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FINDING NEW OBJECTIVES, SEEKING NEW
INSTRUMENTS

David Copham

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Keywords: assignment problem; monetary policy;
inflation targeting; inflation; economic growth

JEL: E42, E52, E58, F33

Finding new objectives, seeking new instruments

by David Cobham, Heriot-Watt University

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Abstract

This short paper use the perspective of the assignment problem to examine the evolution of the workings of monetary policy and the Monetary Policy Committee (MPC) of the Bank of England over its first 25 years. It outlines how the Bank, and the MPC, came across additional possible objectives and searched for additional possible instruments. It then argues the need for some recasting of the role of the MPC and the way in which it operates.

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Contact: David Cobham, email d.cobham@hw.ac.uk

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The adoption of inflation targets in the UK, with the Monetary Policy Committee (MPC) of the Bank of England given instrument independence in 1997, is often presented as the answer to the assignment problem: the MPC was made responsible for the single objective of price stability, to be attained via its deployment of its single instrument, the policy rate (Allsopp, 2010). In this short paper I use this perspective to examine the evolution of the workings of monetary policy and the MPC over its first 25 years. I outline how the Bank, and the MPC, came across additional possible objectives and searched for additional possible instruments. I then argue the need for some recasting of the role of the MPC and the way in which it operates.

The Great Moderation, 1997-2007: new objectives?

The first decade of the MPC is generally seen as highly successful: inflation was kept close to target, and there were fluctuations in output but no recessions. Performance relative to target was enormously better than that in the UK under monetary targets, between the mid-1970s and the mid-1980s, and that under exchange rate targets at different times (including 1991-92).¹ In addition the Bank upgraded its technical expertise, notably in forecasting, improved its communication, and came to be recognised internationally as an exemplar of inflation targeting. The arrangements for external members of the MPC were generally satisfactory: there were only occasional tensions about appointments and the issue of external members' access to research assistance was addressed. In terms of international comparisons, the UK looks good (Table 1 columns 1 and 2) with lower inflation on average than the Euro Area (in

¹ The classification of monetary policy frameworks at <https://monetaryframeworks.org/> classifies the UK over the monetary targeting period as 'loosely structured discretion' because the targets were so often missed, and as 'loose exchange rate targeting' over 1991-92 because of the wide margins that were maintained until September 1992. On the other hand, the UK is categorised as 'loose inflation targeting' from 1993 to 1996 and as 'full inflation targeting' from 1997 to 2017: there were some overshoots and undershoots but they were short-term and inflation expectations remained anchored.

HICP terms) and the US (in CPI terms), and growth which was higher than in the Euro Area though lower than in the US, but was more stable.²

However, the international comparisons also reveal something rather odd.³ With inflation on average lower by 0.5% than in the Euro Area, and lower by 1% than in the US, the Bank kept its nominal policy rate on average 1.8% higher than the European Central Bank (ECB) and 1.2% higher than the Federal Reserve (Fed). That in turn meant that the real policy rate in the UK was more than 2% higher than in either of the other currency areas. Given the lack of capital controls and the high degree of financial liberalisation, it is difficult to believe that real equilibrium interest rates differed to that extent. A perspective from interest parity relationships would imply that over that period there was a continued expectation of sterling depreciation and/or a significant risk premium attached to the holding of sterling.

As it happens there is considerable evidence of sterling overvaluation throughout the period. Figure 1 shows that sterling appreciated sharply in real terms from 1996 and remained well above its 1990-92 level (which is sometimes thought to have been overvalued) until it depreciated sharply from mid-2007. The MPC spent a lot of time discussing this issue in its early years, and considered (but never implemented) foreign exchange intervention on several occasions.⁴ The IMF was aware of the strong and sustained appreciation, but seemed reluctant to identify sterling as overvalued until the sharp correction from mid-2007. However, it then said that, following depreciation of some 25% between mid-2007 and early 2009, “the currency appears to be broadly in line with fundamentals”.⁵ Estimates of the pound’s divergence from

² Obviously, growth rates reflect a range of other factors, so the volatility finding is more important here.

³ This point was first made in Cobham (2013b).

⁴ See Cobham, 2006, for a detailed discussion of the MPC Minutes covering the period.

