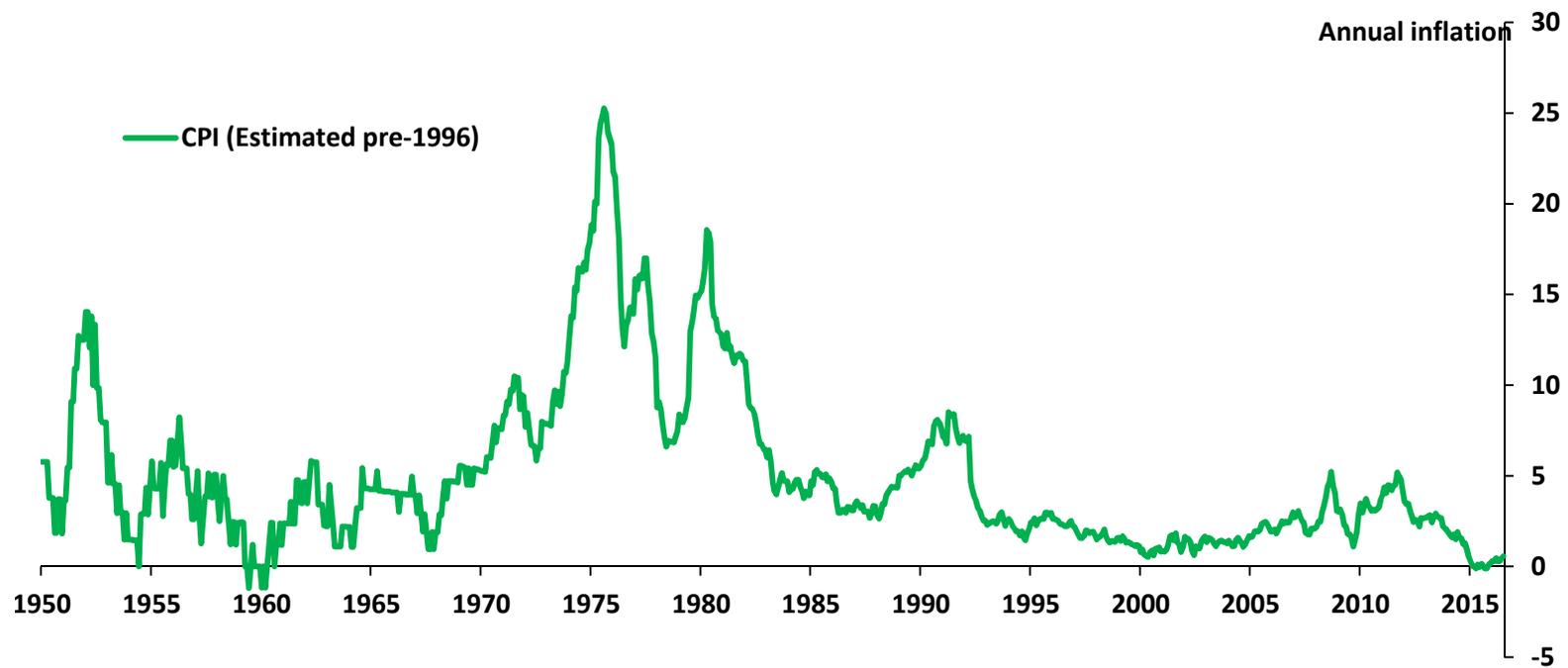


What (not) to expect from central banks

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London, October 5 2016

Why do we have an independent central bank, with an inflation target?



Topics for today

- Can/should central banks control house prices?
- Are central banks responsible for the (slow) real growth rate?
- Should central banks use their expanded balance sheets to hit social objectives?
- Can central banks forecast the future?

Housing

- Questions
 - Does the Bank of England have responsibility for controlling house price inflation?
 - Should it?

