The Monetary Policy Committee of the Bank of England: ten years on

Fourth Report of Session 2006–07

Volume II

Written evidence

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The Treasury Committee

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Written evidence

Memorandum submitted by the Bank of England

EXECUTIVE SUMMARY

Compared to past performance, UK inflation has been low and unusually stable since the inception of inflation targeting, while GDP growth too has been remarkably stable. In part that reflects the effectiveness of the inflation targeting framework and the current institutional arrangements, particularly by anchoring inflation expectations and reducing the sensitivity of inflation to demand and cost shocks.

But other factors have also provided a benign context for the MPC’s efforts: cheaper imports and increased competitive pressures associated with globalisation; and increases in labour supply, associated in part with inward migration. Both have dampened inflationary pressures and reinforced the changes in the inflation process associated with the change in monetary regime. The environment is unlikely to be so benign in the future.

The submission also covers the impact on monetary policy of a number of particular issues that have been relevant to the MPC’s deliberations over the past decade: the balance of demand and the exchange rate; money supply and liquidity; asset prices; household debt; and investment.

INTRODUCTION

1. This submission covers the economic backdrop to the first 10 years of the Monetary Policy Committee (MPC). In the two decades prior to 1992, the United Kingdom’s economic performance was relatively poor, being characterised by volatile growth (Chart 1) and episodes of high inflation (Chart 2). During this period there were also numerous changes in the macroeconomic policy framework and strategy. In the immediate aftermath of the breakdown of Bretton Woods, inflation control was assigned to incomes policies while fiscal policy was assigned the task of managing demand. That was superseded in 1979 by the adoption of monetary targets as a means to control inflation, coupled with structural reforms to boost growth. In the mid-1980s, an informal exchange rate target replaced the money supply as the lodestar for monetary policy. And from 1990–92, the informal exchange rate target was replaced by a formal one in the shape of ERM membership. The current inflation targeting framework was born in the aftermath of sterling’s exit from the ERM in September 1992.

2. Economic performance since 1992 stands in marked contrast with the earlier experience. Inflation has been low, close to target and unusually stable.1 The target was initially defined in terms of RPIX inflation: a range of 1%–4% until May 1997 and a point target of 2.5% thereafter. The target was then switched at the end of 2003 to 2% for CPI inflation (which on average has run about \( \frac{1}{3} \) percentage point below RPIX inflation). RPIX inflation has averaged 2.6% under the inflation targeting regime, while CPI inflation has averaged 1.8%. The corresponding figures for the period since the MPC was created in June 1997 are 2.4% for RPIX and 1.4% for CPI. Moreover, inflation has so far not deviated by more than 1 percentage point from the target—the point at which an Open Letter would be triggered—though it has come close on a couple of occasions, most recently in December 2006. That is a much better performance than was expected when the present arrangements were established: calculations at the time suggested that inflation was likely

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1 Indeed using data back to 1661, Benati (2006) concludes that the inflation-targeting regime constitutes the most stable macroeconomic environment in recorded UK history.
to be more than 1 percentage point away from the target around 40% of the time. And the Bank’s own fan charts for the inflation projection have often shown a significant risk that inflation would differ from the target by more than 1 percentage point. This unexpected decline in inflation volatility is documented in Chart 3.

3. The average annual growth rate of GDP since 1992Q2 has been 2.8%, slightly more than the post-World War II average of 2.5%. And growth is estimated to have been unusually steady, with 58 quarters of unbroken expansion, the longest such run on record. No other G7 country has experienced such a sequence. The decline in the volatility of output is documented in Chart 4. Finally, the unemployment rate according to the Labour Force Survey measure, dropped from a peak of a little over 10% in 1993 to under 5% in 2005, its lowest level for almost three decades.

4. The macroeconomic policy framework has remained broadly stable over this time, with monetary policy set to achieve an inflation target, together with rules for fiscal policy ensuring that fiscal plans are sustainable and continuing structural reforms to raise the economy’s supply potential. But the delegation of interest rate decisions to an independent MPC in 1997 represents an important modification.

5. The thinking that underlies this policy framework represents a confluence of advances in our understanding of how the economy functions, together with the lessons of experience. The essential underpinnings can be summarised as follows. In the short run, changes in the nominal demand for goods and services in the economy tend to be reflected in corresponding fluctuations in output. By affecting nominal and real interest rates, and thence a whole array of asset prices, including the exchange rate, monetary policy can therefore alter the level of nominal demand and with it the level of output and employment.

6. In the long run, however, the level of output and employment depends on the supply potential of the economy, which is determined by the available quantity of real resources—labour, capital, land and other natural resources and the efficiency with which they are combined. If the level of output is running above (below) the level of potential supply, the result will be upward (downward) pressure on inflation, which will tend to bring demand back into line with supply. In the long run, therefore, monetary policy can determine only the inflation rate, not the level of activity or the growth rate (though consistently poor monetary policy that leads to high and unstable inflation could discourage investment and actively depress growth). But because it can have a temporary impact on activity, the conduct of monetary policy can affect the variability of growth. That is why the statutory monetary policy objective enshrined in the Bank of England Act (1998) elevates the achievement of price stability ahead of any objective for growth and employment, but also why the Chancellor’s Remit letter gives the MPC a degree of “constrained discretion” in deciding how quickly to correct any deviation from target, so as to avoid creating excessive volatility in output.

7. The macroeconomic performance over the past 15 years represents a striking improvement on the previous 20 years—so much so that some observers have referred to it as the “Great Stability”. But it would be unwise to conclude that this stability is entirely a consequence of the new monetary framework. Other countries have also experienced a similar, if not so pronounced, improvement in performance (Table A). And there have been developments in the global economy that have independently made the achievement

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2 See Bean (1998).
of low and stable inflation easier than it might otherwise have been. Even so, those changes have also created new challenges for monetary policymakers here and abroad. The remainder of this submission expands on these and related themes.

### Table A

**OUTPUT GROWTH AND INFLATION IN SELECTED COUNTRIES**

**OUTPUT GROWTH**(a)

<table>
<thead>
<tr>
<th>Country</th>
<th>Average growth rate</th>
<th>Standard deviation of growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>2.8(b)</td>
<td>2.0</td>
</tr>
<tr>
<td>United States</td>
<td>4.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Japan</td>
<td>10.4(c)</td>
<td>4.6</td>
</tr>
<tr>
<td>Germany</td>
<td>4.4(e)</td>
<td>2.7</td>
</tr>
<tr>
<td>France</td>
<td>n/a</td>
<td>2.2(f)</td>
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**INFLATION**(g)

<table>
<thead>
<tr>
<th>Country</th>
<th>Average inflation rate</th>
<th>Standard deviation of inflation rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>3.9</td>
<td>9.6</td>
</tr>
<tr>
<td>United States</td>
<td>2.2</td>
<td>6.0</td>
</tr>
<tr>
<td>Japan</td>
<td>4.0</td>
<td>5.4</td>
</tr>
<tr>
<td>Germany</td>
<td>2.2</td>
<td>3.8</td>
</tr>
<tr>
<td>France</td>
<td>n/a</td>
<td>7.7(b)</td>
</tr>
</tbody>
</table>

Sources: Bureau of Economic Analysis, Global Financial Data, IMF, ONS, Thomson Financial Datastream and Bank calculations.

(a) Four-quarter GDP growth.

(b) 1955–69.

(c) 1958–69.

(d) West Germany prior to 1991.

(e) 1961–69.

(f) 1979–92.

(g) Four-quarter inflation rates based on the retail prices index for the United Kingdom, and consumer price indices for other countries.

(b) 1973–92.

### THE CONTRIBUTION OF THE MONETARY POLICY FRAMEWORK TO THE “GREAT STABILITY”

#### The inflation target and inflation expectations

8. A key factor in the improved macroeconomic performance is a better understanding of how the economy functions and what role monetary policy can and should play. Through the late 1970s and early 1980s, academics and policymakers alike became increasingly aware that any trade-off between inflation and activity was likely to be temporary and that sustained inflation was ultimately a monetary phenomenon. In addition, the importance of anchoring inflation expectations became clearer. Many wages and prices are changed only periodically. Since workers care about the purchasing power of their wages, while businesses will be concerned about both their costs and competitors’ prices, the wages and prices that are set today are influenced by expectations of future levels of prices, wages and other costs. Inflation expectations are therefore central in determining inflation today. Indeed, the most potent effect of monetary policy is not so much through the consequences of individual monthly interest rate decisions, but rather through the ability of the policy framework to condition those expectations.3

3 See eg Woodford (2003).
9. In a world where inflation expectations are well-anchored, an increase in nominal demand relative to supply will lead to a smaller and less persistent increase in inflation than in a world where the increase in nominal demand simultaneously raises expectations of future inflation. The effective anchoring of inflation expectations represents one possible explanation for the apparent flattening of the short-run trade-off between inflation and activity that is suggested by Chart 5. (In this chart, the activity variable is represented by unemployment. The post-1992 experience would therefore be consistent with an unchanged short-run trade-off if actual unemployment had at all times stayed close to the natural rate of unemployment. But it is implausible that activity has been controlled that precisely.)

10. Moreover, the response to cost shocks—such as the recent increase in the price of oil—is also likely to be attenuated when expectations are well-anchored. For a given level of total nominal demand, an increase in the price of some goods will reduce the income left to spend on other goods, so putting downward pressure on those prices. Furthermore, raising prices becomes a less attractive way for companies to respond to higher input costs than seeking ways to reduce other costs. In the 1970s, shocks to energy or import prices generated positive “second-round” effects on wages and the prices of other goods and services. But Chart 6 suggests that in recent years, with monetary frameworks in the UK and elsewhere oriented to maintaining overall price stability, there has instead been an inverse relationship between domestic non-energy inflation and energy and import inflation. So cost shocks need not generate second-round effects in the way that they did in the 1970s.

11. Central bankers around the world now recognise the importance of anchoring inflation expectations. This has led to more emphasis on explaining how policy decisions relate to the objective of price stability, and greater transparency. However, a particular virtue of an inflation target, as opposed to say a money supply target, is that it focuses on the final objective of policy rather than an intermediate objective whose relation to inflation might not be so immediately obvious to the general public. Having an explicit and credible inflation target is likely to have directly contributed to anchoring expectations. But there remain important unanswered questions about how expectations are formed and how credibility is gained and lost. Since independence, the Bank has therefore put considerable effort into improving its understanding in this area and has commissioned its own regular survey in order to track the expectations of the general public.

12. A related aspect is that a credible framework, together with a well-understood reaction function on the part of the central bank, means that market interest rates and asset prices tend to act as a stabilising force. For instance, if market participants see that demand is running ahead of supply, they will expect the MPC to raise Bank Rate in order to counter the incipient inflationary pressure. That in turn will push up market interest rates and tend to lead the pound to appreciate, dampening demand ahead of any action by the MPC. In this way the market does much of the MPC’s work for it; the Governor has termed this the “Maradona theory of interest rates”.

13. Without appropriate institutional arrangements to support the new monetary regime and anchor expectations, it is unlikely that such a good performance could have been sustained. The current framework—based on an explicit target for inflation, a high degree of transparency, and Bank of England independence—made it clear that monetary policy is directed towards maintaining low and stable inflation.

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*See King (2005a).*
and that this objective is in place for the long term. The experience of low and relatively stable inflation has helped to reinforce the credibility of the framework and stabilise inflation expectations around the target level. There are a number of features of the current framework that are worth highlighting.

14. First, delegating responsibility for setting interest rates to an independent Committee has reduced the scope for short-term political considerations to enter into the determination of interest rates. And appointing people with an appropriate level of economic expertise has facilitated the process of forming a view about inflation prospects from the myriad of data and other evidence that the MPC processes each month.

15. Second, by holding members of the Committee publicly accountable for their votes, the arrangements have sharpened the incentives for members, individually and collectively, to strive to hit the inflation target.

16. Third, having a regular cycle of pre-announced meetings to determine interest rates has been important in encouraging early action to counter inflationary pressures. This, of course, was a feature of the 1992 reforms; prior to then decisions to change interest rates tended to be reactive rather than proactive.

17. Fourth, public understanding of the MPC’s thinking is fostered by regular and open communications, including the MPC Minutes, the Inflation Report and speeches by MPC members. While most of these features were also present under the 1992–97 regime, they have continued to evolve since independence.

18. Last but not least, the announcement of a clear and credible inflation target reaffirmed annually by the Chancellor has been central. A valuable feature of the arrangements in place since 1997 has been the choice of a symmetrical, point target. Prior to that the target was in the form of a range, but a point target is simple and clear to understand and may have been more effective in anchoring inflation expectations than a range.

19. All of these features have helped to anchor inflation expectations. As can be seen from Chart 7, during the 1992–97 period a measure of long-term (RPI) inflation expectations in financial markets, derived from nominal and indexed gilts, remained around the upper end of the target range. The delegation of the operational responsibility for setting interest rates to the MPC in 1997 was then associated with an immediate credibility gain, with long-term inflation expectations falling sharply to around the new point target. That could have reflected either the virtues of setting a more precise target or the consequence of insulating monetary policy decisions from short-term political pressures.

20. Finally, mention should be made of the supportive fiscal framework. Inflation targeting—or any other monetary framework for that matter—is only likely to be successful if it is accompanied by a prudent and sustainable set of fiscal plans. Though there are a variety of ways that this could be achieved, the MPC has been able to operate against such a background. Fiscal policy has generally been set with an eye to the long term, leaving monetary policy to manage the economy in the short to medium term. That arrangement reflects the current consensus that monetary policy is generally better suited to the active management of the economy, because changes in monetary policy can be speedily implemented. In contrast, changes in taxes or government spending normally require legislation. Moreover, increases in taxes and cuts in public spending tend to be particularly contentious, making temporary fiscal expansions hard to reverse.

21. A lack of co-ordination between the two main instruments of economic policy has sometimes been seen as an objection to central bank independence. But under the current arrangements, the risk of such a co-ordination problem is greatly reduced. First, the Chancellor sets the Bank’s objective, so there should be no conflict in the objectives of fiscal and monetary policy. Second, there is a clear division of roles and responsibilities between the MPC and the Treasury, with each pursuing its role in a transparent and open
fashion. This promotes a close understanding between the Bank and Treasury of how the other operates, which is reinforced by close working relationships at staff level, and the presence of a Treasury observer at MPC meetings.

**The Contribution of Other Factors to the “Great Stability”**

22. As noted earlier, the United Kingdom is not alone in having experienced low and stable inflation coupled with stable growth. That suggests that better monetary policy may not be the only factor at work. Some observers have suggested that central banks in general, and the MPC in particular, just happen to have been lucky in that there have been few major economic shocks to handle. However, the past decade does not seem especially tranquil, for instance at a global level we have seen:

— the integration of China, India and the former Communist countries of Eastern Europe into the world economy;
— the ICT revolution and the associated dotcom boom-bust;
— the emerging-market debt crisis and the collapse of LTCM in 1998;
— the sharp correction in international equity prices and the associated global slowdown in 2001;
— the attacks on the World Trade Centre and subsequent conflicts in Afghanistan and Iraq; and
— the tripling of oil prices over the past three years.

While at a domestic level, the MPC has also had to contend with:

— the effects of the 25% rise in sterling between 1996 and 1998;
— the tripling in house prices between 1997 and 2006;
— ongoing labour market reforms, including the introduction of a National Minimum Wage; and
— substantial, and highly uncertain, net inward migration, particularly from the Accession countries.

**Table B**

**MACROECONOMIC AND ASSET PRICE ANNUAL VOLATILITY**

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<tbody>
<tr>
<td>S&amp;P 500(b)</td>
<td>14.0</td>
<td>15.7</td>
</tr>
<tr>
<td>FTSE All Share(b),(c)</td>
<td>20.4</td>
<td>43.3</td>
</tr>
<tr>
<td>10-year US Treasury bond(b)</td>
<td>3.4</td>
<td>5.4</td>
</tr>
<tr>
<td>10-year UK gilt(b),(d)</td>
<td>3.1</td>
<td>11.2</td>
</tr>
<tr>
<td>£ effective exchange rate index(b)</td>
<td>6.9</td>
<td>4.5</td>
</tr>
<tr>
<td>$ effective exchange rate index(b)</td>
<td>5.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Yen effective exchange rate index(b)</td>
<td>9.9</td>
<td>4.3</td>
</tr>
<tr>
<td>€ effective exchange rate index(b)</td>
<td>1.8</td>
<td>3.0</td>
</tr>
</tbody>
</table>

**Sources:** Bureau of Economic Analysis, Global Financial Data, and ONS.

(a) Volatility is calculated as standard deviation of annual growth rates.
(b) Nominal returns deflated by consumption deflators. US Treasury bonds and UK gilts are based on total return indices from Global Financial Database.
(c) FTSE All Share starts in 1962.
(e) Trade weighted real exchange rate indices start in 1975.

23. Reflecting this dynamic environment, the prices of domestic and international financial assets have at times moved sharply (Chart 8) and equity markets have experienced periods of considerable uncertainty (Chart 9). The volatility of the returns on a range of financial assets has not decreased as much as output and inflation volatility (Table B). So it does not seem obvious that the economic environment has been markedly less volatile than in the past.

24. As far as empirical evidence goes, there are some studies, mainly for the United States, which suggest that a sizable portion of the improved performance is related to good luck rather than better policy. However, others have suggested that the role of improved policy has been central. And Ben Bernanke, Chairman of the Federal Reserve, has pointed out that studies which assign a large role to good luck almost certainly underestimate the role of monetary policy by failing to account properly for the impact of better policy frameworks in reducing the impact of shocks (see paragraphs 8–10 above). So there is, as yet, no clear consensus as to the relative importance of monetary policy and good luck.

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6 Eg Cogley and Sargent (2005), Sims and Zha (2006), and Stock and Watson (2003).
7 Eg Clarida, Gali and Gertler (2000) and Lubik and Schorfheide (2004).
8 See Bernanke (2004).
Globalisation

25. Two particular factors have provided a generally benign backdrop to the MPC’s efforts over the past decade, however. The first is the integration into the world economy of Eastern Europe, China and India. To all intents and purposes that represents a doubling of the labour supply in the world economy. As these economies are relatively labour-abundant and wages are low, they have a comparative advantage in the production of labour-intensive goods and services compared to the developed economies. This has prompted considerable structural change in the UK and other developed economies, as the production of labour-intensive manufactures and tradable services has been replaced by imports from low-cost economies or else shifted offshore (Chart 10). Of course, this is not a new phenomenon: in earlier decades the emergence of Japan, Korea, Taiwan, etc, generated similar pressures. But what is new is the sheer scale of the shock. Moreover, advances in information technology have made it possible to move offshore parts of the production process in a way that that was not previously possible (so-called “task trade”).

26. The globalisation process has affected the environment in which the MPC operates in three main ways. First, the emergence of these low-cost producers has led to a rise in the price of the UK’s exports relative to that of its imports, known as the terms of trade (Chart 11). As a consequence, the real purchasing power of employees’ wages has been higher than would otherwise have been the case. Historical experience suggests that such terms-of-trade improvements temporarily lower the rate of unemployment consistent with stable inflation. Such a terms-of-trade improvement therefore allows the economy to grow a little faster for the same inflation rate, or else for inflation to fall without requiring growth to dip. Globalisation has in effect provided a beneficial “tailwind” to the MPC’s efforts.

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27. However, such a bonus is likely to be temporary, both because workers’ wage aspirations will in due course adjust upwards and because the terms-of-trade improvement will eventually cease, and even unwind, as wages in the emerging economies begin to catch up with their developed economy counterparts. Moreover, the tripling of oil prices since 2004, and the rise in commodity prices more generally, is in large part a reflection of the emergence of these new economies and tends to work in the other direction. This beneficial “tailwind”, and its subsequent attenuation, is reflected in the marked divergence of the inflation rates of consumer goods and services that opened up in the late 90s and early part of this decade, together with its more recent narrowing (Chart 12).

28. Second, globalisation may have altered the way the economy reacts to shocks. The exploitation of comparative advantage has increased import shares. That means that more of any stimulus to domestic demand tends to leak abroad. Moreover, the increased competitive pressures on businesses may make them less inclined to push prices up when demand increases. So globalisation provides another reason why the short-run trade-off between domestic activity and inflation may have flattened, as suggested by Chart 5. And these heightened competitive pressures may also have reinforced the attenuation in the response to cost shocks that was noted in paragraph 10.

29. The third and final impact of globalisation worth recording is the impact on long-term real interest rates. One might have expected the entry of the labour-abundant economies of Asia and Eastern Europe to lead to high investment in those countries, financed by capital inflows, and upward pressure on global interest rates. Investment has indeed been strong, but high savings rates, in China especially, as well as in the oil-exporting countries, has put downward pressure on global and domestic long-term real interest rates (Chart 13), boosting global demand.

Labour supply

30. The second generally benign factor has been an expansion in the effective UK labour supply. That has been associated with three drivers: a decline in the natural rate of unemployment; increased labour force participation; and net inward migration, especially from the A8 countries.

31. The fall in the unemployment rate, from around 10% in the early 1990s to around 5% now (Chart 14), has reflected a number of factors. One is the impact of the changed climate of industrial relations and the move to less centralised pay-setting, in part reflecting past legislative changes. An increased onus on the unemployed to look for work, coupled with initiatives to help them find it, has also improved the effectiveness of job search. The decline in the proportion of youths in the labour force, who typically have higher rates of unemployment, has also contributed. And though the introduction of the National Minimum Wage in 1999 may have tended to push up equilibrium unemployment, its impact so far appears to have been relatively limited.

32. Labour force participation has also edged up (Chart 15), as rising female participation more than offset lower male participation and a shift from long-term unemployment into incapacity benefit. Increases in the retirement age, age discrimination legislation, and measures to encourage more flexible working practices are all likely to support higher labour force participation in the future.

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11 See Millard (2000).
12 See Barwell (2000).
13 See Dickens, Machin, Manning (1999), Manning (2003), and Stewart (2004).
14 See Gutiérrez-Doménech and Bell (2004).
33. Finally, the UK labour force has been augmented by a significant rise in net inward migration, especially since May 2004 and the enlargement of the European Union to include eight central and eastern European countries. The data in this area are poor, so it is difficult to know by exactly how much the labour force has been boosted. But it seems likely that migration from the A8 countries has added between 215 thousand and half a million people to the UK labour force since May 2004.15

34. These various structural changes have served to increase the supply capacity of the economy. As the associated increase in incomes is likely to lead to higher demand, particularly if it is also associated with higher investment by businesses, the net impact on inflationary pressures is in principle uncertain. But in practice, it seems likely that the increase in supply did not immediately lead to an equivalent increase in domestic spending, especially since migrants typically remit a substantial fraction of their earnings to their home country.16 So the increase in the effective labour force has probably tended to reduce inflationary pressures, providing a beneficial “tailwind” similar to that offered by globalisation.

35. A second consequence, associated particularly with migration, is also worth noting. Some A8 migrants would have come to the United Kingdom independently of the state of the UK labour market, drawn by the much higher level of wages here than in their home country. But others would only have come if they had a job to go into, or if they believed they could find one relatively easily. And businesses have increasingly directly recruited workers from the A8 (and other) countries when they needed them, often through specialised agencies. So the flow of migrants is likely to be responsive to the state of the labour market, in effect offering a “safety valve” when it becomes tight and enabling employers to adjust their inputs in response to changes in demand more easily. Moreover, the ability to source workers from overseas has also increased competitive pressures in the labour market, limiting the upward pressure on wages when it tightens. So migration provides yet another reason why the short-run activity-inflation trade-off may have flattened.17

Issues

36. The remainder of this submission addresses a number of particular issues that have arisen over the past decade, some of which are flagged in the Treasury Committee’s Call for Evidence.

The balance of demand and the exchange rate

37. A particular feature of the UK economy over the past decade has been the relative reliance on domestic spending—particularly private and public consumption—as the engine of demand growth. Net trade detracted from growth from 1996 to 2004, the longest such sequence on record. That is in contrast to the period from 1993 to 1996, when domestic demand growth was subdued and net trade was a significant driver of demand growth.

15 See Blanchflower, Saleheen and Shadforth (2007).
16 See Blanchflower, Saleheen and Shadforth (2007).
17 See King (2005b).
38. This strength of domestic demand has been reflected in the balance of payments. Although the picture is clouded by Missing Trader Intra-Community VAT fraud, official estimates for 2005 suggest that the trade deficit was 3.6% of GDP, while the current account deficit was 2.4%. The smaller current account deficit reflects the fact that the United Kingdom runs a surplus on net interest, profits and dividends from abroad, despite being an overall net debtor. In other words, the United Kingdom earns more on its assets than it pays on its liabilities; that in part reflects the fact that its liabilities tend to be more bond-like, while its assets are concentrated in higher-yielding, though potentially riskier, assets.18

39. This current account deficit partly reflects the impact of the sterling effective exchange rate, which, after a period of weakness between 1992 and 1996, returned to levels seen prior to the exit from the ERM (Chart 16). That has placed pressure on the internationally tradable sector of the economy (including, but not exclusively, manufacturing). In the early years of the MPC, the appreciation of 1996, and the resulting downward pressure on import prices, therefore reinforced the beneficial “tailwind” exerted by globalisation.

40. A striking feature of the past decade has been the broad stability in the sterling effective exchange rate, despite substantial swings in the dollar-euro exchange rate. That is because appreciations against the dollar have generally been offset by depreciations against the euro and vice versa. This broad degree of stability was unanticipated: many people expected the replacement of an exchange rate target by an inflation target to result in more, not less, variability in the effective exchange rate. The explanation may lie in part with the credibility of the monetary framework. The value of the exchange rate today is heavily influenced by what it is expected to be in the future: if the currency is expected to be lower tomorrow, then that will encourage traders to sell it, pushing down its current value. So a credible monetary framework will not only lead to stable long-term inflation expectations (Chart 7), but may also help to anchor expectations of future exchange rates.

41. At some stage the current account deficit will probably need to close. At that point, in order to shift resources from the non-tradable sector of the economy into the internationally tradable part, some depreciation of the real effective exchange rate will probably be necessary.

Money supply and liquidity

42. On average, over time and across countries, persistently high rates of broad money growth have been associated with high nominal demand growth and inflation. Sustained and substantial increases in the general level of prices invariably seem to be accompanied by corresponding increases in the money supply. And since the rate of growth of real output is ultimately determined by the quantity of real resources in the economy and the efficiency with which they are used, inflation could ultimately be controlled by targeting the quantity of money if the relationship between money and nominal demand—the velocity of circulation—were stable and predictable.

43. Unfortunately, although sustained rapid monetary growth tends to be associated with high nominal demand growth and inflation in the long run, the velocity of circulation has turned out to be quite variable over the short and medium term (Chart 17). That is because the demand for money holdings can be affected by changes in the relative attractiveness of holding money, such as movements in the returns on alternative assets and innovations that improve the services provided by bank deposits. As a result, most central banks that pursued monetary targets have since ceased actively targeting them. The problems of using a monetary target were aptly summed up by Governor Gerry Bouey of the Bank of Canada who reputedly remarked: “We did not abandon the monetary aggregates; they abandoned us.”

44. Even so, it would be unwise to ignore the money supply entirely. In recent quarters, UK broad money has grown at higher rates, relative to nominal demand, than at any time since 1990 (Chart 17). Investors are likely to take advantage of this ample liquidity and the associated easy credit to purchase other assets, driving risk premia down and asset prices up. Even though the lags may be long and variable, in due course those higher asset prices may be expected to feed through into higher demand for goods and prices, putting upward pressure on the general price level. Moreover, if private agents believe that rapid monetary growth is a harbinger of high inflation to come, then its effects may be telescoped into the present via its impact on inflation expectations and the exchange rate.

45. The analysis of current monetary developments has been complicated by two factors. First, the recent rapid growth in the money supply has been concentrated in the holdings of Other Financial Companies. This is a collection of heterogeneous institutions that includes pension and private equity funds, entities which in effect intermediate funds between different banks, and financial vehicles whose object is to shift risk off banks’ balance sheets. The implications of the activities of each of these for asset prices and future movements in nominal demand are not easy to gauge.

46. Second, the expansion in liquidity has been a global, rather than a purely national, phenomenon. The increased integration of international capital markets means that the consequences of a loose monetary policy now spill across national borders. Thus investors have taken advantage of ample liquidity and unusually low interest rates in eg Japan to borrow in order to invest in higher yielding assets overseas, boosting asset prices internationally. Money supply measures typically include only holdings by residents and thus fail to capture this dimension properly.

47. Along with some other central banks, the Bank of England has been struggling to work out how best to take on board the information in the monetary aggregates. The European Central Bank has opted to do this by adopting a “two-pillar” approach in which an analysis of short-term inflation prospects is complemented by a reference value for money growth. Given the past instability of velocity, the MPC has chosen not to go down this route. Instead it tries to understand the developments in velocity and use the analysis to help isolate the longer-term risks to the inflation outlook.

Asset prices and monetary policy

48. Financial and real asset prices, being forward-looking, potentially contain useful information for monetary policymakers. In particular, asset prices reflect not only current demand pressures, but also expectations of future inflation and future income. Unfortunately, it is not straightforward to extract that information, because many factors affect asset prices, which can be quite volatile over short periods. Nevertheless, they represent an important input into the regular deliberations of the MPC.

49. House prices are a particular asset price that has figured in MPC discussions. While an increase in house prices does not directly make most households better off—a homeowner can only unlock the capital gain if (s)he is willing to move to a cheaper house—it does increase the collateral against which cash-constrained households can borrow and may thus boost consumer spending through that route. So house prices are one factor influencing consumer spending.19

50. The ratio of house prices to household income is presently around two-thirds higher than its historical average (Chart 18). In part, that reflects the decline in long-term real interest rates mentioned earlier. It probably also reflects demographic developments that have led to rising demand for homes coupled with relatively low rates of housing investment. And it may also reflect more efficient credit-scoring by lenders. But it is very difficult to quantify the relative importance of these factors, or to make a projection of how house prices are likely to move in the future.

51. Some economists have, however, gone further and argued that asset prices should actually enter the target in some way.20 That is obviously not consistent with the Government’s inflation target as presently specified. Moreover, trying to stabilise asset prices would potentially result in considerable volatility in

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20 For conflicting views, see Bernanke and Gertler (2001) and Borio and Lowe (2002).
interest rates, activity and inflation. However, it is possible that a period of sharply appreciating asset prices may raise the threat of a future correction, which in turn might result in a cut-back in lending in response to the decline in collateral, a fall in activity and downward pressure on inflation. In principle, policymakers should take account of that possibility and may therefore decide to raise interest rates and undershoot the inflation target in the near term in order to increase the chances of meeting it further in the future. Moreover, they should also want to reduce the future volatility of inflation and output, strengthening the case for preventing financial imbalances building up in the first place. However, calibrating such a “leaning-against-the-wind” policy is particularly difficult once account is taken of uncertainty about: the cause of the rise in asset prices; the likelihood and consequences of a subsequent correction; and the uncertainty about the impact of higher interest rates on those asset prices.

Household debt and monetary policy

52. A feature of the past decade has been the build-up of household debt (Chart 19). Secured debt has risen as a proportion of annual post-tax household income from 75% in 1996 to 120% in 2006. Over the same period, unsecured debt as a proportion of household income has risen from 15% in 1996 to 24%. But while debt has grown quickly, in aggregate it has been primarily used to finance real (housing) and financial asset accumulation, rather than spending on goods and services. The net financial position of the household sector has not changed very much since the early 1990s: net financial wealth as a share of household income was broadly the same in 2006 as in 1993. And including real assets, household net worth was higher as a share of post-tax household income, largely reflecting the increased value of housing wealth (Chart 20).

53. The evolution of secured debt—the bulk of household debt—is primarily associated with developments in the housing market. As house prices have risen and the housing stock has turned over, so younger households moving onto, or up, the property ladder have needed to take out larger mortgages, while older households trading down have placed the bulk of the housing equity so released into financial—often relatively liquid—assets. Since it will take many years for all the housing stock to roll over, secured debt can be expected to continue growing strongly for many years to come, even if the house-price-to-income ratio stabilises at present levels.

54. To what extent should this build-up of debt affect the conduct of monetary policy? Under one view, it is of negligible significance as what matters for household spending is net wealth, not debt. However if, as seems likely, indebted individuals respond more strongly to a rise in their interest payments than do savers to a corresponding rise in their interest receipts, the impact of interest rate changes on demand will be altered. Moreover, even if higher debt is matched by higher assets, the higher leverage involved could amplify the effects of shocks, such as a fall in house prices: a given percentage fall in house prices will generate a larger proportionate fall in wealth in a low price/low debt world than in high price/high debt one. And the repercussions on lenders’ balance sheets and behaviour may also amplify the effects, further complicating the operation of monetary policy.

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22 See Bean (2003).
55. There is little to suggest that the build-up of secured debt has so far had any significant impact on the economy: repossessions remain at relatively low levels and the Bank’s latest annual survey of the borrowers suggests that only one in 12 mortgagees has found any difficulty keeping up their mortgage payments, much less than in the early 1990s. However, the Bank will continue to monitor the situation through its annual survey. It has also recently announced plans for a new survey of credit conditions.

56. There is more evidence to suggest that the level of unsecured debt might be presenting problems. The Bank’s annual survey suggests that around a third of unsecured borrowers find their debt a burden. However, these households are typically low-income households who account for a relatively small fraction of aggregate consumption. So while excessive unsecured borrowing may represent a significant social issue, as yet it does not constitute a material macroeconomic influence.

Investment and monetary policy

57. Investment is one of the channels through which monetary policy affects aggregate demand (the others being consumption and net trade, via the exchange rate). Around 60% of business investment spending is on capital goods produced in the United Kingdom, so higher investment puts pressure on supply capacity, raising inflationary pressures. But in the longer run, investment adds to the supply capacity of the economy, so putting downward pressure on inflation.

58. A reduction in Bank Rate lowers the cost of finance to businesses and should therefore encourage them to invest more. However, the durability of capital, together with its irreversibility, means that it is long-term, rather than short-term, interest rates that tend to matter. As noted earlier, risk-free long-term real interest rates have fallen to historically low levels in recent years. The buoyancy of equity markets and the compression of risk premia on corporate bonds in the past three years have put additional downward pressure on the cost of finance to businesses. Moreover, the price of capital goods, particularly IT goods such as computers, has been falling relative to the price of other goods and services. Despite all that, business investment growth had been quite subdued since the millennium, at least up until 2006, contributing to the imbalance in the pattern of demand growth that was discussed earlier.

59. This weakness reflects the fact that other factors are likely to be of more importance than the cost of finance in determining the level of investment; certainly empirical studies suggest that the influence of the cost of capital is relatively weak. Expectations of future profitability are key, and heightened uncertainty about prospects can lead to investment being put on hold, which may have been the case in the early stages of the recovery from the 2001–03 slowdown. Balance sheet considerations may also have been important, particularly for smaller companies who have to rely on the banks for finance rather than internally generated funds. And for companies with limited access to outside funds, the need to cover pension deficits may also have been a factor. Finally, the recent investment weakness could in part reflect the unusually high levels of investment in IT ahead of the millennium, which reduced the need for subsequent investment.

The Next Decade

60. In October 2003, the Governor described the previous ten years as the “nice”—non-inflationary consistently expansionary—decade. As noted above, the volatility of output and inflation were unusually low over this period compared to past experience. Some of that is probably down to the effectiveness of the monetary framework, but some is almost certainly the result of the broader macroeconomic environment, in particular the beneficial tailwinds from globalisation and the increase in the labour force.

61. We cannot guarantee that the next ten years will be so “nice”. Many of the benefits of globalisation have already worked through, and the adverse impact on commodity prices of the development of China and India is now being felt. And the effective labour force is unlikely to grow as rapidly as it has done over the past decade or so. Moreover, some aspects of the global economy look unsustainable, particularly the pattern of global current account imbalances and the low level of real interest rates and risk premia. So the macroeconomic context is likely to be somewhat less benign.

62. In the face of these uncertainties, the strength of the current monetary policy framework is the flexibility it gives the MPC to adapt its analysis in the light of events and new data, while still maintaining a clear focus on the inflation target and thus anchoring inflation expectations. As a result, the present policy framework should have the capacity to withstand more turbulent times, if and when they materialise.

26 See Waldron and Young (2006).
27 More details are available at: http://externalboeweb/publications/other/monetary.htm
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February 2007

Memorandum submitted by Professor (Emeritus) C A E Goodhart

EXECUTIVE SUMMARY

The structure of the MPC, and of the subsequent Bank of England Act, was excellently designed. The MPC has been extremely successful in practice, though only marginally more so than other Western monetary authorities; so much so that the 1% letter-writing bands have never yet been triggered. Such bands have been widely misinterpreted, as “sanctions”, and I hope that their eventual use will be informative. Quite why economic conditions have been so benign remains a puzzle.

This means that comments and criticisms have to relate more to second-order issues, (since the prime task of varying interest rates to stabilise inflation credibly at the target has been achieved).

I focus on the following issues:

1. Given that official interest rates are, rightly, predicated to the task of achieving price stability, are there secondary monetary instruments that could be used by the MPC, (or by another body),
   (a) to influence exchange rates; notably intervention;
   (b) to influence the mortgage market; notably Loan to Value (LTV) ratios?

2. Concerns about the housing market in this set-up could be lessened if housing inflation was properly included in the CPI. This measurement issue is important and too often overlooked.

3. The MPC meets too often.

4. The appointment process for externals is too opaque.

I also touch on several other issues. But the overall conclusion must be that setting up the MPC has been a great success.

I. INTRODUCTION

1. When I appeared before your predecessor, the Rt Hon Giles Radice, MP, at my confirmation hearings as an external member of the MPC in the summer of 1997, he chided me for relying too heavily on academic references, rather than giving personal opinions. You may find the same fault here; it is a “deformation professionel”. I apologise in advance.

II. THE ECONOMIC CONTEXT

A. “The Great Moderation”

2. Ever since the depression in the early 1990s, which affected almost all developed countries, inflation has remained low and remarkably stable, and output growth unusually steady in all those same countries, (though the level of growth has varied between low in Japan, high in the USA, disappointing in Germany, about normal in the UK). Although the decline in volatility (of inflation and output) has been most marked in the UK, (L Benati of the Bank of England has documented this in several papers), it has been a common
phenomenon in all developed countries; it has been termed “the great moderation” in the burgeoning US literature, and sometimes “the great stability” in the UK. It has occurred in both inflation-targeting (IT) countries and non-IT countries; most econometric studies fail to find significant econometric differences between the economic experiences of these two sets of countries, (references can be provided).

3. The common experience, among developed countries, of the “great moderation” might suggest that it was an absence of global shocks that was responsible, but this is not necessarily so. Monetary policy management moved towards giving primacy to the objective of domestic price stability in most countries simultaneously through the 1990s. Better monetary management in the major countries abroad helped to stabilize the context in which domestic monetary policy operated.

4. Nevertheless it is the case that monetary policy in the UK has not had to do much to achieve its inflation target. Since 1992, official interest rates have remained in a tight band, between about 4 and 7%, moving usually quite gradually, (in sharp contrast to the experiences of the 1970s and 1980s). Applying standard rules of thumb for the transmission mechanism, this indicates that the “touch on the tiller” has been consistently light.

5. Academic attempts to apply various econometric tests, for example Vector Auto Regressions, to try to distinguish the causes of the “great moderation”, (especially in the USA), between “good luck”, ie few external shocks, and good monetary management, have been mixed. Most of such VAR exercises tend to give the answer that it was good luck (references can be provided), but this may well be due to the shortcomings of the technical/econometric approach used.

6. In particular, such VAR exercises usually assume a constant underlying economic structure. The greatest success of modern monetary policies has been in anchoring expectations of future inflation (at the target level). This change in structure—largely due to credible monetary policy—may not get picked up in the VARs. Because expectations are anchored, (transient) shocks to output, or inflation, no longer get incorporated into forward-looking price/wage decisions (and the Phillips curve relating inflation to output gaps flattens dramatically). Since the VARs assume a constant structure, they interpret the resulting stabilisation as due to smaller shocks. In so far as the IT regime, and operational management, of the MPC has been particularly adept at reducing volatility, it is probably because the UK regime has been so successful in achieving credibility and anchoring expectations; there is some FRB research to this effect.

7. In truth, however, no one really knows how much of the “great moderation” to attribute to better monetary management, as contrasted with “good luck”. This has a number of implications. The first is that any such “good luck” may run out in future. The stability of inflation, since 1992 and even more so since 1997, has been extraordinary, in comparison with previous eras. Many of the younger generation now take it for granted. There must be a risk that future outcomes may worsen, and the then current MPC take the blame, as a result of a reversion to (more normal?) worse external disturbances.

8. A second implication is that, in so far as the stability has been due to an anchoring of expectations, any MPC is bound to react strongly in response to evidence that such expectations are shifting from their anchor. A related issue concerns the degree of flexibility that an MPC has to adjust to current, perhaps temporary shocks, so long as the anchor does hold. Too much flexibility and you risk the loss of credibility/anchor; too little and the benefits of such credibility are not properly exploited. So far, in my own view, the MPC has got this balance about right.

