ECONOMIC POLICY IN THE UK

MACROECONOMIC POLICY

'INFLATION TARGETRY' IN PRACTICE

Summary

In 1992 the UK adopted an inflation target. This lecture discusses the development of inflation targeting since then. The monthly policymaking process is described, including how this has changed under the Labour government. In the next few lectures we will investigate various characterisations of inflation targeting, assess the performance of this regime, discuss the best specification for an inflation target and compare inflation targeting to other possible macro policy regimes.

Reading

Influential Bank views
King, Mervyn (2005) "Monetary Policy: Practice Ahead of Theory"
http://www.bankofengland.co.uk/publications/speeches/2005/speech245.pdf
King, Mervyn (2002) "The Monetary Policy Committee Five Years On",
http://www.bankofengland.co.uk/publications/speeches/2002/speech172.pdf
King, Mervyn (2000), "Monetary policy: theory in practice",
http://www.bankofengland.co.uk/publications/speeches/2000/speech67.htm
King, Mervyn (1997) "The Inflation Target Five Years On"
http://www.bankofengland.co.uk/publications/speeches/1997/speech09.pdf

Other useful Bank papers
Walton, David (2005) "Monetary policy challenges facing a new MPC member"
http://www.bankofengland.co.uk/publications/speeches/2005/speech254.pdf
Bell, Marian (2005), "Communicating monetary policy in practice"
http://www.bankofengland.co.uk/publications/speeches/2005/speech244.pdf

Institutional (but also contain assessments & principles)
Key dates since 1990: http://www.bankofengland.co.uk/monetarypolicy/history.htm
Monetary policy framework: http://www.bankofengland.co.uk/monetarypolicy/framework.htm
BoE Core Purposes: http://www.bankofengland.co.uk/about/corepurposes/index.htm
MPC: http://www.bankofengland.co.uk/monetarypolicy/overview.htm
Rodgers, Peter (1998), "The Bank of England Act", *Bank of England Quarterly Bulletin*, (May) 93-9.
Bank of England Act 1998 as it relates to monetary policy: http://www.hmso.gov.uk/acts/acts1998/80011--b.htm
Remit letters: http://www.bankofengland.co.uk/monetarypolicy/remit.htm
Governor's 1997 Mansion House speech given a month after the Bank gained operational independence:
http://www.bankofengland.co.uk/publications/speeches/1997/speech04.htm
Latest Inflation and GDP forecasts: http://www.bankofengland.co.uk/publications/inflationreport/irfanch.htm
For a low-level but approachable summary of policy issues, see
http://www.bankofengland.co.uk/targettwopointzero/mpframework/index.htm

Conjunctural
Bank of England (various), "Agents' summary of business conditions"
http://www.bankofengland.co.uk/publications/agentssummary/index.htm
Bank of England (various), "Inflation Report"
http://www.bankofengland.co.uk/publications/inflationreport/index.htm
Bank of England (various), "Monetary Policy Committee Minutes"
http://www.bankofengland.co.uk/publications/minutes/mpc/index.htm

‘INFLATION TARGETRY’ IN PRACTICE

- **Background: UK left ERM 16 September 1992**.

The initial inflation target regime

- **Inflation target first adopted October 1992**.
  Norman Lamont, then Chancellor of the Exchequer, wrote to the Chairman of the TSC (Treasury Select Committee of Parliament) on 8 October setting out **new framework for monetary policy “to replace that hitherto provided by the ERM”**.

Lamont’s letter set out the details of the **first inflation target**:
“I believe we should set ourselves the **specific aim of bringing underlying inflation in the UK, measured by the change in retail prices excluding mortgage interest payments, down** to levels that match the best in Europe. To achieve this, I believe we need to aim at a **rate of inflation in the long term of 2% or less**.”
“For the **remainder of this Parliament**, I propose to set ourselves the objective of keeping **underlying inflation within a range of 1%-4%**, and I believe **by the end of the Parliament we need to be in the lower part of the range**”.

In sum, the *first* target encompassed 3 objectives for underlying inflation:
- between 1% and 4% until Spring 1997
- between 1% and 2.5% in Spring 1997
- below 2% in long term (this last objective was dropped pretty quickly).