⁵ IMF Article IV Staff Report October 2010 page 14; see also the reports for February 2005 p11, February 2006 p11 and February 2007 p11.

its fundamental equilibrium (FEER) also suggested significant overvaluation from 1997, particularly against the euro (Wren-Lewis, 2003).

A second issue that arose in the Great Moderation (GM) period was that of house prices, which experienced repeated surges with peaks in January 2000, October 2002, June 2004 and July 2007. In the first three cases the MPC was well aware of these developments, to which particular attention was paid by Stephen Nickell who argued that the rises in house prices were essentially the result of structural factors to which the MPC should not respond (Nickell, 2002, 2005). But after he left the MPC in 2006 there was less interest in the issue (Cobham, 2013a).

In principle the MPC could have responded to deviations of both exchange rates and house prices by changing its policy rate, as proposed by Cecchetti et al. (2000) and Cecchetti et al. (2002). Sushil Wadhvani was a member of the MPC from 1999 to 2002, and raised the matter there, but never received much support on this: the view of a large majority was always in line with that of Bernanke and Gertler (1999, 2001), which emphasised both the difficulty of identifying asset price bubbles and the possible cost to the real economy of interest rate rises designed to control asset price bubbles (see also Allsopp, 2002; Bean, 2003). With respect to the exchange rate, the MPC considered foreign exchange intervention on several occasions, for example in the August 1997 Minutes (paragraph 61) it was regarded as one of three “alternative policy instruments that might help to resolve the dilemma without introducing unacceptable distortions” (the others being reserve requirements and changes in debt management), but no such intervention was carried out.

The Global Financial Crisis and its aftermath: objectives and instruments

In the GM period the ongoing development of inflation targeting meant that the Bank was heavily focused on price stability, with financial stability treated as a secondary concern, and there was also a widespread view that “the goal of financial stability is attainable by the means of price stability” (Schwartz, 1995, p22). When the Global Financial Crisis (GFC) erupted in 2007-08, the Bank found itself obliged to adjust its focus and provide liquidity support in various forms to financial institutions which had suddenly become fragile. But it also rapidly became clear that the crisis had profound implications for output and employment, well beyond the kind of short-term cyclical fluctuations assumed in the standard theory of inflation targeting, and that cutting the policy rate in the usual way was not going to be enough.

In early 2009 the Bank initiated quantitative easing (QE), in line with the large scale asset purchases introduced by the Fed. At the time this was expected to be a short-term emergency measure, and it was presented as a way of attaining the inflation target when the policy rate was at the effective lower bound. By the end of 2021, however, there had been two rounds of QE in response to the GFC, another designed to steady the economy in the aftermath of the Brexit referendum result in 2016, and three further rounds in response to the Covid-19 pandemic in 2020-21. So QE had become a standard part of the central bank toolbox (see, for example, Friedman, 2015; Bailey et al., 2020).

The first two and the last three rounds were at a time when there were sharp increases in the budget deficit: the government was issuing debt to cover its deficit on the primary market, and the Bank was then buying that debt on the secondary market (which meant that it did not violate one of the standard criteria of central bank independence, that the central bank should not intervene in the primary government debt market). In both cases, however, the increases in government debt and the amounts of assets purchased by the Bank were broadly comparable,

so that the overall operations looked very much like central bank financing of budget deficits.⁶ Given that quantitative easing had to be agreed by the Chancellor of the Exchequer (Minister of Finance), these operations also suggested a coordination of fiscal and monetary policy which had not been needed and had not occurred in the GM period, together with some infringement on the de facto independence of the Bank.

While early QE can be regarded as an appropriate monetary response to an acute downturn when fiscal policy could not react as fast or as strongly, under the Coalition government from 2010 with its commitment to fiscal consolidation (austerity) QE became the alternative or substitute to fiscal stimulus.⁷ However, the UK's economic recovery was slow and weak, and attention turned towards other means to boost activity. There was some discussion of alternatives to inflation targeting, but this did not go far, not least because a change in target – for example, to nominal GDP or its growth rate – might pressure the monetary authorities to do more but would not in itself provide any new instrument (Goodhart et al., 2013; Goodhart, 2015). There was a Funding for Lending Scheme from 2012 and a Help to Buy Scheme from 2013, both joint Bank-Treasury arrangements, designed to subsidise and so encourage banks' lending in the first case and borrowing for house purchase in the second case. While they may have contributed to rises in house prices and to some small increases in lending, Figure 2, which shows the principal components of broad money growth, makes clear that bank lending

⁶ See Cobham (2012, p738) for 2009-12. For 2020 and 2021 general government gross debt rose by £492bn between end-2019 and end-2021 – see <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicspending/bulletins/ukgovernmentdebtanddeficitforeurostatmaast/december2021> – while Bank purchases of bonds amounted to £455bn – see <https://www.bankofengland.co.uk/monetary-policy/quantitative-easing> – both accessed 20.06.22.

