Evolution of the monetary framework

*The **Governor** reviews[1] developments in the monetary policy framework since the first Loughborough Lecture on financial change and broad money, given by Robin Leigh-Pemberton ten years ago. The **Governor** describes the immediate aftermath of the abandonment of broad money targeting, and the United Kingdom's experience with exchange rate targeting including the ERM. Finally, he describes the present monetary framework, based on an inflation target, and the role of the Bank of England in it.*

Introduction

I am delighted to return to Loughborough this evening to deliver this year's Loughborough University Banking Lecture.

I remember, very well, the occasion of the first Loughborough Lecture ten years ago delivered by my predecessor, Robin Leigh-Pemberton, now Lord Kingsdown. That original lecture had the somewhat technical title 'Financial change and broad money'. As that title suggests, it was not much about the broad objectives of monetary policy. It was about the operational framework for conducting monetary policy. It described in particular the problems we had experienced with a policy framework based largely on intermediate targets for broad money during a period of rapid change in financial behaviour.

Those problems had arisen because the short-term relationship between the broad monetary aggregates and inflation had not been sufficiently robust to serve as a reliable guide to policy. Important changes to the monetary framework then followed: the exchange rate became an increasing focus of policy in 1987 and it became the explicit policy anchor with our entry into the ERM in 1990; then, in 1992, when we were driven out of the ERM, we moved to the present policy framework of an explicit inflation target.

My lecture this evening will follow on from that of my predecessor and explain how and why the monetary framework has evolved in this way. I will also explain the present framework in some detail.

The final objective of monetary policy

But before I embark on that let me just emphasise at the outset that however much the operational policy framework has changed—and there are considerable differences between the way we sought to implement policy then and now—the final objective of policy has *not* changed.

To quote from that earlier lecture:

'The fundamental objective of policy remains . . . to squeeze out inflation progressively and to create a stable basis for the operation of the economy. That is the contribution towards the achievement of wider national economic goals that is to be looked for from monetary policy'.

I am happy to stick with that statement today—indeed in substance it is now very much the received wisdom both internationally and across much of the political spectrum within countries.

The underlying point is that inflation reflects emerging imbalance between monetary demand and the capacity of the economy to meet that demand. It generates uncertainty as to how far it will go, how long it will last, and what action will ultimately be needed to bring it under control. That uncertainty distorts savings and investment decisions—which tend to place excessive weight on the short term; and it obscures the relative price signals that are necessary to efficient resource allocation. So it damages our long-term economic performance.

That in brief is the substance behind the central bankers' mantra—that control of inflation is a necessary condition for sustainable growth, and the biggest contribution that monetary policy can make to our long-term economic performance. But it is important to recognise that 'controlling inflation' is in effect short-hand for seeking to preserve economic stability (avoid imbalance between demand and supply) in a much broader sense.

The policy framework from 1986 to 1992

I will take this objective as given in the rest of my lecture. The question I want to come on to is how we try to achieve it.

Monetary targeting to discretion

Let me begin by referring back to the breakdown of the framework of monetary targets which had spanned the late-1970s to mid-1980s. It is important to remember that in terms of the final objective—bringing down inflation—policy was actually reasonably successful during this period. The difficulty we had was in controlling the monetary aggregates themselves, which was supposed to be the intermediate stage in controlling inflation. In practice,

(1) In a lecture given at Loughborough University on Thursday, 7 November 1996.

against the background of financial deregulation and related changes to financial behaviour, and despite making frequent changes to the precise form of the targets, we had repeatedly to over-ride the message the monetary aggregates appeared to be giving. One might think that this would not have mattered if the final objective was being achieved. In one sense this is right. The problem was that our repeated failure to achieve the intermediate targets undermined public confidence in the policy framework as a whole, including our continuing commitment to low inflation, and that clearly was important given that the final objective was to reduce uncertainty about the future.