Interest rate decisions were still made by Chancellor ‘in light of advice given by the Governor’. Governor was advised by Bank officials. BoE had monthly ***Monetary Review Committee*** **meetings prior to Chancellor-Governor meetings**. **Bank operated in money markets to set interest rates**.
- These changes necessitated that the **existence of monthly meetings** between Governor and Chancellor was **admitted and formalised**.

What did the new regime mean for the targeting of other macro variables?
- **No target range for the exchange rate** (nor a value that was shadowed).
- Autumn Statement 1992 defined **monitoring ranges (not targets) for narrow and broad money** (M0 and M4). Movements outside monitoring ranges would not be sufficient on their own to justify changes in interest rates.

There were some apparently minor, but significant, changes to the regime between 1993 and 1997

First **Inflation Report** published by the Bank in Feb 1993.

From 1993, Bank had discretion over timing of interest rate changes - within limit that change has to be implemented by next meeting. This change was designed to allay fears that timing might be affected by (very) short term political considerations - e.g. timing of local gov’t elections. In practice, changes happened on the day (or certainly within a few days) of the Chancellor-Governor meeting (otherwise markets get upset).

Treasury Select Committee (TSC) **recommended publication of minutes** of Governor-Chancellor meeting. Chancellor decided to do so in **April 1994**. Minutes were **published 2 weeks after *next* meeting = 6 weeks delay (cp. 30 years**, previously).

First major **'restatement' of target** came in Conservative Chancellor Ken Clarke's 1995 Mansion House speech. Announced objective of keeping underlying inflation **"2.5% or less" beyond Spring 1997**. Chancellor predicted that this **implied keeping inflation between 1% and 4% most of the time** - although shocks might push inflation higher when it was too late for policymakers to react (i.e. within approx. 2 year horizon). Bank Chief Economist Mervyn King's (September 1995) interpretation: inflation **target would be satisfied if inflation averaged 2.5% or less *over a long period***.

- Note change of emphasis away from band: range was then thought of as allowing for shocks, rather than as forming target - target was focused on 2.5% (or less). One difference: original implication was action as soon as 4% was exceeded, whereas this was clearly not the case after 1995.
- **Interest rate decisions were still taken by Chancellor**.

Central bank independence and other changes by the incoming Labour government in 1997

A fundamental **change in the regime** came on **6 May 1997**, as new Labour Chancellor of the Exchequer, Gordon Brown, announced that the Government was giving the Bank **operational responsibility for setting interest rates (instrument independence)** and would introduce legislation as soon as possible. The only caveat to the Bank's independence is that **if in extreme circumstances the national interest demands it, the Government has the power to give instructions to the Bank on interest rates for a limited period**.

The **Bank of England Act 1998** (amending 1946 Act) came into force on 1 June 1998.
This restated that the Bank's monetary policy **objective** is to deliver **price stability (as defined by the Government's inflation target** (so BoE does **not have goal independence**)) and, **without prejudice to that objective, to support the Government's economic policy, including its objectives for growth and employment**. Thus made explicit for first time fact that BoE required to design policy to aid employment & growth, subject to aiming to hit inflation target.

In 1997 the price stability objective was to achieve **underlying inflation as measured by the RPI excluding mortgage interest rates of 2.5%**.

If inflation is more than 1 percentage point higher or lower than the target, the Bank will be required to publish an open letter explaining why inflation has deviated from the target and what actions it intends to take to get it back to target.

- Note the increased emphasis on a **point target –** BoE argues that the target involves no band or range. The specification of the target is **symmetric**. Why? Perhaps the original '2.5% or less' could have been interpreted as setting a ceiling but no floor, so it might have been difficult to hold the Bank accountable if it pursued an overly restrictive policy and undershot the target by a wide margin. Previous target was a bit ambiguous, and hence confusing, and maybe not so good as an 'expectations anchor'.

Each year the Chancellor must restate the inflation target in his Budget statement. Until 2003, the target was always reconfirmed as it was set out in the 1998 remit.

