Spencer Dale: Inflation targeting – learning the lessons from the financial crisis

Speech by Mr Spencer Dale, Executive Director and Chief Economist of the Bank of England, at the Society of Business Economists' Annual Conference, London, 23 June 2009.

I would like to thank Rohan Churm, Jens Larsen and Rob Wood for their considerable help in preparing these remarks. The views expressed are my own and do not necessarily reflect those of other members of the Monetary Policy Committee.

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We are in the midst of a deep recession.

Unlike recessions of the late twentieth century, this twenty-first century version is not the result of deliberate, but belated, attempts to slow the expansion of money spending in order to bring down inflation from very high levels. Inflation is close to the Government's 2% target. This recession has at its heart a crisis in the banking system; a crisis that has strangled the supply of credit and undermined public confidence. For the first time in fifty years, the total amount of money spent in our economy during the first quarter of this year was lower than a year earlier. The era of "Great Stability" is over.

The Great Stability followed hot on the heels of the introduction of the inflation targeting framework for monetary policy. Some attributed part of the improvement in economic performance to better policymaking. The abrupt end to that stability has, in turn, led the inflation targeting framework to be questioned.

Today I want to explain why, despite recent events, I believe that inflation targeting should remain a mainstay of macroeconomic policymaking in the UK. But we have to learn from the crisis, and I will discuss my views on the way in which the policy framework needs to be strengthened. I will conclude with a brief review of our asset purchase programme and, in particular, respond to some of the comments made about the programme.

1. Inflation targeting in action

Over the past year, the Monetary Policy Committee (MPC) has responded to the dramatic deterioration in the economic outlook with an equally dramatic easing in monetary policy. Bank Rate was cut by 4.5 percentage points in just six months and by 1.5 percentage points in November last year alone. That was the largest cut for 25 years and is twice the size of any reduction made by another G7 central bank in the past eighteen months. The MPC also voted to purchase £125bn of assets financed by the issuance of central bank money – equivalent to around 9% of annual UK GDP.

The scale of the easing took many by surprise and some of the decisions may, at first blush, look rather courageous. Those of you who remember "Yes Minister" may recall that Jim Hacker, the hapless minister, became very nervous whenever Sir Humphrey suggested his decision was "courageous". Central bankers can have similar instincts. When faced with big decisions, there is a temptation for caution to prevail: do interest rates really need to be moved by that much? Why not wait and see before resorting to the use of unconventional instruments?

And indeed the MPC has tended to move rates in relatively small, sequential steps in the past. But I would argue that this is because for much of the period since the MPC was established the outlook for inflation evolved relatively gradually. That all changed following the collapse of Lehman Brothers. Since the autumn of last year, we have experienced an unprecedented sequence of events that has caused a substantial re-assessment of the economic outlook and of the stance of policy necessary to keep inflation on track to meet the target. As the economy slowed sharply and inflation threatened to fall substantially below the

target, the Committee responded with unprecedented actions that were previously confined largely to the realms of theory.

I believe that the operation of monetary policy during this period demonstrates the strength of the inflation targeting framework in action. The clear numerical target, combined with a framework of transparency and accountability, impose discipline on the MPC. They ensure that we take the decisions necessary to bring inflation back to target, however "courageous" those decisions might seem.

I do not think it is coincidence that arguably the two most significant monetary policy decisions taken over the past year – the decision to reduce Bank Rate by 1.5 percentage points in November and the announcement in February that the Committee had sought approval to use the Asset Purchase Facility to conduct large scale asset purchases – occurred in months when the *Inflation Report* was published. The quarterly forecast round provides an opportunity for the Committee to reassess thoroughly its view of the economic outlook. This view is then explained and communicated via the *Inflation Report* and in particular through the projections for GDP growth and inflation contained in the *Report*. In both November and February, the judgement of the Committee was that, without further substantial easing in monetary policy, there was a significant risk of a large and persistent undershoot of the inflation target. Given the transparency of these judgements and the clarity of the target, it would have been courageous not to have taken the decisions we did.