We had in fact effectively given up the attempt to find a stable short-term relationship between money growth and nominal income or inflation, which could provide us with a reliable guide to policy by the time of the first Loughborough Lecture. And although we have continued ever since to monitor very closely the behaviour of all the monetary—and credit—aggregates, including the sectoral breakdown between persons, industrial and commercial companies and other financial institutions, for what insights they can give us to the behaviour of the economy, formal broad monetary targets were abandoned in the 1987 Medium Term Financial Strategy (MTFS). A target was retained for narrow money and we continued as I say to monitor broad money, but relatively more emphasis than before was placed on a range of other indicators, including the exchange rate and the growth of money income (nominal GDP). In effect, this more eclectic approach—in practice we looked at a wide range of both real economic and monetary and financial evidence—merely confirmed what we had been doing already, and it foreshadowed in many ways our current approach. But coming in the wake of a regime in which there had been an explicit intermediate broad money target, which purported to be of special importance, this approach led to confusion as to which indicator we attached particular weight to at any particular time.

Discretion to the exchange rate

This perceived lack of clarity was difficult to sustain, and there was a continuing instinct to develop a new monetary policy rule. Quite soon, through the summer of 1987, the exchange rate came to dominate policy. The idea essentially was that, just as other major European countries were successfully aiming to hold inflation down by anchoring their currencies to the Deutsche Mark through the ERM, we too could 'lock in' to Germany's enviable record of sustained low inflation even without actually becoming a member of the mechanism. This approach of 'shadowing the Deutsche Mark' was never formally adopted or announced, but it became clear in practice that our exchange rate against the Deutsche Mark, which had fallen very sharply, from DM 4.00 in July 1985 to DM 2.74 at the beginning of February 1987 before the election in May, was not subsequently to be allowed to recover to above DM 3.00, even though this meant cutting interest rates, by 2.5% in 1987 (from 11% to 8.5% by January 1988), in order to prevent it.

I don't suggest that this was the only influence on policy over this period, which covered the stock market crash, for example. But it was certainly an important influence. It had the effect of accommodating the inflationary consequences of the earlier depreciation—indeed of aggravating those effects by loosening monetary policy and stimulating domestic demand.

By the time that the exchange rate cap was lifted, in the spring of 1988, and we reverted to a more discretionary policy, the boom was already well in train. It took until October 1989, by which time interest rates had been doubled to 15%, to bring the situation back under control.

The ERM

A year later, in October 1990, with inflation, which had in the meantime risen to over 10%, slowly coming under control, a renewed attempt was made to re-establish the anti-inflationary credibility of policy, by formally entering the ERM. An important non-monetary consideration at the time was that the United Kingdom would have little influence on the outcome of the European Inter Governmental Conference (the IGC), which was about to start, had we not then joined the ERM. The monetary question was essentially whether joining the ERM in the circumstances, and necessarily in practice at around the market exchange rate at the time, was a reasonable risk. While it is clear that countries have successfully, and with advantage, pegged their currencies to that of another country as an external policy discipline, there is inevitably a danger that the domestic policy needs in the partner countries will at some point diverge. A currency link can survive a degree of stress of this kind, but if the tension becomes severe, then either one party or the other must accept policies that are seriously inappropriate for its domestic condition or the link is likely to break. (It is of course to try to reduce the risks of this sort of tension emerging in the context of the irrevocable locking of parities involved in European Economic and Monetary Union that the famous convergence criteria were built into the Maastricht Treaty. One can debate whether they do in fact sufficiently reduce the risk of tensions emerging between the prospective member countries. But if even those criteria are not met, in substance not simply in form, and on a sustainable and not just a one-off basis, then monetary union could be a considerable adventure—and that of course is the stuff of the economic debate about EMU. But that is by the way in my present context.)

In fact at the time of our entry into the ERM our policy needs appeared to coincide with those of our partners. The economy was responding to the high though falling level of interest rates and inflation was coming down. In principle, it seemed possible that with the enhanced policy credibility that ERM membership was expected to bring, we could hope to complete the domestic economic stabilisation with

lower interest rates than otherwise, and so at less cost in terms of loss of output.

As you know that is not how things turned out. In the event reunification meant that Germany needed to maintain a tight monetary policy at a time when the domestic situation in a number of other ERM countries, including the United Kingdom, required an easing of monetary policy. The results of this unique and unforeseen divergence in the domestic policy needs of countries whose currencies were pegged together through the ERM are certainly familiar to you.

It can certainly be argued that the problems within the ERM—including our own problem—could have been avoided by timely adjustment of the relevant parities. And so in principle they could. But in practice it is never as easy as that makes it sound. By the time the developing tension became apparent, the Deutsche Mark anchor was already entrenched as the absolutely key element of the monetary policy framework in other member countries—on which their anti-inflationary credibility crucially depended. To give that up, without a real fight, would have imposed real economic costs. These costs might have been less if it had been possible to agree upon a unilateral Deutsche Mark revaluation—making it clear that the root of the problem lay in the exceptional circumstances of German reunification. But that approach could not be agreed.

