

BANK OF ENGLAND RESPONSE TO THE KOHN REPORT

Introduction

The Bank of England's Monetary Policy Committee (MPC) was set up in May 1997. Its remit is to meet the Government's inflation target – currently set at 2½%. The procedures by which it conducts its monthly meetings, interacts with the staff of the Bank of England, and produces its quarterly forecast and Inflation Report are all reviewed regularly. The non-executive Directors of the Court of the Bank are charged under the Bank of England Act 1998 with an oversight role on the MPC's procedures. At their suggestion, the Bank decided to commission an informed expert to undertake an external review of the procedures of the MPC, and its analytical support in the Bank of England, with the aim of helping the MPC think further about its own procedures and enabling the non-executive Directors to form a judgment about those procedures.

To that end, the Bank asked Don Kohn, Director of the Division of Monetary Affairs at the Federal Reserve Board in Washington to visit the Bank of England for a period in the Spring of 2000 and to conduct such a review. His terms of reference are attached. To facilitate his work, Mr Kohn spent six weeks visiting the Bank of England in the Spring of 2000 and he returned to present his findings and discuss them with both the non-executive Directors of Court and the MPC in October 2000. The Bank is extremely grateful to Mr Kohn for undertaking this review and to the Federal Reserve Board for allowing him to do so.

The Bank has decided to publish **Mr Kohn's report**. This is being done for two reasons. First, publication of the Report is an ingredient in making the monetary policy process in the UK transparent as it is a key part of the information upon which the non-executive Directors of the Bank will form their judgment about the procedures of the MPC. Second, the Report itself touches on issues which are at the heart of the monetary policy process in all countries. These include how forecasts should be constructed, who should be responsible for their publication, and the way research in a central bank should be conducted. We hope that central banks and those interested in

the monetary policy process around the world will find the Report useful and may find lessons that apply to them as well as to the Bank of England.

The MPC's Response

The MPC has discussed the Report which it found very helpful. It accepts the points which Mr Kohn raises, and agrees with most of the suggestions that he makes. Some of these have already been implemented following discussions with Mr Kohn during his visit. The implementation of the remainder is presently under discussion by the Committee. However, on many of the questions raised in the Report, Mr Kohn notes that there are no simple answers. This is particularly true of one important theme which runs through the Report, namely the problem of reconciling individual accountability of MPC members with the need to present a collective message to the public that explains the decisions of the Committee. The Report stresses the need for the MPC to keep these questions under active consideration, a recommendation the Committee warmly accepts.

More generally, the issues raised in the Report can be usefully summarised under four headings. These are:

- (1) Research in support of monetary policy;
- (2) Arrangements for briefing the MPC on the state of the economy;
- (3) The forecast process; and
- (4) The relationship between the MPC and the staff of the Bank of England.

(1) Research in support of monetary policy

Under a new procedure agreed at the end of 1999, the MPC holds an annual meeting to discuss and agree the research priorities for the Monetary Analysis Division of the Bank for the following year. The first such meeting took place in December 1999. The Report notes that it is important that this research agenda is not simply imposed top-down by the Committee, but allows research ideas to “bubble up” from staff in the Bank. The MPC is aware of this need. The views of the staff are discussed, with those of MPC members, at the annual meeting to set research priorities. At the December 1999 meeting, out of the fifteen proposals agreed by the Committee, eleven were put forward by the staff. The MPC also holds a meeting after each forecast round to set the priorities for

research work with a shorter horizon, typically to be done before the next round. However, research can stretch over more than one round, if that is felt to be appropriate. Such intermediate-term research is then discussed by the Committee each quarter.

The Report suggests that increased resources be devoted to the improvement of the models used by the Committee in its forecast process. The MPC agrees that the resources devoted to model development are at present inadequate, and that there is an urgent need to allocate more resources to this task. The Bank will be reviewing its resources for developing its suite of models, including the short-term macroeconometric model, in its next internal budget round.

(2) Arrangements for briefing the MPC on the state of the economy

The Report suggests that the monthly briefings of the MPC by the staff (known as “Pre-MPC” meetings) be shorter, better focussed and more analytical. The Committee agrees with this suggestion, and, following discussions with Mr Kohn during his visit to the Bank, it has been implemented. The briefings to the MPC have been reduced in length and are now, the Committee believes, better focussed. Heads of Division are also being encouraged to be more analytical in their presentations. But there is a genuine dilemma here. Providing more analytical material, and more views from the staff, will reduce the amount of factual briefing, which some MPC members find useful. The aim of the Pre-MPC briefing is not to generate extensive discussion at that meeting, but rather to provide the information for the Committee to conduct the debate at the MPC meeting itself.

