THE MPC REMIT AT 25 – GROWING PAINS?

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Abstract

The first MPC remit was a critical innovation in the UK macroeconomic policy framework, providing a clear delegation from government and a strong accountability framework with coherent intellectual underpinnings. The clarity of the delegation and the accountability framework are critical to the remits function: though the macroeconomic policy framework has become more complicated after the GFC, the remit retains a critical role.

In principle, the remit does not need to be expanded further to include climate change because the physical and transition risks associated with climate change directly affect the primary objective. In practice, the inclusion of climate change in the remit gives the MPC a democratic mandate when it faces trade-offs and may prompt it to act early.

On 6th May 1997, five days after the 1997 General Election, Chancellor Gordon Brown sent a letter to Governor Eddie George setting out the new framework for monetary policy. That was followed up on 12th June with a further letter, titled 'Remit for the MPC'.[1] Together, the two letters concisely specified the objectives of Monetary Policy Committee (MPC) and gave a steer on how to manage the inevitable trade-offs. It was clear statement of delegation from the government to the MPC that also specified an accountability framework. The remit letter has been an important feature of the UK monetary policy framework since then.[2,3]

This brief essay falls in two part. First, I will provide a brief review of the first remit and why it would come to play such a key role in defining the monetary policy framework in the early years of the MPC. I will discuss why the same concept has worked less well in other contexts, drawing on the UK's attempts to introduce a remit for the IMF and pointing out the absence of a financial stability remit to match that for monetary policy.

With those experiences in mind, I will set out why the remit is still useful post the Global Financial Crisis (GFC), where the macroeconomic policy framework, and the Bank of England's role in it, has expanded reflecting the shortcomings that the GFC identified. The risk of overload of competing objectives is clear, though, with the primacy of the price stability objective at risk.

In the second part of the essay, I will ask whether the MPC's remit should be expanded further to include climate change. There is a strong argument that climate change and the policy response to climate change pose direct challenges to both the Bank's price and financial stability objectives: the central bank hence has an obligation to address these challenges, whether climate change is mentioned in the remit or not. Arguably, the recent inclusion of climate change as a secondary

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[1] These and the following remit and minutes documents are readily available on the Bank of England website.
[2] For a full account of the discussion leading up to the Bank's independence see: James, H., (2020), *Making of Modern Central Bank, the Bank of England 1979-2003*, Cambridge University Press. Kynaston, D. (2017) *The time's last sand – a history of the Bank of England 1694-2013,* Bloomsbury Publishing.
[3] The remit is mandated by Part 2, Section 12 of the Bank of England Act. Section 12 sets out the objectives.

objective provides direct democratic legitimacy to the central bank's involvement, which could be helpful when the MPC faces trade-offs.

A time of innocence, a time of confidences[4] – the first MPC remit

Though the 12th June letter carries the title 'Remit for the MPC', it has to be read with the 06th May letter, which covers more ground than just monetary policy, including reform of the Bank's Court, the Bank's financial affairs and the transitional arrangements to the new regime. The first self-contained remit is dated June 1998. This first remit is a clear, concise and self-contained document. Over three pages, using only about 700 words, it sets out the framework for monetary policy in its entirety:

- The primary objective of monetary policy is to maintain price stability. The Bank is given a clearly sub-ordinated objective of supporting the Government's economic policy, subject to achieving its primary price stability objective.
- Price stability is operationalised through the inflation target, then 2.5% RPIX inflation. The remit also sets out a trade-off between price and output volatility. The two effectively define the MPC's preferences.
- It specifies a mechanism to account for large deviations from target (the letter writing regime) and an accountability framework: the MPC is accountable for its monetary policy decisions to the government, to parliament, and to the public.
- It contains a pithy summary of the Government's central economic objective as achieving high and stable levels of growth and employment. The contribution of price stability to achieving this objectives is spelt out.

Curiously, in retrospect, there was no discussion of the policy instruments. In 1997, it was perhaps self-evident that monetary policy meant 'interest rates': the minutes of the first meeting of the MPC in June 1997 states that the Committee members 'judged that a modest increase in interest rates was needed immediately', a proposition which was supported by all six members.

All in all, the first remit was an exceptionally clear and self-contained document that made the UK monetary policy regime stand out for its clarity and coherence in comparison to other jurisdictions and in sharp contrast with the past. The Remit provided a strong basis for a delegation of a significant public policy responsibility with a clear accountability framework, thereby underpinning the legitimacy of the new regime and overcoming long-standing concerns about the idea of delegating a critical macroeconomic policy tool.

Bar the change of target from 2.5% RPIX inflation to 2% CPI inflation in December 2003, the remit was left largely unchanged and continued to be the main delegation mechanism until the Global Financial Crisis. The extensive debate in policy circles and academia about "leaning against the wind", be it in the form of countering asset price or house price bubbles or taking financial stability into account never had impact on the remit.

