



BANK OF ENGLAND

# Speech

---

## **Concluding Remarks on the Royal Economic Society Public Lecture 2008**

Speech given by

Timothy Besley, Member of the Monetary Policy Committee, Bank of England

At the Royal Institution, London

18 November 2008

[Background paper](#)

The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

In this lecture so far, I have reviewed the historical experience of inflation in the UK and changes in economic thinking that lead up to the adoption of the current framework for the conduct of monetary policy.<sup>1</sup> In conclusion, I will turn to some of the more recent experience.

The period between 1997 and 2007 has often been referred to as the Great Stability. Inflation in the UK was low and stable, especially by the standards of the previous twenty years. Only once before the summer of 2007 had inflation diverged more than 1 percentage point from the target, triggering an open letter to the Chancellor. In a much-discussed article, my colleague on the MPC, Charlie Bean, had noted that on the basis of past history, inflation was likely to be more than 1 percentage point away from the target around 40% of the time<sup>2</sup>.

But since August 2007, the MPC has been dealing with the fall-out of the credit crunch. At the same time, there has been a remarkable degree of volatility in global energy and commodity markets. Increases in these prices drove CPI inflation above the 2% target this year and inflation was at 5.2% in September – the highest level for more than ten years. The threat of persistent inflation led the MPC to be reluctant to cut Bank Rate before clear evidence that inflationary forces were moderating. In today's ONS release, annual CPI inflation was 4.5% in October.

Since the summer, however, the outlook for global commodity prices has changed rapidly. For example, the oil futures curve, which was used in the August Inflation Report projections, suggested that oil would remain at \$120 per barrel for the remainder of the year. The current oil price is now below \$55 dollars per barrel. These global price developments (assuming that they are sustained) mean that inflation is likely to fall below target next year, notwithstanding the upward pressure on inflation from the continued fall in the value of the pound.

---

<sup>1</sup> This discussion was based on the background to this lecture paper co-authored with Neil Meads and Paolo Surico available at <http://www.bankofengland.co.uk/publications/speeches/2008/speech366background.pdf>.

<sup>2</sup> Bean, C (1998), 'The new UK monetary arrangements: a view from the literature', *Economic Journal*, Vol.108, Issue 451, pages 1,795-809.

The failure of Lehman Brothers in mid-September set in train a series of events in financial markets which led to a number of major policy packages announced on 8 October. The centrepiece of these initiatives is a plan to recapitalize UK banks in order to strengthen their balance sheets and to mitigate the impact of the financial crisis for lending to households and businesses. Also in October, the MPC participated in a coordinated action with other leading central banks to lower interest rates by 0.5%.

The projections for growth and inflation published in the November Inflation Report, which was published last week, reflected the news since August. With these projections in hand, the MPC decided to lower Bank Rate by a further 1.5% at its last meeting in November - the largest single change in Bank Rate since the current monetary policy arrangements were put in place. As the minutes are due out tomorrow, I cannot comment any further on the reasoning behind that decision or disclose my vote at the meeting.

There is little doubt that the recent period has constituted the biggest policy challenge that the MPC has faced since its inception in 1997. And, not surprisingly, there has been much debate around the decision – both the size of the cut and its timing.

I want to emphasise two main points that fit closely with my discussion of the broader context that I laid out earlier in my lecture.

First, the best way to understand this decision is in terms of our mandate to target CPI inflation. As the projections in the November Inflation Report show, the move in Bank Rate in November can be justified by the outlook for inflation. It is essential, in my view, that monetary policy decisions remain focused on our inflation targeting mandate.

Second, this decision was based on an independent judgement of the MPC using its normal process of deliberation and decision making. From an institutional perspective, the arrangements in place have shown themselves to be remarkably robust during this testing time. This is essential for the long-term effectiveness of the framework.

So why did the pundits and commentators fail to predict the behaviour of the MPC in November? After all, the data that we based our projections on are in the public domain. One possibility is the obsession with describing the composition of MPC in terms of personalities and labels like “hawk” and “dove”. As I am sure you all appreciate, these constitute a distraction from what really matters – the nature of the economic arguments and how they shape the outlook for inflation. It also seems likely that too much weight was put on the past decisions of the MPC which has generally moved Bank Rate in small steps. However, this was a reflection of the pattern of news in the data rather than a binding convention.

The challenges that the MPC face remain daunting. The outlook is particularly uncertain as we try to assess how quickly normal conditions in financial markets are restored. Many have argued, myself included,<sup>3</sup> that the transmission mechanism for monetary policy is impaired due to conditions in credit markets. However, there are grounds to expect that financial market policies will help to restore things to normality in due course. Alongside the adjustments in financial markets, we have a wider rebalancing of the UK economy as households rebuild their savings, house prices find their new sustainable level and the current account deficit narrows.

In the next phase of the policy debate, there will be renewed discussion around how monetary policy might respond to future imbalances in the UK economy. This will likely include a debate about how to have a better measure of housing costs in our target measure. But we know that there is no simple fix. There will also be discussion around more direct measures to restrict leverage in financial markets and to curb excessive borrowing by some households. However, the latter fall outside the domain of monetary policy as it is conventionally viewed. Hence, it is moot whether such measures should be the responsibility of the MPC.

I outlined earlier in my lecture, the logic behind the monetary policy arrangements put in place in 1997. That logic remains as valid today as it did at the time. Institutional change is a slow process and it is impossible to appreciate fully how institutions will

---

<sup>3</sup> See Besley, T., (2008) ‘Some Current Issues in UK Monetary Policy.’

work until they have been tested under all conditions. In an ever evolving world, I am certain that there will be fresh challenges ahead for present and future members of the MPC. These include making sure that fiscal and monetary policy work together coherently together to meet economic challenges.

The current monetary policy arrangements were fashioned in response to previous periods of economic turmoil and the challenges that these posed to economic management. The strength of the current framework remains the fact that the MPC makes independent monthly decisions based on economic judgements in light of the data and economic analysis to achieve a clearly defined target. In my view, this remains the best hope to make monetary policy work now and in the future.