



BANK OF ENGLAND

Speech

The Monetary Policy Committee Five Years On

Speech given by

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To the Society of Business Economists, at the Royal College of Pathologists, London

22 May 2002

I would especially like to thank Claire Lombardelli, James Proudman and James Talbot for their expert help in conducting and analysing the experiment reported in this paper. I have also benefited from useful comments from Charlie Bean, Mark Cornelius, Spencer Dale and Peter Rodgers. Richard Geare provided help with the data.

THE MONETARY POLICY COMMITTEE: FIVE YEARS ON

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Five years ago, the power to set interest rates in this country was given to a new Monetary Policy Committee (the MPC). That decision is still widely regarded as the most important taken by the incoming new Labour Government. At the time, the decision to create the MPC was controversial. That is hardly surprising. Few decisions have as much economic impact as the level of short-term interest rates. They attract the interest of politicians and the media, yet when the MPC sets interest rates, it acts independently of government. The government sets the target, but the Committee sets interest rates to meet that target.

Compared with many other countries central bank independence in the UK is relatively recent, although not unprecedented. The most famous cartoon of the Bank of England – Gillray's *The Old Lady of Threadneedle Street* – shows Pitt, Prime Minister at the time, ravishing an old lady – personifying the Bank – whose dress is made of one pound notes. The Pitt Government had made repeated demands on the Bank of England for gold to pay for the wars against France. Eventually, the fall in the Bank's reserves forced it to suspend convertibility of its notes into gold, and low denomination notes were issued for the first time. The Gillray cartoon – which appeared in May 1797 – was the origin of the moniker, the Old Lady of Threadneedle Street. Was it mere coincidence, or divine retribution, that it was exactly two hundred years later, to the very month, in May 1997, that the Bank of England regained its independence?

In an age when governments are increasingly held responsible for more and more aspects of our lives, there are not many examples of major decisions being delegated to a non-political body. The Monetary Policy Committee has broken new ground in British constitutional history. Only three months before the MPC was set up, Peter Hennessy described the British system of government as dependent upon “a handful of inside advisers spinning between them what Phillip Ziegler has called ‘instantly invented precedents’ from the warp and woof of past constitutional practice and experience”. For much of the past forty years there have been rather too many “instantly invented precedents” in the conduct of monetary policy. But, very occasionally, a constitutional reform occurs which leads to a new piece of machinery. That was the case with the MPC.

The Committee itself has an interesting and unusual structure: five executive members of the Bank and four external non-executive members, all chosen for their expertise on monetary policy and not

as representatives of different interest groups. You may wonder whether the nine members of the MPC have any historical antecedents. If you look carefully you can see them in one of our few remaining great Jacobean houses – Aston Hall in Birmingham. In the Great Dining Room there is a frieze, a marvellous example of early seventeenth century plasterwork, showing a set of nine warriors. These are known as the “nine worthies”, described as “high-relief figures in their own niches separated by scrolling”, a pretty good description of the MPC. The Nine Worthies of Chivalry as they are known, comprise three groups: three honest heathens, three Old Testament heroes and three champions of Christendom. It is interesting to speculate into which of these groups various members of the MPC fall, but I will leave that to you. But, wait a moment, there are two additional figures in the frieze. One is Perseus – presumably the minute taker. The other is described as a “so-far unidentified figure, certainly a later pastiche”. This must be the Treasury representative. Sadly, the debates among the nine worthies, presumably recorded in the minutes and reported to Sir Thomas Holte who commissioned the frieze, are lost to posterity. In contrast, the debates among the MPC are published in the monthly minutes and are the subject of much commentary in the press.

I want, this evening, to pose four questions about the role and record of the MPC. First, why give the power to decide interest rates to a committee rather than an individual? Second, does it matter that the MPC frequently disagrees about its decision? Third, has the Committee communicated clearly the reasons for its decisions? Fourth, does the MPC require reform?

Let me try to answer those questions in turn.

1. Why give the power to decide interest rates to a committee?

The academic argument for central bank independence is well established, but why delegate monetary policy to a committee rather than an individual? In many other situations where expertise is crucial, groups of experts are often regarded as superior to individuals. So one motive could be that committees make better decisions. The technical nature of the monthly interest rate decision gives a natural division of responsibilities between a democratically elected government that chooses the target and an appointed group of experts who set rates to meet that target.

