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What Can The MPC Do About The Exchange Rate? - Speech by Sushil Wadhvani

In a forthcoming speech, Sushil Wadhvani, a member of the Monetary Policy Committee, discusses whether, given its remit, the MPC can do anything about an overvalued exchange rate. He says that, although there are good reasons why the markets re-rated sterling relative to the deutschmark, it is very difficult to justify the level, equivalent to around DM3.40, that was achieved in early May. He argues that sterling is still “overvalued” against the euro (equivalent to around DM3.14 at close of business 26 May), and that it should plausibly decline further over the coming years. However, since periods of persistent exchange rate overvaluation are costly, can cause macroeconomic instability, and can often endure for longer than expected, it makes sense to explore policy alternatives.

Dr Wadhvani rejects calls for a change in the MPC’s remit. One alternative possibility is for the interest-rate setting decision to be influenced by both the prospective inflation forecast - for example, two-years ahead - and any obvious asset price misalignments. Dr Wadhvani asserts that this would help the MPC fulfill the Chancellor’s remit more effectively because it is likely to reduce the volatility of inflation around the inflation target. In the current conjuncture, a policy guide of this kind would plausibly lower the level of sterling. Dr Wadhvani argues that this proposal merits further discussion.

Another possibility is for the MPC to intervene in the foreign exchange markets. Dr Wadhvani says that there are circumstances in which foreign exchange intervention can help – for example, in cases where there is a significant misalignment, coordinated intervention can sometimes succeed. However, intervention is no panacea and, since it can easily fail, should only be used when the chances of success are relatively high.

Dr Wadhvani concludes by arguing,

“..... I do not believe that one can offer any ‘quick fix’ to the problem of an overvalued exchange rate. Given that the MPC’s remit is consumer price stability, there are clear limitations (for good reason) on what we can do. I have, though, discussed some suggestions with respect to our interest-rate setting procedures and foreign exchange market intervention that might alleviate the extent of the pound’s overvaluation and, thereby, help us to do a better job in terms of delivering consumer price stability.”

Key Resources

The Exchange Rate and the MPC: What can we do? - Full Speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2000/speech88.pdf>