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 - Does the Bank of England have responsibility for controlling house price inflation?
 - Should it?
- George Osborne (2014):
 - 'I want to make sure that the Bank has all the weapons it needs to guard against risks in the housing market.'*

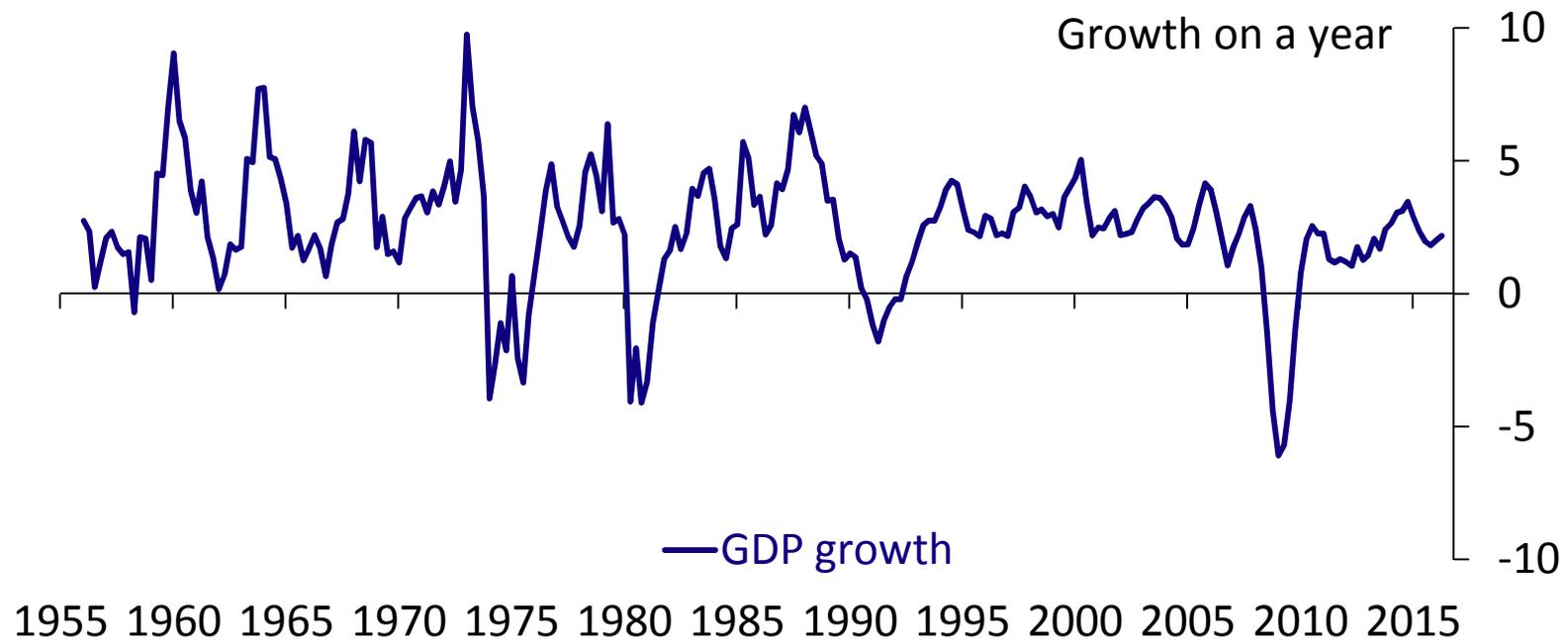
Housing

- Why are house prices so volatile in UK?
 - Supply of land, planning system, infrastructure: act to limit supply.
 - Population growth, smaller family groups, tax break for owner occupation, benefits system: keep domestic demand strong.
 - Overseas investment demand, especially in London.
 - Mortgage finance easy to obtain.

Housing

- What policy levers does Bank of England have?
- It could change Bank Rate and create a recession 😞
- Or through its prudential supervision and via the FCA, it can take action to influence lending.
- It does this because of financial stability risks arising from excessive household debt – not because of house prices.
- **The Bank does not build a single house.**
- Nor does it control the tax, benefit or planning systems.
- Nor should it. But you could be forgiven for thinking otherwise!

Who has responsibility for GDP growth?



Growth

- What determines the sustainable rate of growth?

Growth

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- What is the influence of monetary policy?