B. What role for the Monetary Aggregates?

9. Now that interest rates are being set directly for the purpose of controlling inflation, there is a strong body of academic thought that argues that paying attention to (any of) the monetary aggregates is superfluous, especially in the light of the demonstrable instability of (velocity) demand-for-money functions. There was a Conference held by the ECB in Frankfurt on 9–10 November on this general subject, on “What role for Money in Monetary Policy”. The above argument, that the monetary aggregates are superfluous to the decision on the determination of interest rates, was made there in an important paper by Michael Woodford, and strongly supported by discussant comments by Uhlig and Gali. Your staff could obtain these if you asked them to do so.

10. In my view, Woodford went too far in dismissing specific monetary influences on inflation. Fluctuations in the willingness and confidence of banks to make loans, and, during crises, fluctuations in the willingness of the public to hold their monetary funds with (some subsets of) banks, can have sharp and dramatic effects on the economy. I am preparing a paper on this subject (to be delivered on 28 February).

C. Asset and House Price Inflation

11. There is considerable evidence, (again references could be provided), that fluctuations in housing and property prices have much closer inter-relationships with commercial banks, and significantly stronger effects on (real) expenditures and output, than do equivalent percentage variations in equity prices. The general consensus, that central bankers have no particular expertise on what is the equilibrium equity index level, and that equity prices should only concern MPC in so far as it influences forecasts of future output and inflation, is, in my view, absolutely correct.
12. The arguments are more complex in the case of housing. First, and most important, there is a vital question of how housing prices should enter an index of inflation, whether RPI or CPI. The problem is that this is a complicated question, and there are several competing methods of so doing advanced. Eurostat has been trying to address this question for years, but it has been too difficult to resolve. So, largely as the lowest common denominator, housing prices have just been left out of the European Harmonised Index of Consumer Prices entirely, and by extension from our own CPI. In my view this is not only analytically invalid, but it matters hugely in practice in the frequent occasions when housing and other non-housing prices are moving very differently. If countries could overcome the measurement problem, of incorporating housing prices properly into a CPI/RPI, much of the heat about the treatment of asset prices by MPCs would fall away. This, apparently mundane, measurement problem is a truly important issue in monetary policy, that has not yet been properly resolved.

13. The banking system, widely defined to incorporate all mortgage credit originators, has frequently played a major role in amplifying housing (price) cycles by varying the terms on which it will make mortgages available. Using changes in the general level of interest rates specifically to affect the mortgage market is, normally, unwise. Official interest rates should be predicated to controlling overall inflation, (though subject to the above comment on such measurement). But that leaves open the question whether there are secondary instruments, notably in the form of changes in required levels of Loan to Value (LTV) ratios, that could and should be employed to target undesirable fluctuations in mortgage finance. Such instruments have been used, eg in Hong Kong and Estonia. The main problem is whether such controls might not too easily be bypassed by financial innovation. This is, however, another topic well worth exploring in some depth.

14. I have a new book, jointly co-authored with Boris Hofmann, on these issues, Housing Prices and the Macroeconomy (OUP, 2007), coming out in the next month, or two.

D. The Transmission Mechanism and External (Balance of Payments) Developments

15. It was odd that there was no mention of the various links between monetary policy on the one hand and exchange rates and other external matters on the other in the guidelines on key issues for your Committee. The main disturbing feature of the last decade has been that the interest rate levels consistent with price stability in the UK have also been consistent with (surprisingly) strong levels of real exchange rates. Be that as it may, the persistently strong real exchange rate has contributed to a number of “imbalances” within the economy, notably declines in manufacturing, tradeable goods and exports, and increases in consumption, services, non-tradeables and the current account deficit. It is, perhaps, arguable that “globalisation” would have forced the UK in these directions anyhow, so that the more rapid adjustment may have been beneficial, but that is not a view that I share. It is probably better to take adjustments at a more graduate pace.

16. If one considers, as I do, that the strong real exchange had a disadvantageous effect on the domestic composition of output and expenditures, then that raises the question of whether there was anything that the MPC could, or should, have done about that.

17. Another economic puzzle is that the pass-through effect of changes in exchange rates first on import prices, and subsequently on the generality of goods and services prices, seems to have weakened considerably since the late 1980s, around the world, not just in the UK (references could be provided). Consequently the stronger real exchange has had less offsetting effect on domestic prices, and hence on interest rates than would in earlier years have been expected. There has been a separate China/globalisation effect lowering the prices of many manufactured imports, but this is conceptually distinct from the exchange rate pass-through.

18. The MPC was given the primary task, correctly in my view, of stabilising domestic inflation, defined first in terms of RPIX, more recently of CPI. Given this remit, it was not in a position to give weight, in setting the general level of interest rates, to the exchange rate, except in so far as this might influence the future value of RPI/CPI, (and less so given the decline in pass-through).

19. Another problem of recent years has been a severe shortage of ultra-long gilts, indexed or straight, for pension funds and insurance companies to buy. This has distorted the long end of the yield curve, and damaged pensioners’ economic prospects. If I had been a dominant economic tsar, I would have initiated during these years a large program of intervention to buy foreign exchange, financed by the issue of long
22. This programme is contentious. Many academics argue that sterilised intervention, except in astronomical amounts, can be shown to be ineffective, though this issue remains debated (references can be given). It is also a risky exercise, and large losses can be made. It is arguable whether a non-elected body, like the MPC, should put taxpayers' money at risk, for an exercise that is not central, (just secondary), to their primary remit. If the MPC should do, on such arguments, be done by the Chancellor, not by the MPC. Anyhow for such (and other) reasons when I put a proposal for such intervention to my colleagues on the MPC, it was roundly rejected. Whether the Chancellor and HM Treasury ever separately considered such an exercise, I do not know.

23. Several decades ago the main links in the transmission mechanism between monetary policy and domestic inflation ran through the external effects. A rise in official interest rates would strengthen the exchange rate, thereby reducing import prices, and then affecting domestic prices more broadly. All the chains in this linking mechanism have recently weakened to some extent, notably pass through. But that has not meant that monetary policy has become less effective over time, rather the reverse.

24. The increasingly important links in the transmission mechanism have shifted to the housing market, construction, private sector wealth and personal consumption. The reasons for this are well-known. The danger for the MPC and for monetary policy is that a tightening policy (rising interest rates) could be perceived as working largely through applying economic pressure to vulnerable social groups (eg young families) and causing social distress (eg repossessions). It is partly for this reason that I believe that it would help the conduct of monetary policy overall if the MPC, the Bank and the FSA took steps to avoid the vulnerable getting too far into debt (eg via time-varying LTVs) during the boom periods when the commercial, financial community was relaxing its own standards. In my view regulatory and prudential controls should be varied, to the extent possible, on a contra-cyclical basis; whereas current developments, notably the adoption of Basel II, are making them even more pro-cyclical. While that is another story, it could well complicate the conduct of monetary policy.

III. The Monetary Policy Framework

25. It is, I hope, otiose to rehearse once again the arguments supporting the delegation of operational independence to an MPC for the primary purpose of achieving price stability. The main weakness of this move is the potential “democratic deficit” involved in the delegation of a powerful instrument to unelected technocrats. In this respect keeping the choice of the form and level (and symmetry) of target a political decision was absolutely correct, (and far superior to the arrangements in the euro-zone, where the ECB has too much goal independence for its own good).

26. My main concern about the choice of CPI, in place of RPIX, was that the latter included some partial measure of housing costs, while the CPI did not, (see II.C above).

27. One, somewhat academic, concern that you do not raise specifically is whether the target should be set in terms of price levels or of inflation targets. The former requires the MPC to correct prior mis-hits; the latter allows bygones to be bygones. Under some restricted conditions, ie perfect credibility and forward looking expectations, the former can be shown to be preferable. I do not believe that the necessary conditions hold, so I support the standard IT approach.

28. A much more common complaint about the form of target is that it makes no reference to real variables, growth, unemployment, etc. There are several responses to this. First, over the medium and longer term, an MPC cannot control real variables; all it can achieve is price stability, and this latter is the best achievable nominal platform for growth. Second, even in the short run, the maintenance of price stability is almost certain to require seeking to maintain output close to its sustainable level, a small output gap. The main exception to this could come with a really large supply shock (eg oil price jump, physical catastrophe, etc).

29. This brings me to the letters when the 1% band is passed. First, this should not be regarded as a “sanction”, though it commonly and, in my view mistakenly, is so seen. Thus letters could often be triggered by factors totally outside the control of the MPC, eg the supply shocks already noted or even a fiscal decision to alter indirect taxes such as VAT. What the letter-writing at the band triggers is a need for explanation of what has occurred, and, I would expect, an outline plan of how, and at what speed, to revert to target.

30. Second, what is often overlooked, is that the letter from the Governor to the Chancellor gives the latter an opportunity to write back. Should the Chancellor think that the proposed speed of reversion to the inflation target is so fast (so slow) as to imperil the desired path of output (the credibility of the inflation target), he could write back asking for a different path to be adopted. Thus in my view the letter writing procedure brings the short-run trade-off between output and growth back within the political arena if, and when, anything goes seriously off-course, for whatever reason.

31. In practice, of course, and to everyone’s initial astonishment, nothing has gone off-course, so far. In some ways it is rather a pity that the letter writing system has not yet been activated, to see how it might work. Output growth has been extremely stable by historical comparison. This means that, in practice, the...
only queries about whether the MPC could have had more “regard to the economic policy of the government” relate to the composition, not the level, of output. This goes back to the questions raised in II C and D, whether there are secondary monetary instruments, eg intervention and variable LTV ratios, that the MPC could/should use to try to affect the exchange rate and the housing market.

32. Turning finally to the question of the optimal number of meetings, my answer would be eight per year, four forecast meetings and four half-way between forecasts (as the FOMC does). Twelve is too many. One month after the previous forecast is usually too short a period for anything to have happened; and one month before the next forecast generally leads to a suggestion to wait until one can see the full picture in the context of a new forecast. Also monthly meetings use up too many resources, especially over the summer holidays. The counter-argument, that monthly meetings are always fitted into the same, most efficient, point in the monthly cycle of “news” releases, while true, is not in my view a really strong point. Nevertheless this is a second-order issue. The requirement for a monthly meeting (unwisely) got included in the Bank of England Act. Unless there are separate, sufficient reasons for now revising that, it is hardly worth having a separate new Act just to change the number of meeting dates.

IV. THE MPC AS A BODY

33. I have already commented on (most of) those issues in my earlier written submission to your counterpart House of Lord Committee. This has now been published by them.

V. THE MECHANICS OF SETTING AND IMPLEMENTING MONETARY POLICY

34. On the whole the MPC in the UK is one of the most transparent in the world. When there is disagreement, the identity of the dissentient is published, the relevant arguments are published in the Minutes, and the dissentients are encouraged to explain their positions further in public. All this is good.

35. There is one technical issue, relating to transparency, on which the MPC has recently been challenged. Until 2004 the MPC’s forecasts were based (conditioned) on an assumption that official interest rates would henceforth remain constant at their latest level. Then the assumption was switched to the assumption that interest rates would adjust along the lines implicit in the money market yield curve. But several economists, notably Giavazzi and Wyplosz, have been calling for the MPC to base (condition) its forecast on, and publish its own best guesstimate of the optimal future path for interest rates, as is already done in New Zealand and Norway.

36. I have argued against this latter proposal. There was an exchange of correspondence in the FT in July 2006. My arguments are that it would be extremely difficult to get a nine-member committee to agree on any one (best?) future path, and that the scale of uncertainty involved is so great that the true additional information provided is small, and probably much smaller than the weight that such a forecast would then be accorded. Be that as it may, I am currently working on this same topic, and I could provide the Committee with a paper that is currently under submission to a Journal.29

December 2006

Memorandum submitted by Stephen Nickell

EXECUTIVE SUMMARY

1. Real and nominal long-term interest rates are likely to rise over the next decade.

2. The success of monetary policy in stabilising inflation expectations has contributed to economic stability in recent years.

3. The MPC has, and should have, only responded to asset prices insofar as they influence inflation prospects.

4. The build-up of household debt and asset holdings has probably made household expenditure more sensitive to changes in short-term interest rates.

5. By and large, the overall framework is satisfactory. However, the appointment process is opaque and it would be better if external appointments were made using the standard procedures which are already used for nearly all public appointments.

6. External members should be appointed for a single term of six years. Some may be expected to resign before their time is up.

7. External members should be allowed to choose whether they do MPC work for three, four or five days per week. This was the situation before 2003.

29 Not printed.
8. MPC members should each write a short paragraph in each issue of the Minutes explaining their position.

9. Each time MPC members appear before the TSC, the session should start with a series of questions addressed to each member in turn designed to elucidate their particular position.

THE ECONOMIC CONTEXT

1. In recent years, long-term nominal and real interest rates throughout the world have been at historically low levels. The forces at work here (basically excess savings by East Asian and oil producing economies) are likely to moderate at some point over the next decade and long-term rates will consequently rise. This will probably have a negative impact on asset prices.

2. The monetary policy framework and the conduct of monetary policy has succeeded in stabilising inflationary expectations. In particular, the explicitly forward looking nature of monetary policy decisions and the success of the MPC in explaining these have been particularly important in this regard. The stability of inflation expectations has meant that the economy has been more stable than it would have been had inflation expectations responded to the nominal shocks hitting the economy on a regular basis (eg energy price shocks).

3. The MPC has, and should have, only responded to asset price and house price movements insofar as these have influenced aggregate demand and hence inflation prospects. Any other type of response would have risked undermining the credibility of the MPC.

4. The build-up of household debt and asset holdings has made household expenditure more sensitive to short-term interest rate changes. This has the probable implication that interest rate fluctuations are likely to be lower than in the past. Generally, monetary policy should not be used specifically to encourage or discourage the accumulation of household debt.

THE MONETARY POLICY FRAMEWORK

5. By and large, the framework is satisfactory. The fact that the Government sets the target and the Bank has operational independence and sets interest rates to hit the target is wholly appropriate. The symmetrical nature of the target is vital both to avoid deflationary bias and to assist members of the MPC in making simple and clear explanations of their policy decisions.

THE MPC AS A BODY

6. The appointment process is opaque and it would be better if external appointments were made using the standard procedures which are already used when making appointments to other public bodies. The TSC should play the same role as it does today in holding “confirmation hearings”. The terms of external members should be longer—say six years—and they should not be eligible for reappointment. However, it should be expected that some external members will resign before their time is up. There should be a convention that they would stay for at least three years. The purpose of these arrangements is to ensure that there is a wide range of willing and able applicants.

7. External members should be allowed to choose whether they do MPC work for three, four or five days per week. This was the situation when I joined the Committee in 2000, but this is no longer the case. Currently, external members can work on the MPC for no more than three days per week. Thus potential external members who work in jobs where there would be an obvious conflict of interest would have to resign in order to take up a part-time position on the MPC. This is obviously less attractive than the possibility of a full-time position such as that taken up in the past by DeAnne Julius or Sushil Wadhwani. The current three day per week restriction reduces the field of potential MPC members.

THE MECHANICS OF SETTING AND IMPLEMENTING MONETARY POLICY

8. Improvements can easily be made both in transparency and in how the MPC explains its position. First, it is important to understand that the MPC decisions are taken by simple majority voting. They are not taken as the result of a search for consensus although it is inevitable that the forecasts published in the Inflation Report are, to some extent, the result of compromises by MPC members. However, because of this, it is equally inevitable that MPC members may hold views which differ from those implied by the published central projections.

9. In order that members of the MPC may make their views clear, they are, of course, able to publish speeches. However, more is required. One possibility, which I favour, is that in every issue of the Minutes, each member of the MPC has the right to a paragraph which summarises their own position. This would make the position of each member of the MPC absolutely clear on each decision and enable the general public to receive a regular update on the views of individual members. Given that each member has a vote, this would enhance the overall transparency of both the decision and of the position of the MPC as a whole.
10. In addition to this, when members of the MPC appear before the TSC, the session should begin with a series of questions addressed to each individual member in turn designed to elucidate their particular position. Currently, for a variety of reasons, there is an excessive focus on the Governor which is not helpful in enabling the public to understand the overall position of the MPC and the conduct of monetary policy.

January 2007

Memorandum submitted by Professor Tim Congdon CBE

INTRODUCTION

The 10th anniversary of the Monetary Policy Committee is an opportune moment to conduct a review of its record, but the questionnaire in the Treasury Committee’s press notice of 21 November 2006 was wide-ranging. This written evidence—which is anyhow very long—cannot cover every topic mentioned.

The focus will be on the questions asked under the heading of “The economic context”. The first section of evidence will assess the performance of monetary policy since May 1997. It will argue that the dramatic improvement in macroeconomic performance since 1992 is due mainly to a better approach to policymaking. Also relevant have been supply-side gains which partly reflect wider global trends. The nature of the supply-side gains is discussed in the second section. Despite the relatively good economic outcomes of the last 10 to 15 years, some commentators continue to worry about excessive personal debt and inadequate national investment. The third section argues that these anxieties are misjudged.

A variety of issues are raised under the questionnaire headings of “The monetary policy framework”, “The MPC as a body” and “The mechanics of setting and implementing monetary policy”. A fourth section skirts most of these issues, which—in view of the marked success of the MPC in its first decade—cannot be regarded as pressing. But it does suggest that the current institutional structure neglects an important aspect of macroeconomic policy. This oversight has not so far been of much importance, but it could become so.

A final section discusses the present macroeconomic situation. The main theme is that current high rate of money supply growth—with the M4 money measure up by 13% in the last year—poses a serious threat to the continuation of low, on-target inflation and macroeconomic stability. My concern about the inflationary consequences of high money supply growth reflects a view of the economy’s workings which is not widely shared among British economists. Whether this diminishes the value of my remarks is for the members of the Treasury Committee to decide.

1. AN ASSESSMENT OF MONETARY POLICY PERFORMANCE SINCE MAY 1997

Overview

The pound left the European exchange rate mechanism late in the evening on 16 September 1992, after a day of ridiculous shenanigans in which interest rates changed from hour to hour. It was a turning point in the UK’s macroeconomic fortunes. Shortly afterwards the then Chancellor of the Exchequer, Norman Lamont, announced a regime of inflation targeting. This regime was reinforced by the decision, by the newly-elected Labour government in May 1997, to grant the Bank of England operational independence in the making of monetary policy.

No one disputes that macroeconomic performance has been dramatically better since the end of 1992 than before. In a paper published in World Economics in late 2002 I showed that the average annual rate of inflation on the RPIX measure (ie, the retail price index minus mortgage interest costs, which had been the subject of the official target) had been 2.6% in the decade of stability after September 1992 compared with 9.6% in the previous two decades of boom and bust. (In the paper I dated the boom-bust period more precisely from the first quarter 1971 to the third quarter of 1992.) The standard deviation of this inflation rate was 5.66 during the boom-bust period, but only 0.41 in the subsequent decade. In other words, not only was inflation much lower, but its volatility fell by over 90%! The paper is to be republished in my forthcoming book, Keynes, the Keynesians and Monetarism, where I have updated the analysis to the summer of 2006. In the four years to mid-2006 the inflation target was on average again met almost exactly and the variability of inflation was even lower than in the decade to September 1992! (1)

These are astonishing numbers. Moreover, the improvement on the inflation front has not been bought at the expense of the so-called “real economy”. Since 1992 output growth has been more stable over a more extended period than at any other time in British history, while employment growth has been strong and continuous. The interesting question is “why”? Does the MPC—which has been in existence for the bulk of the post-1992 period—deserve credit for the huge advance in macroeconomic stability that seems to have occurred?
One view is that—since the achievement of greater macroeconomic stability has been common across the industrial world since the mid-1990s—UK policy-making has not made a special or noteworthy contribution. This is unconvincing. Since 1992 the UK’s record in macroeconomic management has been better than the average in the industrial world, whereas in the 1970s and 1980s it was much worse. Benign policy-making has been crucial. Something happened in late 1992.

In part policy-making has been successful over the last 15 years because the decisions on interest rates, month by month and year by year, have been appropriate and well-judged. But that also is not a satisfactory and complete answer, as it begs the question of why decisions on interest rates (among other matters) were so much less judicious in the decades before the 1990s. In fact, the improvement in outcomes is better explained by:

(i) large-scale changes in the organization of macroeconomic policy-making (ie, in the way that policy instruments are used to affect outcomes, including the inflation rate) and,

(ii) a “paradigm shift” in the theories that that policy-makers and their advisers hold about the economy and, in particular, the inflationary process.

Changes in the organization of macroeconomic policy-making

It must be heavily emphasized that macroeconomic policy-making in the UK today is radically different from what it was in the 1960s and 1970s. A fair generalisation is that in those decades the management of demand was seen as largely the province of fiscal policy (ie, by changes in the government’s budget position, in order supposedly “to inject” or “to withdraw” demand from the economy), with the intention of securing “full employment”. The emphases on fiscal policy and full employment were widely termed “Keynesian”. If excess demand led to high and rising inflation, the correct antidote—which might be called “corporatist”—was thought to be a centrally-determined ceiling on wage and price increases administered by a specialist government bureaucracy. Meanwhile monetary policy was widely deemed to have little or no significance for either demand or inflation. If the setting of interest rates had any role in policy-making, it was to protect the exchange rate. (2)

The key changes in the organization of macroeconomic policy-making have been in the relative importance assigned to the various branches of policy. Four developments need to be highlighted.

(i) The abandonment of prices and incomes policies as a means of controlling inflation,

(ii) The neutralisation of fiscal policy by the adoption of medium-term budgetary rules,

(iii) The directing of monetary policy to the attainment of domestic stability (ie, particularly the stability of inflation at a low rate) instead of the maintenance of a fixed exchange rate, and

(iv) The elevation of monetary policy (in the sense of the setting of the short-term interest rate by the Bank of England) to pre-eminence in policy-making, so that it has become the virtual factotum of macroeconomic policy.

The demise of the Keynesian and corporatist styles of macroeconomic policy-making has happened within the lifetime of most economists practicing in Britain today. Many of them supported these styles of policy-making and would claim that it is too early to reach a balanced historical appraisal. Nevertheless, over the last 30 years most people actually involved in UK policy-making have been persuaded that Keynesianism and corporatism were misguided. Unfortunately, the discussion has to be limited to brief—far too brief—summaries of developments in the four main areas, set out in the accompanying box. The essential point is that the variation of the short-term interest rate is now regarded as an omni-competent macroeconomic policy instrument. This view has emerged pragmatically, because of a process of “learning by events”, and its justification is not to be sought in any particular economic doctrine.

1. Role of incomes policies. Prices and incomes policies were discredited in the 1970s, by the disastrous results of the conflict between the Heath government and the National Union of Mineworkers in 1974, and by the “winter of discontent” in 1979. Most economists now regard such policies as likely to lead to macroeconomic inefficiency and to prove ineffective in the long run.

2. Role of fiscal policy. Confidence in the potency of fiscal policy was dealt a decisive blow by the sequel to the 1981 Budget, when the economy recovered after a large increase in taxes and a reduction in the budget deficit. The 364 economists who wrote a letter of protest about the 1981 Budget to The Times were quite wrong. (3) The 364 were undoubtedly representative of majority opinion in the UK economics profession, but the economy’s behaviour after mid-1981 left them intellectually humiliated. The announcement of the medium-term financial strategy in the 1980 Budget has been followed by over 25 years of medium-term fiscal rules. The specification and rationale of these rules changed somewhat in 1997, when the Labour government announced a new code for fiscal policy, but—as in the previous 18 years of Conservative rule—decisions on the budget balance continue to be framed within a medium-term setting and geared to the achievement of fiscal solvency. Fiscal policy is not used to manage demand.

3. Role of monetary policy. Because fiscal policy is subordinate to medium-term rules and is not used to manage demand, threats to low inflation have to be tackled by other types of policy. In the 1960s and 1970s the most widespread view among economists was that monetary policy was
ineffective, and that reliance should instead be placed on prices and incomes policies. Today, by contrast, most economists regard the variation of short-term interest rates by the Bank of England as an extremely powerful macroeconomic weapon. It is widely accepted that variations in interest rates can and should be used to manage demand and, at a further stage, to keep inflation on target.

4. **Interest rates as instrument of monetary policy.** The apotheosis of interest-rate setting is the unintended and unforeseen sequel to the changes in macroeconomic policy-making set in train in the early years of the 1979–97 Conservative government. Originally that government envisaged that inflation would be curbed by control over the quantity of money, not the price. But there was much confusion about how the quantity of money should be controlled and about the appropriate money aggregate for targeting purposes. In the late 1980s two Chancellors of the Exchequer—Nigel Lawson and John Major—determined that monetary policy should instead be set according to the exchange rate. When this policy failed with the pound’s expulsion from the ERM in September 1992, hardly any of the policy nostrums of the previous 30 years retained credibility. Incomes policies, activist fiscal policy, money supply targets and a fixed-exchange-rate regime had all in one way or another been disappointing. (4) *The practice of varying the short-term interest rate to keep inflation on track evolved not because any prominent school of economic thought advocated it, but because all other options had been eliminated.*

**Paradigm shift in the dominant theory about the inflationary process**

However, if the justification for the present emphasis on the short-term interest rate has no obvious doctrinal roots, that does not mean the macroeconomic debates of the last 40 years have been futile. Consensus thinking about “how the economy works” has changed radically. As noted above, in the 1960s and 1970s policy-makers were committed to the goal of full employment. It would be possible nowadays for the short-term interest rate to be the favoured instrument (ie, for policy-makers to have dispensed with incomes policy, activist fiscal policy and a fixed exchange rate) and yet for policy-makers to set interest rates with the aim of achieving full employment.

But that is not what they do. Instead the short-term interest rate is varied by the MPC to keep output more or less at a “trend” or so-called “natural” rate, with an “output gap” as close to zero as possible, in order to stabilise inflation at its target level. (5) These terms will be explained shortly.) Neither the government nor the Bank of England is any longer consciously trying to promote full employment. The story of the replacement of the goal of full employment by an ultimate target of low inflation, to be met by keeping the economy close to (what is, in effect) an intermediate target of a zero output gap, is eventful, complicated and controversial. Again, only the main features can be discussed here for reasons of space.

There is general agreement that—at the intellectual level—the vital contribution was Friedman’s presidential address to the American Economic Association at the end of 1967. (6) Before the 1967 AEA presidential address most economists believed in a long-run trade-off between inflation and unemployment. The belief in the existence of this trade-off or *accelerationist hypothesis* argued that the targeting of full employment was therefore inexpedient and unwise.

In 1962 the American economist, Arthur Okun, published a paper on the relationship between output and employment in the USA, arguing that cyclical changes in output were much larger than cyclical changes in employment. (8) In fact, he interpreted his data as showing that a 1% shortfall in employment from its “full employment” level—which he took to be associated with a 4% unemployment rate in the USA—would be accompanied by a 3% loss of national output (ie, in his words, a 3% “GNP gap”). Okun’s Law (ie, the three-to-one short-run elasticity of output with respect to employment) established a strong case for maximising employment and so reinforced the Keynesians’ commitment to full employment. Given the Phillips curve result, the result would be high inflation, but it was thought that inflation would be stable at the high rate.

The core message of Friedman’s 1967 AEA presidential address was that inflation would not be stable at any arbitrarily-defined low rate of unemployment (ie, at what politicians might deem to be “full employment”). Instead—because rational agents would come to expect inflation and alter their behaviour in response—an over-ambitious “full employment” rate of unemployment would be associated with *ever-rising inflation*. This “accelerationist hypothesis” argued that the targeting of full employment was therefore inexpedient and unwise.

Friedman proposed that the rate of change of wages was stable at only one level of unemployment, which he called “the natural rate”. If unemployment were continuously beneath the natural rate, wage inflation would rise without limit; if unemployment were continuously above the natural rate, wage inflation would
fall to zero and eventually become negative; only at the natural rate would wage rises be constant. There was no long-run Phillips curve. Indeed, in his 1976 Nobel lecture Friedman took the argument further. (9) He suggested that price stability would help markets work better, which implied that in the long run an economy with stable prices would have more employment than one with high and volatile inflation. Paradoxically, policy-makers might do better on jobs if they focussed their attention on price stability.

In the late 1960s and the early 1970s the pursuit of full employment policies by expansionary fiscal policies was associated with rapid monetary expansion and rising inflation in the USA, the UK and many other countries. Incomes policies to combat inflation routinely fell apart. Meanwhile several economists challenged the statistical basis for Okun’s Law. (10) The scene was set for a radical shift in the organization of macroeconomic policy. In the 1980s Conservative governments in the USA and the UK emphasized that low inflation took priority over full employment, and defended their approach by appealing to the absence of a long-run trade-off between inflation and unemployment.

Some economists saw that Friedman’s ideas, which in the 1967 presidential address related only to the labour market, could be generalised to the whole economy. It was proposed that there is a level of output associated with the natural rate of unemployment and that this level of output is accompanied by stability in the rate of inflation (or, at any rate, in the rate of domestically-generated inflation in the absence of major supply shocks). Various names have been given to this level of output and the terminology has not yet settled down. (These names include “the natural rate of output”, and the “trend”, “potential” and “equilibrium” levels of output. The term “trend output” is adopted in the rest of this note.) The difference between the actual and trend level of output is then called “the output gap”, and can be expressed as a percentage of trend output. The output gap is positive when output is above trend and negative when it is beneath trend.

The thinking behind the accelerationist hypothesis can be elaborated within the context of the economy as a whole. If the output gap is positive, so also is the change in inflation; if the output gap is negative, so also is the change in inflation; and a zero output gap enjoys a stable inflation rate. Further, this framework is easily extended to a growing economy. Every economy has a trend rate of output growth, at which the factors of production are utilised at a constant rate (ie, the unemployment rate, the rate of capacity utilisation in manufacturing, the office vacancy rate and so on do not change over time). If actual output growth is above the trend rate, a positive output gap becomes more positive or a negative output gap becomes less negative; if it is in line with the trend rate, the output gap is constant; and so on. Assuming that the current inflation rate matches the o

As explained above, the available policy instruments have been narrowed down to one (ie, the short-term interest rate set by the Bank of England). So macroeconomic policy-making has been drastically simplified compared with the 1960s and 1970s. It is reduced—essentially—to the formula, “If at present the output gap is zero and inflation is on target, the Bank of England should vary the short-term interest rate to keep the output gap as close as possible to zero.” Its job is to meet the inflation target and only the inflation target; it should not try to maximise output and employment. Over the medium term the financial stability delivered by this regime may lead to growing employment, but that is not the central bank’s direct and immediate concern.

Four miscellaneous points

Four more points need to be made before closing this section. First, the identification and measurement of the output gap are complex. Several methods of calculation are available and, when handling historical data, they serve as cross-checks on each other. But—in actual, forward-looking policy-making—the GDP data are published rather late and remain subject to substantial revision. Fortunately, a shortcut to the measurement of the output gap is provided by business survey data. In most countries—including the UK—reliable and comprehensive business surveys started in the early 1960s or later, and a decade or more of numbers were needed before they could be related meaningfully to other macroeconomic data. But by the 1980s many business survey series could be cross-checked with output and other series prepared by official statistical agencies (ie, the Central Statistical Office in the UK). The business survey results—which were produced with hardly any lag at all—could themselves be taken as a rough, “quick and dirty” guide to the value of the output gap. Nowadays the MPC is deluged with business survey information, in a way that would have been unimaginable in the 1950s, the 1960s or even the 1970s. (See any issue of the Inflation Report.) This information is of immense value in its work.

Business surveys have been helpful in a further respect. In the late 1960s it was hoped that, with the advance of computer power, large-scale econometric models would be so accurate in forecasting the economy that policy-making could be reduced to a mechanical exercise with no scope for human error. In the event, forecasts of computer-based models have been poor at critical moments, notably in the booms of the early 1970s and the late 1980s. Instead financial markets and policy-makers have increasingly found that the best short-term guide to the economy comes from business surveys. (Businessmen are asked what they expect to happen to demand and investment over the next few months, among other questions.) In the UK the CBI industrial trends survey, begun in 1961, has traditionally been the leader in the field. In the USA
Wall Street analysts found that the NAPM survey (ie, the National Association of Purchasing Managers' survey) was among the best short-term guides to the direction of the economy. In the last few years surveys like the NAPM have been standardised across the industrial nations by the private sector, with the aim of “jumping the gun” of official economic releases. (The Hendon-based NTC Publications has—I believe—been the UK leader in this field, but I am open to correction.)

The PMI (“purchasing manager index”) surveys are now produced every month at the beginning of the month, for all the major economies. They often cause large movements in interest rate contracts, as market participants believe—often rightly—that the PMI survey is an accurate guide to the strength of demand in the economy and conjecture that central banks will react to it. The constant monitoring of business surveys has become far more important in the day-to-day formation of thinking at the Bank of England (and other central banks) than the output of computer-based macro models. Business surveys have undoubtedly made a major contribution to the improvement in policy-making in the last 10 to 15 years.

Secondly, the output gap framework allows monetary policy to be de-politicised. The widespread acceptance of the Phillips curve in the 1960s implied that politicians had to be involved in policy-making, because only a democratic government could legitimately make such a fundamental choice as that between unemployment and inflation. But the accelerationist hypothesis and the associated output gap framework argue that, at any particular time, the inflation target can be met at only one level of output (and only one level of unemployment, although this is not usually made too explicit). The job of keeping actual output close to that trend level is therefore technical, not political. As no politically sensitive inflation/unemployment trade-off exists in the long run, this job can be safely delegated to a committee of experts. Of course that committee (ie, the MPC) can be made subject to democratic scrutiny (ie, by the Treasury Committee of the House of Commons, as well as the government of the day). But the political oversight can be high-level and rather remote. Day-to-day political meddling in the determination of interest rates, and indeed the absurd hour-by-hour interventions on 16 September 1992, are unnecessary.

Thirdly, no authoritative account has yet been agreed about the development of the output gap framework. The standard academic reference is to a 1993 paper by Taylor, because that paper suggested that central banks had for many years been adjusting interest rates to differences between actual and trend output. (11) Other economists used this descriptive work on so-called “central bank reaction functions” as the basis for prescriptive “Taylor rules”, in which the appropriate interest rate varies with levels of the output gap (among other variables). But the 1993 Taylor paper did not in fact use the phrase “the output gap” or make any large statements about the relationship between it and inflation. In my forthcoming book _Keynes, the Keynesians and Monetarism_, I suggest that the output gap framework developed among practitioners (more precisely, the research departments of the IMF, the OECD and City stockbroking firms) in the mid- and late 1980s, was adopted by policy-makers in the early 1990s and entered academic discussion thereafter. The core ideas behind the now dominant conception of the gap nevertheless originate in Friedman’s 1967 presidential address.

<table>
<thead>
<tr>
<th>Concept of output relative to which the gap is measured</th>
<th>Keynesian concept of gap</th>
<th>Monetarist concept of gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full employment level of output</td>
<td>Level of output associated with natural rate of unemployment, or “natural rate of output”</td>
<td></td>
</tr>
<tr>
<td>Only positive values, taking value of zero at full employment and rising with unemployment.</td>
<td>Positive and negative values, taking value of zero at natural rate of output and positive with output above natural rate.</td>
<td></td>
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</tbody>
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**Seminal paper(s)**

**View on the inflation process**
- Level of inflation a function of level of gap, and change in inflation a function of change in gap.
- Change in inflation a function of the level of the gap.**

**Name of associated hypothesis on wage formation.**
- Phillips curve.

**View on output as a policy objective**
- To be maximised (implicitly at lowest previously attained unemployment rate), as any shortfall is very expensive because of Okun’s Law.

**Accelerationist hypothesis.**
- Output to be kept at natural rate, even if this is less than the maximum “in an engineering sense”.

View on output as a policy objective
Keynesian concept of gap | Monetarist concept of gap
---|---
**View on inflation as a policy objective** | Old “Keynesian”, ie, to be controlled by incomes policy, and control of inflation is secondary to achieving full employment, although with many variations. | Meeting inflation target is paramount objective of policy and takes precedence over full employment. |
**View on money and inflation** | Monetary policy (eg, behaviour of bank deposits) not relevant to inflation; labour market critical instead. | Output gap most reliable guide to direction of inflation in short run, but relationship between money and prices holds in the long run, and short-run fluctuations in real money affect asset prices, demand and employment. |
**Terminology.** | Initially “GNP gap”, following Okun; now “output gap” phrase in so-called “New Keynesian” policy framework, with Taylor rules etc, but 1993 Taylor paper did not use output gap phrase or refer to link with inflation. | First use of “output gap” phrase in monetarist sense uncertain, but probably in IMF/OECD and/or City circles (ie, practitioners) in the mid-1980s; Congdon gave very clear statement in 1991 and phrase appears in UK official documents at about same time. |
**Implied position of macro decision-taking in the wider policy.** | Political, government to decide on right mix of inflation and unemployment. | Technical, decision on interest rates can be delegated to committee of experts. |


** In Friedman’s 1967 the rate of change of real wages is a function of the divergence of unemployment from its natural rate, but in practice changes in real and nominal wages are closely correlated.

Part of the trouble in the subject is that the beginnings of the output gap idea can be found in two distinct traditions of thought, the Keynesian (from Okun’s “GNP gap”) and the monetarist (from Friedman), although both traditions owe much to the work done at the LSE by Phillips and his colleague, Frank Paish, in the 1950s. At any rate, the monetarist notion of the gap has now more or less supplaned the Keynesian. (See the accompanying table. Paish amplified Phillips’ labour market analysis into an account of the cyclical relationship between the margin of space capacity in the economy as a whole (ie, a prototype “output gap”) and the rates of wage and price increase. (12) Although this branch of macroeconomics is therefore at least 50 years old, many textbook statements muddle up the two gap concepts. Ironically, the monetarist concept has become integrated in a set of principles about policy-making known in some circles as “New Keynesianism”. Economics is a strange subject.)

Finally, the output gap framework—which can be stated without any explicit reference to the quantity of money—has been so successful in the last 15 years that many economists believe no useful purpose is served by central bank targeting of the quantity of money. Roughly speaking, leading American macroeconomists—including some at the Federal Reserve—believe that money aggregates can and should be forgotten, the European Central Bank (taking its cue from the Bundesbank) remains loyal to money targets (ie, its “second pillar”), and the Bank of England lies somewhere in the middle of the TransAtlantic debate. In my opinion the attack on the policy relevance of the quantity of money is to be interpreted as the re-appearance of the Keynesian-monetarist debates of the 1970s. Bluntly, the Keynesians lost those debates. They were wrong about a whole mass of subjects, notably the policy usefulness of incomes policies, the validity of fiscal policy as an instrument of demand management, the interest-inelasticity of total expenditure, the impact of money on asset price movements, and the significance of both money and asset price movements to domestic demand. They had to retreat as and when their advice failed. The improvement in inflation and employment outcomes over the last 15 years should be seen, at least partly, as the result of policy-makers’ recognition of the superiority of monetarist thinking. (I accept that a muddled process of “learning by events” has perhaps been even more important. Of course the monetarists have had their problems, and fierce internal debates, as well.)

But in the USA and the UK most university economists were and are Keynesians, and a variety of practical difficulties in money supply targeting have given them the opportunity again to denounce any role for the quantity of money in policy-making. In my view the current academic criticisms of the relevance of the quantity of money to inflation will be dangerous if policy-makers take them seriously. I discuss the inflationary risks in the current high rate of UK money supply growth in the final section. (This section concludes with a table summarising the main features of the macroeconomic paradigm shift over the last 40 years.)
Organization of macroeconomic policy in 1960s and 1970s (“the ‘old Keynesian’ paradigm”) | Organization of macroeconomic policy today (“the paradigm of ‘output-gap monetarism’, also called—strangely—‘new Keynesianism’”)
---|---
**Ultimate objective** | Full employment. | Price stability (or, at any rate, low inflation).
**Intermediate target** | Fixed exchange rate. | None explicitly, but in practice maintenance of zero output gap (i.e., unemployment at natural rate) guides decisions.
**Policy instruments** | Primacy of fiscal policy; interest rates assigned to exchange rate stability; an assortment of administrative interventions, including prices and incomes policies. | Omni-competence of short-term interest rate; fiscal policy neutralised by medium-term rules.
**Guide to conduct of policy** | Large-scale, computer-based macro-econometric models, sometimes with hundreds of equations, plus anecdote. | Business surveys mainly, but with results of macro-econometric modelling in the background.

2. **The Improved Supply-side Background**

Over the last decade the compound annual growth rate of the UK’s national output has been more than satisfactory by past standards. In fact, the compound annual growth rate in the decade to the third quarter 2006 (i.e., the last for which reasonably full data are available and closely corresponding to the period in which the MPC was responsible for monetary policy) was 2.8%, higher than in the four preceding decades. In fact, the UK’s growth rate over the last decade has recovered to a level similar to that in the fast-growth period in the 1950s and 1960s, whereas in most European nations growth rates are much lower—sometimes a half or less—of their levels in the 1950s and 1960s. Again, the question has to be asked “why?”.

