

Setting the appropriate objectives for economic policy

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Over the last week there have been two proposed changes to the obligations of the Bank of England. First of all, John McDonnell [received a report](#) suggesting that the Bank of England should keep its current structure, but have an additional obligation to promote productivity within the UK economy. Then, without prior warning or consultation, Philip Hammond and Mark Carney [reached agreement](#) on a new structure for the management of the Bank of England which grants the Bank independence whilst giving it, at the same time, the authority to intervene within the economy at unprecedented levels. In my opinion, both proposals are deeply unsatisfactory. In that case it is time to stand back and ask how UK economic policy should be managed, with what objectives. Given that I think that any policy on this issue should be widely understood, I will try to avoid technicalities.

The objectives of economic policy

There will always be quite appropriate political argument about the objectives of economic policy. However, few would dispute but most political parties hold many objectives in common including:

- * Full employment;
- * Growth;
- * Environmental sustainability;
- * Low inflation;
- * Low trade imbalances.

There are, of course, inherent conflicts between these objectives. Many would argue that growth and environmental sustainability are incompatible, whilst others would argue that there is a trade-off between full employment and low inflation. Redistribution will also be a priority for others. These conflicts are precisely why detailed interpretation of the objectives of economic policy is necessary: if everything was

glaringly obvious economic management would not be required.

Others would also argue that there should be objectives stating that the government should balance its books and taxation should be kept low. I do not agree. To suggest that these are objectives of economic policy is to confuse strategic goals with the instruments that the government has available to it to deliver them.

The instruments that the government can use to deliver economic policy

There are remarkably few instruments available to the government to influence economic policy within a democracy. Beyond political persuasion, they are:

- * Tax system design;
- * Targeted tax yield;
- * Specific spending objectives;
- * Total government spending;
- * International capital controls;
- * The base level of interest;
- * Banking regulation, including on lending.

Each of these could be explained in greater detail but in essence they are all the weapons there are in the armoury. And when it comes down to it, they all come down to one thing, which is controlling the amount of money flowing in the economy.

Money flows and their regulation

As Charles Adams explained on the [Progressive Pulse blog](#), there are only two ways in which money can be created within the UK economy. The first is that commercial banks can lend that money into existence. Private debt is created as a result, and the borrower then has the obligation to make repayment of the loan that they have taken, plus interest and charges, which provide a bank with its profit. As the money in question is repaid it is destroyed in the sense that the promises to make payment that created it, and which identify the existence of money, have been fulfilled.

Secondly, money can be created by the government injecting it into the economy. This money, which is created on its behalf by its own bank, which is the Bank of England, is then cancelled by way of taxation. This is how the government fulfils its promise to pay: it accepts the money it creates in settlement of tax liabilities.

It is my suggestion that the only mechanisms that the government has

available to it to control the economy come down to controlling these two flows of money.

So, for example, control of the interest-rate and banking regulation on lending are primarily intended to control the flow of private funds into the economy by regulating the total volume of private debt, which is the source of bank created money.

In combination, the difference between total government revenue in total government spending regulates the amount of money that the government injects into, or withdraws, from the economy.

And capital controls, if they exist or are used, are intended to regulate the flow of funds into an out of the country in its own currency.

Why regulating money flows is important

Regulating the flow of money is important. If there is too little money in an economy a number of unfortunate consequences arise. First, a lack of credit will restrict the level of trade, and so growth, with resulting unemployment. Second, the same lack of credit will reduce investment, with the same overall consequence. Third, this may well result in deflation, which is at least as economically unattractive as excessive inflation as a result of the instability that it creates. Fourth, the economy will work at less than full capacity and essential services will not be supplied. Fifth, in real terms, the repayment of debt becomes more onerous.

Too much money also creates problems. An excess of available credit creates booms in private debt, some of which often proves to be of poor quality as a consequence, and banking crashes can result as happened in 2008. If excess credit is created so too can excess demand be stimulated. This can then result in inflation, the control of which is hard to achieve. The excess of private demand can also mean that there is a shortage of available resources for the delivery of essential services. The economy becomes unbalanced. Those owed money realise less than they expected in this situation: lending becomes more expensive as a result. The consequence is a 'boom and bust' scenario. If this is not synchronised with activity in other economies then capital and trade imbalances result.

The aim is then to deliver enough cash to the economy to stimulate sufficient economic activity to create full employment at relatively stable prices, with steady but sustainable growth which reflects the underlying need for fundamental change in the economy to a low carbon base, with credit being made available at affordable prices to those who can repay it, and with government making good any shortfall in the money creation process that this results in by running a necessary deficit to ensure that the combined demand for new money created by growth and inflation are met.

