DOES THE MODEL REMAIN FIT FOR PURPOSE? MONETARY POLICY CONSIDERATIONS

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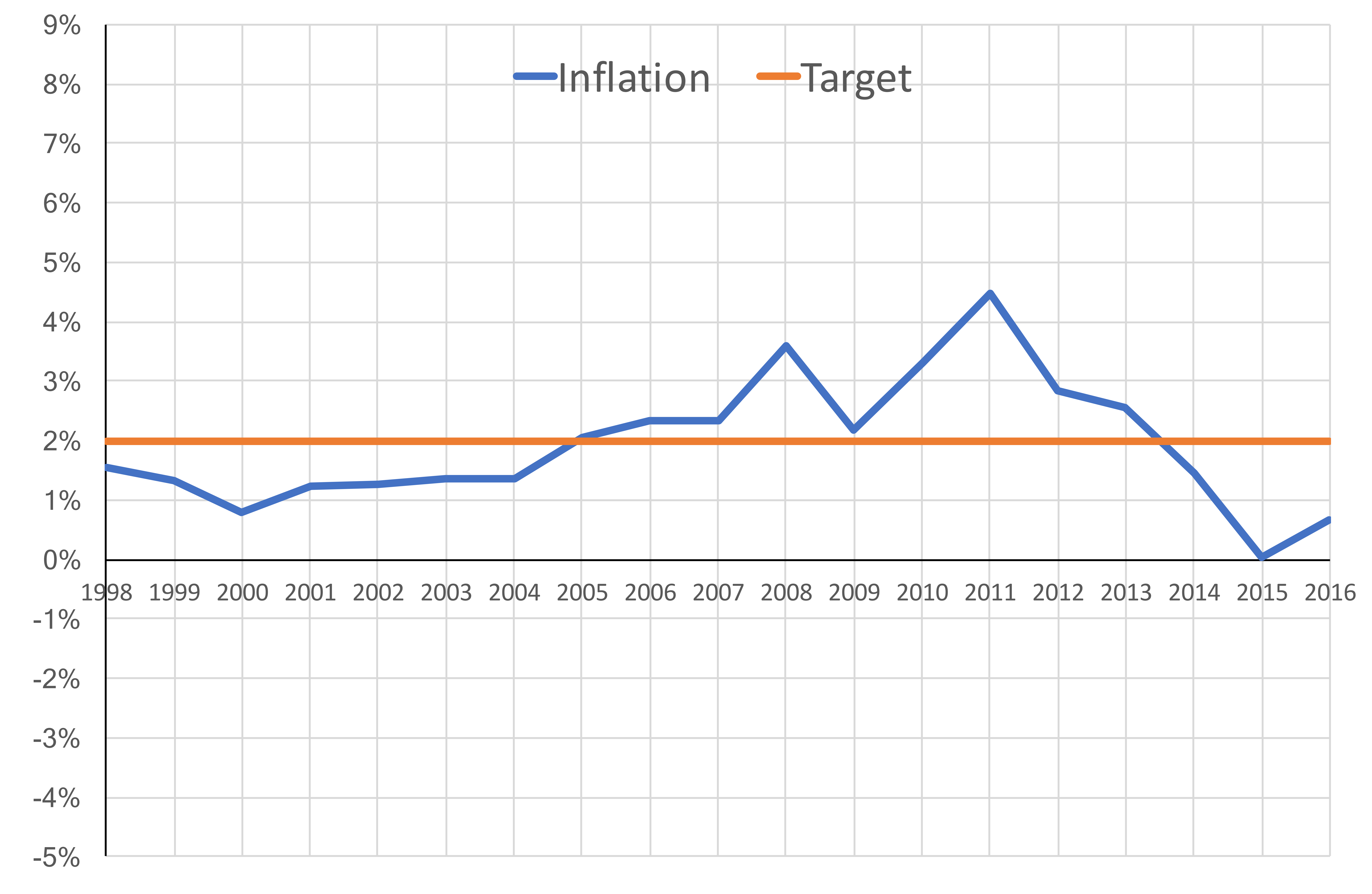
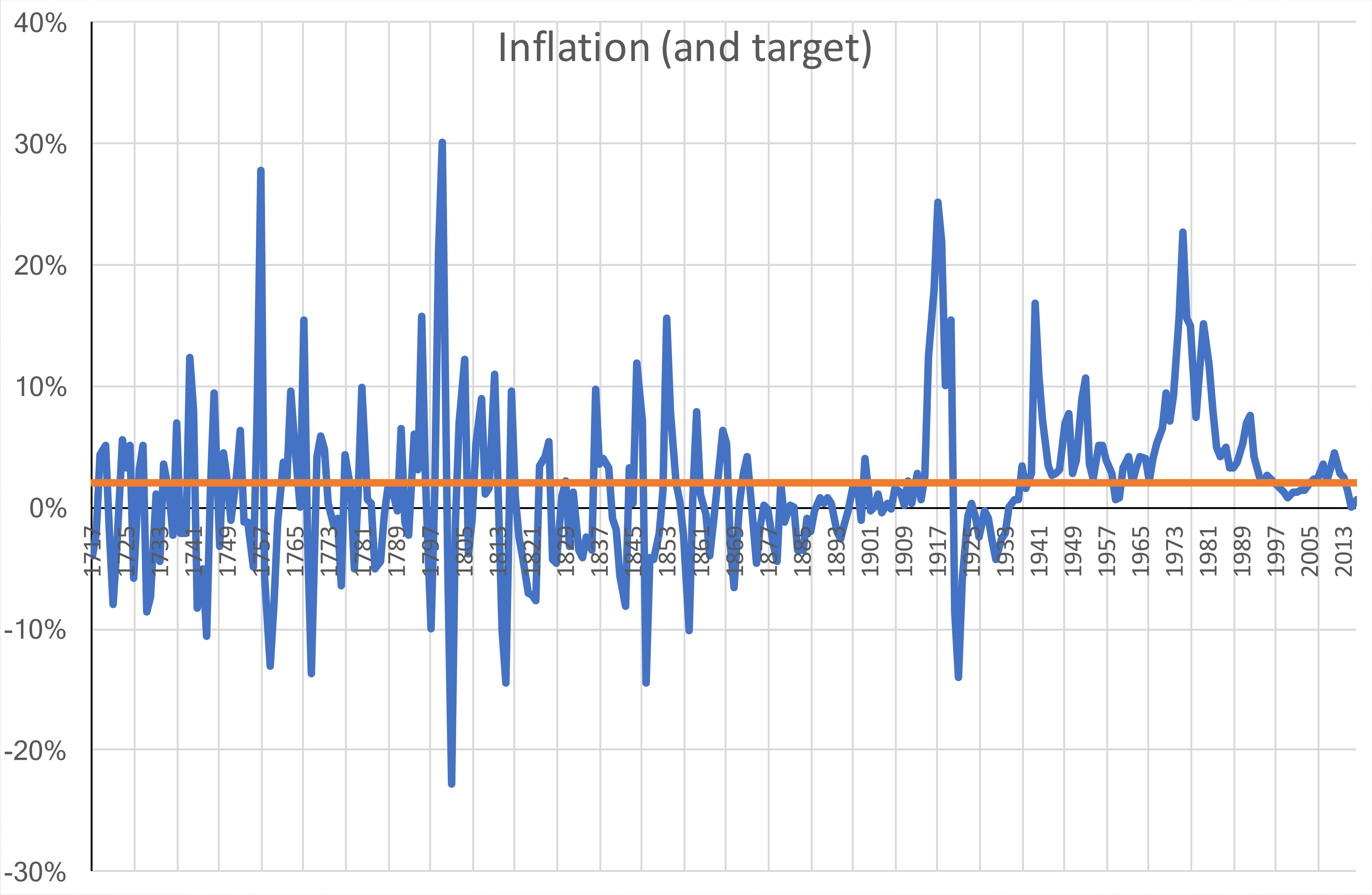
Bank of England Independence 20 Years On
London, 28th of September, 2017

