Resolution Foundation

The Bank of England's options for supporting the economy: lessons from the US

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Ahead of this week's Monetary Policy Committee meeting, we discuss what recent changes to how US policy makers approach setting interest rates might tell us about what additional support the Bank of England could provide in the face of a second national lockdown. The most important change was the introduction of a 'flexible average inflation target', the implication of which is to raise the inflation target *temporarily* after recessions. This aim of this policy is to ensure that periods of low inflation don't become entrenched in inflation expectations, as this can lead to prolonged periods of low growth, as well as inflation. To reinforce its low-inflation fighting intentions the Fed has said it will respond to employment 'shortfalls' by keeping policy loose, but will not tighten policy proportionately when the employment rate is high.

So, what can UK policy makers learn from all this? Despite the consensus-building benefits of the process of reviewing its approach, our view is that the substantive changes to the Fed's mandate are not things the UK should copy. Fundamentally this is because what has hampered the Bank of England is, largely, not an inadequacy in the target, but a shortage of effective tools. In the near term, this leaves the Bank of England with little choice this week but to continue supporting fiscal policy through an extension of its existing QE programme.

As the UK returns to a full national lockdown, and the economy prepares to take a further hit, an important question is how much can the Bank of England do to provide further stimulus? This week's meeting of the Bank's Monetary Policy Committee will provide the short-term answer. In the US, the Federal Reserve has also been grappling with the question of how to ensure it can provide sufficient support to the economy. So, in this Spotlight, we look at whether any of the changes made there can help the Bank of England.

The context for the Fed's review: low global interest rates

As we and others have said before, the coronavirus crisis has been different to the financial crisis because the Bank of England has been unable to provide large-scale stimulus to boost the economy. This is because the low level of interest rates globally has reduced drastically

the room to cut policy rates, forcing monetary policy to play a supporting role to fiscal policy by extending QE, a less effective instrument and where diminishing returns have arguably already set in. But in recent weeks the Federal Reserve Board has announced changes to the way it sets interest rates designed to address these problems. So, could we usefully implement a similar approach in the UK?

The context for these changes is an approach to setting interest rates that has changed little in a generation. Central banks generally approach their policy setting by aiming to achieve a numerical target for inflation, and doing this with a view to also stabilising the real economy. This is referred to as 'flexible inflation targeting' and dates from before the financial crisis. What was known as the 'great moderation' – a two-decade long period of low and stable inflation, and relatively stable growth immediately prior to that crisis – was judged to be the result of economists and policy makers better understanding booms, busts and inflation and how to use policy to tame them.

But the financial crisis prompted a period of low growth and low interest rates that has challenged this consensus approach to monetary policy. A key realisation has been that central bank policy rates are going to be at their effective floors for long periods, not least because even when recessions have been dealt with, the resting point for rates will be much lower than before. This realisation is very clear in the culmination of the Federal Reserve's framework review which observes that interest rates are unlikely to rise far above zero for the foreseeable future.

These phenomena are global ones, opening the possibility that the UK Treasury – which sets the mandate for the Bank of England – could adopt a similar approach here. So below we discuss the changes in more detail and assess how effective they could be on this side of the Atlantic.

So what has the Fed announced?

The two key changes coming out of the review are: first, a 'flexible average inflation targeting' regime, with a recommitment to the 2 per cent goal already stressed under the previous Fed Chair, Bernanke; and second, a change of emphasis about the goal of 'maximum employment' encoded in the Act of Congress that provides the mandate for the Federal Reserve, to emphasise that monetary policy should respond to 'shortfalls' of employment, implying an asymmetry with the Fed responding to low employment (high unemployment) by loosening policy but *not* tightening policy proportionately when employment is high (unemployment is low) unless that feeds through into higher inflation.

The innovation to the inflation target is to turn it from a regime in which 'bygones are bygones' – that is, previous undershoots were simply forgotten about – into what it describes itself as a 'flexible average inflation target'. Under the new regime, an undershoot – such as one experienced since the financial crisis, with policy constrained by the low level of interest rates – is compensated for by a subsequent overshoot. The idea behind this policy is that the

expectation of a subsequent overshoot in inflation acts as a stimulus during periods of low inflation. This is because higher expected inflation in future has the effect of lowering inflation-adjusted interest rates today, boosting spending. This provides – in theory at least – an extra lever on the economy when the main tool, central bank rates, is constrained by the low level of interest rates.

The key implication of all this is that, given that the Fed *has* undershot recently, the short-term target for inflation is higher than before.

The change of emphasis on the employment goal appears to comprise two things. First, an implicit – and partly explicit – recognition that 'shortfalls' are more costly, particularly to those on low incomes who suffer disproportionately from unemployment. Second, a corollary of deciding that the Phillips Curve models, traditionally used to predict what labour market slack might mean for inflation, have proven less reliable, leading the Fed to decide that they should respond vigorously and pre-emptively to 'shortfalls', but wait until excess employment prompts changes in actual inflation before responding on the other side.

Could the same sort of review happen in the UK?

