Treasury Committee Questionnaire ahead of appointment hearing for Mr David Walton

A. Personal and Professional Background

1. Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in carrying out your duties as a member of the MPC? Are there any relevant personal or other factors of which the Treasury Committee should be aware in considering your appointment?

I have no conflicts of interest concerning my duties as a member of the MPC. My appointment to the MPC was on a 3-day a week equivalent basis (the terms and conditions were determined by the Court of the Bank of England). I have since accepted the post of Visiting Research Professor in Monetary Economics at the University of Oxford on a part-time, 1-day a week equivalent basis. This has been approved by both the Chancellor and the Governor of the Bank of England. They also agreed that I could continue to serve as Chairman of the Society of Business Economics, though I have stood down from the Society's Investment Committee.

2. Do you intend to serve out the full term for which you are appointed?

Yes.

3. Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the MPC.

I have more than 20 years experience as a professional economist, much of it spent analysing and forecasting the UK economy. My career began in September 1984 as an economist with HM Treasury working, first, in the Economic Briefing division and, subsequently, in one of the monetary policy areas. After gaining a Masters degree in Economics from Warwick University, I joined the economics team at Goldman Sachs in October 1987, eventually becoming Chief European Economist. Throughout my time at Goldman Sachs, the economics team was regarded as one of the best in the City for its analysis of the UK economy. During this period, I published many articles of relevance to monetary policy (a representative list is attached). I served as a specialist adviser to the Treasury Committee on both monetary policy and fiscal policy issues during the last two parliaments.

B. Accountability

4. How important do you think it is for MPC members to be subject to ex post parliamentary accountability? Could the current procedures be improved?

The MPC seeks to achieve the inflation target set by the Government and, subject to this, support the economic policy of the Government. Hence it is very important that MPC members are accountable to Parliament for their actions. The MPC does this in a number of ways: issuing minutes of each meeting; publishing a quarterly Inflation Report; writing an open letter to the Chancellor if inflation deviates by more than one percentage point from target; and by members giving speeches and interviews. Given the closeness of the vote at my first two MPC meetings, I thought it was important to give a speech at an early opportunity to set out my reasoning. I delivered this to a business audience in Exeter on 16 September (a copy is attached). I also believe that accountability is enhanced by the Treasury Committee probing the views of individual MPC members in regular face-to-face meetings. I think the current procedures work well and I have no suggestions at this time for improvements.

5. If you were to make yourself available for reappointment to the MPC at the end of your term, what criteria should be used to assess your individual record as an MPC member?

Whether or not I wished to be reappointed, I would hope to be judged, internally, on my contribution to the MPC's decision making; and externally, on my contribution to building and maintaining a consensus for low inflation. One part of the latter is to try to ensure that the Committee hits the inflation target but it also involves communicating clearly the reasoning behind our decisions, something I tried to do in my Exeter speech.

C. <u>Monetary and economic policy</u>

6. How might the post-1998 monetary policy control system be improved? Is the framework of an explicit symmetrical inflation target the best within which to conduct policy?

The monetary policy framework, since the Bank of England was made independent, has worked extremely well. During this period, despite a number of potentially severe shocks to the economic system (e.g. the bursting of the internet bubble, 9/11 and, more recently, a sharp rise in oil prices), inflation has remained close to target. At the same time, the economy has grown steadily and unemployment has remained low and stable. A symmetric inflation target is important since it provides an assurance that the MPC will try to avoid deflation as well as excessive inflation. And by making the target explicit, the private sector does not have to second guess the MPC's intentions, thereby helping to anchor inflation expectations at the target. At the same time, the framework has sufficient flexibility to allow the MPC to use its judgement how best to respond to shocks; the open letter system – should inflation stray more than one percentage point from its target – ensures that the Committee is accountable for its actions. In my view, it would be hard to improve on this framework.

7. What factors do you think have led to the increase in CPI inflation over the last 12 months? How far does it reflect pressures of demand on supply within the UK economy?

