

Mervyn King: Monetary policy developments

Extract from a speech by Mr Mervyn King, Governor of the Bank of England, to the Bank of Israel, Jerusalem, 31 March 2008.

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Central banks, along with the rest of the financial world, have changed markedly over the past 20 years. More open and competitive financial systems have developed hand in hand with a recognition that the prime responsibility of central banks is to maintain price stability. To help them achieve that, more and more central banks around the world have been made independent of Government. The nature and extent of that independence varies from country to country, but in essence it is the freedom of either an individual Governor or a Monetary Policy Committee within the central bank to set interest rates free from political interference. That policy independence needs to be backed by organisational and financial independence which, in the case of the Bank of England, is entrusted to a Court of Directors of the Bank which decides on the budget and other relevant financial matters.

For those central banks with a long tradition of independence, their pre-existing frameworks of monetary policy have proved sufficient to enable them to bring inflation down and contribute to what has become known as the Great Stability. But in most of the countries whose central banks have been made independent more recently, policy has been based on an explicit inflation target. Inflation targeting has been the framework of choice for the past 20 years. It most clearly represents an explicit commitment by the central bank to the objective of price stability. In the United Kingdom, that commitment is in the form of a target for inflation that is defined as 2% a year, as measured by the consumer price index.

In the medium term, a central bank can affect only monetary values – the price level. It cannot change the amount of goods and services an economy is able to produce. Over time, there is no trade off between inflation and output, as recent UK history illustrates. Between 1950 and 1997, UK inflation averaged nearly 6%. In contrast, since 1997, inflation has been close to target and much more stable, but annual output growth has averaged a little *above* its post-World War II average of 2.5%. In the medium term, low and stable inflation does not imply lower output. Moreover, even in the short term, meeting an inflation target is in many cases fully consistent with maintaining steady growth of activity. If demand falls below the supply capacity of the economy, inflation will tend to fall. If demand rises too quickly, putting pressure on capacity, inflation will tend to rise.

Inflation-targeting central banks can, however, face an apparent dilemma when inflation moves away from the target not as the result of fluctuations in demand, but in response to commodity price changes. Following increases in gas and electricity bills, consumer price inflation in the UK has risen. The central projection in our February *Inflation Report* is for it to rise further, to around 3%. That pronounced pickup stems from sharp rises in commodity prices around the world. Food prices on world markets are more than 50% higher, and oil prices two-thirds higher, than they were a year ago.

To some it might seem odd that an inflation targeting central bank has not tried to offset those inflationary pressures. That is because we operate “flexible” inflation targeting within a framework that recognises that it is not, in practice, always possible to keep inflation at target. The remit for our Monetary Policy Committee states that:

“The framework takes into account that any economy at some point can suffer from external events or temporary difficulties, often beyond its control. The framework is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output”.

The time lag between changes in interest rates and their impact on inflation means that the MPC can have little effect on the short-term path of inflation. What is crucial is that the pickup proves to be temporary, just as the rise in inflation last year was. As commodity prices stabilise, inflation will fall back towards our target next year. But that does not mean we can ignore the pickup in inflation that is now underway. In judging how far inflation is likely to fall back next year, we have to gauge the extent to which high inflation in the short term will enter the expectations of those setting prices and pay. If it does so, then without some margin of spare capacity, inflation will have some tendency to persist above the target.

Our inflation target is symmetric. We are not aiming for inflation *below* 2%, but at 2%. So even though some slowdown in the growth rate of economic activity is likely to be necessary to ensure that inflation returns to the target, we cannot allow the economy to slow too sharply, lest a margin of spare capacity is produced that pulls inflation down below the target next year. We face a difficult balancing act.

Why should we not focus on growth for a while and forget about inflation? The answer is that once higher inflation becomes entrenched, it may be costly to dislodge. Past UK recessions were associated not with slowdowns in the world economy, but with attempts to squeeze inflation out of the UK economy. The best thing that we can do to promote economic stability is to avoid inflation, and inflation expectations, from becoming dislodged from the target in the first place.

The most important function of an independent central bank is its role in monetary policy. Price stability is a necessary foundation of economic stability more generally. But central banks around the world are also called upon to engage, to a greater or lesser extent, in the supervision of financial institutions. Unlike monetary policy, where in large part a common framework prevails around the world, there is no uniformity in the roles played by central banks in the supervision of the financial system.

The supervision of financial institutions is sometimes regarded as part of the functions of a central bank and sometimes given to one or more other regulatory bodies. It is striking how varied are the arrangements in different countries. In the United Kingdom, an important ingredient in the 1997 reforms which took banking supervision away from the Bank of England and handed it to a single regulatory body, the Financial Services Authority, was the view that it was no longer sensible to try to distinguish commercial banks from investment banks, and banks from securities companies. A common regulatory framework was needed. There are, however, important differences between prudential supervision and “conduct” of business regulation, so some countries have adopted a “twin peaks” solution in which the central bank is responsible for prudential supervision and conduct of business regulation is given to a different body.

This is evidence that the appropriate division of responsibilities will depend on local circumstances. One of the most important of those is the number of institutions which merit supervision. In a country with a limited number of banks it is less clear that a separate supervisor is needed and the central bank may well be able to take this responsibility on without risk to its reputation or of other contagion to its primary monetary policy responsibilities. In contrast to monetary policy, where the appropriate institutional framework is common to all countries, there is unlikely to be uniformity in the roles played by central banks in the supervision of the financial system.

Regardless of where responsibility for regulation lies, it is hard to imagine taking steps either to prevent, or to deal with, the consequences of a financial crisis without the active involvement of the central bank. Central banks are currently at the heart of efforts to restore confidence in the banking system by the provision of liquidity against assets which have proved to be highly illiquid. But the recent challenges presented by the latest episode of financial turmoil suggest that much hard thought will need to be given to the structure and nature of banking regulation in the future. In the longer-term, it seems extremely likely that banks and other “near” banks, especially those that have been regarded as similar to banks

in terms of their eligibility for financial assistance, will be called upon to hold more capital and a greater quantity of liquid assets than hitherto. It is too early to foresee clearly where the long-term direction will go. But serious thinking and a willingness to contemplate radical change will be necessary.