⁷ Insofar as there was a theoretical (as opposed to political) underpinning to fiscal consolidation in the UK it lay in the ideas of expansionary fiscal contractions and the alleged debt threshold for growth. Those ideas have been comprehensively rebutted, notably by Jordà and Taylor, 2013; and Chudik et al., 2017. On the other hand, studies of the effects of QE have typically paid no attention to the accompanying fiscal developments, which could be regarded as providing an additional transmission mechanism for QE.

to the private sector (M4ex)⁸ has still not recovered since the GFC to anything like its mid-2000s level.

The next major innovation was forward guidance. This is discussed elsewhere in this volume, but three points are worth making here. First, forward guidance was (thought to be) required only because of the slowness of the economic recovery (related to fiscal consolidation) and the lack of other efficient ways to boost lending and activity. Second, it seems clear that the pressure for forward guidance came from the political authorities (it is also likely that Mark Carney's previous introduction of it at the Bank of Canada was an important factor in his appointment as Governor of the Bank of England), in a further infringement of the Bank's de facto independence. However, it seems that there was then some pushback from the MPC on the details of the scheme and that the pushback made the scheme more complicated, less transparent and, probably, less effective (Cobham, 2013c).

The third, and here most important, point is that the introduction of forward guidance involved a greater emphasis on the short-term trade-off between the attainment of the inflation target and the stabilisation of GDP. The Stockton review (2012, p51) had suggested that the Bank's staff should produce for the MPC "material on alternative possible sequences of actions and their implications for the economic outlook...The material might include information on so-called 'optimal' policies and on a variety of alternative rules". The 2013 Remit for the MPC (Chancellor of the Exchequer, 2013, pp3-4) said that the MPC should "promote understanding of the trade-offs inherent in setting monetary policy to meet a forward-looking inflation target while giving due consideration to output volatility", and that it should set out "the trade-off that

⁸ M4ex (technically M4 excluding intermediate other financial corporations) is the Bank of England's preferred measure of broad money in the UK, so this is the related change in bank lending. The 'public sector contribution' is essentially the amount of monetary financing of the government, including the effect of QE.

has been made with regard to inflation and output variability in determining the scale and duration of any expected deviation of inflation from the target”. In response Bank staff began to produce, on a regular basis by 2016, what came to be called optimal policy projections, which would allow the MPC to consider the impact on output of different paths for interest rates and inflation. The discussion of this issue was always cast in terms of the primacy of the goal of price stability, but it clearly involved the introduction of a more explicit secondary goal of output stability than had been identified before.

Meanwhile, with regard to asset prices, the Bank, like many other central banks, embraced the possibilities of macroprudential policies, which would act more directly on banks’ lending to particular sectors such as property. The Financial Policy Committee, a junior sibling of the MPC, has made use of the countercyclical capital buffer (additional cyclically varying capital requirements for banks) and of two mortgage market measures (a limit on the number of mortgages at high loan-to-income ratios, and an affordability test for new borrowers). At the same time the Bank has remained opposed to any monetary leaning against the wind. Indeed, Bean et al., (2010), a paper presented at the 2010 Jackson Hole conference which parallels Bernanke’s (2010) paper, argued that in the UK low policy rates in the run-up to the GFC had made only a modest contribution to the rises in credit growth and in house prices, and reiterated the view that leaning against the wind, as interpreted in the paper, would have had severe consequences for output.⁹

What do the international comparisons look like for this period? Columns 3 and 4 of Table 1 provide comparable data for the period from 2008. First, inflation is now higher than in the

⁹ See Cobham (2013a, ppi59-60) for the argument that the Bean et al. (2010) model and the Dokko et al. (2009) model on which Bernanke draws both mis-specify expectations and are vulnerable to the Lucas Critique.