### Growth of gross value added at basic prices (i.e., national output)

<table>
<thead>
<tr>
<th>Compoun annual growth rate (%)</th>
<th>Decades to</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>2.9</td>
</tr>
<tr>
<td>1975</td>
<td>2.4</td>
</tr>
<tr>
<td>1985</td>
<td>1.7</td>
</tr>
<tr>
<td>1995</td>
<td>2.4</td>
</tr>
<tr>
<td>2005</td>
<td>2.8</td>
</tr>
<tr>
<td>Q3 2006</td>
<td>2.8</td>
</tr>
</tbody>
</table>

*Source:* ONS website (as at 7 January 2007) and author’s calculations.

Part of the answer is undoubtedly the pay-off from greater macroeconomic stability. This stability has led to more accurate and reliable business planning, more efficient investment and a higher level of capacity utilisation (on average) than before. However, I would like to point out a further aspect which (in my opinion) has not had the attention it deserves.

Over the last 30 or 40 years the composition of UK output has changed drastically. Whereas in the 1960s manufacturing output bulked large in total output and dominated UK exports, value added in the manufacturing sector is now only 18.1% of total value added. The service sector has become far more important as a source of value both to domestic consumer and to foreign customers. In fact, the UK’s role in the world economy is increasingly as one of the leading suppliers (and in the some areas the leading supplier) of international business services. The table on the next page shows that exports of services in 2005 amounted to slightly more than a third of total exports of goods and services compared to about a quarter in the mid-1980s. Exports of services are in turn can in be divided into exports of travel, transport and government services, where the UK runs a deficit and appears not to have a comparative advantage. The area of buoyancy in UK exports is in what might be termed “international business services”, which include financial services and a wide range of consultancy activities, mostly located in central London. Over the 18 years to 2005 their growth rate was twice as fast as that of exports of goods. They are now worth slightly less than a third of exports of goods. If the growth rates of the last 18 years continue, exports of international business services will overtake those in goods about 25 years from now.
This might seem to be a supply-side development, a change in “real” things, without any direct relevance to monetary policy. However, what happens on the supply side of an economy can have a bearing on monetary policy in several ways. In the present context the boom in international business services may have been important, because the demand for these services is less price-elastic than, say, the demand for standard grades of steel or synthetic fibres. By concentrating on areas of economic activity in which they retain some “pricing power”, UK producers have been able to cope with an apparently much higher value of the pound than would have seemed likely from the experience of the preceding 20 years. (The emphasis here has been on the boom in international business services. But in manufacturing also UK companies may have been moving away from standard lines of production, in which they are uncompetitive relative to, say, Asian suppliers, and specialising on niches, where—again—they have some pricing power.)

Initial confirmation for this hypothesis comes from a comparison of two ratios,

(i) the ratio of the price deflator of exports of goods and services to the price deflator of imports of goods and services, on national accounts data, and

(ii) the “terms of trade”, understood as the ratio of the prices of exports of goods only to the prices of imports of goods only.

As the accompanying chart shows, the first ratio (goods and services) has been steadily catching up with the second (goods only) since the early 1980s.

The improvement in the UK’s international pricing position has implied an appreciation in its real exchange rate. This appreciation could have occurred either by having higher inflation than the rest of the advanced world or by a rise in the nominal exchange rate while inflation rates were similar in the UK and
other advanced nations. In practice the existence of the inflation target has been associated with a higher value of the nominal exchange rate than most economists (including myself) would have thought plausible back in the mid-1990s.

Has government policy been relevant here? Arguably, the UK’s comparative advantage in the 21st century will be as an exporter of business services. (Among its most basic attributes as a nation are that it is the source of many of the business practices—in finance, accountancy, law and so on—which are now spreading around the world because of globalisation, and its language is also the common language of a more interconnected world.) Before 1979 government tended to worry about “de-industrialisation” and to subsidise companies (in shipbuilding, cars, coal, steel and so on), often in state-owned hands, that could not compete internationally. Since 1979 these subsidies—which led to systematic resource misallocation—have stopped. The ability of the UK economy to cope, since the mid-1990s, with an apparently overvalued exchange rate may be explicable partly in these terms. Of course members of the MPC need to keep a watchful eye on the exchange rate, because a large fall in the pound would be inflationary.

3. **MISJUDGED ANXIETIES ABOUT DEBT AND INVESTMENT**

Anxiety about excessive debt is a hardy perennial of media comment on the economy. The period of very low interest rates from November 2001 to February 2004—with base rates of 4% or less—was indeed accompanied by rapid growth in household debt. In the two and half years to the first quarter of 2004 household debt increased by over a third, whereas personal incomes advanced by slightly more than a tenth. But scare mongering about debt is—in one sense—always a misunderstanding. A nation can never be in debt to itself. The debts owed by some people must be assets in the hands of other people. The idea that “the nation” or the entire “household sector” could go bankrupt, or even face serious financial trouble, because of excessive internal debt is therefore preposterous. Sure enough, a nation can be in debt to other nations, but that is not what has been motivating the newspaper stories.

It needs to be remembered that lenders require collateral. Since collateral is typically in the form of readily-saleable assets (such as houses or securities), extensive problems of debt repayment are likely to arise only if the value of collateral is eroded by large asset price falls. Indeed, a feature of all economies—including the UK—is that the value of gross assets is a multiple of debt. Official data are available on the household sector’s gross assets, liabilities and net assets since 1987. The first chart below shows the ratios of gross assets and liabilities to GDP, and the second chart shows the ratio of net assets to GDP. The message of the second chart is compelling. Despite the jump in the debt/GDP ratio since 1998, the ratio of net assets to GDP is higher than at any time in the last 18 years (and in fact—almost certainly—than at any time in British history.)

Concern about supposedly “excessive” debt can be the prelude to state intervention of some sort, often in the form of credit restrictions. Implicitly, the people making the judgement that “household debt is excessive” believe that they know more about the borrowers’ interests and well-being than the borrowers themselves. While it is always possible to find individual cases of delinquency, paternalism of this kind should be treated with suspicion. Generally, people have a far better understanding of their own particular financial circumstances than anyone in Westminster, Whitehall or the London-based media. Indeed, the ratio of unsecured household debt to households’ assets in the UK is extremely low and always has been. (Unsecured household debt at the end of 2005 was about 3% of household gross assets. About three-quarters of it was credit card debt. In practice credit card companies are able to enforce claims on people who run up unduly large debts, even if they are unsecured.)

Concern about inadequate investment has been a recurrent theme in UK economic commentary since at least the late 1940s. To some extent this concern is also paternalistic and is open to the same criticism as that just levelled against anxiety over personal debt. It makes sense only if the commentator (or politician) bewailing the nation’s under-performance is better able to take decisions for the millions of individuals in a nation than they are themselves. But that is hardly credible. As it happens, over the last decade the UK has enjoyed a satisfactory growth record despite having a relatively low ratio of investment to GDP by international standards, whereas Japan—with a high ratio of investment to GDP—had done badly. In the cross-country comparisons of the last 15 years no correlation has been found between savings and investment on the one hand and growth on the other. (13)
Gross assets and debts, relative to GDP

Value of ratio

- Ratio of household debt to GDP
- Ratio of gross assets to GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>1987</th>
<th>1989</th>
<th>1991</th>
<th>1993</th>
<th>1995</th>
<th>1997</th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
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</thead>
<tbody>
<tr>
<td>Value of ratio</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td></td>
</tr>
</tbody>
</table>

Net assets (i.e., wealth), relative to GDP

Value of ratio

<table>
<thead>
<tr>
<th>Year</th>
<th>1987</th>
<th>1989</th>
<th>1991</th>
<th>1993</th>
<th>1995</th>
<th>1997</th>
<th>1999</th>
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</thead>
<tbody>
<tr>
<td>Value of ratio</td>
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<td>1</td>
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<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
</tr>
</tbody>
</table>

Ev 30  Treasury Committee: Evidence
4. THE INSTITUTIONAL STRUCTURE OF POLICY-MAKING

Since the MPC system has been so successful, it seems difficult to argue that much is wrong with its institutional structure. Like many other observers, I have been puzzled by some of the people the Chancellor of the Exchequer has selected to be outside members of the committee and believe that a better procedure must be possible.

But the main point I want to make is that the definition of monetary policy is potentially much wider than is now conventionally recognised. Roughly speaking, “monetary policy” has come to be understood as the determination of the money market rate by the Bank of England. Technically, the Bank is the monopoly issuer of legal tender money (or “monetary base”). Because it is the monopoly issuer it can fix the position and shape of the supply schedule of base money. In practice the supply curve of base money is (more or less) infinitely elastic and control is achieved by variations in the position of the supply schedule (ie, variations in the money market rate). As the clearing banks provide cash transmission services to their own customers (ie, they help their customers move legal tender between bank accounts), the money market rate sets banks’ marginal cost of funds. A whole mass of interest rates, including clearing banks’ base rate, then move up or down with the money market rate.

But there is another way of thinking about “monetary policy”. (The textbooks are rather bad at distinguishing between them.) (14) The alternative view is to say that the quantity of money is equal to non-banks’ holdings of legal tender notes and bank deposits, since deposits can be converted into notes on a one-to-one basis with little difficulty. The central bank could—if it wished—conduct transactions with non-banks in order to alter this wider quantity of money. However, for a number of excellent institutional reasons, central banks do not nowadays routinely conduct transactions with non-banks. Their business counterparties are predominantly commercial banks. By contrast, the government has continuous transactions with non-banks and these transactions can have monetary effects. Because of this possibility, the government’s financial operations can be viewed as part of “monetary policy”.

The explanation here is simple. The government is a very unusual agent which—in the absence of civil insurrection or foreign invasion—cannot go bankrupt. As a result, it does not need to hold money to anticipate the risk of bankruptcy. Indeed, its money holdings have no effect on its expenditure decisions and its bank deposits are, very properly, excluded from official definitions of money. This has a vitally important consequence which is often overlooked. When the government makes a payment from its bank deposit to a private sector agent, that agent’s bank deposit—and hence the quantity of money—increases. (In fact, explosively rapid growth of money because of government borrowing from the banking system has been the cause of all past hyperinflations.)

So the way that public debt is managed may have monetary effects. If the government finances a budget deficit by borrowing from non-banks, private sector bank deposits are unchanged and no monetary effect ensues; if it finances the deficit (and maturing debt) by borrowing from banks, private sector deposits increase. The balance between the two types of debt issuance—issuance that leads to borrowing from banks and issuance that does not—affects the quantity of money. When the budget deficit is low relative to GDP (as it has been since 1997), debt management decisions—decisions on the forms of debt to be issued and the type of borrower to be tapped—may be of only limited macroeconomic importance. In its first decade the MPC has been able safely to ignore this branch of policy and to focus on setting the money market rate. But—if budget deficits were to return to the levels of the 1970s—the interdependence of debt management and monetary policy might again become significant. The principles of debt management would then need to be rediscovered. (15)

5. THE CURRENT MONETARY SITUATION

The House of Lords’ Select Committee for Economic Affairs conducted an enquiry into “The Current State of Monetary Policy” towards the end of last year. (Its Report with Evidence was published on 18 December, as HL Paper 14.) I gave written evidence to the Committee, with the purpose of expressing concern about the medium-term “inflationary implications” of the current high rate of money supply growth. Not much has changed in the last few weeks to require any major amendments to it. In fact, most of the economic data since early November (when my evidence was submitted) has justified further worry about future inflation and the Bank of England raised its rate by ¼% at its January meeting. If I may, I would like to refer members of the Treasury Committee to this evidence, where they will see the analysis which led me to take a rather pessimistic view of the outlook for inflation and interest rates over the next two or three years.

However, there is one topic which may benefit from further discussion here. In my research work in the City of London over the 30 years to 2005 (and particularly at Lombard Street Research), I emphasized that the monetary behaviours of the three non-bank parts of the UK private sector—households, companies and financial institutions—were different. The household sector’s demand for money showed far greater stability than that of companies and financial institutions. In particular, financial institutions’ monetary behaviour often appeared to be very erratic. A tendency of economists at the Treasury and Bank of England was therefore to dismiss financial institutions’ money holdings as of no macroeconomic importance. In my opinion, this was a dreadful mistake. At the intellectual level, it was partly responsible the blunders which led to the boom-bust cycles of the 1970s and 1980s.
In a monograph published by the Institute of Economic Affairs in 2005 I argued that, while financial institutions did not buy groceries or spend anything “in the High Street”, they played a critical role in asset price determination. (16) Further, over the medium term (ie, say, periods of two to five years) movements in asset prices have an important bearing on the strength of demand and so on movements in prices of goods and services. In his oral evidence to the House of Lords’ Select Committee for Economic Affairs Mr Mervyn King, the Governor of the Bank of England, showed that the Bank had taken this argument on board, but noted some difficulties in interpreting the data. I would like to quote the relevant passage in Mr King’s evidence:

... it is quite possible that in due course [excess money held by financial institutions] will feed through to their portfolio decisions to invest in other assets. That would push up asset prices and that in turn would then affect the spending of households and companies, which in turn would put more pressure on capacity and have some effect on inflation What is difficult about [this argument] is that movements in the holdings of money by the other [ie, non-bank] financial corporations sometimes reflect movements which it seems highly plausible to imagine would ultimately pass through to asset prices and in other cases may affect movements between bank and some of their own affiliates which may not really reflect a true underlying transaction, or at least one that is likely to affect asset prices. You really have to look at the detail ... The main transmission mechanism is through asset prices.

In other words, financial sector money balances are of (at least) two kinds,
- balances held by (what one might term) genuine non-bank financial institutions (NBFIs), often long-term savings institutions, usually unaffiliated to banks, which are actively involved in asset selection and so in the determination of asset prices, and
- balances held by quasi-banks, which are affiliated to banks (from which they take deposits), and which make loans rather than hold non-monetary assets (ie, bonds, equities, property and so on).

The Bank is apparently concerned about excessive growth in the money balances of the genuine NBFIs, but not in those of the quasi-banks. I would like to make three comments, presenting them in the form of answers to questions.

1. Are the deposits of quasi-banks in the NBFI sector relevant to future asset price developments and so of macroeconomic significance?

The main point here is that Mr. King is right, broadly speaking, to regard quasi-bank money holdings as of little macroeconomic significance. They are typically matched on the other side of the balance sheet by a loan (mortgages granted by specialist housing finance intermediaries, consumer credit loans granted by hire purchase companies). Such loans are of fixed nominal value, while each individual loan usually stays on a quasi-bank balance sheet for months, if not years. The loan extension of the quasi-banks is therefore of limited macroeconomic interest. In many ways loans from banks to quasi-banks (and the resulting deposits) are analogous to inter-bank loans and deposits. Inter-bank deposits are (correctly) excluded from all measures of the quantity of money.

I have one qualification. This is that in the last 25 years one particular type of NBFI business has exploded in the UK, namely the business of securities dealers. (I believe investment banks are included in this category.) In general, securities dealers—like banks—have large balance sheets relative to capital and finance much of their asset holding by short-term loans. In my opinion the activities of securities dealers are not important to the determination of asset prices, since their “longs” and “shorts” are normally of similar size. However, other economists have different views. A possible compromise position is to see investment banks as half-way between quasi-banks and genuine NBFIs, as occasionally they have large net exposure to asset price movements.

I would add that the policy significance of deposits at NBFI quasi-banks is not a new subject. In the boom of the late 1980s the building societies increased their bank deposits rapidly, because of a regulatory change which discouraged them from holding liquidity in the form of short-dated gilts. These deposits were included in M3, but not in M4. As a result, M3 grew at a higher rate than M4. (M4 was calculated after netting out the building societies’ claims on the banks, as if such claims were inter-bank deposits). Analysts noted the problem at the time and allowed for it in their forecasting. (16)

2. How important are deposits at quasi-banks in the NBFI sector?

Mr King has therefore identified a valid criticism of the macroeconomic importance of one type of deposit held in the financial sector. But how important is this criticism in practice?

For some years now the Bank of England has published detailed data on the holders of bank deposits. It is therefore possible to split genuine, asset-holding NBFIs from loan-making quasi-banks. The results of this exercise are shown in the accompanying table, which relates to the period from mid-2004 (when the current upturn in money growth began) to the third quarter of 2006 (ie, the last quarter for which the numbers in this dataset are available). One difficulty is that by far the largest increase in money holdings in
this period has been recorded in the group “other financial intermediaries”. As this label is not specific, analysts cannot be certain whether such intermediaries are quasi-banks or genuine NBFIs. My hunch is that they are dominated by hedge funds, private equity funds and property investment companies, not by quasi-banks, but I may be wrong about this. (The Bank of England has to protect the confidentiality of the companies that provide the data, but I think it can spell out the position here—at least in general terms—without revealing commercial secrets.)

**Deposits held in the financial sector**

Figures relate only to sterling balances and are in £ million, where they are not % changes.

<table>
<thead>
<tr>
<th></th>
<th>Insurance companies and pension funds</th>
<th>Auxiliary to financial intermediation and unit trusts</th>
<th>Other financial intermediaries</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 Q2</td>
<td>48,557</td>
<td>29,636</td>
<td>9,903</td>
<td>145,466</td>
</tr>
<tr>
<td>2006 Q3</td>
<td>52,257</td>
<td>40,330</td>
<td>16,222</td>
<td>246,143</td>
</tr>
</tbody>
</table>

The increase in “genuine NBFIs’” money balances in the nine quarters was 69.2%.

2. Securities dealers

<table>
<thead>
<tr>
<th></th>
<th>2004 Q2</th>
<th>2006 Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>18,380</td>
<td>35,774</td>
</tr>
</tbody>
</table>

The increase in securities’ dealers sterling money balances was 94.6%.

3. Quasi-banks

<table>
<thead>
<tr>
<th>Financial leasing corporations</th>
<th>Non-bank credit grantees</th>
<th>Credit unions</th>
<th>Factoring corporations</th>
<th>Mortgage and housing credit corporations</th>
<th>Money market funds</th>
<th>Bank holding companies</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 Q2</td>
<td>3,401</td>
<td>4,379</td>
<td>297</td>
<td>477</td>
<td>6,785</td>
<td>115</td>
<td>10,497</td>
</tr>
<tr>
<td>2006 Q3</td>
<td>5,361</td>
<td>7,286</td>
<td>408</td>
<td>546</td>
<td>12,510</td>
<td>210</td>
<td>11,867</td>
</tr>
</tbody>
</table>

The increase in quasi-banks’ money balances was 47.2%.

If the assumption that “other financial intermediaries” are predominantly genuine NBFIs is correct, the total of all sterling financial sector deposits at the end of the third quarter 2006 was just over £230 billion, and it was divided between genuine NBFIs’ deposits of £246,143 billion. (76.9% of the total), securities dealers of £35,774 million. (11.2%) and quasi-banks of £38,188 million. (11.9%). (18) In other words, genuine NBFIs dominated financial sector deposits. Moreover, the fastest growth of the last two years or so has not been in quasi-bank deposits. Whereas their deposits increased by under 50%, the much larger deposits of genuine NBFIs advanced by almost 70%. The conclusion has to be that Mr King’s objection to the policy significance of quasi-banks’ deposits has little practical force. The surge in financial sector money has occurred mostly in organizations which are balancing their money holdings (ie, their deposits) against their non-money assets. Almost certainly, the remarkable increase of about £100 billion (from £145.5 billion to £246.1 billion) in genuine NBFIs’ deposits in the nine-quarter period to the third quarter of 2006 was relevant to the buoyancy of asset prices in the same period.

(Since writing this section my attention has been brought to the Roy Bridge Memorial Lecture given by Paul Tucker, the Bank of England’s executive director for markets and a member of the MPC, on 11 December. In that lecture Mr Tucker suggested that a high proportion of the money held by “other financial intermediaries” is in the hands of so-called “Special Purpose Vehicles”. When such SPVs are created to effect transaction within banking groups, he said that their deposits “should ideally be netted off”. He also argued that—since UK equities, bonds and property are highly substitutable with their foreign equivalents — global money trends, and not just those in the UK, are relevant to current UK asset price inflation. No doubt there is some validity in Mr Tucker’s remarks, but—to me—they are reminiscent of the excuses that Bank officials made in 1972 and 1986 in the early phases of previous boom-bust cycles. In my experience a recurrent feature of all cycles is that Bank of England officials are incapable of recognising when excessive money growth is the cause of asset price buoyancy and the associated strength of domestic demand. Having said that, I am in favour of detailed, rigorous analysis by the Bank of the composition of OFC/OFI deposits, and—as I have said—I agree that deposits of quasi-banks in the OFC/OFI total should be “netted off”.)

3. How much inflation is implied by the high rates of M4 growth?

Asset price movements are not the MPC’s direct concern. They matter only insofar as they affect the prices of goods and services in the CPI basket. But in the long run the prices of assets and the prices of goods and services are related. How much inflation is implied by the current 13%–14% annual rate of M4 growth? And is a bust of some sort unavoidable after the asset price mini-boom of the last few years?
The answer is that “much depends on what happens to money growth from here”. As inflation has already risen somewhat and pay-bargaining research companies have reported that pay settlements are edging upwards, it seems plausible that UK output is above trend (ie, the output gap is positive), although not by very much (perhaps ½%). If output growth were now to run at its trend rate, inflation would rise only very slowly from here. (An acceleration of ½–1½% a year is suggested by most of the econometrics with which I am familiar, but I wouldn’t over-emphasize the arithmetic.) Indeed, if beneath-trend growth were to emerge quickly, inflation ought to stabilize and return to target in a few quarters.

The trouble is that the fast growth of money, and the strength of asset prices, signal above-trend growth of demand in the next few quarters. Several retailers have said that they had an excellent Christmas, with upmarket and luxury retailers doing particularly well. (This is logical, because it is wealthy people who have done best from recent asset price gains.) My guess is that—if interest rates were to stay unchanged at 5%—domestic demand would grow at an annual rate of 3%–4% in 2007. With the world economy still in robust form (which will help exports), UK output might be 1%–1½% above trend by early 2008. The implied acceleration in inflation would then be of the order of ½% to 1½% a year. Relative to its impressive performance over the last decade, the MPC would be in quite serious trouble. Interest rates would have to increase to, say, 6%–6½% (perhaps even higher) in order to bring inflation back to target in 2009. It has to be said that an inflation rate of 4%–5% in 2008 or 2009 would not be a surprising sequel to the burst of money growth seen since mid-2004. By the standards of the 1970s and 1980s the possible macroeconomic numbers in the year from, say, mid-2008 (an inflation rate of 4%, and an output growth rate of 1% in the context of falling house prices and 6½%–7% base rates) would be not be at all bad. (Note that the numbers suggested here in the year from mid-2008 are not a forecast, but an indication of possibilities. Rather poor macroeconomic numbers are normal for a few quarters, after output has gone well above trend.)

My view is that the MPC should—and probably will—raise interest rates further in coming quarters. One condition for re-establishing a macroeconomic environment consistent with target inflation is that the annual rate of M4 growth needs to be lowered to single digits and, ideally, back towards 6%–8%. Assuming that household sector money keeps on growing at about 8% a year (as it has been doing for the last few years), it is inevitable that the money balances of companies and financial institutions will—for a significant period of a few quarters—at least, stagnate and they may even contract. That will not be good news for asset prices.

Notes

(1) Tim Congdon “The UK’s achievement of economic stability: how and why did it happen?” *World Economics* (Henley-on-Thames: NTC Publications), vol 3, no 4, October–December 2002, pp 25–41. *Keynes, the Keynesians and Monetarism* is to be published later this year by Edward Elgar Publishing.


(3) The 364 economists were defended by Professor Stephen Nickell, the immediate past president of the Royal Economic Society, in his contribution to the Institute of Economic Affair’s collection *Were 364 Economists All Wrong?* (London: IEA, 2006). I have criticised Nickell’s argument in the current issue of the IEA’s journal, *Economic Affairs*. For the resulting exchange, see pp 34–45 in Economic Affairs (IEA: London), December 2006 issue.

(4) My own view is that money targeting regime of the 1976–85 period was working satisfactorily when it was abandoned by the then Chancellor of the Exchequer, Nigel Lawson, but this is not the consensus evaluation.


(6) Milton Friedman “The role of monetary policy” *American Economic Review* (American Economic Association), vol 58, no 1, March 1968. Professor Edmund Phelps—who was awarded the 2006 Nobel Prize for economics—developed a similar argument at about the same time. Phelps’ paper was in fact published a few months before Friedman’s address. (Edmund S Phelps “Phillips curves, expectations of inflation and optimal unemployment over time” *Economica*, vol 34 (August 1967). But in comments at seminars in 1966 Friedman had developed the thesis that evolved into the 1967 presidential address.


(13) My personal view is that investment in physical capital and particularly in human capital is sub-optimally low and inefficiently allocated in the UK. The main cause is that health and education services are provided by the state, with much inefficiency and in association with needlessly high levels of public expenditure and tax. But these are very large subjects and the UK is not unique in these arrangements.

(14) In my view the ultimate explanation for the muddles is again to be sought in Keynes’ intellectual legacy. British economists have an exaggerated respect for his book The General Theory and Employment, Interest and Money. In that book Keynes failed to distinguish properly (as he had done in his previous Treatise on Money) between the monetary base and bank deposits. Keynes certainly realized that the government’s financial transactions could directly affect the quantity of bank deposits, but his practice was to talk about “the authorities” and to lump the base and deposits together in “money”.

(15) Several statements are available. See, for a recent example pp 6–12 in Charles Goodhart “Beyond current policy frameworks” BIS Working Papers (Basle: Bank for International Settlements), no 189.

(16) Tim Congdon Money and Asset Prices in Boom and Bust (London: Institute of Economic Affairs, 2005).

(17) The problems of interpretation created by the rapid growth in building societies’ bank deposits between 1985 and 1988 were discussed at the time. See footnote (17) on p 197 of Tim Congdon “Monetarism: a rejoinder” World Economics (Henley-on-Thames: NTC Publications), July–September 2004.

(18) Note that the £320 billion of sterling deposits identified by this analysis as belonging to various non-bank financial institutions does not correspond to the figure for the M4 holdings of “other financial institutions” in the aggregate money supply data. In the money supply data OFIs’ M4 holdings at the end of September 2006 were £388.6 billion. The differences between the data in the “industrial analysis of bank lending and deposits” and the money supply data were discussed in Robert Golcher and Simon Walls “A comparison of the industrial analysis of bank lending to and deposits from UK residents and sectoral M4 and M4L” Monetary and Financial Statistics (London: Bank of England), January 2005 issue, pp 9–12.

January 2007

Memorandum submitted by Dr DeAnne Julius CBE

EXECUTIVE SUMMARY

I strongly support the existing monetary policy framework and I believe it is sufficiently flexible to handle the challenges of the future. However, I propose three areas for improvement in the workings of the MPC as a body:

— term limits of six years should be set for all members, internal and external, except the Governor;
— external appointments should be offered on a full- or part-time (at least three days/week) basis and candidates should be encouraged to accept the position full-time; and
— a more formal selection process for MPC members should be established, based on a “person specification” published six months in advance of an anticipated vacancy and used by the Treasury Committee in its vetting of appointees.

Thank you for the opportunity to contribute evidence to your inquiry into the context and workings of the MPC, 10 years after its formation. That is a sufficient time to judge its success and also to identify any shortcomings in structure or procedures. Based on my time as an MPC member and on observation of the developments since then, I wish to put forward several specific suggestions for consideration under your Area 3: The MPC as a body. In addition, and by way of providing the context for my suggestions, I will make some general observations under each of your other three areas.

I. THE ECONOMIC CONTEXT

1. Unless the UK decides to adopt the euro or move away from a floating exchange rate regime in some other way, I do not believe the economic context within which the MPC operates will undergo radical change over the next decade. This is not to say that the challenges of the future will mirror those of the past. Rather, I consider the current monetary policy framework sufficiently flexible to accommodate most foreseeable possibilities; such as a rise in global inflation, the bursting of asset price bubbles, growth in the UK’s fiscal deficit, major shifts in currency alignments, even the break-up of the eurozone.

2. There will, of course, be changes in the transmission mechanism of monetary policy as the structure of the economy evolves and especially if the housing market becomes more flexible. But these are the sorts of issues that the research and modelling staff in the Bank keep under constant review.
II. THE MONETARY POLICY FRAMEWORK

3. I think the framework for monetary policy (ie, the symmetrical target, its setting by the Chancellor of the day, the monthly frequency of MPC meetings, the prompt publication of the minutes with individual votes revealed, the quarterly inflation report and the letter-writing stipulation) has proved to be an excellent one and should not be changed without good reason.

III. THE MPC AS A BODY

4. Given an excellent framework for monetary policy, its successful implementation depends heavily on the quality and composition of the MPC as a body. The interest rate decision is very often a fine judgment call. During the MPC meetings, at least in my time, argumentation around the table was thick and fast. Different perspectives produce different interpretations of the same data. Minds and votes—are changed by a high quality debate.

5. Such a debate requires a diverse group of equally empowered, high quality people. The equivalence in numbers of “internal” and “external” members (in addition to the Governor) is a good feature of our system. When the system was new, all members were, by definition, equally new to it. We often discussed our own procedures and changed a number of them to keep the debate fresh. Now, 10 years later, most of the internal members have much longer tenure than the external members, and the procedures have developed a corresponding inertia. In addition, recent external members have been given only part-time appointments, which mitigates against deep engagement with the research and preparation work. The “pre-MPC” Friday briefing has been cut from a full day to half a day, and I understand that the US-resident member attends many forecast and minutes meetings by video-conference. All of this suggests diminished engagement by external members.

6. To correct these deficiencies I would like to make three recommendations that I believe would enhance the performance of the MPC as a body over time:

   — Term limits: Set a term limit of six years for all members except the Governor.
   — Full engagement: Encourage external members to take up their appointment on a full-time basis, with a minimum three days/week if not full-time.
   — Diversity and balance: Prepare and publish a “person specification” when a vacancy arises to set out the desired experience base of candidates, in light of the skills and experience of existing MPC members.

Term Limits

7. Both internal and external members should be limited to a six-year period of service on the MPC. This would provide a rolling, but equivalent mix of tenure and institutional memory around the table. For external members it could be achieved simply by limiting them to two consecutive terms of three years. For internal members, it could be done in two ways. One would be to impose a maximum term of six years on the positions of Deputy Governor, Chief Economist and Executive Director for Markets. However, these are largely managerial positions where continuity is an asset. An alternative (and my preference) would be to de-link MPC membership from Bank hierarchy and position. This would create a wider pool of candidates (who need not have the managerial skills needed for the top jobs), with a broad range of economic specialties, while preserving continuity in top management. The staff in the Bank are a hugely talented group with a well-honed understanding of the data, modeling and institutional workings of the British economy. This is a resource that could be more directly utilised on the MPC.

8. How would the de-linking work? One might wish to preserve the balance of internal membership between the economic stability wing (research) and the financial stability wing by appointing two MPC members from each side. However, these members would be drawn more widely from senior Bank staff based on the fit between their expertise and the “person spec” for the MPC vacancy. Once appointed (I would suggest for a three year term, as for external members) they would be released from a portion of their normal Bank duties to allow time for their new MPC responsibilities. In addition to providing fresh thinking to the MPC, it would also be a source of internal motivation for Bank staff who could then aspire to a period on the MPC as part of their career, independent from climbing the managerial ladder.

Full engagement

9. Making sound decisions on interest rates requires much more than simply showing up at the regular round of MPC meetings. Interaction with the Bank’s research staff, talking with City forecasters, touring the regions of the UK with the Bank’s Agents, preparing articles and speeches to elaborate on MPC thinking and, indeed, discussing issues informally with one’s colleagues over lunch all deepen one’s understanding of the current conjuncture and likely evolution of the economy. These informal observations and weak signals are especially helpful at cyclical turning points when data are most misleading.
10. Internal members of the MPC gain much of this informal knowledge from the other aspects of their Bank jobs. External members need to devote special time to it, and I believe their “external” status comes with a special responsibility to maintain contacts with those outside the Bank who make forecasts using different models and who are actively engaged in the financial markets and the business sector. This requires time.

11. Some external members are able to combine a part-time academic appointment with their MPC responsibilities, but where significant teaching is entailed, clashes frequently arise (particularly during forecast months). For non-academic members of the MPC, a part-time appointment entails financial sacrifice, as they are not permitted to take up any private sector role while they serve on the MPC.

12. To remedy this situation, I propose that all external appointments be offered on a 60–100% basis, at the sole discretion of the chosen candidate, and that candidates be encouraged to take on the position full-time.

**Diversity and balance**

13. A more formal selection process is needed for MPC members. Appointment renewals have been left until the last minute, positions have not always been filled on time, external members who have made their leaving intentions clear to the Treasury have been unable to make a timely announcement to enable them to openly seek their next jobs, and the economic credentials of some appointees have been questioned.

14. While I would retain the confidential nature of the selection process (in order not to discourage employed potential candidates from applying), I would recommend a procedure much like that used for new board members in the private sector. A “person specification” should be prepared—perhaps jointly by the Bank and Treasury—would be prepared out the type of skills and experience that is sought; eg, academic, business, financial markets, public policy, or whatever. This should be published at least six months before an anticipated vacancy. Candidates could then apply (and be head-hunted or invited to apply) with a guarantee of confidentiality. Once selected by the Chancellor, the vetting by the Treasury Committee could include the degree to which the selected candidate fits the “person specification”.

**IV. The Mechanics of Setting and Implementing Monetary Policy**

15. While not perfect, I do not have any particular recommendations to suggest. This is an area where one needs to strive for continuous improvement, which can best be defined by those actively involved.

Former member of the MPC (1997–2001)
Former member of the Bank of England Court (2001–04)

January 2007

Memorandum submitted by Professor Simon Wren-Lewis,
Department of Economics and Merton College, Oxford University

**Summary**

This evidence looks at two main issues: the Bank’s forecasting model (item 4.6 in the Committee’s terms of reference), and the measure of inflation used in the inflation target (2.1). However I will suggest that the nature of the Bank’s model has implications for the composition of the MPC (3.1), and I shall also comment on the transparency of the forecast (4.1). Discussion of the inflation measure will also include more general remarks about the amount of discretion allowed by the current system (2.5), the response to asset bubbles (1.3), and whether the Bank should be given additional instruments.

My main conclusions are as follows:

1. The Bank’s model represents a considerable academic achievement, but it requires considerable expertise to use and interpret (paras 1–15 below).

2. The complexity of the Bank’s model has implications for the expertise required of at least some external MPC members, which in turn may imply a change in the balance between internal and external members of the MPC (paras 19–20).

3. The Bank could also adopt a more systematic approach to engaging the academic community in its model development (paras 16–18).

4. Transparency would be improved if the Bank published its own projections for future interest rates (paras 21–27).

5. There are arguments for focusing on output price inflation, or wage inflation, rather than consumer price inflation (paras 28–35).

6. While it is too early to say how robust these arguments are, they emphasise the need to treat the 1–3% inflation range as a “soft” target, that should be breached on occasion (paras 36–40).
7. In theory, one such occasion could be the emergence of an asset price bubble (para 41).

8. The Bank’s role in stabilising the economy would be improved if it was given the ability to temporarily change a few selected fiscal instruments (paras 42–47).

**The Bank’s Forecasting Model**

1. At the turn of the century, the Bank embarked on an ambitious project to build a new macroeconomic model that would form the basis of its forecasting activity. In 2004 that model, BEQM, was completed, extensively tested, and used for the first time. A natural question to ask is whether BEQM, to borrow a phrase from the committee, is “fit for purpose”. (Terms of reference, point 4.6.)

2. To answer this question, it is useful to provide some background about the nature of macroeconomic models, which are rather different from models in, say, engineering. (For those who want to skip this discussion, my assessment begins with paragraph 10.) The first decision the Bank had to make was what type of model to construct. When modelling an economy, there is a real tension between theory and macro evidence. In most scientific disciplines, theory and evidence work together: theories are developed to explain the data, and if evidence contradicts theory, theory adapts. This methodology is less applicable in macroeconomics for two reasons: first, macroeconomists cannot carry out experiments on a macro scale, and second, evidence from the past is generally indecisive.

**The nature of forecasting models**

3. As a result, different techniques to modelling the macroeconomy exist, and they differ primarily in the weight they give to historical evidence relative to theory. At one extreme, we can simply model the statistical correlations observed in the past among key macroeconomic variables, and forecast by projecting those correlations to continue. This technique (generally termed VAR modelling) makes almost no demands on macroeconomic theory, and instead focuses on the econometric techniques used to capture historic relationships. At the other extreme we have macroeconomic models that follow precisely a particular theoretical perspective, where parameter values are calibrated rather than econometrically estimated.30 Such models go by the rather pretentious name of Dynamic Stochastic General Equilibrium (DSGE) models.

4. From the 1970s to the 1990s, the models used by governments and central banks to forecast the economy lay somewhere between these two extremes. They looked to macro theory to provide a basis for their equations, but they tended to be fairly eclectic in their choice and use of theory. Their equations were nearly always econometrically estimated, but theory was used to place restrictions on what was estimated. We can label these “compromise” models Structural Econometric Models (SEMs).31

5. However, SEMs were increasingly criticised by academic economists: time series econometricians moved towards VARs, and macroeconomists adopted DSGE models. The criticisms from DSGE modellers essentially amounted to claims that SEMs allowed the data to compromise or distort theory, so that theory was not applied consistently. These claims had some force, for the very simple reason that econometric evidence often rejected the consistent application of theory. However those using DSGE models were able to ignore this difficulty, simply because these models were not econometrically estimated on an equation by equation basis.

**The Bank’s new model**

6. In developing a new model to lie at the heart of its forecasting process, the Bank therefore had to make a critical choice at the very beginning: what type of macro model was it going to develop? Here the Bank took a bold decision, which was to develop a DSGE model suitable for forecasting. The decision was bold for two reasons: first, there were only a few examples of DSGE models used for forecasting around,32 and second, to build such a model was academically ambitious.

7. The DSGE models built by academics are used for either policy analysis (eg “what is the effect of changing interest rates?”) or understanding broad features of macro experience. In both these cases, inconsistencies between aspects of the model and evidence can be ignored. For example, no attempt will generally be made to see whether the model’s consumption function tracks the data on consumption. (Indeed, this is why SEMs, which did not ignore this evidence, were often forced to override theory). However, for a model to be useful in forecasting its individual equations must track the data.

8. To get round this problem, the Bank split BEQM into two (see Harrison et al., 2004). One half, its “core”, was an elaborate DSGE model. The other half, the “non-core”, was a set of data based econometric equations linking core values to the data. The core allowed the model to consistently apply theory in a rigorous way, while the non-core made it possible for forecasters to use the model.

30 Calibration involves choosing parameter values from other sources of information than time series econometric estimation. This can include evidence from microeconomic, cross section studies about individual behaviour.

31 The models I helped construct at the National Institute and elsewhere in the 1980s and 1990s were SEMs.

32 Two important examples were the models maintained by the Bank of Canada and the Reserve Bank of New Zealand.
9. While estimating the non-core equations is relatively straightforward, building the core was an extremely ambitious task for the following reason. Academic SDGE models tend to be small, in the sense of involving only a subset of macro variables. However forecasting models tend to be more elaborate, because forecasters want to incorporate a wide range of information. So the Bank needed to build a large DSGE model. This required considerable efforts to ensure theoretical consistency. To put it crudely, it would require hundreds of pages of algebra.

Fit for purpose?

10. Hopefully the above discussion suggests an answer to this question has to have two parts: did the Bank build the right kind of model, and given that decision, is BEQM a good example of that class of model?

11. I believe the majority of academic macroeconomists would answer yes to the first question. By building a DSGE model, the Bank aligned itself with current mainstream academic practice. However, you would probably get a different answer from many eminent time series econometricians. They could argue that DSGE models almost always stray too far from the data, and that therefore any decisions based on these models could be misleading. BEQM guards against that problem to some extent through its non-core equations, but only partially.33

12. As the above discussion suggests, the Bank’s decision could not satisfy everyone. However, although BEQM is at the centre of the Bank’s forecasting activities, the Bank also employs a “suite” of alternative models that can be used in the forecasting process.34 This suite includes data-based VARs. So alternative approaches to macromodelling are not neglected or ignored. Furthermore, as BEQM will be used for policy analysis as well as forecasting, it would have been a mistake to take a very data based approach in building this model. So in my view the Bank’s decision to give a strong role to theory in its model building was correct, although with a caveat about resources that I note below.

13. Having taken that decision, is BEQM a good DSGE model? Here my answer is unequivocal.35 BEQM represents a considerable achievement, from both an academic point of view and from a policy maker’s perspective. BEQM was built by a small team, but this team comprised exceptionally able individuals who complimented each other in the skills they brought to the exercise. The model building process was also very well managed. As I noted above, pages of algebra were required, and pages of algebra were produced. I was particularly impressed by the dedication the team showed in fulfilling the DSGE goal of consistently applying theory: invariably this made their task more difficult to achieve, and it would have been all too easy to cut corners, but few corners were cut.

14. My only mild criticism is that the Bank has been rather reticent in publicising its achievement. Although the Bank held a conference in early 2004 to “launch” the model, details of the model were not made available at this conference, and only published considerably later. Whatever the reasons for this were, I think an opportunity to engage academic and other expertise in the detail of how BEQM is constructed was missed.

