House of Commons

Treasury Committee

Appointment of Dr Mark Carney as Governor of the Bank of England

Written Evidence

Only those submissions for the inquiry into Mark Carney's appointment and accepted as written evidence are included.

List of written evidence

Written evidence submitted by Professor Simon Wren-Lewis, Oxford University

1. Monetary policy has two objectives: to stabilise inflation at an acceptable level, and to try to eliminate any output gaps. As a result, academic work on monetary policy has two ultimate goals for monetary policy: to minimise excess inflation and to minimise the output gap. Views about the relative importance of these two objectives vary, and our knowledge here is very partial, but both objectives matter.

2. The current UK monetary policy regime places one of these objectives - targeting inflation - above the output stabilisation objective. This is in contrast to the regime in the United States, which has a 'dual mandate', which essentially corresponds to the two objectives outlined above. So why have in the past most macroeconomists, including myself, been relatively content with focusing on inflation as the primary policy objective?

3. The most important reason was that these inflation targets were interpreted in a flexible manner. (The regime is often called flexible inflation targeting.[1]) Specifically the Bank of England has interpreted this flexibility as trying to hit the inflation target in two years time. The general view was that over this kind of time frame, hitting the inflation target would be consistent with closing the output gap. So although minimising the output gap was not a primary policy objective, that objective would be fulfilled under flexible inflation targeting. The theory behind this view is that inflation is ultimately determined by a Phillips curve, which implies inflation will only be stable in the long run if the output gap is zero.

4. Recent UK experience has unfortunately shown that view to be seriously incomplete. Inflation has been persistently above target, yet output is well below its sustainable level.[2] The MPC has currently set policy to achieve the inflation target in two years time, but it does not expect the output gap to come near to being closed in two years time. So the inflation objective is overriding the output gap objective.

5. There are probably two reasons why we now have a conflict between hitting the inflation target and closing the output gap. The first could be called bad luck. The UK economy has been hit by a series of positive inflation shocks: a large depreciation with lagged effects, increasing commodity prices, and increases in certain government charges and taxes. The second is more fundamental and also more a matter of conjecture. When inflation is low, high unemployment appears to have a smaller downward influence than

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[1] See, for example, http://www.norges-bank.no/en/about/published/speeches/2004/2004-01-23/

[2] Macroeconomists use almost as many names for this sustainable level as there are estimates for its magnitude (natural rate, NAIRU, natural level, output potential…), but unless anyone wants to suggest that none of those currently unemployed are capable of working, there can be no doubt that UK output is currently below this level.

when inflation is higher. One obvious reason for this is that workers are particularly resistant to nominal wage cuts.

6. Whatever the causes, there is now a clear conflict between what a sensible UK monetary policy would be doing and what is actually happening. Monetary policy is not providing enough stimulus to the UK economy, because it is focusing on the inflation target, and not the output gap. Inflation targeting in the UK is not working, and something needs to change[3].

7. Some commentators suggest that a change in personalities may be sufficient to deal with this problem. I think this is quite wrong. It is clear to me that the MPC takes the Bank's interpretation of inflation targeting very seriously. It was put very well by Adam Posen in his recent (22nd Jan 2013) evidence to this Committee: "anyone who was on the [MPC] basically took the equivalent, in my opinion, of an oath of office. They were serving on the committee under the terms of the given inflation target." Posen was generally a 'dove', not because he wanted inflation above the target, but because he thought inflation would come down more quickly than others.

8. For this reason, I do not think the MPC would be able to do what the US Fed is currently doing with monetary policy. The Fed has said that they are willing to see inflation go (a little) above their 2% target in order to get unemployment down. I believe the MPC would regard that as violating their remit. It would be useful if the Committee could see if the new Governor takes a different view.

9. If I am right, some change (or official reinterpretation) in the UK monetary regime has to take place. There appear to be three types of change that could be explored: moving to a dual mandate, looking at other measures of inflation, or getting rid of the inflation target completely.

