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Monetary Policy After the Fall - Paper by Charles Bean

In a paper presented at the Jackson Hole Economic Policy Symposium, Charles Bean - Deputy Governor of the Bank of England and member of the Monetary Policy Committee (MPC) - discusses the lessons learned from the financial crisis for the future conduct of monetary policy.

He begins by describing the pre-crisis consensus over the appropriate macroeconomic policy framework. Following the crisis, it is natural to ask what the events of the past three years tell us about the suitability of that policy framework. Charles Bean states: "Monetary policy makers would ... be remiss if they did not re-examine their own decisions in the lead-up to the crisis and strive to learn the lessons for the future conduct of policy."

The paper goes on to present empirical work suggesting that monetary policy decisions can explain only a part of the excess growth of credit in the United Kingdom and United States prior to the crisis. It shows evidence to support the idea that periods of economic stability might encourage exuberance in credit markets. But Charles Bean goes on to say, "...it would clearly be a mistake to conclude that policy should aim to induce fluctuations in the macro-economy in order to prevent financial market participants becoming too confident about the outlook. The right moral is surely that policy makers need to be most vocal about the risks to the outlook when things appear to be going well and to take appropriate restraining action if needed."

Charles Bean then turns to the discussion about the merits of using monetary policy to 'lean against the wind' and prevent asset and credit bubbles. The case for this appears strengthened by the financial crisis but he says, "...monetary policy seems too weak an instrument reliably to moderate a credit/asset price boom without inflicting unacceptable collateral damage on activity. Instead, with an additional objective of managing credit growth and asset prices in order to avoid financial instability, one really wants another instrument that acts more directly on the source of the problem. That is what 'macro-prudential policy' is supposed to achieve."

The paper briefly discusses the multiple dimensions to macro-prudential policy and goes on to explore two related issues. First, are monetary policy and macro-prudential policy sufficiently close in their effects that they are perfect substitutes? Second, to the extent that they are independent, what are the potential co-

ordination problems when the two instruments are set by different policy makers? On the first, Charles Bean presents evidence to show that when shocks occur, "...policies should be assigned to the frictions that they have a comparative advantage in addressing." On the second, he states: "Delegation of the monetary and macro-prudential instruments to different decision makers with distinct objectives is certainly appealing on the grounds of clarity and accountability..." But, he adds, "...the likelihood of a 'pull-me, push-you' outcome in some circumstances may also be correspondingly greater." It is therefore important to ensure mechanisms to facilitate co-ordination. He says: "In the arrangements recently proposed by the new government in the United Kingdom that is to be achieved by putting both the decision makers - the Monetary Policy Committee and Financial Policy Committee - in the same institution and ensuring that they have a number of members in common."

Charles Bean also reviews the argument that inflation targets should be increased in order to give monetary policy makers more leeway to cut rates aggressively during a severe recession. He is sceptical of the benefits. Higher inflation is likely to be more volatile and so "...more likely to generate resource misallocation and the capricious redistribution of income and wealth."

Charles Bean asks whether unconventional policies such as asset purchases financed by money creation should be part of central banks' toolkits in normal times. He argues that it makes more sense to rely primarily on short-term interest rates as the main policy instrument given that their effects are more certain and better understood. Asset purchases are likely to be at their most effective when financial and credit markets are under stress; and there is a risk that regular purchases of government debt during normal times would give rise to the suspicion that the central bank is intending to monetise the debt permanently, prompting both inflation expectations and long term nominal interest rates to rise. Charles Bean concludes "...asset purchases ... are probably best kept in the locker marked For Emergency Use Only."

Key Resources

Monetary Policy After the Fall – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech444.pdf