15. The Committee can therefore be reassured that the Bank’s modelling is much more than “fit for purpose”—it represents the “state of the art” as far as current academic practice is concerned. However, by adopting the approach that they did, I think there are implications for other aspects of the Committee’s inquiry which should be noted.

Putting the model in its place

16. As a result of the Bank’s endeavours, BEQM is an extremely advanced, highly complex tool, both in terms of its detailed structure and from a conceptual point of view. However, this does not mean that it necessarily produces good forecasts. Indeed, as I hope the above discussion suggests, it is the type of model that could, if mishandled, lead to serious forecast errors. This has two important implications.

17. First, the Bank itself needs to ensure that considerable resources are devoted to analysing and developing BEQM. Generating sensible forecasts with BEQM requires considerable expertise in terms of understanding how BEQM works. As a result, there is a danger that too small a team might get bogged down in the process of producing regular forecasts, and that as a result the model itself may decay. I know from experience that this is a real possibility.

18. Luckily, the Bank has large resources available. However, considerable skill is required in ensuring that these resources are applied to the maintenance and development of BEQM in an optimum way. In addition, I feel that outside academic expertise is underutilised at present. When HM Treasury was responsible for demand management, it had an Academic Panel to discuss its model and related issues. While this particular structure had some drawbacks, there is a danger that current academic arrangements

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33 The reasons why this is only a partial safeguard are somewhat technical: in particular, the non-core is “recursive” to the core.
34 As I have no direct knowledge of the Bank’s forecast deliberations, I cannot say how much these alternative models are used, how often conflict arises with the main model and how such conflicts are handled.
35 I should at this point declare an “interest”: the Bank employed me as an external advisor on the construction of BEQM, given my experience in constructing UK macromodels. However, my impact on strategic decisions about the model was fairly small.
at the Bank are too ad hoc. To put the point another way, the Committee needs to know which academics it can turn to who will have a good knowledge of the model (or suite of models) and who can give an independent account of its suitability.

19. Second, the complexity of BEQM has implications for the membership of MPC. I believe it is important that at least one of the external members of MPC has the expertise to be able to critically understand how BEQM works, so that the forecasts it produces can be properly assessed. From informal discussions at the Bank I know how important the presence of such an economist on the MPC can be in keeping Bank staff on their toes. In practice, I believe this means that at least one external MPC member should be an academic macroeconomist with a reasonable knowledge of DSGE models.

20. I also recognise that there are also good arguments for having external academic expertise in some other areas, such as labour markets, and I also recognise that it is important to have external members from other areas besides academia. This may suggest adding one or two more external MPC members. If it is felt that this makes the MPC too large, my own view would be that the number of Bank members could be reduced to compensate. While I know this suggestion would not be popular with the Bank, I can see no objective reason why Bank members should be in a majority on MPC, and I would have thought the Bank should be capable of ensuring that all views within the Bank get represented by its own members on MPC.

### Forecast Transparency, and the interest rate assumption

21. The Bank provides a good deal of information about its forecast in the Inflation Report. For most readers of the Inflation Report this is probably sufficient. As the forecast comes from a model, then in principle the Bank could give much more information: not just paths for all model variables, but also a breakdown between equation projections and residuals (off-model judgement). This would throw considerable light on the detailed discussions that went on during the forecast, as well as the contribution of the model to that forecast. However this detail would only inform the public debate if there were sufficient economists outside the Bank able and willing to interpret it. I have little idea whether this is the case or not, but if it was the case then I can see no reason why this detail should not be published.

22. One aspect of the Bank’s forecast that I have always found puzzling is their assumption about interest rates. Every other variable in the forecast involves the Bank’s best judgement about what will happen. The exception is interest rates, where the Bank substitutes the market’s projection for its own. Ironically, of course, this is one area where the Bank clearly has more expertise than the market. Worse still, market projections may well be based on a quite different view about the rest of the forecast. In that sense, a forecast that uses them may be internally inconsistent.

23. So why does the Bank not publish its own projection of the future course of interest rates? More specifically, when it knows that the market’s perception is incorrect, why does it hide this from the public? I have never heard a convincing reason for this lack of transparency. Furthermore, I think there will be occasions when it is positively advantageous for the Bank to indicate its own expectations.

24. This view was reinforced when I spent six months at the Reserve Bank of New Zealand in 2003–04.56 The Reserve Bank does precisely what I suggest, which is to publish a projected path for interest rates over the forecast horizon. This gives the public a clear indication of what the Bank thinks is the “trend” level of real interest rates, and how long it expects any deviation from this trend to persist. In contrast, in the UK much wasted effort is spent by city economists pouring over the exact wording of MPC minutes in an attempt to guess just this.

25. One argument that I have heard is that it would be much more difficult to get the MPC to agree on a path for interest rates, rather than just make a decision about current rates. However, I think this argument reveals a more basic fear or misapprehension, which is that a published interest rate path will be seen as some kind of unconditional commitment (or decision) about what future interest rates will be. It clearly does not: it is a forecast, based on current information and the rest of the forecast. If, as will certainly happen, actual events do not follow the forecast, or new information arises, then judgements will change. In this respect, I cannot see why it is more difficult for the MPC to project future interest rates than it is to project future GDP.

26. Actually, having to explain why interest rates are not what they were projected to be has a distinct virtue. One of the concerns that macroeconomists have about monetary policy is that it will be revised over time simply because it is convenient to do so, rather than because the world has changed. (This is the problem of “time inconsistency”.) Publishing a projected path for interest rates makes it more difficult for the Bank to behave in this way, which should add to its credibility.

27. Publishing interest rate paths also has another, extremely important, advantage, which the Reserve Bank of New Zealand does exploit. At present the Bank publishes a central projection, and a fan chart. It gives a verbal indication of possible uncertainties. However, it has no way of indicating how it will react to those uncertainties. What it could do is publish alternative scenarios, or forecast variants, which illustrated what might happen in particular circumstances—for example, if oil prices behaved in a very different way to the central projection. This could provide invaluable information to the public. However, at present it cannot do this because it publishes just one path for interest rates, based on market perceptions.

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56 New Zealand’s central bank was one of the pioneers of inflation targeting.
Inflation and relative price movements

31. The first question we need to ask is perhaps the most basic question of all—why is inflation costly? The ‘man on the street’ answer will generally involve falling real incomes, but of course inflation involves all nominal variables increasing at the same average rate, so real incomes will not change. One of the standard academic responses to why inflation is costly is that it leads to unwarranted movements in relative prices.37

32. The argument goes as follows. When preferences or supply conditions for particular products change, this leads to changes in relative prices, which in a properly functioning market is exactly what is required to bring demand and supply into line, and allocate resources optimally. However, if inflation is positive, prices will be changing to keep up with inflation, and inevitably individual prices will respond to inflation at different times. As a result, relative prices will change, without any reason in terms of preferences or supply conditions. These relative price changes are what economists term “distortionary”: they imply movements in the relative output of goods that are unwarranted by underlying micro conditions, and as a result welfare will deteriorate.

33. For the consumer, such movements in relative prices are a nuisance, but their impact can be partially mitigated by changing the amount that is bought as relative prices vary. Although ideally I would like to eat an equal quantity of apples and pears, if the price of apples falls at least I can eat more apples. The overall benefits from consumption will not be greatly affected. However, workers typically cannot react in the same way. If they work in a firm that has seen demand for its product fall (because it has raised its price to keep up with inflation, whereas its competitors will not do so for some time), then employment in that firm will fall. The worker is unlikely to be able to make up the shortfall in hours worked by working those missing hours in another firm where demand is temporarily high. As a result, the quantity of labour supplied by individual workers will vary over time, and this will be costly (particularly if this involves spells of unemployment).

34. So the costs of inflation that follow from relative price changes will be mainly located in the labour market rather than with consumers. It follows that, from the point of view of national welfare, the relevant measure of inflation relates to what is produced in a country, and not what is consumed. As a result, the natural target from a welfare point of view should be some measure of output price inflation (like the GDP deflator) rather than the CPI. For the same reason, inertia in wage setting will lead to distortions in labour supply, and so controlling wage inflation may be important alongside output price inflation.

35. The academic literature that has quantified these costs of inflation is in its infancy, and so it is too early to tell how robust this argument is, or whether there are important counter arguments. As a result, I would not suggest changing the type of inflation target just yet. However, I think the discussion does emphasise some of the merits of a soft inflation target over a more strict version of inflation targeting, as well as throwing some light on other debates. (It also suggests that a very detailed discussion about the precise composition of any inflation measure is missing the wood for the trees.)
The importance of a "soft" target

36. Differences between consumer price inflation and output price inflation are not normally large (as long as inflation is low), and are likely to be temporary and reversed, as they mainly reflect movements in the real exchange rate. Nevertheless, a consumer price inflation target that was rigidly enforced (as far as was possible) could lead to policy errors. For example, following an appreciation in sterling that reduced the cost of imported goods, the MPC might cut interest rates in an effort to stabilise the CPI, leading to rising output price inflation, and that could be costly. In practice this is unlikely to happen very often, in part because domestic retailers absorb a good part of any exchange rate change in profit margins.

37. However, the lesson I would draw from this example is that the Bank should look at other inflation measures besides the CPI, and be prepared to breach the 1% bands in certain situations where the CPI was out of line with either output prices or wage inflation.

38. A very similar point arises with a more topical example, where CPI inflation increases because of sharp rises in commodity prices, such as the price of oil. An increase in the CPI that reflects higher oil prices, but which does not encourage an increase in the rate of change of unrelated prices, is largely harmless in my view, and should not lead to any policy response. If that leads to CPI inflation going over 3%, so be it—this is precisely the kind of flexibility that the current system should allow.

Allowing (and requiring) MPC discretion, and bubbles

39. The argument above can be made more general. It is widely agreed that a low average inflation rate is a good thing, and this can justify an explicit, but soft, inflation target. However, as macroeconomists we still have a great deal to learn about the welfare costs of business cycles, such as which measures of inflation are more important, the relative importance of inflation relative to output, and the interaction with other distortions. As a result, it would be folly to nail our colours to the wall prematurely on any of these issues.

40. Luckily, we have in the MPC an institution which is well designed, and which has established considerable credibility. As a result, we can afford to give the institution considerable discretion on these issues, as long as it is transparent in the judgement it makes. It should therefore feel free to breach the inflation target on a temporary basis, if it has good reasons for doing so. Indeed, if there are good arguments for the inflation target being breached, we should expect the MPC to do so, and we should not let it hide behind a rigid interpretation of the target.

41. This general argument is relevant to the debate about house and other asset prices, which the Committee raises. The argument here is mainly about bubbles. Asset prices are subject to fads or bubbles ("irrational exuberance"), and the question is whether monetary policy has any role in trying to avoid or "prick" these bubbles. The official Bank line appears to be that movements in these prices are only relevant in so far as the impinge on the 2% target. This line can be interpreted in two ways. The first interpretation is that such asset price movements are essentially harmless, or unstoppable, or can only be prevented by causing problems equally as great. This is largely an empirical judgement, that others are better able to make. The second interpretation is that the Bank could stop these bubbles, in a way that might be generally beneficial, but it will not do so because its official job is to hit an inflation target. This second interpretation runs counter to my argument about discretion above. In my view, if a bubble arose that might cause serious costs in terms of the misallocation of resources, then the Bank should seriously consider whether it should try and remove this bubble, even if this meant temporarily missing the inflation target.

Additional instruments

42. One of the difficulties the Bank has in thinking about issues like asset price bubbles is that it has in practice only one instrument: the rate of interest. In the past I have argued that we should consider giving the Bank limited, short term control over a few fiscal instruments as well (Wren-Lewis, 2002). One role that these additional instruments could have is to dampen irrational exuberance.

43. However, the case for extending the Bank’s role in this way is much more general. The Bank should be seen as the institution that has responsibility for short term macroeconomic stabilisation. Fiscal instruments differ widely in their impact and ease of use, but some at least can in principle be used for short term stabilisation. The conditions under which interest rates are the only instrument required to stabilise the economy are very stringent, and unlikely to apply in practice (Leith and Wren-Lewis, 2006). As a result, the economic case for giving the Bank additional instruments seems compelling. We should not allow the rather benign experience of the past 10 years to allow us to neglect these advantages.

44. At present these fiscal instruments can only be used for short term stabilisation by the Chancellor. For the Chancellor to do so raises two problems. First, there are good economic arguments for giving the short term stabilisation role to an independent institution, and these arguments apply to the business of short term stabilisation, not to monetary policy per se. Second, having two institutions trying to do the same thing raises serious co-ordination issues.

45. Giving limited control of selected fiscal instruments to the Bank to change temporarily does not compromise either the government’s macroeconomic role in determining the tax structure, or its long term macroeconomic role of managing the public finances. I have argued elsewhere that there is a case for a new
form of watchdog to monitor the latter, but this should not be the Bank (Kirsanova, Leith and Wren-Lewis, 2006b). Fortunately macroeconomic issues of stabilisation can be largely separated from long term issues of public debt management.

46. The political arguments against this proposal fail to distinguish why changing interest rates is fundamentally different from changing a tax rate, except for the labels we give them. Both have distributional consequences, but under my proposal these consequences would be short term. Both impact on the government finances, so no new arrangements are required to handle these (although various mechanisms could be put into place nonetheless).

47. Of course, we need to establish which tax rates the Bank would find useful to change. Fortunately, one of the many advantages of BEQM is that it includes a wide array of fiscal instruments (and can be easily adapted to include others), and so it represents an ideal tool to carry out such an investigation.

REFERENCES


January 2007

Memorandum submitted by David Kern, Economic Adviser to the BCC

1. THE ECONOMIC CONTEXT

— The economic context in the next decade, compared with that in which the MPC has operated in its first decade: The past decade has been unusually propitious, both globally and in the UK. The world economy has experienced strong and relatively steady economic growth, particularly since 2002, and inflationary pressures have been muted. In spite of recurring geo-political crises, including an emerging threat of terrorism, the periods of slowdown in world growth have been mild and short-lived and there has been no major world recession. Looking forward, it would be sensible to work with the cautious assumptions that circumstances would be less favourable over the next decade. But the economic outlook is still positive overall. Factor such as globalisation, greater integration of the emerging economies in the global trading system, and the falling cost of transferring information, should make it possible for satisfactory growth to continue to coexist with relatively modest inflation.

— Future Risks: At the same time, huge and persistent global economic imbalances remain unresolved, and the risk of an abrupt and damaging adjustment cannot be shrugged off. In the UK there are also signs of increased risks, as the increased regulatory burden, and factors such as social legislation and the minimum wage, make the economy less competitive. Though a major economic crisis is unlikely, there is a real danger that the trade off between growth and inflation will become more unfavourable, and keeping inflation under control would become more difficult in the next few years. If containing inflation would entail bigger costs in terms of higher unemployment and lost output, it becomes even more critically important to secure the widest and strongest possible public consensus in support of low inflation.

— Economic context vs institutional arrangements: More favourable economic circumstances, and the superior institutional arrangements, have clearly both been important in explaining the improved performance of UK monetary policy since 1997. It is impossible to attribute precise weights to the relative importance of the various factors. But, on balance, it seems to me that the new institutional arrangements (set up against the background of a strong and widely shared UK political commitment to low inflation), have been the key factor. The new monetary policy framework has played a vital role in dampening inflationary expectations, which was critical in creating the necessary conditions for the MPC’s success. The full independence given to the Bank of England in May 1997, and the formal focus on the achievement of a “point” inflation target (rather than a range), was the final stage of a process that was set in motion in 1992, after the UK left the ERM.

— Treatment of movements in asset and house price inflation: There is wide agreement that movements in asset and house price inflation cannot be ignored by the MPC, because they can affect trends in general inflation. But most people also accept that the official inflation target should not apply
formally to asset and house prices. Many aspects of the subject remain a controversial. In particular, there is no agreement on the transmission mechanism from asset prices to general inflation. There are also acute differences of view on the most appropriate reaction to warnings that may be signalled by the housing market or other asset prices. Those who believe that that money supply growth influences initially asset prices recommend giving greater weight to various measures of the money supply. Some even recommend using a money supply target that would supplement the inflation target. Others, but only a small minority, suggest a more formal separate target for asset prices. The vast majority, including the central bank, prefer a "judgemental approach". But the weakness of a "judgemental approach", unless explained very clearly, remains a persistent lack of clarity and transparency.

**Money supply, credit and liquidity:** Extreme monetarism, which uses a formal quantitative money supply target as the main focus for policy, is now totally out of fashion, and no central bank is prepared to use it. But there are important differences of emphasis. Even the Eurozone’s ECB is primarily concentrating on an inflation target. But the ECB is using the broad money as an important policy reference and guide. In the US, the Fed virtually ignores the money supply, and it has recently been reported that the publication of money supply statistics is being discontinued. In the UK, the MPC has not paid too much attention to the money supply, and it has clearly not been an important policy guide. Nevertheless, the Governor and various MPC members have referred more often to the money supply in recent months, particularly when they wanted to draw attention to inflationary threats. While the money supply is unlikely to become a major UK policy target, there is case for increasing public awareness of trends in the money supply, and of related measures of credit and liquidity. This is particularly important in the light of the persistent uncertainties surrounding the importance of asset and house prices.

**The build-up of household debt** has important economic and above all social consequences. The higher the level of debt, the greater the pain, and potential human misery, associated with higher interest rates. At the same time, high debt levels may increase the effectiveness of tighter monetary policies, if the necessary reduction in consumer demand occurs more quickly. The interest rate peak required to achieve a certain degree of restraint may be lower, if debt levels are high. The devastating social effects associated with bankruptcies and repossessions are clearly very serious. But the elected government must deal with these matters. The main role of the MPC must be the delivery of the inflation target, and household debt should not stop them from taking the necessary action.

**Monetary policy and structural changes in labour and product markets:** The more flexible the labour and product markets, and the fewer the bottlenecks in the economy, the smaller the inflationary pressures associated with a given level of demand. Structural changes can have important effects (positive as well as negative) on the supply side of the economy, and on the trend growth rate in output. By affecting potential supply, these structural changes can affect the environment within which the MPC operates, making its job either easier or more difficult. In particular, structural changes in the labour and product markets can affect the output gap of the economy, and can therefore alter the trigger points necessitating MPC action to contain inflationary pressures.

**Relationship between investment and monetary policy:** A number of possible relationships appear relevant, depending on the sequence of events one considers. Higher investment would tend to improve output growth and the economy’s supply potential, thus reducing the inflationary pressures associated with a given level of demand. At the same time, higher interest rates would tend to reduce investment spending other things being equal. One can argue that, over the past decade, the MPC’s success in keeping inflation and interest rates down has helped to stimulate investment. But this is one of the expected helpful consequences of a successful monetary regime aimed at containing inflation.

**Monetary and fiscal policy frameworks, and overall policy coordination:** The fiscal policy is extremely important in setting the framework within which the MPC operates. Surges in the budget deficit would push interest rates to a higher level than they would otherwise be. Conversely, reductions in government borrowing would mitigate pressure for higher rates. Given the MPC’s remit, it is difficult to achieve overall policy coordination. The MPC is clearly entitled to urge fiscal restraint without being accused of meddling in politics. But, ultimately, the MPC must accept as a fact the fiscal framework set by the Chancellor, and then act accordingly to try and ensure that the inflation target is achieved.

### 2. The Monetary Policy Framework

**The inflation target:** The level at which the inflation target was set, 2.5% for RPIX and then at 2% for CPI, is appropriate overall. A higher target would have meant condoning unjustifiably high inflation, while a lower target would have heightened the threat of deflation. The level of the inflation target is not, in itself a problem. But the choice of an accepted and credible measure of inflation has become more important over the past year (see below). Furthermore, since two of the MPC’s most recent three increases in Bank rate have been surprises (or shocks), the MPC must improve its communication strategy. It must ensure that experts, as well as the general public,
understand more clearly how its actions are intended to deliver the inflation target. More fundamentally, the MPC must have better appreciation of the speed with which it is expected ring back inflation to target, and at what short-term price in terms of lost jobs and output.

— **The switch from RPIX to CPI** as the basis for the target has been with hindsight unnecessary, and has not been adequately explained; it has introduced regrettable complications that may have damaged public credibility in the official measurement of inflation. The CPI may have technical advantages over the RPIX, but this has been more than offset by the more limited coverage, particularly the exclusion of any element of housing costs. The RPIX accounts for housing costs in a very imperfect manner, but this is still preferable to the total exclusion of housing costs from the CPI. Though the CPI is now the focus of the inflation target, the public still regards the RPIX as a superior measure of inflation, and any attempt to link wage settlements and contractual arrangements (eg pensions) to the CPI would be strongly resisted.

— **The symmetrical nature of the UK inflation target** is a valuable and positive feature of the UK system. But the MPC must persuade the markets as well as the public that they are genuinely committed to symmetry. There is a widespread view that overshoots in the target are being taken more seriously than undershoots. The MPC must either refute these perceptions or explain why such attitudes are necessary.

— **The MPC and the economic policy of the Government:** By and large the MPC is doing its best in a situation that inevitably entails ambiguities and contradictions. “Having regard” to broader Government policies, while you have only one policy instrument to deliver a very specific target, is potentially a woolly and meaningless objective. Given the MPC’s remit, it is primarily the Government’s task to ensure that its key economic policies (eg on spending, borrowing, and public sector pay) do not force the MPC to adopt steps that may worsen the threat of recession. In the case of a truly exceptional national emergency, it would be preferable for the Government to suspend the target, rather than for the MPC to initiate a breach of the target.

— **The way in which the inflation target is set:** The UK system, where the elected Government sets the inflation target, compares favourably with both the US, where there is no formal target, and the Eurozone, where the ECB sets its own target. But the potential confusion caused by the switch from RPIX to CPI, and the differences between the various measures, makes very important to maintain public support for the target. This inevitably means public acceptance that delivering the target may occasionally entails painful costs.

— **The statutory objectives of the Bank** are broadly appropriate. But, if we are moving into a decade in which the economic context is “less nice”, the MPC may require greater clarity. The MPC may be forced to make decisions in the future on painful tradeoffs between tolerating prolonged overshoots to the target, or bringing inflation back to target quickly, but at very high costs. If such situations were to arise, it would be difficult for the MPC to make such a decision purely on the basis of technical considerations of monetary policy.

— **The monthly frequency of MPC meetings:** Overall, the current monthly frequency of MPC meetings is appropriate and no change should be made. While a case could be made for reducing the frequency (say, to eight meetings a year, as currently adopted by the US Fed), the existing system is predictable and fits in well with the monthly cycle of economic indicators.

— **The sanction of the Governor writing a letter to the Chancellor when inflation moves 1% either side of the target level** has fortunately not been tested yet. Overall this seems an appropriate mechanism. But it also highlights the potential weaknesses and ambiguities of the current system. The implicit assumption that the need to write such a letter signals failure on the part of the MPC is not necessarily correct.

### 3. The MPC as a body

— **The size and composition of the MPC**, including the balance between “internal” and “external” members, appears appropriate. The system has worked reasonably well and should be maintained. Expertise in monetary economics must be a primary criterion for eligibility to become a member of the MPC. But, subject to this overriding rule, there are good arguments for having a wider range of experiences on the Committee. This means people with differing academic approaches, and more people with commercial and business backgrounds.

— **The appointment process:** The prestige of the MPC is very high, and there should be no shortage of highly qualified candidates. But there is scope to improve the appointment process, by making it more transparent and methodical. The Chancellor should make the final choice, but the process can be made less secretive. There is room for open and independent advice to the Chancellor, naming suitable candidates. The criteria for choosing between the different potential candidates can also be more open and transparent.

—— **The role of the Treasury Select Committee be in the appointment process:** The final responsibility for appointing MPC members should stay with the Chancellor. But the Treasury Select Committee can play an important role in scrutinising the process and making it more open and transparent.
4. **The Mechanics of Setting and Implementing Monetary Policy**

— **Are the Bank and the MPC transparent enough?** There is considerable scope for enhancing transparency. This would enhance the prestige of the MPC, and also help to strengthen public support for the MPC’s role in sustaining low inflation.

— **The MPC’s communication strategy:** This is an area that definitely requires improvements, particularly following the recent shock increase in interest rates. The MPC already explains its position via the Inflation Report, speeches, and press conferences. But there is clearly a problem, if the reaction to the MPC’s action is one of shock. Shocks are generally undesirable. But if the MPC genuinely believes that a shock was needed in a particular situation, this has to be very clearly explained after the event. The communication strategy definitely needs to be strengthened, particularly if the wider economic context is set to become more difficult and less benign.

— **Should the Bank undertake more work to educate the public on monetary policy issues?** The MPC and the Bank are already doing a great deal in this area, but it is important to spell out more clearly some of the difficult choices involved. The Bank is right to stress on its website the following: “Price stability is a precondition for achieving a wider economic goal of sustainable growth and employment. High inflation can be damaging to the functioning of the economy. Low inflation can help to foster sustainable long-term economic growth”. But these are long-term benefits. The public must also understand more clearly that low inflation can entail painful short-term costs.

— **The Bank’s capabilities and technical expertise:** There is no problem here. The Bank’s capabilities and expertise are first rate.

— **The methods of ensuring the accountability of the MPC, including via the Treasury Committee:** This is a critical area that needs to be clarified. What is the precise meaning of accountability? If, for example, the MPC fails to deliver the inflation target over a prolonged period, one must conclude that that something is wrong. But, can one necessarily conclude that the MPC must take the blame for such a failure? What would be the expected penalty for such a failure?

— **Determining the pain of the adjustment:** In explaining its policy framework the Bank makes on its website a number of very plausible statements: “A target of 2% does not mean that inflation will be held at this rate constantly. That would be neither possible nor desirable Instead, the MPC’s aim is to set interest rates so that inflation can be brought back to target within a reasonable time period without creating undue instability in the economy”. But this leaves open many issues that have to be resolved, or at least openly discussed, before we can talk in a meaningful way about accountability, and the correct allocation of responsibility between the MPC and the democratically elected Government:

   — What is the precise meaning of terms such as “a reasonable time period” and “creating undue instability in the economy”?

   — The determination to avoid a resurgence of inflation is now so strong that most people would probably accept that, in extreme circumstances, the MPC should be supported even if their policies produce temporarily economic recession. But can one be certain that the politicians would back the MPC?

   — Even those who are prepared to pay a high price to avoid “high inflation” (say, 5% or more) may be less clear on whether they really wish to make significant sacrifices in terms of jobs and output to cut annual inflation from, say, 3–3.5% to 2–2.5%.

   — Do we want to be precise about the answer to these questions, or is it preferable use an element of deliberate ambiguity, given the uncertainties?

   — While a degree of ambiguity may have its uses in some situations, greater clarity and transparency are very probably necessary in the long run, if the MPC is to perform its job effectively in a harsher and less propitious economic environment.

*January 2007*

Memorandum submitted by Michael Saunders, Citigroup

**The MPC 10 Years On: Submission to the Treasury Select Committee**

The MPC’s overall record on the inflation target has been good. On average over the period June 1997–November 2006, target inflation was just 0.1% below the target (using RPIX to end 2003, CPI since then). The MPC’s record compares well versus other inflation targeting European central banks. The UK, Sweden, Norway and ECB have all been running inflation targets with independent central banks since the start of 2001. In that period, target inflation undershot by an average of 0.1% for the UK, versus undershoots
of 0.5% and 1.2% respectively for Sweden and Norway, and an average overshoot of 0.5% for the euro area. Over that period, target inflation has been within 0.5% either side of the target in 69% of the months for the UK, 42% for the euro area, 35% for Sweden and 34% for Norway (see figure 1).

To keep inflation so close to target is a highly creditable achievement in the face of big global shocks (EMU creation, global downturn and equity collapse of 2001–03; oil price surge 2003–06; rapid growth of emerging markets and change in balance of global trade), as well as the swings in UK fiscal policy (restraint in early years, rapid public spending growth since then). There is a lot that is good about the current MPC framework of a forward-looking central bank that acts to stabilise its inflation forecast close to target, with the letter-writing system to give some tolerance for limited deviations from the target.

Given that, there is scope for improvement, which is what this note aims to address.

**Incomplete Credibility of the Target**

The UK’s inflation target framework has high financial market credibility. Breakeven inflation rates between conventional and index linked gilts have risen to about 3% recently, but this includes a perception that the gap between YoY RPI and CPI inflation will be wider than previously expected. This gap averaged 0.8% in 1997–2002, 1.2% in 2003–06 since then and in December 2006 was 1.4%. The consensus view among economic forecasters is that UK CPI inflation will average 2.0% per year each year 2008–11, and remain at that level on average in 2012–16.

But, the credibility of the inflation target framework in the real economy is far more doubtful. Household inflation expectations do not appear to be well anchored on the 2.0% inflation target.

- According to annual results from the BoE/NOP survey, most people are unaware that the UK has a 2% inflation target. When asked, only 22% of people correctly believe the inflation target is between 1.5% and 2.5% (see figure 2). Roughly half of people will not even have a guess. About 30% of people incorrectly believe the government has raised the inflation target from a year ago (see figure 3), whereas a similar number believe (correctly) that the target has been unchanged and about 9% think it has been lowered. More than half the adult population do not know (unless prompted) who sets interest rates (see figure 4). These results have not changed significantly over recent years.

- The BoE/NOP quarterly survey suggests that household inflation expectations for the year ahead rose to 2.7% in November from 2.5% in August, matching February 2006 as the highest recorded since the survey began in early 2000. Our YouGov/Citigroup survey suggests that the median expectation for average annual inflation over the next 5–10 years is 3.6%. Fully 80% of people expect inflation to average more than 2% per year over the next 5–10 years. Only 7% expect inflation to average less than 2%, and 12% don’t know (see figure 5).

- Even some quite well-informed groups do not stress the 2.0% CPI inflation target as the benchmark. For example, pay specialists Incomes Data Services publish inflation forecasts as a guide to people involved in pay bargaining, but publish forecasts for RPI inflation not CPI inflation.

These results are a bit disappointing after nearly 10 years of BoE independence. The problem may be a mix of (a) ignorance that there is a 2% inflation target; (b) scepticism about the durability of the inflation target framework. After all, many earlier UK monetary policy regimes have come and gone. Moreover, the inflation target framework is not set in stone. The target is usually set once a year, but can be changed by the Chancellor at any time. Indeed, the Chancellor changed the inflation target without parliamentary approval in mid-2003 from 2.5% for the RPIX to 2.0% for the CPI; (c) a belief that inflation currently really is significantly higher than CPI inflation (and this may be fuelled by the ONS’s new calculator to allow personalised inflation rates); (d) doubts about the MPC’s technical ability to actually keep inflation close to the target over time.

The evidence that longterm household inflation expectations are not anchored on the inflation target has not been a critical problem in the last few years. As noted above, inflation on average has been close to target. But, the MPC has had the good fortune to be setting rates against the backdrop of persistent declines in consumer goods prices. UK prices for consumer goods ex food, drink, tobacco and energy (CPI weight of about 30%) fell by 12.7% between January 2000 and January 2006—an average drop of 2–2.5% YoY. The biggest drop among other European economies was for Norway, a total drop of 2.1%. The euro-area had about 30%) fell by 12.7% between January 2000 and January 2006—an average drop of 2–2.5% YoY. The biggest drop among other European economies was for Norway, a total drop of 2.1%. The euro-area had

38 We assume that the ECB’s target, which is not fully defined, was 1.5% for the CPI during January 1999–May 2003 and 1.75% since then.
With that drop in consumer goods prices, the MPC could tolerate—indeed, had to encourage—a relatively high growth in UK services prices, unit labour costs and pay in order to prevent an even bigger inflation undershoot (see figure 7). The MPC could keep the jobless rate a little below the non-inflationary level (OECD estimate) throughout 2001–05. That drop in UK consumer goods prices may now be ending. Eurostat estimate that the UK price level has converged down to match the EU15 average. The drop in UK consumer goods prices has eased to minus 0.8% YoY in December, the smallest drop since 1998, and the BoE agents’ surveys suggest that consumer goods prices are actually now rising again. If goods prices in the UK CPI do stop falling, then UK CPI inflation will tend to exceed the 2.0% target unless services inflation actually slows.

Indeed, this potential problem could be compounded by domestic developments. With the buoyant economy, the highest CPI inflation since 1995 and the highest RPI inflation since 1991, there is some risk—perhaps a large risk—that inflation expectations also head higher. That would further boost demand by lowering perceived real interest rates, and probably also lead firms to grant higher pay growth because they would assume they can raise selling prices enough to cover the cost. Business surveys (eg by the BoE agents, and British Chambers of Commerce) indicate that many firms believe they can raise their prices relatively rapidly—which would allow them to cover the costs of higher pay growth.

The UK may therefore face a double inflation problem: an end to the decline in consumer goods prices plus a pick up in pay growth and services inflation. In that case, the MPC would probably push interest rates significantly higher to slow demand and ensure that those extra costs are not passed on to consumers. The result is likely to be a sharper slowdown in the overall economy, with adverse effect on jobs, incomes and tax revenues. Of course, by moving interest rates up or down enough, the MPC can always eventually slow the economy enough to keep inflation on target regardless of whether consumer goods prices and pay growth are rising. But, the economic cost of stabilising inflation (in terms of lost output and lost jobs) will probably be less if inflation expectations and pay growth are anchored on a sustainable pace, one that is consistent with the inflation target which may not be the case at present.

My proposals therefore aim to better anchor private sector inflation expectations on the target, or, rather to remove possible factors that may be keeping inflation expectations elevated.

First, it should be less easy for the Chancellor to change the inflation target. At present, the inflation target is set annually in the Budget by the Chancellor but, as in 2003, the target can be changed by the Chancellor at any time. While the government should continue set the inflation target, any change to the target should be subject to a parliamentary vote. This should introduce an extra hurdle to any change in the target and ensure some degree of scrutiny. It also would probably extend political buy-in to the target across all major political parties.

Second, the Chancellor should lose the current sole discretion over the appointment process for the MPC externals. So far, the quality of the MPC externals overall has been very high. But, there clearly is a risk that a Chancellor might choose to manipulate appointment for political reasons, either using the job as a reward or appointing people who would avoid raising interest rates at politically difficult moments. Possible solutions would be either a beefed-up and biting confirmation process from the TCSC, or the creation of a non-government body to produce a short-list of candidates.

Third, the MPC should add a fan chart of the possible path of interest rates that might be needed to keep inflation on target under different scenarios. Their current habit is to present fan charts of inflation and growth forecasts under the assumption of stable interest rates and “market” interest rates (the average path for rates projected by markets in the 15 days before the Inflation Report MPC meeting). The technical construction of these charts is good. But, as a pedagogical device, it could be useful to also present the same information as a fan chart of the possible path of interest rates. This would have the advantage of stressing that the uncertainties are mainly in terms of how far interest rates will have to move (up or down) to keep inflation on target rather than where inflation itself will be in two to three years’ time. This change might help to anchor inflation expectations on the target, by highlighting that the MPC is not a passive observer in the inflation outlook, but (by its actions) can return inflation to target. It might usefully remind borrowers and lenders to allow for risks that interest rates might vary significantly. It might at present also help ensure that risk premia in the interest rate curve and financial assets do not become overly low and provide unneeded stimulus. In other words, such a change might create less inflation uncertainty, and appropriately create more interest rate uncertainty.

Doubtless, there are some technical difficulties in such a presentation. But, it does not appear impossible given that the MPC already publishes inflation fan chart forecasts and has well-established models for the effects of interest rates on inflation. The Norwegian central bank already publishes projections for the path of interest rates that they believe are needed to keep inflation on target over time, with bands of uncertainty around that forecast. The Swedish central bank has now said it will do the same.

39 The Swedish and Norwegian central banks have been less willing to tolerate relatively high growth in services prices and pay to offset declines in consumer goods prices and hence have experienced a bigger inflation undershoot.
41 See Speech by Irma Rosenberg, Riksbank Deputy Governor, 17 January 2007.
Fourth, the Treasury Select Committee should continue its confirmation hearings and regular sessions with MPC members. The confirmation hearings are an important signal to MPC members that they must have their own voice. But, the TSC might explore ways to boost its resources to quiz MPC members. The quality of these sessions rests in part on the quality of the questions. Within a world of limited resources, it may be that the BoE itself, in an enlightened gesture, could find a way to provide the TSC with more resources with which to improve the MPC’s public accountability?

January 2007

Average Deviation of Inflation From Target, Jan 2001-November 2006
BoE/NOP Public Opinion Survey: What is Inflation Target For Year Ahead?

BoE/NOP Public Opinion Survey: Has Inflation Target Changed Since Last Year?
Treasury Committee: Evidence

BoE/Nop Public Opinion Survey:
Who Sets Interest Rates?

Pct of People Expecting Inflation To Fall Into Various Ranges In Next Year and Next 5-10 Years

Inflation in Year Ahead Average Annual Inflation In Next 5-10 Years

Average YoY Gains in Key Prices and Costs, 2000-2006H1
Memorandum submitted by Bridget Rosewell, Volterra Consulting

INTRODUCTION

For the last 10 years, the Bank of England Monetary Policy Committee has been tasked with keeping a particular measure of inflation within plus or minus 1% of a central target. It has met this objective throughout the period to January 2007, although it teeters on the brink of an end to this run of success.

This note examines the background to this success and tries to balance the effects of good luck and good judgement in achieving this outcome.

THE RECORD

The chart shows the performance of both measures of inflation that have been targeted including some pre-history. It can be seen that the decline in inflation on either of these measures pre-dates the establishment of the MPC. Nevertheless, the good performance has continued along the same lines and has not been squandered, so some credit needs also to be given to the Committee.

![Chart 1](chart1.png)

Stability has also been the experience in the real economy, as Chart 2 illustrates.

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42 The target was $2\frac{3}{4}$% increase in RPIX from May 1997 to December 2003, and 2% in CPI from then to the present day.
The causality and feedbacks in this system are in fact not very well understood. Though the interest rate is used to target inflation, while taking account of the real economy, the lagged impact is around two years and the interaction between growth and inflation mediated by a number of routes.

The stable path of growth has itself been battered by stock market crisis, supported by public sector expansion and undermined by slow investment growth. This combination of factors and their timing are, as in all other cycles, unique.

**Taking Account of Risks**

One of the major contributions that the Governor has made to the consideration of these issues, both as Governor and previously as Chief Economist, is the presentation of the fan chart as an attempt to illustrate the extent of uncertainty that the system and its putative managers face.

The current versions of these charts are shown below, from the Inflation Report produced in February (Chart 3). Comparison of these charts, which use quite a short time period, and the longer periods illustrated above show that both variables are expected to move within the bounds set by the recent decade. In other words, we remain in the low inflation, stable output growth regime which has been experienced over that time period.

This has been a period in which monetary policy has therefore been easy, as indeed the Bank recognises. This has been the experience of other jurisdictions as well. In this sense the UK is not unique.
The fan charts from the Inflation Report show ranges of GDP growth and inflation over the forecast period. The outturns are expected to lie within these bands with a probability of 90%. We do not have the exact numbers which correspond to the bands, but an earlier exercise\textsuperscript{43} we have undertaken, reading off the published charts, showed that for 2005 the approximate ranges for the variables within the 90% probability bands were:

- GDP growth: 1.5 to 3.5%  
- Inflation: 1.0 to 2.0%

These are rather narrower than the current bands, and the outturn for that year was around 2% for inflation, at the top of the band and also around 2% for growth, towards the bottom of the band. Although both outturns were within the bands published at the time, it is worth testing the ranges that have been published.

Consider first of all the growth rate of real GDP. Two methods of creating a probability distribution were used, linear interpolation and kernel density estimation. Of the two, the latter should be regarded as being in general the more accurate.

### Table 1

<table>
<thead>
<tr>
<th>Range for real annual GDP growth rate (%) in the UK in 2005: 90% range</th>
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<tbody>
<tr>
<td><strong>Low</strong></td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>MPC judgement</td>
</tr>
<tr>
<td>Linear interpolation of probability density function of data 1949–2004</td>
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<tr>
<td>Kernel density estimation of pdf 1949–2004</td>
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</tbody>
</table>

The statistically based estimates of the 90% range of the data are much higher than the judgmentally based ones of the MPC. In retrospect, no recession took place in 2005. But anticipating turning points, and recessions in particular, is well known to be the weakest aspect of macroeconomic forecasting.\textsuperscript{44} In recession years, forecasts made early in the year have often projected positive growth.

In terms of inflation, the current rate has now moved outside the previous probability band and indeed is at the top of the current one. In 2005, the MPC saw the then current rate of 1.5% as persisting during 2005, within a 90% probability band of 1 to 2%. In the event the outturn was slightly higher than this, at 2.\textsuperscript{x}%. Table 2 sets out the various estimates for the 90% probability band for 2005 using the data on the change in inflation. With the inflation data we cannot reject the hypothesis of the data being normally distributed, with a Kolmogorov–Smirnoff normality test returning a p-value of 0.5.

