



BANK OF ENGLAND

Speech

Opening remarks to the Bank of England 'Independence – 20 years on' Conference

Remarks given by

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Welcome to this conference marking 20 years of independent monetary policy making in the UK.

We are here because long and varied experience has shown that price stability is the best contribution monetary policy can make to the public good.

High inflation hurts the least well off in society the most. It distorts price signals, inhibits investment, and ultimately damages the economy's productive capacity. Equally, deflation imperils growth and employment, and, in the extreme, leads to financial ruin and economic collapse.

The happy medium is low, stable and predictable inflation. A little inflation greases the wheels of the economy, and it gives monetary policy space to deliver better outcomes for jobs and growth when shocks hit.

Recognising the value to society of price stability is one thing, delivering it is quite another.

The Bad Old Days

Prices were anything but stable during the 1970s and 80s. With the collapse of Bretton Woods in 1971, UK monetary policy lost its nominal anchor. There followed a series of botched experiments, with targets for incomes, monetary aggregates and the exchange rate. The costs of such failures were enormous, with prices rising by 750% in the twenty-five years to 1992, more than over the previous two hundred and fifty years. Unemployment was high and growth volatile.

The inflation target rose from the ashes of the ERM debacle twenty five years ago this month, marking the point when price stability became the unambiguous objective of UK monetary policy.

The new framework was a success, though only a partial one. That's because, with interest rate decisions still made by the Chancellor, it wasn't fully credible. Experience teaches that political control of monetary policy decisions suffers from time inconsistency, in which policymakers promise low inflation, then go for faster growth and ultimately achieve neither.

Conversely, welfare can be improved if governments first choose the preferred rate of inflation and then delegate operational responsibility to the central bank to achieve it.

The UK Framework for Monetary Independence

So it was in 1997 when Gordon Brown boldly gave the Bank of England operational control for setting monetary policy.

The Bank of England Act of 1998 clarified – for the first time in three centuries – the Bank’s responsibilities.¹ It gave a new independent body of the Bank, the MPC, a clear remit to achieve the inflation target over the medium term. The inflation target is symmetric (meaning we care as much about returning inflation to target from below as from above), and it applies at all times. Subject to achieving the target, the MPC is also required to support the Government’s economic policy objective, currently strong, sustainable and balanced growth.

Accountability

Under what Mervyn King termed constrained discretion, the Bank takes its orders from the remit and is accountable to Parliament and the people for its performance.

Their expectations certainly have changed since Montagu Norman justified his decisions to a compliant predecessor of the TSC by appealing opaquely to his “instincts.” Not a response I’ve dared to venture during my thirty odd parliamentary testimonies. More seriously, the need for the Bank to be open and accountable is greater than ever, not only because of the growing distrust of institutions and the ‘experts’ who reside within them, but also because better public understanding makes our policies more effective.

That’s why the Bank has increased dramatically the scale and quality of its outreach. We now publish all relevant information for each policy decision on the day it is released. We disclose the key judgments underlying our forecasts and account for differences when they occur. Leveraging our network of 12 regional agencies, we meet with thousands of businesses every year, discuss with the tens of thousands of people who attend our town halls and Public Forums, and engage with the hundreds of thousands more through social media.

Performance and Lessons Learned

The gains from independence have been enormous. In the two decades that followed independence, inflation averaged just under 2% compared with over 6% in the preceding two. It’s been one-fifth as volatile. Crucially, independence allowed monetary policy to respond boldly and effectively to the biggest financial crisis in a century. And it leaves the Bank well placed to address a range of possible developments around Brexit.

¹ As former Governor Eddie George once remarked, in the half century that followed its nationalisation in 1946 “the Bank operated under legislation which, remarkably, did not attempt to define our objectives or functions.” They were, instead, “assumed to carry over from [the Bank’s] earlier long history.” George, E (2000), ‘Central bank independence’, speech at the SEANZA Governors’ Symposium, 26 August 2000.

Over the past twenty years, we have also learned a few important lessons. Allow me to highlight three.

First, the financial crisis exposed how a healthy focus on price stability became a dangerous distraction. Central banks had won the war against inflation during the Great Moderation only to lose the peace as vulnerabilities built inexorably.

