The New Monetary Policy Framework

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Executive summary

A broad consensus now exists that price stability is an essential pre-condition for achieving the Government's central economic objective of high and stable levels of growth and employment. It is clear that tolerating higher rates of inflation does not lead to higher employment or output over the long term. Indeed, high average rates of inflation – which, more often than not, are accompanied by more variable rates of inflation – discourage the long-term planning and investment vital to sustaining high rates of economic growth.

Yet, for most of the last 30 years, the UK's inflation record has been very poor. During the 1970s, inflation averaged 13 per cent per year, peaking at almost 27 per cent in August 1975. Inflation averaged 7 per cent during the 1980s and reached over 9 per cent in the early 1990s. From 1980 to 1997, among the G7 countries, the UK had the second highest average inflation rate and greater variability in inflation than all but France and Italy.

This performance reflected numerous shortcomings in the design and conduct of monetary policy. Objectives were often inappropriate or unclear, while decisions were often poorly co-ordinated with fiscal policy or were made too late to prevent inflationary pressures from building. Roles and responsibilities were also ill-defined, creating the impression that policy decisions could be based on short-term political considerations. A lack of transparency hindered accountability and meant that policy-makers were unable to build credibility.

Allowing these problems to continue was unacceptable. Consequently, upon entering office, and faced with an economy showing strong signs of a sharp pick-up in inflation, the Government moved quickly to reform the framework for monetary policy. The reforms were based on a coherent set of principles:

A platform of stability, including low and stable inflation, is necessary for high and stable levels of growth and employment.

- It is widely recognised that high and variable inflation harms, rather than helps, long-term growth and employment. Price stability, therefore, must be a key component of any successful economic strategy.

The goal of monetary policy, price stability, should be defined in terms of an inflation target which is clear and stable over time.

- A clear and stable inflation target is the best way of making the objectives of monetary policy credible, thereby ensuring inflation expectations are consistent with price stability. By contrast, intermediate targets, such as monetary aggregates, have an uncertain relationship with the ultimate goal of maintaining price stability.

A symmetric inflation target is vital so that monetary policy is forward-looking and supports the Government's objectives for growth and employment.

- The achievement of price stability is a means to an end, not an end in itself. It is important that the inflation target is symmetric – with deviations below target treated equally seriously as those above – so that monetary policy is neither unnecessarily tight nor unnecessarily loose.

There should be a clear separation of roles and responsibilities with respect to the setting of the framework and the implementation of monetary policy to meet the inflation target.

- Clear roles and responsibilities are necessary to ensure that each party understands, and is accountable for, exactly what it is required to achieve. Therefore there should be a clear separation of roles and responsibilities between the Government's role, creating and overseeing the monetary policy framework, and the Bank of England's task of implementing monetary policy so as to meet the Government's inflation target.

An independent committee of experts, backed up by specific procedures, should have responsibility for implementing monetary policy to achieve the Government's inflation target.

- Independent experts, skilled in judging often complex economic and financial information, and unencumbered by short-term political pressures, are best able to make forward-looking decisions in the long-term interests of the UK economy. Moreover, the development of specific procedures helps to ensure that all relevant information is taken into account when policy decisions are made.

Monetary policy should be characterised by high levels of openness, transparency and accountability.

- Openess and transparency allows public and parliamentary scrutiny, thereby enhancing the accountability of policy-makers and improving the quality of decisions. This boosts the credibility of the framework and also helps to ensure that price and wage-setting decisions are consistent with the inflation target, allowing the benefits of price stability to be maximised.

The framework must allow monetary policy to respond sensibly in the face of certain specific types of economic shocks.

- In certain circumstances, such as when confronted by large supply shocks, the output and employment costs of preventing a temporary deviation in inflation from target might justify a more moderate adjustment path. The framework must allow for such circumstances, whilst ensuring that price stability remains the ultimate goal.

Monetary and fiscal policy should support each other in promoting stability.

- In order to deliver economic stability, both arms of macroeconomic policy must act in a co-ordinated way. An open approach, with the Government setting the objectives of both monetary and fiscal policy, allows this co-ordination to be achieved.

Applying each of these principles, the Government fundamentally redesigned the framework for monetary policy. This framework is formalised in the *Bank of England Act 1998* and in the Chancellor's remit to the Monetary Policy Committee. Key elements of the reform were:

- A symmetric inflation target – $2\frac{1}{2}$ per cent annual growth in the Retail Price Index excluding mortgage interest payments (RPIX) – and a requirement that

monetary policy also support the Government's wider economic policy objectives.

- The establishment of a Monetary Policy Committee (MPC), composed of highly respected independent experts, and charged with, and held accountable for, setting interest rates to meet the Government's inflation target.
- A series of mechanisms to promote openness, transparency and accountability, such as: the publication of voting records, minutes of the monthly MPC meetings and the quarterly *Inflation Report*; a requirement that MPC members appear before parliamentary committees; and direct accountability for decision-making to the Government and the Court of the Bank of England.
- The introduction of an 'open-letter' system. A transparent approach to significant deviations of inflation from its target level gives the MPC an opportunity to respond sensibly to particular economic shocks. The letter must explain the reasons why inflation has diverged from the target, the action being taken to deal with it, when inflation is expected to return to target, and how any actions taken will support growth and employment.

These measures have been accompanied by a set of parallel reforms to fiscal policy, including the Code for Fiscal Stability, backed by legislation, and the adoption of two strict fiscal rules: the golden rule and the sustainable investment rule. This ensures the same high standards of transparency, responsibility and accountability apply to fiscal policy decisions. The objectives of both monetary and fiscal policy are set by the Government. This means that both arms of policy work together in a co-ordinated way to deliver economic stability.

Recent reports by both the House of Commons' Treasury Committee and the Lords Select Committee on the Monetary Policy Committee of the Bank of England, and by international organisations such as the IMF and the OECD, have acknowledged the success of the first two and a half years under the new framework. This success can be measured in a number of ways.

- RPIX inflation since the new framework's introduction has averaged 2.6 per cent.
- Inflation has not only been low, it has also been very stable. Since the introduction of the new framework, inflation has moved in a narrow band between 2.1 per cent and 3.2 per cent, with no breach of the thresholds that require an open letter from the Governor of the Bank of England.
- Interest rates peaked at 7½ per cent for four months in 1998 compared with a peak of 15 per cent for a year in the previous economic cycle, and have since fallen to 5¼ per cent. Lower interest rates, together with prudent fiscal management, will also reduce the Government's debt interest payments by around £4 billion this year.
- Monetary policy decisions have been more forward-looking. Prompt and decisive action by the MPC – both in raising and lowering interest rates where necessary – has meant that price stability has been maintained, avoiding the damaging boom and bust cycles seen so often in the past. There has also been much better co-ordination of monetary and fiscal policy.

Looking ahead, survey and financial market data suggest that this success is expected to be maintained.

- Inflation expectations of financial market participants 10 years ahead have fallen from over 4 per cent in April 1997 to just under $2^1/_2$ per cent in October 1999, consistent with the inflation target.
- Long-term interest rates have fallen to levels not seen in a generation. In addition, the differential between UK and German bond yields is now at historically low levels.

While the success to date has been encouraging, the MPC must continue to perform well if inflation is to remain on target. Wage and price setters must continue to act responsibly so that real increases in wages and profits are consistent with improvements in economy-wide productivity. In addition, more could be done to communicate the aims and rationale of monetary policy to those sectors of society – such as households – whose inflation expectations, while lower than in the past, remain above the inflation target.

A pro-active monetary policy focussed on a symmetric inflation target, together with a prudent fiscal policy, provides the foundation for economic stability. The MPC's record so far in meeting the Government's inflation target, and supporting a more stable path for output and employment than in previous cycles, is a good one. Nonetheless, both the Government and the MPC recognise that it is important not to be complacent. A forward-looking and vigilant approach will continue to be needed to maintain this track record.

1 INTRODUCTION

1.1 The Government's central economic objective is to achieve high and stable levels of growth and employment. It is widely accepted that price stability is necessary to meet this objective. High and variable inflation creates uncertainty and leads to an inefficient allocation of resources, adversely affecting both the quantity and the quality of the investment essential for long-term economic and social prosperity.

1.2 Maintaining low and stable inflation, therefore, is the best contribution monetary policy can make to achieving high and stable levels of growth and employment. To that end, the primary objective of the Government's monetary policy framework is price stability.

1.3 For the monetary policy framework to work effectively, it must be designed appropriately. However, as discussed in Sections 2 and 3 of this paper, monetary policy in the UK has not worked well in the past. This reflected serious shortcomings in both its aims and procedures. The Government was determined to make a decisive break with the past and to avoid any repeat of previous mistakes. In designing the new monetary policy framework, a coherent set of principles were taken into account. Those principles, discussed in more detail in Section 4, are as follows.

- A platform of s**tability**, including low and stable inflation, is necessary for high and stable levels of growth and employment.
- The goal of monetary policy, price stability, should be defined in terms of an inflation target which is **clear and stable** over time.
- A **symmetric inflation target** is vital so that monetary policy is forward-looking and supports the Government's objectives for growth and employment.
- There should be a **clear separation of roles and responsibilities** with respect to the setting of the framework and the implementation of monetary policy to meet the inflation target.
- An **independent committee of experts**, backed up by specific procedures, should have responsibility for implementing monetary policy to achieve the Government's inflation target.
- Monetary policy should be characterised by high levels of **openness, transparency, and accountability**.
- The framework must allow monetary policy to **respond sensibly** in the face of certain specific types of economic shocks.
- Monetary and fiscal policy should **support each other** in promoting stability.

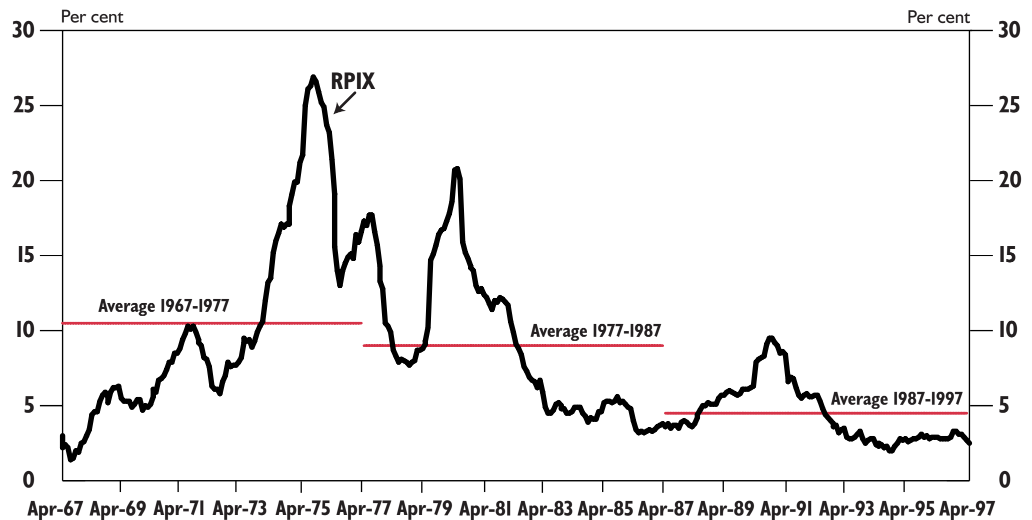
1.4 By incorporating these features, the UK's monetary policy framework has been put on a sound footing and now ranks among the world's best. As discussed in Section 5, the new framework has, to date, succeeded in maintaining low inflation during a period of considerable instability in the global economy. More importantly, the credibility of the framework has increased confidence that inflation will stay low, helping the UK to steer a course of stability and steady growth, in contrast to the boom and bust of the past.