We were then confronted with a situation in which raising interest rates made no economic sense in terms of our domestic conditions and so we sought to maintain the parity through intervention in the hope that the pressures in Germany would ease. In the event they didn't ease soon enough and after very heavy intervention, and a last ditch rise in interest rates, we had no choice but to withdraw from the ERM—on 16 September 1992, Black or White or even Grey Wednesday, depending on your point of view.

An explicit inflation target, 1992–date

There are certainly a lot of lessons that could be drawn from this somewhat cursory description of our experience with what were essentially all intermediate target policy frameworks. The conclusion I think that I have drawn is that there *is* no magic formula. Any intermediate target you might choose can let you down and may need to be over-ridden in setting policy in the light of all the other information available to you. But if you accept that, then you have the dilemma that over-riding an intermediate target is likely to have a damaging effect on monetary policy credibility. Perhaps it is *post hoc* rationalisation—because in practice we really had nowhere else to go once we'd been driven out of the ERM; but these considerations point to the adoption of an explicit target for the immediate objective of monetary policy itself—inflation; and they point to comprehensive analysis of *all* the information bearing on inflation—in effect a comprehensive inflation forecast—as the preferred technique. That of course is the framework we now use.

But before I describe it in more detail, I should perhaps just mention that our experience over the past decade or so was not unique. Most countries had comparable difficulties—and a number have drawn similar conclusions. Canada, for example, dropped her monetary aggregate target in 1982 and eventually introduced an explicit inflation target in 1991. And other countries that have gone down this route include New Zealand, Sweden, Spain and Finland—the last two now combining it with membership of the new, wide-margin, ERM. But even in the many more countries that have not gone down the route of inflation targeting, it's true I think to say that the expected future rate of inflation itself does nevertheless play a larger role in their policy formulation process than it did.

The inflation target itself

The inflation target was initially set shortly after our ERM exit, in October 1992 when the then Chancellor Norman Lamont wrote to the Treasury and Civil Service Committee announcing the new monetary framework, with the objective of keeping retail price inflation (measured precisely by RPIX ie excluding mortgage interest payments) within a band of 1%–4%, with the further objective of being in the lower part of that range (ie 1%–2½%) by the end of the present Parliament. The target was reset by Kenneth Clarke in his Mansion House speech in June of last year—as 2½% or less (on the RPIX measure) for the indefinite future.

Now for the specialist there are some interesting questions about this precise formulation of the objective—whether it would be better as a price *level* than as a rate of *change*, is RPIX the best measure, how close is it to price stability allowing for technical progress, and how close should it be and so on. The much more important thing at this stage, it seems to me, is that we should do what we say, and convince people that we will continue to do what we say.

The Inflation Report

In order to help to underpin our commitment to achieving the inflation target, the Chancellor at about the same time asked the Bank to produce and publish a quarterly '*Inflation Report*' giving the Bank's independent assessment of where inflation stood and where it was headed in relation to the target. Inevitably there was some initial cynicism about just how independent that assessment would in practice turn out to be. Well I can tell you it is *totally* independent. Neither the Chancellor nor his Treasury officials actually see the *Inflation Report* before it is printed for publication—although we do inform them some days in advance where we have finally decided to come out.

This is not simply a matter of amour propre. It is essential to the integrity of the process. It obliges the Bank to explain, and makes it accountable for its analysis. This means that the Bank's professional reputation is on the line as never before, and that, I have to tell you, concentrates the mind wonderfully well. And it provides outside commentators with the opportunity to debate that analysis,

which provides us with valuable additional insights into things we may have wrong. The essence of this part of the framework is its transparency. The *Inflation Report* would lose much of its value if it were subject to comment by Whitehall or Downing Street pre-publication. The corollary is that we should not be upset if they, or others, disagree with us post-publication.