One dissenting voice comes from Sir Alec Issigonis – inventor of the Mini – who once said, ‘A camel is a horse designed by a committee’. Despite this view, there is a wide range of evidence to

suggest that in many other real-world scenarios, a committee is often the preferred decision-making body. Really important people are treated by teams rather than a single doctor, and when legal decisions reach the highest level of appeal it is to a panel of judges such as the Law Lords and the Supreme Court, not a single individual, to whom the case is referred.

Decisions that depend on technical knowledge seem, by revealed preference, to be given to groups rather than individuals, and setting interest rates by committee is no exception. A wide-ranging survey undertaken by the Centre for Central Banking Studies at the Bank of England found that 79 central banks out of a sample of 88 use some form of committee structure when setting monetary policy.¹ But there is, by its very nature, rather little empirical evidence on the relative merits of decision-making by individuals versus groups. And, even if one accepts that some decisions should be delegated to technical experts, what is the best way to weight together the opinions of those experts?

This problem motivated Alan Blinder – a former Vice-Chairman of the Federal Reserve Board – and his colleague John Morgan at Princeton to adopt a different approach: carrying out two ‘laboratory experiments’ using groups of Princeton students to test whether groups do indeed make decisions differently.² Their first experiment was purely statistical: subjects were asked to identify when a one-off change in the proportions of red and blue balls in an electronic urn took place. The second asked participants to play a simple monetary policy game, setting a short-term interest rate in order to minimise a loss function described by deviations of unemployment and inflation from desired target levels. The data generating outcomes for this hypothetical economy came from a two equation macroeconomic model of a fairly standard kind. Again a structural change – this time to the “natural” real rate of interest - would occur at some point during the game, and, by observing data generated by this economy, players would need to learn about the change in structure in order to set the appropriate interest rate.

All the students who participated played both as individuals and in a group. In both experiments success could be measured on a quantitative scale, and both led to a common conclusion: that decisions made by committees were superior to those of individuals. How robust was this result? And what explained it?

Last year, a team from the Bank of England attempted an exercise very much like Blinder and Morgan’s monetary policy experiments using a sample of just under 200 economics students from the London School of Economics.³ Using a simple macroeconomic model that was broadly

representative of the UK economy, the experiments examined how the performance of groups differed from that of individuals. And again they found striking evidence that committee decisions were superior.

In the Bank study, each participant was asked to play a simple, computer based, monetary policy game sixteen times: four rounds as individual policy makers, followed by eight rounds in a committee of five players, and finally a further four rounds as individuals. The committee stages were divided into two parts: four rounds where committee members were not allowed to discuss their decisions – although they could observe the unattributed votes of other players – and a further four rounds where discussion was permitted. As a control for learning, the order of the ‘discussion’ and ‘no discussion’ set of games was randomised across the committees.

Each game consisted of ten periods of play in each of which the individual or committee had to decide what interest rate to set in response to the data for output and inflation generated in the previous period. In the committee stages, the majority – or more precisely the median - vote was implemented once all committee members had entered a vote into their respective computers.

Participants were told nothing at the start of the experiment about the structure of the economic model with which they were playing, or the disturbances that it was subject to, other than that a structural change occurred at some point during each play of the game. In short, they were operating – much like real-life monetary policy makers – in uncertain conditions, doing their best to identify the shocks that hit the economy and offsetting their impact by adjusting the short-term interest rate.

To quantify their performance, players were scored according to their ability to keep inflation close to a pre-specified target and to minimise output fluctuations, and were paid a modest amount for doing so. Chart 1 shows the pattern of average scores over the different stages of the game. Three features are striking:

- (i) The significant upward trend in the results. Players clearly learned how to play the game as time went on.
- (ii) The large upward movement in scores when players moved to committee decision-making.
- (iii) The large downward move in scores when participants returned to playing as individuals.

These results support the idea that committee decisions represent a significant improvement over those of the individuals that comprise them. What might account for these results? The Blinder and

Morgan and Bank studies suggest two main reasons. First, collective decision-making appears to give more weight to the better and less weight to the worse committee members, as judged by their scores when playing the game as individuals, than would be implied by taking the mean of individual performance. The best player had some influence on the decisions of the group of which they were a member. And the impact of the worst player was offset by majority voting. In other words, the median score of the players in the individual rounds was significantly above the mean, implying that the average was being pulled down by a minority of relatively bad players.

