

Press Release: Monetary Policy Under Labour

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By 2006, monetary policy in the UK was approaching its "end of history" moment. The arrangements that had evolved to target inflation after 1992, culminating in Bank of England independence and the creation of the Monetary Policy Committee (MPC) in 1997, had not only slain the inflationary dragon but appeared to have delivered wholesale macroeconomic stability. Gordon Brown's claim to have found the ingredients to end "boom and bust" seemed credible and central bank independence as a means of securing this stood as a proud monument to Labour's economic achievements.

Before the 1990s the UK could hardly be held up as a paragon of macroeconomic management. In this context, the period 1997-2007 was a period of remarkable stability in inflation and output growth compared to the UK's past history. Indeed the UK went from being one of the most volatile major economies to being one of the most stable. Inflation has been both lower and more stable under Labour than in any period since the 1970s. This time has also been a period of stability in both inflation and growth across much of the world, often dubbed the "great moderation".

Since late 2008, the story has been quite different. Following the failure of Lehman Brothers, a period of global economic turmoil ensued with the UK experiencing a 6% fall in GDP. This led to a dramatic loosening in monetary policy and from March 2009, a series of unconventional policy measures frequently referred to as quantitative easing. The cornerstone of this has been purchases of almost £200 billion of government debt via the creation of central bank reserves.

Unlike fiscal policy, Labour's record on monetary policy is not an election issue. Indeed, all major political parties in the UK now accept the broad notion that monetary policy is best conducted independently and technocratically. The political consensus now lies in favour of the arrangements that Labour introduced in 1997. Creating this consensus is an achievement in and of itself.

The story of monetary policy under Labour actually begins five years earlier with the UK's exit from the ERM on Black Wednesday in September 1992. The idea of using monetary policy to target the exchange rate was roundly discredited and the subsequent focus moved towards inflation targeting - focusing monetary policy on meeting a numerically specified target for inflation. Granting the Bank independence could also be seen as the culmination of a series of reforms begun by the Conservatives, starting from their first tentative experiment with inflation targeting in October 1992. A number of key features of the UK's monetary policy strategy thus predate the Labour Government. Under the Conservatives' version of inflation targeting, the Bank of England's role was merely that of a mentor to the Chancellor, one that could publicly offer an assessment of the likely consequences for inflation of the Chancellor's actions. The Bank was the "conscience" of inflation targeting, but had no formal power. Labour's key reform was to grant the Bank independence.

The effect of Labour's new monetary policy framework can be seen most starkly in terms of what inflation premia were demanded by bond-market participants, as revealed by the spread between conventional and index-linked gilts. This reflects both the expected inflation rate, as well as risk premia associated with uncertainty about inflation. The record of the Conservative's inflation targeting regime between 1992 and 1997 was also one of fairly stable inflation, but it is fair to say

that in spite of this success, inflation expectations remained stubbornly high (mainly above 4%), suggesting that the public believed the next upsurge of inflation was always just around the corner. After independence of the Bank of England in 1997, measures of inflation expectations exhibited a significant fall of almost 2% in the period to 2001. The fall in long-term interest rates was even more marked. Long-term nominal interest rates dropped by 4% in the space of just over two years. The disinflations of the 1980s and 1990s achieved a similar reduction in long-term rates only over a period of about 15 years. While the Conservatives brought down inflation, Labour finally convinced the country that it was down for good.

After a long period of success, UK monetary policy must now face up to some formidable challenges. First, it needs to learn how to control inflation and stabilise the economy using previously untried tools. Second, it needs to maintain the credibility of the inflation targeting regime in the face of greater interdependence between monetary and fiscal policy, and between monetary policy and support to the banking system and financial markets.

The challenge for the MPC is in demonstrating to the public that it remains independent of the Treasury. The MPC's decision about the quantity of central bank reserves to create is subject to the maximum level of asset purchases set by the Chancellor. Experience of the past thirteen years may suggest that any loss of independence is likely to be a temporary phenomenon and that the customary division of labour between the Treasury and the Bank of England on fiscal and monetary policy can be resumed. However, given the current state of the economy and the fiscal challenge that lies ahead, it may still be some time before this is the case. And this may create a need for a more joined-up approach, particularly as the path of fiscal tightening becomes clearer after the election.

It is not unlikely that there could be tensions between the Bank of England's policies to support financial markets and commercial banks and its ultimate goal of price stability, though this tension is probably latent at the current time. The Bank must come to some judgement about how much liquid central bank reserves it wants to inject into the financial system and thus how much it wants to reduce spreads and liquidity premia. Financial stability may require it to aim for the spreads that financial-market participants were expecting, or had previously become accustomed to. Price stability may require it to aim for spreads that are "normal" in the sense of not reducing the cost of borrowing for risky and illiquid lending to the point that it stimulates demand and inflationary pressure.

One potential danger in more turbulent times derives from one of inflation targeting's advantages: its eclecticism. Inflation targeting could be said to make the central bank's inflation forecast its intermediate target, but no constraints are placed on how inflation should be forecasted, nor on the extent to which the central bank can exercise judgement about the confidence intervals surrounding its central projection. A more volatile macroeconomic environment, and one where there is more ambiguity over what ultimate goals monetary policy should be striving to meet, may make the trade-off swing in favour of intermediate targets in the future, especially if other factors (quantitative easing, monetary/fiscal policy interactions) call into question the independence of central banks and increase the need to demonstrate commitment to a strategy.