10. Perhaps the most straightforward change would be to make monetary policy in the UK more like policy in the US, by adding an output gap or unemployment objective alongside the inflation target. It would not be necessary, and given current uncertainties it would not be desirable, to specify a particular number for unemployment or output. Instead the MPC could be charged with ensuring output was at a level consistent with long run inflation stability, or some similar phrase. The risk that this change would lead us back to the 1970s is zero. What this change would enable the MPC to do is allow inflation to be above target in 2 years time if they expected the output gap to persist.

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[3] I discuss this point further here: http://mainlymacro.blogspot.co.uk/2012/05/inflation-targeting-is-not-working.html

11. Another possibility would be to stay with an inflation target, but to broaden the range of inflation measures that were looked at. There is no reason from economic theory why consumer price inflation is the 'right' inflation measure to target, and other measures (like output prices, or wage inflation) may be at least as relevant. Unfortunately the series of positive inflation shocks the UK has recently experienced have their maximum impact on consumer prices. Monetary policy in the UK would now be very different if the inflation target was for earnings growth - and there is no reason in terms of the macroeconomics why it should not be[4].

12. Both these suggestions have one apparent disadvantage: we lose the simplicity and clarity of a single target. By specifying more than one target, and not specifying the trade-off the MPC should use when the targets conflict, we are leaving more to the discretion of the MPC. However, such a regime would still give less discretion to the MPC than monetary policymakers in the US or Eurozone currently have. The targets would still be set by the Chancellor.

13. The third alternative is to replace a single inflation target by a single target for something else. Targets for nominal GDP have been widely canvassed. It is absolutely vital that here a clear distinction is made between targets for nominal GDP growth, and targets for the level or path of nominal GDP. It is the latter that many economists have recently suggested might offer some clear advantages over inflation targets, and which were discussed in a recent speech by the new Governor.

14. As some eminent macroeconomists, like Michael Woodford, have been arguing for the advantages of such 'history dependent' targets for some time (well before the recession), a debate on their merits is overdue. Although this issue is widely discussed in the US, we have very little discussion in the UK. This may be because the natural host for such a discussion would be the Bank, but the Bank has felt that it would be inappropriate for it to question its own remit. I hope the new Governor does not take that view, and it would be useful for the Committee to ask him about this. If the Bank, under its new Governor, still felt it inappropriate for it to lead a discussion on the merits or otherwise of NGDP targets, then the Committee itself should think about undertaking this role.

15. While I would welcome an extensive discussion of this type, it would be unfortunate if that debate put on hold any change in UK monetary policy. As I have argued above, policy is providing insufficient stimulus to the UK economy now, because of the form of the current monetary policy regime. Changes could and should be made to that regime now, without in any way prejudicing the results of a more extensive debate on NGDP targets.

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[4] The economics are discussed further here: http://mainlymacro.blogspot.co.uk/2012/06/but-which-inflation.html

That is why I think it is important to address the possibility of moving to a dual mandate, or looking at alternative inflation measures.

January 2013

Written evidence submitted by British Chambers of Commerce

The British Chambers of Commerce (BCC) welcomes the opportunity to respond ahead of Dr Mark Carney's evidence session on the Treasury Committees Autumn Statement Report.

The BCC is an influential network of 54 Accredited Chambers across the UK, representing the interests of over 104,000 businesses. No other business organisation has the geographic spread or multi-size, multi-sector membership that characterises the Chamber Network. Every Chamber sits at the heart of its local business community, providing representation, services, information and guidance to member businesses and the wider local business community.

BACKGROUND

Dr Carney will take office at a crucial time for both the UK and global economies as the Bank takes on greater supervision of Britain’s financial services sector, and in particular our major lending banks.

ACCESS TO FINANCE/BUSINESS BANK

We also hope that Dr Carney will play an instrumental role in bringing the British Business Bank to life through his experiences with a similar institution in Canada. The Business Development Bank of Canada (BDC) is a financial institution owned by the Government of Canada and has been successfully serving Canadian SMEs for more than 65 years.

BDC have a mandate to support entrepreneurship and plays a leadership role in delivering financial and consulting services to Canadian small and medium-sized businesses, with a particular focus on start-ups, innovators, fast growth companies, manufacturers and exporters.