CPI

In 2003 the Chancellor changed the inflation target to one expressed in terms of an annual rate for inflation as measured by the 'harmonised' Consumer Prices Index (**CPI**), instead of RPIX. The target was chosen to be **2% CPI inflation**. This should be achieved **'at all times'**.

RPIX and CPI differ in terms of composition. Importantly, RPIX includes a measure of owner-occupied housing costs, buildings insurance and Council Tax, all of which are currently excluded from the CPI. Together, these costs account for around 9% of the RPIX basket of goods and services. In addition, some goods and services appear in both baskets but are measured in different ways. E.g. cars: the RPIX uses only second-hand car prices, while the CPI uses new and second-hand prices.

RPIX and CPI also differ in terms of coverage. In order to make the chosen basket of goods and services closer to that of an 'average' UK household, the RPIX excludes expenditure by the highest 4% of earners, and pensioners largely on benefits, and residents of institutions. The CPI includes the expenditure of all private households and residents, as well as foreign visitors to the UK, so takes account of spending by all consumers.

RPIX and CPI differ in how they combine disaggregate price information into an aggregate index. The RPIX uses an arithmetical averaging procedure for the 60% of goods and services that do not have sufficiently disaggregated expenditure information to allow direct inclusion in the aggregate index. In contrast, the CPI uses geometric averaging. The latter was introduced about 3 years ago by the US Fed, is generally thought to be a better method, and tends to reduce measured inflation by around 0.5 p.p. (this difference has been constant over time).

At the time of the change in the index, RPIX inflation had been higher than CPI inflation for some time. There was some concern among commentators that the equivalent inflation target using the CPI was lower than for a RPIX target. The contribution of housing costs to the RPIX had been particularly large and has been the main source of the gap between the two indices. As house price inflation has subsided, the gap has shrunk. CPI is not necessarily a finalised index – e.g. there are moves in Europe to somehow include housing costs in the index.

Other features of the targeting regime

Exchange rate policy: the Government is still responsible for determining the exchange rate regime. The Bank now has its own separate pool of foreign exchange reserves that it can use at its discretion to intervene in support of its monetary policy objective. If the Government so instructs, the Bank, acting as its agent, will intervene in the foreign exchange markets by buying or selling the Government's foreign exchange reserves.

Funding the **national debt**: the Bank's role as the Government's agent for debt management, the sale of gilts, oversight of the gilts market and cash management was transferred to the Treasury.

MPC

In May 1997, the **Monetary Policy Committee** was set up at Bank to take interest rate decisions. Usually meets monthly, on Weds & Thurs after first Monday of each month. One-person, one-vote, but Governor has a second, casting, vote in event of a tie. **Decisions** announced at 12 noon on the second day of each meeting, after Chancellor has been informed.

The MPC should comprise **9 members**, but recently there have been some vacancies lasting for several months:

The Governor	Mr Mervyn King
Two Deputy Governors	Ms Rachel Lomax
	Sir John Gieve
Two Bank Executive Directors	Mr Charles Bean
	Mr Paul Tucker
Four experts appointed by the Chancellor	Ms Kate Barker
	Professor David Blanchflower
	Professor Tim Besley
	Dr Andrew Sentance

The Treasury has the right to be represented in a non-voting capacity.

[The Governor has a 5-year term; Mervyn's first term expires 30 June 2008. Two of the MPC members take management responsibility for monetary policy and market operations, respectively Bean and Tucker. They are appointed by the Governor, after consultation with the Chancellor, for three year terms. The four 'external' members are appointed by the Chancellor, again for three year terms. They are 'recognised experts'. They are allowed to engage, with the Chancellor's approval, in other activities that do not give rise to a conflict of interest.]

Accountabilty

The functions and appointment arrangements of the MPC and Court (see below) were intended to enhance accountability, as was the fact that the Government is accountable to Parliament for economic policy, including the setting of the inflation target.

The Bank of England reports to the House of Commons, through the **Treasury Select Committee**. This is intended to provide accountability in relation to the Bank's first 'core purpose' (monetary policy). [Core Purpose 1: Maintaining the integrity and value of the currency; Core Purpose 2: Maintaining the stability of the financial system, both domestic and international; Core Purpose 3: Seeking to ensure the effectiveness of the UK's financial services.]

