Lecture summary

Having worked as a senior economist at the Bank of England and currently a senior European economist at RBS, Richard Barwell gave a talk about what he does as a central bank watcher and his perspective on some of the most interesting current economic topics, including austerity measures and the effectiveness of Quantitative Easing.

The Bank of England has been given responsibility for the delivery of monetary and financial stability and as a result, the Bank's policy decisions have a wide impact on an array of asset prices such as bonds, equities and currencies, which are of great interest to investors in those assets.

In theory, the transmission mechanism of economic policy is straightforward and, so there is no need for investors to employ a "watcher" to predict obvious changes in the policy stance. In reality, how the Bank reacts and responds to changes in the economy are much more complicated to forecast. One does not just simply use the Taylor Rule to predict how the central bank will respond to developments in output and inflation to deliver price stability. Policymakers take decisions on the basis of a large information set of noisy indicators and the reaction function to data evolves through time.

This essentially gives rise to the role of central bank watching – specialists who observe these mind-boggling data and forecast how the central bank reacts, as well as how assets prices may change in response. In other words, the investment banker's complex task can simply be explained as: by providing predictions on the state of the economy, the next change in the policy stance or how the policy stance will evolve over time which if they "beat the market" can provide opportunities for clients and investors to make money given the typical response of asset prices to these surprises.

In the second part of the lecture, Richard shared his expert knowledge on the widely debated topic of austerity. The central bank has operational independence for the conduct of monetary policy and that requires the central bank to lean against shocks to demand including those which originate within finance ministries. When government tightens fiscal policy, the Bank is likely to loosen monetary policy in response by reducing interest rates, which should ultimately lead to increased consumption and investment. Thus, in principal, fiscal policy has no persistent impact on output or employment in the presence of monetary policy.

The problem is that during the crisis in 2008-09, the interest rate hit the near-zero lower bound. Since nominal interest rates could not be cut any further, central banks were unable to create that much-needed stimulus in demand, and so the Bank turned to QE as a substitute for further rate cuts. The question of whether fiscal consolidation in the UK depressed output and employment essentially boils down to whether QE works in the opposite direction – that is, whether purchases of government bonds can stimulate demand.

The standard critique of QE is that it cannot have worked since it failed to generate a sustained recovery: after the initial bounce-back in 2010, the UK recovery slowed down to near-halt in 2011-12. However, that observation may simply indicate that the Bank did not buy enough bonds.

In 2011 when inflation nearly hit 5%, the Bank came very close to raising interest rates. Richard asserted that had the government not stepped up the pace of austerity measured in mid-2010 and increased spending instead, the outlook for aggregate demand and therefore inflation would have been even more elevated and that might have forced the Committee's hand.

What does this then mean to a central bank watcher? From this lecture, it is argued that through the understanding of how the economy responds to the austerity measures, a central bank watcher can forecast changes in how a central bank will respond and therefore will have a substantial advantage in predicting movements in interest rates and asset prices .