



15<sup>th</sup> February 2007

## Special Report

### Professor Tim Congdon's evidence to the enquiry on the 10<sup>th</sup> anniversary of the Monetary Policy Committee, conducted by the Treasury Committee of the House of Commons

Professor Congdon's evidence is in the form of answers to a very detailed questionnaire on the Treasury Committee's website. The central topic is the explanation for the apparent achievement of macroeconomic stability in the UK in the 15 years since 1992 and, more specifically, in the first decade of the MPC's existence. A final section asks whether the stability is threatened by the current high rate of money supply growth.

#### Achievement of stability since 1992

The conduct of macroeconomic policy has been transformed compared with the 1970s and 1980s, with

- i. the abandonment of prices and incomes policies,
- ii. the neutralisation of fiscal policy by medium-term rules and
- iii. the acceptance that domestic stability should come before stability of the exchange rate in policy-making.

Variations in the short-term interest rate by the Bank of England have become the virtual *factotum* of policy. The key analytical framework turns on the concept of 'the output gap', with an implicit intermediate target that the output gap should be zero in order to stabilise the rate of inflation at target. Two concepts of the gap, Keynesian and monetarist, are distinguished. The monetarist concept of the gap is critical in contemporary policy-making.

#### Further key points

1. The UK economy is increasingly specialising on international business services, where its comparative advantage in international trade seems to lie. A favourable terms-of-trade shift in the last 10 to 15 years – in which tradable goods have become cheaper relative to tradable services – may explain the UK's ability to cope with a large appreciation in the real exchange rate.
2. Media concerns about 'excessive personal debt' and 'inadequate national investment' are expressions of paternalism, and will be dangerous if they are translated into policy. People are better judges of their own circumstances than politicians, newspaper editors and observing economists.

#### Is high money growth a threat to stability?

The current double-digit annual rate of M4 growth is a serious threat to continued on-target inflation. M4 growth needs to be reduced to 5% - 8% a year, if on-target inflation is to be restored. The Bank of England will need to raise interest rates further, perhaps to about 6%. **This will lead to a squeeze on corporate and financial sector money growth, and a period of asset price weakness (to compensate for unjustified asset price strength at present), probably in 2008.**

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