Now monetary policy isn't best placed to address risks to financial stability but the challenge is that the necessary financial policy decisions are also subject to time inconsistency problems. Financial lobbies are strong, and the temptations of a dash for growth are powerful. Conversely, there are no obvious or immediate rewards to the tough decisions necessary to avoid future crises. In the world of financial stability, success is an orphan.

That is why when the Bank was fundamentally reformed after the crisis, the procedures and structures of the MPC were largely replicated in the Bank's two new policy committees, the FPC and the PRC. Crucially, all the Bank's committees have access to the Bank's information and analysis, all are well-informed about each other's reaction functions and all can coordinate their policies when appropriate. The Bank's Committees are independent but not isolated.

The second lesson of the past two decades has been the importance of the flexibility in flexible inflation targeting.

While the inflation target applies at all times, the remit has always acknowledged that inflation may deviate temporarily from the target on account of shocks. Since 2013, it has explicitly recognised that in exceptional circumstances, bringing inflation back to target too rapidly could cause undesirable volatility in output and employment.

In exceptional circumstances like today when the economy is facing profound structural change, the MPC can extend the horizon over which it returns inflation to target from above in order to balance the effects on jobs and activity. After all, even though monetary policy cannot prevent the weaker real income growth likely to accompany the transition to new trading arrangements with the EU, it can influence how this hit to incomes is distributed between job losses and price rises.

This brings me to my final point: while carefully circumscribed independence is highly effective in delivering price and financial stability, it cannot deliver lasting prosperity and it cannot solve broader societal challenges. This bears emphasising because in recent years a host of issues have been laid at the door of the Bank of England from housing affordability to poor productivity.

Calls for the Bank to solve these challenges ignore the Bank's carefully defined objectives. And they confuse independence with omnipotence.

Monetary and financial stability are foundational. They are necessary for prosperity but they aren't sufficient to deliver it.

The biggest determinants of the UK's medium-term prosperity will be the country's new relationship with the EU and the reforms it catalyses. Most of the necessary adjustments are real in nature and therefore not in the gift of central bankers.

The Bank will do everything it can to support adjustment consistent with its statutory obligations. We will continue to assess and express our independent assessment of the risks associated with Brexit. We will also use all our powers, consistent with our remits, to mitigate those risks and to smooth the adjustment to new opportunities.

Monetary policy will be set to achieve the inflation target in a way that helps smooth real adjustment in the economy and supports jobs in the wake of very large external forces.

Banks will be capitalised so that they can withstand any severe shock that could be associated with Brexit – however unlikely – and still meet demand for credit.

The financial system as a whole will have the capacity to finance the transition and the opportunities beyond.

These are the best contributions the Bank of England can make to the good of the people of the United Kingdom.

Ultimately, the prosperity of the UK will reflect not just the final Brexit arrangements but also the government's fiscal and structural policies. The first speaker at this conference is the best placed to address these topics.

It could, however, have been very different. As some of you may know, the Prime Minister began her career as a new graduate at the Bank before leaving after six years to pursue other interests – ultimately politics. Whilst at the Bank, the Prime Minister worked in the Economic Intelligence Department – then the cutting edge of our activities. During her time she accomplished great things and was destined for much more. Just imagine what could have become of your career, Prime Minister, if you had stayed at the Bank: you could have been in Fishmongers Hall...

Instead you came here by a road less travelled. Theresa May was elected as MP for Maidenhead in 1997, just as the Bank was getting to grips with its newfound monetary policy independence. She held a number of positions in the shadow cabinets of a string of opposition leaders and served as the Chair of the Conservative Party. After the formation of the coalition government in 2010, she would become the longest-serving Home Secretary in over 60 years. During that period, she confronted many of society's biggest challenges – for example introducing legislation to tackle domestic violence, to eradicate modern slavery and to counter terrorism.

Never afraid of a challenge, she stepped into the breach to become Prime Minister following the referendum.

The Prime Minister and her Government are committed to making the most of the opportunities that Brexit brings, and more fundamentally to working to build a stronger, fairer and more prosperous country for all.

Please join me in welcoming the Prime Minister, Theresa May.