

## The UK needs monetary policy to be as expansionary as possible and this isn't going to happen under the current system

*In the run up to the Autumn Statement, with commentators focusing on fiscal announcements likely to be made by the Chancellor, [Simon Wren-Lewis](#) argues that it is in fact radical thinking on monetary policy that the UK currently needs.*



Wednesday will be Autumn Statement day in the UK: one of the two times a year the Chancellor makes big fiscal announcements. Yet this post will not be about fiscal policy: current policy looks too much like rearranging the [deck chairs](#), and so I will just be repeating myself in [saying](#) that the strategy is all wrong. Instead this post is about monetary policy. How come – that is the MPC at the Bank of England surely? I think not – they are just rearranging the deck chairs too. The big picture on UK monetary policy is down to the Chancellor.

The MPC's mandate, set by the Chancellor, is to hit 2% for CPI inflation 'within a reasonable time period'. In the past I and others thought the phrase reasonable time period would allow the MPC in practice to minimise a combination of excess inflation and the output gap, which is what most macroeconomists assume monetary policy is all about. I think this was true, within limits. In the UK these limits were surpassed following the Great Recession, where we had a large negative output gap but above target inflation. We are at the ZLB, and have had Quantitative Easing (QE), because the MPC looked at the output gap as well as inflation, and thought that a large output gap would mean inflation would come tumbling down. It did not, so now they are [just](#) targeting CPI inflation (and rather [conservatively](#) at that).

What we need is for UK monetary policy to be as expansionary as it can be, and we are not going to get that under the current system, even with a new man running the Bank. I have talked to enough MPC members to know that they take the mandate they are given very seriously. They certainly believe they do not have the discretion to follow a different strategy while still paying lip service to the current set up. The system can only be changed by the Chancellor. Now some would like him to move to nominal GDP targets, and I'd be happy with that. However I cannot see him doing that overnight: the move to include output and go from changes to levels is probably too much for something that is not widely discussed in the UK. The best we can hope for (and hope is the word) is for him to launch some kind of inquiry into this (and other) possibilities – I have [suggested](#) in the past that the Treasury Select Committee could do this.

So for the next year or two we are almost certainly stuck with inflation targeting. He could announce an increase in the inflation target, which he has the discretion to do as part of the current system. But he will not, because it plays terribly in terms of politics. As Noah Smith [laments](#), what we as economists understand as inflation is not what everyone else understands by inflation. The number of people in the UK who would be prepared to defend raising the current CPI inflation target to 4% (which I would) is probably less than the number of economics departments in the UK.

However, why not change the measure of inflation being targeted? The GDP deflator is the obvious alternative, but there is a better candidate if the aim is produce a significant but temporary rise UK inflation (and thereby to start a proper recovery in UK output). My suggestion is that 2% CPI inflation is replaced by a target for 4% growth in average earnings. In normal times 4% earnings growth and 2% CPI inflation would be quite compatible (because real wages grow with productivity), but currently average weekly earnings inflation is below 2% [1]. So moving wage inflation from 2% to 4% is a real challenge for monetary policy. To help with this challenge, the Chancellor could at the same time sanction unlimited QE, and could suggest this goes beyond just buying gilts.

If monetary policy still has some power despite the ZLB, then this move would have a significant effect in reducing real interest rates. It would also play well politically. “In the last few years hard working families have seen the real value of their earnings fall, as wage growth has been held back while the Bank of England has failed to keep consumer price inflation on target. It is time that we changed things so that the rewards from working increased rather than decreased over time. That is why I am announcing today ...” Rhetoric that is nonsense in terms of economics, but no worse than much of the rhetoric the government currently uses.

Now of course plenty of people will complain that this is returning us to the 1970s, losing all the gains in inflation credibility that we have carefully built up etc etc. But their arguments can be easily countered. If CPI inflation does rise, this helps get round the ZLB, and so should stimulate a recovery. Yet it cannot ‘open the floodgates’, because all that has happened is that the definition of the inflation target has been changed. There is no further change in definition that can lead to yet higher inflation. In the longer term 4% wage inflation is pretty compatible with 2% price inflation, unless you believe that UK productivity growth can never grow again at levels that were thought normal before the recession. Finally I do not [think](#) there is anything in the academic literature which says that the CPI index is a significantly better measure to target than an earnings index.

In an ideal world, would I be suggesting this change? Almost certainly not. Do I think it is better than nominal GDP targeting? Probably not. However, we are not in an ideal world, and we need some action right now. Otherwise there is a great danger that we continue down a road of [self-fulfilling pessimism](#), with all the [misery](#) and loss of resources that this entails.

**[1] That wage inflation is currently well behind price inflation plus underlying productivity growth is not just a UK phenomenon – it applies in the US and Eurozone as well. To that extent this proposal is not just of relevance to the UK, although elsewhere central banks have the power to make this change, whereas in the UK they do not.**

This article was first published on Simon Wren-Lewis’ [Mainly Macro blog](#).

*Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our [comments policy](#) before posting.*

### About the author

**Simon Wren-Lewis** is a professor at Oxford University and a Fellow of Merton College. He began his career as an economist in H.M. Treasury. In 1981 he moved to the National Institute of Economic and Social Research, where as a Senior Research Fellow he constructed the first versions of the world model NIGEM. From 1988-1990, as Head of Macroeconomic Research, he supervised development of this and the Institute’s domestic model. In 1990 he became a professor at Strathclyde University, and built the UK econometric model COMPACT. From 1995 to 2006 he was a professor at Exeter University. He has published papers on macroeconomics in a wide range of academic journals including the *Economic Journal*, *European Economic Review*, and *American Economic Review*. His current research focuses on the analysis of monetary and fiscal policy in small calibrated macromodels, and on equilibrium exchange rates.

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