatest increase in personal wealth from the housing market since 1997 have, on the whole, been willing to reward the Government with their continued support. As a consequence, there would be a clear political impact of restructuring the mortgage industry in Britain so that the repayment on house purchases became increasingly concentrated in long-term fixed rate mortgages. Such restructuring would eliminate the sensitivity of the housing market to changes in the interest rate, by dissolving the link between the interest rate and the value of mortgage repayments. At the same time, though, it would also be sure to eliminate the significant ‘wealth effects’ that have been generated over the last ten years by the reduction of interest rates to a near forty year low, as well as eliminating the political ‘feel-good factor’ that has been created by the enhanced consumption possibilities facilitated by such ‘wealth effects’.

The credibility that the Chancellor claims can thus be seen as something of a double-edged sword. In the absence of the ability to appear credible when making counter-inflationary commitments, it is generally assumed that financial markets will severely restrict the policy autonomy of any government. ‘New’ Labour certainly gave voice to such an assumption before it came to power, and it has continued to do so once in government. Yet, the means through which it has secured a reputation for counter-inflationary credibility has, at the same time, injected other sources of imbalance and instability into the British economy. As I have argued, these are perhaps most evident within the housing market, and they look likely to have both economic and political repercussions for the Government. The economic repercussions (i.e., the heightened sensitivity of the economy to movements in interest rates) may be at least tempered by internal changes to the market for housing finance. However, the political repercussions (i.e., the problem of continuing to sustain the material basis of a successful electoral coalition solely through 'wealth effects') may be somewhat more difficult to withstand. Indeed, these political repercussions may require nothing less than challenging the orthodox policy basis of the ideology of credibility on which the Government has relied so heavily in its attempts to construct a reputation for sound macroeconomic management.

---

* I would like to thank Andrew Gamble for his helpful and perceptive comments on a previous draft of this article. All responsibility for content, of course, remains my own.

[1] The figures in this paragraph are taken from successive issues of the *Financial Times*, 16.07.02 and 17.07.02.

[2] *Financial Times*, 17.07.02.

[3] *Financial Times*, 13.03.03.

[4] See, for instance, Peter Kellner, 'Why the Tories were Trounced', *Parliamentary Affairs*, 1997, pp. 616-30; Anthony King, 'Why Labour Won - At Last', in idem et al, *New Labour Triumphs: Britain at the Polls*, Chatham, New Jersey, Chatham House Publishers, 1998.

[5] This is the basic proposition of the 'structural dependence' thesis – for the origins of which, see Adam Przeworski and Michael Wallerstein, 'Structural Dependence of the State on Capital', *American Political Science Review*, 1988, 11-30; Charles Lindblom, 'Democracy and the Economy', in idem, *Democracy and the Market System*, Oslo, Norwegian University Press, 1988.

[6] The evidence for the performance of the FTSE 100 share index during the 1992 election is taken from Anthony Heath, Roger Jowell and John Curtice, 'Can Labour Win?', in idem (eds), *Labour's Last Chance? The 1992 Election and Beyond*, Aldershot, Dartmouth, 1994; Mark Wickham-Jones, 'Anticipating Social Democracy, Pre-empting Anticipations: Economic Policy-Making in the British Labour Party, 1987-1992', *Politics and Society*, 1995, pp. 465-94. That for the 1997 election is taken from Dennis Kavanagh, 'The Labour Campaign', *Parliamentary Affairs*, 1997, pp. 533-41.

[7] For a more detailed analysis of the reasons to look beyond such assumptions, see Matthew Watson, 'The Institutional Paradoxes of Monetary Orthodoxy: Reflections on the Political Economy of Central Bank Independence', *Review of International Political Economy*, 2002, pp. 183-96.

[8] See Gordon Brown's budget speech, transcribed in full, *Financial Times*, 10.04.03.

[9] On this point, see Hengyi Feng et al, 'A New Business Model? The Capital Market and the New Economy', *Economy and Society*, 2001, pp. 467-503.

[10] There is an important difference in the way that these two types of investment are made. While investments on the housing market are typically made directly by the individual, most of the wealth held on the stock market is the result of investment made on behalf of individuals by collective entities such as pension funds. Nonetheless, these are the two primary forms of invested wealth in Britain today.

[11] *Financial Times*, 17.07.02.

[12] The figures in this paragraph are taken from *The Economist*, 31.08.02, p. 64, and BBC Ceefax, 03.09.02.

[13] Although it must be pointed out, of course, that the Government no longer has the authority to actually determine interest rate settings.
[14] BBC Ceefax, 12.09.02.
[15] The figures in this paragraph are taken from the *Financial Times*, 17.07.02 and *The Economist*, 31.08.02, p. 64.
[16] On which point, see Colin Hay and Matthew Watson, 'The Discourse of Globalisation and the Logic of No Alternative: Rendering the Contingent Necessary in the Political Economy of New Labour', *Policy and Politics*, 2003, forthcoming.
[17] See Gordon Brown's budget speech, transcribed in full, *Financial Times*, 10.04.03.
[18] See Gordon Brown's budget speech, transcribed in full, *Financial Times*, 10.04.03.
[19] Figures cited in John Plender, 'The urgency of fixing the house price problem', *Financial Times*, 10.04.03.