PERFORMANCE: INFLATION STABLE



NOT ALWAYS SO



Source: Greenwood et al (2014)

INDEPENDENCE IN PERSPECTIVE

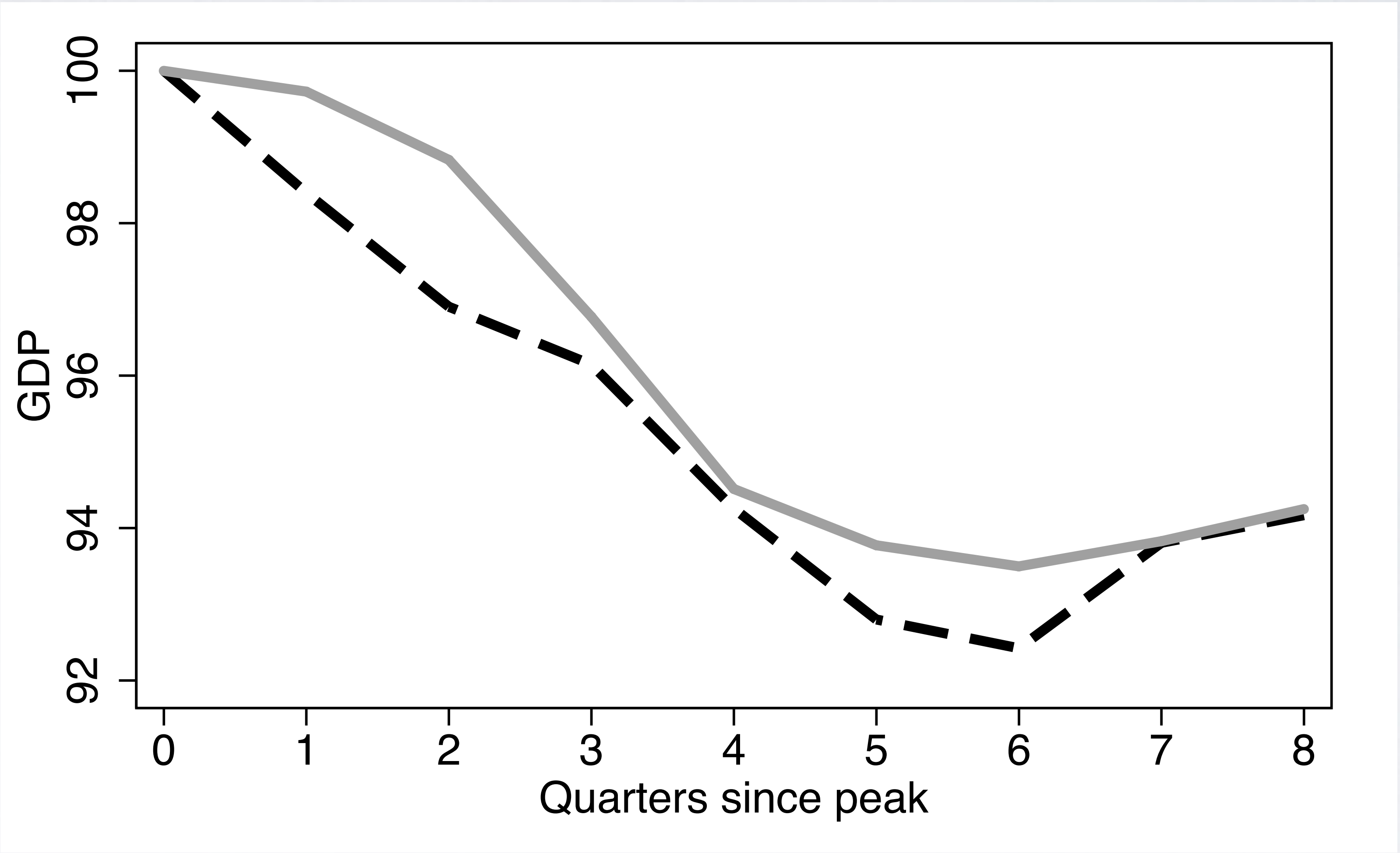
CPI inflation over decades (annual data)				
	Average	Standard Deviation	Minimum	Maximum
1717-2016	1.9%	6.6%	-22.8%	30.0%
1717-1913	0.5%	6.4%	-22.8%	30.0%
1914-1945	3.5%	8.8%	-14.0%	25.2%
1946-1973	4.8%	2.7%	0.6%	10.7%
1974-1997	7.6%	5.7%	1.8%	22.7%
1998-2016	1.9%	1.1%	0.0%	4.5%
1998-2010	1.9%	0.8%	0.8%	3.6%
2011-2016	2.0%	1.6%	0.0%	4.5%

