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Memorandum submitted to the Treasury Committee inquiry, 'The Monetary Policy Committee of the Bank of England: ten years on' January 2007

About us

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1. Executive summary

1.1. History is important. The recent past helps explain the proximate reason for the MPC. The more distant past gives a perspective on several elements.

1.2. Although appearing revolutionary the granting of independence to the Bank of England in 1997 can be seen as a further step in an evolution.

1.3. Central bank/government relations have evolved, not just in Britain but world wide, for in some cases over one hundred years.

1.4. Notable changes in these relations have always resulted from a failure or major problem in the preceding situation.

1.5. A recurrent problem has been fiscal policy overwhelming monetary arrangements with demands for finance. Current arrangements in the UK can not protect us against this.

2. Introduction

2.1. Reason for the MPC

2.1.1. In 1997 a dramatic gesture was made in granting the Bank of England ‘independence’, and giving it the task of delivering an inflation rate that fell within a narrow band. But although certainly a surprise at the time, the move can be interpreted as the outcome of changes in the relationship between the Bank and Government that had been made by previous administrations. Interpreting the move thus is illuminating. It lets the move be placed in the context of how Bank/government relationships have changed over the past two centuries, and shows that the changes have a considerable degree of continuity to them. (*At the time of the 1997 change the Bank was deprived of its role of bank supervisor. This could under some circumstances have significant consequences for financial stability and hence for the Bank’s other responsibility, monetary stability. Space dictates that we focus narrowly on monetary stability*.)

2.1.2. 1997 was not the first occasion, and now is not the first time, that the Bank has had both a degree of independence and a target it is expected to achieve by use of its independent decision-making and actions. Some historical background reveals the pattern of fluctuations in the position of the Bank.

2.1.3. The basic reason for the changes in monetary policy-setting arrangements in 1997 was the poor performance of monetary policy and of the real economy in Britain across the post-World War Two period and culminating in the disastrous experience of the 1970s and into the 1980s. The connection was not direct, however. The poor performance led first to various ways to “import” superior monetary policy, by pegging to or “shadowing” a currency whose value was stable. This led first to “shadowing” the DM, and then to ERM membership. The latter did succeed in bringing down inflation, but the squeeze on the British economy was going on longer than needed for that purpose, interest rates in the ERM’s anchor, Germany, were rising when they needed to be falling in Britain, and the situation was unsustainable. There was heavy selling of sterling and it fell out of the ERM.

2.1.4. When this happened there was an immediate need to find a way to give a focus to monetary policy, and one which was sufficient to both anchor domestic price expectations and appear credible in the foreign exchange markets. Such a mechanism was rapidly devised, and then another step was taken. The meetings between the Chancellor and the Governor at which interest-rate decisions were taken had their dates announced, and as well as having their conclusion announced the views of the two participants were made public. That last step leads us to say that the changes of 1997, dramatic as they were, were part of a process of evolution. For suppose there had been a Chancellor-Governor meeting at which the Governor had urged an increase in rates, but it was immediately public that the Chancellor had refused to allow it. Under some circumstances the markets might have been unperturbed, but under others a run on sterling was highly likely. The authority the Chancellor retained was so circumscribed that surrendering decision-making to the Bank, subject to clear instructions and to penalties for failure, was a natural step.

2.1.5. Having set out the recent history of the 1997 change, we turn to some longer-run perspective on the principal elements in the story – inflation, the development of central banking, monetary policy, and central bank independence. Doing so helps to put more recent events into a clearer perspective, and can also help reveal whether there are possible problems remaining which may need to be discussed.

3. Inflation experience

3.1. Long run

Persistent inflation is essentially a twentieth century phenomenon. Over many centuries prior to that inflation was close to non-existent. Prices, with some cyclicality around the trend, were more or less stable century after century with only a few exceptions. Where “great inflations” are discussed in history (e.g. the Roman Empire, or sixteenth and seventeenth century Europe) even bearing in mind the difficulties in constructing reasonable price indices it is clear that inflation was still in low single figures. The “greatness” of these inflations arose from their time span rather than from the rates of inflation experienced.

3.2. Episodes of high inflation

There were however, some isolated bursts of high inflation. These can be divided into two main categories: hyperinflation and very rapid inflation.