They currently help more than 28,000 businesses and as a complementary lender, they offer loans and investments, that fill out the services available from commercial financial institutions. It is also important to note that their funds are borrowed on the money market like other commercial banks and they do not receive government funding for the money they offer in loans.

The BCC believes that the British business bank must develop into a major source of both patient growth capital and risk capital, similar to the BDC in terms of outcome rather structure, if it is to succeed where decades of interventions have failed. Further to this, we believe that Dr Carney's views on the structure and purpose of the new business bank will be an important step to clarify the road map to attain the right type of business bank to help firms around the UK achieve their full potential.

USING MONETARY POLICY TO SUPPORT GROWTH

We hope that the new Governor will be questioned on the role that the Bank of England can play in supporting business growth across the UK. In particular, the BCC believe that the new Governor must work closely with the Treasury to find ways to boost the supply of credit to new and growing businesses.

February 2013

Written evidence submitted by the Association of British Insurers

- The UK insurance industry welcomes the appointment of Mark Carney and looks forward to the start of his tenure as Bank of England Governor in July this year.

- The incoming Governor's recent comments at the World Economic Forum in Davos centered on growth. The UK insurance industry uses its significant assets to invest in growing the economy, with ABI members' current assets amounting to investments of £1.8 trillion in the wider economy – equivalent to 26% of the UK's total net worth.

- As you know, Mark Carney signalled at Davos that Central Banks inflation targeting should be approached more flexibly with the mandate of delivering sustainable growth in mind. He added this could include "the use of communication and use of other unconventional instruments."

- A second key issue for economic growth is how the un-wind of Quantitative Easing (QE) will be managed – which also carries consequences for savers annuity rates.

- **ABI members are concerned that if either inflation targeting or un-winding QE is unsuccessful, the UK will face a major inflation problem. Getting these decisions right and ensuring the markets have both certainty and a clear understanding of the Governor's position is therefore critical to investors.**

- The insurance industry has an important role in returning the UK economy to growth. With key government policy initiatives such as auto-enrolment into workplace pensions now successfully underway, the role of insurers as investors of people's hard earned money is central to delivering responsible capitalism. Maintaining good corporate governance in the way we act as investors and encouraging best practice in UK boardrooms is key to making the best use of people's savings – some of which could be put towards valuable infrastructure projects.

- As part of the overhaul of financial services regulation, the prudential regulation of insurers and asset managers will come under the Bank of England's remit for the first time.

- During final stages of debate on the Financial Services Act, the industry was reassured by Lord Newby's statement that "the Government absolutely agree that insurance expertise should be represented on the PRA Board." The PRA has a specific insurance objective and a distinct approach to supervising insurers, recognising their unique business model: **we look forward to working with the new regime so that these new responsibilities are best implemented for the benefit of our customers and the UK economy.**

About the UK insurance industry

The UK insurance industry is the third largest in the world and the largest in Europe. Paying out almost £200 million a day to our customers, insurance is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 30% of its net premium income coming from overseas business.

About the ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has almost 350 members, accounting for some 90% of premiums in the UK.

January 2013

Written evidence submitted by Professor Jagjit Chadha, Chair in Banking and Finance, School of Economics, University of Kent

Evidence to the Treasury Committee on the Current Monetary Policy Regime: Time to Move to Nominal Income Targeting?

This short note considers the case for a move from inflation targeting to another widely championed form of nominal anchor, nominal income targeting, which can also be thought of as targeting a limit on the quantity of cash spending in the economy in any one year or average rate of growth in such spending over a number of years. As is well known, following the end of Bretton Woods, the UK experimented with a number of nominal anchors which dragged with alarming frequency from wage and price controls, to various forms of monetary targets through to shadow and then explicit exchange rate targets. The ultimate purpose of these mechanisms was to establish price stability and also inculcate agents with the belief that price stability would persist, so that consumption and investment plans were also formulated conditional on price stability. Even though inflation targeting was adopted rather hastily in the UK, after ERM exit in 1992, and in its current form with an operationally independent but goal dependent central bank, only after the election of the Labour government in May 1997, it has actually played a key role in the establishment of price stability in the UK and should not be lightly discarded.

