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Monetary failures [1]

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Despite the obvious monetary-induced stresses that have emerged since mid-2007, few economics commentators have questioned the role that monetary policy has played in causing this situation. In fact, monetary policy has *everything* to do with where we are today. The low levels of interest rates that were maintained on both sides of the Atlantic between 2002 and 2004 are the main reason why there was a surge in debt-financed activity, undertaken by financial businesses, households and government.

In the UK, inflation targeting has failed to create the conditions necessary for sustainable growth. Indeed, it has more than failed; it has actually been a significant cause of the credit boom. The problem with all static policy targets, whether they are for monetary variables, the currency or inflation, is that they work only so long as they remain consistent with longer-term equilibrium between supply and demand. Inevitably, however, they are framed by politicians and civil servants looking into the rear-view mirror.

Had it been in place earlier, inflation targeting inflation might have prevented some previous acts of economic vandalism. But it is hard to establish a rigid policy framework capable of accommodating future changes in the economic environment. Worse than that: the goal of monetary policy becomes solely to achieve the target; policy makers become blind to other evidence that suggests a change of course might be appropriate. The problem in the UK has been that the inflation target was not designed to accommodate a situation in which there was excess domestic demand *at the same time as* significant downwards pressure on inflation.

Because the policy framework established by Gordon Brown in 1997 was so narrow, the MPC was encouraged, if not mandated, to ignore obvious signs of overheating in the economy. The result was that the policy signal became stuck on Go.

The MPC should be given a broader remit. This may still have inflation at its heart, but it should also be made clear that policy must be formulated to ensure that the UK is on a sustainable growth path. Sometimes this may mean that inflation deviates from an explicit target ? but on the basis that this is consistent with a wider balance being maintained in the economy.

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