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Mark Carney and first impressions in monetary policy

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Markets will be perusing the new Bank of England Governor's comments for hints on his hawkishness. This column presents evidence showing that Monetary Policy Committee members tend to become more dovish as they become more experienced (i.e. after having participated in 18 or more meetings), with this tendency most marked in members with dovish preferences.

Much of modern monetary policy is concerned with managing inflation expectations. The establishment of independent central banks, the move to inflation targeting, and the more recent use of forward-guidance rules by some central banks all reflect the importance of managing inflation expectations. The change of senior central bank personnel, such as the appointment of a new Chairperson or Governor, is often a period of particular importance for anchoring inflation expectations. Since the preferences of the incoming banker are not known, there is much speculation surrounding his or her perceived policy stance and its impact on expectations. For example, Cottle (2012) discusses whether newly appointed Bank of England Governor Mark Carney is a 'hawk' or a 'dove'.

Now that Governor Carney has taken office, what can we expect of his behaviour and does it give us a good guide to policies he will follow later in his five-year appointment? While some observers will no doubt begin to proclaim Carney a dove or a hawk on the basis of his first few months in office, his inherent policy stance may take quite a bit of time to be revealed through his policy actions because of an idea called signalling.

There is a large academic literature on signalling that has explored how central bankers might try to strategically affect inflation expectations at the beginning of their tenures (see Backus and Driffill (1985a, 1985b), Barro (1986), Cukierman and Meltzer (1986), Vickers (1986), Faust and Svensson (2001), Sibert (2002, 2003, 2009) and King, Lu, and Pasten (2008). In a nutshell, the story is that new policymakers initially act more toughly against inflation than their natural instincts (which we call policy preferences) alone would dictate in order to convince the public they are serious inflation fighters. After this period of initial toughness, they ease back into a policy in line with their underlying preferences.

Recent research on the Monetary Policy Committee

While the earlier academic literature focused on the idea that more dovish monetary policymakers are the ones subject to the incentive to signal toughness on inflation, our recent work clarifies how one should expect policymakers to behave when the public doesn't know their preferences (Hansen and McMahon 2013). We show that when central bankers are concerned about keeping inflation expectations from getting too high, both hawks and doves have an additional incentive to be tougher on inflation (more hawkish) when new and then they will become more dovish over their tenure on the committee; we call this idea "delayed dovishness" (though it is equally "early hawkishness"). While all policymakers are subject to such dynamic behaviour, we also show that the effects are greater for the inherently more dovish preference types who care most about the future output gap.

While the idea of signalling in monetary policy has existed for several decades, we provide the first empirical evidence that the behaviour of members of the Bank of England's Monetary Policy Committee, the body now chaired by Mark Carney, is consistent with such signalling. We find that members become more dovish as they become more experienced members of the Committee (which we define as having participated in 18 or more meetings). We also find that more dovish preference types signal more.

All of this work seems to suggest that if Mark Carney is inherently a dove, and he wishes to establish credibility as a tough inflation fighter, his early moves will involve attempts to signal hawkishness to the market. This would mean that his behaviour as the new Bank of England governor is an overstatement of his true level of hawkishness.

However, the standard signalling logic relies on central bankers wishing to prove that they are tough on inflation in order to anchor inflation expectations from a tendency for over-inflation. This has been the case over most of the economic times since the establishment of the Monetary Policy Committee in 1997. However, there may be periods, such as when the economy is particularly weak or especially when it is in a liquidity trap, when policymakers instead wish to raise inflation expectations. Such circumstances would generate the reverse predictions about policy behaviour; members would be more dovish at the start of their tenure and, with experience, become more hawkish. This is because higher inflation expectations lower (ex-ante) real interest rates and incentivise both investment, which has been particularly weak in the UK as discussed by The Economist (2013), and consumption. The recent appointment of Haruhiko Kuroda, a much more dovish Governor of the Bank of Japan who has committed to aggressive monetary easing, might be well-captured by such dovish incentives.

All told, the difficult economic circumstances in the UK and the natural tendency for central bankers to establish their anti-inflation credentials push the new Governor in opposite directions regarding how he should behave in the early part of his five-year appointment. This makes the job of figuring out whether Mark Carney is a hawk or a dove much more difficult and means that we will need even longer to judge his appointment. And of course, more so than the two previous Governors of the Bank of England, Governor Carney has a larger remit which includes macroprudential policy and prudential regulation, in addition to the inflation target. While it will be tough for us to figure out exactly how he views the right policies, it will be even tougher for him trying to fight so many fires on so many fronts.

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