The role of bank of england and its monetary policy in real estate

Business

The role of bank of England and its monetary policy in Real Estate Independent Research Study Table of Contents Introduction. 4 Aim..

 IntroductionThe Bank of England is the central bank of The United Kingdom and is the second oldest central bank in the world after The Swedish Riksbank. It has a long history as it was founded in 1694 and nationalized by William Paterson on March 1, 1946. The Bank of England has been playing an important role in The UK's economy by maintaining financial stability and acting as the central financial system of the United Kingdom.

The role of The Central Bank is to ensure price stability and support the economic policies of The British Government for a healthy economy. To achieve this goal, The Central Bank makes the monetary policy by stabilizing prices and instilling confidence in the currency of the country in order to keep the economy growing. Moreover, The Central Bank controls the interest rates charged by banks, hence, the monetary policy tries to control supply of money in macro economy. A good monetary policy plays an important role in a nation as it is used to stabilize the economy, lower the level of inflation and minimize unemployment. The government of England encouraged competition in the mortgage market by adopting a loose monetary policy such as charging the lowest interest rate in a decade which boosted growth in the housing market. However, the reluctance of some households to take long term fixed rate mortgage, and instead opting for variable mortgage loans including sub-prime, self-certificate, led to increased demand and hence competition thereby increasing the housing prices.

According to the DCLG report, the house prices went up by 12. 4% in over a year. The Bank of England took steps to regulate the real estate market such as when it increased the interest rate by 5 percent in the summer of 2006. The variation of interest rates has a significant effect on investments. This is because high rates lead to price increase of property making them less affordable thus reducing the demand. According to the survey, the volume of transactions in real estate decreased by 26 per cent from the previous year at that rate (5%), with an average of 81, 926 transactions per month.

Furthermore, housing prices decreased from 5. 3 per cent to 3. 6 per cent as the average housing price went down to ? 184, 798. However, the UK housing prices are still overvalued and there is a huge gap between real income of households and the ability to pay back the mortgage loan. The Bank of England imposed an austere monetary policy to calm down housing boom but this weakened The UK's economy due to less liquidity of money in macroeconomics.

Thus, a monetary policy plays an important role in regulating demand for property and managing the supply of money which significantly influences the real estate market. The Bank of England takes full responsibility for cooling down the housing boom, and has put effort to improve the economy. However, there are still limitations of this monetary policy and there is room for improvement on the part of The Bank of England. This research proposal presents a way to study the effective monetary policy of managing the real estate market in The UK and determines how it can be improved to come up with an optimal monetary policy. AimThe aim of this research study is to examine the complex and significant role of the Bank of England and to find the most suitable monetary policy to stabilize the price of real estate property in The United Kingdom.

ObjectivesThe objectives of this paper include: To describe the theoretical mechanism of monetary policy that can be used in discussing the monetary policy in the real estate market in The United Kingdom by analyzing the past monetary policy in The UK from 2005 to 2010 and using Taylor’s rule and its impact on real estate industry using secondary data. To analyze the efficiency of the monetary policy of The UK, examine and investigate the monetary policy of Sweden and the United States as case studies. To identify challenges that the Central Bank and its monetary policy must address in order to resolve financial crises and prevent future crises. Research DesignResearch strategy & MethodsTo successfully meet the objectives of this research paper, different research methods will be used to illustrate the different ideas floated. Basically, this section will discuss the research strategy by use of a variety of methods to collect data for each objective. This research will utilize secondary data.

This is the type of data that has already been collected and researched by another entity for a different research purpose (Smailes & McGraine, 2000). Generally, reliable secondary data will be used from different sources including articles, online news, working papers, database and other information that are pertinent to the study. In addition, the paper will make use of secondary data collected from government records to demonstrate the current monetary policy and the economic situation of the country. Peer reviewed journals such as Euromonitor and Emerald will be used to provide support or other researchers' views on the subject. In this study, both quantitative and qualitative data will be used to accomplish each of the above objectives. Qualitative approach will be employed to research, discern and explore hypotheses which provide understanding of the quantitative data available.