It is impossible to allocate precisely the causes of the increase in CPI inflation from a low of 1.1 per cent in September 2004 to 2.4 per cent in August 2005. Between one-third and one-half seems attributable to higher oil prices, both the direct effect on petrol prices and the indirect effects working through the supply chain. Part of it may also reflect the pressures of demand on supply. In particular, revisions to the National Accounts in July substantially altered the path for market sector output such that growth was much stronger during 2003 and the first half of 2004 than previously estimated by the ONS and much softer thereafter. This could have contributed to some of the pickup in inflation observed over the past year. But it is also interesting to note that CPI inflation has picked up much more sharply than RPIX inflation over the past year. While the MPC's remit refers to CPI inflation, it suggests to me that we should be careful not to over-analyse very short-term movements in this, or any other individual, measure of inflation.

8. How does the measurement of public sector output affect estimates of spare capacity and inflationary pressures within the UK economy?

When considering inflationary pressures within the economy, it may be more appropriate at times to consider the private sector resources being absorbed by the government rather than the real consumption of the government or the quantity of value-added that it produces, much of which is not traded. This distinction is particularly relevant in times when there is a rapid increase in nominal government spending, such as that which has taken place since 1999. Methodological changes in the way in public sector output is measured would have very little impact on my estimate of spare capacity in the economy because I derive this mainly from survey measures of factor utilisation and labour market tightness.

9. What do you regard as the main risks to the MPC's forecasts for GDP growth and CPI inflation contained in the August inflation report?

I believe that there is a downside risk to the MPC's central projection for growth which, in turn, creates a downside risk for inflation further out. Household spending growth, in particular, has been weak during the first half of this year. Although these data could yet be revised higher, a further period of subdued consumption growth seems quite likely. Higher oil prices and a loosening in the labour market will curb the growth of household real incomes. And households' willingness to borrow to maintain spending growth may be limited by their existing high levels of debt. Prospects for business investment are also very uncertain. Business investment has been fairly soft in recent quarters and surveys of investment intentions have eased despite favourable financing conditions. Companies might remain reluctant to invest in the face of increased uncertainty about demand and profitability associated with high energy prices.

10. How great is the risk to UK growth and inflation posed by high oil prices? How should monetary policy react to higher inflation caused by increased oil prices?

Oil is a big uncertainty for the outlook for both growth and inflation. Oil prices have doubled since the beginning of 2004; the oil futures market suggests that much of this increase in prices may persist. High oil prices act like a tax, transferring money from consumers to oil producers: as a result the growth rate of the real consumption wage will be somewhat lower than it otherwise would have been. For example, if oil prices were sustained around current levels, and taking the share of oil in total final expenditure, there might need to be a downward adjustment in the real consumption wage by around 1½% over the next couple of years relative to what would otherwise have been possible.

The oil shock poses a dilemma for monetary policy because it tends to dampen growth and boost inflation. The appropriate monetary policy response depends on how households and businesses react. There is a wide range of possible outcomes. Demand could conceivably soften too much if the necessary downward adjustment to the real consumption wage proceeded too rapidly and damaged confidence. Alternatively, inflation expectations could become destabilised if inflation moves too far away from target, increasing the risk that households will demand higher wages in response to higher consumer price inflation in an attempt to try to maintain their spending power. And we have little idea whether oil prices at these levels will permanently reduce the productive capacity of the economy. For the moment, at least, inflation expectations seem well anchored on the target and wage inflation has not picked up by as much as the rise in the CPI inflation which suggests that the adjustment in the real consumption wage is proceeding without jeopardising the inflation target.