Second, there was also evidence from the experiments consistent with the hypothesis that committees enable all members to improve their performance by sharing information and learning from each other. And it was striking that the performance of committees was on average somewhat better than that of the performance of the single best player on the committee when playing alone. So in terms of group decisions, it appears that the whole is different from – and generally better than – the sum of its parts.

Producing the perfect design of a committee structure that would make the best decisions is a task with no simple answer. But the MPC embodies several features that seem desirable. First, there is a clear objective given to the Committee from outside, in this case by the government. Second, the members are chosen for their technical ability. Third, the votes on the MPC are transparent, and hence members can be held accountable. The merit of individual accountability is that each individual in the group has a genuine incentive to reach a good decision. This aspect leads us directly into my second question.

2. Second, does it matter that there are differences of view among Committee members?

From the outset, commentators have been unable to resist labelling members of the Committee as either ‘hawks’ or ‘doves’. I have argued before that it makes no sense to use these descriptions because each member of the Committee has the same objective. Members of the MPC cannot entertain closet views about their desired inflation rate because they will be held personally accountable for their judgments about the level of interest rates necessary to meet the mandated inflation target. As circumstances change, it is easy to imagine that ‘hawks’ shall be ‘doves’ and ‘doves’ shall be ‘hawks’.

But that is not to say that differences of opinion do not, and should not, exist amongst committee members. If part of the reason for the improvement of groups over individuals is their pooling of knowledge, then differences of opinion during the discussion that takes place at each MPC meeting

should be central to the Committee's performance. As *The Economist* put it back in 1998 (when there were only eight serving members)⁴:

‘With the economy on the turn, the MPC has to sift mixed evidence... It would be remarkable if eight intelligent, well-briefed economists could be of one mind.’

But this point is not always readily understood, even by the most astute commentators. In July 1998 the *Financial Times* suggested:

‘...the MPC bears a closer resemblance to a post-graduate seminar than to a forum for strategic decision making... To put [several] economists in the same room is to invite what one commentator has called paralysis by analysis.’

And in the same month, *The Times* described the MPC as ‘a committee bursting to the brim with individual opinions’ implying that ‘periods of badly co-ordinated and erratic behaviour are only to be expected’.

But it is precisely the exploration of alternative views about what is happening in the British economy, and the discussion of these views by the Committee in a spirit of investigation not advocacy, that is central to the pooling of knowledge through which committees reach decisions that are superior to those taken by individuals. I think that is increasingly understood by commentators, and helps to explain why split votes are now regarded as normal and not a source of great excitement. It is, nevertheless, important that there are no ideological differences among Committee members that would make rational debate difficult, and, in this respect, the Committee has so far been fortunate.

A famous 1970s laboratory experiment also showed the value of a frank exchange of views within a committee.⁵ It featured groups of senior managers working together to solve a complicated problem in a game called ‘Lost on the Moon’. Subjects were asked to rank a list of objects in order of their necessity for survival after their spaceship had inadvertently crash-landed on the moon. It was found that the best-performing groups – or those which got closest to the ranking suggested by experts at NASA - were those which were least consensual in the early stages of discussion, exploring all possible avenues and ideas. Groups which established a common consensus quickly were often ineffective, suggesting that at least some disagreement is beneficial for committee performance

because it stimulates discussion and hard thinking. Differences of view on our Committee are an honest reflection of the uncertainty about both the data and the structure of the economy.

To date there have been 61 meetings of the Monetary Policy Committee. The votes cast at those meetings are summarised in Table 1. It includes the votes of this month's meeting which were published this morning. At those 61 meetings, interest rates were raised on nine occasions, were lowered on 14 occasions, and left unchanged at 38. At the first seven meetings during 1997, decisions were reached unanimously. The number of voting members varied between five and eight as the membership of the Committee built up. The first dissenting vote was cast in January 1998. Since the beginning of 1998, the voting has been divided reasonably evenly among all possible combinations of votes (remember that there were nine voting members only from June 1998 following the passage of the Bank of England Act.) Of the 54 meetings since January 1998, four dissenting votes have been cast on six occasions, three on seven occasions, two on eleven occasions and one on 16 occasions. At only 14 meetings has the vote been unanimous, and no one – sensibly – has seen fit to abstain, so that during the past five years the frequency of unanimity among the Committee has been little more than one in four. Differences of view have become accepted as the norm, and this appears to have done little damage to the credibility of the Committee.

