Independence needs nine sensible people

Agenda

The Bank of England's primary new role has costs, not just benefits

GERARD LYONS

The most important economic decision since the war. This is how the Prime Minister described last week's decision giving the Bank of England independence to set interest rates. The same was said the day the pound entered the ERM and we all know the consequences of that. Hopefully, Bank of England independence will not end in tears, but much depends on how responsible the new nine person monetary committee is in setting interest rates.

Giving the Bank control over interest rates shows the Government is committed to low inflation. This will be followed by a tough fiscal stance when Gordon Brown delivers his Budget in a few weeks. It is unlikely there will be any surprise tax increases, but there will be a commitment to existing tight spending plans. This has reassured the City, allowing long-term gilt yields to fall, reducing the Government's debt-servicing bill and releasing money for other areas such as education.

The benefits of independence are overstated and the costs underestimated. The experience of other countries and academic research suggests independence may not be the best way to achieve low inflation. Other factors, such as the structure of an economy, explain why some countries have low inflation.

Analysis in the Bank of England's *Quarterly Bulletin* finds against independence. In 1995, Professor Barro analysed the relationship between inflation and central bank independence in 67 countries, using data from 1960-90. There was no correlation, suggesting: "Low inflation cannot be attained merely by instituting changes that appear to promote a more independent central bank."

Some countries with low inflation have an independent central bank, others do not. Germany has the most independent central bank whilst Japan is at the other extreme, with a central bank dependent on the government. Yet both countries have a good inflation record.

The Government had a number of role models to choose from. The German Bundesbank is given goal independence, free to choose its own inflation targets, in addition to setting interest rates. By contrast, the Reserve Bank of New Zealand is given instrument independence, allowing it to set interest rates to achieve the inflation target, which is set by the Government after consultation.

The model for the Bank of England is along the lines of New Zealand. And if we are to enter a single currency then there will be a further shift to the German model.

It is disappointing the Bank was not given twin objectives, like its US counterpart, whose role is to achieve low inflation and stable employment conditions. Whilst independence will remove political interference from interest-rate decisions it replaces this with the risk of monetary overkill. The new policy committee has only one objective, low inflation. It also has an in-built Bank of England majority and needs to establish its credibility. This risks interest rates being pushed too high.

A further problem is that independence does not guarantee consistency between monetary policy and fiscal policy.

Much depends on the people involved, and whether they act sensibly or not. The 1993 Roll Committee decided in favour of independence but argued: "The effective independence and hence credibility of a central bank is linked to its operational record. In such circumstances, individuals can make a difference."

We will have to judge the bank by its record. Whilst the markets assume independence can only be a good thing, particularly in the long-run, Alan Greenspan, the head of America's central bank, has said: "Ill-advised short-run perspectives on the part of a central bank lead to inflationary instabilities in the longer-run."

In theory, monetary policy should be set by an authority that is more anti-inflationary than society as a whole, namely a central bank. But for the best outcome, the degree of central bank conservatism must not be too high, otherwise policy will be too tight and the cost of reducing inflation in terms of lost jobs and unemployment will be too high.

Brown is certainly right to stress the need for long-termism in the UK. Central to that is the need to boost investment. Whether independence of the Bank of England will help achieve this depends on sensible interest-rate decisions being made. Former Labour Chancellor Stafford Cripps used to take great pleasure in describing the Bank of England as "his" bank. And until Tuesday it had remained the Treasury's bank. Let us hope Brown does not live to regret the decision, as base rates could now rise to 7% by the end of the year. to choose the goal of policy.

Dr Gerard Lyons is Chief Economist of Dai-Ichi Kangyo Bank (DKB) International