\textsuperscript{43} B Rosewell, Macro Uncertainty and Monetary Policy, Paper prepared for the Brisbane Club conference on complexity, University of Queensland, July 2005.

Table 2

Range for inflation (%) in the UK in 2005: 90% range

<table>
<thead>
<tr>
<th>Low</th>
<th>High</th>
<th>Probability of growth &lt; 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary Policy Committee judgement</td>
<td>1.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Linear interpolation of probability density function of data</td>
<td>-0.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Kernel density estimation of data</td>
<td>-1.0</td>
<td>3.8</td>
</tr>
<tr>
<td>Hypothesised distribution of data (normal distribution)</td>
<td>-0.7</td>
<td>3.8</td>
</tr>
</tbody>
</table>

(note that since Inflation is highly autocorrelated all calculations are carried out on the difference of inflation, i.e. this is actually 2005 predictions calculated using 2004 value of inflation).

It may at first sight seem surprising that negative inflation is possible given a history in which this has yet to occur. The current level of inflation is, however, very low, and thus a further downward shock could take it below zero. The chances are not high, being between 12 and 14% depending upon which method of estimation is used. But the MPC is effectively ignoring this possibility completely.

Yet in fairly substantial sectors of the economy, negative inflation has been a feature for several years. Manufacturing producer prices, for example, fell in every year between 1996 and 2002. The annual rate of increase in average earnings in the construction sector, after having been around 5% for several years, has fallen to zero because of an increased labour supply from the new EU countries.

Equally, upward pressure was also more likely than the MPC thought, and this risk has indeed materialised, with commodity price increases feeding through to higher inflation than the previous analysis suggested.

In effect, the MPC has been taking a relatively short view of the range of likely outcomes. An analysis based only on the previous ten years of data suggested that the ranges were much closer to those seen in 2005.

Table 3

Range for inflation (%) in 2005: 90% range based on 10 years of data

<table>
<thead>
<tr>
<th>Low</th>
<th>High</th>
<th>Probability of inflation &lt; 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK data</td>
<td>1.7</td>
<td>4.3</td>
</tr>
<tr>
<td>UK data</td>
<td>0.6</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Interestingly, the output growth range shown here is very similar to that of the most recent Inflation Report of November 2007. However, the inflation range shown there is considerably higher and wider, ranging from 0.9% to 3.1. This is a range of 2.2% compared to the 10 years from 2005 experience of 1.3%.

We already appear to have moved into a world which is going to be unlike the next decade and the Bank will need to take a longer historical period as their frame of reference. It will be interesting to see whether they are able to present and to consider wider potential outcomes than have been the case over the last 10 years.

Living with Greater Risk

The Monetary Policy Committee does not of course operate in a vacuum. Not only is it affected by developments across the world economy over which it has no control, but its independence also has limits.

The MPC is given, for example, the target which it is expected to hit. This has also once been changed in the life of the Committee and there appeared at the time to be little consultation about the merits of this move.

The members of the Committee are also appointed by the Chancellor, although they can be vetted by the Treasury Select Committee. However, there is no open appointment process. Constraints on those appointed as external members as to their other activities create a substantial deterrent.

This is not to suggest that the MPC fails to exercise its judgement to the best of its ability. There must remain a concern that independent members can both fail to make much headway against any Bank consensus when this exists and that the appointment method undermines their position in any disagreement.

These difficulties have not as yet caused any serious problems, but the more difficult environment which the economy now faces has the potential to open up any potential fault lines in the structure.
CONCLUSION

The Monetary Policy Committee inherited a strong position at its inception. It has managed to build on this and the record shows that there has been no deterioration. The ability to bed in good performance is a huge asset for when time get tougher, as they currently are.

Good luck has gone alongside good judgement. Exercising good judgement as uncertainty increases is harder and even more luck is required.

The scale of external shocks which may face the economy could still increase, if the US economy slides further and is accompanied by weakness elsewhere. In 2001, government expenditure stepped into the economic breach, leaving a legacy of borrowing and inflationary pressures even as growth underperformed.

The Bank has always stressed that it does not target asset prices but concentrates on the output gap and the labour market. Neither of these is easy to call at the moment.

January 2007

Memorandum submitted by the CBI

The CBI speaks for some 240,000 businesses that together employ around a third of the private sector workforce. Member companies, which decide all policy positions, include 80 of the FTSE 100, some 200,000 small and medium-size firms, and over 150 sectoral associations.

EXECUTIVE SUMMARY

The UK’s macroeconomic performance has been much more satisfactory over the past decade than over the previous 25 years. The CBI believes that today’s monetary policy arrangements are superior to previous frameworks and that, together with the sound judgement of the MPC itself, they have contributed substantially to this successful record. However, the arrangements are best seen as building on rather than overturning the previous framework put in place in 1992, and the economic context has also been helpful. Labour market policies set in train previously have allowed the “structural” unemployment rate to come down, while globalisation has exerted downward pressure on prices in the markets for goods, tradable services and some labour.

Looking to the next decade, this economic context is unlikely to prove quite so benign, and the MPC will as ever need to stand ready to raise base rates when appropriate to keep inflation on track. However, as high levels of household debt ought to make consumers more sensitive to a given interest rate change, the Committee must be wary of over-reaction, and must equally stand ready to cut rates where appropriate. In the near-term, the most immediate cause for concern is the possibility of a price-wage spiral. The MPC must do whatever is necessary to prevent this taking hold. But while, with hindsight, base rates were a little too low in 2005, we do not believe that the MPC was mistaken at the time, given the deflationary as well inflationary risks then evident.

Broadly speaking, it would be best to avoid further change in the MPC’s remit or ways of operating. Achievement of a consumer price inflation target should remain the paramount goal for the MPC, and for macroeconomic policy more broadly. Where the government believes other economic goals to be important, then it is for the government to use policy levers at its disposal to ensure that these are achieved, in a way compatible with the inflation target.

While the MPC should take house and other asset price inflation into account insofar as this might be expected to knock on to consumer price inflation, it should not seek to influence asset prices independently of that aim. Similarly, MPC members should take debt into account only insofar as that affects the inflation target and macroeconomic stability; they should not be expected to set base rates to seek to target a particular level of indebtedness independently of that goal.

The recent macroeconomic climate has if anything been supportive of business investment, although a marked investment cycle has occurred over the past decade, driven largely by other factors. However, the macroeconomic climate would have been more supportive still under a different fiscal-monetary policy mix, in which lower debt-funded government consumption was offset by lower interest rates. More generally, we believe there is scope for better dialogue between the Treasury and the Bank, to ensure that the fiscal-monetary policy mix is achieved as a result of proper consideration, rather than as an “accidental” outcome. One attractive option to “tidy up” the policy framework would be for the Treasury to use the Bank’s economic forecast as the basis for its fiscal projections.

We believe the CPI measure to be appropriate for the purposes of monetary policy, and would caution against further change. But alternative inflation indicators will be more relevant for other purposes, and we recommend that the government or Bank, or both, should seek to educate the public on this and related matters.
We believe that the MPC adequately takes into account the government’s broader economic goals, insofar as that does not compromise the inflation target. However, it is important to realise the limits placed on the Committee by the fact that it has only one policy lever and so can only target one policy goal. The rate of unemployment consistent with the inflation target, for example, will ultimately depend on government policies towards the labour market. Similarly, the MPC cannot affect the composition of GDP, nor the balance of economic performance across the regions, unless fiscal or other government policies ensure that any objectives in those areas are consistent with the inflation target.

Finally, we recommend changes in the appointments process to: make it more open and transparent; ensure greater input and power for individuals or bodies other than the Chancellor-of-the-day; and ensure that membership gaps in the Committee—as seen in 2006—are avoided in future.

The Economic Context

1. The UK’s macroeconomic performance has been much more satisfactory over the past decade than over the previous 25 years. Deviations in the path of GDP from its long-term “trend” have been modest, with no absolute decline in any quarter, while inflation has been acceptably low with minimal volatility. Few comparable economies have performed as well on this basis, and this relative macroeconomic stability has clearly reduced the degree of uncertainty facing business decision-makers amongst others.

2. More specifically, the out-turn for the targeted measure of consumer price inflation has not, to date, deviated by more than one percentage point from its target. This is a substantial feat considering how inflation (on the RPI measure) varied between 4.9% and 26.9% in the 1970s, 2.4% and 21.9% in the 1980s, and 1.2% and 10.9% in the early 1990s. Crucially, inflation expectations—as reflected in markets and surveys—have in general been well-anchored during the last decade, in stark contrast to previous experience.

The respective roles played by economic context and institutional arrangements, and the economic context going forward

3. The CBI believes that the monetary policy arrangements, together with the sound judgement of the MPC itself, have contributed substantially to this successful record.

4. However, while we agree that the MPC arrangement is superior to previous framework put in place in 1992, it should be seen as building on that framework—which included inflation-targeting and a public role for the Bank of England—rather than as a wholesale replacement. By the same token, the economy’s improved macroeconomic performance can be dated back to the early-to-mid 1990s, rather than 1997 and Bank independence specifically.

5. The economic context has also been helpful. The level of “structural” unemployment (ie the NAIRU or non-accelerating inflation rate of unemployment), judged to be 5.3% by the OECD, is lower than in previous decades, thanks at least partly to earlier labour market reforms. By allowing achievement of the inflation target to be consistent with a relatively low level of unemployment, this may well have helped in terms of public acceptance of the current arrangements. It has also, probably, reduced the temptation for politicians and others to attempt to place pressure on the MPC to hold interest rates at inappropriately low levels.

6. Globalisation, or more specifically intensified international competition in the markets for goods and tradable services, and effectively in parts of the labour market, can also be thought of as helpful (see further below), as can the impact of strong growth in the available UK labour force.

7. Looking to the decade ahead however, the economic context is unlikely to be quite as benign as it has been over the past 10 years. The global backdrop became less benign in 2005 and 2006, as the price of oil and other commodities was driven up in the international markets. Such high and rising commodity prices are more likely than not to be a fact of life in the future. It is also possible that the downward impact on goods prices of the entry of China and others into the global market will become less intense, as incomes and labour costs in those countries begin the long process of catch-up with the west.

8. In addition, the rate of growth in labour supply may not be quite as great over the coming years as it was during the 2004–06 period, when immigration from the EU accession states was a major factor (though not the only one). And the direction of labour market regulation seen in recent years, together with the increase in the employment “tax wedge”, would if anything nudge the level of “structural” unemployment upwards in due course, in the absence of offsetting developments.

9. All of this means that the MPC must stand ready to raise interest rates as high as necessary to keep inflation on track. Ironically, failure here would almost certainly mean rates ending up higher than otherwise, on average into the medium term (akin to what happened in the mid-to-late 1980s, when with hindsight rates were too low for a relatively brief period, but subsequently had to be very high, for a long time, to get inflation back down).
10. Nevertheless the Committee must still be alert to opposite danger, of causing unnecessarily slow growth by setting rates too high, or by failing to “manage” rate expectations so that an unexpected rise results in a sharp change in spending behaviour. It should be remembered that today’s high debt levels ought to make households more sensitive to a given rate rise. The MPC should of course stand equally ready to cut rates, as and when warranted by conditions in future, as they have done over the past decade.

The present inflation picture

11. Concerning the latest increase in CPI inflation, to 3.0%, it can be argued with hindsight that base rates were too low some 18 months or two years ago (they were 4.75% in early 2005, and subsequently cut to 4.5% in August). However, we do not believe that the recent upward drift in inflation could have been foreseen at the time. Along with many others, the CBI supported the MPC’s decisions to hold rates through the spring of 2005. While recognising the buoyancy of employment and commodity prices, we also pointed to benign wage behaviour, the pressure on household finances, the strength of sterling and the mixed performance of the economy—with signs of weakness in manufacturing, retailing and the housing market—and argued that a rate rise would have been “risky and premature”.

12. With signs of economic fragility increasing, the CBI started to argue in July 2005 that a quarter point cut would be appropriate, and we supported the MPC’s decision to deliver this the following month.

13. Obviously there is a danger that today’s level of inflation could begin to become more embedded through higher wage settlements. Certainly there are signs of wage claims at levels which—if granted and repeated across the economy—would be inconsistent with inflation coming back to target. The MPC’s remit effectively requires it to set rates at a sufficiently high level to prevent such a price-wage spiral taking hold. We believe that rates are either at or very near the level required to achieve that, but the MPC must stand ready to raise rates to the level necessary, however high, to achieve its objective.

14. The present arrangements are well-suited to bringing inflation back down, with minimal damage to the real economy. There is certainly a much better chance of achieving that goal than under any of the previous arrangements.

Specific policy issues: a general introductory comment

15. Broadly speaking, it would be best to avoid further change in the MPC’s remit or ways of operating. Achievement of a consumer price inflation target should remain the paramount goal for the MPC, and for macroeconomic policy more broadly.

16. Other goals must of course form part of a wider economic policy strategy. And arguments can be made for extending this beyond eg economic growth and employment to eg housing affordability, other factors affecting the “cost of living”, debt levels, regional economic balance, the trade balance and/or the consumption-investment balance. But any goals other than the inflation target need to be achieved alongside it, and should not conflict with it. Crucially, their achievement should be regarded as dependent on policies under the control of government; the MPC cannot and should not be expected to take responsibility, nor to take these goals into account where that might compromise the inflation target.

17. This view reflects four facts. Firstly, standard economic theory suggests that with only one policy lever (as the MPC has in the form of the base interest rate), it will simply not be possible to successfully target two or more policy goals, except by coincidence. For each additional goal that policy makers wish to achieve, an additional policy lever is required.

18. Secondly, the policy has been successful over the past decade, in the sense that the given inflation target has been continuously achieved—despite some considerable shocks—without any clear evidence of a detrimental impact on the real economy. Thirdly, credibility has an important role to play in the achievement of the inflation target, because of the potential role played by self-fulfilling expectations. This provides a powerful case for not altering the target or framework, in the absence of clear-cut evidence that change would be beneficial. And finally, we believe it is reasonable to target inflation of consumer goods and services prices specifically, because of the relatively predictable relationship between this and the base interest rate.

The treatment of asset and house price inflation

19. It follows from the above that while the MPC should take house and other asset price inflation into account insofar as this might be expected to knock on to the targeted measure of consumer price inflation, it should not seek to influence asset prices independently of that aim. Seeking to do so might or might not achieve the asset price goal, but could all too easily result in the consumer price inflation target significantly under- or overshooting, with a significant impact on the real economy along the way.
20. This does not mean that the government could do nothing to influence eg housing affordability if it believed that should be a specific policy goal. But in that case the government itself would need to examine the policy options under its control—such as planning relaxation—to achieve that, in a way that would not compromise the inflation target or wider economic stability.

21. In terms of responding to house price developments within this framework, MPC members still have a difficult task because they must make a judgement about house price levels as well as house price inflation. Considered in isolation, faster house price inflation ought to make the MPC more wary about a knock-on to CPI inflation (through the effect of wealth or perceived wealth on households’ willingness to borrow and spend for consumption purposes), and so set rates higher than otherwise. However, where a period of house price inflation has driven house prices to levels that are unsustainably high, this should make the MPC more wary about a reversal in house price trends—as in the early 1990s—with a knock-on, depressing effect for demand and CPI inflation.

22. Turning to global asset price inflation more broadly, where this is seen as a forerunner to UK consumer price inflation then the MPC’s remit already suggests that it should seek to head off that impact by setting interest rates higher than otherwise. But where successful, the main result would be to contain UK consumer price inflation despite wider asset and commodity price inflation; the latter might not be countered as such. This is one reason why some commentators have argued that the present set-up is insufficient, and that new frameworks need to be devised to meet the new challenges thrown up by globalisation and cross-border capital mobility.

23. Certainly these challenges need to be thought about by policy makers. But we would caution against changing the MPC framework. It is just possible that greater international co-operation and co-ordination could reduce the potential for asset price volatility. Or it may be that we will simply have to live with it. The key point is that, to retain credibility and contain fluctuations in the real economy, interest rate changes should target a measure of inflation where there is a good chance of success. Setting interest rates in an attempt to smooth asset or commodity prices, over and above the expected knock-on for consumer prices, may not achieve that and may also run the risk of increasing rather than reducing instability in the business cycle.

Household debt

24. The same principles apply in the case of household debt. The MPC should clearly take debt (and attitudes to it) into account in setting base rates, insofar as this can affect the outlook for consumer price inflation and the longer term stability of the economy. In principle, members’ considerations might even extend to the potential for debt build-up to set in train instabilities affecting inflation beyond the two-year timescale normally looked at (though it is not easy envisaging this working in practice).

25. But the MPC should not be expected to set rates with a view to encouraging or discouraging debt for its own sake. Even if the MPC were able to judge the level of interest rates required to achieve a given “desirable” path for debt, that need not be consistent with the inflation target. Again, if the government believed that a different level of debt were “desirable”, then it would be the government’s role to bring additional influences to bear.

26. To the extent that households have become more willing to take on increased debt, at each given level of interest rates, then we are confident that the MPC will have set rates higher than otherwise—as they should have. That position needs to be maintained in future. However, the MPC will need to be vigilant for signs of a reversal in household attitudes to saving and borrowing. While a gentle rise in the household savings ratio over the medium term may be desirable, a sudden increase would be undesirable as it could depress economic growth by more than required to achieve the inflation target. The MPC must stand ready to cut rates if that prospect arose.

Structural changes in labour and product markets

27. Stable inflation will normally be associated with GDP growing along its potential path. The MPC must therefore monitor the economy’s performance relative to potential, remembering that the latter could change in response to structural change. The Committee will need to monitor relevant indicators of labour shortage and spare capacity, such as those found in CBI surveys, along with other indicators of the “output gap”.

28. Where structural market change improves growth potential, this will obviously allow a faster rate of growth to be consistent with the inflation target. Initially, this could allow interest rates to be held lower than otherwise—as was arguably the case in the wake of the step-up in inward migration of workers in 2004.

29. However, it is not clear that growth-enhancing structural change can allow interest rates to be held lower than otherwise indefinitely, as changes in supply-side conditions are likely to have a knock on for demand conditions over the medium term. There is no systematic tendency for interest rates to be lower in economies with faster underlying growth. The “neutral” level of interest rates is the key concept here, and this will be more dependent on factors such as attitudes to debt.
Investment and monetary policy

30. The low interest-low inflation environment of the last 10 years looks to have been supportive of business investment. For example, the cost of finance has rarely been cited as a significant constraint in CBI surveys. And a CBI survey carried out in 2001 found that “hurdle rates of return” were lower in the manufacturing sector than had been found in a similar exercise in 1994—in real as well as nominal terms. One probable explanation for the drop in real hurdle rates was a reduction in perceived risk, as a result of a perception of improved macroeconomic stability. The reduction in nominal hurdle rates was associated with a reduction in inflation expectations between the two surveys.

31. In practice, however, other factors have dominated business decisions and driven the investment cycle. The “dotcom boom” was partly responsible for a very significant increase in business investment in the late 1990s. But in 2002–05 business investment remained more depressed than might have been expected, considering the backdrop of global and UK economic recovery, and a continued low inflation-low interest rate environment. Costs and uncertainty relating to oil, energy and commodities, pension funding, taxes and regulation may help to explain this. There have, however, been signs of a welcome recovery in business investment in the last year or so.

Monetary-fiscal policy co-ordination

32. The macroeconomic climate might nevertheless have been more supportive still of investment, had the fiscal-monetary policy mix been different. Following the late-1990s budget consolidation, fiscal policy loosening helped to support the economy during the 2001–02 global slowdown. But it has not been tightened very much since, with public borrowing allowed to come in over £100 billion higher in the five years 2002–03 to 2006–07 than set out in the 2001 Pre-Budget Report.

33. The “optimal” level of interest rates has almost certainly been higher than otherwise as a result. Actual interest rates have probably been higher than otherwise too. But as noted earlier, they were set slightly below what has since turned out to be the optimum in 2005. One relevant fact here (though probably not the only one), is that public sector borrowing was allowed to come in £5 billion higher in 2005–06 than set out in the March 2005 Treasury Budget Report. We further note that borrowing is set to come in some £8 billion higher in 2006–07 than portrayed in that Report.

34. A different policy mix—greater public spending and borrowing restraint, allowing slightly lower interest rates—would arguably have been better for the longer term GDP growth outlook, had it resulted in some additional business investment substituting for some of the rise in government consumption. Had sterling been more competitive as a result, then net exports could also have made a less negative contribution to growth over that time.

35. While frequent change in fiscal policy is clearly best avoided, in setting its fiscal parameters the government should take into account their relationship with broader demand developments and the implications for the MPC’s interest rate decisions. Dialogue between the Treasury and Bank would be useful on these matters—as would a shared understanding of the economy. Different views on, for example, the size of the “output gap” could lead to the Treasury pursuing an expansionary fiscal policy, only for this to be countered by the MPC through higher interest rates. Here, the resulting policy mix would arguably have been arrived at by accident rather than design, and might well be less than optimal.

36. One attractive option to “tidy up” the policy framework would be for the Treasury to use the Bank’s economic forecast as the basis for making its fiscal projections.

37. Looking ahead, the slow progress in bringing down government borrowing means that there is less room for fiscal policy loosening to support the economy, in the event of eg another downturn overseas. Monetary policy would need to take most or all of the required policy adjustment in that case. However, most economic forecasts envisage global and UK demand conditions remaining reasonably robust. In this case, the need to bring UK inflation back down to target makes it all the more important that public sector borrowing is brought down as set out in the Pre-Budget Report. If by contrast the government’s finances were allowed to drift further, that would run the risk of pushing the required peak in interest rates higher still, potentially worsening the outlook for business investment.

Globalisation

38. Globalisation has to date put downward pressure on prices in the goods market, and parts of the services and labour markets, by enhancing competition. Most logically, the ultimate impact of globalisation would be to shift relative prices (with the price of tradables falling relative to non-tradables), but not necessarily the aggregate price level. However in practice, the highly visible effect of absolute declines in some major categories of good (such as clothing), and the clearly-felt effect of heightened competition for some groups of workers, may well have acted to depress inflation expectations, making the MPC’s task easier. But as set out earlier this effect may not be quite so benign going forward, as industrialisation in China and elsewhere underpins the growth in commodity prices.
39. Globalisation should also have the effect of increasing output potential in economies around the world by allowing each of them to specialise, shifting resource use over time into more productive sectors. As with structural market change (see above), this will increase the rate of GDP growth consistent with the inflation target. Where the pace of integration is stepped up, that might allow interest rates to be lower than otherwise during an “adjustment phase”, but it would not necessarily reduce the “neutral” interest rate level which determines how interest rates should move over the medium term.

The Monetary Policy Framework

40. We see little reason to change the current framework. The level and symmetrical nature of the target, the MPC’s statutory objectives, the way that the target is set, the monthly frequency of meetings, and the sanction should the target be missed all seem as good as any alternative. And with monetary policy, where credibility is vital, it is best to avoid change in the absence of a clear-cut case. In this section we therefore comment on only two issues: the appropriateness of the CPI target, and the MPC’s “regard to the economic policy of the government”.

The appropriateness of the CPI target

41. The CPI inflation measure targets the price of privately-consumed goods and services only. It therefore includes the effect of VAT and excise duties which are built into the prices of those items, but excludes the impact on “living costs” of: separately-levied taxes including council tax; house prices; and mortgage and other interest costs. Elements of these are included variously in other inflation measures, i.e. the Tax and Price Index (TPI), RPI and the previous MPC target measure, RPIX.

42. The CBI would not dispute the view that measures of inflation other than the CPI are equally valid, nor the view that the CPI may not be the “best” indicator of average household “living costs” (let alone the living costs of particular groups, which of course no national price index could claim to reflect). But we would nevertheless argue that the CPI is the best indicator to target for the purposes of monetary policy, and that therefore the current monetary policy framework should be kept in place. (If the government were concerned about the “cost of living” defined in other ways—e.g. to include tax, housing affordability and/or interest costs—in addition to achievement of the CPI target, then the government’s own tax, regulatory and borrowing policies should be re-assessed.)

43. It is sometimes suggested in other quarters that a broader index of inflation should be targeted. However, we would caution against this:

— The relationship between base rates and house prices is rather less predictable than that between base rates and goods and services prices, increasing the chances of consistently missing the target and undermining credibility. In addition, targeting an index including house prices might well require more significant interest rate swings. The result could be greater volatility in the real economy, as well as in consumer price inflation, with no guarantee that house price volatility would be appreciably lower.

— Taxes are beyond the MPC’s control and can change unexpectedly. The previous RPIX target included council tax, and the MPC had to allow for this in its deliberations. In the event, unforeseen increases in council tax did not cause inflation to diverge significantly from its target—but in principle they could have, despite the MPC’s best efforts. It should also be remembered that, in principle, a rise in the average council tax bill could partly reflect an increase in the volume of related services, not the price alone.

— Including interest costs in the targeted measure would complicate policy-setting significantly due to the perverse short-term effects. Even the previous RPIX target excluded these payments.

44. We therefore regard the CPI index as more appropriate for the purposes of monetary policy than RPIX, which includes council tax (which is beyond the MPC’s control) and, in effect, house prices (which have a much less predictable relationship with base rates than goods and services prices). Any change in target does of course run the risk of damaging credibility, which is important in the context of monetary policy and inflation. However, the Treasury judged that the potentially positive impact of shifting to a more appropriate target outweighed the potentially negative impact of changing target per se, and the CBI would not criticise that judgement.

45. The shift did, however, represent a very slight loosening in the monetary policy objective, as a CPI inflation target of nearer 1.75%, rather than 2%, is likely to prove consistent with RPIX inflation of 2.5% over the medium term. As a result, inflation and nominal interest rates will be fractionally higher over the medium term than would have been the case without the switch.

46. We are aware of questions raised more recently in the national press, concerning the credibility of the inflation statistics and—by extension—the inflation-targeting regime. But we do not believe that the answer lies in a further change in target or framework—partly because of the potential risk to credibility that such a further shift would involve, and partly because we do not see any choice of index that is clearly superior to the CPI for these purposes. However, as we set out further below we do see an educational role for someone (either the Bank or the government, or both) on this and related issues.
The MPC’s “regard to government economic policy”

47. We believe that the MPC adequately takes into account the government’s broader economic goals, insofar as these considerations do not compromise the inflation target. However, it is important to realise the limits placed on the Committee by the fact that it has only one instrument and so cannot achieve more than one policy goal simultaneously, except by coincidence.

48. The inflation target is, and should be, paramount. So far, it has by and large been achieved without a detrimental impact on the real economy. But ultimately the economic performance consistent with the inflation target will depend on broader conditions, mostly beyond the MPC’s control but not all beyond the government’s.

49. Suppose for example that government policies influencing wage-setting behaviour—the minimum wage, trade union power, employment taxes and so on—were to push up the “structural” level of unemployment. In these circumstances the MPC would have no choice but to set interest rates so that the economy ran at a higher level of unemployment than otherwise, despite the government’s proclaimed “full employment” goal.

50. Similarly, the balance of growth—between investment and consumption, and/or between domestic spending and net trade—might be of concern to the government, and individual spending components can be affected by interest rates directly or indirectly. But the MPC could not be expected, for example, to hold interest rates down in an attempt to specifically underpin investment and/or (via a possible currency effect) net exports, unless consistent with the inflation target. Complementary government policy—such as greater public spending restraint—is a pre-requisite for this.

The MPC as a Body

51. We see no strong case to alter the size and composition of the Committee, nor to change the member terms. We do however see scope for the appointment process to be improved.

The appointment process

52. Although we have no argument with the choice of members to date, we believe there is a sound “in principle” case for making the present appointment process more open and transparent. In addition, it would be appropriate to remove the choice of member from the Chancellor-of-the-day alone. A representative expert body, quite possibly the Treasury Select Committee, should have a strong input into the decision process, or failing that at least the power to veto the Chancellor’s choice.

53. In addition steps should be taken to ensure that the membership gaps seen in the course of 2006 are not repeated. The idea of a pre-set list of “approved reserves” looks attractive.

The Mechanics of Setting and Implementing Monetary Policy

54. With regard to the mechanics of setting and implementing policy, we view the arrangements and performance to be, in general, robust and appropriate. We therefore focus on only two of the questions raised by the committee under this heading: education of the public and regional economic conditions.

Educating the public

55. With the recent edging up of inflation and inflation expectations, and heightened comment in the public arena about CPI inflation under-recording the “true” rate of increase in the “cost of living”, we believe that either the government or Bank of England, or both, should seek to educate the public about three issues:

— the relationship between the various official measures of inflation and the “cost of living”, both for the average household and for specific groups;

— why the target measure given to the MPC excludes certain elements—house prices, some taxes and interest payments—which also contribute to the cost of living of many households;

— why significant “wage push”, on the back of recent increases in living costs, would almost certainly need to be countered with further base rate rises—and why that policy, rather than one of “accommodation”, would prove to be better for the vast majority of the population in the medium term.
56. We are satisfied that MPC members and Bank of England agents actively track regional economic conditions. This includes through a wide network of business contacts, with for example regular attendance by agents at CBI Regional Council meetings—for discussions on the local state of trade—amongst many other things. These findings are fed back to the MPC, and we believe they are adequately taken into account in reaching interest rate decisions.

57. However, we would stress that there is little that the MPC could be expected to do where the fortunes of just one or two regions are out of step with the wider economy. There is little choice but to set interest rates to suit economy-wide average conditions, and if the government were concerned about regional imbalances, then the government would need to consider whether other policy instruments could be brought to bear. The fiscal-monetary policy mix and any knock-on for sterling might be relevant here, along with the regional impact of individual tax, spending and regulatory policies.

January 2007

Memorandum submitted by Professor Anton Muscatelli, Heriot-Watt University

INTRODUCTION

1. In what follows I will focus my comments mainly on areas 2–4 of the Committee’s Inquiry, ie: “The Monetary Policy Framework”; “The MPC as a body”; and “The mechanics of setting and implementing monetary policy.” I have already commented on some issues in relation to area 1, “The economic context” in recent written and oral evidence to the Committee.

THE MONETARY POLICY CONTEXT

2. There are two issues in the choice of price index as the basis of an inflation target. The first is the breadth of the index. At times where the broader RPI (and RPIX) index and the narrower CPI inflation deviate markedly (such as the period 1996–98 and 2002–04) questions arise whether the Bank is targeting a measure of inflation which really matters to consumers (which is important from the Bank’s perspective of building and retaining credibility with wage-setters). On the other hand, the comparability of the CPI across European countries offers some advantages. My view of this issue is that it is a secondary one: the differential between the CPI and RPI-based definitions of inflation does tend to vary over time, with periods of divergence and convergence. There is a clear advantage in terms of maintaining the credibility of the monetary policy framework in sticking with a given definition. I therefore see no compelling reason to switch from CPI, particularly if, as seems likely, this index might change in future to incorporate housing costs in a harmonised way across the European economies.

3. The second issue is more interesting, and relates to whether a central bank should actually focus on domestic output price inflation rather than (or in addition to) consumer prices, on the grounds that the latter contains potential feedback effects to consumer prices via the exchange rate. In contrast, the central bank has greater control over domestic output price inflation. This has recently been the subject of academic debate. Although this is an interesting issue for a central bank, the problem can probably be mitigated through having a band around the central target: in my view a 1% band around a consumer price inflation target is probably sufficient to allow the Bank some leeway if monetary policy is having undesirable effects on consumer prices through the exchange rate channel.

4. At present the inflation target is the primary target of monetary policy. Having a single (or lexicographic) target in price stability is an appropriate design for the monetary policy framework. This should not be changed. In practice the Bank has discretion in the time horizon over which it achieves this objective of price stability. In such a framework, it is possible for the Bank to aim for price stability over a horizon of several quarters (possibly as far out as eight quarters in the future) whilst taking account of the impact of its policy on output and employment. For instance, if at any future stage the UK were to suffer a major and very large external price shock, it would be entirely feasible for the Bank to engineer a gradual reduction in inflation which took account of the adverse impact of interest rates on output, whilst exerting some control on inflation expectations through its inflation and output forecast. The “open letter” mechanism is a useful device in these circumstances. Conversely, if the Bank were to be given twin objectives (say price stability and output stabilisation), this would create considerable uncertainty in the absence of precise information on the relative weights which should be assigned to each objective.


5. What sanction would be appropriate if inflation falls outwith the target band? The mechanism of the open letter is potentially effective, as it in effect asks the Bank to explain its policy stance publicly, thus adding further to the private sector’s information set. This could assist the Bank in bringing inflation back under control through its impact on inflation expectations. It seems difficult to think of how one might design more serious sanctions without impairing the public’s confidence in the monetary policy framework, the MPC and the Bank, or indeed by creating more, not less, uncertainty within financial markets.

THE MPC AS A BODY

6. At the time when the MPC was designed, some commentators noted that the balance of internal and external members might have made it difficult for external members to exert a decisive influence on the Committee’s decisions. The evidence from the last 10 years shows the contrary, and indeed demonstrates that these two groups do not vote as “blocks”, and demonstrates the substantive independence of individual MPC members during votes.

7. This does not of course mean that ex post one might not detect patterns in voting behaviour, or indeed that monetary policy will have been totally symmetric over the last 10 years. Indeed, in some empirical work on this issue we have shown that there is some evidence of policy being overly restrictive, with the Bank apparently putting greater weight on inflation control than one might have expected with a symmetric target. One important caveat of this work, however, is that it is conducted on current data rather than real-time historical time series. It is therefore difficult to suggest unequivocally that this asymmetric behaviour is explained by the MPC being overly cautious. It may also be interpreted as a temporary phenomenon, as the MPC was building up its reputation in its early years.

8. I would also hesitate in markedly changing the mechanism for appointments to the MPC. Making them subject to confirmation by Parliament, say through the Treasury Select Committee, runs the risk of politicising the MPC through US-style confirmation hearings. This in turn might have an adverse effect on financial markets as they react to this level of public scrutiny of candidates. In contrast, the current system allows a certain degree of public scrutiny on the competency of the appointees without exerting undue political influence on the process. The purpose of giving the Bank independence was to remove monetary policy from the influence of partisan politics. This is generally seen as something which has had beneficial effects on the UK economy and should be preserved. The existing process seems to have worked well, and there has been general approval for the high quality of appointments to the MPC in terms of competency, and in terms of the breadth of experience of the individuals appointed.

9. At a recent evidence session with the Committee I was asked whether one should look for particular skills in appointing external members. My view, which I still hold, is that given the level of technical support provided to external members by the Bank, it is entirely reasonable that the external MPC block should represent a varied skills set, ranging from highly technical academic economists to economics experts from other walks of life with a good knowledge of economic data and economic linkages. There is no robust empirical evidence suggesting that members from different backgrounds behave differently in their voting patterns on the MPC.

10. Where the process could be improved is by ensuring a speedier nomination process. The events of 2006 suggest that more should be done in advance to allow for all possible circumstances which require a new appointment to be made quickly. It is not impossible to imagine a situation where potential new candidates are considered by the Treasury well in advance of any expected vacancies to take account of such eventualities.

11. Similarly, it may be best to normalise the rules for reappointment. Reappointment to a second term can be useful as an exceptional device in providing some continuity in particular circumstances, but should probably be avoided in general as part of the normal pattern of external MPC appointments.

THE MECHANICS OF SETTING AND IMPLEMENTING MONETARY POLICY

12. This is potentially a huge area of discussion. I will confine my comments to two issues.

13. One interesting issue is whether the Bank should publish its forecasts of its future policy rates as well as inflation. Some central banks have moved in this direction (eg the Reserve Bank of New Zealand and the Norges Bank). They regularly publish their forecasts for the path of future interest rates, explaining that these are the forecasts they input into the policy simulations used to produce the inflation forecast. This approach has had the support of some academic economists, who argue that this provides the best information for markets and the private sector.


14. I am more cautious on following this practice. First, it introduces major complications to voting, as the MPC would need to vote not only on the current policy stance, but also on the path of future interest rates. Therefore what is a sound theoretical recommendation in the case where policy is determined by a single person does not work well within a Committee framework. (At the Reserve Bank of New Zealand decisions on the policy rate are made solely by the Governor.)

15. Second, it potentially ties the Bank into the wrong policy rates path. If after having announced a path for future interest rates the MPC collectively decided that a slightly different course of action was required, it would need to weigh the impact this change in the trajectory for rates might have on market and public expectations; and it may be difficult for the public to distinguish between changes in announced policy which are genuinely due to evolving economic circumstances (ie new available information about the state of the economy) and attempts by the central bank to renege on its earlier policy stance. The result might be to damage the credibility of the monetary policy framework.

16. Third, it removes the one (very small) element of discretion which the central bank has in circumstances where the economic environment changes and it is able to vary the policy stance without facing major adverse changes in inflation expectations. My view of central bank independence is that it was designed to anchor medium-term inflationary expectations by encouraging sufficient transparency in central bank processes and communications. It was not designed to put the central bank (in our case the MPC) and its detailed decision processes in a goldfish bowl, with the potential cost of damaging the public’s confidence in the framework. I am therefore in favour of the current approach followed by the Bank in its Inflation Report. (In any case, in the current relatively benign macroeconomic conditions, conditioning the inflation forecasts on the market forecasts of policy rates rather than the Committee’s view on future rates may not produce major differences.)

17. The final issue which I would raise is that it would benefit transparency if the minutes following the MPC’s decision were to address more squarely the differences in views between Committee members in cases where there was no unanimity on the interest rate decision. There is an attempt at present to give a flavour of why differences emerge, but this is limited to particular aspects of the evidence when in practice it is not always the case that different views have hinged on one element of the data.

January 2007

Memorandum submitted by the Bank of Ireland Global Markets UK

I am a member of both the Society of Business Economists and Association of Corporate Treasurers and have extensive treasury management experience in respect of the impact of interest rate movements on the personal finance and corporate sectors of the economy. I have contributed to a number of seminars on the subject of UK economic management including Parliamentary seminars relating to the Miles Mortgage Market Review and the Barker Housing Market Review.

TREASURY SELECT COMMITTEE SUBMISSION SUMMARY
The Monetary Policy Committee plays an important role in UK economic management. UK target inflation has remained within range since 1997. This has made a major contribution to the stability of the UK economy.

Both fiscal and monetary policy must be compatible to achieve low inflation sustained growth. Adherence to public sector borrowing goals has played a significant role in control of inflation and hence economic stability. Inflation targets must be credible from a public perspective. The significant gap between headline RPI and CPI indicates that there is a case for returning to the previous RPIX target.

Inflationary pressures are likely to be greater in the coming years given the strength of the global economy and growing demand for consumer goods from developing nations. This factor will necessitate a major improvement in UK productivity during the next few years, if the average base rate is remain at the level of the current interest rate cycle.

The MPC has a good track record. The one area of concern is the need for more transparency in monetary policy decision making, given that the timing of the two recent base rate moves were not in line with public expectations. There is strong case for moving to a US system of adding a rider to decisions eg bias towards monetary tightening or monetary easing.

In conclusion, the MPC mechanism has proved to be a robust and effective tool of economic management. Whilst there is a case for reform in respect of transparency there is no apparent reason for a major overall of the current monetary policy framework.
1. The Monetary Policy Committee plays an important role in UK economic management. The success of the MPC in keeping inflationary pressures under control is clearly apparent whether judged by the initial RRIX or the current CPI measure of inflation.

<table>
<thead>
<tr>
<th>Target index</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Average</th>
<th>Target Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 1997–December 2003</td>
<td>RPIX</td>
<td>1.5</td>
<td>3.2</td>
<td>2.4</td>
</tr>
<tr>
<td>January 2004–December 2006</td>
<td>CPI</td>
<td>1.1</td>
<td>3.0</td>
<td>1.9</td>
</tr>
</tbody>
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Source: Office of National Statistics.

2. The Monetary Policy Minutes provide evidence of the diligence of the MPC in respect of the wide range of factors that impact on UK inflation, including the increasingly important role of the international economy. In addition, the Bank of England conducts quarterly briefings with business and public sector representatives through the Bank’s network of regional agents, which my colleagues and I attend. Our perception is that these briefings provide the Bank of England with valuable feedback in respect of both individual sectors of the economy and regional variations in growth and inflation prospects. It is important that Bank of England contact with business and public sector representatives be maintained at both a regional and a national level. The impact of a base rate move varies significantly between different sectors and regions of the economy. The MPC is also known to attach weight to key business survey information. It is very important that economic statistics are supplemented by business and public service expectations in respect of future trends in inflationary pressures.

3. The very recent upturn in inflation largely reflects the sharp rise in commodity prices in first half 2006 and the current strength of retail sales. The increase does, however emphasise the need for all public departments to play a full role in maintaining the inflation target. The significant increase in university tuition fees and the recent increase in excise duty are factors in the recent rise in CPI to the top of the target range.

4. The adoption of credible fiscal policy has played a significant role in controlling inflation. Compatibility of fiscal and monetary policy is an essential element in sound economic management. Over the past ten years, the fiscal and monetary stances have been broadly compatible. Whilst fiscal policy is a less flexible tool of inflation control, sound fiscal policy provides the framework in which an effective monetary policy can operate. There is a case for fiscal parameters being placed under the control of a government agency in order to ensure complete credibility.