3.2.1. <u>Hyperinflation</u>

The most commonly accepted definition of hyperinflation is that of Phillip Cagan: prices rising at more than 50 per cent per month and accelerating, and coming to an end when the rate fell below that and was decelerating.

When defined in that way there was none anywhere before 1920. There were several in the 1920s and then some in the 1940s and there have been some since in for example Serbia in the 1990s. Why these astonishingly dramatic episodes are relevant in the British context becomes apparent after we have considered much lower but by British standards still very high inflations.

3.2.2. Very Rapid Inflation

A different degree of high inflation, one that might be called very rapid inflation, would be, say, annual rates in excess of 100 per cent. Such a definition would capture many more episodes. Before 1950 there were a few instances such as those of the American War of Independence, the French Revolution, and the American Civil War. After 1950 there very many of these experiences around the world - particularly, but far from exclusively, in Latin America. What led to such episodes?

3.2.3. The Role of Fiscal policy

A striking feature of most of those episodes just outlined is that they were associated with civil war or severe social disorder. In the attempts by the governments then in office of these countries to fight or buy off the opposition much revenue was necessary, but loss of tax revenue from the disaffected produced growing budget deficits that could not be covered by borrowing. As a result, the governments printed money to finance their spending. These experiences point to the importance of the link with fiscal policy. As so often, things which are always important become most obviously so under extreme circumstances.

3.3. Post WWII

3.3.1. The period 1939 – 1951 was described as the "Great Inflation" but its greatness was rapidly overshadowed by what followed.

3.3.2. Price controls were in place in many countries in the 1940s, including the UK and US. They were, however, ineffective, in that while they did on some occasions contain inflation while they were in place they showed substantial signs of losing their effectiveness as time went on, and when they were removed prices surged to more or less where they would have been had the controls never been there. A fair assessment of them would be that they hid rather than stopped much of the inflation that was taking place.

3.3.3. In the 1950s and 1960s inflation was rising in the OECD and elsewhere. For Britain the average rate was rising to more than 3 per cent in the 1960s, and accelerating. (These sound modest figures, but recollect that many contemporaries had lived through periods of stable prices.)

3.3.4. In the 1970s inflation everywhere was rising and in Britain peaked in the mid-1970s at close to 30 per cent.

3.3.5. The last 25 years have seen attacks on inflation all around the world. It has been clearly demonstrated that a country could have (on average of course, not necessarily over any one short period of time) the rate of inflation it preferred.

4. Central Banking's Evolution

4.1. Financial stability

Although financial stability does not fall within the remit of this committee we must touch on the subject as the origins of central banks lie as much in this area, that is in responding to financial crises, as elsewhere. It was the development of their lender of last resort role that marked them out. But this is a reminder that financial stability and monetary stability go together. The lender of last resort role developed in recognition that there could be times when distrust of commercial banks was such that people demanded only cash, being entirely unwilling to hold bank deposits. In such circumstances, it was possible for a very large number of even well run banks to collapse unless they could get cash from the central bank. Such a collapse could bring sudden and dramatic deflations and depressions. Thus preventing these is inevitably intertwined with preservation of what is now called monetary stability.

4.2. Monetary policy and exchange-rate regimes

4.2.1. The real beginnings of modern concern with inflation and the connection with central bank emergence can be found in England during the Napoleonic Wars when metallic convertibility was suspended. The inflation was mild. While there were no price indices available at the time the decline in the purchasing power of money was reflected quickly in the depreciating exchange rate.

4.2.2. In so far as there was anything called monetary policy in the nineteenth century it was a case of defending the nation's reserves and preserving the convertibility of the currency into a metal. Gold was the true nominal anchor, and adhering to it was the function of the first nascent central banks.

4.2.3. <u>The gold standard</u> reached its classical form in the period 1880 to 1914 when most developed countries adhered to it and developing countries aspired to it. Conservative monetary and fiscal policies were pursued to allow adhering to the gold standard. It was the credible commitment of the central banks of the core countries (principally western Europe and the US) – made possible by independence from political interference – that meant people believed monetary action would be taken to preserve gold convertibility. Successful central banks did maintain convertibility. Independence was almost taken as given because everyone thought the gold standard the right thing to do.