Nor has there been much sign of “blocs” of votes, whether internal or external. There have been 15 occasions on which members of the executive of the Bank have been on opposite sides of the vote, and 37 occasions when externals have found themselves divided. It is true to say that dissenting votes have been more common among external than executive members. Of the 83 dissenting votes cast during the history of the MPC, 25 have been cast by executive members and 58 by external members. But of these 58, no fewer than 44 are accounted for by three of the eight external members, Willem Buiters, DeAnne Julius and Sushil Wadhvani. For the remaining five external members, the propensity to be in the minority has been very similar to the Bank executive (excluding the Governor), with dissenting as a proportion of total votes at 12% and 11% respectively.

Moreover the differences in votes have been small. On only four occasions has the difference between the highest and lowest interest rate voted for exceeded 25 basis points, and, interestingly, all four were between August 1998 and April 1999, a period of great uncertainty about whether there would be a downturn in the world economy that did not in fact materialise. Since then differences of view have never exceeded 25 basis points. The average difference between the interest rate cast by the member voting for the highest average level of rates and the member voting for the lowest

average level of rates is less than 15 basis points! Such a small difference hardly corresponds to a major difference of view about the outlook for inflation.

3. **Third, has the Committee explained clearly the reasons for its decisions?**

Transparency has been at the centre of the monetary policy framework since 1992 when it was recognised that clear explanations of policy would help to anchor inflation expectations on the target. The first major step in enhancing transparency was the Bank's *Inflation Report*, which first appeared in February 1993, and was subsequently enhanced by publication of the minutes of the meetings between the Chancellor and Governor. That transparency was given a further boost by the creation of the Monetary Policy Committee where the votes of all members are published along with the minutes of the discussion at MPC meetings.

Despite its record on transparency, questions have been raised about whether the MPC could go further. Do the published minutes reveal enough about individual views? Should there not be individual paragraphs in the minutes explaining the position of each member? Why does the Committee not publish a forecast corresponding to the path of interest rates that it feels most likely to be necessary to meet the inflation target? Why does the central projection of the forecast always seem to end up at close to the target of 2.5%?

It is helpful to step back and ask three more fundamental questions. First, what is the MPC trying to communicate? Second, how should it communicate? Third, what is the role of the inflation forecast?

The basic message which the MPC is trying to communicate is that, over the medium term, inflation should be expected to average 2.5%, and that the Committee will respond to events as they unfold in order to keep inflation on track to meet that target. Hence the Committee needs to explain its view of the current state of the economy, how and why it has reacted to events that have already unfolded, and what it believes are the risks lying ahead. All of this can be encapsulated in its "policy reaction function". Commentators and others may form their own views about the likelihood of various economic shocks occurring, and in that respect it is more important for them that the Committee explains its policy reaction function than attempts to provide guidance on the likely future path of interest rates. And when the Bank of Canada tried to anticipate the likely future path of monetary conditions, it found that, despite its clear explanations of why the future could not be easily

anticipated, markets took those anticipations as commitments, and were surprised when unforeseen events resulted in different policy outcomes. In contrast, the MPC does not attempt to anticipate its own decisions.

In addition to explaining the Committee's views on the economy, and the balance of risks to inflation, there is a second important role for communication. That is to explain the views of the nine individual members of the Committee so that they can be held accountable for their judgments. There is, therefore, an inherent tension between a system of nine individually accountable members, with their associated views, and a Committee from which a single decision emerges that requires a clear explanation each month. The former produces, as I have argued, better decisions; the latter is important for the predictability and thus the efficiency of monetary policy. The communication strategy of the MPC must provide a balance between these two objectives, a point acknowledged in the report by Don Kohn on the procedures of the MPC.

The need to achieve such a balance leads directly to the question of how the Committee should communicate its thoughts. The minutes of the MPC meetings, now released only 13 days after the decision itself, provide a detailed explanation of the issues that confronted the Committee and the arguments that were made during the meeting. They also contain the votes of individual members. The Committee has discussed, but rejected, the proposition that the minutes should contain individual paragraphs summarising the views of each member in turn. The reason is that such a procedure would alter the nature of our meetings quite radically. At present, they are a free-flowing discussion in which members discuss propositions and counter propositions in a spirit of mutual enquiry rather than an exchange of fixed and conflicting views. Discussion focuses on the relative merits of different possible explanations for the current state of the economy. If each member faced a deadline by which they had to produce a polished paragraph summarising their views, members would enter the meeting with such a paragraph in draft form and the spontaneity of the discussion would be lost.