A remit for the IMF?

Given the positive macroeconomic outcomes at the time, it is no wonder that there was widespread pride in the regime within which the remit played such a key role. Not only did MPC members regularly sing its praise, the Treasury wrote a book about the macro policy framework.[5] The enthusiasm for the remit as a delegation and accountability tool was in fact so strong that it was considered a potential export item for other areas of economic policy and internationally.

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[4] Paul Simon, Bookends (1968).

[5] HM Treasury, 2001. *Reforming Britain's economic and financial policy: towards greater economic stability*. Springer.

One such was the UK's contribution to improving the quality and the traction of the International Monetary Fund's bilateral and multilateral surveillance in the period after the 1997 Asian Financial Crisis. This was a period where Gordon Brown held the chair of the influential International Monetary and Financial Committee (IMFC),[6] and the Bank of England and HM Treasury were very active in international financial policy. I am not sure exactly when the idea of a remit from the IMFC to the IMF Management was introduced[7] but it caused considerable opposition and consternation. In the end, it was not part of the surveillance framework that emerged from a long and contentious reform process. The ins and outs of that process is well beyond the scope of this paper – in fact, it is the subject of a forthcoming volume on the evolution of the IMF's surveillance framework in the 21st century.[8]

Why is this failure relevant to a discussion of the MPCs remit? The IMF process demonstrated that the remit as a tool is by no means universal. In my view, the main issue was unclear governance arrangements: which of the many international committees and bodies had both the legal standing and political clout to provide a clear delegation to the IMF management and hold it to account? That issue could not be resolved.[9] The absence of a clear intellectual framework, specific objectives and the well-defined policy tools would have made the drafting of a remit more arduous, but it was the lack of clear governance arrangements that made it impossible.

That insight might help us to understand why domestically, there was no remit for the Bank's financial stability mandate to match the remit on the monetary policy side. The absence of a clear and agreed intellectual framework probably played a role, but the fundamental governance issues with the tripartite arrangement played a key role in the failure to provide the clarity to financial stability that so clearly benefitted monetary policy. It took the GFC to change that with the first remit for the Financial Policy Committee (FPC) being issued in April 2013.

Innocence lost: the expansion of the MPC remit

In 2013, the MPC remit was substantially expanded, reflecting the experience of the GFC and the profound rethink of the macroeconomic policy framework. The 2021 version, which I will take as a basis for my discussion, is longer (at close to 1500 words plus a cover letter), uses more complex language and covers more ground than the 1998 remit.

This longer MPC remit sits alongside the remit for the FPC, coming in at 3800 words plus a long cover letter. It is also worth recalling that four of the five internal MPC members are members of the FPC (and of the Prudential Regulation Committee for that matter).

The core of the MPC remit remains the same, and the delegation and accountability framework is unchanged: the Chancellor sets a target that operationalises the price stability objective, specifies trade-offs and how to deal with large inflation under- and overshoots; the remit establishes an accountability framework to the Government, Parliament and the public. But much else has changed, with several important expansions:

- The 2021 remit is more explicit on trade-offs between output and inflation. It gives the MPC more flexibility to choose the pace at which inflation is brought back to target.

[6] For those unfamiliar with the IMFC and its role, see https://www.imf.org/en/About/Factsheets/A-Guide-to-Committees-Groups-and-Clubs#IC. Gordon Brown was IMFC chair from 1999 to 2007.
[7] An early reference is: Balls, E., 2003. Preventing financial crises: the case for independent IMF surveillance. *Remarks made at the Institute for International Economics. Washington, DC March, 6*.
[8] Ghosh, A, Postelnyak, A, 2022. *The IMF in the Twenty-First Century--Surveillance Milestones I: The 2007 Surveillance Decisio*n. IMF, Forthcoming.
[9] It probably did not help that the concept of a remit was unfamiliar to many nor that the UK had followed a less than conventional approach to in getting the IMFC to agree that it wanted a remit. See Ghosh and Postelnyak (2022), p. 151.

- Financial stability risks are explicitly recognised: while the Financial Policy Committee (FPC) is "first line of defence", the MPC is given a clear steer that it "may wish to allow inflation to deviate from the target temporarily, consistent with its need to have regard to the policy actions of the Financial Policy Committee." The co-ordination with the FPC is explicitly mandated, complete with a description of the accountability framework.
- The remit specifies the governance of 'unconventional policy instruments' and in particular clarifies that the MPC has an obligation to seek approval for such instruments – in addition to asset purchases, that includes tools that support the funding of commercial banks' balance sheets, such as the Funding for Lending Scheme. The MPC is allowed to do what it wants on forward guidance, presumably because that is judged not to have financial consequences.[10]
- A substantially expanded section on the government's economic policy objectives which focuses on strong, sustainable and balanced growth. In addition to credible frameworks for monetary and fiscal policies, the government's strategy includes structural reforms to support "levelling up" and the net-zero transition. It also includes maintaining a resilient, effectively regulated and competitive financial system, to protect consumers, the tax payer and – with a second mention – the net zero transition.