5. Inflation control has made a major contribution to the stability of the economy. Since the establishment of the MPC, the UK GDP has moved in a narrower range and withstood the 2001–02 global downturn without a single quarter of negative growth.

6. We are strongly supportive of inflation targeting. The one concern is the divergence between target inflation (CPI) and headline inflation. It is essential that any inflation target remains credible. We fully acknowledge the economic rationale behind the adoption of CPI. Nevertheless, the target measure of inflation must be credible from a public perspective as well as from the viewpoint of monetary economic theory. We believe that the target measure from fiscal 2007–08 onwards be RPIX, in order to maintain public credibility. The previous RPIX target range of 2.5% to 3.5% remains appropriate.
7. There are significant inflation risks, including the growth of advanced developing country demand which has already been translated into higher commodity prices and which in due course will translate into higher retail prices. At present, this factor is being negated by the growth of global competition via the internet. There is a finite limit to the impact of global competition as evidenced by the recent increase in retail prices. This factor will necessitate a major improvement in UK productivity during the next few years, if the average base rate is remain at the level of the current interest rate cycle.

8. The MPC has a good track record. With hindsight, there may have been occasional policy errors, but our perception is that UK monetary policy management has been sound. The one area of concern is the need for more transparency. It is surprising that the MPC has in recent months moved twice from a 9-0 unchanged rate vote to a base rate move in the following month. The UK economy, the fifth largest of the world, does not move that rapidly in one month, bearing in mind that the MPC, in theory, should comprise a diversity of macrocomic viewpoints. There is strong case for moving to a US system of adding a rider to decisions eg bias towards monetary tightening or monetary easing. Unexpected moves in base rates can have a significant impact on foreign exchange markets and business and personnel sector financial planning. We believe that the MPC underestimates the importance of a 0.25% unexpected rate move on the economy given the high gearing of the personal sector and the impact on unexpected moves on business perception of further monetary tightening.

9. Overall, the MPC has proved effective over the past 10 years. The calibre of both internal and external members has been high. The current 5-4 split between internal and external members has worked effectively to date. The strong possibility that CPI may breach the 3% maximum target in the coming months does raise a few questions as the reliability of UK statistics and the Bank of England forecasting model. For example, it appears that the impact of higher tuition fees on CPI could not be quantified ahead of their impact on target inflation. The impact of net migration on labour supply has been extensively researched, but the impact of net migration on consumer demand does not appear to have been fully factored into MPC decision making. There is also a challenge, well outside the MPC remit, in respect of UK natural gas supply. World natural gas prices are on a falling trend but this has yet to be reflected in the UK energy cost element in the CPI.

10. Bank of Ireland Global Markets believe that the current monetary policy framework has proved to be a robust and effective tool of economic management. We would welcome reforms in respect of transparency and statistical input, but see no fundamental reason for a major overall of the current monetary policy framework.

January 2007

Memorandum submitted by Professor Sheila Dow, University of Stirling

THE MECHANICS OF SETTING AND IMPLEMENTING MONETARY POLICY: REGIONAL CONSIDERATIONS

— If the MPC’s considerations reflect the different economic conditions faced by different regions in the UK, this is not generally made apparent. The emphasis if anything, like that of HMT, has tended to be on the benefits for regions of a stable macro environment for supply-side conditions, rather than on how the regional composition of the macro environment impacts on macro policy. The supply-side approach to regional economies reflects the view that regional disparities are primarily due to regional productivity differences, for which only supply-side cures are appropriate. However, if aggregate demand has a regional character (ie there are regional patterns in components of aggregate demand, to which regional multiplier effects apply), then regional considerations are important for understanding UK macroeconomic conditions and the impact of monetary policy, for the UK as a whole as well as for the regions. Since much of the MPC analysis of inflation implies that they view it as a demand-pull phenomenon, it would be appropriate to pay much more attention to the regional composition of the macroeconomy.

— In particular, monetary policy is more efficient the less regional disparities there are in inflation conditions. If economic conditions are reasonably homogeneous across regions, then there is less need for tight monetary policy to address over-heating in only part of the national economy, for example. Preliminary analysis suggests that there are indeed differences in regional Phillips curve relationships in the UK (see Dow and Montagnoli, 2007). But pursuing such analysis further is hampered by data limitations, particularly in that availability of regional price data is no longer on the horizon. It is difficult to conduct regional macroeconomic analysis without information on regional prices, or up-to-date information on regional output.

— There is a more general issue of price indices, where the regional dimension is relevant. If part of the transmission mechanism of monetary policy involves influencing inflation expectations in such a way as to curb wage demands, the different behaviour of different prices indices is material. The expectation had been raised that the difference between CPI and RPIX was relatively stable (such
that 2% growth in CPI was roughly equivalent to 2.5% growth in RPIX), which has not proved to be the case; and in any case wage settlements tend to be based on RPI. The credibility of monetary policy may well be damaged if there is a growing disparity between actual experience of inflation and the headline CPI figure. But, if regional inflation experience is systematically different, even in terms of RPI, then the credibility problem would be compounded.

Where regional disparities exist, one possibility is that a single monetary policy may generally serve to increase them, conflicting with government priorities (and also making monetary policy less efficient, if the argument above is accepted). Some studies of recent UK experience have in fact shown the greatest (short-run) impact of monetary policy on regions with greatest exposure to household debt, particularly mortgage debt. Since these regions have higher average incomes, monetary policy might seem to reduce regional disparities. But, in the past, the long-term experience of varying interest rates (and associated changes in asset prices and aggregate demand) in regions with lower average incomes and wealth (and thus greater financial vulnerability) encouraged more conservative financial habits which have a more persistently damaging effect on economic growth, thus exacerbating disparities over the longer term.

Household financial habits have of course been changing, calling for more disaggregated analysis of behaviour of both borrowers and lenders in order to form a continually-updated view on how monetary policy may affect regional disparities. It is not just a matter, for example, of how household spending is affected by changing interest payments, but also how readily financial institutions make credit available (in light of shifting perceptions of risk), and how they price it, across regions. There has been an increasing focus in Bank research publications and in the Financial Stability Report on disaggregated analysis of financial behaviour, which is most welcome. Particularly when there is a risk of a significant turnaround in asset prices, it is not averages but margins which count, and analysis of margins requires disaggregated analysis. To the extent that regional economies have particular characters, to which different behaviour patterns and sets of expectations are attached, then a regional disaggregation is also called for, insofar as data allow.

There is a limit to how far the MPC can itself ameliorate regional disparities, other than by moderating monetary policy by considering its disaggregated outcome. But this could in itself be significant. Further, were the MPC to conduct regional analysis for this purpose, this would raise the level of debate about the regional implications of monetary policy. It would also, of necessity, increase pressure for regional data availability to be improved. However the MPC already has a unique resource for identifying differential regional conditions, in the monthly economic reports of the Regional Agents, and in particular their scoring of various economic factors, which are currently only reported in aggregate form (Ellis and Pike, 2005). Further, MPC members routinely visit different regions, so that they have a first-hand regional knowledge base to draw on. So, even on the basis of current data, the MPC is very well-placed to consider the regional composition of the macroeconomy flow policy design, and to form a view, at a disaggregated level, of the impact of monetary policy. Bringing such regional data, and whatever analysis follows form them, into the public domain on a regular basis would increase the transparency of the policy-making process.

Central bank independence has brought a variety of well-known benefits. Much of the theoretical support for independence comes from the view that monetary conditions can be treated separately from real conditions, ie that inflation is a monetary phenomenon, which monetary policy can direct affect through a variety of channels. However monetary policy practice (and the analysis underpinning it) has highlighted the interdependence between monetary conditions on the one hand, and real conditions on the other (confirming doubts, in the Keynesian tradition, that inflation is in fact a monetary phenomenon). Here we have focused on the real economic conditions of regions, which can influence the outcome of monetary policy, but which are also influenced by monetary policy. Government’s regional policy is therefore relevant to monetary policy, both in the short run and in the longer run. As Charles Goodhart (1998) among others has explained, the money which underpins the functioning of the economy is a product of state support. Such support is provided not only by central bank overview of monetary conditions, but also through government policies which promote the reasonably homogeneous economic conditions across regions which are necessary for a single national currency to function effectively. (This argument is more commonly addressed to the sustainability of EMU than national currencies: in the absence of fiscal redistribution in Europe to offset the differential effects of monetary policy, EMU may not be sustainable.) However some indicators of regional economic performance suggest persistence, and even increase, in regional disparities in the UK, arguably worsening the conditions under which monetary policy must operate. Monetary policy in turn can affect real economic disparities between regions, and thus the effectiveness of monetary policy. An explicit regional analysis by the MPC which addressed these interdependencies would be the first step in opening up public debate on this issue.
References
January 2007

Memorandum submitted by the Labour Economic Policy Group

SUMMARY
The MPC was introduced to deal with inflation, the major economic preoccupation of preceding decades. The aim was greater interest rate stability and taking rate fixing out of the hands of unworthy politicians to give it to an Independent Central Bank advised by the MPC. Today inflation is less of a threat and problems of growth and competitiveness have come to the fore making this ten year view an appropriate moment to relax the single rubric and to add to it competitiveness and growth as co equal responsibilities.

The composition of the MPC, too dominated by financial interests, monetarists and the Bank, must be widened to include a broader range of interests and backed by advice structures independent of the Bank.

Regional Advisory Councils, representative of interests in each region, should report on the situation in their region and make recommendations to the main body.

We should establish three subordinate Councils, each with its own expert advisers, on inflation, competitiveness and growth to publish regular reports and advise the MPC to enable the MPC to make its decisions on the basis of a wider range of independent evidence.

Our overall intention should be to put its activities and decisions on an open, public, basis to ensure that everything is done after debate and discussion and to require the MPC to explore and justify its decisions.

PART ONE: THE PERFORMANCE OF THE MPC
We were not enthusiastic about Bank of England independence. The two main levers of economic management, interest rates and the exchange rate influenced by them, should be managed by government, accountable to Parliament, for the purposes of the people, not by an unaccountable Bank of England in the interest of Finance.

After 10 years in which Bank of England Independence has been so widely hailed by ministers and the financial community, we accept that the new structure is here to stay but it must be improved by changes made on the basis of the lessons of 10 years.

Inflation
The MPC is widely credited with reducing inflation. In fact Inflation has fallen and remained low in every advanced country. What stands out from the record is Britain’s failure either to deal with rampant house price inflation or to control credit expansion.

There was never any possibility of a return to the high inflation of earlier decades. The power of labour has been broken, businesses have lost the ability to control prices, markets have been freed up and become more competitive, immigration and tax credits hold down wages and enormous new production capacity has come on stream in low cost countries, such as China. All this combines to ease the threat of inflation everywhere. If anything the Bank has added to inflation by keeping interest rates, an added cost to everything, higher than they should and could be. Certainly the Bank has heightened inflationary expectations by constant exacerbation of fear, the Governor’s obsessive preoccupation with inflation and such follies as the new fear inducing website presented by Evan Davis, who should know better.

Interest Rates
Though lower than interest rates over the last two decades, British nominal rates have been higher, and at times double, those in Euroland, the USA or Japan. Our real rates have also been higher. Yet nowhere has there been any indication that higher interest rates produce greater success in restraining inflation. Nor has any explanation of the mechanism by which they do so been forthcoming. In Ireland higher inflation
came down at the same speed when Ireland entered the euro, despite the lower rates resulting from membership. High rates are not necessarily successful in dealing with asset inflation. Indeed they may produce a "buy now" mentality.

There has been no indication that higher rates check a house price inflation largely due to the fact that credit expansion fuels demand while supply, particularly in the south east, is totally inadequate. At the top end of the market big city bonuses and millionaire tax exiles boost prices irrespective of domestic interest rates. At the bottom the failure to build public rented housing produces desperation bids, while Government chucks petrol on the flames with key worker schemes and help to buyers. Similarly, inflationary pressures from rising fuel costs and oil prices can't be tackled by high interest rates and no allowance is made for the fact that energy prices are now falling. Finally what affect do high rates have on all the cost increases imposed by utilities and government? They could merely compound this.

Thus the main claim which can be made for interest rates is to deter wage bargainers, a resurrection of the exploded orthodoxy of the seventies and early eighties. It didn't work then. It won't now. In the real world the Bank is dealing with the future (and heightening alarm). Wage negotiators are catching up on the past. Effectively the Bank is trying to punish the workers and the poor for the follies of the City and its bonuses, the escalation of the more expensive house prices and the consequences of government policy on fees, local taxation and utility charges.

Nor is one club golfing with interest rates a sensible way of managing the new economy of high asset prices, massive borrowing and high levels of debt. High interest rates means management by punishment. The effects of this are very different today to the 1960s and 70s when manufacturing was strong, government had other regulators at its disposal and Finance, which escapes the consequences, was not as powerful.

Growth

Britain has enjoyed a long period of sustained growth but the rate is low compared to earlier post war periods at home, and to the American, the Australian and other economies abroad. The British economy had—still has—the opportunity to grow faster because of North Sea oil, the inflow of capital, the return of dividends and the easing of a balance of payments constraint which crippled the sixties. Instead of seizing that opportunity the economy has been under-run to maintain "stability" despite the fact that over the long term higher growth rates are a good way to check inflation. Growth breaks bottlenecks—nothing else can do that. Higher production boosts productivity. Greater productivity brings bigger economies of scale. Moreover, higher growth does not produce unmanageable inflation as bankers fear. Naturally they prefer low inflation to maintain stability because that serves their interests, but for the rest the last ten years are an opportunity thrown away. Instead the Bank has helped to instil a fear of growth. Every stirring sets alarm bells ringing.

Competitiveness

The pound has been substantially overvalued ever since the boost to competitiveness from the 1992 ERM devaluation faded away. The Bank has done nothing at all about this but has compounded it. The inevitable result has been that that manufacturing and employment in it have declined substantially. It is not now competitive to produce in this country. Off-shoring and transfers of production overseas have multiplied. As a result, the balance of the economy has been badly distorted, Finance has overwhelming power though it can neither pay our way in the world nor provide the jobs manufacturing did.

The consequence is a gaping balance of payments deficit as imports grow and exports fail. The trade balance has not deteriorated as much as it might have done because of City earnings and returned profits. Profits on British capital invested abroad have been greater than the profits of foreign capital invested in this country which is yet another testimony to the way we are failing to run our economy for growth and a return to investment. Such remitted profits and the earnings of the City and financial services reduce the payments gap, but also push up the pound and neither provides the jobs manufacturing and production did. To close the gap the pound will have to come down so we can produce and manufacture more and pay our way in the world. Instead the raising of interest rates, and particularly the recent rises, pushes the pound to ever higher and ever more unrealistic levels.

To sum up

A latter day Churchill would have fun writing “The Economic Consequences of the MPC”. They aren't as disastrous as Gold Standard but they have been beneficial to the City, the Banks, financial institutions and financial interests, but have damaged the long run strength of the economy, exports and the interests of production. As a result, in a decade when prospects for growth and low inflation were good, compared to previous periods of fixed rates, of balance of payments constraints and of ‘stop-go’, Bank of England independence has damped the economy and failed to seize the opportunity to grow and expand capacity. Instead it has created a climate in which glimmers of growth, rising consumer demand or house prices, or any other sign of improvement become causes for alarm. Good is bad. Growth is dangerous.
The British economy cannot be left to market forces and Finance. The national interest, growth and competitiveness are all important. Government takes too little account of them and the Bank of England can't. The theory on which Bank independence is based is that government controls the fiscal weapon, the Bank, the monetary. Clearly both should be managed in the light of a view about the needs of the whole economy. Yet government ignores its responsibilities and the Bank is concerned with only one thing: inflation. Who then attends to the interests of the people?

The MPC has interpreted its role very narrowly. It takes no regard to encouraging growth or boosting the competitiveness of the exchange rate. Yet this is the measure by which economies live or die, because the rate translates domestic production costs into prices on foreign markets. Our exchange rate gradually became substantially overvalued after the boost from the ERM devaluation of 1992. That overvaluation has got worse over the ten years of the MPC and the Bank has done nothing to counteract it. Clearly the rate is affected by other factors than interest rates, but they are the key because higher rates keep the exchange rate higher than it would otherwise be. Lower rates allow it to come down. It is hard to resist the conclusion that the Bank welcomes the high exchange rate to keep the costs of imports down and place pressure on British producers to cut their costs to stay competitive. The exchange rate cannot be treated as an unimportant residual and inflation is not now the major problem. Today's challenges are different. The main dynamics of growth over the last decade have been increasing public and consumer spending. Both are now plateauing. If the economy is not to stall it needs

(i) An acceleration of growth to boost tax revenues to provide the better public services the public want, and to which the government is pledged.

(ii) Competitiveness must be revived to boost production, and jobs and improve the balance of payments position.

(iii) Growth needs a new driver. A big housing and construction programme may be the only one to fit the bill.

Yet instead of paying attention to these problems the MPC, by its recent decisions, has put the economy on a downhill slide to the follies of the past.

What Needs to be Done

1. The single inflation objective must be relaxed and widened to include competitiveness and economic growth. The Fed has wider responsibilities and the US benefits. The ECB, the Reserve Bank of New Zealand and the MPC do not. Their economies suffer. It is unrealistic to concentrate the most powerful and flexible of the levers available for economic management on just one aspect while doing nothing about growth or competitiveness. So give the Bank a trio of objectives: inflation, competitiveness and growth. Then let it determine the balance between these three responsibilities, guided by broad performance targets on each so that it can make judgements in the light of the long term needs of the economy and necessary adjustments to immediate pressures, such as the threat to exports posed by a fall in the dollar, by changes in European markets, or by regional imbalances. It is likely that the dollar has further to fall, the euro further to rise in consequence. Our exchange and interest rates need to respond to maintain competitiveness and growth here. Allowing the pound to bob up and down in their wake is damaging, though less so than deliberately propping it up by high interest rates.

With this done the MPC could meet less frequently for longer and more open sessions which are better prepared and documented. Indeed it may need to do this the better to attend to the long term balance between its objectives rather than responding to immediate panics on house prices (which aren't part of CPI but still obsess the Bank). Monthly meetings can produce a preoccupation with short fever charts of consumer spending, house prices, wages, etc, producing speculation, and tiny shifts up and down, perhaps to indicate that the Bank is doing something without actually doing anything. Meetings every two months could be better prepared, take a longer view, give more serious consideration to the wider range of responsibilities and reduce the use of minor shifts in response to short term fluctuations.

2. The obsessive preoccupation with inflation has excluded real concern for any other aspect of economic performance. The Bank has never sought to explain the mechanics of how higher interest rates reduce inflation while increasing every cost in the economy. Its explanations for actions, such as increasing rates now so as not to have to increase them by more later, have more in common with astrology than economics. It has never bothered to analyse the effects of the interest rate changes it has made, to show how they work, or to prove its claims that the effects come through two years later. It can't, because of all the beasts locked up in the ceteris paribus pound. So it acts like a priesthood and neither explains nor justifies its actions in public. Instead it doles out small doses of the folk wisdom of bankers, largely unchanged, though more amiably put, since the 1920s. As for the old issue of the money supply, the Bank has been mystical and has neither analysed nor explained its importance. As a result, it has exuded confusion on asset and house prices. Are they a transmission mechanism or not? We need to know. The Bank clearly doesn't.
As a group we have made regular representations, as fruitful an exercise as throwing pebbles into Gaping Ghyll: no sound, no reaction, no response, no discussion. The Bank behaves like a Financial Pope speaking ex cathedra and brooking no discussion. It neither explains nor justifies its decisions.

The Bank can’t, of course, be held responsible for a widespread ignorance, higher in the City than among ordinary people, about the way the economy works, about the importance of competitiveness or the problems of inflation. Yet it should alleviate it and educate the nation. In fact, because the interests of Finance are so dominant in its counsels it has neglected any responsibility to develop a wider public understanding of how the economy works and what the consequences of policies are. Nor has it generated a wider public debate beyond providing endless opportunities for the self-interested speculations of teenage City scribblers to create the impression that growth is dangerous any economic vigour leads to disaster because the British economy, despite all the reforms of the 80s, just isn’t capable of doing better. The Bank has helped to create a climate of caution, fear and defeatism.

3. The Committee’s perspective is too narrowly financial, being dominated by bankers, monetary economists, and the Financial Interest and chaired by an inflation hawk. The interests of manufacturing, labour, exporters, consumers and debtors, all of whom suffer the consequences of interest rate increases, are silent. So are the voices of alternative schools of economics, such as Keynesian expansionists, labour economists or experts on competitiveness. If the MPC is to remain the only body responsible for economic management through the monetary instrument it must be made more representative, include people who know something about production and exporting, and be made less of a tool, and a voice, for a Financial interest which is more than powerful enough already. The Treasury Committee should have the power to recommend and reject appointments as well as to hold them to account.

4. The inflation target is too tight. It should be widened. Observance should be more relaxed. The Bank is always prompt to increase interest rates whenever inflation rises slightly but is never disposed to reduce them when it under-runs. It should be required to explain “why” on both occasions and analyse the subsequent effects.

5. Each area of the wider rubric should have its own Advisory Council of experts and interests issuing regular republished reports and reviews to advise the MPC and the wider public.

6. The MPC is a London dominated body of London experts preoccupied with London pressures and house prices. Yet its decisions affect all parts of the country in far away regions of which they know next to nothing, and whose views and needs, if they hear them at all, are filtered through the Bank. Regional advisory committees meeting and reporting the needs, problems and prospects of their regions via published representations to the main committee can focus it on the needs of the wider community and, at the very least, ensure that regions have a voice and are heard.

7. Soon after the MPC was established, as MP for Grimsby, I invited the Governor and its members to Grimsby to see the problems of the real world. The invitation was declined but, to her great credit, De Anne Julius came. She was impressed and influenced by what local businesses told her. Sadly, her example hasn’t been followed. Nor has there been any proposal to meet outside London out of the shadow of the Bank.

8. New structures should be backed at all levels by independent and expert advisers for each council and committee. This would emancipate it from the present heavy dependence on the Bank, its statistics and staff, all of whom are part of the interest of Finance and the banks, not the wider interests of the economy. Conflicting streams of advice will produce better decisions and a wider debate to put the issues before the community in a way the secretive MPC can’t. It doesn’t discuss, it distils the so-called wisdom of the bankers in pawky doses without ever explaining, testing or justifying the basic banker concepts on which it seems to work, such as that there is a NIARU, a level below which unemployment can’t fall, some rate at which growth means higher inflation, a “natural” level of interest rates or a capacity ceiling on the economy. All are opinions, not provable facts and neither true nor verifiable. Yet the Bank seems to accept it all as unwritten law.

CONCLUSION

Finance is far too strong in this economy so it was a mistake to enthrone it. The MPC acts as its agent and is dominated by the interests of Finance, monetary experts (and monetarists) and by the Bank. It should be made more widely representative and required to cover a wider range of interests and opinion otherwise the system is seen as government of the financial interests, by the financial interests, for the financial interests. A high and stable exchange rate and dear money, the traditional objectives of the financial community, become its weapons, creating a climate of low expectations, a view that Britain is incapable of growing at anything but a pathetically low rate and an expectation that any buoyancy is a positive danger. They also undermine competing interests and build a very unbalanced economy.

It would be wrong to regard a system with outdated preoccupations set up ten years ago as so perfect that its performance can’t be improved. The ten year record should be questioned and this ten year review provides an opportunity to make the MPC’s processes more open and professional, to involve other interests and to respond to the new needs of a changing situation. On that basis we have proposed changes which
will improve the performance of the MPC, qualify it to deal with the bigger job now facing it and the country and redress the imbalances developed over its first ten years. We commend these changes to the Treasury Select Committee, to the Bank and to Government.

January 2007

Memorandum submitted by Marian Bell
Former “external” Member of the Monetary Policy Committee (1 June 2002 until 30 June 2005)

EXECUTIVE SUMMARY

The Economic Context

1. Inflation is ultimately a monetary phenomenon. The MPC’s success in meeting the inflation target reflects the policy of the MPC. It is likely that the MPC has also contributed to the achievement of the government’s other economic policy objectives, but real economic developments will have played a major role. Monetary policy can best contribute to other economic policy objectives by providing monetary stability.

2. The MPC has set policy in the face of major structural change and shocks, significant both in number and magnitude. The changes and shocks in the next decade will be different but, through appropriate policy, the MPC should be able to achieve the inflation target set for it. It may however be less popular.

3. To achieve the inflation target the MPC must pay attention to a wide range of information, but it can only be concerned with the performance of particular regions, sectors, groups or prices, including asset prices, in so far as they affect overall inflation. Monetary and nominal data are important sources of information.

The Monetary Policy Framework

4. A well-defined, symmetric point target, such as we have, aids the formulation and communication of monetary policy and helps keep inflation expectations anchored. The target is a legitimate subject of democratic choice and it is appropriate that it be set by an elected politician.

5. The letter writing procedure is a valuable part of the framework. Should inflation deviate significantly from target, an exchange of letters should be welcomed, providing a mechanism for communicating and discussing the choices in terms of output and employment of bringing inflation back.

The MPC as a Body

6. The current size of the MPC is appropriate. It should be no larger. The balance between internal and external members is appropriate and should not be moved in favour of internal members.

7. The terms of appointment for the four external members should be four years. There should be no re-appointment at the end of the term.

8. The Treasury Select Committee can best fulfil its role of holding MPC Members accountable if it takes no part in the appointment process.

9. The timing and procedure for appointing new members should be published.

The Mechanics of setting and implementing Monetary Policy

10. The Bank is well resourced to help the MPC meet its objectives. External members are adequately resourced. The models are “fit for purpose”.

11. There is a tension between communicating the overall policy stance and the views of individual members. It will be important to build understanding and support for monetary policy in the decade ahead.

12. The Treasury Select Committee could do more to draw out individual views and hold individual members to account in Inflation Report hearings.
THE ECONOMIC CONTEXT

1. In 1997 the newly established Monetary Policy Committee was charged with the narrow but important job of meeting a target for inflation as laid down by the Chancellor and, subject to that, of supporting the Government’s economic objectives, including those for growth and employment. It has succeeded. Inflation has not deviated far from target; the economy has grown steadily; growth, like inflation, has been unusually stable; unemployment has fallen and employment risen significantly.

2. When the Monetary Policy Committee was established, the UK had operated an inflation targeting regime for four years and the MPC inherited low and stable inflation, though the inflation risk premium in financial markets fell at its inception suggesting that the new procedures were more credible than the old. But it was not inevitable that the inflation target continued to be met. Inflation is ultimately a monetary phenomenon and the inflation record of the last decade is attributable to monetary policy. Not all other countries have had the same favourable experience.

3. It is sometimes argued that the MPC has been operating in very favourable circumstances over the last ten years and that it has been plain sailing. But that is to forget that there have been significant structural changes in the UK and world economies over the period, the pace and scale of which were largely unforeseen in 1997. There has been a large, structural fall in the natural rate of unemployment, an appreciation of the exchange rate, a pick up in the pace of globalisation with rapid growth in world trade and the emergence of the Chinese and Indian economies, increased use of the internet, pan-European migration, and a new single European currency. There have also been plenty of shocks. For example: the Asian financial crisis of 1997 and the crisis in the world’s capital markets in 1998; a rise in the real effective exchange rate; the problems in the ICT sector, the fall in equity markets and synchronised global slowdown of 2001–02 rapid house price inflation and a tripling of the oil price.

4. In practice over the last decade, monetary policy has entailed keeping nominal demand in the economy growing steadily in line with growth in potential supply and inflation at target. The operation of monetary policy has thus also contributed to macroeconomic stability. Moreover, a stable, low inflation macroeconomic environment with predictable monetary policy provides a stable and predictable backdrop against which economic agents, such as consumers and firms, can make decisions and is likely also to contribute to economic efficiency. However other favourable developments are a reflection of the economic context and are not solely, or even primarily, the result of monetary policy. For instance, while monetary policy might have assisted by contributing to growth and macroeconomic stability, the fall in the natural rate of unemployment over the last decade is likely to have been predominantly the result of real, rather than monetary, factors.

5. There will undoubtedly be other shocks and structural changes in the decade ahead, many of them currently unforeseen. There is no reason why this should prevent the MPC meeting its inflation target, but one can envisage circumstances in which the macroeconomic environment is less comfortable and the MPC becomes less popular in so doing. This might occur if, for instance, keeping inflation at target were accompanied by rising unemployment for structural reasons, if the burden of high levels of indebtedness depressed consumers’ ability to spend, if there were a sharp fall in asset prices, or if a deterioration in the terms of trade made consumers less well off. The MPC might find that in order to achieve its prime objective of meeting the inflation target, its support for the government’s other economic policy objectives, including those for growth and employment, is questioned.

6. The role of monetary policy is limited to the narrow one of achieving stability in the overall price level. Just as the MPC should not take the credit for many aspects of the favourable economic performance of the last 10 years, nor should it be blamed for things outside the purview of monetary policy.

7. The MPC cannot control any particular price at the same time as meeting a target for overall inflation. The MPC should only consider movements in asset prices and house prices, or indeed any other price, in so far as they affect the prospects for overall inflation. Although the build up of a bubble in an asset price might argue for tighter policy to reduce the likelihood of an adverse shock to demand from an eventual bursting of the bubble, our knowledge of the likely scale and timing of such eventualities makes it near impossible to set monetary policy appropriately without risking missing the target in the interim. Policy can be adjusted after the bubble bursts. Moreover it is likely that large moves in interest rates would be required by any attempt to control asset prices, leading to excessive volatility in output, employment and inflation.

8. Money supply, credit and liquidity data are important indicators that can contain valuable information about the economy. Over the long run there is a close relationship between money growth and inflation. But there are no automatic relationships in the short to medium term and the data have to be viewed in context. The Bank has a specialist unit that monitors and seeks to understand such data. But in practice, the MPC’s attention to monetary data has been variable with opinion over their importance divided. In my experience many MPC members paid little attention to monetary or nominal value indicators, preferring to concentrate on separate real and price information. The relationship between money and other indicators and the MPC’s detailed focus on the whole panoply of other data has meant that, so far at least, it has been able to pick up emerging developments in inflation over the relevant time horizon from other sources. The MPC frequently uses a wide range of data to cross check and corroborate the picture of the economy painted by other data. Information will be lost if monetary data are not also used in this way.
THE MONETARY POLICY FRAMEWORK

9. A single monetary area such as the United Kingdom should have a single monetary target. It is not possible for national monetary policy to have objectives for any particular region, sector, interest group, or price.

10. It is appropriate that the MPC be set a single, well defined, quantified target for inflation. A clearly defined target is beneficial in setting policy, for transparency and in holding the MPC accountable. A well-defined, symmetric point target, aids the formulation and communication of monetary policy and helps keep inflation expectations anchored. I support a low, positive, symmetric inflation target such as we have with the current CPI inflation target.

11. It is appropriate that this target should be set by the democratically elected government. The choice and level of the target is a legitimate subject for democratic debate, perhaps to a greater extent than we have seen. I could, for instance, envisage a change in the level of the target being a manifesto commitment of a political party.

12. Given the broad parity of the targets set, the move from RPI to CPI had little implication for monetary policy, but it was unclear how the Committee should react to the warning that the target was likely to be changed ahead of the event.

13. The MPC has had regard for the economic policy of the Government in so far as it affects inflation. Other economic policy objectives are subsidiary and cannot be taken into account if to do so would jeopardise meeting the target. One instrument (monetary policy) can only be directed at one target. However other government objectives can be taken into account by the MPC in determining the pace of returning inflation to target, and the associated costs in terms of the level and variability of output and employment, when inflation diverges, or is expected to diverge, from target. The remit gives little guidance as to the relative importance the MPC should attach to output and inflation in such circumstances and in practice it has been up to individual members to reach their own judgements. Should inflation be appreciably away from target, however, the framework allows guidance to be given through the letter writing procedure.

14. The letter writing procedure should not be seen as a sanction but as part of the transparency of the process. It allows the Chancellor input into how quickly inflation should be brought back to target. The communication of policy may benefit from occasional letter writing.

15. It is important that monetary policy meetings and rate announcements are regular and timetabled. The Bank of England Act requires that meetings are held monthly. While meetings need to be fairly frequent to allow the policymakers to respond to developments, limiting the need for additional unscheduled meetings with surprise rate moves, it is not essential for the operation of monetary policy that meetings are held monthly. Although much data is released on a monthly schedule, it is usually not necessary, and can be foolish, to react to one month’s data which is often affected by noise and can be misleading.

THE MPC AS A BODY

16. The size of the MPC is appropriate at nine members. In my experience it was small enough to enable good discussion and large enough to reflect a breadth of views. An odd number reduces the likelihood that the Governor will be called upon to use his casting vote. A larger committee could stifle discussion and be unwieldy. Although a slightly smaller committee of seven members would probably also function well there would be a danger of insufficient diversity if the Committee were to fall below full strength and the balance between the number of internal and external members could become more crucial.

17. Although all members of the MPC vote as individuals and feel themselves to be individually accountable for meeting the inflation target, external, and new internal, members can offer a perspective from outside the Bank and may be more likely to question any prevailing or developing Bank orthodoxy. Having a sufficient number of external members on fixed terms allows the Committee to be regularly refreshed without any other consequences for the management of the Bank. The current balance between internal and external members is appropriate, but should not be moved in favour of internal members.

18. On balance, I favour non-renewable terms for external members. This would ensure a turnover of Committee membership, make it less likely that the external member became “tainted” with Bank orthodoxy reducing his or her willingness to challenge thinking, and prevent any member making less than objective judgements in an attempt to be reappointed. Although I witnessed no instance of political interference during my time on the Committee, non-renewable terms would help to protect against such interference in future. I would favour a regular turnover of external members with one being replaced each year. That would prevent undue instability in the membership of the Committee and an excess of new appointees if new terms for two or more members coincided with a change of internal members. With the current complement of four external members, this would mean staggered non-renewable four year terms.

19. Three years is the shortest acceptable period for the fixed term of appointment for MPC members. It can take up to around two years for an interest rate decision to have its maximum effect, so a Member who serves for three years can only be held fully responsible for his first year’s decisions.
20. Internal members are appointed to the Committee by virtue of the posts they hold at the Bank. It is appropriate that, in addition to the Governor, the Chief Economist serves on the MPC and that there are individuals from the markets and financial stability areas of the Bank because of the information and experience they can bring.

21. MPC appointments to date have been successful. There is little evidence that there has been any difficulty in attracting the right people. However, there has at times been some confusion over the process and timing of MPC appointments. A more transparent procedure and timetable would allay fears that the process is not undertaken with the seriousness it merits.

22. The Treasury Select Committee has an important role to play in holding the Monetary Policy Committee and its individual members to account for their policy decisions and achievement of the inflation target. (see paragraph 26 below). In my view it can best exercise this responsibility if it plays no role in the appointment of members.

THE MECHANICS OF SETTING AND IMPLEMENTING MONETARY POLICY

23. The Bank of England is extremely well resourced to carry out its monetary policy functions. Provided this resource is managed flexibly to be responsive to the needs of the MPC, the Bank has a sufficient number of very able economists with access to the best models and data. The staff of the Bank work closely with statisticians at the Office for National Statistics and elsewhere to gain access to the best quality data available needed to fulfill the MPC’s objectives. Nevertheless, there are occasions, many of them well publicised, when available data fall short of what might be desired.

24. Individual MPC members have a modest staff designated to them. External members, who have no other staff to draw on, need their own staff to help them with their own research, with the drafting of speeches and the preparation of presentations. External members are allocated two research staff each and a shared secretarial facility. This is adequate but not generous. External members also have full access to the support functions of the Bank in areas such as Information Technology, Human Resources and Media Relations.

25. There is a tension between communicating the overall policy stance and the views of individual members. Individual MPC members could appear more frequently in the media and be less reticent about giving comment on news programmes but this may not aid the communication of the overall stance. Observers have a responsibility too. They should take MPC comment at face value and not look for hidden messages. Nor should they assume that an individual Member is speaking on behalf of the MPC as a whole. Media interest is almost exclusively focused on the next move in interest rates and house prices and MPC comment can often be over interpreted in the search for an interest rate signal.

26. The Treasury Select Committee could be more robust in holding individual members to account for their decisions. I would have welcomed the opportunity to present my individual views in more detail and more frequently to the Committee. Some divergence of view is often alluded to in the Inflation Report but not explored in depth by the Select Committee. In my view Select Committee, where several MPC Members as well as the Governor are present, is the best forum for exploring individual views without jeopardising communication of the overall stance.

27. Beyond concern about the current conjuncture and the next move in interest rates, there is tremendous scope to better educate the public about wider monetary policy issues, and indeed financial issues in general. The Bank of England’s website is helpful on the role and importance of monetary policy, and the Bank does an excellent job through its Target Two Point Zero schools’ competition, run in conjunction with The Times newspaper. But more needs to be done to reach the wider public to build support and understanding for monetary policy. This could become a more pressing issue in the decade ahead.

January 2007

Memorandum submitted by Ray Barrell and Rebecca Riley,50 NIESR

THE ECONOMIC CONTEXT

Over the last 10 years NIESR has made regular (quarterly) commentaries on the work of the MPC, and has also forecast output growth and inflation on a regular basis. A comparison of our forecasts to those of the Bank of England (Barrell et al., 2005) suggests that our forecasts are no worse than those of the Bank of England, and perhaps for one year ahead we are marginally better at forecasting inflation. However, not great store can be set on the differences, and we should note that this has been a particularly easy period to forecast for the UK and the World.

50 These comments reflect our research, and are the authors views and not those of the Institute.
The fact that over the last decade output growth and inflation have been relatively straightforward to forecast, in comparison to earlier years, may be taken to provide some support for the assertion that monetary policy has been relatively unchallenged over this decade. The former is evidenced, for example, by the reduction in the magnitude of forecast errors made by NIESR with the shift to the low inflation regime and a more stable macroeconomic environment in the 1990s. Historical forecast errors can be used to gauge the uncertainty around macroeconomic predictions, and hence the difficulty in making accurate point forecasts. Examining density forecasts of inflation, Mitchell (2005) finds that the magnitude of inflation forecast errors made in the 1980s and early 1990s greatly exaggerate the uncertainty associated with current one-year ahead predictions of retail price (RPIX) inflation. Thus we may infer that inflation forecasting has become an easier task in the last decade or so. This is not to say that the conduct of monetary policy has necessarily been easy, but it may have been less demanding than it would have been in more volatile economic circumstances.

Several developments are likely to have contributed to the benign circumstances in which monetary policy has operated. First we note that the last decade has been a period of global economic stability, and business cycles have become much less severe. Inflation often results from periods where there is excess demand, and greater global stability has meant that these periods have become less common everywhere. Thus the experience of the UK economy in the last decade has to be seen against this background. Globalisation which has been associated with improved access to relatively cheap imports, has meant peaks of demand can be more easily met by increased imports, reducing domestic price pressures in booms. Perhaps related to this, the globalisation of the world economy has also helped to keep inflation in check over the whole of the business cycle. In the decade ahead we may reasonably expect to continue to have access to relatively cheap imports. Another important factor underlying the stable macroeconomic performance of the last decade is likely to be the significant reduction in structural unemployment observed over the last two decades, allowing for robust economic expansion without generating inflation and improving the economy’s resilience to macroeconomic shocks. It is difficult to envisage that further significant reductions in unemployment will provide the backdrop to non-inflationary growth in the future, since unemployment has fallen to historically low levels, although gains in labour market flexibility may continue to enhance the economy’s ability to respond to shocks.

Inflation expectations are likely to have been crucial in providing an anchor for inflation over the last decade and should continue to be. Expectations of inflation will be influenced by the credibility of the Bank of England, and as such the Bank of England is in a sense the creator of its own success. As described above, there are likely to be several reasons for the reduction in expectations of inflation on average over the last decade.

Should the Bank concern itself only with inflation?

The remit of the Bank is to hit an inflation target of currently 2.0% per annum and also to explain major deviations from that target. Inflation tends to deviate from target either because the pressure of demand is too high (or low) or because expectations of inflation have begun to drift away from target. The pressure of demand is too high (or low) because output can deviate from equilibrium, and hence anything that is a potential cause of an increase in or reduction of demand should be of concern to policy makers. Technical approaches to monetary policy making, such as that in Bean (1998) see the Bank as having a relatively clear objective of jointly minimising the deviation of output from its equilibrium and of inflation from its target. Hence any variable that might cause demand or inflation to deviate from target should be of concern to the Bank (Bean 1998). We may divide the ‘other factors’ into those that affect the level of demand and those that indicate potential risks of major infrequent events such as banking and currency crises.

There is strong evidence that house prices and other asset prices affect the level of demand, and hence they should be of concern to the Bank. Financial liberalisation in the major economies, including the UK, has been increasing the role of asset prices and wealth stocks in the determination of consumption (Barrell and Davis 2007). After financial liberalisation in the UK in the 1980s changes in housing and, to a lesser extent, financial wealth had noticeably more effects on consumption than they did beforehand. Hence the Bank should take account of house prices to the extent that they think they may be raising demand (or may raise demand in the future) in an unacceptable way. However, it would be hard for the Bank to use monetary policy alone to reduce house price increases. A one per cent rise in interest rates sustained for two years is unlikely to reduce the rate of growth of house prices by more than one per cent a year for a couple of years. It would therefore require a four percentage point rise in interest rates to reduce house price inflation from current rates of increase to around the level of target CPI inflation this year. The effects on the rest of the economy would be dramatic and unnecessary.