(3) The forecast process

Many of the substantive issues identified in the Report revolve around the forecast process. There is one common theme that runs through all the suggestions in this area. It is the need for the MPC to explain clearly both the nature of the forecast – described in the *Inflation Report* as the “best collective judgement” - and how it is constructed. In what way is the forecast representative of the view of a majority of the Committee? Is it that of the median voter on the Committee? In other words, what is the relationship between the views of the nine individual members of the Committee and the published forecast? The Report makes clear that there is no simple answer as to how best to present the views of a Committee where the members are both individually and collectively accountable for its actions. The MPC already has discussed this issue on a number of occasions, and will keep it under review. The Report points to a number of costs and benefits of making changes from the present procedures, but does not recommend any one alternative as the preferred choice; all have some drawbacks. This is not an area in which there is a single best approach.

The Report discusses five ways in which the published forecast could be said to reflect the “centre of gravity” of the Committee’s decision. Each corresponds to a different way of constructing the forecast. This goes to the heart of the difficulty of producing a Committee forecast with nine members whose individual views determine their voting patterns, and who are accountable for those votes. The present method of constructing the forecast ensures that the fan charts do indeed represent the “centre of gravity” of opinion on the Committee, with Table 6.B of the *Inflation Report* providing an indication of the magnitude and source of the main differences of view within the Committee.

A more technical issue related to the forecast concerns the conditioning assumption about interest rates underlying the forecast. At present, the MPC publishes two sets of fan charts. The first is based on the assumption of constant official interest rates throughout the two-year forecast horizon. The second assumes that official interest rates follow market expectations. As the Report points out, trying to condition the forecast on the Committee’s own views on the path of future interest rates is problematic. There is no collective view of the Committee on the likely future path of interest rates, and the Committee instead focuses on communicating its views about the likely paths of inflation and output under the assumption that the current level of interest rates is maintained.

The Kohn Report suggests that the Committee treat the two-year forecasting horizon flexibly in *Inflation Reports* as well as policy making. In fact, this is already part of the current forecast process although it may not always be obvious from reading the *Inflation Report*. The Kohn Report also suggests that the MPC should try to explain in more detail the relationship between the forecast for inflation two years ahead and the policy decision. The MPC accepts that this is an area requiring further examination and public explanation and accordingly the November *Inflation Report* contained a box explaining the relationship between the two-year ahead central projection and the policy decision. It also stressed the crucial point that a forecast is a probability distribution, not a point estimate, and that accordingly there is no mechanical link between the central projection and the policy decision.

The Report suggests that there be more evaluation by the Committee of the difference between the outturns and forecasts. Such a comparison has always played a part in the construction of the forecast, and recently more explicit attention has been paid to the details of this. The MPC recognises that more resources need to be devoted to the analysis of past forecast errors, and implementation of this is on the agenda for the next meeting to determine research priorities.

Mr Kohn also suggests that the staff play a greater role in the process of producing the forecast. The MPC agrees with this suggestion, and has implemented it. The forecast process now starts with an updating by the staff of the earlier forecast which explicitly considers the implications of recent data and suggests the key issues which the Committee needs to discuss.

The Report contains a number of suggestions as to how the forecast process could be made more efficient. These include: reducing the number of MPC meetings on the forecast; starting the forecast process somewhat later than at present; ensuring that the MPC focuses its discussions on the “big issues” rather than on the detail of constructing the forecast from the bottom up; and enabling the staff to play a greater role. All of these suggestions have been implemented following earlier discussions with Mr Kohn.

(4) The relationship between the MPC and the staff of the Bank of England

The Report notes the high quality of Bank staff, both in the conjunctural and research areas. It makes some observations and suggestions concerning the relationship between the MPC, on the one hand, and the staff of the Monetary Analysis (MA) Division of the Bank on the other. Amongst other things Mr Kohn identifies the potential impact on MA of the creation of a separate support unit for the external members of the Committee, and the tone of relationships between MA staff and MPC members.