EXPECTATIONS ANCHORED IN SPITE OF SHOCKS

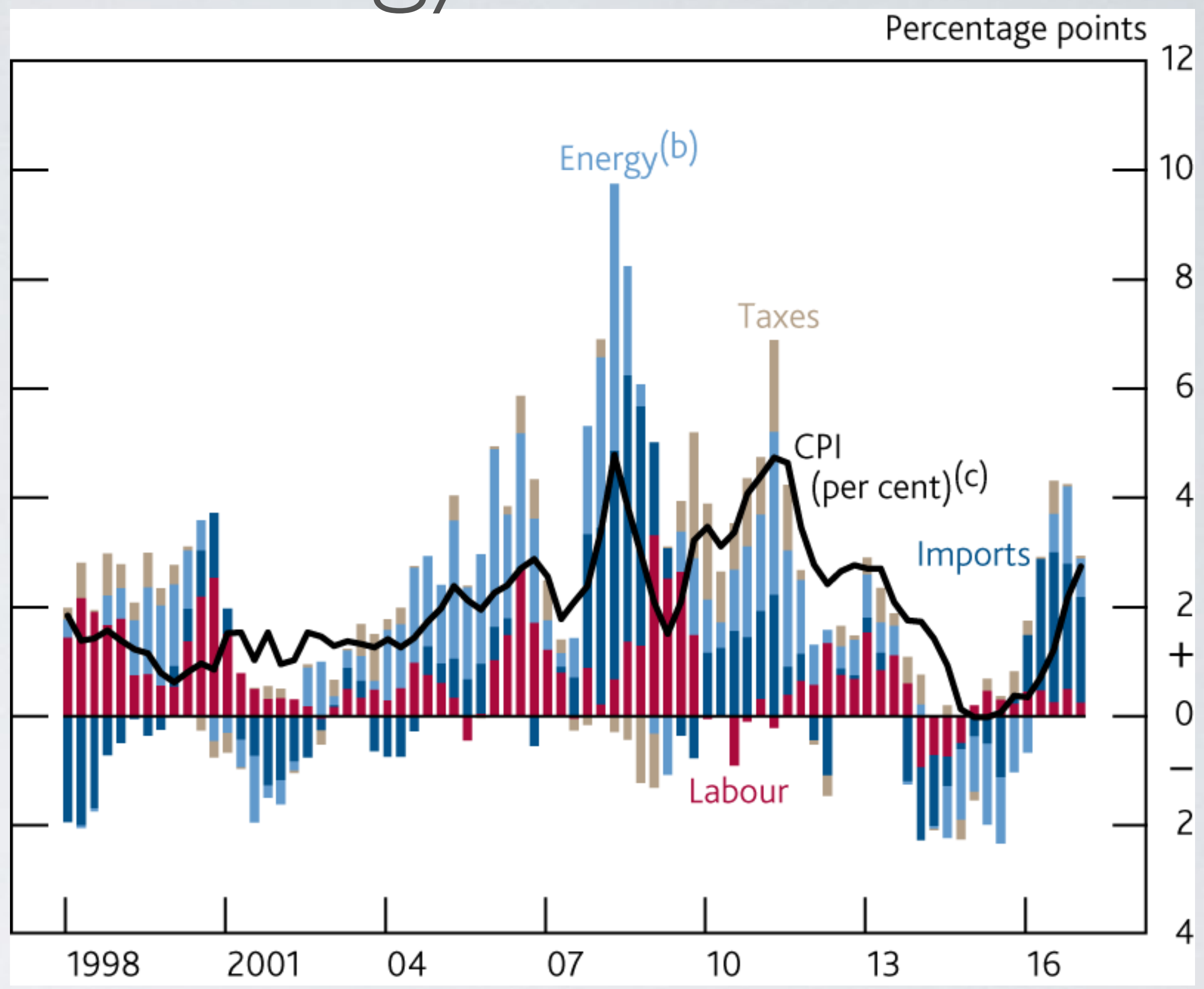
Per cent

	2000 (or start of series) to 2007 averages[b]	Averages since 2008	2014	2015	2016 H1	2016 H2	2017 Q1	2017 Q2	2017 Q3[c]
One year ahead inflation expectations									
Households[d]									
Bank/GfK/TNS[e]	2.4	3.0	2.7	2.0	1.9	2.5	2.9	2.8	n.a.
Barclays Basix	2.8	2.8	2.3	1.5	1.7	2.0	2.2	2.4	n.a.
YouGov/Citigroup (Nov. 2005)	2.5	2.4	2.0	1.3	1.5	2.1	2.6	2.6	2.5
Companies (2008 Q2)[f]	n.a.	0.6	0.6	0.4	0.4	0.9	2.0	0.9	n.a.
Financial markets (Oct. 2004)[g]	2.6	2.8	2.8	2.5	2.5	3.2	3.6	3.4	3.4
Two to three year ahead expectations									
Households[d]									
Bank/GfK/TNS (2009 Q1)[e]	n.a.	2.7	2.7	2.3	2.2	2.4	2.7	2.8	n.a.
Barclays Basix	3.2	3.0	2.6	1.9	2.2	2.4	2.8	2.9	n.a.
Professional forecasters (2006 Q2)[h]	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.2	2.0
Financial markets (Oct. 2004)[i]	2.8	3.0	3.1	3.0	2.8	3.2	3.5	3.3	3.2
Five to ten year ahead expectations									
Households[d]									
Bank/GfK/TNS (2009 Q1)[e]	n.a.	3.2	3.1	2.8	3.2	3.1	3.2	3.3	n.a.
Barclays Basix (2008 Q3)	n.a.	3.7	3.6	3.1	3.6	3.4	3.9	3.9	n.a.
YouGov/Citigroup (Nov. 2005)	3.5	3.2	2.9	2.7	2.7	2.7	3.1	3.0	3.1
Financial markets (Oct. 2004)[j]	3.0	3.4	3.4	3.3	3.1	3.3	3.5	3.4	3.3
Memo: CPI inflation	1.6	2.4	1.5	0.0	0.4	1.0	2.1	2.7	n.a.