Growth

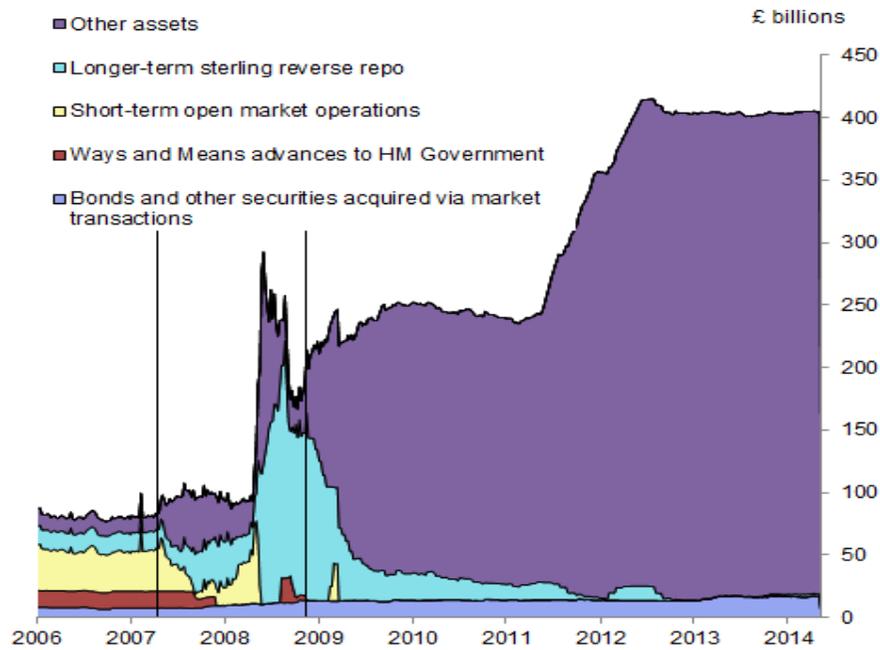
- What determines the sustainable rate of growth?
- What is the influence of monetary policy?
 - Can help push demand into line with supply.
 - Hysteresis effects on labour market, capital stock?
 - Reduce the risk premium?
 - Low inflation improves utility of everyone.
- FS policy – mitigate the effects of financial shocks?

Growth

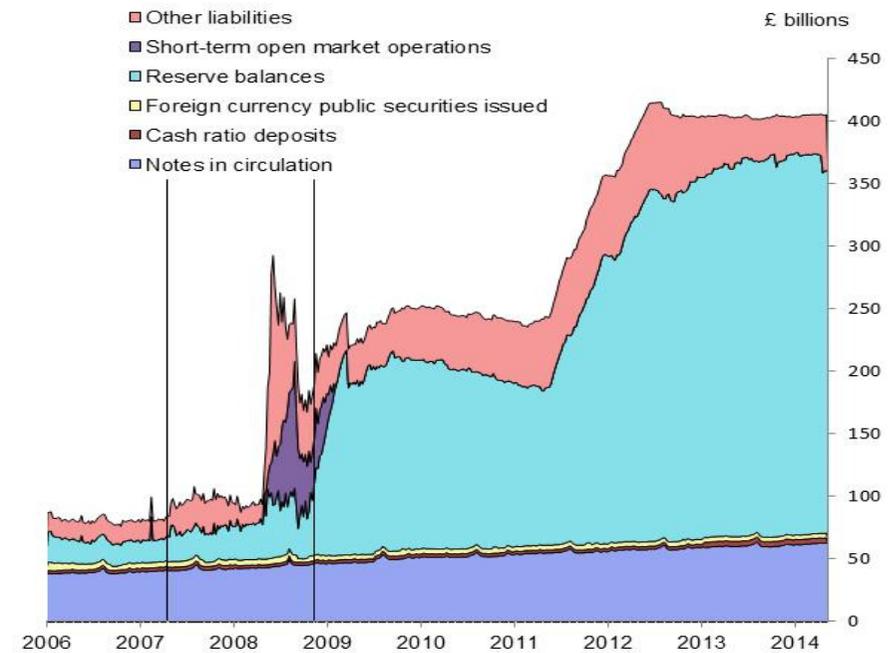
- What policy levers would one need to improve the real rate of growth?
- A programme of supply-side reforms is urgently needed across the developed economies.
- Taxes, benefits, social spending, legislation, green projects, cultural shifts ...
- So why is there such expectation that the central bank should act to boost growth? Especially the ECB?
- Slow growth in developed economies is not the result of tight (or too loose!) monetary policy.