11. What consideration should be given to the exchange rate and to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?

Monetary policy needs to respond to asset prices to the extent that they convey information about the path for consumer price inflation. I do not believe that they should play much of a role in decision making beyond this. I doubt whether we have either the ability to identify asset price bubbles in good time or the instruments to prick them without jeopardising our ability to hit the inflation target. My scepticism dates from observing the UK monetary authorities' attempt during the first half of 1988 to prick one supposed bubble – cutting interest rates to try to stop sterling appreciating against the D-Mark – only to help fuel another in the housing market. But this scepticism has been reaffirmed on at least three other occasions since. Monetary policy would have been too loose if it had tried to prevent the 25% appreciation in sterling during 1996/97. And monetary policy would have been too tight if it had tried to pop the internet bubble and rein back the house price increases of recent years. I'd also note that since only the internet bubble has burst, it is legitimate to question whether there have been bubbles in either sterling or the housing market in recent years.

12. The IMF recently recommended that "it would be worthwhile for the [Bank of England] to expand the number of key macroeconomic variables for which quantified projections are published". Do you agree with this statement? Which additional key economic variables should the Bank publish projections for?

I believe that the Bank of England should be as open and transparent as possible. I would have no objection, in principle, in publishing more detail behind the MPC's projections along the lines of those published by most other forecasters. I have two caveats, however. First, the uncertainties around the central projections are as important as the central projections themselves. This is captured by the fan charts in the Inflation Report. Extending the range of fan charts may not help with the MPC's communication. Second, there is a subtle, but important, difference between the Bank's projections and others: for most forecasters, the projections are their best guess, including for interest rates, about what will happen. This is not true for the MPC: the Committee's projections are the best guess about what will happen for a given interest rate path – either constant or market-based. Since the MPC is able to set interest rates to influence the actual outcomes, the GDP and inflation projections in the Inflation Report are not necessarily a true reflection of the MPC's view of how it expects the economy to develop.

13. Do you believe that the natural rate of unemployment is a useful concept? On your assessment, where is unemployment currently relative to the natural rate?

I prefer to use the term "equilibrium" rate of unemployment, or NAIRU, rather than natural rate. It is a very useful concept since it is the unemployment rate that matches demand and supply in the labour market without generating any tendency for wage inflation to rise or fall. Inflation pressures will tend to increase (decrease) if unemployment falls below (rises above) the NAIRU. Like the output gap, it is impossible to measure precisely; the NAIRU can shift through time due, for example, to changes in the structure of the labour market, the tax system and the real exchange rate. But, given the broad stability in wage inflation in recent years, it seems reasonable to believe that the equilibrium rate of unemployment has been fairly close to, or perhaps slightly below, the actual unemployment rate of 4.7 per cent for some time. In judging whether there is slack in the labour market there are other important considerations such as flows to and from those classified as inactive, movements in average hours, and compositional changes in the workforce.

14. What weight do you place on (a) the monetary aggregates and (b) the output gap in your assessment of inflation prospects?

There is a positive correlation in the long run between money and prices and it is hard to think of examples of episodes of high inflation that have not been accompanied by rapid monetary growth; hence, money is very important. And it is the job of monetary policy to control inflation. However, the monetary aggregates are not necessarily the most reliable guide to the stance of monetary policy due to variations in velocity that are difficult to predict. In particular, when inflation is low and stable and inflation expectations are well anchored, it is likely that fluctuations in money growth mostly reflect changes in the demand for money that may be of limited significance for future inflation. And when they are of significance, this should also show up in other indicators. I prefer, therefore, to consider money as one of the many indicators that are available of future inflationary pressure.

The output gap, like the NAIRU, is a very important concept. When output is above (below) potential, domestic inflationary pressures will tend to build (ease). But the output gap is impossible to measure precisely because, like the NAIRU, it is unobservable. I try to infer the size of the output gap from survey measures of factor utilisation, skill shortages, recruitment difficulties and so on, as well as taking into account the behaviour of wages and prices.

15. To what extent should fiscal policy play a demand management role alongside monetary policy in the short run?

I believe that demand management should be left primarily to monetary policy – interest rates are much easier to adjust than public spending and taxes, and they are far less likely to distort the supply side of the economy. While it is desirable that fiscal policy is supportive of monetary policy, it is far more important for the Government to set a medium-term-oriented framework for government borrowing and debt.

Attachments

CV
Selected publications
Speech given in Exeter on 16 September 2005