BANK OF ENGLAND

What we know now: The BoE's past 15 years

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Fifteen years ago – almost to the day – the Bank of England was given responsibility for the conduct of monetary policy.

The first 10 years were part of the most stable period in British economic history. Each month, the Monetary Policy Committee agonised over whether to tweak the bank rate 25 basis points this way or that.

We did not expect these benign conditions to continue indefinitely. But while we saw some of the risks, we didn't come close to anticipating that the next five years would include the most severe international financial crisis since the 1930s, as Sir Mervyn King acknowledged in his BBC Today Programme Lecture.

So what have we learnt regarding the conduct of monetary policy?

First, hitting the inflation target is not enough to guarantee economic stability. Long periods of stability encourage households, companies and investors to extrapolate such conditions into the future, to underprice risks, and to increase leverage, so increasing the vulnerabilities in the system.

But the answer is not to jettison the inflation target and direct monetary policy to other ends. The application of regulatory tools of the sort considered by the bank's new Financial Policy Committee could offer a more effective way to increase economic resilience.

There may, though, be times when monetary policy will need to work in tandem with such macro-prudential policies, particularly if some financial activities lie outside the FPC's reach. We have always accepted temporary deviations of inflation from target so as to avoid excessive volatility in output and employment. The need to avoid future build-ups of unsustainable financial imbalances constitutes another justification for accepting occasional temporary deviations.

Second, it is easier than one expects to find oneself in uncharted territory. During the first decade of the MPC, there didn't seem much danger of the bank rate approaching its zero floor, let alone of us having to resort to quantitative easing. The financial crisis changed that, in part because concerns about the solvency and liquidity of banks drove a wedge between the bank rate and market interest rates, and in part because a highly stimulatory monetary stance was needed to sustain demand.

QE is often described as "printing money", conjuring up images of Weimar hyperinflation. That is indeed the fate of countries that resort to the permanent monetary finance of a persistent budget deficit. QE is different. It involves temporarily exchanging one liability of the state – government bonds (gilts) – for another – claims on the central bank. That change in the quantities of the two assets held by the private sector results not only in a rise in the price of gilts, but also in the prices of substitute assets, such as corporate bonds and equities. That boosts demand by increasing wealth and by reducing companies' cost of finance. It also increases banks' liquidity and may prompt more lending, though that channel is often weak after a financial crisis.

The evidence suggests that QE has worked. That is corroborated by studies of the Fed's large-scale asset purchases. But there is considerable uncertainty about the precise impact. And it is plausible that the effectiveness of the policy depends upon the state of the economy.

Third, a long period of abnormal monetary policy strains social support for a central bank's actions. Changes in policy always have distributional consequences, shifting income from savers to borrowers or vice versa. That is an unavoidable byproduct, rather than the aim, of policy. Society usually accepts such consequences because they are transitory, and what one loses on the swings today, one may gain on the roundabouts tomorrow. But the sustained period of very low interest rates has, quite reasonably, prompted complaints from savers who feel they are bearing an unfair burden.

Part of the problem is that people can see the direct impact on them of policy, but are less conscious of the indirect effects. The present highly stimulatory policy stance means activity, employment and asset prices are all higher than they would otherwise be. So many savers are benefiting indirectly. But, most importantly, the highly stimulatory monetary stance should help put the economy back on to an even keel. That is the best medicine for us all.

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