The inflation target is symmetric. Likewise, the discipline it imposes on the MPC is symmetric. The inflation target has been instrumental in ensuring that monetary policy has responded boldly and decisively to the events that have unfolded since the autumn. And, when the time comes, the clarity and transparency of the inflation targeting framework will ensure that the Committee takes the right decisions on the way back up, however courageous or unpopular those decisions might appear.

The public commitment that the Committee will do whatever it takes to hit the inflation target is central to the conduct of monetary policy. It underpins the credibility of the inflation target. This commitment is more important than ever in the current environment of unprecedented shocks and unconventional policy measures.

Recent events have raised the question of whether the Committee could provide even more information about its policy strategy by committing to keep interest rates low for a particular period of time or until the economic outlook evolves in some specified way.

The difficulty is in designing such a commitment that would be both useful and that the Committee would be willing to adhere to. A commitment to keep interest rates low for a certain period of time runs the risk of being overtaken by events. The past eighteen months has demonstrated only too well how rapidly the state of the economy can change. I truly have little idea as to how long Bank Rate will need to be maintained at its current low level in order to meet the inflation target. As such, it would make little sense to commit to a rule that suggested I did!

The potential benefit of a state contingent commitment – in which the MPC commits to maintaining Bank Rate at its current level until the economic outlook has evolved in a particular way – is that it may aid the public's understanding of how the Committee is likely to react to economic developments. It may convey information about our reaction function. But such a commitment is not easy to design. If too general, it will not add anything to our existing – and over-riding – commitment to do whatever it takes to hit the inflation target. If too precise, it will not capture the myriad of factors that affect the outlook for inflation. The array of judgements underlying the Committee's policy decisions are not easily summarised by reference to one or two economic variables.

The Committee's preferred approach is to describe its assessment of the outlook for output and inflation, and allow the public and markets to make their own assessment of the likely future path of interest rates. In the most recent *Inflation Report* published in May, the

Committee judged it was more likely than not that CPI inflation would be below the 2% inflation target in two or three years time if interest rates followed a path implied by market yields and the stock of purchased assets increased to £125bn. Market participants subsequently revised down their view about the pace at which Bank Rate was likely to rise.

2. Strengthening the policy framework

I remain firmly convinced that an inflation targeting framework should continue to be central to the design of macroeconomic policy in the UK. The benefits of low and stable inflation are clear and well understood. And, as I have argued, the combination of a clear quantitative target and an open and transparent policy regime have been instrumental in shaping the response of monetary policy to the current crisis and will continue to be so.

But recent events must serve as a wake up call for policymakers. The spectacle of bank runs, asset price falls and a sharp unwinding of economic imbalances testifies that inflation targeting as currently operated is not sufficient. How should the macroeconomic policy framework in the UK be strengthened to reduce the likelihood of such events reoccurring?

One common suggestion is that the conduct of policy under inflation targeting should be modified to take greater account of movements in asset prices or economic imbalances that threaten the attainment of the inflation target, even if those risks may not materialise for several years. In principle, the remit given to the MPC provides the latitude for policy to respond to such medium-term risks. In particular, the Committee's objective is timeless – it is tasked with keeping inflation close to target "at all times" in the future. Therefore, if the Committee judged that intentionally undershooting the inflation target in the near term would help to reduce the risk of a much larger deviation from target in the future, it has the scope to follow such a policy.

But a policy of "leaning against the wind" is difficult to implement in practice.

In part this reflects the difficulty of identifying changes in asset prices and economic flows which are unsustainable. At which point, for example, did the run up in UK house prices over the past 10 years cease to be warranted by a change in economic fundamentals, such as the rise in the number of households and the move to a low and stable inflation environment? Likewise, at which point did it become clear that sub-prime lending had ceased to be a beneficial financial innovation with the scope to allow people who had not previously had access to credit the chance to own their own home and had instead become a source of international financial instability?