Between 2001 and 2006 the financial liabilities of the personal sector rose by around 70%, whilst financial assets grew by around 30%. Net financial wealth still increased, but the owners of assets and those liable for debts are not the same people, and hence the relative increase in indebtedness could pose a problem in the event of a crisis in the banking system. Such events are rare, but as Barrell, Davis and Pomerantz (2006) suggest, they have been becoming more common and more severe. They also show that the impacts of a banking crisis are heightened when households have large amounts of debt as compared to income. Hence
the risks to the economy rise when the debt to income ratio rises even if the probability of a banking crisis is unchanged. The build up of debt we have seen in the UK should be a worry to the Bank, and for holding interest rates higher than they would otherwise have been.

Monetary Policy and the Labour Market

The sustainable level of employment is an important determinant of capacity output and is determined by a combination of bargaining in the labour market and the behaviour of price setters in goods markets. An understanding of the relationship between unemployment or employment and inflation is particularly important at the moment where we see a strong expansion of the labour force arising in part from a combination of strong and unanticipated inward migration to the UK and increasing labour market participation amongst older workers. Strong growth in the labour force that is unanticipated may result in a temporary increase in unemployment, putting downward pressure on wages and inflation, as discussed in Riley and Weale (2006). To the extent that increases in labour supply are unanticipated, the appropriate capital stock may not be in place, such that the relationship between equilibrium unemployment and capacity output changes in the medium term. The skill mix and the type of occupations taken by migrants or older people joining the workforce is also likely to be important for the effect of the increase in labour supply on inflation, due to differences in wage flexibility across skill groups (Riley and Young, forthcoming).

Monetary Policy and Investment

Monetary policy has an important role to play in determining the level of investment, and it has an impact through two channels. One of these is through the level of the interest rate and the more important one is through its impact on perceptions of uncertainty about the future. The Bank sets short term interest rates and these have an impact on the cost of capital to the firm, and the demand for firms’ products in the near future. However, the link to the cost of capital is weak because this depends on the expected interest rate over the life time of a project, which is reflected in market long term interest rates. Long term rates are in many ways beyond the control of the Bank. If the monetary framework reduces the volatility of output, as it appears to have done, and decreases the volatility of the real exchange rate and of long term interest rates, then uncertainty about the future will be less. As a result risk premia applied to investment decision making. Hence a well designed monetary framework that reduces these volatilities is essential to the health of the economy and to the encouragement of investment. The evidence of the effects of uncertainty on the level of investment (Byrne and Davis 2005) suggests that the volatility of the real exchange rate and perhaps of the long term interest rate matter for investment. Investment has been relatively strong in the UK in the last three years, and this may reflect an increased confidence in continuing stability. However, low real interest rates and increased migration may have also played a role in boosting investment as well.

Co-ordinating Monetary and Fiscal Policy

The coordination of the stance of monetary and fiscal policy is problematic, especially in the UK at present. Public sector net borrowing has risen from around –2% of money GDP in 2000–01 to in excess of 3% of money GDP over the period 2003–04 to 2005–06. Some of the fiscal loosening over this period comes as a result of changes in the cyclical position of the economy. However, the majority of the increase in public sector borrowing over this period is structural. Since the generous public spending plans initially set out in Budget 2002 and detailed in the Comprehensive Spending Review 2002, we have repeatedly drawn attention to the need for a substantial fiscal consolidation to put the public finances back on a sustainable footing. We estimate that in 2009–10 discretionary tax changes implemented since 2002 will be worth approximately £20 billion, half of which is due to fiscal drag. Thus, the Government has with time gone some way in addressing the issue of fiscal imbalances. In addition, with the re-assessment of the cyclical position in Pre-Budget Report 2006, the Treasury seems to have recognised that the current budget deficits run this fiscal year and last are largely structural. The Treasury has revised down its estimate of the cyclically adjusted budget surplus this year by per cent of money GDP.

There is little doubt that the conduct of fiscal policy in recent years has meant that interest rates have needed to be higher than they would otherwise be, as discussed in Barrell and Riley (2004). The increase in public sector net borrowing between 2000–01 and 2005–06 has been associated with an increase in the share of government spending (total managed expenditure) in money GDP of 4% percentage points. Our work suggests that an increase in government spending of 1% of GDP that is expected to be permanent would mean that interest rates would, on average over the five years after the increase, be at least of a percentage point higher than otherwise. The Bank has to engineer this increase in interest rates in order to fulfil its remit to keep inflation on target, and it would have been remiss of it not to do so.

We expect the public finances to return to a sustainable position in the years ahead. However, it is important to stress that this improvement depends to a large extent on a slowdown in public sector spending from the very rapid growth observed in 2005–06 and a reduction in the share of government spending in the economy in the period to be covered by the next Spending Review. Thus, the expected medium term improvement in the public finances, by NIESR and the Treasury, depends on a tight spending regime, and it is difficult to envisage significantly stronger spending without commensurate increases in taxation, the
The Changing Transmission Mechanism

The transmission mechanism for monetary policy depends on the structure of the economy and how interest rates affect behaviour. When interest rates increase the cost of borrowing generally rises and the exchange rate normally reacts by “jumping” upwards. The impacts of a monetary policy are the sum of these two effects, or channels, plus any credit rationing effects we might expect from a tighter monetary stance. We concentrate on the first two as they are the channels we expect to dominate in a financially liberalised economy.

A rise in the exchange rate that follows from an increase in interest rates will help dampen activity and reduce inflation. It reduces inflation in the short run by reducing import prices as compared to where they would otherwise have been. It dampens activity by reducing exports and raising import penetration, and this effect will have been increasing over time as the economy has become more open. Between 1997 and the start of 2007 the share of imports plus exports in output has increased by 25%. Hence the effect of import prices on inflation and of net trade on output have increased, and therefore the exchange rate channel has increased in importance.

The effects of increased borrowing costs are made up of the impacts on consumption and investment. We are not at all clear how interest rates affect investment behaviour because the effects must come largely through expectations of future interest rates and of levels of activity. However, there is no clear evidence this part of the transmission mechanism has changed over the last decade or so. Consumption behaviour responds to interest rates, as well, and there is evidence (Barrell and Davis 2007) that the impacts will have been increasing over time. As financial liberalisation has proceeded consumers have become less liquidity constrained and are able to smooth their consumption more when incomes fluctuate. However, they will also become more responsive to the expected path of interest rates, and consumption behaviour has probably become more interest sensitive over the last 10 years.

It is widely thought that globalisation has changed the prospects for monetary policy, making it harder to operate. Increased trade with expanding countries such as China, and the resulting change in the terms of trade as import prices have risen less than they might. If this has not been allowed to be reflected in a lower exchange rate then it will have helped keep inflation down, but if the exchange rate absorbed all of the change then inflation would be unchanged. Globalisation of financial markets has meant that long term real interest rates across the world have tended to move more together than in the past. The Bank cannot control real long term rates, and it has not been able to do so since convertibility was re-introduced in the 1950s. The Bank can affect the expected inflation rate and therefore can influence the long term nominal interest rate, and globalised financial markets leave it free to do as it wishes as long as it is prepared to accept the exchange rate consequences. As these tend to help monetary policy, the Bank is not greatly constrained by globalisation effects.

Overall interest rates have probably become a more effective tool for managing the economy over the last decade as the structure has changed. Larger impacts from the exchange rate and more forward looking consumers should definitely help the Bank in its policy making. Financial liberalisation has been a factor behind the growth of house prices as well, and this may have made the Bank’s job harder.

The Organisation of Monetary Policy

The Bank of England has arrangements for setting interest rates that are perhaps a little unusual in an international context, and they are in part a reflection of the history of the policy regime as much as a question of optimal design. From 1993 interest rate setting in the UK was less political because a target for inflation was set and the Chancellor took advice from an advisory panel of external economists. When the Bank was given independence in 1997 it might have been difficult for the Treasury to abandon this independent advice. A Monetary Policy Committee with rotating external members and published minutes was set up in order to make decisions in relation to an inflation target set by Parliament. There are a number of countries that now inflation target with a Monetary Policy Committee, and as far as we are aware amongst members of the OECD only Australia, Norway, Hungary, Poland and South Korea have external members. Those who do not explicitly inflation target include the US and the Euro Area, and external non-expert members are not common amongst this group either. Amongst the same group only the UK, Norway and Israel have their inflation targets set solely by the government, although elsewhere it generally plays a
joint role. It also appears that (just) over half of the countries that target inflation have meetings every month, as do the Federal Reserve and the ECB. Almost all explicit inflation targeting central banks have now chosen the CPI as the reference index.

There is a strong case for supporting the present structure that requires the Bank to concern itself with inflation, and not to take into account explicit objectives set by the government, for instance in relation to employment or growth. An economy that is operating efficiently should be able to do so with inflation kept within bounds, and there is little monetary policy can do to raise employment and growth in a sustainable way. Given experience elsewhere, it is at least worth asking whether it might be of value to change the nature of the MPC toward a more expert structure and to take the choice of target out of the sole hands of the Chancellor. The shift to more expert members would probably mean shifting the balance of the MPC toward Bank staff. If we are to remain with such a large proportion of non-expert external members it would perhaps be wise for their to be more external scrutiny of the new members, and the Treasury Committee has always seemed the appropriate place for that to happen.


January 2007

Memorandum submitted by Dr. Sushil Wadhwani, CBE

Former member of the MPC

EXECUTIVE SUMMARY

1. The Economic Context

(a) The past decade has seen the MPC operating within a more benign environment than previously, and this has made it easier for the MPC. But the challenges it has faced—including significant rises in energy and other commodity prices—should not be underestimated. It is by no means clear that the environment will be any more difficult in future, for example, with global forces likely to be moderating service price growth, and commodity prices have been falling in recent months.

(b) The MPC has done a good job. The track record is impressive and the institutional framework is something we can be proud of. Having said that, in the spirit of continuing improvement, I have a number of suggestions where things could perhaps be changed for the better.

(c) The Bank should modify the way it operates within the existing inflation-targeting regime to explicitly “lean against the wind” with respect to asset price misalignments.

(d) Money measures have, in practice, too loose a connection with activity to be of much use in monetary policy.

(e) In the past the MPC has had a tendency to give insufficient weight to improvements in the supply side that reduced inflationary pressures. This has been recognised to some extent in historic analysis, but a danger remains that the MPC might again underestimate the prospective

51 I am greatly indebted to Roy Crumb for many insightful discussions on these issues. Of course, any errors are mine alone.
importance of favourable supply side developments in the future (eg globalisation). Some evidence for this may be that it appears that wage growth has, on average, continued to tend to be below the MPC’s forecasts in recent years.

2. The level, measure and symmetric nature of the target

The Bank of England Act emphasised the importance of the symmetry of the target. However, on several occasions over the past decade, an observer would be forgiven for wondering whether the MPC has actually behaved in a symmetric fashion. One recent example is oil—when oil prices were rising many members of the Committee were concerned about the risk of second round effects through wages, and upward pressure on firms’ costs. However, as of the December 2006 minutes, when oil prices had fallen by around 20% since their peak, there had been little sign of the Committee acknowledging that this risk had diminished.

3. The MPC as a body

I would change the composition of the MPC to consist of three “internal” and six “external” members, mostly professional economists, and all on non-renewable contracts, to help stimulate new ideas. Externals should, if they so wish, be allowed to be full-time.

THE MECHANICS OF SETTING AND IMPLEMENTING MONETARY POLICY

(a) The Bank is probably not sufficiently transparent, as seen by the extent to which rate decisions surprise the market. Not pre-committing on rates does not preclude more guidance being given, including explicit commentary on the market’s implied rates, outside Inflation Report Conferences. Press conferences or at least statements should be made after every decision, and greater and more accessible information given. Externals should play their part in Press Conferences. Also, the Bank sometimes appears to change its mind on the effect of key variables (for example, the oil price), without explaining the rationale clearly. This impedes transparency.

(b) The technical convention used to project the sterling effective exchange rate in the quarterly forecast round should be amended to assume a pure fixed nominal exchange rate, instead of the unsatisfactory fixed/UIP average assumption. The current assumption leads to bias in the forecast. Overall since 1997 the two-year ahead exchange rate has been, on average, 3% above the central projection. Other things equal, this had led the inflation forecast to be “too high”.

1. The Economic Context

1.1 “How will the economic context in the next decade compare with that in which the MPC has operated in its first decade, and how will this affect the work of the MPC?”

1.1.1 The past decade has undoubtedly seen the MPC operating within a more benign environment for the UK economy than in the previous few decades. External inflationary pressures have produced deflation in goods prices, as China and other developing countries have increased production and improved productivity. Worldwide monetary policy has been better focused, helping to bring down world inflation and keep it low. And within the UK structural improvements to the labour market have also helped to bring down the NAIRU.52

1.1.2 But the challenges that have been faced should not be underestimated. In particular in recent years there have been significant external sources of inflation. The rise in oil and other commodity prices have been quite enormous. The crude oil price went up by around sevenfold between the low in early 1999 and the peak in summer 2006, while the Goldman Sachs commodity price index more than trebled (Chart 1 overleaf).

52 In 2003 Mervyn King coined the phrase the “nice” decade to describe this (“So the UK experienced a non-inflationary consistently expansionary—or “nice”—decade; a decade in which growth was a little above trend, unemployment fell steadily, and, supported by the improved terms of trade, real take-home pay rose without adding to employers’ costs, thus allowing consumption to grow at above trend rates without putting upward pressure on inflation”) http://www.bankofengland.co.uk/publications/speeches/2003/speech204.pdf
For the next decade it is possible that the external developments that have helped keep inflation low will have run their course. I do not have a strong view on this. But, it is also possible that global forces will have a greater effect on services prices, for example, as the internet continues to increase competition, and outsourcing to countries such as India gathers pace. Oil and copper prices are considerably lower than their 2006 peak, though we don’t know whether this will prove to be transient. In the UK there remains scope for improvements in productivity and increased flexibility in many areas of the economy. Labour supply could be increased through migration or through measures designed to draw in those who have been out of the labour force for health reasons (see, for example, Layard et al (2006)). So it is by no means clear that the environment will be any more difficult overall than it has been.

“To what degree has the economic performance of monetary policy since May 1997 been a reflection of the economic context, rather than the institutional arrangements?”

1.2.1 It is easier to operate monetary policy when there are favourable supply shocks, such as falling import prices, and a declining NAIRU. Incomes can grow without putting pressure on inflation. Having said that the change in institutional arrangements appears to have had a meaningful impact on inflation expectations. Chart 2 shows that the financial market’s inflation expectations implied by the index-linked market fell, both at the time that operational independence was granted and as credibility has been built up.

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1.2.2 Once inflationary expectations have been anchored, this does make life easier for policy makers. An inflationary shock that once might have led to pass-through into wages—such as the rise in oil prices—no longer has the same impact and requires less action in terms of higher interest rates. Indeed, had I known that oil prices were set to go up sevenfold from early 1999 levels, I would have expected inflation to be above the top of the letter-writing range more frequently. It is a testament to the success of the new institutional framework in anchoring expectations that this has not occurred.

1.2.3 Overall the MPC had done a good job—there have been considerable challenges, and the outcome has been impressive. The institutional framework has been of great benefit. As I said in my last speech before leaving the MPC:54 “The new system appears to have made an encouraging start so far with inflation expectations having come down at a time when unemployment has continued to fall. The combination of steady growth and low inflation witnessed in recent years would have been the envy of previous generations of policymakers”. I believe this good record has continued.

1.2.4 Having said that, in the spirit of constructive suggestions to further improve the workings of the framework, I have a number of comments on the performance and workings of the Committee.

1.3 “How should the Bank treat movements in asset and house price inflation”

1.3.1 I have argued for many years that central banks should modify how they operate within inflation targeting frameworks to take explicit account of asset price misalignments (see for example, Cecchetti, Genberg, Lipsky, and Wadhwani (2000))55 ie asset prices should not be included in the inflation target, but the central bank should react to asset price movements it considers may be bubbles. In that situation, we argued that the central bank should not merely focus on its two year ahead inflation forecast, but be willing to adjust its policy instruments to asset price misalignments as well. Modifying the policy framework in this way could achieve a smoother path for inflation and output by reducing the likelihood of bubbles growing.

which should cut the risk of boom-bust investment cycles. It is a “leaning against the wind” argument, which can reduce output/inflation volatility when you have a shock originating in the asset market itself (but not if it originates elsewhere) because the central bank can affect the probability of the bubble growing by influencing public perceptions.56

1.3.2 In theory this approach can be incorporated into a standard inflation targeting framework by extending the horizon beyond the standard two years. But, while this is a step in the right direction, it is not likely to be practical. For example it would be very time-consuming for a committee to agree on a profile for forecast inflation many years into the future, and debate might become bogged down or focus back on the short-term. Instead a simpler “aiming-off” approach when asset prices deviate from fundamentals is likely to be more successful.

1.3.3 Of course it is not easy to tell when asset markets are in a bubble. But this is not an argument for not trying—central banks have a longer term perspective than markets and, in any case, need to incorporate estimates of misalignments in many areas into their forecasting process.

1.3.4 During my tenure on the Committee, the view that I have outlined here commanded little support. Subsequently, the views of some individuals appear to have changed significantly, for example, both Mervyn King (2002)57 and Charlie Bean (2003)58 outline positions that are rather closer to the view in Cecchetti et al (2000). However, the MPC as a whole has been unwilling to adopt a “leaning against the wind” approach.

1.3.5 In terms of the housing market, the MPC as a whole could have announced that a perceived overvaluation in that market would lead interest rates to be somewhat higher than could be justified by the two year-ahead inflation forecast. Such a course of action may well have led house price growth to be more muted in recent years.

1.4 “The Implications of movements in different measures of money supply, credit and liquidity”

1.4.1 While, theoretically, “inflation is a monetary phenomenon”, in practice, money measures simply have too loose a connection with activity to be of much use in this era of technological innovation in payments technology and financial markets.

1.4.2 I very much agree with the assessment made by Chairman Bernanke in a recent speech—59 the rapid pace of financial innovation in the United States has been an important reason for the instability of the relationships between monetary aggregates and other macroeconomic variables. Unfortunately, forecast errors for money growth are often significant, and the empirical relationship between money growth and variables such as inflation and nominal output growth has continued to be unstable at times.” His conclusion about the US applies equally to the UK—“a heavy reliance on monetary aggregates as a guide to policy would seem to be unwise in the US context” (though he puts this in the context of there being some benefits to monitoring money as part of an eclectic forecasting framework).

1.4.3 In recent years, MPC statements appear to have accorded greater importance to the monetary aggregates. We have not been offered any convincing empirical evidence to justify this increased emphasis.

1.5 “The relationship between monetary policy and structural changes in labour and product markets”

1.5.1 During my tenure on the MPC, there initially was a tendency on the part of many members to dismiss the possibility that an intensification of product market competition or labour market reform might affect the inflation forecast. For some, inflation was purely a monetary phenomenon, so “real” factors affecting the labour or product markets were deemed to be largely irrelevant.

1.5.2 In particular in the early years of the Committee forecasts were persistently too pessimistic on inflation, taking insufficient account of the improvements in the labour and product markets that reduced the NAIRU. I discussed these issues in my speech in May 2002 where I commented: “I note that the actual outturn for inflation has always been lower than the MPC’s two-year ahead forecast, with an average error of up to around 0.5%. A failure to allow for a fall in the level of unemployment consistent with stable inflation appears to have been an important contributory factor.”

1.5.3 However, fortunately, the MPC’s attitude did evolve significantly over time. For example, in the August 2001 Inflation Report box on the MPC’s forecast record, it was stated that, in terms of two year ahead forecasts, “the level of unemployment consistent with stable inflation now appears to have been lower than originally assumed” (page 29). Since then, prospective improvements in the supply-side have often explicitly influenced the forecast.

1.5.4 Nevertheless, during my tenure on the MPC and probably since, there is a widely prevalent attitude that it is “imprudent” to build in much in the way of prospective supply-side improvements into the forecast. On this view the uncertainty surrounding supply-side developments is deemed to be a reason to wait to see if it materialises before incorporating it into the forecast. Yet, during a forecasting process, one is necessarily uncertain about most variables of interest, and I have never understood why prospective supply side improvements should be treated differently from demand-side projections. I wonder whether it is this factor that had led to the apparent tendency for actual wage growth to, on average, come in below the MPC’s forecasts in recent years, which is suggestive evidence that they have continued to overestimate the NAIRU.

1.5.5 Looking ahead, the current MPC has sometimes a tendency to assume that the favourable supply side developments that occurred during the past decade are set to come to an end, and might even reverse. The risks associated with such an attitude is that, once again, the MPC might underestimate the favourable supply-side benefits that might come from factors like the outsourcing of services or increased inward migration.

1.6 “The relationship between monetary policy and globalisation”

1.6.1 As noted by Charlie Bean (2006), the term globalisation is often used rather loosely. He takes it to mean the impact on industrialised economies, and in particular on their inflation process, from “the integration of China, India and the emerging economies of Eastern Europe into the world economy and the increased ease with which production can be relocated around the globe”. This is a positive supply shock that has probably had a significant impact on inflation pressures in recent years.

1.6.2 As I discussed in my speech on the New Economy in 2001, even then there was evidence of increasing product market competition, including an impact from globalisation. The reduction in import prices and intensification of product market competition that had been partially caused by globalisation had probably contributed to a reduction in the NAIRU.

1.6.3 Once again, during the last decade, the MPC was initially resistant to allowing globalisation to have a significant impact on the inflation forecast. For example, during my tenure on the MPC, there was an active debate on whether the equation for domestic prices in the Medium-Term Macroeconomic Model should allow for an influence from world prices. This was not merely consistent with best-practice economic theory and empirical evidence, but would also have been a rather straightforward way for globalisation to exert a direct influence on our inflation forecast. In my speech I noted that, with the global economy weakening significantly, using an alternative equation including world prices could have had a significant impact on one’s inflation forecast (not captured in the central case projection of the August 2001 Inflation Report). I should note that this amendment in the model did not occur until towards the end of 2002. Hence, this is another instance where the MPC was slow to incorporate the effects of a favourable supply shock into its forecast.

1.6.4 Globalisation has also made the economies more integrated, and more competitive, so that it has become less meaningful to think of output gaps domestically as producing inflationary pressures. When demand rises above supply, with inflation expectations well anchored, imports can meet the additional demand, with little rise in domestic prices. Only if inflationary expectations move do we see major effects. In effect the Phillips Curve has become flatter, and some of the consequences of this were recently discussed in Charlie Bean’s fascinating paper on globalisation.

1.6.5 Ongoing globalisation, likely aided by the increased outsourcing of activities in the services industry, is likely to continue to exert downward pressure on the NAIRU. Yet, in their recent projections, the MPC do not allow for a continuing fall in the NAIRU, and, instead, constantly speak about the lack of spare capacity. I wonder whether the MPC is in danger of repeating its past error with respect to failing to sufficiently account for the disinflationary effects of globalisation.

61 Of course, outside observers can only attempt to infer this by textual analysis of the Minutes and Inflation Reports. Regrettably, the Bank does not publish its forecasts for earnings growth.


1.6.6 It is sometimes asserted that globalisation has boosted inflation because of its effect on higher commodity prices. While the emergence of China, India and other have likely boosted commodity prices, this is already incorporated in the MPC’s inflation forecast through the use of commodity futures prices. However, by not allowing for the beneficial effects of globalisation on the NAIRU, the MPC is in danger of incorporating a rather one-sided view into their forecast.

2. “THE LEVEL, MEASURE AND SYMMETRICAL NATURE OF THE TARGET”

2.1.1 The Bank of England Act emphasised the symmetry of the inflation target. The Government has continued to emphasise the importance of this feature of the framework. Ed Balls and Gus O’Donnell (2002)66 stated that “the UK has introduced a clear, single, symmetric inflation target. The symmetry of the target means it is clear that inflationary and deflationary pressures will be resisted equally” (my emphasis). Ed Balls has also stated to the House of Lords Select Committee67 that “it was an important consequence of the symmetric target that deviations below the target were taken just as seriously as those above. This would have the effect of removing deflationary bias from the MPC’s decisions and consequently encouraging a longer-term view (Q283)”. However, on several occasions over the past decade, an observer would be forgiven for wondering whether the MPC has actually behaved in a symmetric fashion. Sometimes, developments that point to inflationary pressures ahead are highlighted, only to be ignored if these reverse or perversely even sometimes to be reinterpreted as worrying for inflation in a different way. There are a number of examples that might be discussed. For brevity, I shall focus on just two instances.

2.1.2 One example is oil. When oil prices were rising, the MPC noted that (see, for example, the September 2005 minutes):

- (a) There might be negative supply-side effects in that unemployment might need to rise in order for the required reduction in the growth rate of the real consumption wage, and productivity growth might suffer.

- (b) Inflation expectations might pick up, and this might bring a rise in wage settlements.

2.1.3 Indeed, Mervyn King, in a speech in October 2005,68 asserted that “Higher oil prices affect not just current inflation but also demand and potential supply and hence future inflation”.

2.1.4 However, although oil prices have fallen significantly since their peak in the summer of 2006, the MPC appears to have downplayed their effect on future inflation. For example, as of the December MPC minutes, when oil prices had fallen by 19% since their July peak, the MPC had said nothing in the way of suggesting that it feels more comfortable about inflation expectations or the supply-side effects. In a speech in October 200669 (by when oil prices were already down a quarter), Mervyn King explicitly and notably downplayed it: “A change in oil prices does not in itself tell us where overall inflation is headed in the medium-term. For that, we need to look at the balance between money spending and potential supply”.

2.1.5 A second example is the exchange rate. When the committee was set up sterling was a very high level compared to the previous years, having risen sharply in late 1996. Most members of the Committee considered this to be above its warranted rate. But rather than suggesting that policy should act to offset this strength, with lower interest rates, many members of the Committee argued that higher interest rates were needed than otherwise, because overvaluation meant there was a risk of future exchange rate falls, stimulating inflation.

2.1.6 This was embodied to some extent into the Inflation Report projection for the exchange rate. Not only was a downward path for sterling assumed in the forecast based on the technical assumption to use uncovered interest parity to project the exchange rate,70 the Committee sometimes also assumed that there were downside risks to this path (for example, in the August 1998 Inflation Report “In the MPC’s view, a substantial fall in sterling is more likely than a substantial rise”. In the minutes of the May 1998 meeting it is noted that “Towards the end of the forecast horizon, the net risks to inflation were thought to be on the upside, largely because of the possibility of sterling depreciating more quickly than implied by interest rate differentials”).

2.1.7 However, this reaction to an exchange rate overvaluation contrasts with the reaction to the perceived overvaluation of house prices, which the same members felt warranted higher interest rates. Yet, were they acting in the same way with respect to the exchange rate they should have been stressing the deflationary impact that would occur should house prices have crashed.

67 http://www.parliament.the-stationery-office.co.uk/pa/id199899/delect/dmon/34/1021305.htm
2.2 “Whether the monthly frequency of MPC meetings is appropriate”

2.2.1 Twelve meetings a year is probably more than enough, given the flow of economic news, but I wouldn’t recommend much of a reduction given the speed with which things can sometimes change.

2.2.2 Ten meetings a year would facilitate staff holidays, and provide a breathing space away from the regular activities, stimulating fresh ideas and giving more time for research. Obvious months for breaks would be August and perhaps January given the usual difficulty of assessing news over the holiday period.

3. The MPC as a Body

3.1 “Is the size and composition of the MPC, including the balance between ‘internal’ and ‘external’ members, appropriate?”

3.1.1 I would change the composition to consist of three “internal” and six “external” members. This would lead to a regular healthy infusion of new views. In addition, given that, empirically, internal members seem more likely to vote with the Governor than external members, it might lead to superior decision-making.

3.2 “Is the appointment process for members of the MPC appropriate and is the MPC attracting the right members?

3.2.1 We are not looking for identikit members, and a range of different skills brings a good balance to the committee. Having said that, the majority of the committee should be professional economists. This is essential in order to ensure that, for example, the inflation forecast produced by the staff gets sufficient scrutiny.

3.3 “Are the terms of members of the MPC appropriate and should ‘external’ members be eligible for reappointment?”

3.3.1 I would make all MPC members terms non-renewable, both “internal” and “external”. If necessary the length of each term can be increased, for example, up to seven years. This will help stimulate fresh ideas.

3.3.2 In the early days several external members were full-time. More recently, there is a requirement for external members to be part-time. This is a retrograde step. Some candidates may wish to be full-time members, rather than spreading themselves thinly. This might enable them to engage more fully in research that is relevant to monetary policy decisions.

4. The Mechanics of Setting and Implementing Monetary Policy

4.1 “Are the Bank and the MPC transparent enough?”

4.1.1 The Bank is, probably, not sufficiently transparent. As I discussed in my May 2001 speech, “there is some evidence which suggests that our interest rate decisions have, on average, surprised the markets more than the corresponding decisions by other central banks over the last four years”. Given recent major market moves following two out of the last three interest rate increases, this does not seem to have improved.

4.1.2 It is all very well for the Bank to say that they make their mind up at each meeting, on the basis of the data at that meeting, and that they do not pre-commit. But this is understood, and does not preclude giving more guidance during the month on how they are thinking about they data.

4.1.3 A part of the problem is a lack of desire to discuss the appropriateness of market interest rates. Other central banks regularly question the plausibility of the markets implied interest rate path. In the UK, these are used as an input to the quarterly MPC forecasts, and, in Inflation Report months the path of forecast inflation conditional on market rates gives some broad sense of where the Committee feel rates will have to move in the future. But this is not enough.

4.1.4 First, there is no guidance outside Inflation Report periods. Implied interest rates can and do move considerably during the quarter. Second, the Inflation Report forecasts can be consistent with several alternative interest rate paths. We are offered scant guidance on how the MPC thinks about this subject.

4.1.5 It is also possible that the Bank’s lack of consistency on certain issues (for example, the oil price, the exchange rate see the discussion under section 2 above), also reduces the degree of transparency.

4.2 “Can improvements be made to how the MPC explains its position, either via the Inflation Report, speeches or press conferences?”

4.2.1 There is considerable scope for better communication. The aversion to guiding the markets needs to be addressed, and more light shed on developments in the MPC’s thinking.

4.2.2 Another problem with the existing communication strategy is that, at Inflation Report press conferences, we do not know whether the Governor is revealing his personal biases or actually representing the Committee. One way of dealing with this problem would be to allow the questions at the Press Conference to be shared more equally between those on the podium, and to insist that, by rotation, “external” members are also present to answer questions at the Press Conference. Given that the Inflation Report is produced by the MPC as a whole, it has always been anomalous that 4/9ths of the committee (ie the external members) have no representation at the Press Conference. One minor matter—it would be helpful, if like the ECB, transcripts of the Press Conferences were included on the website, including the Q&A session (currently only a video is available)

4.2.3 Ideally, there would be press conferences after each MPC decision, on the same day as the decision. The ECB does this each month, and this is generally regarded as a desirable feature of their system. If a Press Conference is not held, at least the MPC might release a press statement after each interest rate decision—whether or not rates have changed.

4.2.4 Importantly, there should be more detail released about the components of the Inflation Report forecasts. Had the wage forecasts been published, for example, this would have given a better idea of how the MPC’s NAIRU assumption was faring. Some other central banks are happy to release much greater detail on the make-up of their forecast.

4.3 “Are ‘external’ MPC members properly supported by the Bank in their roles?”

4.3.1 When I first arrived in the Bank as an external MPC member I was quite shocked at the lack of direct support in terms of economic support staff and other resources. This was eventually addressed by the formation of the MPC unit (after opposition from elements within the Bank that argued that externals should continue to work through the Bank hierarchy). Subsequent to the setting up of the External MPC Unit, there was a significant improvement in one’s ability to carry out one’s tasks. By the time I left, one remaining unsolved issue was one’s inability to interact enough with the Staff.

4.3.2 As mentioned above I believe that externals should be allowed to work full-time within the Bank, as some potential members would want to focus fully on monetary policy, including research in the area, and not wish to spread themselves thinly or need to divert their focus into other work, given the importance of the job. Of course, those who wish to work part-time should also be encouraged, as they can add to the diversity needed to bring fresh ideas from outside.

4.4 “Are the Bank’s capabilities, both in terms of economic modelling and data availability, ‘fit for purpose’?”

4.4.1 The Bank’s current convention for projecting forward the sterling effective exchange rate is to use “the average of a constant nominal rate and a path related to the pattern of market interest rate differentials for the central projection.” Prior to the introduction of this convention in November 1999, the projection reflected only relative interest rate differentials (uncovered interest parity (UIP)).

4.4.2 Changing the convention for the exchange rate projection was an improvement over UIP. There is a large body of empirical literature that finds UIP to be a biased predictor of exchange rates for developed countries. A constant rate is found to be superior. However, keeping any element of UIP was a mistake, and has led to a bias in projections, which, over this period, has been towards too low an exchange rate path, and hence a bias towards higher interest rates.

4.4.3 As Chart 3 below shows, the projection has generally been too high, particularly in the early years of the Committee when UIP alone was used. For the Inflation Reports produced between August 1997 and February 2005, the outturn for the ERI has been, on average, 3% above the two-year out central projection.

4.4.4 More recently the exchange rate has risen, while the Inflation Report projections made after February 2005 continued to project falls. Hence, the bias in their exchange rate process appears to be enduring.

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54 Outturns measured by the 15 day average used in the Inflation Report two years ahead. The degree of underprediction is even larger if instead we use the “average” projection, which allowed for the downside risks to sterling assumed in Inflation Reports between February 1998 until May 1999.
Chart 3

Sterling ERI 2 year IR Projections vs Actual Outturn*
(new definition figures scaled to old definition)

*15d moving average
Figure for Feb05 is 22 Jan07

January 2007

Memorandum submitted by Professor Forrest Capie and Professor Geoffrey Wood

About Us

The authors

Forrest Capie is Professor of Economic History at the CASS Business School, City University, London. He was Head of Department of Banking and Finance at City University from 1989 to 1992; Editor of the Economic History Review from 1993 to 1999. He was a member of the Shadow Chancellor’s advisory panel from 1999 to 2005. He is currently a member of the Academic Advisory Council of the Institute of Economic Affairs, and on the Council of the Taxpayers Alliance. He is an Academician of the Academy of Social Sciences.

Currently, he is writing the next instalment of the Bank of England’s history. His latest book, The Lender of Last Resort, is co-edited with Geoffrey Wood was published at the beginning of 2007.

Geoffrey Wood is Professor of Economics at Cass Business School, London, Visiting Professorial Fellow in Commercial Law at the University of London, and Visiting Professor of Monetary Economics at the University of Buckingham. In the past he has worked in the Bank of England and in the US Federal Reserve System. He has acted as an adviser to the New Zealand Treasury, and has also been economic adviser to two stockbroking partnerships, and to a bank. He is a regular academic visitor to the Bank of Finland.

History and Policy is an independent initiative working for better public policy through an understanding of history. The initiative was founded by historians at Cambridge and London Universities who believe today’s “evidence-based” policy environment would benefit from more historical input and the involvement of professional historians. History and Policy works to increase the links between historians and those analysing, discussing and deciding public policy in the UK today, and makes historians and their research findings more accessible to policy and media audiences. See http://www.historyandpolicy.org for more details.
1. EXECUTIVE SUMMARY

1.1 History is important. The recent past helps explain the proximate reason for the MPC. The more distant past gives a perspective on several elements.

1.2 Although appearing revolutionary the granting of independence to the Bank of England in 1997 can be seen as a further step in an evolution.

1.3 Central bank/government relations have evolved, not just in Britain but world wide, for in some cases over 100 years.

1.4 Notable changes in these relations have always resulted from a failure or major problem in the preceding situation.

1.5 A recurrent problem has been fiscal policy overwhelming monetary arrangements with demands for finance. Current arrangements in the UK can not protect us against this.

2. INTRODUCTION

2.1 Reason for the MPC

2.1.1 In 1997 a dramatic gesture was made in granting the Bank of England “independence”, and giving it the task of delivering an inflation rate that fell within a narrow band. But although certainly a surprise at the time, the move can be interpreted as the outcome of changes in the relationship between the Bank and Government that had been made by previous administrations. Interpreting the move thus is illuminating. It lets the move be placed in the context of how Bank/government relationships have changed over the past two centuries, and shows that the changes have a considerable degree of continuity to them. (At the time of the 1997 change the Bank was deprived of its role of bank supervisor. This could under some circumstances have significant consequences for financial stability and hence for the Bank’s other responsibility, monetary stability. Space dictates that we focus narrowly on monetary stability.)

2.1.2 1997 was not the first occasion, and now is not the first time, that the Bank has had both a degree of independence and a target it is expected to achieve by use of its independent decision-making and actions. Some historical background reveals the pattern of fluctuations in the position of the Bank.

2.1.3 The basic reason for the changes in monetary policy-setting arrangements in 1997 was the poor performance of monetary policy and of the real economy in Britain across the post-World War Two period and culminating in the disastrous experience of the 1970s and into the 1980s. The connection was not direct, however. The poor performance led first to various ways to “import” superior monetary policy, by pegging to or “shadowing” a currency whose value was stable. This led first to “shadowing” the DM, and then to ERM membership. The latter did succeed in bringing down inflation, but the squeeze on the British economy was going on longer than needed for that purpose, interest rates in the ERM’s anchor, Germany, were rising when they needed to be falling in Britain, and the situation was unsustainable. There was heavy selling of sterling and it fell out of the ERM.

2.1.4 When this happened there was an immediate need to find a way to give a focus to monetary policy, and one which was sufficient to both anchor domestic price expectations and appear credible in the foreign exchange markets. Such a mechanism was rapidly devised, and then another step was taken. The meetings between the Chancellor and the Governor at which interest-rate decisions were taken had their dates announced, and as well as having their conclusion announced the views of the two participants were made public. That last step leads us to say that the changes of 1997, dramatic as they were, were part of a process of evolution. For suppose there had been a Chancellor-Governor meeting at which the Governor had urged an increase in rates, but it was immediately public that the Chancellor had refused to allow it. Under some circumstances the markets might have been unperturbed, but under others a run on sterling was highly likely. The authority the Chancellor retained was so circumscribed that surrendering decision-making to the Bank, subject to clear instructions and to penalties for failure, was a natural step.

2.1.5 Having set out the recent history of the 1997 change, we turn to some longer-run perspective on the principal elements in the story—inflation, the development of central banking, monetary policy, and central bank independence. Doing so helps to put more recent events into a clearer perspective, and can also help reveal whether there are possible problems remaining which may need to be discussed.

3. INFLATION EXPERIENCE

3.1 Long run

Persistent inflation is essentially a 20th century phenomenon. Over many centuries prior to that inflation was close to non-existent. Prices, with some cyclicality around the trend, were more or less stable century after century with only a few exceptions. Where “great inflations” are discussed in history (eg the Roman Empire, or 16th and 17th century Europe) even bearing in mind the difficulties in constructing reasonable price indices it is clear that inflation was still in low single figures. The “greatness” of these inflations arose from their time span rather than from the rates of inflation experienced.
3.2 Episodes of high inflation

There were however, some isolated bursts of high inflation. These can be divided into two main categories: hyperinflation and very rapid inflation.

3.2.1 Hyperinflation

The most commonly accepted definition of hyperinflation is that of Phillip Cagan: prices rising at more than 50% per month and accelerating, and coming to an end when the rate fell below that and was decelerating.

When defined in that way there was none anywhere before 1920. There were several in the 1920s and then some in the 1940s and there have been some since in for example Serbia in the 1990s. Why these astonishingly dramatic episodes are relevant in the British context becomes apparent after we have considered much lower but by British standards still very high inflations.

3.2.2 Very Rapid Inflation

A different degree of high inflation, one that might be called very rapid inflation, would be, say, annual rates in excess of 100%. Such a definition would capture many more episodes. Before 1950 there were a few instances such as those of the American War of Independence, the French Revolution, and the American Civil War. After 1950 there very many of these experiences around the world—particularly, but far from exclusively, in Latin America. What led to such episodes?

3.2.3 The Role of Fiscal Policy

A striking feature of most of those episodes just outlined is that they were associated with civil war or severe social disorder. In the attempts by the governments then in office of these countries to fight or buy off the opposition much revenue was necessary, but loss of tax revenue from the disaffected produced growing budget deficits that could not be covered by borrowing. As a result, the governments printed money to finance their spending. These experiences point to the importance of the link with fiscal policy. As so often, things which are always important become most obviously so under extreme circumstances.

3.3 Post WWII

3.3.1 The period 1939–51 was described as the “Great Inflation” but its greatness was rapidly overshadowed by what followed.