First off, the UK monetary framework is different in a fundamental way, with the Treasury reserving itself the right to set the Bank of England's goals. The Fed has, for a second time now, undertaken itself to 'interpret' the vague mandate for 'price stability' and 'maximum employment' given to it by Act of Congress. By contrast, in the UK, the Bank of England Act is, each year, translated into an operational target by the Treasury. This is a better state of affairs: the central bank already has a lot of power delegated to it; giving it the power to set the target against which it is to be judged is a step too far.

While our view is that this is a strength of the UK system, it also creates a problem. This is because central banks tend to be where the deepest expertise in monetary economics lies: how do you exploit this when you want to overhaul the central bank mandate without seeming to allow the BoE to set its own goals? One way might be to repeat the 'Five Tests' model used by the Treasury when it did its study on euro membership, when senior Bank of England researchers were seconded from the central bank to the Treasury. So while our view remains that a review of the UK monetary framework would be beneficial, it would need to be run by the Treasury rather than the Bank of England.

What are the benefits of adopting these changes in the UK context?

In answering this question, a key point to keep in mind is that, if the objective is to generate more capacity for monetary policy to support the economy in the current crisis, these reforms will not really be of much help. The inability of central banks to provide a significant boost to the economy in this crisis is a result of constraints on their tools – most obviously the floor in interest rates – and not on the target. This is why central bankers the world over – including Jerome Powell, the current Chair of the Fed's rate-setting committee – have been calling for hefty conventional fiscal stimulus.

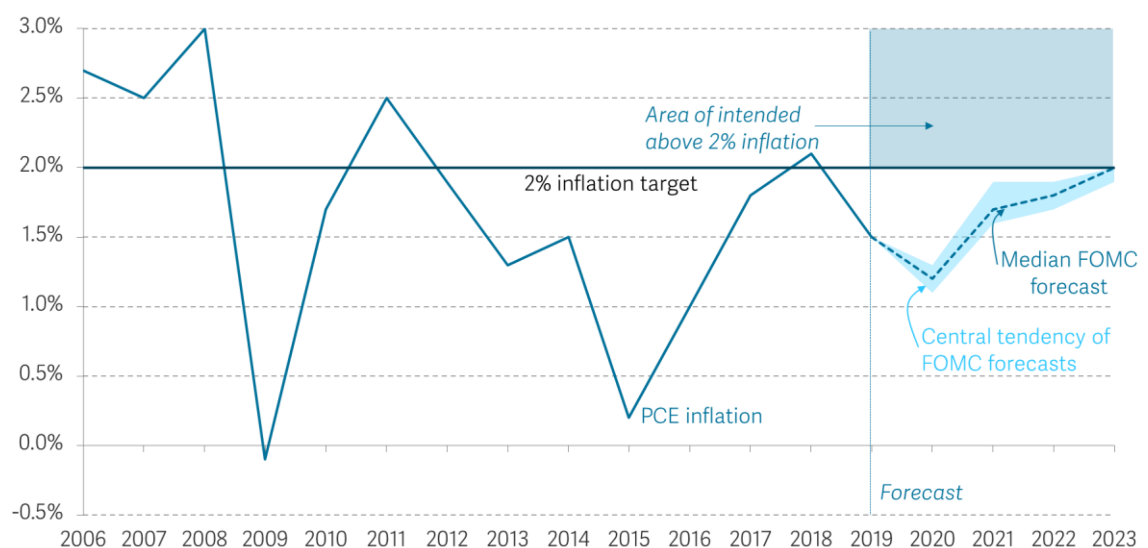
But how effective might these changes be in helping to fight *future* recessions? Here it is important to think about how these changes will work in practice.

We regard the average inflation targeting regime as problematic. While the idea works well in the sort of macroeconomic models most often used to analyse monetary policy decisions, in reality it is doubtful that people look ahead or have as much information at their disposal as the 'rational expectations' agents in those models. Indeed, a known problem with such models is that aggregate demand is much more sensitive to changes in future inflation-adjusted interest rates than economies seem to be in practice. Even if people were forward-looking like the agents in macro models, pronouncements that the Fed will seek high inflation for a prolonged period may well simply not be believed. There is nothing binding the central bank to follow a recession with an overshoot. And no time-horizon is specified over which the inflation gets made up. Finally, turnover on the Fed's interest-rate setting committee (the Federal Open Market Committee, or FOMC) may mean that individuals around to follow up weren't part of the decision to promise an overshoot. So it is not clear that such an approach will be able to deliver the expectations-based stimulus envisaged in the new approach.

The FOMC's forecasts of what it thinks will happen to inflation, despite the change in mandate, reveal that inflation is expected to remain below the 2 per cent target out to 2023 (Figure 1). This tells us that the Fed itself thinks its mandate is not the thing weighing on inflation, but the limitations on the tools at its disposal, and other things outside its control – most obviously the fiscal policy reaction and the state of the economy and the virus.