Just as reform of the operating practices of the Bank of England (the inflation report, publication of minutes and operational independence etc) was part and parcel of the adoption of inflation targets, to some extent, the evolving nature of the Bank of England's role following the financial crisis leads to an open question about whether a different nominal anchor, such as nominal income growth, would be not only be more achievable but also more appropriate for a central bank mandated to ensure economic resilience. It has been argued that moving to a nominal income target will force the central bank to consider the growth consequences of both economic developments but also the implications of its new macro-prudential policies for growth and so ensure better co-ordination across these roles by helping to prevent the build-up of imbalances, which was, of course, the precursor to this crisis. Clearly even without the change in the structure of the Bank of England, the failure of monetary policy to prevent a financial crisis and also engineer a sustained recovery leads a number of reasonable people to conclude that it is the regime of inflation targeting that has failed, rather than, in my view, the more prosaic bread and butter of economic management that involves the careful analysis and understanding emergent economic tensions and, where possible, act against them.

Nevertheless, nominal income targets, it is argued, are consistent with price stability as they comprise a given inflation target plus the long run likely growth rate in output capacity. The policy maker thus simply sums these two numbers in his or her objective function and adopts policy choices that generate growth in nominal expenditures that is equal to inflation and growth. Specifically, it is argued that a nominal income target would allow the policymaker to stand back from two highly uncertain parameters. First they will be able to ignore the split between real output and inflation in the short run. Secondly, it would also imply less weight being placed on the measurement of the output gap, which is also rather hard to estimate, in order to forecast inflation. In some sense, nominal income targets would therefore be quite close in spirit to Milton Friedman's K% rule for the growth of money and as such would allow the continuation of rules-based monetary policy. Furthermore it is argued that in the presence of supply shocks, which send real output and inflation in opposite directions, the central bank could avoid having to make difficult decisions about the trade-off, or choice, between which of the two to stabilise.

At a practical level three types of criticisms have been levelled at nominal income targets. First that nominal GDP and the deflator are only available at a quarterly frequency, rather than monthly for CPI, and subject to large revisions, which would mean that current policy could only be assessed less frequently and also may have to offset previous errors that have only been discovered. Secondly, the index for the GDP deflator does not correspond to the expenditure patterns of households and so may be not impart significant surprises to the plans for real household consumption, even if targets are hit. Finally, from a technical control perspective, some have argued that because output responds before inflation to a policy shock, nominal income targetry may be more prone to generating dynamic instability as there is not necessarily a synchronised response in nominal GDP to any given shock.

My own main concern about any move from inflation targets is that it weakens the signal about price stability and credibility over a given inflation target. Following a hypothetical move to nominal income targets, the public will no longer be formulating their plans with respect to a given path for inflation but conditional on their real output forecast, so that high inflation should be expected when growth is low and vice versa, which seems a recipe for considerably more inflation variance. And so even if the central bank no longer has to worry about the split between inflation and growth the public will. Additionally, if we want to use signalling about the duration of a given interest rate stance, it seems to me that this is more difficult to achieve if the central bank is formally charged with twin rather than a single objective. Actually much of the strain for output stabilisation has traditionally already been assigned to fiscal policy and thus it makes sense to continue with price stability as the main assignment for monetary policy. In fact, in the face of severe dislocations in economic activity, the inflation target can be given a further degree of freedom by simply allowing or stating that return to target will be gradual over a number of years in the interests of limited output volatility - a flexible approach to inflation targeting can thus retain the commitment to price stability but also ensure that output is not ignored.

I certainly think that some considerable attention and thought needs to be given to the monetary policy making framework e.g. the development and transparency of the suite of Bank models, their ownership and use, as well as the level of support given to external MPC members may once again have to be considered. But given an economic history comprising an almost dilettante adherence to monetary frameworks, the retention of anchor in terms of inflation *per se* remains attractive. The failures of monetary policy over the most recent period, are not really ones about the form of nominal anchor but more about the integration of financial and monetary analysis into a more comprehensive analysis of economic vulnerability. There is much work to be done but that is probably where we should begin.

February 2013