The Bank's Balance Sheet

Assets



Liabilities



Central Bank Balance Sheets

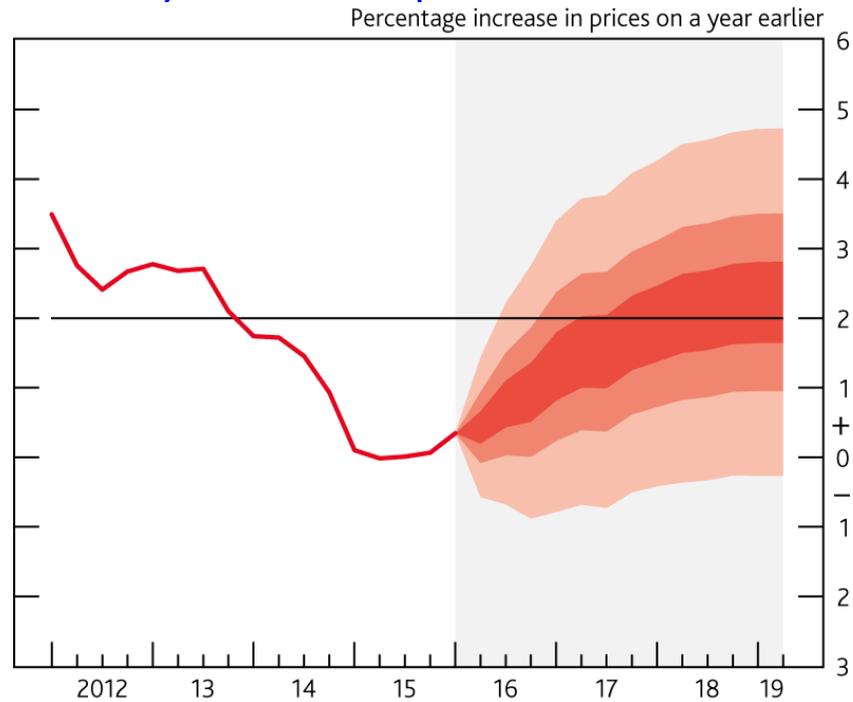
- QE creates central bank money – for a while, maybe sustained.
- Has not caused inflation – capital constrained banks and liquidity regulations limit banking channel.
- Creates a one-off funding opportunity, without taxation?
- So should there be ‘People’s QE’ or ‘green QE’?

Central Bank Balance Sheets

- Not for unelected, technical officials at the Bank to decide whether to spend, reduce taxes, or reduce the stock of debt in the market permanently.
- Not the remit and no relevant skills or expertise.
- And there are no restrictions on government choices.
- Social expenditure is important and necessary – but is for governments, not central banks to decide and to execute.

Forecasting errors

May Inflation Report



Why do people expect Bank forecasts to be accurate to within a fraction of 1pp?

What do we know about macroeconomic forecast errors?

- Forecasts will always be wrong : stuff happens.
- What would be the effect of a Trump victory? Brexit?
- What might happen that is completely unanticipated?
- A true model has n-step ahead forecast errors which are serially correlated and heteroskedastic.
- The variance of forecast errors for growth and inflation a few years ahead will be pretty close to the data variance.
- The size and properties of forecast errors are not very interesting!

How should we think about forecasts?

- Projection on an information set.
- That is, a statement of what we think inflationary pressure is, today, based on everything we know, conveniently expressed in terms of a possible future distribution for inflation.
- That expression of inflationary pressure will change as a result of stuff that we don't know yet is going to happen.
- But that's the best way we have to think about and explain a forward-looking policy.

How should we evaluate forecasts?

- We need to ask why a forecast was wrong.
- Can be decomposed into different sources of error – effects of different assumptions, models, judgments etc.
- That way we can learn about the evolving economy.
- Examples – exchange rate pass through, earnings, productivity etc.
- Could one have made a better forecast at the time?

NB a forecast made with the true model and best possible assumptions will still be wrong unless one has a crystal ball. Stuff happens.

Summary?

- Don't hold central banks responsible for things outside their remit and outside their control. And don't expect them to have a crystal ball to predict the future.
- If we over-expect, then we risk losing the prize of inflationary control which has worked so well relative to previous policies.
- And if we always look to the central bank then we let others off the hook.
- Governments are responsible for what happens in the real economy. We need supply-side reforms.