Euro Area or the US, while output growth (all currency areas have lower growth than in the GM period) is intermediate but more volatile. Second, the UK nominal policy rate is marginally higher but its real policy rate is at the low end, while the UK nominal shadow policy rate and the UK real shadow policy rate are both intermediate: the odd puzzle of the GM period has disappeared and the real exchange rate (Figure 1) is also much lower on average (though the REER-ULC, but not the REER-CPI, rises close to its previous peak in 2015 and again in 2021). This disappearance may of course reflect the overall weakness of the UK economy, resulting from austerity and Brexit, rather than any improvement in policymaking.

Assessment

The MPC started out with a clear strategy of pursuing the single objective of price stability with the single instrument of its policy rate. However, over its first 25 years the MPC has found itself having to think about other possible objectives – particularly asset prices in the form of exchange rates and house prices, financial stability, and output volatility – and adopting other instruments – notably quantitative easing and macroprudential policy (wielded by the FPC but with some coordination with the MPC). The question that arises, therefore, is whether it is time to move explicitly on from inflation targeting towards a strategy in which, while price stability remains the primary goal, other goals are also admittedly present.

Orphanides (2010, p14) wrote that “inflation targeting may be particularly effective as a monetary policy framework for central banks that are institutionally challenged in some way, for instance because they lack a history of political independence or because they have an impaired credibility in pursuing monetary-stability-oriented policies”. It is arguable that back in 1992-93 with the cataclysmic exit from the Exchange Rate Mechanism the UK really needed the simplicities of inflation targeting to change the perception as well as the direction of

monetary policy.¹⁰ But 25 years after the Bank acquired basic instrument independence in 1997, with large positive effects on its credibility (Chadha et al., 2007), followed by a long period of relative price stability despite the shocks of the GFC, there is little or no such need.

There is now strong evidence that the adoption of inflation targeting does not in itself necessarily deliver improvements in inflation performance (Ball, 2010; Cobham and Song, 2021). Monetary policy frameworks such as inflation targeting are frameworks for policymaking, and they do not dictate individual policy decisions, so that the same decisions can be taken by policymakers from within different frameworks or, indeed, different decisions can be taken by policymakers from within the same framework (Cobham et al., 2022).

It is therefore not clear that anything would be lost by a switch away from simple inflation targeting. On the contrary, a lot could be gained by explicitly adopting a broader set of goals reflecting the shocks to which economies are exposed but retaining the primacy of price stability, perhaps under the tagline of ‘inflation targeting plus’. This would recognise the inherently ‘messy’ nature of central banking (Posen, 2019). At the same time it would also allow, indeed require, more transparency about the Bank’s inevitably circumscribed de facto independence, on the one hand, and about the coordination of fiscal and monetary policy, on the other.

¹⁰ There may be a parallel here with the introduction of monetary targets in the 1970s, which were repeatedly missed but fundamentally changed public perceptions of the nature and role of monetary policy. See Fforde (1983).