The **Court** (of Directors) of the Bank of England manages/ensures accountability for all the Bank's affairs except monetary policy (i.e. for the second and third of the Bank's 'core purposes'). Court comprises 19 members consisting of the Governor, his two Deputies, and 16 non-Executive Members. Supposed to be 'representative of the whole of the United Kingdom'. The 16 non-Executive Members of Court are appointed for their expertise, for three year terms, and are supposed to be drawn widely from industry, commerce and finance. They form **NedCo**, whose job it is to review the performance of the Bank as a whole, including the Monetary Policy Committee. They have particular regard to whether the Bank is collecting proper regional and sectoral information for the purposes of monetary policy formation. In addition, they are responsible for ensuring that the internal financial affairs of the Bank are properly conducted.

Transparency

MPC meeting info: Since 1998 the **MPC minutes** have been published 2 weeks after the meeting. (The Bank of England Act 1998 says that the Bank "shall publish minutes of the [MPC] meeting before the end of the period of 6 weeks beginning with the day of the meeting.") Governor explained rationale for earlier publication in letter to Giles Radice, Chair of TSC. Con: market uncertainty might be exaggerated (large fluctuations) if the period of uncertainty is short. Pro: Transparency and clarity. Also, efficiency considerations can imply it's better if market knows earlier what factors influenced decision.

The MPC voting records are now published http://www.bankofengland.co.uk/monetarypolicy/mpcvoting.xls or e.g. http://www.bankofengland.co.uk/monetarypolicy/decisions/decisions06.htm).

There is still no *attribution* of particular views to MPC members beyond their voting records, although the Minutes have increasingly been willing to make it clear when MPC members' views differed on certain issues.

The Bank issues a press release to accompany the announcement of the MPC's decision. When the rate changes, a summary of the reasons why is given. When there is no rate change, no explanation is given.

Every 3 months the Bank publishes an *Inflation Report*. In part, this collects together the information contained in the three relevant Minutes (with emphasis on the latest decision). Importantly, it is only with the *Inflation Report* that the **inflation forecast** is published (alongside a GDP forecast). The consensus view in the UK is that this forecast is a key part of the current monetary policy regime, but there are dissenters from this view (see Bofinger (2001)).

Since August 2003, the Bank has published (in the form of a WebCast) the Press Conference held alongside publication of the *Inflation Report*. This is another step towards transparency. The Press Conference is led by the Governor, Mervyn King. He argues that he represents the collective view of the MPC, the view that is embodied in the Inflation Report.

The MPC goes into 'purdah' for eight days from the Friday before the MPC meeting to the Friday immediately after the announcement. (When the Inflation Report publication and press conference take place (February, May, August and November) the purdah extends to midnight at the end of the day of publication.) During purdah they avoid giving speeches and speaking to the media etc, on or off the record, about policy, the economy, etc.

We shall examine the inflation forecast further in future lectures, after first looking at the theory, in the form of **the correct definition of an inflation targeting regime** and issues relating to the **optimal design of an inflation target**.

KEY MONETARY POLICY DATES SINCE 1990

Source: http://www.bankofengland.co.uk/monetarypolicy/history.htm

18.10.90 Britain joins Exchange Rate Mechanism (ERM) at Deutsche Mark 2.95.

16.09.92 Britain's membership of the Exchange Rate Mechanism (ERM) suspended.

08.10.92 First inflation target – rate of annual RPIX inflation of 1-4%. Bank asked to assess inflation prospects every quarter in independent report. Government objective for inflation to be in lower half of range by end of that Parliament.

10.12.92 1st Monthly Monetary Report, an overview of the current economic situation, published by the Treasury for monthly meeting between Chancellor of the Exchequer and Governor of the Bank of England.

16.02.93 First Inflation Report published by the Bank of England.

13.04.94 Minutes of Chancellor's meeting with Bank of England Governor first published.

14.06.95 Chancellor of the Exchequer in Mansion House speech announced an inflation target of 2.5% or less as measured by RPIX.