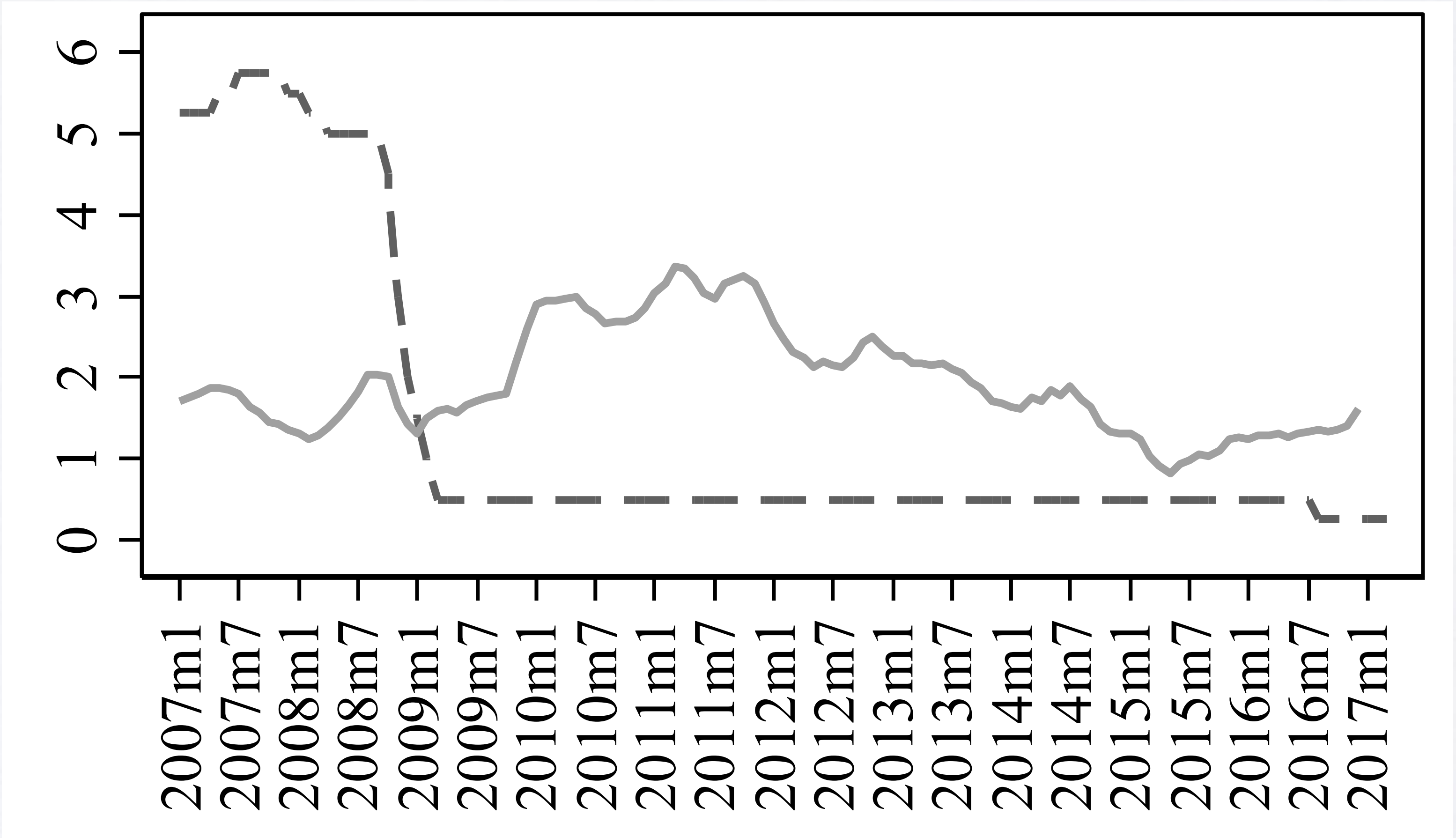
Massive recession



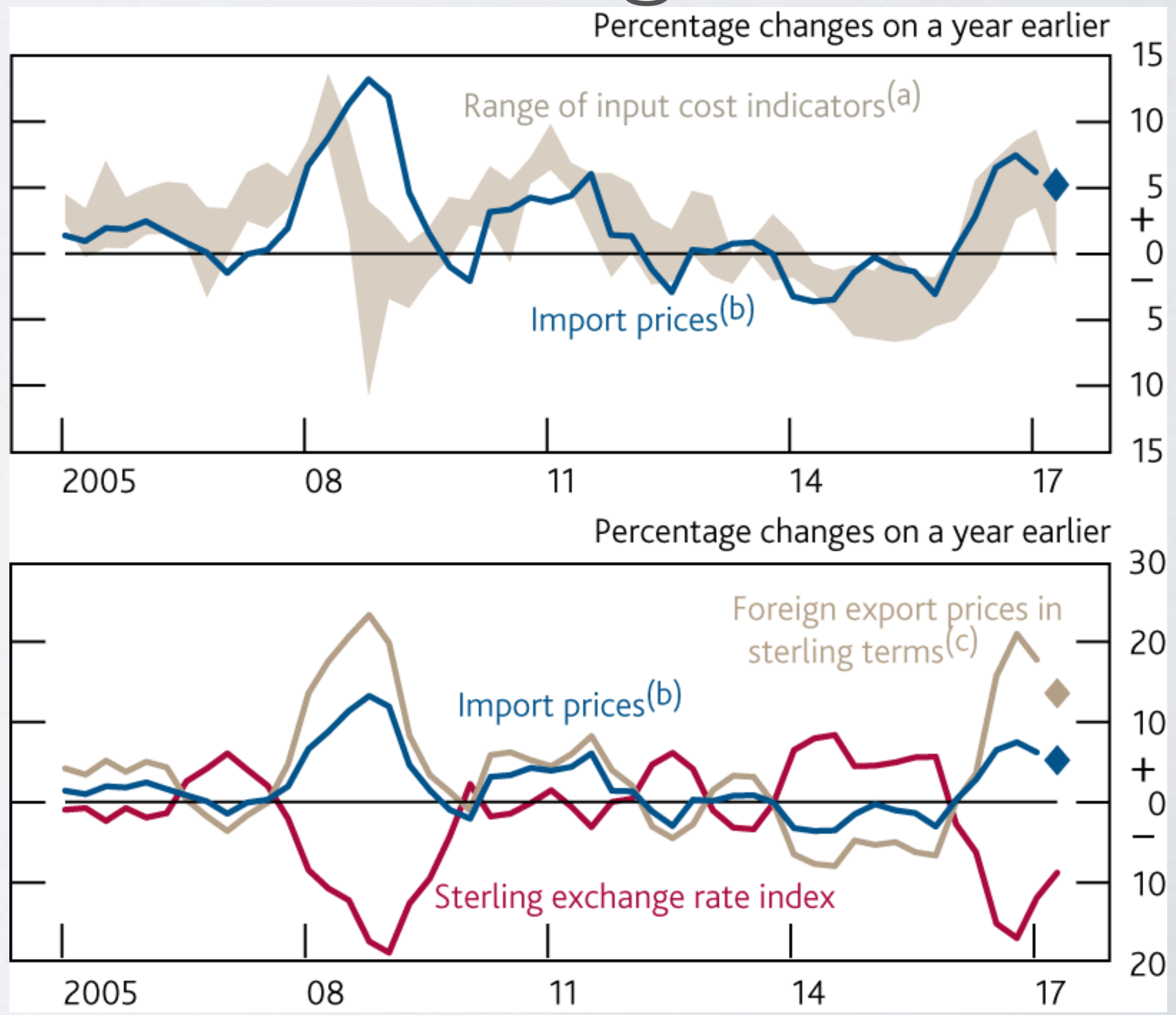
Energy and taxes



Interest rates



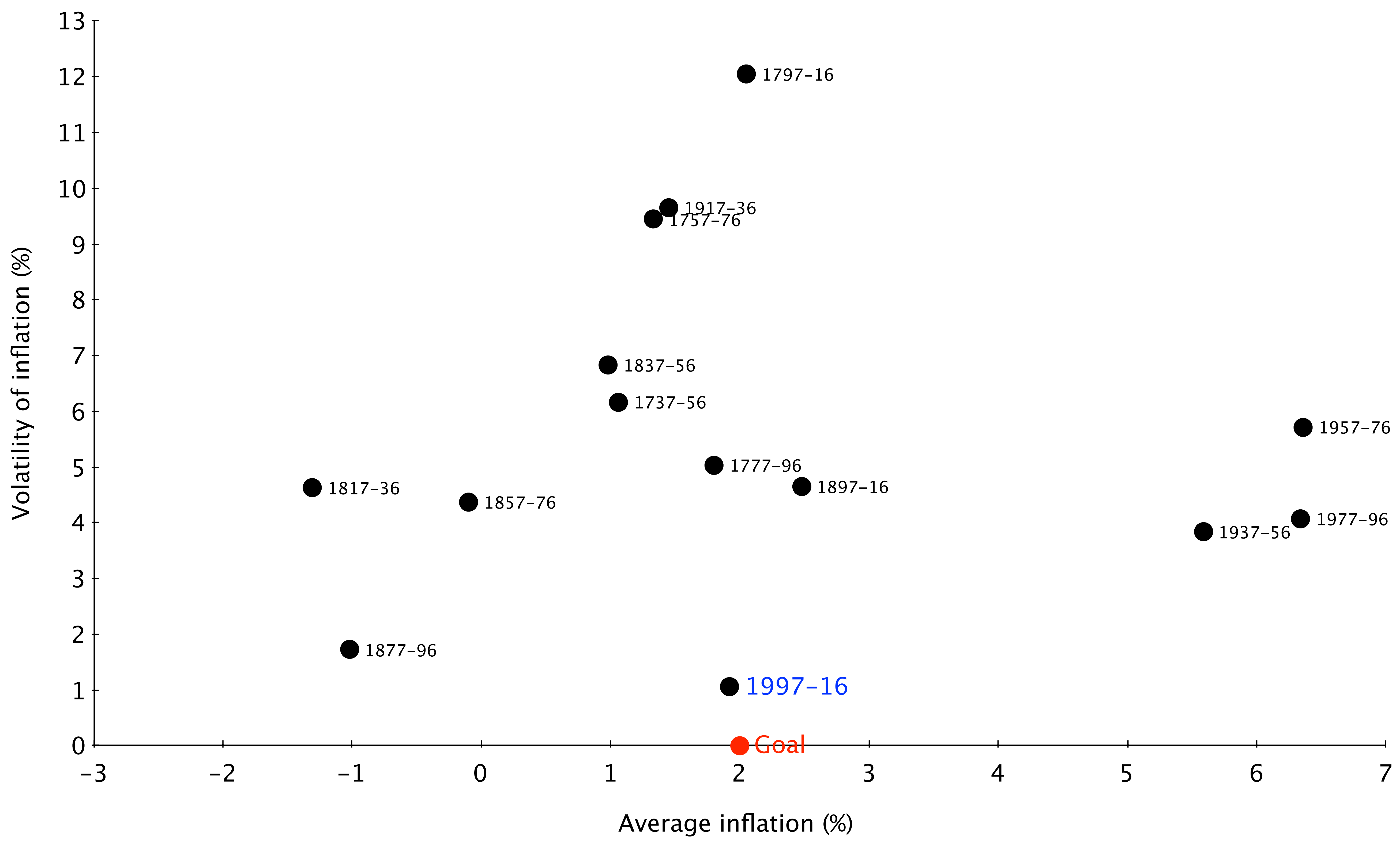
Exchange rate



Source: Miles et al (2017) and Inflation Report (August, 2017)

CONCLUSION FROM EVALUATION

In 400 years, ***no*** 20-year period had such low and stable inflation.



In spite of bad shocks, kept trust in the value of pound stable. Central bank independence has been an **astounding success!**

THE CASE FOR INDEPENDENCE

Which policies, not mandates, should be delegated to technocrats?

1. Technically complex decisions.
2. Goal is clear and consensual.
3. Providing a stable framework is more important than quick reactions.
4. Redistribution issues are not first order.
5. Accountability and transparency can be enforced.

These arguments apply today as they did 20 years ago.

We do not vote on which side of the road to drive all the time; or on using metric versus imperial system. Standards are important. **Central bank is the safe-keeper of a standard, the unit of account, what a pound is worth.**

THE MANDATE

- **Inflation:**

  Since can control it, and it matters for welfare.

