The beginning of the end… …but not the end of the beginning

Governor Carney's valedictory speech discusses the future of the UK's monetary policy remit – but this is just the start of an important debate

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The beginning of the end…

After several false starts, the appointment of his successor (Andrew Bailey) means Mark Carney finally has a leaving date (15 March). He can now concentrate on the serious business of ~~organising his leaving parties~~ securing his legacy from his longer-than-expected time as Bank of England Governor. That all started yesterday with a major speech about monetary policy developments since his arrival in Threadneedle Street in 2013.

Perhaps unsurprisingly, he had a lot to say. Indeed, in a wide-ranging speech delivered at a closed-door event to discuss the future of inflation targeting, he defended his record as Governor.

There's certainly plenty to be proud of. Judged narrowly on achieving the Bank's 2 per cent inflation target, his tenure has seen inflation average a respectable 1.7 per cent, with inflation much less volatile than it was prior to inflation targeting. (Although more volatile than during Mervyn King's tenure.) More than that, Governor Carney makes the case that the way the Bank has conducted monetary policy under his leadership – referred to by monetary policy wonks as 'flexible inflation targeting' – has played a key role in supporting the economy. In particular, his approach saw the Bank use the flexibility afforded to it under its remit to support the recovery in 2013, even as employment recovered rapidly, and to respond proactively after the referendum in 2016, despite a sharp rise in inflation. So he can rightly point to success in keeping inflation relatively close to target, albeit with a little help from some large falls in sterling. Indeed, it is striking that the UK has not experienced the protracted low inflation that has been seen in other advanced countries. That said, GDP growth – and particularly pay growth – have been stubbornly weak during his time.

…but not the end of the beginning

But the more interesting part of his speech focussed on the future. Here the warning was clear: "winter is coming". His view is that a cocktail of continuing downward pressure on

inflation from (for example) advances in technology, combined with limited space for policy rates to fall further, is likely to test the monetary policy framework to its limits.

In this context, we learnt two important things yesterday: first, exactly how much capacity the Bank of England thinks it has to support the economy in the next downturn; and second, how the Bank plans to contribute to a wider debate about the future of the monetary policy framework.

> "It feels like *winter is coming*."
>
> **Bank of England Governor, Mark Carney**

Supporting the economy in a future downturn

Governor Carney was very clear that conventional monetary policy – boosting the economy by cutting short-term interest rates – would not be enough come the next recession. This is nothing new: with Bank Rate at just 0.75 per cent, and the Governor reiterating his position that there is little to be gained by cutting rates below zero, there is clearly far less capacity to support the economy than the average rate cut of around 5 percentage points seen in past recessions.

But he was much more upbeat on unconventional policy. This optimism mirrors Ben Bernanke's American Economic Association Presidential Address last week, with Governor Carney pointing to the scope for expanding so-called Quantitative Easing (or QE) "to at least double the August 2016 package of £60 billion asset purchases". That would deliver the equivalent in policy space of around a 1 percentage point cut in rates. On top of that, he intimated that forward guidance policies – essentially promises to keep rates low for a long time – could add a further 0.75 percentage points worth of loosening. Taken together with conventional monetary policy space, that gives policy space equivalent to around 2½ percentage points of interest rate cuts.

This is a very similar assessment to ours. Indeed, in *Recession Ready?*, we estimated that there was scope for the Bank to loosen policy by the equivalent of around 2 percentage points of interest rate cuts. (The difference here is Governor Carney's optimism about the scope for forward guidance policies to support the economy.)

Despite being a bit more optimistic than us, there is no hiding the fact that the Bank would still need help from fiscal policy in fighting a future recession. Governor Carney notes that 2½ percentage points is equivalent to the policy easing seen in pre-crisis easing cycles. But, crucially, this is not the same as what would be needed in a recession (monetary policy easing cycles were seen in response to small negative shocks pre-crisis). And – based on the Bank's own policy multipliers – would only offset a downturn of around 1 per cent of GDP –

far less than the average peak-to-trough fall in GDP during post-war recessions (around 4 per cent).

The Bank's plans for contributing to a wider debate about the future of the monetary policy framework

So if the Bank doesn't have enough space to fight a recession what can it do?

One option, highlighted in our previous work, is raising the inflation target. If successful, such a strategy would raise the level of *nominal* interest rates, increasing the space for conventional policy loosening in the next recession. But the Governor was dismissive of this option. He cited uncertainty about how to move to a higher target, including the risk of a destabilising loss of public confidence in the inflation target. While we would agree that achieving a higher inflation target would not be without its own practical challenges, the gains from such a change are potentially very significant – with estimates suggesting policy rates could be mired at the zero lower bound (ZLB) as much as 40 per cent of the time if the target remains at 2 per cent. So this is not a policy that should be dismissed lightly, and is one the Resolution Foundation's Macroeconomic Policy Unit will return to in future work.

Looking beyond the level of the inflation target, the Governor said that the Bank would conduct a dedicated research programme over the next year on the UK's monetary policy framework. This was something of a surprise, not least given his imminent departure. But the announcement is interesting and welcome: being prepared to think hard about whether you are doing the right thing is always laudable and should help spark much needed wider debate. As he emphasised, the announcement brings the Bank of England into line with its peers – including the Fed, ECB and Bank of Canada – who are undertaking similar exercises.

But in conducting this review the Bank will need to be mindful to keep to the institutional division of labour between itself and the Treasury. Here a key point is that the Bank's inflation-targeting objective is ultimately a decision for elected politicians. That is not the case for many other central banks (including the Fed, ECB and Bank of Canada, who have more say over their own targets), but it is a strength of the UK framework – allowing the government to explicitly stand behind the Bank's monetary policy decisions. While this is a point that Governor Carney acknowledges, the fact that he is discussing the right level of the inflation target does pose some risk to this institutional division of labour. While we ourselves have called for the Bank to be upfront about the limits imposed on monetary policy at the ZLB given the current inflation target, this division clearly means the Bank's focus should be operational questions, such as: what interest rate and unconventional policy strategies should be used, and how should they be communicated.

What makes this more complicated, however, is that the Bank of England is where technical expertise on monetary policy frameworks is concentrated. So while the crucial task of reviewing the level of the inflation target undoubtedly belongs in the Treasury's own review of the monetary policy framework (originally scheduled to take place last year, and which we

are now expecting towards the end of this year[1]), that review should ensure that it draws on expertise from the Bank. Perhaps a useful template for such an exercise is the Treasury's 'Five Tests' for assessing membership of the single currency. That involved a team of experts from the Bank being seconded to the Treasury to provide technical assistance.

Perhaps more than anything, the one thing that came across in yesterday's speech was the size of the task facing Andrew Bailey. He will inherit a weak economy and an uncertain outlook, with some MPC members already voting for cuts, and others suggesting they may follow suit absent signs of an improvement in the outlook. Meanwhile, there's obviously a pressing need to make progress on the monetary policy framework. All this reinforces the case for a broad debate on these issues. So yesterday's speech should signal the beginning of a debate that will shape the future of UK monetary policy.

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1 See page 7 of: Review of the monetary policy framework, HM Treasury, March 2013.