2 The need for a new framework

Inflation was high and volatile

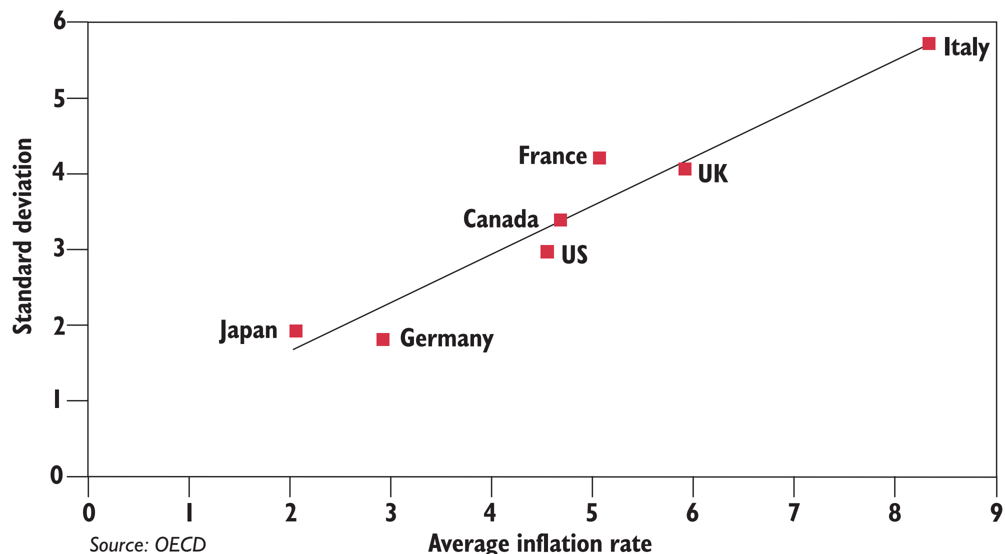
2.1 In order to understand why the Government decided to overhaul the way in which monetary policy was conducted, it is instructive to examine the UK's past inflation record. As Chart 1 shows, for most of the 30 years prior to the introduction of the new framework, this record was very poor. During the 1970s, annual inflation averaged 13 per cent, peaking at almost 27 per cent in August 1975. During the 1980s, annual inflation averaged 7 per cent, while in the early 1990s inflation peaked again at a high level of over 9 per cent.

Chart 1: Three decades of high inflation



2.2 Inflation was not only high, but also volatile. As Chart 2 shows, between 1980 and 1997, the UK had the second highest average inflation rate among the G7 countries, with only France and Italy having greater variability in inflation. The chart also illustrates a positive relationship between the level of inflation and its variability. Volatile inflation increases uncertainty and thus increases the costs of unanticipated inflation.

Chart 2: G7 average inflation rates and volatility, 1980-1997



Source: OECD

The post-ERM period

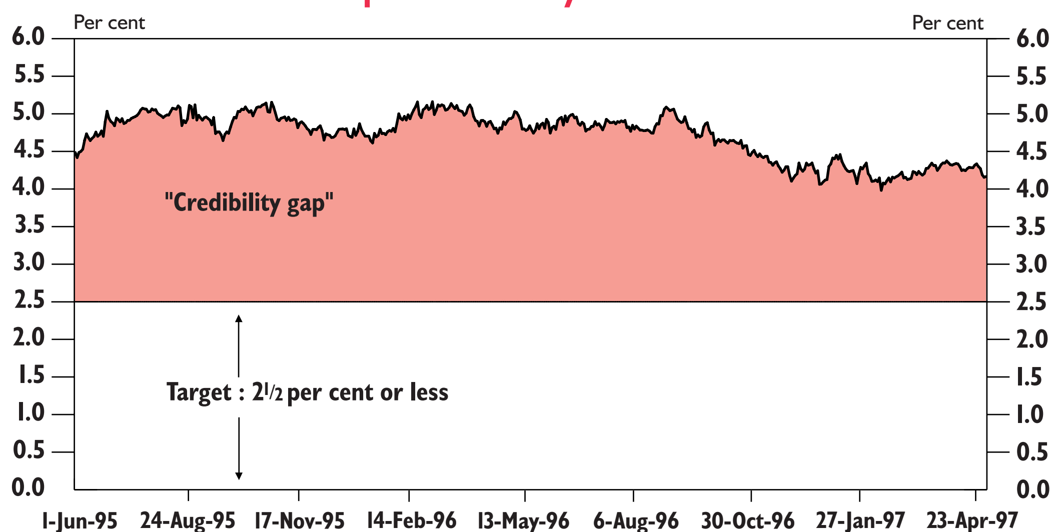
2.3 Following the departure of sterling from the Exchange Rate Mechanism (ERM) in September 1992, there was a noticeable downward shift in the average level of inflation. Since that time, inflation, as measured by the RPI excluding mortgage interest payments (RPIX), has not risen above 4 per cent. In part, this can be attributed to improvements in the conduct of monetary policy that took place around that time. RPIX inflation was targeted directly for the first time from October 1992, and some improvements in reporting arrangements were also introduced. In June 1995, the then Government confirmed a target of $2^1/_2$ per cent or less was to apply from the beginning of the following Parliament.

2.4 These improvements, however, were insufficient. The objectives of monetary policy remained unclear, roles and responsibilities were still poorly defined, and the influence of short-term political factors had not been resolved. As a result, the revised arrangements lacked credibility, as was clearly evident in inflation expectations. For example, in the early 1990s an inflation target of between 1 and 4 per cent was set, with the aim of being in the lower half of that range - that is below $2^1/_2$ per cent - by the end of the Parliament. Throughout this period, however, measures of inflation expectations remained consistently above 4 per cent.

2.5 Despite the June 1995 announcement of the $2^1/_2$ per cent or less inflation target, the next two years saw inflation expectations 10 years ahead, as measured from financial markets, well above the upper threshold of the earlier target range. As Chart 3 shows, there was a large "credibility gap" between what policy-makers were aiming for and what markets expected to happen.

2.6 The failure of inflation expectations to fall during this period demonstrates a lack of confidence in the ability of the previous monetary policy framework to meet the target in the long term. This contrasts with the marked fall in inflation expectations following the introduction of the new framework, as discussed in greater detail in Section 5 below.

Chart 3: Inflation expectations 10 years ahead



2.7 An important factor behind the comparatively low inflation that was recorded between 1992 and early 1997 was the poor state of the economy. In particular, the severe recession of the early 1990s created a large degree of spare capacity in the economy, reducing the inflation rate sharply. This situation persisted for several years, preventing any build-up in inflationary pressures. As has recently been pointed out by the Bank of England's Deputy Governor, Mervyn King,

> *"...from 1992 to 1996, the ability to grow at above-trend rates without an increase in inflationary pressure was made possible by using up the margin of spare capacity created by the deep recession of the early 1990s."*[1]

Inflation was set to rise again

2.8 Although inflation did fall after 1992, for 40 of the 52 months prior to the new Government taking office in May 1997, inflation remained above 2½ per cent. Of more immediate concern, there were strong signs that inflation was poised to pick up again. By early 1997, the UK economy was expanding rapidly to a point where capacity pressures had become evident. Consumer spending was growing at an unsustainable rate and inflation was set to rise sharply above target. For example, in early 1997, independent forecasters, on average, were expecting inflation to increase to almost 3½ per cent the following year, reflecting a lack of confidence in the ability of the then existing framework to maintain price stability. Without further action, there was a danger of repeating the past pattern of boom and bust.

[1] Speech given at the Queen's University, Belfast, on 17 May 1999, printed in the August 1999 *Bank of England Quarterly Bulletin*.

3 Lessons from past policy failures

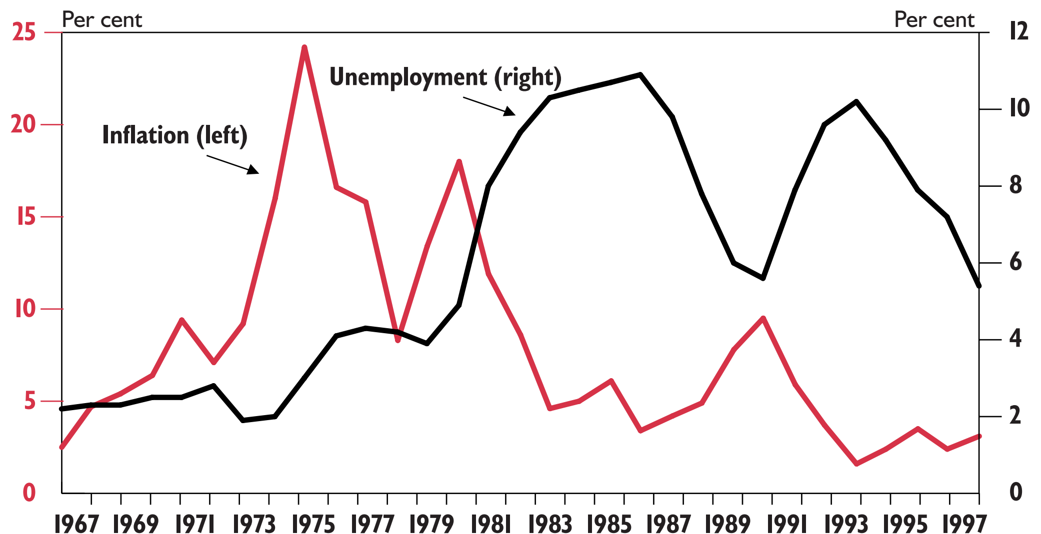
3.1 Although there are many reasons for the UK's poor inflation record in recent decades, one key factor – a factor under the Government's control – was that poor institutional arrangements were in place over this period. Monetary policy, if set correctly, should be a stabilising force for the economy. However, on too many occasions serious mistakes were made, which often meant that inflation was higher and more volatile than it would otherwise have been. This, in turn, created substantial economic instability that harmed the long-term performance of the UK economy. Many of these policy mistakes were made because the aims and procedures of monetary policy were not properly defined. It is possible to identify several lessons from this experience.

The objectives of monetary policy were often inappropriate

3.2 A broad consensus now exists that price stability is an essential pre-condition for achieving high and stable levels of growth and employment. This means the goal of monetary policy should be price stability. However, for part of the last 30 years, monetary policy was not directed at price stability. Indeed, for a long time it was thought that tolerating higher inflation actually enhanced, rather than damaged, long-term growth and employment.

3.3 The UK's poor inflation record can be traced initially to a fundamental misunderstanding about the relationship between inflation and unemployment. During the 1960s and 1970s, policy-makers attempted to use monetary policy to exploit an apparent relationship between the two, hoping that unemployment could be lowered by stimulating demand and trading off an increase in inflation. As Chart 4 shows, attempts to hold unemployment down during this period not only failed in the long term, but were also associated with accelerating inflation.

Chart 4: Inflation and unemployment



3.4 The apparent relationship, therefore, proved to be illusory. Although in the short term, such a trade-off was possible, it could only work by temporarily creating inaccurate inflation expectations. Once people revised their expectations, the trade-off would disappear, and unemployment would rise. This had the long-term effect of ratcheting up the level of both inflation and unemployment.