For the same reason, it is not clear that the publication of transcripts of meetings enhances transparency. The Federal Reserve provides a useful case study. Prior to 1994, members of the FOMC were largely unaware that monetary policy discussions were being transcribed verbatim from audio recordings of the meetings. Congress learned of the availability of the transcripts shortly after this, and in February 1995, insisted that they be published with a five-year lag. Once committee members became aware that their meetings were being recorded, the structure of the discussion

appeared to change. Before 1995 meetings had begun with prepared speeches followed by a free-flowing debate characterised by a frank exchange of ideas. But after 1995, there appears to be a much greater tendency for meetings to become an exchange of prepared statements, and some of the colour of the previous discussion may have been lost.

Explanations of decisions in the form of press statements issued at the time of the announcement of decisions on interest rates have become less frequent. But this is principally because there have been fewer interest rate changes recently. In its first three years, the Committee moved rates 16 times and issued press statements on 14 of those occasions. It also issued two statements when it had not moved rates. Over the past two years the Committee changed rates seven times, accompanied by six statements, with no statements when rates were left unchanged. The purpose of a press statement is to explain a decision reached, by definition by a majority of the Committee. Because it is brief it cannot do justice to the richness of the discussion at the Committee, and the balance of views is not represented. Hence the Committee has come to the view that, by and large, it is better to wait until the publication of the minutes when a fuller view of issues and views can be provided. That is not to say that press statements will not appear in future, but to stress that their purpose is limited to explaining a decision that might be unexpected, irrespective of whether that is a change or no change in rates.

On the whole, the minutes have been successful in creating a wider understanding of the issues discussed by the MPC, and have a devoted, if small, following. The *Inflation Report*, which predates the MPC, has a broader objective in setting out a comprehensive view of the current state of the economy, and describing the outlook for inflation in terms of a forecast over a two-year horizon. The Committee puts great weight on explaining the forecast in terms of probabilities. Hence it has adopted the famous coloured fan charts for its forecasts for both growth and inflation. But there remains some confusion about the role of the forecast. With the advent of the MPC, the tensions between explaining nine individual views and presenting a coherent account of the Committee's view of the economy have complicated the production of the forecast. The *Inflation Report* now contains an explicit description of differences of view among the Committee in respect of both the central projection and the risks to the forecast, as well as the "best collective judgment", or majority view, of the outlook. But the main focus of the *Inflation Report* is to present a collective view. To publish nine individual fan charts would hardly increase transparency, and the differences of judgment have to date been sufficiently small that it would be difficult for commentators to observe significant differences among those charts. This tension between the need to explain the diversity of

members' views, and the need to provide a clear rationale for the single decision, suggests that the Committee may need to explore further ways of putting across its collective view.

It should be clear that there are both benefits and costs to a group decision-making process. The transparency and accountability of individual views helps to make better decisions. But it also complicates the communication of the decision to a wider audience, whose expectations of inflation matter for economic behaviour. The avoidance of confusion requires some forbearance by individual members of the Committee, and a clear understanding of which forms of communication are appropriate to explain individual views and which forms are suitable for explaining the reasons for a collective decision. I am sure that the Committee will learn more about how best to achieve this balance as time goes by.

4 Fourth, does the MPC require reform?

Despite its youth, at least in central banking terms, the MPC has not suffered from lack of advice on how to improve itself. There have been six reports from the Treasury Select Committee, two reports from the House of Lords' Committee on the MPC, reports by a commission of the Conservative Party and by the Liberal Democrats, a report by the Engineering Employers' Federation, recommendations by many economists, including former MPC members, and, last but not least, the report commissioned by the Bank of England itself by Don Kohn, a senior staff member of the Federal Reserve Board and recently nominated by the President for appointment to the Board of Governors. Overall, the verdict on the Committee has been broadly positive. For example, in his 2001 review of the operation of monetary policy in New Zealand, Professor Lars Svensson describes the Bank of England and the Swedish Riksbank as examples of "best practice" monetary policy.⁶

Suggestions for improvement from the various groups cover the following areas: the definition of the inflation target; terms, appointments and composition of the membership of the MPC; arrangements for publication of the minutes; the forecast produced by the MPC; and, finally, a miscellaneous collection of technical matters.