- **Real activity**

1. *Gaps:* business cycle only, long-run monetary neutrality.
2. *Measurable:* unemployment, output gaps.
3. *Feasible:* yes, as long as there is a Phillips curve.
4. *Independent from other goal:* supply shocks.
5. *Constrained activism:* transparent, accountable.
6. *Communication:* goal and performance clear.

TIME TO ADOPT OTHERS?

Cyclical, mimics criticisms of GDP as measure of economic growth

- Twenty years ago: Human Development Index
- Ten years ago: Happiness measures
- Today: **Inequality**

Reasons for skepticism:

1. trend not gap,
2. quite imperfect measures,
3. unclear it is feasible,
4. unemployment already captures the major risk,

5-6. we disagree and vote on redistribution.

ON THE INFLATION TARGET

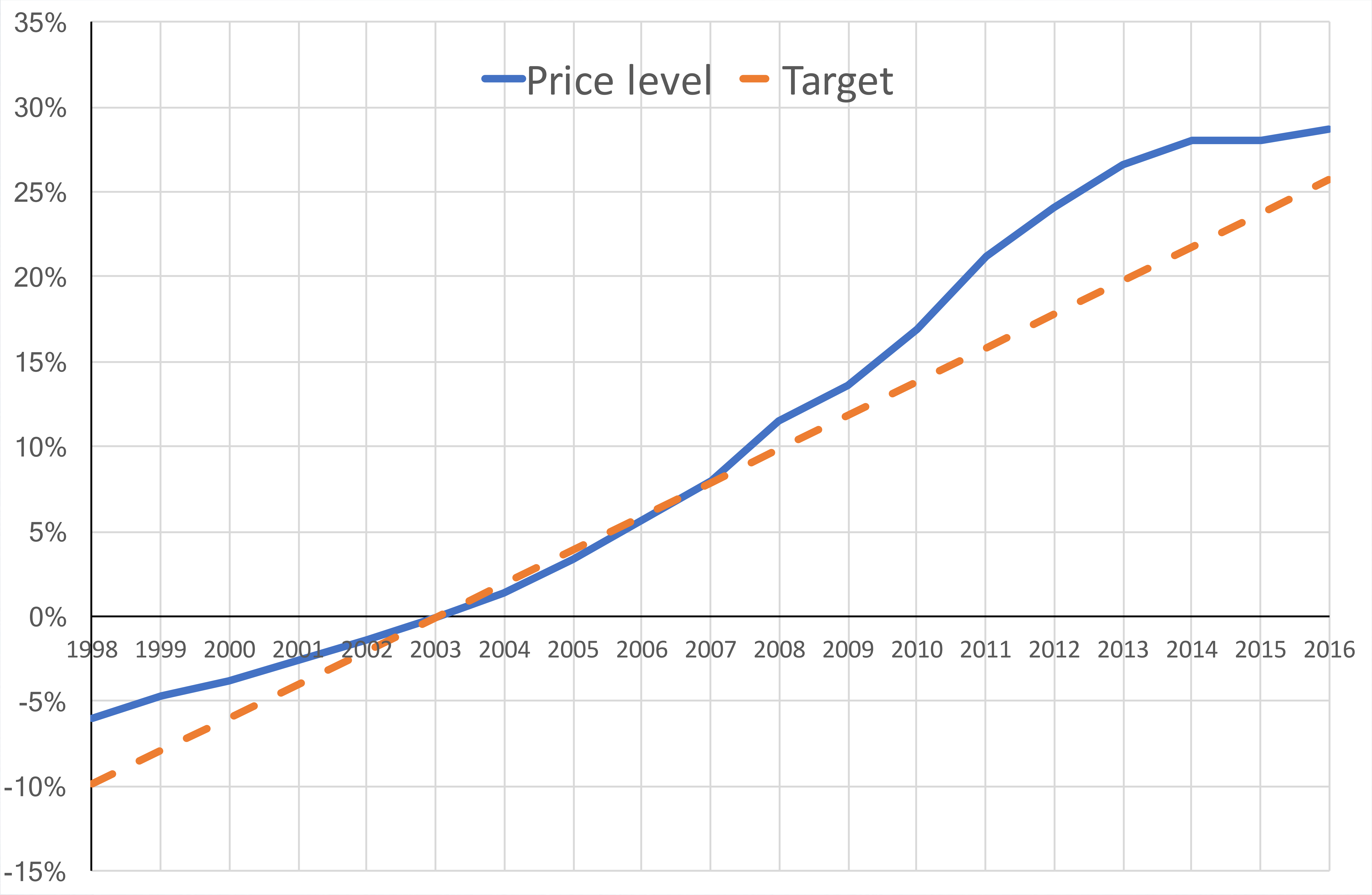
Bank of England, Federal Reserve, ECB, Bank of Japan: different central banks, different countries, different times, yet **all 2% target** on headline inflation.

Review process every 5-10 years, establish mandate. Sweden and Canada are examples. Establish a transparent political review process.