4.2.4. <u>The gold exchange standard of the interwar years</u>. This was the attempted restoration of the pre-1914 world, where the principles were the same but the problems following the great upheaval of war were different. Price levels between countries had been distorted from their pre-War relationships, the distribution of gold had changed greatly, and confidence in the financial system was greatly damaged, All these played their part in preventing success.

4.2.5. Bretton Woods was the attempt to mimic the pre-1914 system with a fixed exchange rate but improving on it by giving countries some autonomy in monetary policy by means of capital controls. The nominal anchor was the exchange rate and central banks generally had the freedom to operate in whatever way they deemed necessary to manage that rate. In that respect there were quite strong similarities between this and the present regime. The nominal anchor is specified by government and the means of achievement left to the central bank. Of course, it must be observed that national Treasuries were supreme; central banks might be said to be allowed to vary interest rates so long as nothing dramatic was involved, and the political and economic timing was not sensitive.

4.2.6. In all of these post-gold standard arrangements there was a lack of transparency but the Bretton Woods years probably reached a nadir in this respect. It would be fair to say that the rules were far from clear even to those who had to operate them.

4.2.7. The failure of the Bretton Woods order together with academic argument saw a number of attempted solutions, including monetary unions, but the case for floating was powerful and generally won. It was recognised that either exchange rates had to float or that currencies had to be locked together by a monetary union. No middle course was sustainable.

5. Monetary policy

5.1. Long run

As the above has indicated over a long run of history monetary policy consisted largely of maintaining convertibility of the currency. The main objective of central banks was maintenance of the external value of the currency, and this, via the link to gold, led to stability in the internal value, as there were no major short run fluctuations in gold supplies. Central banks protected their gold reserves and hence the external value of the currency, and thus indirectly produced price stability.

5.2. Legacy of interwar period

5.2.1. After the First World War largely independent central banks continued to be entrusted with their task of managing the restored gold standard, this being regarded both as a sufficient control over their activities and a desirable objective of policy.

5.2.2. The great depression of 1929-32/33, however, was blamed on the banking system, including under that heading the operations of central banks – chiefly the ineptitude of the Fed – and independence such as it was disappeared. That led to greater government intervention in the 1930s, 1940s, and beyond.

5.3. Post WWII

5.3.1. The role of money and interest rates was down-played and that of fiscal policy was elevated. But there was in fact always the need for a nominal anchor for monetary policy. Again it was found in the exchange rate. Countries pegged their exchange rate to the core country of the system – the USA – and that country for many years delivered stable monetary policy. Countries which inflated had always first displayed wavering commitment to that peg.

5.3.2. But the emphasis of policy had shifted from concern with price stability. This shift was reflected in the Phillips curve, and in particular the Samuelson-Solow version which suggested a menu was available. Governments, it was suggested, could choose the combination of unemployment and inflation rates they desired. A little more inflation could bring a little less unemployment, and, it was for a time believed, could do so in perpetuity. This belief was also supported by the Radcliffe Report, which like these "menus for policy choice" also downplayed the importance of monetary policy.

5.3.3. But inflation was rising through the 1950s and 1960s; with price level performance deteriorating, balance of payments deficits leading to loss of reserves, and on occasions Britain forced to go to the IMF for assistance. Ultimately, the IMF imposed conditions, including that we adopt Domestic Credit Expansion targets (DCE was a proxy for a conception of money supply in an open economy with a fixed exchange rate). This revived interest in monetary policy beyond the small and largely academic group where interest in it had survived.

5.4. Monetary targeting

The lack of a long-run trade-off between inflation and unemployment was increasingly being recognised. Central banks could boost output in the short run but could not achieve it permanently. Rising inflation and the growing awareness that the costs of inflation were high suggested that a better nominal anchor was required. That was a precursor for the monetary targets that followed in the 1970s. Monetary aggregates had been compiled for some time and announcements of targets followed. The Fed announced them in the 1970s and the Bank of England used them internally from 1973 and publicly from 1976. They represent the beginnings of some accountability. However, for a variety of reasons, including the results of substantial changes in the banking system, they were deemed not to have been successful and alternative possibilities were sought. (Also, at low levels of inflation swings in velocity meant a weak relationship between money and prices, so the performance of monetary targets fell below what policy makers had hoped for.) But monetary aggregates contained information and data on them continued to be collected.