These are difficult judgements. They involve second guessing outcomes generated by financial and economic markets. Policymakers will inevitably sometimes get the assessment wrong, with costly repercussions. But these judgements cannot be ducked. Monetary policymakers have to form views about a range of uncertain and ill-defined issues, such as the level of potential supply and the credibility of policy. The sustainability of asset prices and economic imbalances are no different. Ultimately, a policy has to be set even if explicit judgements are not formed.

But policymakers also need better tools to back up these judgements with actions. Short-term interest rates are a blunt instrument best deployed maintaining a broad balance between nominal demand and supply. They are not well suited to the task of managing asset price bubbles and economic imbalances. They may be wholly ineffective in addressing some types of imbalances, particularly those with an international dimension. And, even for domestic imbalances, short-term interest rates would probably need to be held substantially higher for a persistent period in order to suppress rapid rises in asset prices or growing imbalances. Such policy actions could generate significant economic costs.

The practical difficulty of implementing a policy of "leaning against the wind", where the main policy instrument is short-term interest rates, should not be underestimated. If, as

policymakers, we were successful in preventing a bubble from inflating, it might appear as if we were responding to phantom concerns. The bubble or imbalance would be nowhere to be seen, but interest rates would be higher, inflation would undershoot the inflation target and we would appear to have inflicted unnecessary economic hardship. That could undermine public faith and support in both the inflation target and the MPC.

For me, the single most important lesson from the financial crisis is the need to expand the range of instruments available to policymakers. The inflation targeting framework provides the scope to respond to asset price bubbles and to imbalances that threaten future economic stability. But short-term interest rates are not well suited to managing such risks.

The precise design of such new instruments is now the focus of much work and analysis. It is likely that a range of instruments and initiatives will be required. These may extend beyond new regulatory instruments and should embrace the need for greater international policy coordination. The ideal would be policy instruments and processes which are effective in preventing the build up of asset price bubbles and economic imbalances and efficient in minimising the associated costs to the real economy. This would allow short-term interest rates to continue to be the primary tool for hitting the inflation target in the short-to-medium term, supported by additional instruments which are used to manage emerging imbalances which may pose substantial risks to economic stability further out.

Strengthening the policy framework in this way should lead to greater economic and financial stability. But we should not be lulled into a false sense that it will solve all our problems. Operating such a framework will continue to require finely balanced judgements and difficult decisions. And no policy toolkit can anticipate all future changes to the structure of markets and the economy, or to the shocks hitting them. The process of increasing the robustness of the macroeconomic policy framework should be seen as continuous, not a one-off response to the current crisis.

3. A response to some criticisms of the asset purchase programme

Strengthening the policy framework in this way should help to reduce the likelihood of future crises. I thought I would end today with a few words on the progress we are making in managing the current crisis and, in particular, by addressing some of the concerns that have been raised about the asset purchase programme.

As you know, the objective of the asset purchase programme is to increase the growth of nominal spending to a rate consistent with meeting the inflation target. There are a number of channels through which the asset purchases should help to stimulate demand. Purchases of gilts are likely to cause investors to reallocate their portfolios into other assets, including corporate bonds and equities. This increase in demand for corporate assets should help to reduce borrowing costs faced by firms. Moreover, expansion in the supply of money and liquidity may in itself encourage greater levels of lending and borrowing. Not least, bank deposits are likely to increase as a result of our asset purchases, providing banks with a ready source of funding. Purchases of private sector debt should aid the functioning of corporate credit markets and so improve the availability of credit via these markets. And the programme of asset purchases should help to demonstrate the Committee's ability and willingness to do whatever it takes to hit the inflation target and so help to ensure that inflation expectations remained firmly anchored.

The Bank has so far purchased a little over £96bn of assets and is on track to have purchased £125bn of assets by the end of July. It is still early days in terms of judging the ultimate success of the programme in stimulating nominal spending, but initial indications remain encouraging. The growth rate of underlying broad money has picked up in recent months. Gilt yields fell sharply following the announcement of the asset purchase programme and our initial purchases of gilts. Yields have subsequently drifted back up, but this reflects a range of other factors and it is likely that yields are lower than they would otherwise have

been. Borrowing costs within the commercial paper market appear to have fallen as a result of our operations. And in the corporate bond market, spreads have narrowed sharply in recent months and issuance levels have been at record highs. However, this has coincided with a global rally in corporate bond markets and so it is difficult to isolate the incremental impact of our purchases.

