



BANK OF ENGLAND

# Speech

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## **Boring Bankers – Should We Listen?**

Speech given by

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September 15 last year marked a very unusual moment for the US Federal Reserve Board. That evening, the Federal Open Market Committee held a special meeting – its first such unscheduled gathering since 1979: the purpose was to discuss how the Fed should be communicating with the public.

For an institution which around ten years earlier had been so discreet that it did not even announce when it had changed interest rates, this was a significant occasion. How and what they should disclose to the public has in recent years become a matter of pressing importance for members of the FOMC.

The following month, the Bank of Japan was also in a reflective mood. On October 10, its Board voted unanimously to approve a number of measures to “enhance the transparency of monetary policy”. These included a commitment to more timely press conferences, more lucid and concise explanations of the Bank’s view in its Monthly Report, and a shift of emphasis to focus more on expectations of future inflation rather than the immediate outlook.

In November, Jean-Claude Trichet took over as President of the European Central Bank. Much of the comment about his appointment focused on his obvious skills as a communicator – controlled and precise in his language, brilliant at handling the press.

My plan this morning is to discuss the importance of good communications to modern central banks, and why so much emphasis has been placed on this issue over the past year. Looking at the US and Europe in particular, I’ll then explain how each bank’s approach to the subject is shaped by its own history and structure.

Finally, I will talk about the Bank of England: why it communicates in the ways that it does; what I think about various suggestions for improving the process; and my views about how the Bank has been explaining its strategy in the months since I joined the Monetary Policy Committee last summer.

Thirty years ago, it would have been difficult to fit the words “transparency” and “central bank” into the same sentence. The main mission of the Bank of England’s

press officer, I recall ‘was to keep the Press out of the Bank and the Bank out of the Press’. And this was the norm among its peers.

The most highly regarded central banks in the world, the Fed and the Bundesbank, rightly placed a high value on their independence but managed monetary policy on a black box basis: achieving credibility at that time did not require transparency. In most other countries, politics tended to be at least as important as economics when it came to setting interest rates.

For a number of related reasons, all this began to change in the 1970s and 1980s. High and volatile rates of inflation around the world underlined the failure of established approaches to the management of economies. Monetary policy came to play a bigger role and to have visible impacts: Paul Volcker’s appointment as Fed Chairman in 1979 marked a turning point in this respect. Central bankers had to start explaining the decisions which were now having such a marked impact on the lives of ordinary citizens and central bankers no longer seemed so boring.

At the same time, the rapid expansion of capital markets also made central bankers pay more attention to the way they shaped expectations about the future path of inflation and interest rates. Policymakers came to learn that these expectations influenced people’s economic decisions. And they also discovered that there were benefits to be had from publicly explaining their moves - one famous example being the reaction of the newly appointed Alan Greenspan to the stock market crash of 1987. The FOMC explicitly reassured the markets that the Fed would serve as a source of liquidity to support the economy.

In 1994, the Fed began to issue a statement each time it changed rates, and four years later it started publishing more detailed statements when “it wanted to communicate to the public a major shift in its views about the balance of risks or the likely direction of future policy”.<sup>1</sup> Not long afterwards it began releasing statements after each FOMC meeting even when it had not changed rates.

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<sup>1</sup> See Minutes of the FOMC meeting 22 December 1998.

For the UK, the moment of truth came in 1992 when the country was ejected from the European Exchange Rate Mechanism. Faced with a policy failure of this scale, the response was a shift to inflation targeting as a way of imposing discipline on monetary policy and to greater transparency in an effort to build badly-needed credibility. The launch of the *Inflation Report* in the following year marked a big step in this direction.

The logical next step in this process was to give the Bank independent responsibility for the conduct of monetary policy, which as we all know was the first step made by the new Labour government in 1997.

Today, as always, a central bank's effectiveness is largely determined by its credibility. But what that now requires is not just an ability to make the right decision at the right time. In order to manage expectations of interest rates and inflation, those decisions need to be put into context and explained in a way that is rational and consistent.

For obvious reasons, the financial markets invest large efforts in trying to pick up signals from the central bank about future policy. But if these messages are communicated in a confusing or inefficient manner, credibility can be damaged – and with it, the effectiveness of monetary policy.

As Governor Bernanke of the US Federal Reserve Board argued in a recent speech: “Control of the federal funds rate is therefore useful *only* to the extent that it can be used as a lever to influence more important asset prices and yields - stock prices, government and corporate bond yields, mortgage rates – which in turn allow the Fed to affect the overall course of the economy.”

In certain circumstances, central bank talk can be as important as central bank action. This is particularly true in circumstances – such as those of the past year and more – when inflation has been subdued and nominal interest rates have been very low.

You can't cut an interest rate that is already close to or actually at zero. This was the problem faced a year ago in the US – where the federal funds rate fell to 1 per cent

last June – and even more in Japan, where short-term interest rates have effectively been close to zero for the past five years. Faced with fears about deflation in the US and the reality of falling prices in Japan, the authorities in both countries had to think about new ways of influencing expectations of future rates of inflation and of economic activity. Communications became a critical part of their strategy.