06.05.97 Bank of England given operational independence and creation of MPC announced.

05.06.97 First meeting of the Monetary Policy Committee.

12.06.97 Chancellor of the Exchequer in Mansion House speech outlines remit for the MPC's symmetrical target of 2.5% annual RPIX inflation and system of accountability.

27.11.97 Treasury Select Committee holds its first Inflation Report hearing.

01.06.98 Bank of England Act comes into force.

16.06.98 Treasury Select Committee holds first of its 'confirmation hearings' for MPC members.

21.10.98 Period between MPC decisions and publication of minutes reduced to two weeks.

07.12.98 House of Lords sets up its Select Committee on the Monetary Policy of the Bank Of England.

07.03.01 House of Lords sets up its Select Committee on Economic Affairs to replace its Select Committee on the Monetary Policy of the Bank of England.

09.04.03 Chancellor of the Exchequer's Budget speech announces Government's intention to switch to an inflation target measured by the Consumer Price Index (also known as HICP).

10.12.03 Chancellor announces switch of inflation target to 2% annual change as measured by Consumer Price Index (also known as HICP).

News Release
Bank of England Raises Bank Rate by 0.25 Percentage Points to 4.75%

3 August 2006

The Bank of England's Monetary Policy Committee today voted to raise the official Bank rate paid on commercial bank reserves by 0.25 percentage points to 4.75%.

The pace of economic activity has quickened in the past few months. Household spending appears to have recovered from its post-Christmas dip. Business investment growth and investment intentions have also picked up. In the United Kingdom 's main export markets growth has remained robust. As a result, over the past few quarters GDP growth has been at, or a little above, its long-run average and business surveys point to continued firm growth. The margin of spare capacity in the economy appears small.

CPI inflation picked up to 2.5% in June, and is expected to remain above the 2.0% target for some while. Higher energy prices have led to greater inflationary pressures, notwithstanding muted earnings growth and a squeeze on profit margins. Although the path of energy prices is extremely uncertain, energy price inflation is expected to moderate in the medium term. But some recovery in profit margins and pay growth is likely to mean that consumer price inflation will move only gradually back to the target.

Against the background of firm growth, limited spare capacity, rapid growth of broad money and credit, and with inflation likely to remain above the target for some while, the Committee judged that an increase of 0.25 percentage points in the official Bank rate to 4.75% was necessary to bring CPI inflation back to the target in the medium term.

The Committee's latest inflation and output projections will appear in the Inflation Report to be published on Wednesday 9 August.

The minutes of the meeting will be published at 9.30am on Wednesday 16 August.

Note to Editors

The previous change in interest rates was a reduction of 0.25 percentage points to 4.5% on 4 August 2005.

News Release
Bank of England Maintains Interest Rates at 4.75%

7 September 2006

The Bank of England's Monetary Policy Committee today voted to maintain the official Bank rate paid on commercial bank reserves at 4.75%.

The minutes of the meeting will be published at 9.30am on Wednesday 20 September.

Note to Editors

The previous change in interest rates was an increase of 0.25 percentage points to 4.75% on 3 August 2006.

VOTING BY THE MONETARY POLICY COMMITTEE - 2006

Last Updated 20 September 2006

	Voted to Increase	Voted to Reduce	Voted to Maintain	Meetings Attended	12-Jan-06	09-Feb-06	09-Mar-06	06-Apr-06	04-May-06	08-Jun-06	06-Jul-06	03-Aug-06	07-Sep-06
Mervyn King, Governor	1	0	8	**9**								0.25%	
Rachel Lomax, Deputy Governor	1	0	8	**9**								0.25%	
Sir Andrew Large, Deputy Governor	0	0	1	**1**									
Paul Tucker	1	0	8	**9**								0.25%	
Charles Bean	1	0	8	**9**								0.25%	
Kate Barker	1	0	8	**9**								0.25%	
Stephen Nickell	0	5	0	**5**	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%				
Richard Lambert	0	0	3	**3**									
David Walton	2	0	4	**6**					0.25%	0.25%			
Sir John Gieve, Deputy Governor	1	0	7	**8**								0.25%	
David Blanchflower	0	0	4	**4**									
Tim Besley	0	0	1	**1**									
Interest rate					4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.75%	4.75%