5.5. Inflation targeting

The next step was inflation targeting. That allowed the government to decide on what rate of inflation was appropriate - the goal - and let the central bank get on with delivering it - the limited "instrument independence" as this variety of central bank independence is called.

6. CB Independence

Thus part of the solution to price stability lay in giving the central banks the independence from government that would allow them to perform their role, and also a clear mandate to achieve a particular goal.

6.1. Definition

The definition of independence is far from straightforward. What is most commonly allowed is limited – instrument independence as opposed to goal independence. That is they have the freedom to use interest rates or money supply or whatever they choose as the means by which they deliver the goal of price stability. The goal is specified by government. In this respect there are the similarities mentioned with the old convertibility model. In that older setting, central banks were expected to maintain the link with gold – that was their mandate – but they were free to act as they thought necessary to carry out the mandate.

6.2. Historical pattern

6.2.1. Because of the nature of the product (money) there has always been a close relationship between the central bank and the government. (Governments always want control of resources and control of the monetary system to help achieve that.) And it is seldom easy to say what degree of independence prevails at any time. Indeed, it is probably not wise to put much weight on indices of independence.

6.2.2. The broad picture is that central banks had relative freedom in the nineteenth century. That was removed in wartime but it was then restored after the First World War when it was felt that managing the exchange rate was a sufficient check on central bank activities. But then it was lost again after the great depression and the Second World War. And that loss was more formal with many nationalisations.

6.2.3. Also at that point central banks were being asked to do a host of things - from preserving price stability to promoting economic growth and full employment with a fixed exchange rate. Even so it goes too far to say that independence had disappeared. Even in the case of the Bank of England in the 1950s and 1960s the Bank often took the lead in setting Bank Rate and it did whatever was necessary to hold the exchange rate.

7. Other questions

7.1. Asset prices

7.1.1. Historically, central banks have not done well on asset prices. It was the attempt to 'correct' the stock market boom of the late 1920s that led the Fed to tighten money unnecessarily.

7.1.2. There are occasional examples of stock market crashes being followed by real economy recessions. But a reliable generalisation is that stock market falls can safely be left alone unless they threaten to spawn a financial crisis, defined as a panic scramble for liquidity.

7.1.3. The US experience in 1987 was an example of the Fed having learned from 1929. An injection of liquidity calmed the market and ensured that there was no scramble for liquidity which could have threatened some of the smaller banks in the fragmented US banking system, and a later withdrawal served to prevent any inflation.

8. Last ten years

8.1.1. It has been claimed recently that central banks have mastered their task. But have they been lucky or is there some other factor at work? It is really too soon to say. There are big questions still to be answered. An important one is the role of globalisation.

8.1.2. Some argue that the explanation for the price performance of the last ten years is that China has exported deflation. That is not the case. Central banks can set whatever inflation path they want. What Chinese growth and output have probably done is provide a more accommodating environment in which to operate. Evidence of this is provided both from the hugely different inflationary experiences of different countries and in the UK by the wide dispersion in behaviour of the components of consumer price indices – traded v. non – traded goods. What globalisation has done is allow central bank independence to work in an environment where keeping inflation under control was, at least compared to past experience, almost painless.

9. Conclusion

Changes in Bank/government relations have resulted from failures or serious problems with prior policies. There have been many such changes over the years. Can we now conclude that the present situation will endure? No doubt unforeseeable events will occur. But we have emphasised earlier that many major inflations originated with the breakdown of fiscal policy leading to irresistible pressure for monetary expansion. There is nothing in the present position of the Bank to prevent that occurring again. Under the gold standard and then in the 1950s and 1960s, with both of which periods we see the current arrangements as closely parallel, the fiscal situation was crucial. Under the gold standard in Britain fiscal pressure was absent and the gold standard maintained. In the 1950s and 1960s fiscal pressure was irresistible, the exchange rate could not be maintained, and inflation drifted upwards. The fiscal situation is as important under the present system as it was in those two earlier regimes.

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January 2007