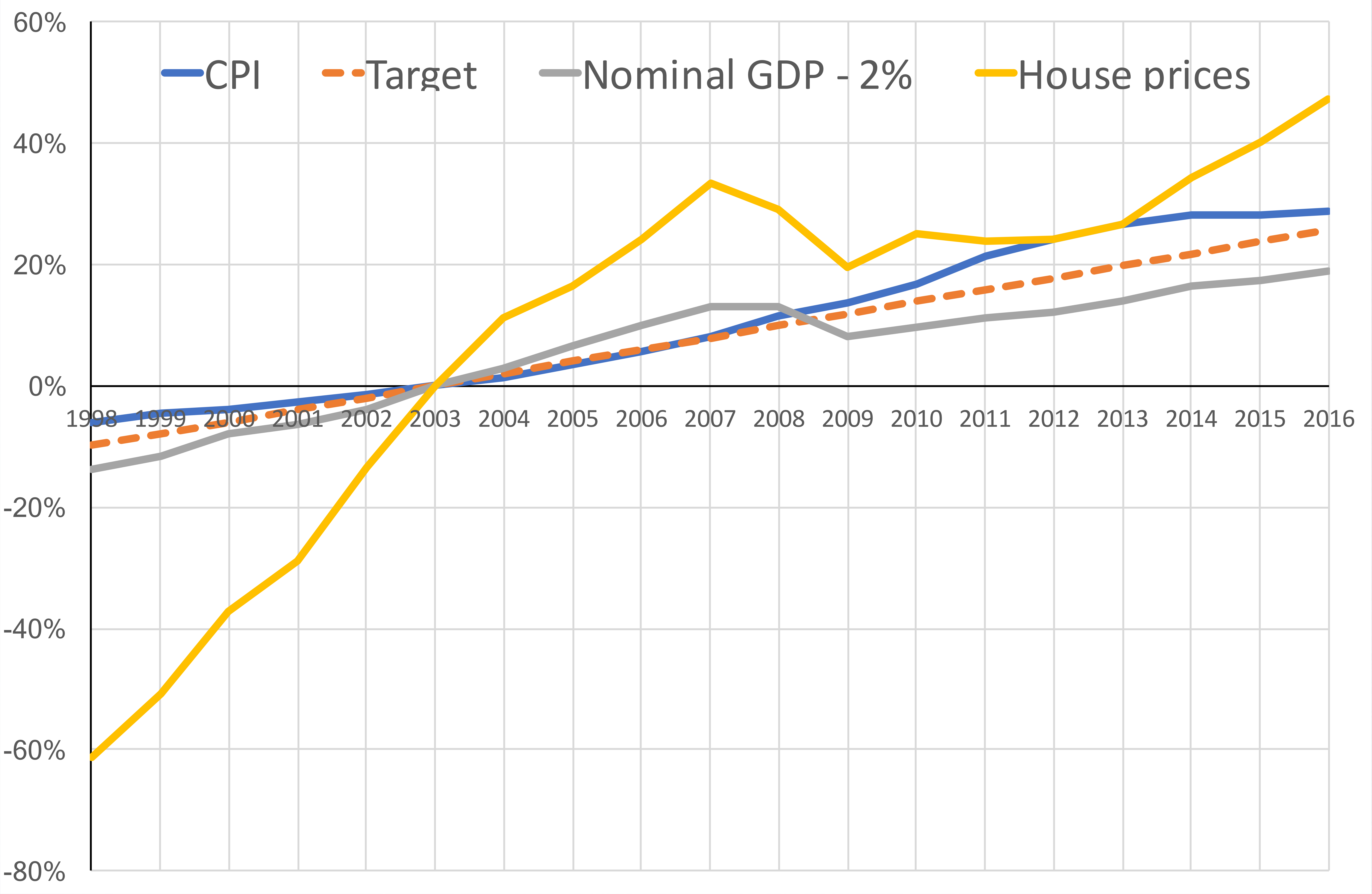
Choices for the nominal anchor, for the standard:

- Levels (averages) or growth rates, bygones or not?
- Include or focus on housing, commodities, nominal wealth, others?
- These are not just technical choices.

PRICE LEVEL OR INFLATION?



HOUSE PRICES, NOMINAL GDP



ON THE TOOLS: MONETARY/FISCAL

Central bank is a fiscal agent. Always true, but so are the courts…

Three traditional fiscal considerations:

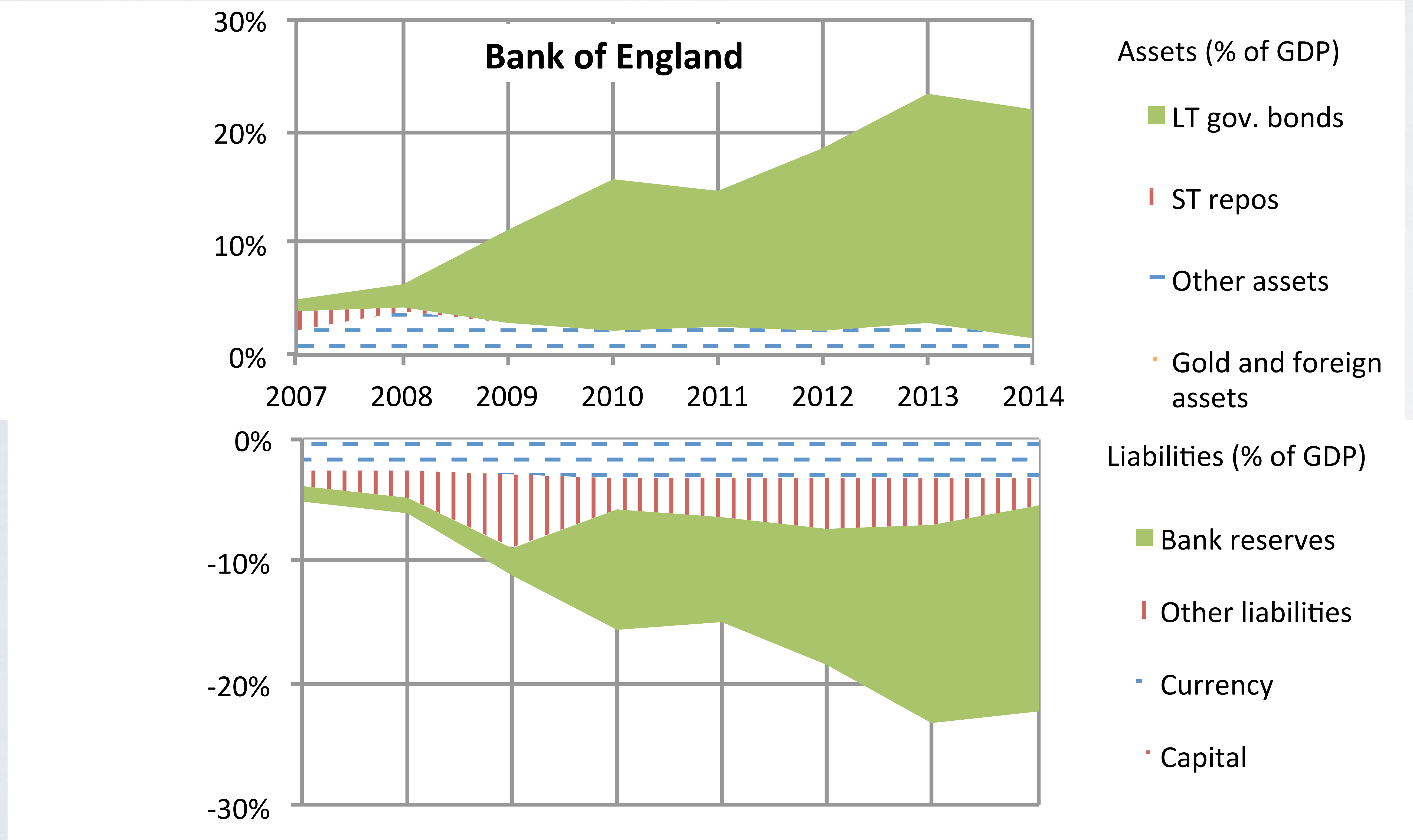
1. *Inflating the public debt.* Motivation for independence, universal evidence on how CBI allows government to borrow cheaper.