3.5 Another example of a period in which monetary policy was directed at an inappropriate objective was in the 1980s and early 1990s, when policy-makers attempted

to use monetary policy to target the exchange rate. This approach was often at the expense of price stability. For example, interest rate reductions were delayed throughout 1991 and the first half of 1992, partly as a result of ERM membership. The consequence was a steeper than necessary fall in output.

The objectives of monetary policy were not specified properly

3.6 It is important to recognise that the goal of monetary policy should be price stability. However, this is not enough. It is also important to ensure that this goal is specified properly. For example, in the 1980s policy-makers believed that low inflation could be achieved by rigidly targeting various monetary aggregates. This approach, however, proved to be misguided. The development of global capital markets, financial deregulation, and changing technology led to significant and unanticipated changes in the velocity of circulation of money. As a result, there was no clear and stable relationship between money demand and inflation over this period, making it impossible to rely on fixed monetary rules to deliver price stability.

3.7 This experience highlights a key shortcoming of targeting intermediate variables, rather than the inflation rate. Intermediate targets can lead policy-makers to focus too much on the variable they are targeting at the expense of the wide variety of other important indicators of inflationary pressures. On a number of occasions, it became clear that the intermediate targets that had been set were not delivering the results expected. However, rather than abandoning this approach, policy-makers instead tried to modify it by setting different target ranges or by targeting different indicators, including the exchange rate. As Table 1 shows, this happened on almost an annual basis during the 1980s and early 1990s.

Table 1: Monetary policy targets (1979-1997)[1]

Target year[2]	£M3	M4	M0	£ exchange rate level	RPIX
1980-81	7-11				
1981-82	6-10				
1982-83[3]	8-12				
1983-84[3]	7-11				
1984-85	6-10		4-8		
1985-86	5-9		3-7		
1986-87	11-15		2-6		
1987-88[4]			2-6		
1988-89			1-5		
1989-90			1-5		
1990-91			1-5	DM2.95[5]	
1991-92[5]			0-4	DM2.95	
1992-93[6]		4-8[7]	0-4	DM2.95[6]	
1993-94		3-9	0-4		1-4[6]
1994-95		3-9	0-4		1-4
1995-96[8]		3-9	0-4		1-4
1996-97		3-9	0-4		2 1/2 or less
1997-98		3-9	0-4		2 1/2 or less

[1] *Annual % change unless stated otherwise.*

[2] *As set in the Medium-Term Financial Strategy (MTFS).*

[3] *Targets were also set for PSL2 and M1 in the 1982 and 1983 MTFS.*

[4] *1987-88 MTFS said 'Monetary conditions are assessed in the light of movements in narrow and broad money, and the behaviour of other financial indicators, in particular the exchange rate'. There was no formal target for broad money. Similar references are to be found in the MTFS in 1988-89, 1989-90 and 1990-91.*

[5] *UK joined the Exchange Rate Mechanism (ERM) of the European Monetary System in October 1990. The 1991-92 MTFS said "Interest rate decisions must now be set consistently with keeping sterling within its announced bands."*

[6] *UK left the ERM in September 1992. The new framework was based on an inflation target for RPIX of 1 to 4 per cent, with inflation in lower part of the range by the end of the Parliament. Medium-term monitoring ranges for M4 and M0 were also announced.*

[7] *Announced in Autumn Statement in 1992 after UK left the ERM.*

[8] *In June 1995 the 1 to 4 range for RPIX was confirmed by the Chancellor and a new target of 2.5 per cent or less was announced for beyond the end of that Parliament.*

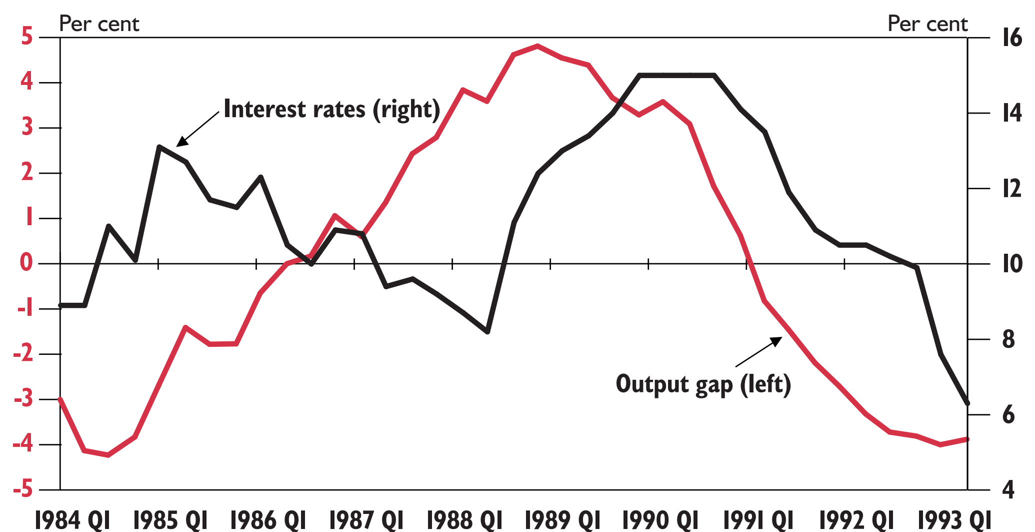
3.8 These frequent changes created uncertainty, damaged the credibility of policy-makers, and led to policy mistakes. Such problems were a direct result of not specifying the goal of monetary policy appropriately. If the goal of policy-makers is price stability, it is best to specify that goal directly in terms of an inflation target. This allows policy-makers to take into account all factors that affect inflation and also enables the objective of monetary policy to be expressed in terms that are well understood and stable.

Monetary policy was not sufficiently forward-looking

3.9 The lack of clear, stable objectives was also one of the main reasons why policy-makers were frequently too slow to react to changing circumstances. Without a well-defined objective, policy-makers were unable to be pro-active. This meant that inflationary pressures were often allowed to build unnecessarily before corrective action was taken. In turn, this meant that interest rates were eventually higher and more volatile than they otherwise would have been.

3.10 In the late 1980s, for example, the economy was allowed to grow at a rate well above its sustainable level, pushing inflation up past 9 per cent. This eventually forced policy-makers to raise interest rates to extremely high levels, peaking at 15 per cent, after which a severe recession followed. Had monetary policy been tightened earlier, rates may not have needed to have been raised so high, and the recession might have been less severe or avoided altogether.

Chart 5: The output gap and interest rates: the late 1980s and early 1990s



Source: ONS and HM Treasury

3.11 Chart 5 illustrates what happened over this period, showing clearly how interest rates consistently lagged the output gap profile.

- From January 1986 to May 1988, interest rates were reduced by 5 percentage points, from 12½ per cent to 7½ per cent, yet the estimated output gap moved from just below trend, –½ per cent, to far above trend, +3½ per cent.
- A belated realisation in June 1988 that the economy was overheating led to four base rate increases in that month alone – a total of 2 percentage points – and by the end of the year rates had risen a further 3½ percentage points to 13 per cent. Rates finally peaked at 15 per cent in October 1989 and remained at that level for a year.
- Policy was also changed too late on the downswing. Interest rates were still at

14 per cent at the beginning of 1991, even though the output gap had turned negative; and interest rate reductions were delayed throughout 1991 and the first half of 1992, partly as a result of ERM membership.

3.12 A failure of policy-makers to act promptly during this period meant that interest rates eventually had to rise by more than they would otherwise have done. As Chart 6 shows, rates frequently rose to very high levels during the 1980s and early 1990s, with the UK's interest rate volatility the highest among G7 countries. This instability made it extremely difficult for individuals and firms to make long-term decisions.

Chart 6(a): Base rates

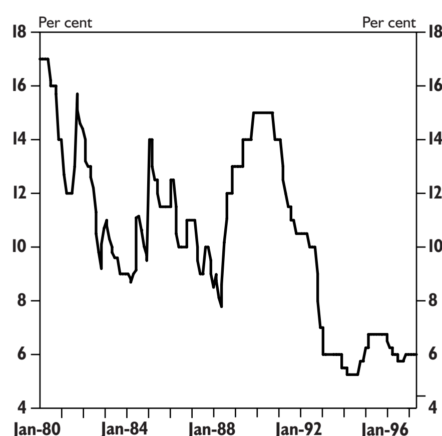
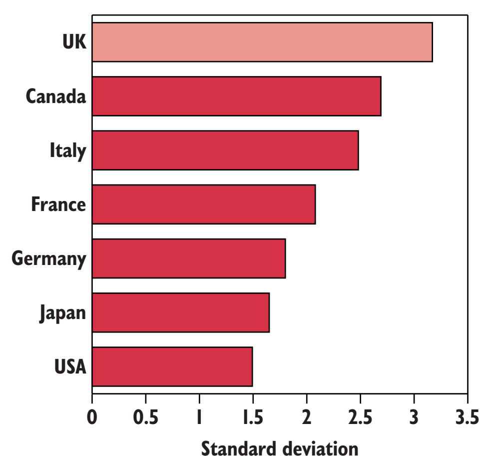


Chart 6(b): Interest rate volatility (Jan 1985 - Apr 1997)



Roles and responsibilities were not clear and consistent

3.13 Under previous monetary policy regimes, the Government, in principle, was responsible for both designing the monetary policy framework and taking policy decisions to meet the stated target. In addition to advising on and implementing the Government's monetary policy decisions, the Bank of England was also responsible for managing the Government's debt, as well as the regulation and supervision of the financial sector.

3.14 However, as already noted, the exact nature of the Government's responsibilities was often unclear due to the ambiguous specification of its objectives. The Bank also faced a potential source of conflict between its requirement to provide advice that would help the Government achieve its inflation target and its responsibility for managing the public debt. A surprise bout of inflation, for instance, would reduce the real value of the Government's debt obligations.

Monetary policy decisions were made by politicians, not independent experts

3.15 Prior to the introduction of the new framework, monetary policy had generally operated on an *ad hoc* basis. Although a range of informal conventions were in place, no specific guidelines were set out to govern the conduct of policy-makers. For most of this period there was not even a precise and regular timetable for monetary policy decisions to be made and announced. There was often little consistency in monetary policy over time, and outsiders were unable to examine the decision-making process.

3.16 This problem was compounded by the fact that decisions were made in the context of a political process where short-term political pressures were often prominent. Although the politicians had access to the advice of independent experts, they would often not follow that advice, making monetary policy even more difficult to predict. For example, between December 1996 and April 1997, in the lead up to the election, the Bank of England, in response to growing inflationary pressures, recommended a 25 basis point increase in interest rates, but this was ignored.

3.17 The mere fact that monetary policy decisions were made by politicians created the suspicion that they could be based on short-term political considerations, rather than the economy's long-term interests. As has been pointed out by Mervyn King, Deputy Governor of the Bank of England,

> *"...long-term interest rates contained a risk premium to reflect the possibility that the timing and magnitude of interest rate changes might reflect political considerations."* [2]

Monetary policy was not transparent or accountable, harming its credibility

3.18 In the past, monetary policy lacked transparency. Policy-makers operated behind closed doors, and decisions were often made with little or no explanation. This lack of transparency meant it was not easy to hold them accountable for their performance. But more importantly, it also meant that they were unable to build credibility with markets and with the general public. Because people did not have a clear idea of what policy-makers were trying to achieve, and how they were operating, they did not have confidence that policy-makers would be able to deliver long-term price stability. In addition to the high inflation expectations that prevailed throughout this period, this lack of confidence was also reflected in wage and price setting decisions that were inconsistent with maintaining low inflation.