The precise definition of the inflation target, and its numerical value, can be debated at length. What is important is that the target is for inflation and not additional objectives that would lead to confusion about the Committee's aims.

On the Committee itself various suggestions have been made: to extend the terms of appointment of members of the MPC, to make those longer terms non-renewable, and to appoint people with more diverse backgrounds. By far the most fundamental of these suggestions is the proposal to appoint representatives of different industries or regions to the Committee, as opposed to monetary policy experts. That would change the nature of the debate and undermine the mutual confidence of members of the Committee in each other if it were felt that some were representing a specific interest group. With experience of the MPC, I think that this argument has come to be accepted.

The proposal that the minutes of MPC meetings should include more description of individual views I discussed earlier. The Committee has been opposed to such a change for the reasons I gave. In its early days the Committee was sensitive to the view that the minutes, then published six weeks after the meeting, should be published earlier, and it shortened that lag to 13 days in October 1998.

The forecast process has attracted much attention, and was discussed at length in the Kohn Report. Presenting the forecast in terms of a fan chart, in order to highlight the balance of risks to the outlook, has proved successful. But it has proved more difficult to explain the role of a projection conditioned on the assumption of constant official interest rates. So the Committee also publishes a forecast conditioned on market interest rates, in order to provide a guide as to how the forecast depends upon the profile of short-term interest rates.

The Committee has had more problems in trying to explain that there is no mechanical link between the central projection of the forecast for inflation two years ahead and the policy decision. This is for several reasons. First, the view of inflation both prior to and after the two-year horizon is important too. The optimal horizon over which to bring inflation back to target depends on the shock which moved inflation above or below target. Second, the risks to inflation around the central projection (defined as the mode of the distribution of inflation at future points) are also relevant to the policy decision. Third, there may be some risks to which the Committee does not wish to respond until they have materialised. But the Committee will continue to explain how its outlook for inflation relates to the policy decision, and, over time, we hope that this educational effort will pay off.

Finally, there have been several miscellaneous suggestions for change to the MPC. First, the MPC has been accused of meeting too frequently and, as a result, changing rates too often. The EEF report suggested that the Committee meet only eight times a year, as does the Federal Reserve, because “meeting once a month could lead a central bank into changing interest rates too often in response to potentially misleading monthly data”. In fact, since June 1997 the MPC has changed

interest rates 23 times and the FOMC 20 times. Changes in rates reflect economic developments, not the frequency of meetings. In any event, the Bank of England Act 1998 states that we must meet at least once a month, and that we shall continue to do.

Second, there has been a suggestion that a more formal voting procedure be adopted for MPC meetings. The current voting procedure of the MPC is straightforward: discussion continues until each person's views are clear. The Governor then puts a proposition to the Committee which will command majority support. Some have questioned whether this procedure is robust and might bias the outcome. For example, the issue has been raised by the House of Lords Select Committee. But I think this is a misunderstanding of the way we work. It is important that our views are known to each other before we cast our votes because that is part of the process of making up our mind. The only complication with the current procedure would be if the Committee was split equally between three different courses of action. In theory, this could lead to a "voting paradox". The Governor would then need to decide which course was eliminated, leaving two policy choices for the Committee to choose between. That would normally be straight forward provided that, in the economist's jargon, preferences between interest rates were "single-peaked". When this is the case the voting paradox does not apply. For preferences not to be single-peaked members of the Committee would have to prefer, for example, both no change and a rise of 50 basis points to an increase of 25 basis points. It is not easy to see under what circumstances this would represent rational preferences.

Third, the set, or as we call it suite, of models used by the Committee should be improved. They are in fact under continuous improvement and the Bank has commissioned Adrian Pagan to carry out a review of the technical aspects of modelling in the Bank. That review will be published in 2003.

Fourth, it has been suggested that the MPC should meet outside London. The Court of the Bank does indeed meet once a year at a destination outside London, and these occasions have proved invaluable in expanding contacts between the Bank and the MPC on the one hand, and the local community, on the other. But MPC meetings themselves, as highly market-sensitive occasions surrounded by a *purdah* period, are quite unsuitable as opportunities to interact with the local business and other community. There would be little point in holding an MPC meeting outside London if the Committee were unable to speak and meet with local people. All members of the MPC travel widely around the UK outside of *purdah*, making some 50 visits during the past year,

and these contacts are an important part of the process by which the MPC is informed about the state of the economy.