Despite these encouraging signs, there have been some questions raised about the design and effectiveness of our operations, and I thought I would take this opportunity to address three particular criticisms that have been levelled against the asset purchase programme.

The first is that the asset purchases have been too heavily skewed towards gilts and that we should have purchased a greater proportion of private sector debt. The aim of our purchases of corporate debt is to improve the functioning of corporate credit markets. This is in line with the remit specified by the Chancellor when establishing the Asset Purchase Facility. It is important not to judge the economic significance of these purchases by their scale. Even relatively small purchases of debt, if appropriately targeted, can improve liquidity and lower the cost of finance to businesses. Indeed, the very knowledge that the Bank stands ready to purchase assets may be as beneficial as the actual purchases. And over a period of time, as market functioning improves, the quantity of private sector assets held by the Asset Purchase Facility may well decline as assets mature and are rolled over into the private market. This should be seen as a sign of success not of dwindling support.

The Bank continues to review actively the case for extending its operations into other corporate credit markets, and recently announced its intention to extend its purchases to include commercial paper secured on loans for working capital. But given the relatively modest size of corporate credit markets in the UK, to increase significantly the scale of our corporate debt purchases would involve changing the nature of our operations. Rather than improve their functioning, large scale asset purchases would risk crowding out private debt markets: substituting for markets rather than supporting them. That is not consistent with the aims of the Asset Purchase Facility and could detract from the long-term efficiency of the economy.

A second criticism that is sometimes made against the asset purchase programme is that some of the gilts we have purchased have been from foreign investors and this may limit the effectiveness of the purchases. This argument is based on the supposition that overseas investors may be more likely to reallocate their portfolios into foreign currency assets, rather than into alternative sterling assets, such as corporate bonds or UK equities. But even if that is the case, it does not mean the asset purchases will not have any economic benefit. Rather, more of the effect will come through a lower exchange rate than through a change in the relative price of domestic assets. As with interest rate changes, the exchange rate is a key channel through which the monetary easing may be transmitted. Moreover, it is important to remember that the additional sterling liquidity created by the original asset purchase still exists. Someone is holding additional sterling deposits and it is possible that these may flow back into sterling assets as investors reallocate their portfolios.

The final criticism that I want to address is that the MPC needs to articulate more clearly its exit strategy. This brings us back to where we started, and the importance of the inflation target. It was the outlook for inflation relative to target that dictated the speed and magnitude of the dramatic loosening in monetary policy. And likewise, it will be the outlook for inflation relative to target that will determine the rate at which the current exceptional degree of monetary stimulus is withdrawn as economic prospects recover. When the time comes, the Committee can tighten policy both by raising Bank Rate and by selling assets. A natural corollary of both actions is that yields will rise – that is what happens when policy is tightened. The most difficult issue concerning the exit strategy will be deciding the timing at which policy should begin to be tightened. Although that decision will be highly uncertain and subject to intense scrutiny, the strategy guiding the decision – and the primacy of the inflation target within that strategy – should be clear.

4. Conclusion

The inflation target remains a vital pillar of the macroeconomic policy framework and should continue to provide the focus for monetary policy. But there are lessons that need to be learnt from this financial crisis. Good policy frameworks should provide policymakers with the right incentives to take difficult decisions and the right tools to implement those decisions. Inflation targeting goes a long way: the clarity of the objective and the transparency of the regime act as an important discipline on the MPC and short-term interest rates are, for the most part, effective in maintaining a broad balance between nominal demand and supply and so generating low and stable inflation. But they are not well suited to nipping incipient bubbles in the bud and restricting burgeoning imbalances. Policymakers need to make difficult judgements about asset prices and imbalances but they also need effective and efficient tools to enact those judgements.