Monetary and fiscal policy were not well co-ordinated

3.19 For most of the last 30 years, the operation of both monetary and fiscal policy was directed by the one person. On the advice of HM Treasury and the Bank of England, the Chancellor of the Exchequer had responsibility for both the public finances and the setting of interest rates. Although it might be expected that such an arrangement would facilitate a high degree of co-ordination between both arms of policy, in practice this was often not the case. A lack of clear goals, and a failure to act in a forward-looking manner, often meant that monetary and fiscal policy were not working in the same direction.

3.20 The experience of the late 1980s again provides a good illustration of this point. During this period, fiscal policy was loosened just as the economy was overheating. Fiscal policy was relaxed, for example, with tax cuts of £6 billion in the March 1988 Budget and £3½ billion in the March 1989 Budget. The structural deficit – defined here as cyclically-adjusted public sector net borrowing (PSNB) – moved from an estimated small deficit of 1 per cent of GDP in 1985-86 to a deficit of 2½ per cent of GDP in 1989-90. When monetary policy was finally tightened, interest rates had to be increased by more than would otherwise have been necessary to offset the cumulative loosening of fiscal policy. Table 2 provides further details.

[2] Speech given at the Queen's University, Belfast, on 17 May 1999, printed in the August 1999 *Bank of England Quarterly Bulletin*.

Table 2: Change in interest rates, structural deficit and output gap, 1985-86 to 1989-90

Change in:		1985-86 to 1987-88	1987-88 to 1989-90
Output gap[2]		4	1 1/4
Interest rates		–2 3/4	5 1/4
Structural deficit[3]		1 1/2	1/4
	1985-86	**1987-88**	**1989-90[1]**
Memo item;			
Output gap level[2]	–1 1/2	2 1/2	3 3/4

[1]One year after peak of output gap
[2]As percentage of potential GDP
[3]Cyclically-adjusted Public Sector Net Borrowing as percentage of GDP

3.21 Another feature of monetary and fiscal policy during the 1980s was that Budgets were frequently followed within days by interest rate cuts. As Table 3 shows, this happened on eight out of ten occasions. On three of these occasions, the interest rate cuts were followed by rises within six months.

Table 3: Post-Budget interest rate changes

Budget Date	Interest Rate Movements	
	Rate Change	Decision
12 Jun 1979	15 Jun	up 2%
26 Mar 1980		
10 Mar 1981	11 Mar	cut 2%
9 Mar 1982	12 Mar	cut 1/2%
15 Mar 1983	15 Mar	cut 1/2%
13 Mar 1984	7 Mar	cut 1/4%
	15 Mar	cut 1/4%
19 Mar 1985	20 Mar	cut 1/2%
	29 Mar	cut 1/2%
18 Mar 1986	19 Mar	cut 1%
17 Mar 1987	10 Mar	cut 1/2%
	19 Mar	cut 1/2%
15 Mar 1988	17 Mar	cut 1/2%
14 Mar 1989		
20 Mar 1990		
19 Mar 1991	22 Mar	cut 1/2%
10 Mar 1992		
16 Mar 1993		
30 Nov 1993	23 Nov	cut 1/2%
29 Nov 1994	7 Dec	up 1/2%
28 Nov 1995	13 Dec	cut 1/4%
26 Nov 1996		

4 THE GOVERNMENT'S RESPONSE

4.1 Given the UK's past record of boom and bust, and the prospect in 1997 of this being repeated, the Government needed to act quickly and decisively upon taking office to deliver price stability. Operational responsibility for the conduct of monetary policy was quickly handed to the newly-established Monetary Policy Committee (MPC) of the Bank of England. The MPC was then instructed to operate within a new framework specifically designed to address the shortcomings of previous regimes. This was done by incorporating into the framework the principles outlined in Section 1.

4.2 The Government is strongly committed to the new monetary policy framework, but recognises that this is not the only way to deliver price stability. Different countries may find that slightly different arrangements better suit their domestic circumstances. The new framework has been based on these principles because the Government is convinced that this is the best way to achieve price stability given the UK's history and circumstances.

Stability is necessary for growth and employment

4.3 Both theory and empirical evidence suggest that it is inadvisable to try to use monetary policy to meet several goals, which often may be in conflict. A better approach is to limit and focus the scope of monetary policy, so that it has a better chance of success. The question then is: what should monetary policy aim to do? In recent years, a strong consensus has developed that the primary goal of monetary policy should be price stability, with many central banks adopting explicit inflation targets. This is based on the conviction that high and variable inflation severely damages the long-term performance of an economy. This occurs in a number of ways.

- In a market economy, prices act as a signal for the allocation of resources. If the price of a product or asset rises, this encourages producers to provide more of that product or asset, while consumers are encouraged to spend their money elsewhere. If, however, all prices are rising due to excessive demand in the economy, producers and consumers find it hard to make relative price comparisons, leading to an inefficient allocation of resources.
- High inflation prompts people to protect themselves from its effects or to engage in speculative activities, rather than concentrating on the creation of new wealth.
- High inflation can also have serious social effects and creates arbitrary changes in wealth. The booms and busts associated with high inflation also result in substantial deterioration in the skills of those made unemployed, particularly those on low incomes.
- More generally, high and variable inflation makes it difficult for individuals and businesses to plan for the future. This is particularly harmful for the investment, both in human and physical capital, that is necessary for long-term prosperity.

4.4 It is for these reasons that the Government has made price stability the goal of its monetary policy framework. By maintaining low and stable inflation, both sharp slowdowns and runaway booms can be avoided.

Monetary policy, opportunity and fairness

Maintaining low inflation is an integral part of the Government's strategy to achieve high levels of growth and employment. There are good reasons to think that low inflation will also help ensure that the benefits of growth are shared fairly.

The relationship between inflation and income (both its level and distribution) has been examined in a recent study.[1] Based on data for 19 OECD economies and a wider group of 66 countries, the study concludes that,

> ***". . . on average, the poor are much better off in countries where monetary policy has kept inflation low and aggregate demand stable."***

Furthermore, the study notes that although higher inflation can be associated with temporarily lower unemployment and higher incomes at the lower end of the distribution, the effect is just that – temporary. This lends support to the Government's emphasis on securing economic stability as the foundation for a productive and fair society.

[1] Monetary policy and the well-being of the poor, C.D. Romer and D.H. Romer (1998), National Bureau of Economic Research, No 6793.

Price stability is defined in terms of a clear, stable inflation target

4.5 The objectives for monetary policy under the new framework are clear and precise. The primary objective, set out in the *Bank of England Act 1998*, is price stability. This objective is explicitly specified and defined by the Government to be a target of $2^1/_2$ per cent for RPIX inflation. The MPC is required to meet this target at all times.

4.6 The optimal target for inflation is uncertain. It is likely to differ between countries and over time, reflecting differences in the extent of measurement bias in price indices, institutional structures and historical experiences, which affect the extent of rigidities in the setting of wages and prices. The academic debate is inconclusive. However, the target chosen by the Government lies in a similar range to those of other industrial countries that have explicit inflation targets.

4.7 An unequivocal inflation target is important for a number of reasons. It ensures that the MPC knows what is expected of it. It also provides an effective anchor for inflation expectations. This should make the task of maintaining price stability easier, allowing the benefits of price stability to be maximised. In addition, such a target allows both the Government and the general public to assess the MPC's performance objectively by comparing outturns with target.

4.8 The inflation target is not only clear, but is also stable. The Government has no plans to change the way in which the inflation target is defined. It is important to have a good track record of achieving a target once it has been set. For example, the Treasury Committee recently concluded:

> *"We agree with the Chancellor's view that keeping to the same inflation target for a period of time makes it clear that the Government is pursuing a consistent aim and adds to the credibility of its anti-inflation policy."*[3]

[3] Treasury Committee, Eighth Report, July 1999.

The target is symmetric and forward-looking to support growth and employment

4.9 Price stability is a means to an end, but is not an end in itself. The new framework aims to maintain price stability because this is the most important contribution monetary policy can make to achieving long-term economic prosperity. The framework makes it clear that the MPC should also support the Government's objective of high and stable levels of growth and employment.

4.10 One way in which the monetary policy framework does this is by specifying a symmetric inflation target, so that deviations below the target are treated in the same way as deviations above the target. If the target was not symmetric – for example, if it was $2^1/_2$ per cent *or less* – policy-makers could have an incentive to drive inflation as low as possible to ensure they met their target comfortably, even if there were detrimental consequences for output and employment in the long term. The symmetric target means that monetary policy is neither unnecessarily loose nor unnecessarily tight. In effect, it allows policy-makers to aim for the highest level of growth and employment consistent with keeping RPIX inflation at $2^1/_2$ per cent.

4.11 The Government has on several occasions made it clear that it views undershooting of the target just as seriously as overshooting. This point was also made recently by the Governor of the Bank of England, Eddie George, in his Mansion House speech on 10 June 1999:

> *"We have made it clear by our actions that we are just as vigorous in relaxing policy when the risks to inflation are on the downside as we are in tightening policy when the risks to inflation are on the upside."*

4.12 The symmetric target also ensures that the dangers posed by deflation – a fall in the general level of prices – are viewed by policy-makers just as seriously as those posed by inflation. As the recent experience in Japan demonstrates, once expectations of deflation become entrenched, the stability of the economy can be threatened as consumers hold back demand in expectation of future price falls.

4.13 In order to support growth and employment, monetary policy needs to be forward-looking. By acting promptly, policy-makers can prevent a build-up in inflationary pressures, thereby reducing volatility in both inflation and output. Under the new framework, monetary policy is pro-active and the MPC is required to act preemptively in order to meet the target.

The framework sets out clear roles and responsibilities

4.14 Under the new framework, roles and responsibilities are exceptionally clear.

- The Government is responsible for designing the framework, including setting the inflation target which the MPC must achieve. The Government is also responsible for monitoring the success of the new framework and for keeping the MPC accountable for its performance.
- The MPC is responsible for setting interest rates to meet the inflation target.

4.15 The introduction of the new monetary policy framework was accompanied by the transfer of certain other functions away from the Bank of England. This allows the Bank to focus its attention on making the best monetary policy decisions, backed up by quality economic analysis. Under the new arrangements, the Debt Management Office is responsible for managing the Government's debt, while the Financial Services Authority is responsible for financial regulation and supervision. This clear separation of responsibilities means that all parties are aware of what each is required to achieve, promoting transparency and accountability.

Policy is implemented by independent experts backed up by specific procedures

4.16 Under the new framework, not only is the objective of monetary policy clear, but the way in which that objective is to be pursued is also clear. The rules governing the conduct of monetary policy are set out explicitly in the *Bank of England Act 1998* and the Chancellor's remit to the MPC.

4.17 In order to maximise the MPC's effectiveness, the legislation provides for four external independent experts who have experience or knowledge relevant to the functions of the MPC. These experts are appointed by the Chancellor for three-year terms which are renewable. The other five MPC members are Bank officials, including the Governor and the two Deputy Governors. The Governor and Deputy Governors are appointed, under statute, for a period of five years, while the other two Bank members of the MPC are appointed by the Governor. These arrangements ensure that interest rate decisions are removed from political pressures and are based solely on the long-term interests of the economy, rather than short-term political considerations.