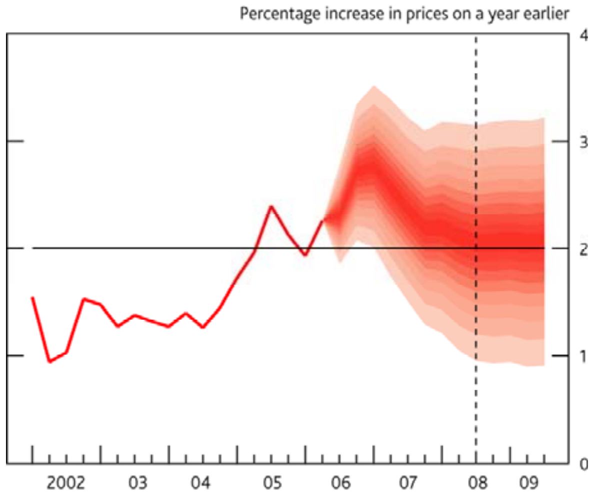
Increased
Maintained
Reduced

Interest Rates in 2006
Increased 1 times
Reduced 0 times
Maintained 8 times

Inflation Report Fan Charts - for August 2006 and May 2006 Reports

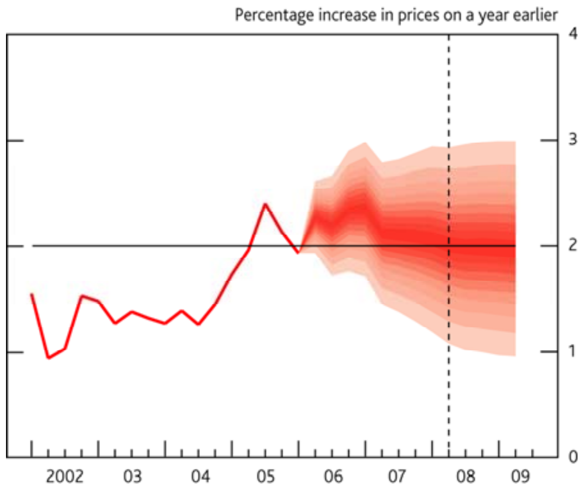
August 2006 CPI fan chart

Chart 5.3 Current CPI inflation projection based on market interest rate expectations



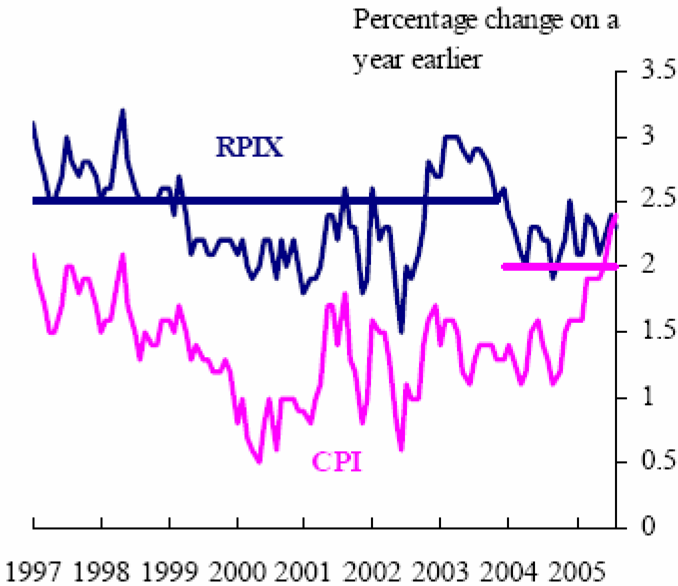
May 2006 CPI fan chart

Chart 5.4 CPI inflation projection in May based on market interest rate expectations



Charts 5.3 and 5.4 The fan charts depict the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan charts are constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan charts on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents. The dashed lines are drawn at the respective two-year points.

Chart 4: CPI and RPIX inflation*



*Until December 2003, the target for monetary policy was 2.5% for RPIX inflation. Since then, the target has been 2.0% for CPI inflation