A key feature of the *Inflation Report* is, of course, its forecast of inflation some two years ahead—which is a fundamental influence on the Bank's policy advice, because of the long and variable time lags before monetary policy has its full effects. We have from the beginning been concerned to explain that such forecasts are not, and cannot be, a precise science producing point estimates for future inflation in which we are uniquely confident. We now illustrate the extent of our uncertainty by displaying the forecast as a probability distribution, a sort of open fan on its side—with the uncertainty typically increasing though not necessarily symmetrically, the further ahead you look. That's not simply to reduce the chances of our being proved wrong! It is in fact telling it as it is, and trying to bring home to people that monetary policy is an uncertain business—whatever the policy framework.

I am sometimes asked whose forecast exactly is it? Is it the analysts', or their managers', or the Directors' or the Governors'? The answer is that it is the Bank's, with inputs at all those levels as well as points in between. In fact, we have a sequence of meetings at which we assess the 'news' since the last forecast (ie that's to say those developments that are not as we had expected), then discuss the behavioural assumptions in the light of past relationships and the news in the current data, and we discuss the nature of the risks; then we review the results as reflected in an initial forecast, in light of which we may re-examine some of the assumptions or our assessment of the risks until we are all reasonably comfortable with the result. It is important, given the crucial role it plays in the process, that the forecast should be something that all those involved in its preparation should feel that they own. It is not just what spills out of a vast macroeconomic model—in fact we do not use a vast macroeconomic model although we do model particular aspects of the economy and use these in the forecasting process.

The meeting with the Chancellor

So much then for the *Inflation Report* and the quarterly medium-term forecast of inflation which it encompasses. Let me now turn to the third element of the present monetary policy framework, the (more or less) monthly meetings with the Chancellor.

This meeting is sometimes represented as a rather casual affair lasting no more than an hour at which we might almost toss a coin. The reality is not quite like that.

In fact, the monthly meeting comes at the end of a rather lengthy and rigorous process, structured in relation to our receipt of the key monthly economic, monetary and financial data. This process begins, in the Bank at least, with the production of an internal 'Monthly Economic and Financial Report' which incorporates the latest information. That report is then discussed at a Monetary Review Committee, chaired by the Deputy Governor and attended by some fifty or so officials of the Bank ranging from analysts to directors and, importantly, including not only the economic specialists but also the financial market specialists, and now some of our regional agents. They assess the current situation against the background of what we would have expected to happen and analyse the 'news' to try to decide whether it points to a need for policy change. About a dozen of the more senior people at that meeting then attend a meeting of the Monetary Policy Committee which I chair myself and at which we discuss the analysis and agree upon the assessment that we send to the Treasury—in fact to Sir Terence Burns, the Treasury Permanent Secretary. The Treasury itself has meanwhile been going through similar preliminary procedures.

The more senior of the Bank team—about seven or eight in all, normally led by the Deputy Governor, then meet with their Treasury counterparts in the Burns Committee to establish the facts and discuss their respective assessments. The Bank team report the outcome of their discussion to me, and the Treasury report to the Chancellor. You will find the result of the Burns Committee's review of the facts in the early part of the minutes of the meeting with the Chancellor that are subsequently published.

In the light of all these inputs from the Bank team I then prepare my own draft speaking note for the meeting with the Chancellor, setting out briefly our analysis and the advice that follows from it. The Monetary Policy Committee then reconvenes, usually early on the morning of the meeting with the Chancellor, to take account of the latest data and market information, and we agree the text of the speaking note. At the meeting with the Chancellor, which is attended on our side by the Deputy Governor and the two Monetary Stability Wing Directors, as well as myself, I then read out the speaking note and hand it to the Minutes Secretary so that it is recorded verbatim for publication. (I have reserved the right to make omissions, relating particularly to the exchange market situation or to the Budget, although in practice I cannot recall having done this other than to exclude very occasional confidential statistics.) This somewhat elaborate procedure is designed to ensure both that the advice that I give is the Bank's advice and not simply the Governor's, and that that advice is recorded accurately without any lengthy negotiation. The Chancellor—who will know the way the Bank is likely to be moving from the discussion in the Burns Committee then typically gives his own assessment, and after discussion around the table involving other Treasury Ministers and Bank and Treasury officials, the Chancellor takes his decision.

Since April 1994, the minutes for the meeting have been published two weeks after the following meeting. I hope

that next time you read them you will now appreciate the intensive labour—usually a labour of love—that leads up to them!