4.18 There is also a stable and well-organised process by which monetary policy is conducted. The MPC goes about its business according to a regular monthly cycle, augmented by the quarterly *Inflation Report*. This helps to ensure that its decisions are consistent and well thought out, and it also allows all relevant information to be taken into account when policy decisions are made. This is done in a number of ways.

- The MPC benefits from having access to a substantial number of professional staff from the Bank of England who provide reports and analysis on all relevant factors.
- The MPC is required to consider regional and sectoral issues, and a comprehensive network of thirteen regional agents has been established for this purpose. The main role of these agents is to report back on local business conditions and sectoral developments.
- The MPC also has access to a representative from HM Treasury at its meetings to ensure that it is well briefed on fiscal policy and other issues.
- To improve its access to timely and accurate data, the Bank has established a formal Service Level Agreement with the Office of National Statistics.

4.19 Importantly, the MPC publishes the dates of its meetings well in advance. Together with its reporting obligations and other transparency measures (discussed below), these procedures mean that monetary policy is conducted in a regular and predictable fashion.

Openness, transparency and accountability to ensure credibility

4.20 The granting of operational independence to the Bank was accompanied by the introduction of a range of measures aimed at improving the transparency and accountability of monetary policy. These aim to ensure that the public is well informed of what the MPC is trying to achieve, what it is doing to meet its objectives, and how well it is performing. This makes monetary policy more consistent and predictable, helping people to make better long-term decisions.

4.21 The new framework incorporates a wide range of reporting obligations and accountability measures. The main reporting obligations are:

- the publication of minutes and members' voting records from the monthly MPC meetings (these are published two weeks after the meeting, even though the statutory requirement is up to six weeks, thus reducing the period of uncertainty about the reasons taken for decisions); and

- the quarterly *Inflation Report*, which contains the MPC's inflation forecast and a comprehensive assessment of the factors underpinning that forecast.

4.22 These publications not only improve transparency, but also serve as a forum for the MPC to explain the reasoning behind its decisions, thereby improving public understanding of monetary policy. As a result, the conduct of monetary policy is no longer hidden from the public. The public are able to examine the arguments and issues that lie behind monetary policy decisions and are given a thorough explanation of those decisions.

4.23 Accountability measures are also crucial in the new framework. Authorities with responsibility for decisions that affect the daily lives of most people in the UK must be held accountable to the public for their performance. The main measures are as follows.

- The MPC is directly accountable to the Government for its performance. It is responsible for meeting the target and must provide an open explanation to the Chancellor and the public if inflation deviates more than one percentage point above or below target.

- The MPC is also responsible to Parliament via the appearances of members before the Treasury Committee and the House of Lords Select Committee.

- In addition, the MPC is responsible to the Bank's Court of Directors who are required to ensure that the MPC collects the regional, sectoral and other information needed to formulate monetary policy.

4.24 One of the major benefits of improved transparency is greater credibility of monetary policy. When people can follow the decisions of monetary policy authorities and know that these authorities will be held accountable for the inflation target, they have increased confidence that the target will be met.

Monetary policy is able to respond sensibly to shocks

4.25 Although the best way the MPC can support growth and employment is by delivering price stability, the monetary policy framework also allows some flexibility in certain circumstances. Any economy can at some point be subject to external events or temporary difficulties which can cause inflation to depart from the desired level. Attempts to restore inflation back to target too rapidly in such circumstances might cause undesirable volatility in output. For example, if the economy were subject to a large supply shock that pushed inflation temporarily above or below its target, the new framework would not require the MPC to over-react to keep inflation at its target level at the expense of substantial instability in output and employment. Rather, the MPC might choose to accommodate the first-round impact of the shock on the price level, while ensuring that this temporary deviation was not translated into a more permanent departure by inflation from the target.

4.26 While the new framework recognises the need for flexibility, it does not give the MPC a free hand. The framework makes clear that when inflation does deviate from target as a result of economic shocks, the onus is on the MPC to justify its actions. Further, if inflation is more than one percentage point below or above the inflation target, the Governor is required to write an open letter to the Chancellor, setting out:

- the reasons why inflation has moved so far away from the target;

- the policy action that is being taken to deal with it;

- the period in which inflation is expected to return to target; and

- how this approach meets the Government's objectives for growth and employment.

4.27 Another letter is required after three months if inflation remains more than one percentage point below or above target. It is important to note that an open letter would not necessarily be a sign of failure. For example, if the deviation was the result of a economic shock, the open letter provides a further, and immediate, means by which the MPC can explain the reasons behind its decisions.

Monetary and fiscal policy are co-ordinated

4.28 One potential concern with the new monetary policy framework is that central bank independence may lead to less effective co-ordination of fiscal and monetary policy. Some commentators have suggested that by separating responsibility for monetary and fiscal policy, the two sets of policy-makers would find it more difficult to have both arms of policy working in the same direction.

4.29 This view, however, is too simplistic. First, it fails to recognise that even if monetary and fiscal policy decisions are made by the same set of policy-makers, they may not be well co-ordinated. In the case of the UK, the IMF concluded in a recent report that,

> *". . . experience before 1997 shows that having both policy instruments under the control of the government provides no guarantee of effective policy coordination."*[4]

4.30 The view that central bank independence is likely to hinder monetary and fiscal policy co-ordination also fails to take into account the procedures in place to prevent this from happening. The new macroeconomic policy framework addresses the potential co-ordination problem in three main ways.

- Most importantly, co-ordination is achieved because the Government sets the objectives for both monetary and fiscal policy. Indeed, both arms of policy have the same fundamental objective of helping to achieve long-term growth and employment by delivering economic stability. Monetary policy does this by aiming to deliver price stability, while fiscal policy aims to deliver sound public finances.
- Because the objectives of both arms of policy are clear, and their procedures transparent, both sets of policy-makers are aware of what the other is trying to achieve and how the other will react to their policy decisions.
- This process is also aided by the presence at MPC meetings of a representative from HM Treasury, who is able, in particular, to provide information on fiscal policy.

4.31 These features ensure that the granting of operational independence to the Bank of England has not been done at the expense of effective co-ordination between monetary and fiscal policy. As the IMF concluded in May this year,

> *"...when independence accompanies a general move toward stable policies, as seems to be the case in the United Kingdom, the impact on macroeconomic stabilisation is likely to be positive."*[4]

[4] IMF (May 1999) "United Kingdom: Selected Issues" IMF Staff Country Report No. 99/44.

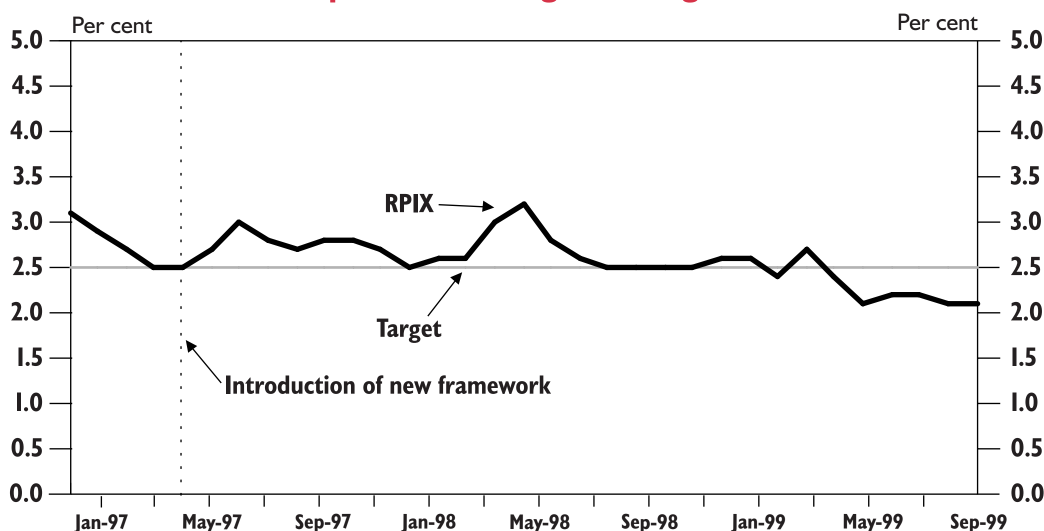
5 AN ASSESSMENT OF THE FRAMEWORK

Inflation has been low, stable and close to target

5.1 As Chart 7 shows, the UK's inflation record has been very good since the introduction of the new monetary policy framework. Between May 1997 and September 1999, RPIX inflation averaged 2.6 per cent, only slightly above the target.

5.2 Inflation has not only been low, it has also been stable. Since the introduction of the new framework, inflation has moved in a narrow band, between a low of 2.1 per cent and a high of 3.2 per cent. As a result of this performance, there has been no breach of the thresholds that trigger an open letter from the Governor to the Chancellor.

Chart 7: Inflation performance against target



5.3 Although this performance has been impressive, disinflationary pressures in the global economy over the last two years have helped to keep UK inflation low. It is also the case that the full effects of monetary policy decisions flow through to inflation with a lag. Nevertheless, it is clear that the MPC can take a good deal of the credit for keeping inflation low and stable over the last two and a half years. Over this period, there has been considerable instability in the global economy. The MPC's performance has built confidence in the new framework, which, as discussed below, has been reflected in a marked shift down in inflation expectations.

Policy-makers have been pro-active and forward-looking

5.4 The MPC has already established a track record of operating in a pro-active manner. There have been a number of examples of its willingness to act quickly and decisively to maintain price stability.

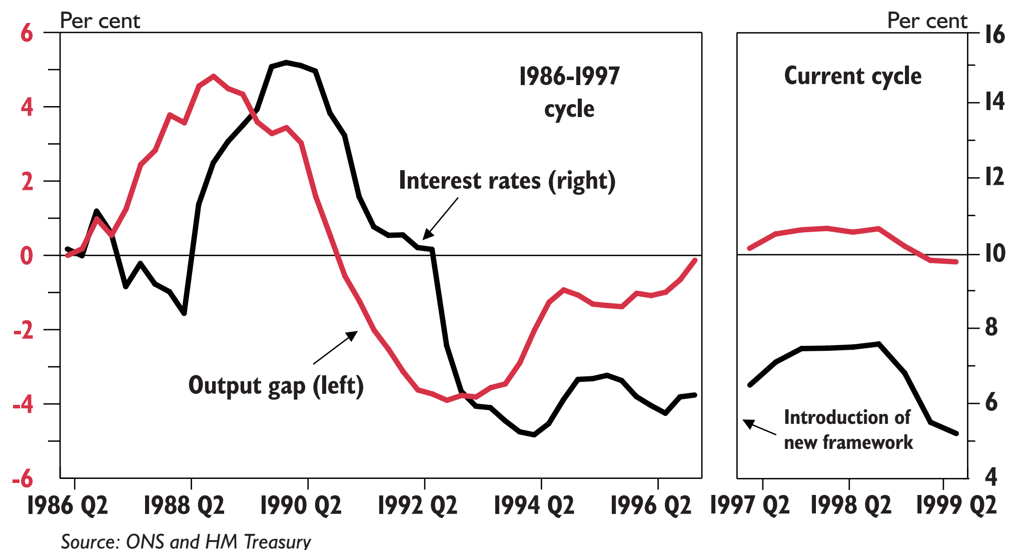
- Throughout mid and late 1997, the MPC raised interest rates four times to head off mounting inflationary pressures.
- Over late 1998 and the first half of 1999, the MPC cut rates aggressively, action that not only lessened the risk of a significant undershoot of the inflation target but has also been widely credited with helping to avoid a sharp slowdown in activity.
- The MPC's decision to raise rates in September 1999 at a time when actual inflation was below target again reflects its pro-active approach to monetary

policy. This decision was based on its assessment that a rise was necessary to keep inflation on track further ahead, and that an early move could lower the level at which interest rates might otherwise need to be set in future.