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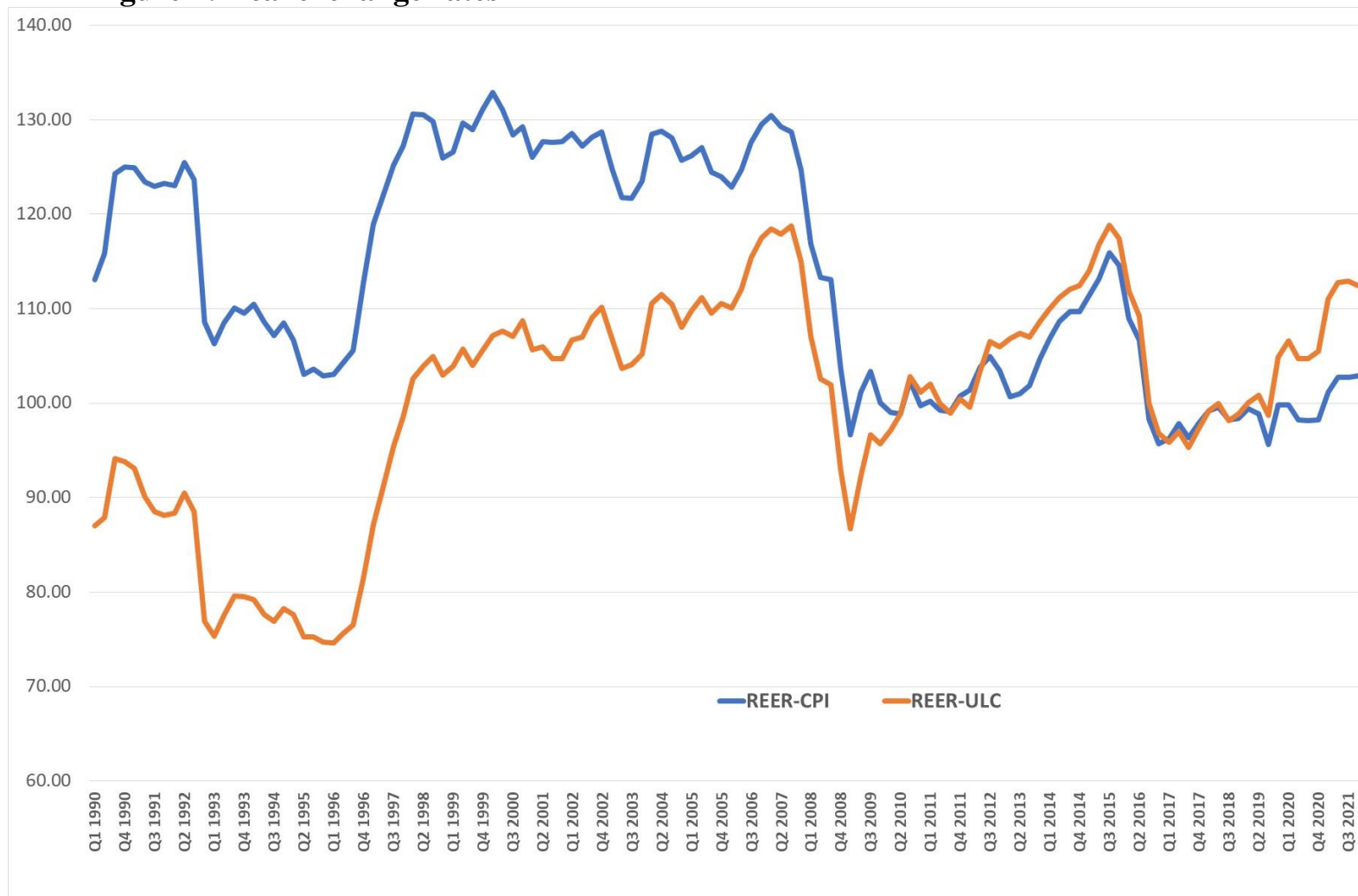
Table 1: Inflation, growth and policy rates, averages of quarterly data

	1	2	3	4
	1999-2007	1999-2007	2008-2021	2008-2021
	mean	standard deviation	mean	standard deviation
inflation				
UK CPI	1.74	0.48	2.12	1.04
UK HICP*	1.56	0.57	2.26	1.25
Euro Area HICP	2.06	0.43	1.42	1.12
US CPI	2.71	0.76	1.94	1.48
GDP growth				
UK	2.63	0.74	1.06	5.14
Euro Area	2.30	1.12	0.65	3.57
US	2.94	1.30	1.61	2.75
nominal policy rate				
BoE	4.81	0.74	0.76	1.11
ECB	3.01	0.88	0.62	1.01
Fed	3.60	1.85	0.62	0.78
real policy rate**				
BoE	3.07	0.85	-1.36	1.21
ECB	0.96	0.90	-0.80	1.01
Fed	0.89	1.64	-1.32	1.46
nominal shadow policy rate***				
BoE	4.82	0.87	-0.58	2.32
ECB	2.98	0.94	-1.78	2.82
Fed	3.42	2.00	-0.76	2.21
real shadow policy rate				
BoE	3.08	0.95	-2.77	2.49
ECB	0.93	0.97	-3.22	2.36
Fed	0.71	1.78	-2.53	2.44

Notes: * HICP data to 2020 Q3 only; **ex post, using CPI rates; ***shadow rates to 2019 Q3 only.

