A sensible target to aim for

Agenda

Despite Brown's long-termism monetary policy could still be too tight

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Interest rates are likely to head still higher, despite good inflation news and a relaxation of the Government's inflation target.

On Thursday, Chancellor Gordon Brown delivered the annual Mansion House speech. Traditionally this focuses on monetary policy, but Brown used it to give a broad overview of his economic thinking. The message was clear: he favours a conservative, mainstream policy in order to establish a basis for longer-term economic growth. Central to this is the Bank of England's independence, which he hopes will achieve low inflation and from which he expects healthier growth to follow.

It is nothing new for Chancellors to emphasise the long-term. All of them want investment, employment and growth to increase. So do the rest of us. The question is: can he deliver?

Having gained the goodwill of the financial markets by making the bank independent, it became clear that one of the biggest hurdles to achieving stronger growth could be the bank itself. The danger consists in over-zealous behaviour by the Monetary Policy Committee (MPC) as it aims to achieve low inflation. With this in mind the Chancellor made a sensible adjustment to the inflation target last Thursday, widening the band and raising the ceiling.

Britain's post-ERM monetary framework is still in an evolutionary phase. After the pound left the ERM, the original inflation target was 1% to 4%, and subsequently it was refined to 2.5% or less. The policy worked well but this set-up was not ideal, for a number of reasons.

Instead of being the ceiling, 2.5% was effectively seen as the target. The fact that it was not hit for over two years to April created the wrong impression that inflation was not being controlled. After giving the bank independence, it was essential for the Chancellor to define the target more precisely. He could have tightened the target, announcing 2.5% as the ceiling, forcing the MPC to aim for a lower inflation rate around 2%.

This tight target would not have overcome the problem that the MPC might always be encouraged to err on the side of caution. Now, under the new set-up, the bank has still been given a tough inflation rate of 2.5%, but it has been given a margin of error of 1% on either side. Effectively the range is 1.5% to 3.5%, but undershooting 2.5% by too much is seen as being as bad as overshooting too much.

Having already made the bank independent, Brown clearly felt relaxing the inflation target would not undermine the Government's anti-inflationary credibility. It is a sensible move as it gives the MPC room for manoeuvre and it recognises there will be times when shocks and temporary factors could push inflation up, and this need not force a policy tightening.

The speech at the Mansion House from the Bank of England Governor, Eddie George, also showed he is sensitive to criticisms the MPC will be too aggressive and push interest rates too high at the expense of growth. His argument was there is no conflict between the need for low inflation and the desire for stronger growth, citing that in three of the last four years growth has been above inflation.

Clearly the MPC will have to take into account growth conditions in the economy. If it sees growth as being too strong it will add to its inflation fears; a slowdown should ease inflation worries. Much depends on where the MPC sees the potential inflation risks. Judging from the Bank's Inflation Report, its concern is that the economy is growing too strongly. In the US, the Federal Reserve Board has effectively adopted a nominal GDP target, often hiking rates when growth has been above trend. But the Fed has a twin mandate of stable growth and low inflation. The MPC does not have this twin goal. Thus the hope has to be that the new inflation target will force it to assess the upside and downside risks for the economy and discourage it from being over cautious. I still have my doubts, particularly in the early stages as the economy grows strongly and the MPC needs to establish its credibility.

The Committee needs to weigh up the case for interest rates staying unchanged on account of low inflation with the risk that continued strong growth could push inflation higher in the future. As the Governor said, forecasting inflation is not an exact science as forecasts are uncertain and subjective judgments need to be made about the risks and balance of probabilities facing the economy. Additionally monetary policy takes time to feed through.

A lack of consistency between monetary and fiscal policy still remains a potential problem in this new policy framework. Although inflation risks appear on the upside, the likelihood is inflation will remain low, particularly as the combination of a strong pound, tight fiscal stance and higher interest rates already looks set to slow the economy next year.

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