On the whole, this is a significant expansion of the role of the MPC. The primary objective may still be price stability as stipulated by the Bank of England Act, but the MPC has:

- more flexibility in dealing with inflation deviations.
- more choice in terms of instruments, including some that directly affect the availability and cost of credit.
- a significant role in financial stability, even if it is secondary to the FPC.
- a much broader secondary objective including a double mention of the net zero transition.

Some regret the loss of clarity of the remit: not only is it now too long and too complex for a non-technical audience to appreciate, but there is also a view that the expansion of the role of the MPC, and more generally of the Bank of England, poses substantial democratic challenges and ultimately threatens the Bank of England's independence and capacity to do well what only it can do: ensure price stability.'[11]

While I have sympathy for those looking for a simpler world and certainly agree that an independent monetary policy is critical, I think it is a strength of the remit that it attempts to deal clearly with the complex challenges facing macroeconomic policymakers. That is not an invitation to overload the MPC or the Bank of England with objectives it has neither the tools nor capacity to deal with. But the remit should reflect the reality that the MPC and the Bank of England now play significant roles in the allocation of liquidity, funding, capital and risk.

It would be wrong to pretend that these tools can be deployed in a "neutral" fashion – these policy decisions clearly play an important role in the allocation of resources, and that allocation depends on what other policy steps the government might take. To my mind, it is much better to acknowledge and codify that influence, provide clear and limited objectives for the central bank, underpinned by an appropriate delegation and an accountability framework. That is the lesson of the GFC.

The risk, though, is clear: the primacy of the price stability objective may be undermined by an overload of subordinated objectives and competing policy concerns, particularly for those policymakers that wear multiple hats.

[10] The remit curiously still does not spell out what the conventional policy instrument is.
[11] Tucker, Paul. *Unelected power*. Princeton University Press, 2018.

Should the remit include climate change?

Does the current remit strike the right balance? Given the already substantially expanded role of the MPC and the Bank, is it wise to also include climate change in the remit, and if so, how?

It is clear that the central bank will not be the principal economic policymaker in this area. Most would agree that the net-zero transition will require a substantial re-allocation of resources, using tax, investment and regulatory tools that properly lie with government. The MPC's remit should not be overloaded with a climate mandate in order to provide the government with an excuse for insufficient action.[12] So far, so easy.

But the scale of the transition and the effect on macro outcomes are broad, and will affect the MPC's ability to meet its primary objective. For this brief discussion, I would point to:

- Large and persistent moves in relative prices as the cost of carbon emissions rises to achieve the necessary re-allocation of resources.
- A substantial initial rise in investment expenditure share at least in the next decade in order to support the green transition.
- Rising uncertainty and risk, associated with physical and transition risks.

It is beyond the scope of this short essay to discuss these effects in any detail. But even at this superficial level, it is clear that the central bank's ability to achieve its objectives is going to be affected by these developments. It is also clear that the policy measures central banks take will matter.

This is perhaps most obvious in the financial stability sphere: if you accept the argument that there are physical and transition risks that could give rise to substantial financial losses, then climate change will likely have financial stability impact, and there is a strong argument for policy intervention.[13] The Bank has micro and macro prudential policy tools that affect the allocation of risk and capital so it can respond to these risks as they would to others. It is thus hard to argue against climate change as a first order concern in a financial stability context.

But what about monetary policy?[14] Even in the absence of secondary objectives, monetary stability is likely to be directly affected by climate change and policies that respond to it. Indeed, we need look no further than the current dramatic rise in energy prices to see an instance where past energy policy decisions have contributed to increased energy price volatility that challenges price stability.

In broader terms:

- While climate change is not the principal driver of these current price stability concerns, it could well be the case in the future that a mix of physical climate outcomes and carbon reduction policies cause real economic and price volatility.
- A shift in resources towards a higher investment share might increase the real interest rate associated with price stability (known affectionately as RSTAR) by increasing savings relative to investment.
- More tail events – be it in terms of physical events or in terms of negative financial outcomes – might put downward pressure on RSTAR by increasing uncertainty and risk.

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[12] Lord King in House of Lords Debate, 12 March 2021, col 1914 [Lords Chamber].

[13] There is now a large literature on this topic. The classical reference is Carney, Mark. "Breaking the tragedy of the horizon–climate change and financial stability." *Speech given at Lloyd's of London* 29 (2015): 220-230.