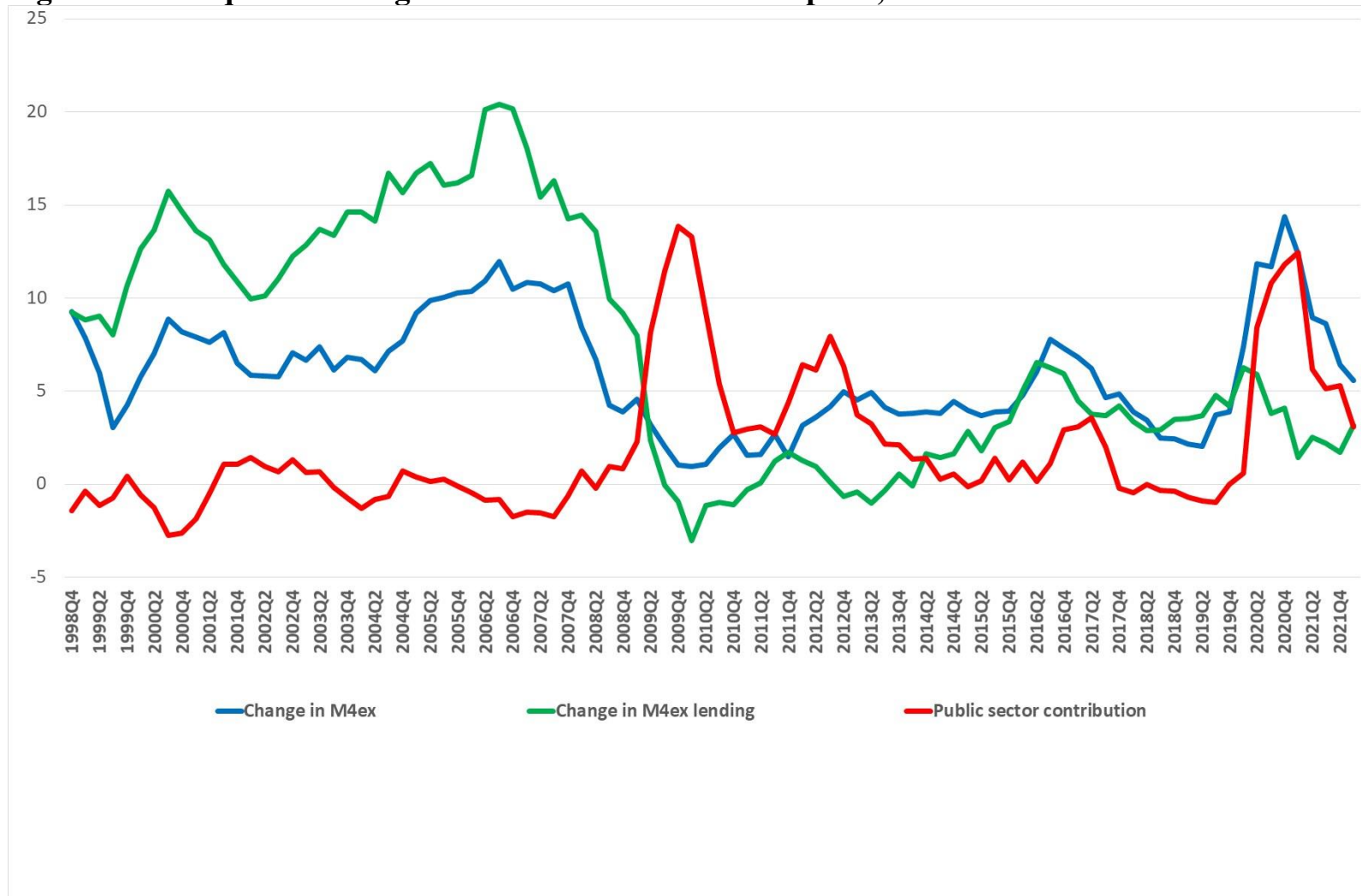
Sources: shadow rates from Leo Krippner at <https://www.rbnz.govt.nz/hub/research/additional-research/measures-of-the-stance-of-us-and-international-monetary-policy> (accessed 20.6.22), all other data from International Financial Statistics database (IMF).

Figure 1: Real exchange rates



Source: *International Financial Statistics*, accessed 22.06.22. The REER-CPI is the real effective exchange rate in terms of relative consumer prices, the REER-ULC is the real effective rate in terms of relative unit labour costs.

Figure 2: Four quarter changes in M4ex and main counterparts, % of M4ex



Source: Bank of England statistical database, accessed 22.06.22.