The qualitative approach used will explain the economic models pertaining to the study. The quantitative data such as statistical or mathematical is a way to compare and contrast differences between case studies. In this study, the analytical induction shall allow identification of similar events that fits the hypotheses and exceptions, accounting for both the positive policies (those used by Sweden) and negative policies (the subprime crisis in the United States). Data CollectionThe researcher collected and studied past monetary policies from a series of information such as online news, articles and government publications in The UK in order to provide a general overview of the current monetary policy corresponding with the exact figures which indicate current economic situation. In addition, this research will study the interaction between monetary policy and the economy, especially its impact in the real estate market in UK.

To achieve this, the combination of quantitative and qualitativ data will be used in analysis and discussion. The qualitative data shall explain the mechanism of monetary policy and how it performs in the economics of The UK. Moreover, qualitative data will be supported and discussed in analysis of the data quantities for better understanding. Furthermore, the quantitative data includes statistical and mathematical approaches such as graphs and tables that show the average price of real estate and the changes of demand and supply. The quantitative data also used for analysis and discussion is supported by qualitative data in order to provide a reliable conclusion.

Furthermore, in order to provide information and a clear description on the role of The Bank of England and its monetary policy which has a huge impact on the real estate market, the researcher also gathered data from peer-reviewed journal articles that are available on online databases such as Emerald Insight, ProQuest, and Ebsco where the topics of monetary policy in UK are plenty, based on previous research. The researcher will investigate the monetary policy of Sweden as a case study to compare and contrast with that of The UK and their impact on the respective countries. The main reason for analyzing the Swedish monetary policy is that it had different characteristics and outcome as opposed to The USA's monetary policy that failed to control the real estate market and it brought a huge economic crisis in 2008, called Sub-prime mortgage crisis. On the hand, Sweden is one of the countries which have had success in controlling and affecting positively the real estate market by adopting an appropriate monetary policy. The primary source of information was from government records, news and report peer-reviewed academic journals.

The various peer-reviews will be used to eliminate the inaccurate information or bias from the random websites over the internet. Furthermore, as the third objective consist of investigation and comparisons of cases, therefore, most of the data or information will be presented as qualitative and quantitative. Finally, the researcher extracted the desirable strategy which would help to make real estate market stable based on analysis of each case studies and address suitable recommendations for The Bank of England in order to help resolve financial crises and prevent future rises. Reliability and ValidityThe reliability and validity of data is the main concern when collecting data as this information is used for discussion, analysis and providing recommendation. Generalization creates a more credible qualitative research. As such, generalization is an important tool in qualitative research.

If the validity can be tested, it will lead generalization of the study. During the process of data collection, data was first triangulated before being accepted as evidence in the study, ensuring reliability and validity of resources because inaccurate data or biased information used in analysis and discussion may cause incorrect conclusion and recommendation. In order to increase the reliability and validity of the data, the research will use library catalogues, books, or peer-reviewed articles which provide more details and comprehensive information than the internet. In ensuring the reliability and validity of the data collection and data analysis, the study takes note of the tactics described by Miles and Huberman (1994) in verifying findings, “ checking for researcher effect, weighting the evidences, looking for negative evidences, ruling out spurious relations and spotting out rival explanations”. Data Presentation & Data Analysis The data is presented in three sections. The first section contains the theory framework of monetary policy and relation with the real estate market.

The second section contains a review of monetary policy Rules in UK from 2005 to 2010. The third section contains the case study of Sweden that was used to provide recommendation and improvement for The Bank of England. The machanism of Monetary policy and impactThe main role of The Central Bank and the impact of the monetary policy in real estate markets are well established in Literature. A review found out that there’s a strong linkage between real estate returns and the relevant financial and economic variables, including a monetary policy and the term structure of interest rates (Darrat and Glasock, 1993). The monetary policy is actively used and influences the real estate market as shown in the research that focused on the impact of monetary policy on housing price.