Figure 1 **US monetary policy makers do not yet expect to be able to overshoot their 2 per cent inflation target**

Core Personal Consumption Expenditures inflation: data and FOMC forecasts: US



Notes: the dotted line shows the median of FOMC participants' forecasts for PCE inflation; the central tendency excludes the three highest and three lowest projections from FOMC members for each variable in each year. The shaded blue area shows the area of the intended inflation overshoot.
Source: Bureau of Economic Analysis; Federal Reserve.

A final issue with the flexible average inflation target is that there is confusion about how accidental overshoots of inflation would be treated. In order that the Fed achieves what it is now emphasising, that inflation averages 2 per cent, and bygones are not bygones, accidental overshoots would have to be offset by engineered undershoots. But this has not been explicitly discussed. If such target undershoots were attempted, how would they sit with the new emphasis on avoiding shortfalls of employment? And how, since they would generate pain at the point they were begun, would the Fed persuade people that they intend to follow through?

Likewise, on the change to the employment objectives, there are problems with how the new framework will be implemented. Here, although we are sympathetic to the concerns behind the re-interpretation of the employment mandate – after all, an undershoot in desired employment *is* more harmful than an overshoot – it is not clear that this change will add all that much in practice. For starters, the asymmetry was to some extent already encoded in the words 'maximum employment'. And there are questions about how different interest-rate setting will be under the new regime. Without giving much of a clue, the re-interpretation is a recipe for discretion and confusion. In the UK context, an important lesson from the past decade is that the sustainable level of employment is very uncertain (we have repeatedly underestimated it, as discussed in our previous work). This means monetary policy makers should focus on inflation measures, rather than trying to second guess the response of the labour market. Adjusting to this new reality does not require a change to the mandate, however.

In terms of fighting the next crisis, the reform is interesting as much for what was *not* done as for what was done. Announcing the start of the Review, FOMC member Richard Clarida made clear that the Fed was *not* going to consider raising the inflation target above 2 per cent permanently. The benefit of a permanent increase in the target is that it raises the resting point for central bank rates roughly one-for-one with inflation, and so makes more room for interest rate cuts to the floor when a new recession hits. In this case, the change in the target increases the capacity of monetary policy tools. But this idea has been left out almost certainly because it was judged too much of a stretch to 'interpret' this as consistent with the Fed's Congress-given mandate of 'price stability'. Though note that 2 per cent is, bearing in mind the relatively small contribution made by measurement error in prices, already bending the 'price stability' mandate to take account of other factors – such as frictions in how prices are set and constraints from the lower bound. Nonetheless, taking the step of pushing the target further away from one that implied 'stability' in prices might have provoked Congressional intervention leading to other changes in the mandate that the Fed could not control and did not want.

Since a decision like this in the UK would be for the Government, such calculations would not constrain it; and we would hope that this option is on the table in any future review of the remit, a topic we will write in more detail on ourselves in the future.

Tooling up

But our main response to this change at the Fed is that it doesn't address the need to rethink the tools used to manage the macroeconomy, and not just the goals. This leads to the question: how would we augment the toolkit, or change the way in which existing tools are used?

A proper answer to this needs a paper all of its own. The Bank of England is clearly going through a period of introspection in this regard about whether to try pushing its policy rate below zero: Governor Andrew Bailey has commented that they are thinking about the merits of this; here Sam Woods, the Deputy Governor in charge of bank regulation, has made it clear that time is needed to prepare banks against the detrimental impact of negative rates for profit margins.

As discussed in our previous work, the most promising reform here is to change the way that monetary and fiscal tools are coordinated. Central bank independence was introduced to take macroeconomic stabilisation policy out of the hands of government, thought too prey to the electoral cycle, and also to lay the emphasis on the more nimble interest rate instrument. But very low global interest rates have meant that such concerns now need to be set aside, and conventional government and tax instruments need to be used more consciously in support of the macro economy. This begs the question of what the Bank of England does in the meantime. One possibility is that their advice is solicited by the Chancellor about the size of the stimulus while their own instruments are constrained, leaving political decisions about its precise design, and ultimate say-so over whether it goes ahead or not, in the hands of government. Whether this happens formally or informally, fiscal policy makers will need to be much more active given the constraints on the Bank of England.

Conclusion

Central bank mandates need to command legitimacy, and for that to be sustained means that they are designed in a way that reflects the changing challenges of the day. The Fed's new policy of reviewing periodically is a step forwards in that regard. But their review has been hampered by the fact that they are confined, as the Treasury's agents, to interpreting mandates laid down in an Act of Congress. And they clearly do not want to do that in a way that would spark invasive re-legislating of their powers at a time of divisive politics. The actual substantive changes to the mandates are problematic and we hope that they are not copied in the UK. They are, in any case, reforms directed at the next crisis. In our view, mandates have not constrainted central banks from responding to the coronavirus crisis; it is the natural limits on central bank tools and the political economy of fiscal policy that have been the constraints. All this leaves the Bank with little option but to continue using its existing tools – most obviously QE – to continue its role of supporting the fiscal response to the significant hit to the economy from a second national lockdown.