During its short life-time the MPC has made changes in its procedures and remains open to the possibility of further improvements. But unnecessary tinkering would be a distraction from its main purpose. One does not have to go as far as Lord Falkland, who said in 1641 that “If it is not necessary to change something, then it is necessary not to change it”, to believe that, at least for the time being, major changes to the MPC are unnecessary. And if imitation is the sincerest form of flattery, then the Government can draw comfort from Michael Howard’s speech in March of this year when he argued that “Nor, given the importance of stability and continuity, do I think it right to propose any major changes in either the remit or the composition of the Monetary Policy Committee”. The fact that there is a broad, cross-party consensus on the objectives and broad framework of monetary policy is one reason to think that the stability we have experienced in the first five years of the MPC will continue in the future.

5 Conclusions

The idea behind the MPC was to take day-to-day politics out of monetary policy. It is now widely accepted that this was desirable. Macroeconomic policy in Britain had been much too exciting for comfort for most of the post-war period. In the 1970s, inflation averaged over 13% a year, and reached a peak of 27% in August 1975. During the 1980s inflation averaged 7% a year, and it is only since the inflation target regime was adopted in late 1992 that inflation has returned to both low and stable levels. Britain tried most types of monetary regime: targeting monetary aggregates both narrow and broad; shadowing an exchange rate target, and an explicit exchange rate target through membership of the Exchange Rate Mechanism. None was pursued for long, and none carried real credibility. It was following our exit from the Exchange Rate Mechanism in 1992 that the opportunity arose to put in place a new monetary framework based on an explicit target for inflation and a floating exchange rate.

The aim of the MPC is to keep both inflation and inflation expectations at the target level of 2½%. It is no small part of a central bank's role to create confidence and credibility in the belief that it will respond to any change in economic circumstances in order to maintain a broad degree of economic stability. In the economists' jargon, the public must believe that the central banks "policy reaction function" is consistent with stability, and if it is predictable, then announcements on interest rates should not come as news. The economic data will have led to expectations about the likely course of interest rates which, in most instances will prove a reasonable guide to the course of policy. A clear sign of the success of the MPC will be when we are no longer news.

The MPC has proved to be one of those rare "instantly invented precedents" that seem to have worked. It may not achieve the cult status of the Nine Worthies who, in the Middle Ages, inspired poetry, sculpture and stained glass windows. As one writer has remarked, "If one reviews the list of virtues that contemporaries found valuable in a knight – courtesy, loyalty, prowess, hardiness, largesse, and frankness – the Nine Worthies seem to meet the standard". If that level of achievement is no more than an aspiration for its nine members, at least the MPC can claim a record of reasonable competence during its first five years. As Stephen Bayley remarked in 1986, "civilisations are remembered by their artefacts, not their bank-rates".

Endnotes:

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² **Blinder, A S and Morgan, J (2000)**, 'Are two heads better than one: an experimental analysis of group vs individual decision making', *NBER Working Paper*, No. 7909, September