The loose monetary policy such as lowering interest rate and expanding the quantity of money, significantly affected housing price inflation. Furthermore, relatively high housing price precede financial crisis. Thus, the appropriate direction of monetary policy has a positive impact on real estate market and also the economy. The Central Bank has to respond to the prevailing economic situation. These insights are important in identifying the major role of the central banks and how those roles affect the real estate industry. In order to gauge whether monetary policy is “ loose” or “ tight”, the federal fund provide the rate for baseline.

According to Taylor, the Central Bank sets and adjust rates in order to stabilize the economy in the short-term and long-term growth based on 3 factors; actual versus targeted inflation levels, actual employment versus full employment levels and the appropriate short-term interest rate consistent with full employment. Taylor’s rule suggests that when economic growth is higher than the potential growth rate which a Central Bank targeted, the Fed increase interest rates in order to prevent economy over growth which may lead to high inflation (Taylor, 1993). On the other hand, when the economic growth and inflation rate is lower, a Central Bank decreases interest rate to revive a stagnant economy. Each Central Bank has its own goal depending on the country’s economic situation (Krugman & Olney, 2007). For instance, a country which is more likely to concern itself more on economic growth than inflation will change interest rate more sensitively with growth rate. Additionally, the country has to concern itself with price stabilization and try to adjust interest rates to reflect the fluctuation in price.

There are several ways to evaluate the effective monetary policy in macroeconomics. Dernanke and Mihov (1998) argue that measuring the stance of monetary policy is important for the economists to make optimal policy and choose alternative macroeconomic theories for the future. They, economists, develop one method for measuring monetary policy which is based on VAR methodology as a model to measure the efficiency of the monetary policy and its impact on macroeconomics. The model extracts information and data from bank reserves and the federal fund rate and performs explicit statistical comparison and trace responses of dynamic economic indicator such as GDP and GDP deflators. Furthermore, the approach is derived from an estimated model of the central bank’s operating procedure for constructing the optimal policy fit for current economic situation and focuses more on identification of significant system of endogenous component of the policy.

Monetary policy in UK between 2005 and 2010It is significant to analyze the historical monetary policy performed in The UK and its interaction with real estate market before discussing recommendations for The Bank of England. The following section will present data for monetary policy related to targeting interest rate in United Kingdom. In addition, the data will present how the monetary policy will impact on the real estate market and the reason that caused the real estate bubble in UK. According to BBC News, the Bank of England tended to conduct the loose monetary policy in order to stimulate housing activity growth by lowering interest rate which make money less expensive to borrow. This was after the 2001 recession. From the above figure 1, the interest rate went slightly down during the start of 2005 until 4.

5 % in the late of 2005. According to Taylor, “ too loose” monetary policy may cause a spur in housing activity. The Central Bank determines base rate on loans as they can adjust funding through the base rate. Therefore, all rates on loan are reflected by the base rate of a country. The changing in interest rate is the main key policy for central bank which significantly

affects an investment as it influences consumer spending, demand for loan, and investments.

As seen, the residential on most of fixed mortgage loan interest rate dramatically goes down when the standard variable is highest at 8%. It shows a maximum 5% difference through 5 years. It revitalized the investment on real estate market which caused high aggregate demand. These are the factors that boost the growth rate and inflation in housing market. According to Krugman & Olney, when there is economic downturn, the fall in interest rate may rapidly boost economic growth in short term. I Interpret the relationship between these three data series using historical data.

The relationship between interest rate and real estate market does not explain the increasing price of real estate. Because monetary policy had a limited role in the real estate bubble, the extent of developments in housing finance and mortgage markets may have contributed to the rapid growth in house prices. The4 mortgage loan approval increased and became broad in The UK since 1993 till 2006 when they went on a downward trend. Various mortgage loans including interest-only, negative amortization, payment options and extended amortization provide more opportunity to lenders to borrow much more money for a given initial monthly payment. That’s why these mortgage loans provide more opportunity to borrow money and increase demand and money supply for housing market.

Demand for real estate boosts rapid growth in real estate market. It causes high price in real estate price and create property bubble. This occurs when people can easily get a mortgage loan; some investor speculates on real estate by purchasing and selling and gets trading profit from real estate transactions.