Although in principle the Bank may decide when to implement the Chancellor's decision—up to the next meeting, in practice we would nowadays expect to implement it on the next occasion on which we intervene in the money market (which may be later the same day, or, if the meeting is in the afternoon, the following morning) unless there were a wholly overwhelming reason for delay. For that timing to be possible, Treasury officials will have prepared a contingent draft of a press notice before the meeting if they think there is any likelihood of a change!

The Bank's advice is based partly on its medium-term forecast for inflation which I have described earlier and which itself includes an assessment of the probabilities of alternative possible outcomes. But our advice, which must necessarily crystallise into a precise recommendation, takes account too of subsequent data, and includes a judgment as to where on the spectrum of risks we should aim to be. Our accepted interpretation of the inflation target is that we should aim consistently for a position in which it is more likely than not that RPIX inflation will be at 2½% or below in two years' time. We stand to be judged by that advice, as the Chancellor stands to be judged on the basis of his decisions.

Assessing the present framework

How then, Mr Chairman, should we assess this—still relatively new—monetary policy framework?

I see it as having a number of advantages.

First, the focus on the immediate end objective of monetary policy—permanently low inflation—is unambiguous, and better publicly understood than the intermediate alternatives.

Second, it provides a sharper focus too, for our own analysis—which I think has improved as a result—but then you would expect me to say that. At the same time it allows us to make use of *all* the information about the economy that is available to us in relation to that objective rather than attaching particular weight to this or that intermediate target—which as we have seen can all too easily either lead us astray or, if we disregard its message, run us into damaging credibility problems.

Third, it provides a clearly forward-looking focus. That is enormously important in my view partly because we know that monetary policy operates with a considerable time lag, even if we don't know much about the precise nature of the lag; but it is important, too, because it ensures that we take account of what is happening to the real side of the economy, including what is happening in the short term, because of the influence that this can have on the inflation outlook further ahead. Because of the emphasis we give to sustaining activity growth into the medium and longer term, it is sometimes suggested that we ignore these real short-term effects. I don't think that is true.

Fourth, they have the great merit of transparency, so that everybody can see not just what we are aiming to do, but the content of our analysis and how and why we give the advice or reach the decisions that we do.

And fifth, they ensure clear public accountability for that advice and those decisions, which, as I say has certainly served to sharpen up our act but which also acts as an additional check and balance to the Chancellor's discretion—something which he fully appreciated when he took the decision to publish the minutes of our meetings.

'That's all very well' I hear you say 'but will it work?'

It is of course early days.

But the results so far are encouraging. Inflation itself over the past four years, on the target measure, has averaged 2.7%. This compares with an average of nearly 10% in the 20 years before we adopted the inflation target in 1992, including one single year when inflation rose to nearly 25%. Activity has grown consistently—and reasonably steadily—for eighteen successive quarters—at an average annual rate of 2.6%. Unemployment has fallen almost month by month during this period, from a peak of over 10.5% to below 7.4% now. And the prospect for the next two years—the extent of most forecasting horizons—remains very encouraging, with most forecasters predicting continuing steady growth with low inflation.

And though it may be tempting fate to say so, we have not had a serious financial crisis during the whole of this time. Where in the past policy was too often made on the hoof, in Pavlovian reaction to pressures in the financial markets, it now seeks to anticipate events and is based upon a regular, systematic and structured discussion of the economic facts. We've also moved to a situation in which we can—meaningfully—adjust rates by small amounts. You cannot imagine what a difference all this has made.

I don't think this is simply coincidence. Certainly it is true that we started in 1992 with some degree of slack in the economy post-ERM; and it is also true that the inflationary climate worldwide has been better than for a very long time helped everywhere by increasing competition—nationally and globally—and by rapid technological advance, especially in information technology. But it has not all been plain sailing. We have, for example, had to contend with a sharp rise in world commodity prices last year as well as with weak economic activity in continental Europe. And more generally I would have to say that we have contrived to throw away strong hands before. So time alone will tell.

But I am very hopeful, Mr Chairman, and I feel a good deal more comfortable with the monetary framework that we have today than I have at most times in the past.

I should like to think that my successor will be able to come to deliver the Loughborough Lecture in ten years time and review a decade of growth through stability. If he—or she—can't do so, you will be able to judge for yourselves whether this was a result of our own technical incompetence or some failure of the political process. In the former case I suspect you would see a lot of unfamiliar faces at the Bank. In the latter case you may just find that the Bank of England had been made independently accountable for decisions about monetary policy—but that is the subject for another lecture!