5.5 These examples demonstrate that the new monetary policy framework has allowed policy-makers to be forward-looking, avoiding the need for large changes in interest rates. Whereas rates peaked at 15 per cent for a year in the last cycle, they reached only 7½ per cent for four months this cycle. Lower interest rates, together with prudent fiscal management, means that the Government's debt interest payments will fall by over £4 billion this year alone.

5.6 Chart 8 demonstrates the extent to which monetary policy has operated in a more timely fashion since the introduction of the new framework. Under previous arrangements, policy-makers were slow to react to swings in the output gap, allowing the economy to gain (or lose) momentum before tightening or loosening policy. As a result, short-term interest rates were more extreme than they otherwise would have been. In the current cycle, however, the MPC has acted quickly so that interest rates have approximately matched developments in the output gap. Output has been much less volatile, and interest rates have not had to vary by as much as previously.

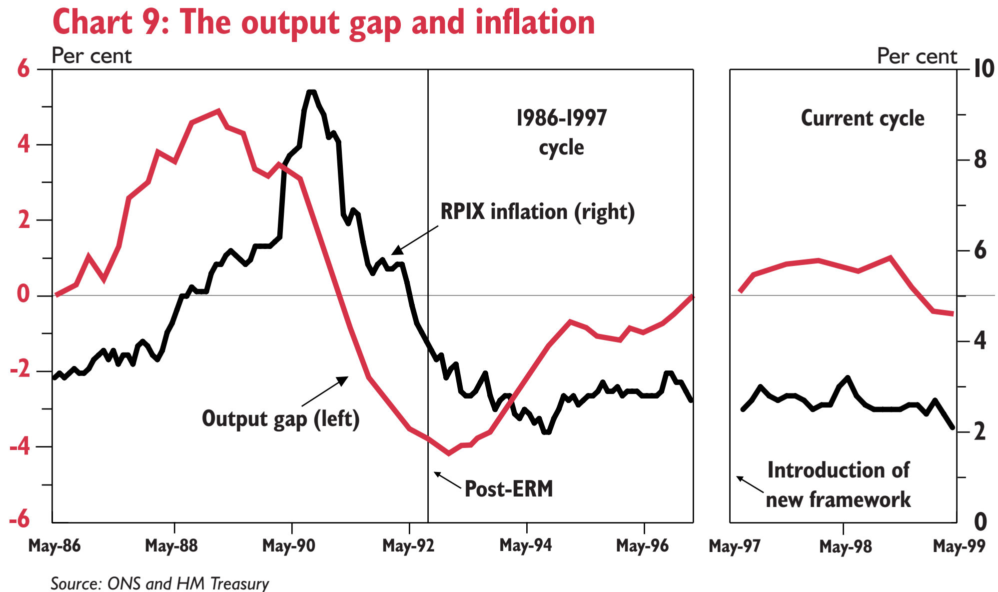
Chart 8: The output gap and interest rates



Source: ONS and HM Treasury

5.7 This pro-active and forward-looking approach has not only helped to smooth activity, but has also been instrumental in keeping inflation low and stable. As Chart 9 shows, both output and inflation have been significantly less volatile since the new framework was introduced, compared with previous regimes.

Chart 9: The output gap and inflation



Source: ONS and HM Treasury

Monetary policy has supported growth and employment

5.8 To date, there is evidence to suggest that the MPC has not only done a good job in delivering price stability but also in supporting the objective of high and stable levels of growth and employment. The box on the following page examines this point further. In contrast to the boom and bust of the past, the UK economy has enjoyed a period of stability and steady growth. This has taken place despite considerable instability in the global economy and has also been contrary to the expectations of many independent observers who forecasted a boom in 1997 and a recession in 1999.

Having independent experts, backed up by specific procedures, has worked well

5.9 The MPC – bringing together expertise from both within and outside the Bank of England – has played a major role in the success of the new framework. The quality of the members making up the MPC was recognised by the Treasury Committee which concluded that,

> *"...all the MPC members fulfil the criteria of demonstrable professional competence and personal independence."* [5]

5.10 This has been reflected in the thorough and complex debates that have characterised the MPC's deliberations. For example, the most recent set of published MPC minutes (those relating to the September 1999 meeting) illustrate that a wide range of economic and financial indicators are considered. These indicators include the state of the world economy, developments in monetary aggregates and financial markets, trends in domestic demand, the labour market and growth in earnings, and various measures of inflation and costs in specific parts of the economy. Its decisions are informed further by reports from the Bank's regional agents.

5.11 The Treasury Committee has also acknowledged the quality of the decision-making process in a recent report which examined the performance of the MPC over the first two years of its existence. The report said:

> *"The Chancellor's decision to transfer day to day control of monetary policy to a politically independent Bank of England has been vindicated so far in the transparency and technical quality of the process of decision making."* [6]

[5] Treasury Committee, Sixth Report, June 1998.
[6] Treasury Committee, Eighth Report, July 1999.

Measuring the success of monetary policy – the loss function

The MPC's remit is to achieve the Government's inflation target and to support the Government's objectives for growth and employment. One formal way of evaluating its performance, adopted by some academic economists, is to construct what is known as a loss function.

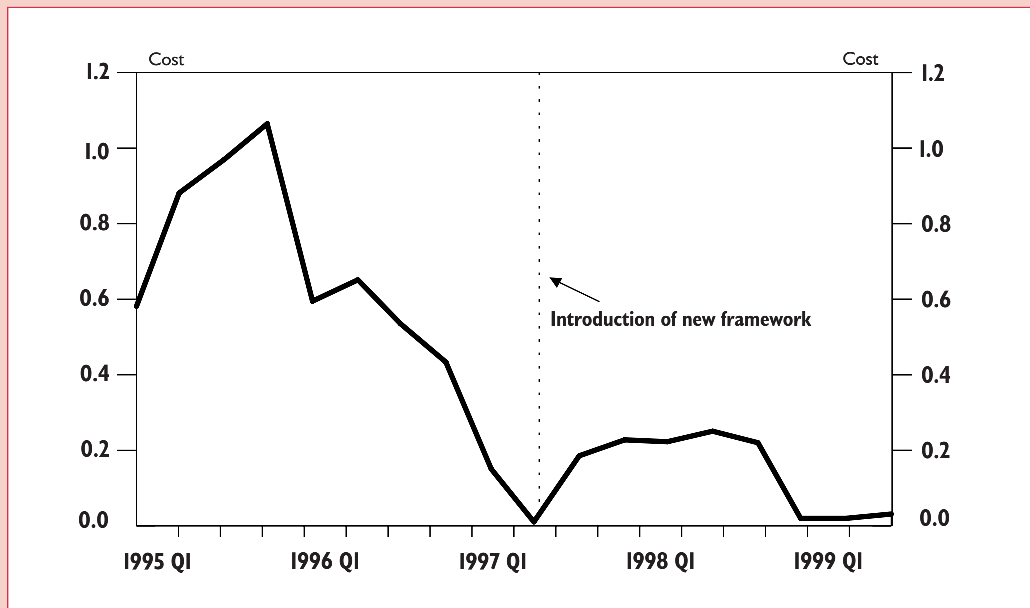
A loss function weights together the cost of deviations from a given state – in this case deviations of inflation from the target and deviations of output from trend. Formally, the quadratic loss function – which penalises larger deviations from target proportionately more than smaller deviations - can be written as:

$$L = \alpha_1(\pi - \pi^*)^2 + \alpha_2(Y - Y^*)^2$$

where:

L	=	cost
π	=	actual inflation
π^*	=	inflation target
Y	=	actual output
Y^*	=	trend output
$\alpha_{1,2}$	=	weights

The chart below calculates the loss function from 1995 Q1 to 1992 Q2, arbitrarily assuming equal weights on inflation and output stability and using 1999 Budget estimates.



The chart shows that the estimated loss has been negligible since the new framework was introduced. This contrasts sharply with the high loss recorded under previous arrangements, especially in the early 1990s. Whereas the loss has been well below one since the introduction of the new framework, the equivalent figure in the early 1990s was around eight.

Furthermore, the same report notes the success of the MPC in carrying out its duties:

> *"The MPC has had initial success in establishing credibility, in helping to ensure that inflation has been so close to target over the last six months, and in helping to manage the consequences for Britain of instability in the world economy."* [7]

5.12 The successful operation of the MPC vindicates the Government's decision to establish it in the way it did. It also supports the Government's commitment to continue to appoint members based on their experience and expertise in monetary policy.

Greater transparency and accountability has improved the credibility of monetary policy

5.13 One of the key themes of the new monetary policy framework is the need for greater transparency in order to facilitate accountability and build credibility. There is widespread recognition that the framework has delivered on this point. International authorities, such as the IMF and the OECD, have praised the transparency of the UK's monetary policy framework, while those parliamentary committees overseeing the work of the MPC have also commended the reporting and accountability arrangements. For example, the Lords Select Committee recently noted that,

> *"...both the Chancellor and the Governor have committed themselves fully to a policy of transparency which is unprecedented in this country or, as far as we know, elsewhere."* [8]

A similar point has also been made by the Treasury Committee.

> *"We welcome the clarity with which the minutes have explained potentially complicated policy decisions and the openness with which the MPC have discussed their decisions in their appearances before this committee."* [9]

5.14 There are also many signs that the MPC recognises the importance of transparency and is committed to achieving it. Although it is legally required to publish the minutes of its meetings within six weeks, last year the MPC decided to speed up that process. The minutes are now publicly available after two weeks.

5.15 One of the most important benefits of the enhanced transparency and accountability of the new monetary policy framework is that it has greatly improved the awareness of the aims and procedures of monetary policy. As a result, the monetary policy framework has established considerable credibility, with people increasingly expecting that price stability will be maintained. Four important quantitative measures of the credibility of monetary policy are:

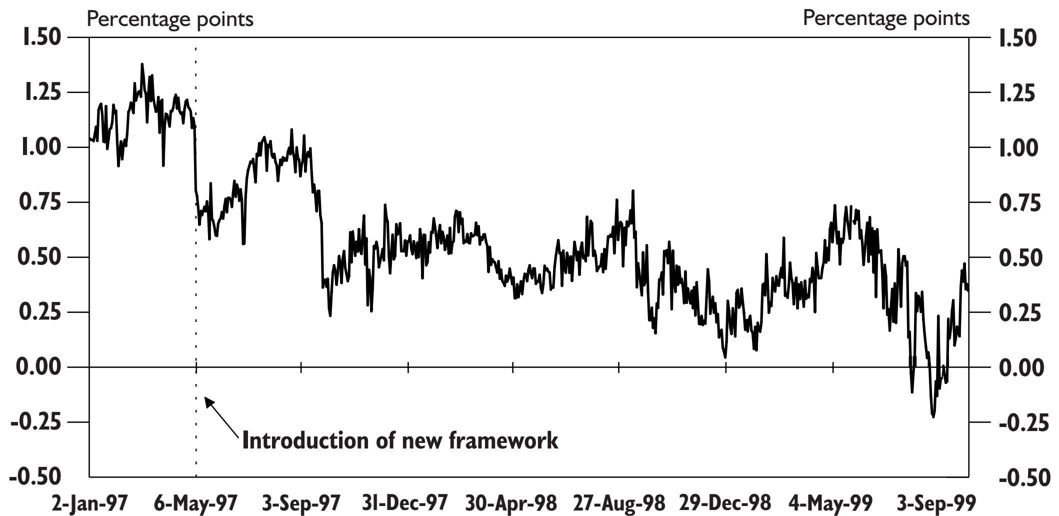
- long-term interest rate differentials;
- inflation expectations derived from index-linked and conventional gilts;
- independent forecasts of inflation; and
- the public's perception of inflation.