How to achieve the goal of appropriate new money creation

There is no one way to achieve this goal of new money creation: there are too many variables in the equation for that to be true. Equally, the government is able to influence most of those variables, simultaneously. What this means is that economic policy has to be based upon a combination of monetary policy, which has the aim of regulating the money flows in the private banking and commercial and domestic borrowing sectors, and fiscal policy, which has the objective of delivering sufficient new government money into the economy to assist the overall achievement of economic goals whilst delivering the public services that the government has been mandated to supply. There is no case for saying that one is obviously superior to the other: both create money flows and both, therefore, have equal significance if the overall objective of economic policy is to be achieved.

It is also the case that if both policies are to be effective, and both have the eventual same goal of controlling new money flows, then they must be controlled together: it is impossible to achieve the overall goal if each is subject to separate supervision. That also makes it easier to recognise that there are occasions when one policy may be of more use than another.

For example, in a booming, private sector growth led and credit fuelled economy then it is almost certainly the case that the government will want to prioritise monetary policy to control the economy. It is likely that it will be appropriate to restrict the availability of new credit to constrain inflation. At the same time, it is at least possible that a government may wish to run a surplus because the tax available to it will exceed its capacity to spend within the physical constraints of the economy in such a situation. Those policies, in combination, control the availability of new money supply to the economy, to constrain growth to the point that it is sustainable. But it is not just one of these actions that will be required; both will need to be considered simultaneously.

In contrast, when there is a shortage of demand in the economy, bank lending is relatively low, and investment is likewise below the capacity that the economy could sustain, then interest rates might be so low that any change in them is virtually ineffective in creating new demand. This has been the overall situation since 2008. In that case monetary policy is likely to have very little impact, and so fiscal policy has to take priority, with the government running a deficit to create the new money that is required to stimulate the economy to increase demand to create full employment and bring the overall level of economic activity back to a sustainable capacity, whilst at the same time running an economic policy that delivers the process of change towards environmental sustainability that is an essential feature of modern economic life.

The control of money creation is not, then, a job for a central bank in isolation, or a Treasury in isolation if it only has control of fiscal policy, but is instead a policy that has to be coordinated from one central authority. Given the essential political nature of the activity being undertaken, this must be under democratic control. And that means a

Treasury must be in control.

What is the role of Central Banks in that case?

If the central bank cannot undertake economic policy, because it is not under democratic control, the question has to be asked as to what role it might have in a truly integrated modern economic policy that appreciates that the control of new money creation, from wherever it might come, is at the core of economic management. There are still three essential functions for it. The first is to act as the government's banker, creating for it the opportunity to inject or withdraw money from the economy, overall. Second, it can act as the regulator of commercial banks, and is ideally suited to this task. Third, it can advise on interest-rate policy, but not have the final say on the issue.

And what is the role of a Treasury?

In a modern economy where the proper nature of money is understood and the government has objectives of the type that I noted at the start of this post, then the Treasury has to be in control of economic policy. This means that it must control interest rates as well as be fully aware locations of its own fiscal policy. Coordination of economic policies is impossible in any other situation.

In that case it has also to make clear what its economic objective is. This would require interpretation of the five possible economic goals I have noted. So, for example, the tolerable level of unemployment should be stated. An inflation target should be set. A target for carbon reduction has to be established. Trade imbalances have to be tackled, either through a tacit exchange-rate policy or through a policy of productivity improvement, since this is the main driver of imbalances in the sector. The result is a growth target. And to make that target meaningful it should be expressed in a way that people understand: I would suggest that it be stated as a change to median income because this then implies that consideration of the distributional aspects of any policy is a fundamental element within their design.

The resulting policy statement will, of course, be more complex than the setting of an inflation rate target, but this was always simplistic and in itself gave rise to indifference to key factors within the economy which created instability in their own right. If a broader-based target had been in existence the probability of a crash in 2008 would have been reduced.

Economic policy is not simple. There is nothing to be gained by pretending that it is. On the other hand, if the ultimate goal of economic policy was to be something that the vast majority of people felt to be in their own best interests, which would be the case if median pay was chosen for the growth target, then political coherence could be achieved around a new economic narrative that put people, real economic activity, redistribution, sustainability and appropriate growth at the heart of our economy with banking, finance and the control of the money supply seen as instruments to help

deliver this, rather than as priorities in their own right.

This, I suggest, is where debate on this issue should be heading. We should stop debating the minutiae of who does what at the Bank of England and look at the bigger picture. This is what I have sought to do with the post.