In December 1999 a new arrangement was introduced whereby the external members of the MPC were each provided with two economists to work for them. These new arrangements had only just been introduced at the time of Mr Kohn’s visit. The MPC believes that the new arrangements are working well, but the Committee recognises the need to monitor and adapt these arrangements in the light of experience. In particular, the Committee will want to ensure that the allocation of the dedicated researchers of the external members does not lead to reduced interaction between MA staff and the MPC. The Committee recognises the need to maintain an appropriately constructive relationship between MA staff and members of the MPC.

The Report also draws attention to pressure on staff working for the MPC. Bank management is exploring ways of reducing the burdens on staff, through more effective use of IT for example, and efforts in this area will be stepped up. The Report also notes a number of salary and non-salary issues that need to be addressed, and this is in hand. For instance the Bank has recently introduced a “Senior Economist” position alongside the management grade, thus ensuring that progressive career paths are open to staff members with different strengths. There are currently seven such Senior

Economists, and it is expected that the number will expand as experience levels rise. Finally, the Report emphasised that staff promotion and reward must depend on merit and not be influenced by whether the staff member is working within MA or working for an external member of the MPC. The MPC agrees that the promotion and reward of staff must be, and must be seen to be, entirely meritocratic.

In conclusion, both the MPC and the Bank welcome the thoughtfulness and perceptive insights which Don Kohn has provided in his report. We recognise that it is unusual for a central bank to publish such an external review of its work. But we believe that both our monetary policy process and public understanding of that process will benefit from publication, and we hope that the Kohn Report will also be useful to others.

ANNEX : REMIT FOR DON KOHN'S REVIEW OF MPC PROCEDURES

The Monetary Policy Committee (MPC) is a Committee of the Bank of England constituted by the Bank of England Act 1998, with responsibility for formulating the United Kingdom's monetary policy. The MPC meets monthly to determine interest rates.

The non-executive Directors of the Bank of England (NEDs) have a statutory requirement to keep under review the procedures followed by the Monetary Policy Committee, including whether the Monetary Policy Committee has collected the regional, sectoral and other information necessary for the purpose of formulating monetary policy.

You have kindly agreed to undertake a review of the MPC procedures. On behalf of the Court of Directors, we would like you to consider the following issues:

Written briefing for the MPC

- How does the quality compare with the briefing prepared by the Federal Reserve or other examples of best practice?
- Is it provided in the appropriate quantity?
- Do the notes provide the appropriate amount of information?
- Can you detect any bias, in a policy sense, from what is provided?
- Does the briefing adequately address regional and sectoral issues, and how does it compare with the Fed in this regard or other central banks with which you are familiar?
- Do you have any comments on the way information is disseminated, that is by paper, email, or intranet?
- Apart from the answers to the above questions, do you have any suggestions as to how the briefing could be improved?

Pre-MPC briefing meeting

- How does the quality compare with similar oral briefings at the Federal Reserve or other examples of best practice?
- Does the meeting provide the appropriate quantity of information?
- Are there any data, which are missing from the presentations, or are there data which are superfluous?

- Can you detect any policy bias in the presentations?
- Do the presentations cover sufficiently regional and sectoral data?
- What is your view on the chart pack supplied for the meeting?
- Apart from the answers to the above questions, do you have any suggestions as to how the meeting could be improved?

Forecast and Inflation Report process

- What are your general views on the process, and how does it compare with the Fed’s approach or other examples of best practice?
- Do the meetings achieve their objectives efficiently? How could they be improved?
- The MPC takes the view that no one model can adequately capture the key features of the economy. It has therefore decided to use a suite of models as described in the book “Economic Models at the Bank of England”. Do you have any comments on this approach, do you think it makes a material difference to the forecast?
- What is your view of the fan-chart approach to forecasting?
- What is your view of the Inflation Report document? Its objective is to enhance the transparency of the policy-making process. Does it achieve that aim?
- Does this process give adequate consideration to the regional and sectoral impact of monetary policy? How does it compare with the Fed’s or other central banks’ treatment of these issues?

The work of Monetary Analysis

- As the main area of the Bank to service the MPC, does Monetary Analysis have the appropriate level of resources to do its job?
- Are the resources being used efficiently?
- Is the current split between briefing and research appropriate? How does it compare with the Federal Reserve and other examples of best practice?
- Is there anything Monetary Analysis should be doing that it is not?
- Is there work being done, which is unnecessary?