[7] Treasury Committee, Eighth Report, July 1999.
[8] Lords Select Committee, Report, July 1999.
[9] Treasury Committee, Eighth Report, July 1999.

Long-term interest rate differentials

5.16 Differentials between countries' bond rates reflect market expectations of inflation and other risk premia. In the past, yields on UK government bonds have typically exceeded those of other major countries, primarily because of the UK's poor inflation record. Chart 10 compares the five-year forward rates for UK and German government bonds.

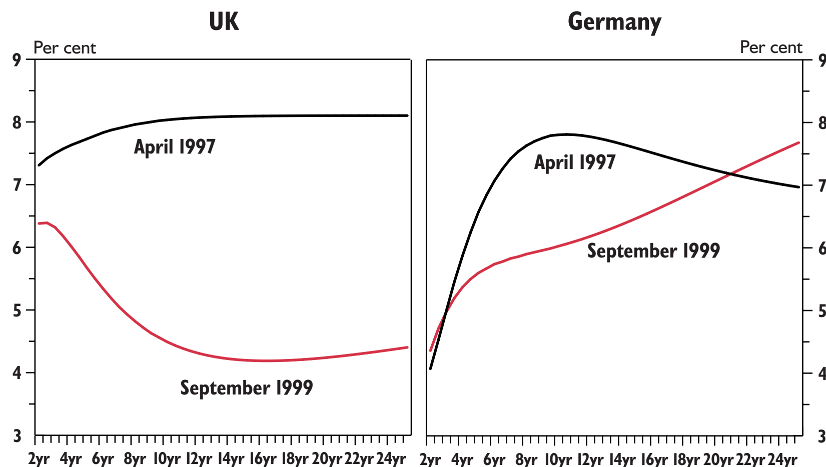
Chart 10: UK-German 5-year forward rate differential



5.17 Chart 10 shows that the spread between UK and German bonds dropped sharply after the introduction of the new monetary policy framework and has since trended down to historically low levels. This outcome reflects market confidence in the ability of the framework to deliver low inflation in the future.

5.18 Chart 11 shows the yield curve in April 1997, just before the new framework was introduced, and in September 1999 for both the UK and Germany. It shows that there has been a marked fall in UK forward rates across all maturities in the last two years. While there has also been an overall fall in German rates, the magnitude of this fall is much smaller, while at longer maturities, rates have actually risen. While other factors lie behind some of these changes, the data suggest that there has been a considerable fall in long-term inflation expectations for the UK compared with Germany.

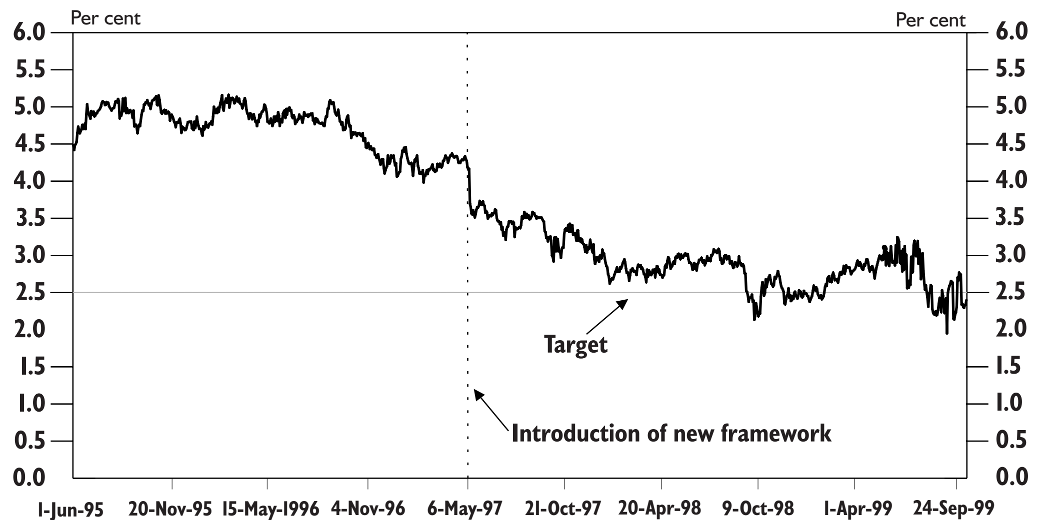
Chart 11: UK and German forward nominal interest rates



Inflation expectations derived from financial markets

5.19 Lower inflation expectations help to reduce the costs of maintaining low inflation. One way to derive inflation expectations from financial markets is to compare the yield curves for conventional and index-linked gilts. As Chart 12 shows, market expectations of inflation 10 years ahead immediately fell sharply from over 4 per cent on the introduction of the new framework, and have since fallen to a level close to the target, indicating that markets are confident that price stability will be maintained over the longer term.

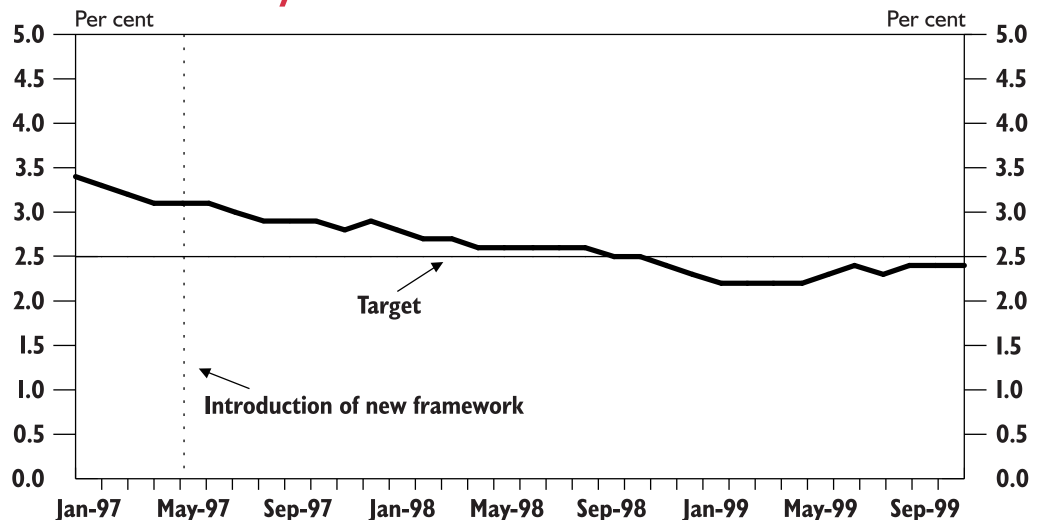
Chart 12: Inflation expectations 10 years ahead



Independent forecasts of inflation

5.20 Another indication of the credibility of the inflation target is given by the expectations of independent forecasters. Each month, HM Treasury collates the inflation forecasts of more than 30 independent organisations. Chart 13 plots the average forecast for RPIX inflation one year ahead made each month by those surveyed. It shows that the average inflation forecast has fallen substantially since the new framework was introduced, with forecasts remaining very close to the target for most of this time. This suggests that independent observers are confident in the ability of the MPC to act quickly to ensure that inflation is kept close to target.

Chart 13: Average of independent forecasts of RPIX inflation one year ahead

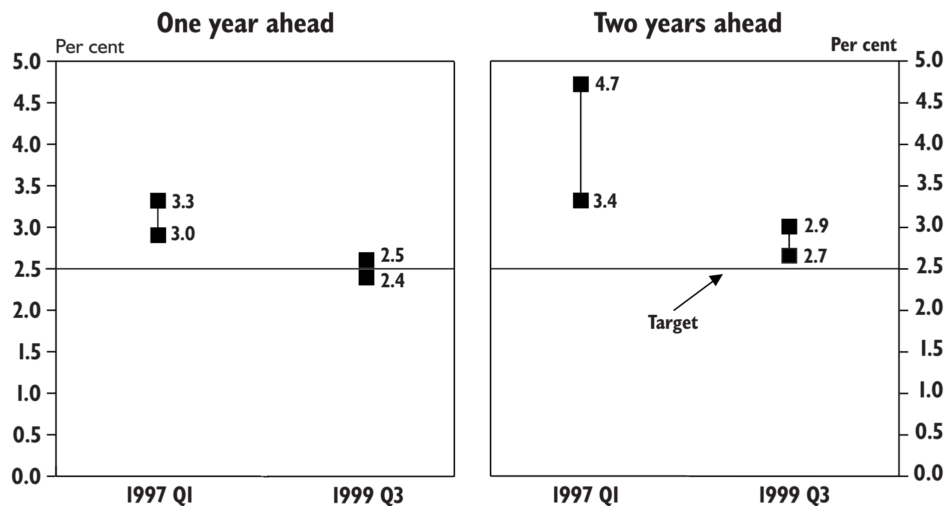


Source: HM Treasury

The public's perception of inflation

5.21 An important goal of the new framework is to reduce the public's expectations of future inflation. This is particularly relevant for the wage bargaining process. If those involved expect inflation will be low, this will help to moderate wage growth which is one of the key factors that influence inflation. Barclay's Basix survey provides a quarterly indication of the inflation expectations of a range of groups. Chart 14 shows that the inflation expectations of several key groups have both fallen and narrowed since the new framework was introduced.

Chart 14: Range of inflation expectations†



† *Includes business economists, academic economists, trade unions, finance directors, and investment analysts.*

Source: Barclays Basix survey

5.22 By contrast, the inflation expectations of the general public have not fallen greatly over this period. The Barclays Basix survey reports that the public's expectation of inflation two years ahead has fallen from 4.7 per cent just before the new framework was introduced to 4.3 per cent.

5.23 With the general public remaining somewhat sceptical that price stability will be maintained, policy-makers must continue to focus on meeting the inflation target and on promoting the low inflation message in order to show that the record over the last two years is not a temporary phenomenon. With this in mind, the Bank of England convened a working party, with the objective of determining how the Bank can build up a constituency for low inflation. The Bank is also examining the degree of public understanding of the inflation target to determine if this helps to explain why the general public's inflation expectations remain higher than in other sectors.

Monetary policy has responded sensibly to shocks

5.24 The UK economy and the new monetary policy framework has faced a difficult period over the past two years. Starting from a point in early 1997 when inflation pressures were rising sharply, due partly to the failure of the previous Government to heed the Bank of England's advice, policy-makers have also had to face challenges posed by considerable global instability, including a number of major financial crises, large swings in oil prices, and recessions in several countries. The implications of these factors have all had to be considered by the MPC when setting interest rates.

