Can you bank on the BANK OF ENGLAND?

In recent decades governments have developed mechanisms to try to make their monetary policy and inflation promises more believable or "credible". Unfortunately, since the financial crisis, it appears the Bank of England has not been taking the inflation targeting part of its mandate seriously, says ANDREW LILICO

"Credibility" is the term economists use to refer to the belief, by economic agents, that promises will be kept even if keeping them is unattractive at the time.

If a government promises "credibly" not to raise corporation tax for the next five years, then economic agents believe corporation tax will not be raised even if the government becomes in urgent need of extra revenue or even if opinion polls suggest voters would be very keen to see corporations punished by tax rises.

If a government promises "credibly" to balance the budget for the next two years, economic agents believe the budget will be balanced even if there is a big recession and tax receipts fall significantly.

It is, in fact, very difficult for politicians to make credible promises because circumstances often change in such a way that it would be beneficial for the government to renege on their commitments.

However, it can be useful for the government to make credible promises. In the case of corporation tax, for example, a low and stable rate might attract more investment.

But, if investors do not believe that the government will keep the promise when times get difficult, the investors may stay away.

Credibility and inflation

One of the most important and widely-discussed forms of credibility concerns monetary policy. Governments and monetary authorities can make various promises in this area.

For example, they might promise to keep fixed the rate of exchange of the domestic currency (say, the pound) to, say, the dollar or to gold. They might promise to keep interest rates no higher than 2 per cent for the next three years. Or they might promise to keep inflation within, say, 1 percentage point of some inflation target (e.g. 2 per cent).

If economic agents can feel confident that an inflation target will be met, whether or not the politicians find it convenient to meet it, those economic agents can plan with much greater confidence.

Suppose your boss offers to raise your salary from £20,000 this year to £21,000 next year – a 5 per cent rise.

Will that mean you are better off next year or worse off? If you are confident inflation is going to be 2 per cent next year, that 5 per cent rise means your boss is raising your salary in real (inflation-adjusted) terms. But if inflation might be 10 per cent, despite the promise to keep it to 2 per cent, that 5 per cent rise could actually be a pay cut in real terms.

So instead of you, say, consuming a bit extra now in anticipation of your greater riches next year, you should probably cut back a bit to save up for when you get poorer.

If you don't know which is the right strategy, because you don't know how much to trust the government, you may well end up making costly mistakes.

Multiplied across the economy, such mistakes, arising from the lack of credibility of inflation promises, can damage economic efficiency significantly, leading to lower growth and lower economic welfare in general.

SUCH MISTAKES, ARISING FROM THE LACK OF CREDIBILITY OF INFLATION PROMISES, CAN DAMAGE ECONOMIC EFFICIENCY SIGNIFICANTLY

One well-known form of inefficiency that we try to avoid using more credible monetary policy concerns unemployment.

Firms offer employment and workers accept it based on nominal wage offers plus their expectations about inflation. If inflation is lower than expected, workers will mistakenly have turned down jobs expecting to be able to get higher salary offers later that never come (because the original offers were actually more lucrative, in real terms, than expected) and unemployment will rise.

If inflation is higher than expected, workers will mistakenly accept job offers they should have rejected in favour of a better offer later, and unemployment will end up very low but at the cost of excessively low wages.

Unemployment will only be at an equilibrium full-employment level consistent with healthy wage growth if the expectations of workers and firms about inflation are correct.

We can see how credibility can be lost by grasping how tempting it will be for the monetary authorities to allow inflation to overshoot, especially if the economic situation is fragile.

An inflation over-shoot means unemployment being lower at the cost of somewhat lower real wages. It is like everyone having an unexpected wage cut to pay for the jobs of some extra employees.

Has the Bank of England lost credibility?

It is for this reason that governments have gone to great lengths to try to make their monetary policy credible.

In recent years, they have done that by delegating decisions to independent central banks and giving them targets to meet which can only be changed through a transparent process.

In the UK, after five years of pursuing a system of inflation targeting from 1992, a system was introduced in 1997 whereby the Chancellor of the Exchequer set an inflation target for the Bank of England which was also made independent.

If the Bank did not make sure inflation was close enough to the target, the Bank's Governor had to write an open letter to the Chancellor explaining why and what would be done to bring inflation back to target.

Initially it was expected that having to write such a letter might be a rather serious matter, resulting in the Chancellor criticising the Bank and perhaps some members of the Bank's Monetary Policy Committee being dismissed if the miss were seen as the result of policy errors or if inflation did not return to target swiftly.

For almost exactly the first ten years of the system, up to April 2007, inflation was always so close to the target that no letter was written.

But then, when inflation

Figure 1: Inflation versus target and the "letter-writing trigger"

finally was far enough from the target to require a letter, the system collapsed.

In the past ten years there have been 22 letters written. Not a single one has resulted in any criticism of the Bank by the Chancellor, let alone any MPC member being disciplined or dismissed.

The Bank made no discernible effort to prevent inflation from reaching 5 per cent in 2008 or 2011 (indeed, in 2011 it did not raise interest rates a single time as inflation rose) and little obvious effort in 2015 to prevent inflation from under-shooting.

Inflation is above target at the time of writing; and it was clear a long time before it went above target that this was likely to happen. There has been no reaction from the Bank.

The average deviation from target over the last ten years is 0.35 per cent – and there is a clear bias in how the Bank treats positive and negative deviations (*see Figure 1*).

That lack of credibility could be very important if the Bank needs to keep inflation down in the future.

In the 1960s and 1970s the UK authorities lost monetary credibility with failed promise after failed promise. When Margaret Thatcher came into office, unions and firms and investors had become used to politicians failing to keep their promises. So, when she said inflation would fall, they didn't believe her.

As she made her famous 'the Lady's not for turning' speech in October 1980, inflation was 15 per cent and falling.

But because unions and firms expected her to be just like the rest, they had raised wages by 23 per cent over the previous year.

When inflation did, in fact, fall back to below four per cent by 1983, workers had priced themselves out of the market. Unemployment soared to above three million and stayed there for 51 successive months. At the same time, the government (and companies) had to pay inflated prices to borrow money.

Thus, monetary credibility is easily lost and, once lost, expensive to recover.

There has been little to no monetary credibility in the UK for around 10 years. For a while, when it remains convenient to keep inflation close to target anyway, that may not obviously matter. But, at some point, there will, alas, be a reckoning•

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