As US core inflation rates fell close to historically low levels in the early part of last year, Fed officials gave much thought – some of it in public – to the kind of unconventional tools that might be deployed to boost the economy should the fed funds rate hit the zero bound. One suggested move would have been for the central bank to start buying government bonds.

In early June, Mr Greenspan spoke of the possible need to build a “firebreak” to ensure that deflation did not happen. By the time of the FOMC meeting later that month, the markets were pricing in the possibility of a sharp cut in the rate and of a Fed intervention in the bond market. But they had been picking up the wrong signals – and when all they got was a quarter point rate cut, bond prices fell sharply.

By the time of its next meeting, the Fed was determined to leave no room for doubt about its strategy. Like most other central banks, it normally shies away from giving any indication of how it might move rates more than a month or two ahead. But under these special circumstances, Mr Greenspan felt it appropriate to send out a loud and clear message to the markets. After what was reportedly a lively meeting of the FOMC, the August statement made it clear that in the committee’s view, an accommodative approach to monetary policy could be maintained “for a considerable period.”

That form of language was repeated in subsequent statements until the beginning of this year, when it was modified to reflect the belief that the Committee could “be patient in removing its policy accommodation”.

This communications policy has been successful so far. Despite a robust rate of economic recovery, real interest rates in the US were until recently standing close to

long-time lows.<sup>2</sup> Fears of deflation have faded almost out of sight. And although everyone understands that the present federal funds rate – still at 1 per cent – is unsustainably low, the timing of any likely increase is very much a matter for speculation.

This outcome shows how the language that central banks use can influence market expectations at a time when the scope for actual policy changes is limited. Of course, the big question for the next few months is about how the Fed will manage its so-called exit strategy: how it will shift away from the promise of an accommodative policy without upsetting the markets.

The Bank of Japan will face a similar challenge, although perhaps over a different time-scale. Both will need to deploy communications skills of a high order.

The Fed's approach has been shaped almost entirely under the long chairmanship of Mr Greenspan. The main instruments are now the monthly statements, testimonies by the chairman to the Congress and frequent speeches by members of the FOMC. His personal record and credibility, together with the somewhat disparate nature of the FOMC, gives Chairman Greenspan a central role in the process of communications.

Votes by individual members at the rate setting meetings are published, but by convention there are rarely more than one or two dissenters. And the minutes of the meetings are not published until the Thursday after the *subsequent* FOMC meeting, which means that they can be curling round the edges a little before they reach public consumption.

By contrast, the European Central Bank does not publish the votes of individual board members or minutes of its proceedings – the reason being that board members could come under pressure from their home countries if their actions were to be disclosed in this way. In my view, however, members might find that their independence would actually be strengthened if their votes and arguments were in the public domain.

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<sup>2</sup> As measured by the yields to maturity on US Treasury Inflation-Protected Securities.

The current consensual approach to decision-making means that the ECB's single most important instrument for communicating with the public is the press conference which its President holds after the first council meeting each month. This takes the form of an introductory statement summarising the Governing Council's views, followed by a question and answer session.

Hence the importance of the President's ability to handle detailed and sometimes aggressive questioning from the media. In his latest meeting (in April) for example, President Trichet was peppered with questions about a subtle change in wording in the opening text: monetary policy was now said to be "in line with the maintenance of price stability over the medium term"; in the past, it had been described as "appropriate". Mr Trichet responded with enigmatic aplomb.

Where does the Bank of England fit into this picture? Compared with other central banks, it has at least two distinguishing features, which again are the results of history and of structure. Given the history of monetary policy in the UK since the war, it should be no surprise that the Committee's efforts are focused squarely on a single target which is set each year by the Chancellor of the Exchequer: a rate of CPI inflation of 2 per cent. That target is symmetric, which means that aiming too low is not the easy option, and other objectives – including growth and employment – are subject to the overriding goal of achieving price stability.

The second distinguishing feature of the Bank's Monetary Policy Committee is that its nine members are individually accountable to Parliament by way of the Treasury Select Committee, and to the public by way of frequent regional visits and presentations as well as through speeches and interviews. Our votes are published each month, and we can be asked to justify them. Unlike the Fed or the ECB, the monthly meeting does not try to arrive at a consensus.

Not only do members have to explain their own positions: more important, the Committee as a whole has to present a coherent view. This explains why the single most important method by which the MPC communicates with the public is its detailed monthly minutes. These were initially published six weeks after the MPC meeting, as dictated by the Bank of England Act, but since late 1998 the publication

date has been brought forward so that they are now released two weeks after the meeting.

The importance of the minutes is that they discuss how the Committee views the economic outlook and the developments since its last meeting. They can also reflect the different arguments put forward by its members.

The fullness of the discussion could not be brought together in a brief press statement published on the day of the meeting, in the way that the Fed does the job. It is true that these days the Bank sometimes does publish a short statement, usually on the days when it changes the rate. Yet it can be quite difficult to hit on the right language even for these few sentences in the tight time-scale available.