5.25 Monetary policy has reacted sensibly to these shocks, thus avoiding the boom and bust pattern of the past. This has been recognised by the Treasury Committee, which concluded that,

> *"...the MPC has had initial success in...helping to manage the consequences for Britain of instability in the world economy."* [10]

The Treasury Committee also noted that:

> *"Witnesses told us that survey evidence of the type seen in the second half of 1998 had in the past always been a strong indicator of an economic recession. In light of this, the actions of the MPC have helped to stave off recession."* [11]

5.26 This performance is not only a credit to the expertise and judgement of the MPC. It also demonstrates the benefits of the new framework which has been designed to give policy-makers a clear target and the ability to act in a forward-looking manner.

Fiscal policy has acted in concert with monetary policy

5.27 During this economic cycle, monetary and fiscal policy have worked in tandem to help deliver greater stability. Unlike in the last cycle, the tightening of the fiscal stance during 1997-98 supported monetary policy in containing the inflationary pressures which were emerging when the economy was above trend, at the same time restoring the public finances to a sound position. This was another factor that enabled interest rates to peak at a much lower level and subsequently to fall more quickly.

5.28 A similar role was played by fiscal policy as the economy moved below trend. Here, the automatic stabilisers have been allowed to play their role in supporting monetary policy, while ensuring the structural fiscal position has remained sound, supporting longer-term stability.

5.29 Comments made by both the Governor and the Chancellor illustrate that monetary and fiscal policy-makers are fully satisfied with the degree of co-ordination under the new framework. As the Governor said, when appearing before the Lords Select Committee on 26 January 1999,

> *"... I do not believe that the worry that there is not enough co-ordination between the monetary and fiscal side is a real one. I do not feel any discomfort on that score at all."*

This view was reiterated by the Chancellor at his Mansion House speech on June 10 1999, when he said,

> *"...today there is a much more informed discussion of the interaction of monetary and fiscal policy - and as a result much better co-ordination."*

[10] Treasury Committee, Eighth Report, July 1999.
[11] Treasury Committee, Eighth Report, July 1999.

6 Conclusions

6.1 Much of the poor inflation record of the UK over the last 30 years can be attributed to policy mistakes that were the result of numerous shortcomings in the design and conduct of monetary policy. Taking account of the lessons of these policy mistakes has been an important step forward.

6.2 The monetary policy framework established by the Government was specifically designed to address these problems. The new framework is based on a better understanding of the proper role of monetary policy and also recognises the need for clear objectives and procedures and for greater openness and transparency.

6.3 To date, this new framework has delivered good results. Inflation has been low, stable and close to target, while the economy has recorded solid growth and rising employment. All this has taken place during a period of instability in the global economy. The pro-active and forward-looking nature of the MPC has helped the UK to steer a course of stability and steady growth, in contrast to the boom and bust of the past.

6.4 While the success to date has been encouraging, the MPC must continue to perform well if inflation is to remain on target. Wage and price setters need to act responsibly so that real increases in wages and profits are consistent with improvements in economy-wide productivity. In addition, more could be done to communicate the aims and rationale of monetary policy to those sectors of society – such as households – whose inflation expectations, while lower than in the past, remain above the inflation target.

6.5 A pro-active monetary policy focussed on a symmetric inflation target, together with a prudent fiscal policy, provides the foundation for economic stability. The MPC's record so far in meeting the Government's inflation target, and supporting a more stable path for output and employment than in previous cycles, is a good one. Nonetheless, both the Government and the MPC recognise that it is important not to be complacent. A forward-looking and vigilant approach will continue to be needed to maintain this track record.

Annex: A guide to the Bank of England Act 1998

A.1 On 6 May 1997, within a week of taking office, the Chancellor of the Exchequer wrote to the Governor of the Bank of England, establishing a new monetary policy framework in which the Bank was given operational responsibility for setting interest rates to deliver price stability. After operating on a *de facto* basis for twelve months, this new regime was formalised by the *Bank of England Act,* which came into force in June 1998.

The relationship between the Government and the Bank of England

A.2 There is a clear distinction in the Act between the roles of the Government and the Bank. It is the Government's responsibility to decide what the objectives of monetary policy should be, while it is the role of the Bank to ensure that these objectives are met. The maintenance of price stability is the Bank's chief responsibility under the Act. Subject to this primary objective, however, the Act also requires the Bank to support the Government's economic policy objectives, including those for growth and employment. This makes it clear that price stability is not considered to be an end in itself, but is instead regarded as an integral part of the Government's overall economic strategy.

A.3 As well as providing the Bank with its objectives, the Government is also responsible for defining, on an annual basis, what is meant by price stability. In practice, this has been done by specifying a particular inflation target. The Act also requires the Government to inform the Bank what its economic policy objectives are.

A.4 Although the Act gives the Bank responsibility for the conduct of monetary policy, it grants HM Treasury reserve powers in certain exceptional circumstances. In particular, HM Treasury may give the Bank directions with respect to monetary policy if it is satisfied that they are required in the public interest and by 'extreme economic circumstances'.

The Monetary Policy Committee

A.5 The Bank's Monetary Policy Committee (MPC) has responsibility for ensuring the Government's monetary policy objectives are met. A remit to the MPC was first set in June 1997. The MPC's job is to set interest rates, on the basis of a majority vote, to achieve the inflation target it has been given.

A.6 The composition of the MPC is set out in detail in the Act. In particular, the Act specifies that the MPC consists of the Governor and two Deputy Governors of the Bank, two other internal members appointed by the Bank after consultation with the Chancellor, and four external members appointed by the Chancellor for three-year terms.

A.7 The two members appointed by the Bank are the Bank officials responsible for monetary policy analysis and monetary policy operations, while the four members appointed by the Chancellor must have knowledge or experience relevant to the MPC's functions. In addition, the Act also allows for a representative of HM Treasury to attend and speak at MPC meetings, but this representative has no vote. The MPC is required to meet at least once a month.

A.8 In addition to setting interest rates, the MPC is also able to conduct monetary policy by intervening directly in financial markets (but only where this furthers the achievement of the price stability objective). As part of the changes introduced with the Act, the Bank can now manage its own pool of foreign exchange reserves, separately from those it manages on behalf of HM Treasury. These reserves are available for use in operations related to monetary policy, subject to limits authorised by the Bank's Court of Directors.

A.9 Another means by which the Bank has been able to intervene in financial markets is via the weekly tender of Treasury bills. In April 1998, however, the newly formed Debt Management Office (DMO) took over responsibility for the management of the Government's debt and the oversight of the gilt market. Although the Bank currently retains responsibility for the weekly cash management of the Government's accounts, the DMO will take over this function in due course.

Transparency and accountability

A.10 The granting of operational independence to the Bank in the Act is accompanied by a range of measures aimed at improving the transparency and accountability of monetary policy.

A.11 One of the most obvious features of the monetary policy framework that helps to improve transparency and accountability is the nature of the inflation target, set in the remit from the Chancellor to the MPC. Because the target variable – RPIX inflation – is a high-profile, good quality, and widely understood economic indicator, it is clear to all parties what the MPC aims to achieve. The fact that the MPC has a point target – 2½ per cent – also makes it easy for the public and financial markets to monitor the MPC's performance. The inflation target is also the standard against which the MPC is held accountable to the Government.

A.12 Although it is the MPC's responsibility at all times to meet the inflation target that has been set, the monetary policy framework does recognise that the actual inflation rate will on occasions depart from its target as a result of various shocks and disturbances. The remit to the MPC requires the Governor to write an open letter to the Chancellor if inflation deviates from the target by more than one percentage point. Such a letter must contain an explanation for why this divergence has occurred, the policy action that is being taken to deal with the divergence, the period within which inflation is expected to return to target, and how this approach meets the Government's monetary policy objectives. Should this deviation persist for a further three months, a second letter is then required.

The MPC's reporting obligations

A.13 The Act imposes a range of reporting requirements on the MPC. These requirements not only improve the transparency and accountability of monetary policy, but also provide the means for the MPC to explain the reasoning behind its decisions and the factors that need to be considered.

A.14 The primary reporting obligation contained in the Act is the requirement that the MPC publishes the minutes of its meetings within six weeks. These minutes report the discussions that took place at the meeting, record how individual members voted on particular decisions, and also present, in an annex, a summary of the data presented by Bank staff to the MPC. If there is disagreement within the MPC about the appropriate decision, these differing views will all be published, thereby giving the public more information about the range of factors that need to be considered, as well as giving them an opportunity to judge for themselves whether or not the MPC made the right decision.

A.15 The minutes must also contain a record of decisions to intervene in financial markets, unless the MPC considers that publication would be likely to impede or frustrate the achievement of the intervention's purpose. If that is not the case, the minutes relating to the decision to intervene must be published within six weeks of the announcement of the intervention.

A.16 Provided it meets its statutory deadline of six weeks, the timing of the release of the minutes is a matter for the MPC to decide. In October 1998, the MPC decided to publish the MPC minutes two weeks after the meetings take place. By improving the timeliness with which information is made available, the MPC has further enhanced the public's ability to scrutinise and understand the conduct of monetary policy.

A.17 The Bank is also obliged under the Act to publish a report every three months that reviews recent monetary policy decisions, assesses developments in inflation, and indicates the expected approach to meeting the Bank's objectives. This requirement is met in the quarterly *Inflation Report*. This report serves two purposes – its preparation provides a comprehensive and forward-looking framework for discussion among MPC members, while its publication allows them to explain the reasons for their decisions. Preparation of the *Inflation Report* is supported by a statutory power to collect information for monetary policy purposes given to the Bank under the Act.

A.18 In addition to the material that it is obliged to contain, the *Inflation Report* also typically includes a detailed discussion of economic developments, including sections on money and financial markets, demand and output, the labour market, and costs and prices. The report also includes the minutes of recent MPC meetings and a record of MPC announcements.

Supervision of the MPC

A.19 The Act instructs the Court of Directors of the Bank, through a sub-committee of Non-Executive Directors, to keep under review the procedures followed by the MPC. This includes ensuring that the MPC collects the regional, sectoral and other information required to formulate monetary policy. In turn, the MPC is obliged to submit a monthly report on its activities to the Court of Directors.

A.20 The Act also requires the Bank to submit to the Chancellor of the Exchequer an annual report. This must include a report by the sub-committee of Non-Executive Directors on the activities of the MPC. The Chancellor is obliged to lay copies of the annual reports before Parliament.

A.21 In addition to the reporting obligations of the MPC, it is also subject to considerable scrutiny by the Parliament. The main avenue through which this scrutiny is exercised is the Treasury Committee, which has at least two sessions a year dedicated to monetary policy following publication of two of the four *Inflation Reports*. These sessions give Members of Parliament the opportunity to question Bank officials and MPC members on their decisions and their performance. Further opportunities for parliamentary scrutiny of the MPC's performance are provided by the House of Lords Select Committee on the MPC and by debates on the Bank's annual report.

Other aspects of the Act

A.22 In addition to formalising the new monetary policy framework, the *Bank of England Act* introduced a number of other measures. Most significantly, the Act provided for the transfer of the Bank's supervisory functions to the newly-established Financial Services Authority.

A.23 The Act also makes a number of changes to the Bank's administration and finances. In particular, the Act specifies that the Bank's Court of Directors is to consist of the Governor, two Deputy Governors, and sixteen Non-Executive Directors. The Act also provides for the formal creation of a Committee of all Non-Executive Directors, with a Chairman designated by the Chancellor. While the Court as a whole is responsible for managing the affairs of the Bank, including setting its objectives and strategy, the Committee of Non-Executive Directors is responsible for reviewing the Bank's performance in relation to the objectives and strategy, and its financial affairs.

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