2. *Collecting seignorage from issuing banknotes.* Regular, small, in decline. Not so different from collecting ticket prices.

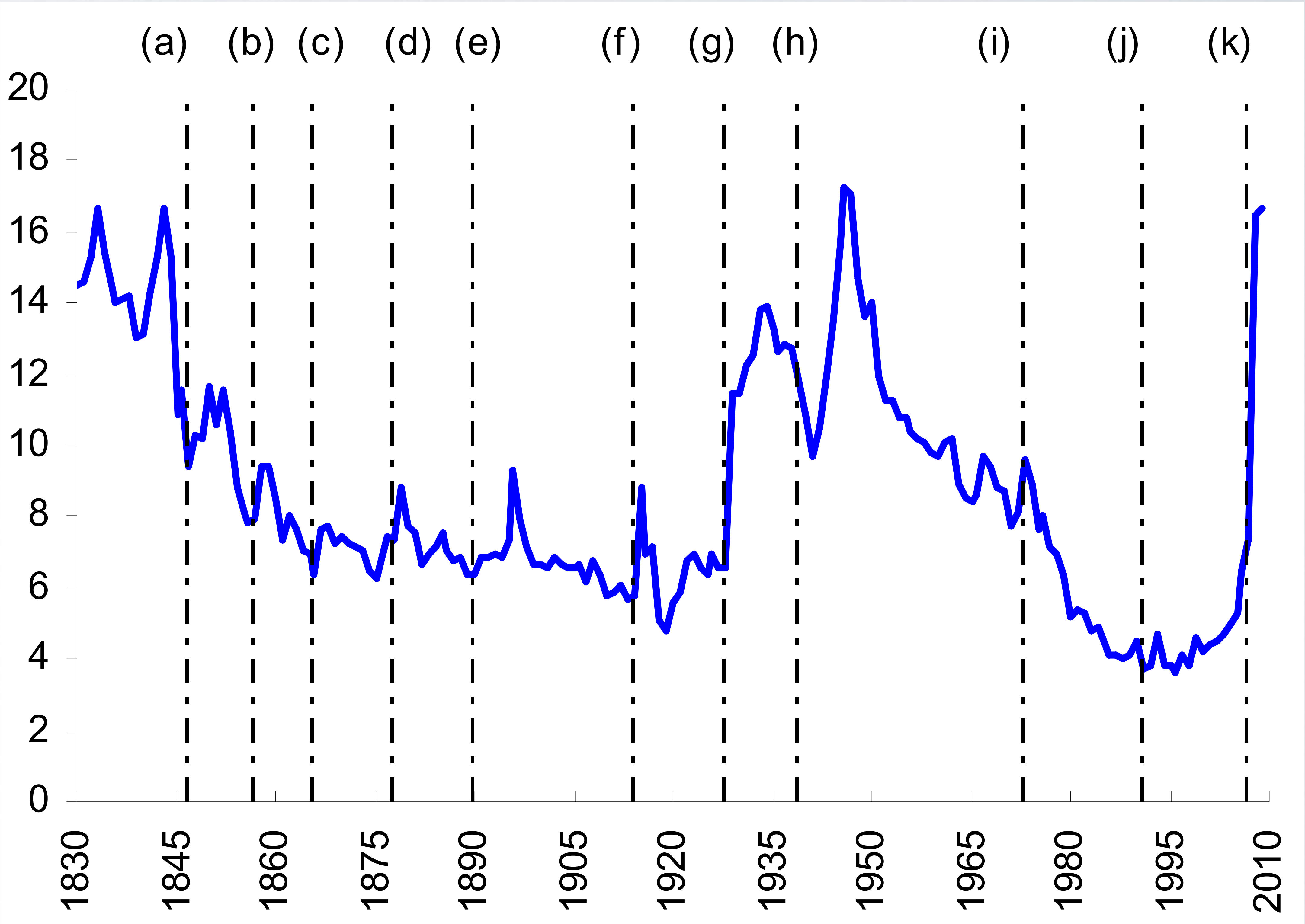
3. *Adapting to fiscal stance.* Since this affects inflation and real activity. The job may be hard, but that is the job.

THE LARGE BALANCE SHEET

Assets and liabilities



Size of balance sheet, historically



Source: Reis (2016) and Haldane (2012)

SIZE DOESN'T MATTER (MUCH)

1. **QE buys public liability by issuing another public liability.** Deposits by banks at the central bank (reserves). On net, zero effect on public debt. Like debt buybacks at the debt management office.

2. **Interest bill from paying interest on reserves is never an issue.** Because earn interest on government bonds that it at least as high as the interest it pays on the deposits.

3. **Makes implementation of monetary policy more focused:** interest on deposits controls inflation, balance sheet other tool.

4. **Cashless world is reserve-plentiful world.** Power is intact.

FISCAL SUPPORT AND RISK

Key is composition of balance sheet, or income it generates/requires.

Case i) Gilts-only.

Have maturity risk. Can be controlled, managed.

Case ii) Other assets (foreign currency, private bonds, equities).

Other risks, classic one is exchange rates. Key is to have effective risk management tools, value at risk, transparent portfolio. Discussion of controls is really about discretion and rules.

Case iii) Helicopter drops or QE to fund fiscal outlays.

This yes, is clearly activist discretionary fiscal policy.

CONCLUSION

1. **Model has delivered:** low stable inflation, anchored expectations.
2. **Case for independence:** as strong as it was.
3. **Case for expanding mandate:** doubtful.
4. **Case for reviewing the nominal anchor:** periodically wise.
5. **Worries about size of b/s and gilts portfolio:** exaggerated.
6. **Transparent risk management, limits to asset holdings:** open for debate, should be discussed and clarified.