

## COMMENT

## Please be sure to share your thoughts, Mr Governor

**John Taylor**

As Mark Carney, the new governor of the Bank of England, sits down for the first time with his colleagues and staff, he will not want for unsolicited advice from around the world. As central-bank balance sheets continue to explode and economic growth languishes, many distinguished economists are expressing concern about the global wave of asset-buying by monetary authorities.

Paul Volcker, former chairman of the US Federal Reserve, recently warned of the risk that central banks are stoking "speculative distortions and . . . inflationary potential". Raghuram Rajan, the Chicago economist and chief economic adviser to the government of India, channelled Winston Churchill: "Never in the field of economic policy has so much been spent, with so little evidence, by so few."

By their own accounts, central bankers have become worried about these policies, which they say were undertaken because they were the only game in town. Sir Mervyn King, who is now leaving town, has said:

"There is an understandable yearning for a return to normality." Six of Mr Carney's new colleagues on the Monetary Policy Committee – a majority – have voted against further large-scale asset purchases or quantitative easing.

The recent market gyrations that followed the Fed's discussion of an exit from such policies vividly demonstrate how inherently difficult it is for any central bank to unwind these interventions. It is not a communication problem; it is a policy problem and it is causing a great deal of uncertainty.

But it is not enough simply to point to the harm and dangers attached to these unconventional policies; we are where we are. The question now is what do you do if you are Mr Carney faced with this new information and analysis?

First, and most importantly, he should make sure that any new unconventional monetary policy comes with a credible, low-risk exit strategy, set out in advance. Otherwise, uncertainty about the unwinding could offset any positive effects.

Second, Mr Carney should focus on instruments of policy that we

know something about – interest rates or the money supply. These have clearer effects and are better understood by investors (and the central bank) than the volume of asset purchases.

Third, he should provide more clarity about the instruments of policy by stating how much the zero lower bound in interest rates is constraining policy. For example, under current inflation and output conditions, some policy guidelines or rules imply that the bank rate would be minus 3 per cent if it were possible simply to reduce the rate to below zero. Is that what the BoE's analysis shows? Or would the ideal rate be minus 2 per cent? This would give markets a sense of how far the UK still is from normality.

Fourth, Mr Carney should state under what inflation and output

**Any new BoE monetary policy that Mark Carney starts should come with a credible exit strategy set out in advance**

conditions he would take the bank rate back into positive territory in the future. This forward guidance would provide an exit strategy in which people would see how long it would be likely to take to get back to normality.

Fifth, the BoE should announce a guideline for setting interest rates that would be used after rates have been raised again. The guideline could be a rule for all seasons that would state that the bank rate would remain lower by a measurable amount than would normally apply, related to the length of time and degree to which the desired bank rate fell below the zero bound.

Building confidence that the BoE will not raise short-term interest rates quickly will help keep longer-term rates down today. This would be the trickiest part of a new policy – and an improvement over the Fed's current strategy, which tries to commit to keeping interest rates low in the future but in a vague and confusing way that has riled markets in recent weeks.

The novelty of this approach would be that it put emphasis on the policy instruments – not simply on the BoE's 2 per cent inflation target.

Goals are essential but they are not enough if they are simply part of a whatever-it-takes approach to the instruments of policy that results in discretionary and highly unpredictable interventions with unintended consequences – as we have seen recently.

Despite these dangers, some still argue that the central bank can and should intervene in any market, by any amount, over any timeframe, with any instrument or programme (old or new) with little concern for unintended consequences in the long run or collateral damage in the short run (say, on certain groups of people or markets) as long as it furthers that goal.

This is a crucial time for British and global monetary policy. The difficult situation presents a huge challenge for Mr Carney and I wish him the very best of luck. He has a good chance to help put the British economy back on track, and also, by way of example, restore the health of global monetary policy.

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