3.3.2 Price controls were in place in many countries in the 1940s, including the UK and US. They were, however, ineffective, in that while they did on some occasions contain inflation while they were in place they showed substantial signs of losing their effectiveness as time went on, and when they were removed prices surged to more or less where they would have been had the controls never been there. A fair assessment of them would be that they hid rather than stopped much of the inflation that was taking place.

3.3.3 In the 1950s and 1960s inflation was rising in the OECD and elsewhere. For Britain the average rate was rising to more than 3% in the 1960s, and accelerating. (These sound modest figures, but recollect that many contemporaries had lived through periods of stable prices.)

3.3.4 In the 1970s inflation everywhere was rising and in Britain peaked in the mid-1970s at close to 30%.

3.3.5 The last 25 years have seen attacks on inflation all around the world. It has been clearly demonstrated that a country could have (on average of course, not necessarily over any one short period of time) the rate of inflation it preferred.

4. Central Banking’s Evolution

4.1 Financial stability

Although financial stability does not fall within the remit of this committee we must touch on the subject as the origins of central banks lie as much in this area, that is in responding to financial crises, as elsewhere. It was the development of their lender of last resort role that marked them out. But this is a reminder that financial stability and monetary stability go together. The lender of last resort role developed in recognition that there could be times when distrust of commercial banks was such that people demanded only cash, being entirely unwilling to hold bank deposits. In such circumstances, it was possible for a very large number of even well run banks to collapse unless they could get cash from the central bank. Such a collapse could bring sudden and dramatic deflations and depressions. Thus preventing these is inevitably intertwined with preservation of what is now called monetary stability.
4.2. Monetary policy and exchange-rate regimes

4.2.1 The real beginnings of modern concern with inflation and the connection with central bank emergence can be found in England during the Napoleonic Wars when metallic convertibility was suspended. The inflation was mild. While there were no price indices available at the time the decline in the purchasing power of money was reflected quickly in the depreciating exchange rate.

4.2.2 In so far as there was anything called monetary policy in the 19th century it was a case of defending the nation’s reserves and preserving the convertibility of the currency into a metal. Gold was the true nominal anchor, and adhering to it was the function of the first nascent central banks.

4.2.3 The gold standard reached its classical form in the period 1880 to 1914 when most developed countries adhered to it and developing countries aspired to it. Conservative monetary and fiscal policies were pursued to allow adhering to the gold standard. It was the credible commitment of the central banks of the core countries (principally western Europe and the US)—made possible by independence from political interference—that meant people believed monetary action would be taken to preserve gold convertibility. Successful central banks did maintain convertibility. Independence was almost taken as given because everyone thought the gold standard the right thing to do.

4.2.4 The gold exchange standard of the interwar years. This was the attempted restoration of the pre-1914 world, where the principles were the same but the problems following the great upheaval of war were different. Price levels between countries had been distorted from their pre-War relationships, the distribution of gold had changed greatly, and confidence in the financial system was greatly damaged. All these played their part in preventing success.

4.2.5 Bretton Woods was the attempt to mimic the pre-1914 system with a fixed exchange rate but improving on it by giving countries some autonomy in monetary policy by means of capital controls. The nominal anchor was the exchange rate and central banks generally had the freedom to operate in whatever way they deemed necessary to manage that rate. In that respect there were quite strong similarities between this and the present regime. The nominal anchor is specified by government and the means of achievement left to the central bank. Of course, it must be observed that national Treasuries were supreme; central banks might be said to be allowed to vary interest rates so long as nothing dramatic was involved, and the political and economic timing was not sensitive.

4.2.6 In all of these post-gold standard arrangements there was a lack of transparency but the Bretton Woods years probably reached a nadir in this respect. It would be fair to say that the rules were far from clear even to those who had to operate them.

4.2.7 The failure of the Bretton Woods order together with academic argument saw a number of attempted solutions, including monetary unions, but the case for floating was powerful and generally won. It was recognised that either exchange rates had to float or that currencies had to be locked together by a monetary union. No middle course was sustainable.

5. Monetary Policy

5.1 Long run

As the above has indicated over a long run of history monetary policy consisted largely of maintaining convertibility of the currency. The main objective of central banks was maintenance of the external value of the currency, and this, via the link to gold, led to stability in the internal value, as there were no major short run fluctuations in gold supplies. Central banks protected their gold reserves and hence the external value of the currency, and thus indirectly produced price stability.

5.2 Legacy of interwar period

5.2.1 After the First World War largely independent central banks continued to be entrusted with their task of managing the restored gold standard, this being regarded both as a sufficient control over their activities and a desirable objective of policy.

5.2.2 The great depression of 1929–32/33, however, was blamed on the banking system, including under that heading the operations of central banks—chiefly the ineptitude of the Fed—and independence such as it was disappeared. That led to greater government intervention in the 1930s, 1940s, and beyond.

5.3 Post WWII

5.3.1 The role of money and interest rates was downplayed and that of fiscal policy was elevated. But there was in fact always the need for a nominal anchor for monetary policy. Again it was found in the exchange rate. Countries pegged their exchange rate to the core country of the system—the USA—and that country for many years delivered stable monetary policy. Countries which inflated had always first displayed wavering commitment to that peg.
5.3.2. But the emphasis of policy had shifted from concern with price stability. This shift was reflected in the Phillips curve, and in particular the Samuelson-Solow version which suggested a menu was available. Governments, it was suggested, could choose the combination of unemployment and inflation rates they desired. A little more inflation could bring a little less unemployment, and, it was for a time believed, could do so in perpetuity. This belief was also supported by the Radcliffe Report, which like these “menus for policy choice” also downplayed the importance of monetary policy.

5.3.3. But inflation was rising through the 1950s and 1960s; with price level performance deteriorating, balance of payments deficits leading to loss of reserves, and on occasions Britain forced to go to the IMF for assistance. Ultimately, the IMF imposed conditions, including that we adopt Domestic Credit Expansion targets (DCE was a proxy for a conception of money supply in an open economy with a fixed exchange rate). This revived interest in monetary policy beyond the small and largely academic group where interest in it had survived.

5.4 Monetary targeting

The lack of a long-run trade-off between inflation and unemployment was increasingly being recognised. Central banks could boost output in the short run but could not achieve it permanently. Rising inflation and the growing awareness that the costs of inflation were high suggested that a better nominal anchor was required. That was a precursor for the monetary targets that followed in the 1970s. Monetary aggregates had been compiled for some time and announcements of targets followed. The Fed announced them in the 1970s and the Bank of England used them internally from 1973 and publicly from 1976. They represent the beginnings of some accountability. However, for a variety of reasons, including the results of substantial changes in the banking system, they were deemed not to have been successful and alternative possibilities were sought. (Also, at low levels of inflation swings in velocity meant a weak relationship between money and prices, so the performance of monetary targets fell below what policy makers had hoped for.) But monetary aggregates contained information and data on them continued to be collected.

5.5 Inflation targeting

The next step was inflation targeting. That allowed the government to decide on what rate of inflation was appropriate—the goal—and let the central bank get on with delivering it—the limited “instrument independence” as this variety of central bank independence is called.

6. CB Independence

Thus part of the solution to price stability lay in giving the central banks the independence from government that would allow them to perform their role, and also a clear mandate to achieve a particular goal.

6.1 Definition

The definition of independence is far from straightforward. What is most commonly allowed is limited—instrument independence as opposed to goal independence. That is they have the freedom to use interest rates or money supply or whatever they choose as the means by which they deliver the goal of price stability. The goal is specified by government. In this respect there are the similarities mentioned with the old convertibility model. In that older setting, central banks were expected to maintain the link with gold—that was their mandate—but they were free to act as they thought necessary to carry out the mandate.

6.2 Historical pattern

6.2.1 Because of the nature of the product (money) there has always been a close relationship between the central bank and the government. (Governments always want control of resources and control of the monetary system to help achieve that.) And it is seldom easy to say what degree of independence prevails at any time. Indeed, it is probably not wise to put much weight on indices of independence.

6.2.2 The broad picture is that central banks had relative freedom in the 19th century. That was removed in wartime but it was then restored after the First World War when it was felt that managing the exchange rate was a sufficient check on central bank activities. But then it was lost again after the great depression and the Second World War. And that loss was more formal with many nationalisations.

6.2.3 Also at that point central banks were being asked to do a host of things—from preserving price stability to promoting economic growth and full employment with a fixed exchange rate. Even so it goes too far to say that independence had disappeared. Even in the case of the Bank of England in the 1950s and 1960s the Bank often took the lead in setting Bank Rate and it did whatever was necessary to hold the exchange rate.
7. OTHER QUESTIONS

7.1 Asset prices

7.1.1 Historically, central banks have not done well on asset prices. It was the attempt to “correct” the stock market boom of the late 1920s that led the Fed to tighten money unnecessarily.

7.1.2 There are occasional examples of stock market crashes being followed by real economy recessions. But a reliable generalisation is that stock market falls can safely be left alone unless they threaten to spawn a financial crisis, defined as a panic scramble for liquidity.

7.1.3 The US experience in 1987 was an example of the Fed having learned from 1929. An injection of liquidity calmed the market and ensured that there was no scramble for liquidity which could have threatened some of the smaller banks in the fragmented US banking system, and a later withdrawal served to prevent any inflation.

8. LAST 10 YEARS

8.1.1 It has been claimed recently that central banks have mastered their task. But have they been lucky or is there some other factor at work? It is really too soon to say. There are big questions still to be answered. An important one is the role of globalisation.

8.1.2 Some argue that the explanation for the price performance of the last ten years is that China has exported deflation. That is not the case. Central banks can set whatever inflation path they want. What Chinese growth and output have probably done is provide a more accommodating environment in which traded v non-traded goods. What globalisation has done is allow central bank independence to work in an environment where keeping inflation under control was, at least compared to past experience, almost painless.

9. CONCLUSION

Changes in Bank/government relations have resulted from failures or serious problems with prior policies. There have been many such changes over the years. Can we now conclude that the present situation will endure? No doubt unforeseeable events will occur. But we have emphasised earlier that many major inflations originated with the breakdown of fiscal policy leading to irresistible pressure for monetary expansion. There is nothing in the present position of the Bank to prevent that occurring again. Under the gold standard and then in the 1950s and 1960s, with both of which periods we see the current arrangements as closely parallel, the fiscal situation was crucial. Under the gold standard in Britain fiscal pressure was absent and the gold standard maintained. In the 1950s and 1960s fiscal pressure was irresistible, the exchange rate could not be maintained, and inflation drifted upwards. The fiscal situation is as important under the present system as it was in those two earlier regimes.

January 2007

Memorandum submitted by the TUC

This is an important inquiry for the TUC and I would, of course, be willing to represent the TUC at a future oral evidence session, comprised of wage bargainers. However, I am glad I have the opportunity to comment on wider issues relating to your inquiry. This is particularly important, given recent media interest in CPI inflation reaching 3% (and RPI reaching 4.4%) and the effect that this might have on the forthcoming round of pay bargaining. I am, therefore, copying this letter to Colin Lee, the Clerk to the Treasury Select Committee and hope you will consider it to be a written submission from the TUC.

THE MONETARY POLICY FRAMEWORK

The TUC has taken a close interest in the work of the MPC ever since it was established in 1997. We submitted written evidence to an inquiry conducted by the House of Lords Select Committee on the Monetary Policy Committee of the Bank of England in 1999 and gave oral evidence to that inquiry on 15 March 1999.

Then, as now, we took the view that the symmetrical nature of the inflation target is of paramount importance. This means that it is as important to avoid falling too far below the inflation target as it is to avoid going too far above it. Low and stable inflation is one of the most important economic objectives of any government, but it is not the only one. The obsession of the government of the 1980s with low inflation to the exclusion of other policy objectives left lasting damage in terms of unemployment.
The TUC believes that a target rate of CPI inflation of two per cent is broadly correct. We have made it clear, however, that in our view, the all item RPI is the best measure of the overall cost of living, enjoys widespread public confidence and remains the basis for most wage negotiations. Since most working people have mortgages and pay council tax, it is unrealistic to ask them to base year-on-year wage increases on a measure of inflation that does not take these and other associated housing costs into account.

We are concerned about the danger of overestimating the prospect of second round inflationary effects of pay increases. In fact, we believe the Chancellor has done this too, in his letter to the Pay Review Bodies instructing them to seek public sector pay increases in line with the 2% CPI inflation target. Inflation has been running at higher than 2% CPI throughout the second half of 2006, yet neither the Bank nor the Treasury has suggested that this has been caused by wage increases. High energy prices have been the major cause of higher, but still historically low, inflation and there is no reason to believe that wage increases will be high enough to cause a wage-price spiral.

The economic context

As noted above, inflation is an important concern, but not the only concern, facing policy makers. UK manufacturers are struggling to cope with the effects of higher interest rates and a strong pound, which make investment and exports difficult. It seems that not a week goes by without a major announcement on manufacturing, usually resulting in job losses. On current trends, manufacturing employment will fall below 3 million in 2007, for the first time in 100 years. The reasons for the difficulties faced by manufacturing are complex, yet a monetary policy framework that recognises the need to support industry as well as to keep inflation low would be welcomed by trade unionists.

In our evidence to the House of Lords Select Committee in 1999, we called for a remit for the MPC that is more balanced between growth, employment and price objectives as, for example, in the remit given to the US Federal Reserve. As we said at that time, getting the balance right between different objectives is the art of the central banker. We consider that the needs of industry need to be taken strongly into account in the deliberations of the MPC.

Globalisation is one of the key economic challenges that we face and the role of monetary policy in a UK response to globalisation must be considered. HM Treasury has argued that, in order to meet this challenge, the UK must become more competitive in those high skill, high value areas of work that are less likely to migrate to lower cost countries. However, with China and India producing four million graduates per year, as the Chancellor told the TUC’s Congress in 2005, it is not as simple as imagining that only low cost, low value work will move abroad. For this reason, HM Treasury has, correctly, highlighted the importance of improving UK productivity, which historically lags productivity levels of France, Germany and the United States. HM Treasury has gone on to describe the five drivers that, taken together, can help improve the UK’s productivity record. These are: skills; investment; science and innovation; enterprise and competition.

The TUC supports this approach. The UK must raise its game, particularly relating to improving skills, investing more in science and converting new ideas into practical ways to make our businesses more competitive, and improving investment. Interest rates affect all of those issues, since if the cost of borrowing rises, industry is less likely to respond to the need to invest in these areas. As the voice of people at work, the TUC places a strong emphasis on these issues, because they are so important to the livelihoods of working men and women. It is for this reason that, when the MPC considers interest rates, we call for it to balance other concerns, such as the rate of inflation or the housing market, with an understanding of the effects of high interest rates on the workshops and factories of the UK.

The workings of the MPC

The TUC supports the requirement for the minutes of each MPC meeting to be published, including the voting record of MPC members. We also support the publication of a quarterly “Inflation Report”, which sets out the Bank’s economic analysis. By international standards, this represents a high degree of openness.

We also support the MPC’s engagement with various regional actors. We highlighted this matter early on and were pleased to see the Bank move quickly to improve its intelligence about what is going on in particular regions of the country. The Bank’s Regional Agents are an important source of intelligence to the MPC and we welcome the contacts they have with trade union officers who are, in turn, in touch with many businesses and undertakings as part of their routine intelligence gathering.

January 2007
Memorandum submitted by Jagjit S Chadha, Alan Clarke, and Paul Mortimer-Lee, BNP Paribas

SUMMARY

1. We applaud the adoption of operational central bank independence in May 1997 and the appointment of a monetary policy committee to pursue the government’s inflation target with symmetrical monitoring bands. This monetary reform has heralded a period of exceptionally stable macroeconomic performance. For which the regime should probably take considerable credit.

2. Economic growth has been considerably more stable than the UK’s main trading partners. Inflation has yet to diverge from target by more than 1 percentage point and again, has been less volatile than the UK’s main trading partners.

3. That said we remain concerned about how the MPC will operate in a changing economic environment where economic models may need to alter significantly—not least as a result of the credibility of policy itself, which, inter alia, may have led to an under pricing of risk and to changes in the response of inflation and output to shocks. We believe the MPC’s decision to downplay the role of the housing market has gone too far with the result that household balance sheets may be vulnerable to shocks.

4. Over the period of the MPC’s operation, there seems to have been some move away from rules-based forward-looking policy to “constrained” discretion and from there to the use of heuristics, or rules of thumb. Overall, we believe the MPC’s interest rate setting behaviour has become somewhat more inert and this has contributed to more volatile inflation of late.

5. In terms of the MPC, specifically, we call for:
   (i) Full publication, allowing web-based replication, of the Bank of England’s inflation forecasting models;
   (ii) Further information to be published alongside the monthly interest rate decision, namely the actual split in the vote and a mandatory short statement;
   (iii) Regular opportunities for professional economists to meet and discuss the economic outlook with MPC members, particularly at the time of the publication of the Inflation Report, possibly in a new forum;
   (iv) Further publication of analyses of monetary, liquidity and asset price developments and their relationship to real activity;
   (v) The clear adoption of the principle that appointments to the MPC continue to be drawn from those with significant professional economic expertise.

OPENING REMARKS

The establishment of operational independence for the Bank of England on 6 May 1997, to be implemented by the Monetary Policy Committee, was one of the key economic decisions of the past generation. Operational independence was a signal about the anti-inflationary preferences of the newly formed Labour government and was rightly interpreted as such by financial markets that immediately lowered the yields on long-dated UK nominal bonds by some 50-60Bp. This early judgement by the financial markets looks to have been basically sound as subsequently inflation has not (yet) strayed outside the 1% threshold of the policy framework and both inflation and output volatility have remained low by historical and international standards.

Over the period since independence, pre-emptive monetary policy has insulated UK economic growth in comparison with the gyrations in US and eurozone GDP growth. The low-point in UK GDP growth over the period has been 1.6%—over a percentage point higher than the equivalent for the UK’s main trading partners, the US and eurozone. The range between the peak and trough in GDP growth has been 2.7% points, compared with 4.6% points for the US and 4.1% points for the countries of the eurozone.

Since 1997, the target measure of inflation has not yet strayed beyond one percentage point either side of the target threshold. As with GDP growth, the targeted measure of UK inflation has been in a narrower range than that in our two main trading partners, the US and eurozone. From peak to trough, UK inflation has been in a 2.2% point range (which is somewhat exaggerated by the shift of inflation target in 2004). This compares to 2.3% for the eurozone economies and 3.6% points for the US.

However, we would note that over the last two years, the gyrations in UK inflation have become rather more severe. The target measure of inflation has challenged the boundaries of the target range on both the upside and downside within less than two years. This has been far more volatile than in the early years of MPC independence, which was not without its challenges. Clearly factors such as the volatility in the price of crude oil have contributed, but we believe MPC interest rate setting behaviour has not helped matters.

The 10-year period of operational independence has involved maintaining inflation targets, which were explicitly adopted after ERM-exit in 1992. What might be termed the First Inflation Targeting Regime had largely seen the Bank of England perform the role of senior policy advisor to the Chancellor, who pursued the inflation target as one of a number of ongoing policy objectives. The Inflation report was effectively an
audit of the Chancellor’s decisions as far as they affected inflation, rather than an explanation of those policy decisions, as it became under operational independence. This earlier regime did seem to achieve some degree of monetary stability but looked vulnerable to the electoral business cycle. The best practice from the perspective of academe and the City was to charge an independent central bank, whose monetary policy committee members would wish to guard their reputation, with the pursuit of the inflation objective set by the elected government of the day.

The government, acting as the representative of the public, maintains overall control of the regime by setting the actual policy target and making appointments to the policy-making body (the MPC) directly. In this case the target was initially set as an annual inflation rate of 2.5% as measured by RPIX with a symmetrical monitoring range of 1% plus or minus, the breaching of which would require a letter of explanation to be written by the Governor to the Chancellor. The symmetrical monitoring range signals the need to stabilise the economy in general terms, as a deflation was potentially as costly to the MPC as rapid inflation.

In this sense, there would be a mandate for the policy target as it reflected the wishes of the government of the day and public consensus for price stability, but it is pursued by experts with sufficient technical knowledge. Furthermore, these experts would not be inclined to do anything other than to pursue this one inflation goal consistently through time. This regime, with its particular model of central bank independence, was probably the best way to tie the hands of future policy makers and to ensure that the gains from the Great Moderation and disinflation of the 1980s and 1990s were not dissipated. In this evidence to the Committee we consider the questions raised by the Inquiry against the overall view that the 10 years to date have been a great success.

### THE MPC IN CONTEXT

The technical role of the MPC could be thought of as choosing a sequence of interest rates sufficient to minimise inefficient fluctuations in output, while seeking to achieve the stated inflation objective. Although we might reasonably think that a significant fraction of business cycle fluctuations are likely to be associated with non-monetary events, such as technological change, supply-side innovations or reform, or real spending patterns etc, the existence of wage, price and financial rigidities ensure that there is a role for monetary policy to attenuate inefficient fluctuations. There is also a case to be made that many extreme events are closely related to errors in monetary policy eg the Great Depression, the 1970s inflation and arguably the Japanese Deflation. So as well acting to limit inefficient fluctuations, which lead to inflation volatility, the MPC thus also has to act in a manner that minimises the possibility of large-scale errors.

The MPC has benefited from operating within the context of an international move to price stability, which has bolstered the support to the world economy from trade, product and labour market liberalisation in many countries, including the UK. The mandate for sound monetary policy, involving _inter alia_ the support of employer and employee institutions has helped to create a favourable climate for the MPC’s choices. Despite the views of some commentators, there have been large and important shocks in the past decade eg LTCM, East Asian Crises, Hi-Tech bubble and collapse, the US recession of 2001, very fast global growth in recent years and the recent oil price shocks: the MPC has coped with these shocks well.

The MPC’s performance relative to other economies has been commendable. However, in absolute terms, we have noted some deterioration in the MPC’s track record over the very recent past. Specifically, we believe the committee has become slower to respond, and—at least until January 2007—less willing to change the interest rate. The committee has moved from being forward looking to backward looking, with an increased tendency to “wait and see”. We view MPC interest rate setting behaviour as having become more reactive and less pre-emptive and see the January 2007 surprise acceleration in the pace of tightening as the consequence of that—getting behind the curve at some stage implies catching up, which is what seems to have happened.

We believe the slower pace of response to be particularly evident over the period since late 2004—in turn helping to explain why inflation has deviated from target to a greater extent. Specifically, it appears that the Bank left it too late to cut interest rates during 2005—signs of a sharp consumer slowdown were evident from the end of the previous year yet rate cuts were delivered only in the summer when there were signs the economy was turning. In 2006, we would argue that the start to raising interest rates was also tardy, lagging by some time upward revisions in the inflation forecast. We believe that the MPC could have started raising interest rates as early as February 2006, a full six months before the first hike, and that the Bank’s own inflation projection would have justified an interest rate hike by the May MPC meeting, yet the committee passed the opportunity. The committee is now paying the price for dragging its feet on interest rates, with inflation threatening to breach the upper boundary of the monitoring range, in turn threatening to dislodge inflation expectations.

As a result there are at least several issues that we would like to see the MPC devote more time to considering:

1. Problems with inflation equations. As inflation persistence has declined and arguably economic structure has changed, inflation seems to have become somewhat more difficult to forecast. This difficulty is linked to the apparent flattening of the Phillips Curve. Professor Ken Wallis (Warwick) has found, for example, that the distribution of forecasts from the Bank of England’s fan chart
has systematically overestimated the range for future inflation outcomes. This implies, *inter alia*,
that Bank has perhaps been overly cautious in assessing possible inflation outcomes. We also
suspect that the attainment of price stability has increased the contribution of relative price
movements—which would result from sector-specific shocks and are thus difficult to forecast—to
the overall level of inflation volatility, which has been difficult to model.

2. Problems with non-standard indicators. Related to the previous problem, traditional mark-up
equation models and money demand equations do not paint a complete picture of inflationary
pressure as more weight seems to be placed by the MPC on developments in astructural
indicators such as inflation expectations. A wide range of evidence is assessed on inflationary
expectations, from the Bank's own NOP survey to the inflation expectations derived from the
nominal and index-linked government yield curves. But after a period of inflation stability there
is a danger that these indicators do not reflect incipient inflationary pressure, as they also
incorporate an expectation that policy will be tightened in response to any such pressure. Stable
expectations may signal the expectation that policy will be moved, rather than indicating that it
need not be.

3. Asset prices and financial markets. Further and extensive financial market liberalisation over the
past decade has, in part, driven global liquidity and compressed yields and priced risk at very low
levels in the world financial markets. One tangible result has been the increasing access by private
individuals to personal credit, which should allow welfare-enhancing consumption smoothing, but
may also lead to excessive debt creation by agents in a period of low real interest rates, which may
leave household balance sheets vulnerable to economic shocks. We welcome the Bank of England’s
plans to publish a formal survey of credit conditions. But we would like to see the MPC articulate
more modelling of the macro-finance nexus enabling economists to evaluate the role of policy in
driving global liquidity and also the feedback from asset price developments to the real economy
and future inflationary risks.

4. Communication and Transparency. Since the MPC's inception, we have observed a major
improvement in the communication and transparency with a clearly established timetable for
MPC decisions and inflation report publication. A welcome recent development was the
publication of the Bank of England Quarterly Model (BEQM). As well as communicating and
signalling risks to the current conjuncture, the MPC has used the inflation fan chart as a device for
signalling uncertainty about future outcomes. Transparency can improve the efficacy of monetary
policy by helping to ensure that the expectations of the private sector are consistent with the central
bank objectives and this can act to improve the trade off between inflation and output volatility.
But there are likely to be limits to transparency as the public information from central banks can
swamp the private information that would otherwise be shared by the market and so we do not
call for the publication of forecasts of the central bank’s policy rate, as is undertaken in Norway,
for example. That said there are still some areas where MPC transparency would possibly benefit
from further attention:

(i) We do not know of anybody outside the Bank that has been able to replicate the Bank model
with the description provided by the published book. As a comparison, the Treasury model
is used and maintained outside the Treasury;

(ii) more and regular plans by MPC members to speak and explain the current policy conjuncture
to the public and the financial sector, where currently speeches seem relatively few as
compared with the Federal Reserve and ECB and

(iii) more information to be provided at the time of the interest rate announcement eg on voting
patterns and a mandatory statement.

**MONETARY POLICY AND ASSET PRICES**

*Housing*

The current high level of many asset prices reflects not only previously low levels of real rates but also low
perceived levels of systematic risk. One obvious example in the UK is recent developments in the housing
market. In fact, we believe that part of the deterioration in the MPC's performance has reflected its attitude
towards the housing market. In its November 2004 Inflation Report, the Bank reported that the relationship
between housing and consumer spending had been substantially diluted. We believe this went too far and
did not give sufficient weight to analysing reasons why simple correlations had declined, where we believe
that external shocks, eg in 1998 and 2001, played an important role. The housing market has been a major
influence on GDP growth and pressures on resources over the last three to four years. Our early recognition
of trends and turning points in the housing market has been instrumental in being able to predict the turning
point for interest rates early.

Further still, the effect of house price inflation has also been partly responsible for the recent upside threat
to wages. Though the MPC targets the CPI, which excludes house price inflation, the latter is included in
the RPI. This is significant currently since this index is still the preferred benchmark for wage settlements.
House price inflation has accounted for just under a quarter of the acceleration in RPI inflation over the last year. Since the CPI overlooks this crucial influence on growth and the RPI (to which wages are benchmarked) the committee should have been more sensitive to the housing market, not less.

**Principles**

The standard answer on the question of asset prices, such as housing, and monetary policy is that asset prices matter for policy insofar as they contain systematic information for developments in inflation and output—basically the same as other economic variables. But the prices of financial and non-financial assets bring into sharp relief many of the problems faced by monetary policy-makers as, more obviously than other economic variables, asset prices perform a dual role. First, they represent near-continuously traded market clearing prices, which reflect forward-looking expectations about the likely payoffs flowing from assets, relative to the overall state of the economy. Secondly, they form an important channel of the transmission of monetary policy, which tends to be most clearly propagated via interest rate sensitive sectors. In setting the appropriate path of interest rates, monetary policy makers thus have to extract the signal being sent from volatile traded prices about the likely future state of the economy and then also gauge the response of those self-same prices from the interest rate sequence chosen by policy-makers. The correct calibration of this feedback is central to the setting of monetary policy.

Any disconnect of volatile asset prices from the macroeconomy throws open a number of puzzles for monetary policy makers and questions the way policy implements the standard answer to the asset price question. Are asset prices more closely related to long term factors and/or international factors that are relatively unrelated to short-run or cyclical domestic developments in the policy rate? Do volatile asset markets result from the pricing of previously missing and possibly riskier markets? Has the structural change brought about by the changing macroeconomic environment meant that we are using the wrong models to price assets or that market participants may still be learning about the implications of the regime change? Or has the reduced level of macroeconomic volatility reduced the rate at which future payoffs are discounted and thus made asset prices more sensitive to macroeconomic developments? The key current issues for policy makers to consider then are how to deal with any “excess” sensitivity of asset prices in terms of extracting news on developments in the economy and in understanding the impact of policy on the economy.

Specifically, the current constellation of asset prices and monetary policy creates the following tension. Financial and non-financial asset prices are at elevated levels, compared to historic measures of value, and imply that they are vulnerable to sharp downward corrections, with correspondingly long-lived risks to the level of demand in the economy. But this risk does not seem to be priced into forward-looking measures of asset price uncertainty. Inflation lies above the inflation target and at the edge of the monitored range, in the territory of letter-writing, and implies some need for policy to restrain aggregate demand. Moving to higher levels of policy rates will tend to restrain aggregate demand and lead to some correction of asset prices and possibly the revaluation of their riskiness.

But because of the perceived vulnerability of asset prices, the MPC seems willing to approach the central band of the inflation target rather slowly, ie let the expected period of adjustment become prolonged, what has been termed “flexible inflation targeting”. Given the uncertainties about the relationship between asset prices and the economy, a prolonged period of adjustment may make sense as we learn more about the fuller implications of the Great Moderation in output volatility. The danger of this strategy though, particularly if inflation is not especially responsive to a moderate slowdown in activity, (the so-called flattening of the Phillips curve) is that inflation expectations become dislodged from the target. A further danger is that a change in the policy reaction function is perceived by agents as providing policy “support” for elevated asset prices and leads to a further period of asset price appreciation. The alternative strategy of getting inflation back to its mid-point more quickly risks a sharper correction in asset prices and the possibility of triggering deeper and more persistent falls in demand.

How the Bank of England approaches the solution to this current dilemma will be a crucial factor in maintaining macroeconomic stability in the short to medium term. Ultimately, as well as modifying the implied policy reaction function to take account of the risks from asset price deflation (eg requiring some further form of distribution forecast targeting) there may be a need to adopt complimentary strategies involving the regular publication of assessments about the causes of elevated asset prices and the nature of the consequent macroeconomic vulnerabilities.

**FURTHER DEVELOPMENTS IN THE TRANSMISSION MECHANISM**

There have been several developments in the traditional transmission mechanism of monetary policy. As is well understood, the impact of shocks on the economy is exacerbated by the existence of price and wage rigidities. And although, as seems likely, these rigidities have dissipated to an extent alongside the continuing reform of the real economy some elements of nominal stickiness remain safely in place. The continuing extent of these rigidities implies a continuing role for the MPC in stabilising inefficient fluctuations in output via interest rate policy. The escalation in private debt without an offsetting reduction in levels of public debt imply that the economy has been kept at relatively high levels of capacity utilisation. But these highly levels of debt also suggest that the sensitivity of the economy to interest rate policy may have increased. Although
supply-side pressures in the labour market have been alleviated by high levels of net immigration, investment remains low by European standards and implies some future capacity pressures. The emergence of developing countries such as China has brought about persistent downward shocks to the prices of traded goods, which has increased the share of manufactured goods supply from these developing countries. Overall these mean that the economy has had to be run at a higher level of internally generated inflation in order to meet a given inflation target. And this means that real interest rates have tended to be lower than would otherwise have been case and this has acted to bid up asset prices eg in property and has led to an increase in debt.

**MONEY AND MACRO MODELS**

One ongoing concern is the absence of money or liquidity from the current generation of macroeconomic models. There is probably more agreement in practice over the use of money than it appears. As with a good trader, monetary policy makers should seek to exploit all available and robust correlations with the objects of primary interest. The trader will be concerned with the prices of assets on his or her book and the central banker with fluctuations in output and inflation. There are a number of reasons why a monetary policy maker should not, and in practice probably does not, ignore measures of monetary aggregates when setting monetary policy.

First, money may well provide an early real-time, albeit noisy, signal to the monetary policy maker about the state of the economy. Even though, in the fullness of time the information from output and inflation may encompass the news from money, for those who have to make decisions in real-time many indicators, including money, may have valuable information. Secondly, the components of broad money are likely to provide some clues as to the extent to which financial frictions and collateral constraints are being altered by lending practices and whether the economic cycle is being amplified.

Finally, some fundamental aspects of the monetary balance sheet may require the central bank to monitor developments with monetary implications. For example, monetary and fiscal policies are tied via the government’s budget constraint and imply a commitment by the fiscal authority to stabilise the level of public debt is a requirement of monetary stability. In this respect we encourage the continuation of the use of a clear long term framework within which fiscal policy operates. Finally, the implications of developments in our measures of money may not fully reflect the impact of liquidity provision elsewhere on domestic markets (eg through the carry trade) nor on the quantum of risk being run in domestic financial markets (eg due to an increased role for hedge funds)—so we would call for more work to measure monetary dynamics.

**USE OF POLICY RULES AND COMMUNICATION**

We would applaud the track record of the MPC in avoiding pre-announcing upcoming interest rate decisions via the use of statements, trigger language or MPC voting patterns. The committee can be proud that it takes each meeting as it comes and does not tie its hands by pre-committing to future action. By and large, the minutes and speeches do provide vital clues to the key pressure points for monetary policy going forward, though a more frequent pattern of speeches would more effectively guide thoughts on evolving issues and give more feel for the balance of opinion on the committee.

One notable case where communication was relatively poor was the January 2007 hike, which took markets by surprise—not that rates rose, but when they rose. While central banks should not be constrained to signal moves in advance, financial markets provide an important transmission mechanism for policy, and avoiding excess noise in those markets arguably should increase the efficiency of such transmission mechanisms as well as reinforcing the credibility of the central bank. In the case of January 2007, the unexpected shift in the speed of hiking was, in our view predictably, taken as a sign of more to come. There were sharp movements in the money and foreign exchange markets, which arguably delivered a degree of tightening greater than intended. Some of these movements were unwound subsequently when the minutes revealed a 5:4 split on the MPC. In our view volatility would have been more muted and the signal about policy would have been much more distinguished from the noise had the vote been made clear at the time of the decision rather than a fortnight later.

In general, we feel that there is scope for improvement in the MPC’s communications policy. Firstly, public comments by MPC members have been rather “scatter-gun” in nature. Speeches have tended to come without much warning. Further still, comments have tended to appear in regional publications rather than prominent financial press, which seems to reflect Bank policy.

Secondly, we would view it as useful if there were more opportunity for professional economists to discuss the rationale behind MPC decisions with members of the committee—perhaps in a regular forum. Journalists have access to Bank staff and MPC members either at the Inflation Report Press Briefing or with informal briefing sessions, but some of the more technical questions that may be important to understanding the MPC’s views do not always make good copy and are sometimes missed. Some further transparency is required.

It is important that policy is thought to respond in a rule-like manner and not to have become discretionary. We are thus lucky that both the experience of the Bank of England under operational independence and the recent literature on monetary policy have pushed forward our understanding of the
debate on rules versus discretion. Initially policy rules looked to be useful constructs but came up against the problem of pervasive uncertainty about the economy in real-time. One possible resolution was a search for robust feedback rules. But this led to a question of how can a monetary policy rule, which is itself subject to updating and revision, reduce uncertainty? And given that the impact of any chosen sequence of policy rates is also highly uncertain with not only long and variable lags but also varying degrees of efficacy, it is a wonder that policymakers should think in terms of rules rather than discretion and judgement. Indeed, such is the apparent difficulty in stabilising an economy that it is not even clear why discretion should work either.

But there are at least three good arguments for rules-based monetary policy. First, that in the absence of a stated and clearly understood commitment to a rule, policymakers may be perceived by economic agents to have an incentive to behave in a time inconsistent manner. Such a commitment does not necessarily imply that policymakers should then tie their hands completely to a mechanical rule but that a target is pursued, subject to forecast errors, by an instrument which feeds back from our best guess of the state of the economy. Note the guess and the outcomes may be wrong, involve judgement and learning but these factors can be built into the decision rule that is adopted.

Secondly, it is clear that policymakers increasingly understand that multiplying uncertainties is not a sensible way to proceed when managing risk. Taking a lead from Alan Greenspan, the risk management approach to monetary policy seems to be an attractive approach to uncertainties as it conceives of the monetary policy instrument as responding to the range of risks faced by an economy. In this framework the range of risks are quantified with specific reference to many economic models and policy becomes the rule for interest rates that minimises risk across various model-based scenarios. Finally, simple rules provide guidance when we have partial information by allowing us a benchmark against which to guide judgement.

So when an economy is faced by unusual events such as liquidity trap or by escalating levels of private sector debt, we can take a view on how much, if any, (temporary) discretion to apply and accordingly give the private sector guidance. Rules thus seem preferable but should be exercised with care. In this sense the current vogue is to think of rules in practice as involving tracking constraints on discretion, or constrained discretion. Whether constrained discretion turns out to be sufficient to avoid serious policy errors we are not sure, but we do know very interesting times lie immediately ahead. This constrained discretion has been referred to by policy makers—but what worries us though is that we end up coming up with ideas to justify increasing levels of discretion in the operation of policy over what might be suggested by model-based rules. All of this calls for more explanation and greater levels of transparency for judgement exercised rather than less and this is the main thrust of our evidence to the Treasury Committee.

January 2007

Memorandum submitted by Richard Lambert, Director-General, CBI

THE MONETARY POLICY FRAMEWORK

The framework set out 10 years ago is robust and successful, and has been well supported by a formidably strong team of economic analysts at the Bank. The symmetrical nature of the target is an essential part of the process, forcing the Committee to be as concerned about undershooting the target as it is about overshooting it.

I think the statutory objectives of the Bank are appropriate, and I also believe it’s right that the Chancellor should be responsible for setting the target, since this brings democratic legitimacy to monetary policy. CPI is probably a “better” index than RPIX, and it would not be a good idea to change the target index again in the foreseeable future, since that could undermine credibility.

If you were rewriting the legislation you would probably not require monthly meetings of the MPC—but I don’t think it would be worth going to great trouble for such a minor change.

I think it is wrong to suggest that the process of letter writing by the Governor is necessarily a “sanction”. Instead, it should be seen as a very important part of the communications process.

The main focus of the Committee has to be on the inflation target and, subject to that, on the broader economic policy of the Government. The MPC’s great strength is its focus. It would be a mistake to broaden its remit or to suggest that it takes account of asset prices except insofar as they might have an impact on the future path of inflation.
The MPC as a Body

The size and composition of the MPC is appropriate, as is the mix between insiders and outsiders. There is plenty of evidence that a group of committed individuals from different backgrounds is more likely to make good decisions than specialists from a single culture.

I told the Select Committee on my appointment hearing that I would favour a step towards the Nolan procedures for appointments to the MPC. I have changed my view. I think it is right that the Chancellor and the Governor should have a considerable degree of discretion in appointing members of a group which needs to get the right balance of intellect and personality. The Chancellor—any chancellor—has an enormous vested interest in the credibility of the MPC, and will choose its members accordingly.

However, more attention needs to be given to the appointment process to ensure that there aren’t hurried decisions or gaps in the line-up.

The role of the TSC in the process is to hold the Chancellor’s feet to the fire. If it thinks his appointments threaten the credibility of the MPC, it should say so.

In an ideal world, appointments to the MPC should be for a rather longer period, and should probably be non-renewable. However, moving beyond a three-year period might well make it harder to attract talented individuals who might otherwise see the job as an attractive career break.

The Mechanics of Setting and Implementing Monetary Policy

The MPC is strongly committed to the idea of transparency. The Bank is far more open than it ever used to be, and no doubt this process will continue to develop over time.

The MPC is a group of individuals, each personally responsible for his or her decision. So I would be strongly against the Governor giving a press conference immediately after the decision, as happens at the ECB. It would be impossible for him to capture the ideas of individual MPC members in such a forum.

That’s why the minutes are the key tool in communicating the MPC’s decisions. It would be worth debating whether there might be ways of making them more transparent without limiting the free discussion at the meetings themselves.

The Bank is very good indeed at communicating to the financial markets and the business press. I think it could probably do more to educate the public on monetary policy issues. This will become more important as memories of the horrors of inflation fade into the past.

External members are well supported by the Bank, and the Bank’s capabilities are indeed fit for purpose. The Court takes seriously its responsibilities for the proper functioning of the Committee.

The Bank’s agents do a good job of reporting regional economic conditions to the MPC, and Committee members are frequent visitors to the regions and nations of the UK. However, there can only be one inflation target, which has to reflect the macroeconomic circumstances of the country as a whole.

February 2007