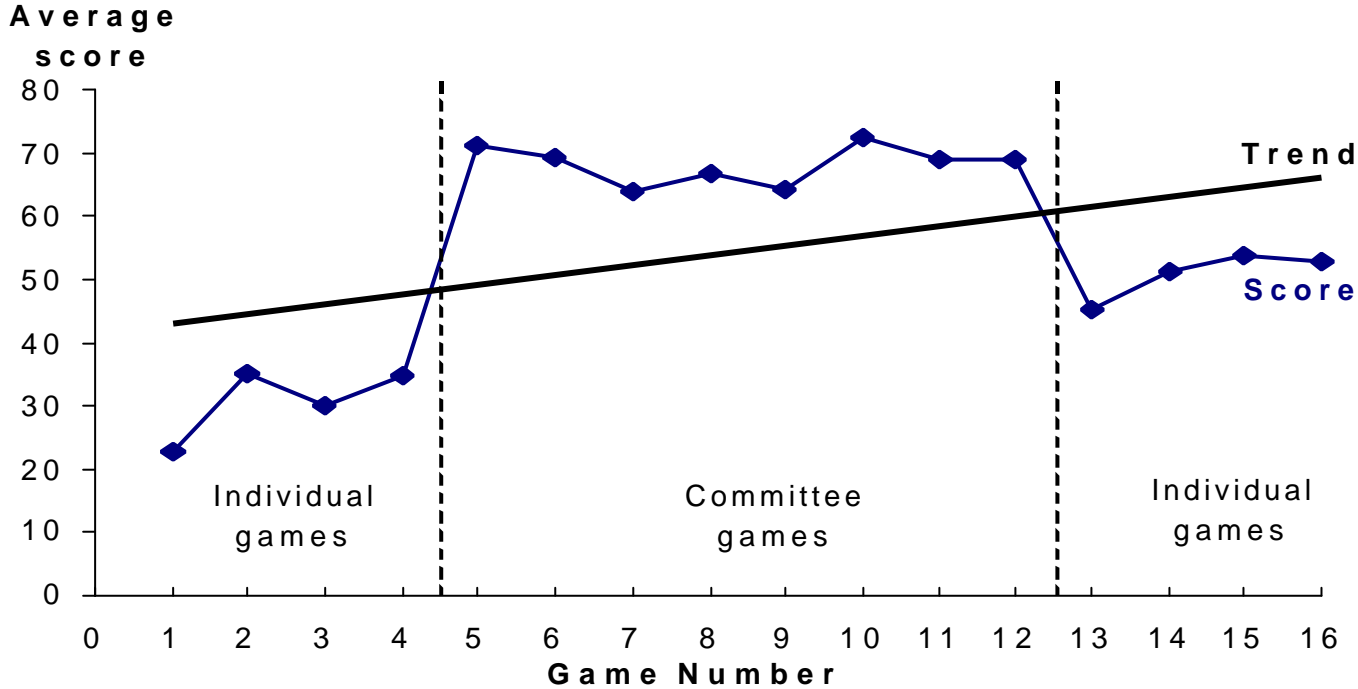
³ **Lombardelli, C, Proudman, A J and Talbot, J I, (2002)**, 'Committees vs individuals: an experimental analysis of monetary policy decision-making', *Bank of England Working Paper* (forthcoming)

⁴ **Economist**, 18 April 1998, p.28.

⁵ **Hall (1971)**, 'Decisions, decisions, decisions', *Psychology Today*, November

⁶ **Svensson, L.E.O (2001)**, 'Independent Review of the Operation of Monetary Policy: Report to the Minister of Finance', www.princeton.edu/~svensson/

Chart 1: average committee scores over time¹



¹ Players are scored according to their ability to keep inflation close to a pre-specified target and to minimise output fluctuations across each of the sixteen, ten period games. The Chart shows the evolution of scores over time:

- For the individual games, numbers 1-4 and 13-16, each diamond represents the mean individual score across the 170 participants.
- For the committee games, numbers 5-12, the diamonds represent the mean score across the 34 committees. In these stages, the five members of the committee vote in each period and the 'majority' - or more precisely - the median interest rate is set. Each committee is then scored according to this median outcome.

Table 1

<u>CUMULATIVE MPC VOTING RECORD</u>																
VOTING STATISTICS (SINCE JUNE 1997)	Eddie George	Howard Davies	Mervyn King	David Clementi	Ian Plenderleith	John Vickers	Willem Buiter	Charles Goodhart	DeAnne Julius	Alan Budd	Sushil Wadhvani	Stephen Nickell	Christopher Allsopp	Charles Bean	Kate Barker	Actual
MEETINGS ATTENDED	61	2	61	58	61	28	36	36	45	18	37	25	25	21	13	61
VOTED UP	9	2	17	8	9	10	17	12	2	5	3	3	0	0	0	9
VOTED DOWN	14	0	12	14	13	7	10	7	18	6	16	7	10	8	4	14
VOTED NO-CHANGE	38	0	32	36	39	11	9	17	25	7	18	15	15	13	9	38
VOTED WITH MAJORITY	61	2	51	54	56	23	19	33	31	14	24	22	21	20	13	-
VOTED DIFFERENT TO MAJORITY	0	0	10	4	5	5	17	3	14	4	13	3	4	1	0	-
VOTED NO-CHANGE WHEN CHANGE	0	0	2	1	2	0	0	0	3	0	1	0	0	0	0	-
VOTED CHANGE WHEN NO-CHANGE	0	0	8	3	3	5	17	3	11	4	12	3	4	1	0	-