[14] The ECB's 2021 strategy review includes an extensive review of climate change. See: Drudi, F., Moench, E., Holthausen, C., Weber, P.F., Ferrucci, G., Setzer, R., Nino, V.D., Barbiero, F., Faccia, D., Breitenfellner, A. and Faiella, I., 2021. Climate change and monetary policy in the euro area.

Given the potential importance of these effects, monetary policy should at the very least be climate aware – that is, a policy that takes effective account of the impact of climate change and climate change policies on achieving its primary objective.

Does that mean that it is unnecessary to include it as a secondary objective? Arguably, including it in the secondary objectives is helpful in that it provides a clear mandate. The Bank has already heeded that change in remit by giving its balance sheet policies a 'green tilt'.[15] That reflects what is now a widely held view in the academic literature that this is the appropriate course of action.[16] This may matter less now, where the MPC is on the cusps of disposing of its corporate bond portfolio. But looking ahead, as a matter of consistency, it would surely make sense that purchases are conducted in a forward-looking manner, in line with the requirements that the Bank as a regulator imposes on banks and insurance companies, as opposed to a backward looking 'market neutrality' concept that reflects historic issuance. Even if the impact of such a decision is likely to be small, it would send the wrong signal not to acknowledge the role the Bank plays in the allocation of capital.

But does the secondary objective matter directly for monetary policy decisions? If the monetary policymakers were care to directly about emissions, then it could create a direct trade-off with output: it would mean a willingness to sacrifice growth and accept higher volatility, in return for more emission reduction through a reduction in output.[17]

What does that mean in practice? We will need a well-specified model to answer that question with any precision – it will depend critically on the trade-off between output and emissions, and of course the weight the central bank puts on avoiding emissions now and in the future. Government policy will matter too. But to get a sense of the direction, consider the following thought experiment: if the government imposes a carbon tax that raises the price of carbon intensive consumption – how should the central bank respond?[18]

If we accept that emission reduction is part of the objective function, then it would be wrong to act to fully off-set that decline in consumption by easing monetary policy. First order, the right reaction would be to act if this was any other supply shock: monetary policy should act to ensure that the increase in some prices are off-set by the decline in others, over time. It should, on the usual mantra, avoid second round effects.

But if emission reduction is part of the objective, you could argue the central bank should act more aggressively – because the reduction in emissions that comes from lower output makes an output deviation less costly, and because the higher real interest rate shifts resources away from consumption towards investment. If, on top of that, the government is able to redistribute the proceeds and raise investments, then the argument for higher real interest rates becomes stronger.[19]

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[15] See the announcement here: https://www.bankofengland.co.uk/news/2021/november/boe-publishes-its-approach-to-greening-the-corporate-bond-purchase-scheme.

[16] See Fisher, P., 2021. *Greening the central bank balance sheet, or not? - Central Banking*. [online] Central Banking. Available at: <https://www.centralbanking.com/central-banks/governance/7873141/greening-the-central-bank-balance-sheet-or-not> [Accessed 19 February 2022*].*

[17] This is similar to the sustainable finance literature, where some argue that the traditional focus on returns and volatility should be extended to a third dimension, e.g. sustainability or impact. It seems reasonable to argue that at least in the short run, there could be a trade-off between impact and expected returns.

[18] The optimal policy response will clearly depend on the policy action taken by the government. Papoutsi, M., Piazzesi, M. and Schneider, M., 2021. *How unconventional is green monetary policy. JEEA-FBBVA Lecture at the ASSA.*

[19] Schnabel, I, 2022. *Looking through higher energy prices? Monetary policy and the green transition.* Remarks at the American Finance Association 2022 Virtual Annual Meeting

There are clearly limits to that argument: including climate change as a secondary objectives for the Bank of England does not require it to cause a recession to get emissions down or to deter consumption. But it does establish a trade-off.

That may feel like taking things a step too far at this point. I think the argument will become stronger over time, as it becomes clearer that we are behind when it comes to achieving the required emission reductions and the impact on the economy and markets becomes more pronounced. The presence of climate change in the remit may help the MPC anticipate these developments and react early.

Conclusion

The first MPC remit was a critical innovation in the UK macroeconomic policy framework, providing a clear delegation from government and a strong accountability, underpinned by a simple and clear intellectual framework. The remit has stood the test of time, in my view principally because of the clarity of the delegation and accountability framework, rather than the simple intellectual underpinning, specific objectives and the well-defined policy tools. In fact, even when it turned out that the intellectual underpinnings were inadequate and the macroeconomic policy framework was substantially redesigned with a broader role for the MPC and with the addition of a comprehensive macro prudential framework, the remit has retained an important role.

In principle, the remit does not need to be expanded further to include climate change as an objective because the physical and transition risks associated with climate change affect the primary objective. But in practice, it is helpful for the MPC that the delegation explicitly mentions climate change, particularly when the Committee inevitably faces trade-offs.