This is also why I believe that it would be a mistake for the Governor to run a press conference on the day of the meeting. It would be difficult for him to capture the mood of the meeting in the face of sometimes aggressive press questioning. And it would take attention away from the minutes themselves, which are the key to understanding the Committee's thinking.

Should the individual votes be published on the day of the rate decision? The case in favour is that this can be price sensitive information, which is best disclosed as soon as possible.<sup>3</sup> One good example came last October, when an unexpectedly close vote to hold rates was interpreted as a trailer for a rate increase in November.

The case against is that publishing the votes without the minutes could mislead the markets. A good example of this came in March of this year, when the vote for no change was 9-nil, but the minutes subsequently showed that several members had come close to favouring a rate increase.

On balance, I would favour sticking with the present arrangements.

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<sup>3</sup> Gerlach-Kirsten (2003) finds some evidence that votes do contain price sensitive information; in particular that split votes can help to predict future changes in the policy rate.



Some have argued that publication of the minutes should be speeded up yet further. The challenge here is that these are not like the minutes of the local tennis club. First, the staff has to distil six hours of often quite discursive argument into an orderly text. Then individual members of the Committee have to be sure that their views are properly represented. Finally, the Committee as a whole has to consider the text – both for the big picture which it is presenting, and the more subtle images which it may contain. This is a world where adjectives can matter a great deal.

It is worth noting that when in January the FOMC considered the idea of bringing forward the publication of its minutes from around six weeks after each meeting, some members objected on the grounds that this might not give them enough time to review and comment on the text, and to reconcile differences of opinion.

So it is not easy to see how the Bank's processes could be speeded up significantly.

What might be worth considering, however, is whether the views of individual members could be attributed explicitly to them in the text – perhaps in the concluding section on the policy decision. This would mean that members were publicly accountable for the justifications of their votes, and it might allow the public to make more informed judgments about how each member reacts to news events.

There are good arguments against, though. Such disclosures could, for example, affect the dynamics of the Committee's meeting – free-flowing discussions of issues could be replaced by more formal statements. And they might tend to focus attention on sometimes quite minor disagreements among members, rather than their broad agreement on the big picture.

Another very important instrument for influencing expectations about future rates of inflation and economic growth is the quarterly *Inflation Report*. This serves a double purpose. First, since the MPC is itself responsible for the projections which are updated in every issue, its members have to get to grips with the details of the outlook in much greater depth than is possible in the monthly round. The discussions also allow the MPC to step back a little and think about long-term trends. One of the

things that surprised and impressed me as a newcomer was the amount of thinking time and attention paid by the entire committee to this process.

Second, the *Report* is a way of communicating the Bank's views about developments in the economic outlook to the general public. Some have argued that the *Report* simply goes over the top in the amount of detail it provides. Writing last year in a report commissioned by the Riksbank, Eric Leeper said that the Bank of England wins the "fill the bathtub" award, reporting as many facts as possible seemingly regardless of their relevance or importance.

But one of the aims of the *Report* is to give a broad picture of economic trends, allowing the readers to make their own judgment about the direction in which the economy is moving. Chapter Six, the Prospects for Inflation, is where the Committee gives its own summary of the issues that matter when it comes to setting interest rates. And there is room within that structure for dissenting opinions to be expressed.

Moreover, the Bank gets a further opportunity to explain its priorities through the press conference chaired by the Governor, when the *Inflation Report* is published. This has the benefit of *not* being associated with an immediate policy decision, which means that the message can be broader and more forward-looking than would otherwise be the case.

One criticism made by Leeper, Donald Kohn and others which has more weight, it seems to me, is about the prominence given in the *Report* to the projections of inflation and GDP growth which are based on the assumption of a constant interest rate.

This formula has the benefit of not expressing a view about the likely course of future rates, with each policy decision being taken afresh as events unfold. But in most cases, it may not be credible that interest rates will remain constant for two years, and asset prices may reflect different expectations for interest rates. And the *Inflation Report* contains a forecast conditional on the path of interest rates implied by the market yield curve, to which observers should also pay attention.

What messages has the Bank been sending to the public in recent months? I should emphasise here that these remarks represent my views, rather than those of the Committee as a whole.

If you had read the minutes since the October meeting, together with public statements by the Governor and other Committee members, I think you would have come away with the clear message that interest rates were considered to be at a level which would stimulate the economy; that inflationary pressures were likely to be building gradually over the forecast period; and that rate increases would be forthcoming if growth were to continue above trend.

There were several reasons for being willing to talk about the likely future path of interest rates in this rather frank way.

The first was that last autumn marked a turning point in the UK interest rate cycle. After declining for almost four years, the repo rate was pushed up by a quarter of a percentage point in November. Such turning points are moments of uncertainty in the financial markets, and there is some evidence that policy changes can have larger effects on market rates at such times.

So they need careful handling – and the case for caution was increased by the high level of household debt. It was hard to know how borrowers might react to the first rate increase and so it seemed sensible to signpost what was happening with particular care.

Another consideration was the Chancellor's announcement in June of last year that the policy target was going to be switched from the RPIX measure to the Consumer Price Index. Although the actual target number was not set until the Pre-Budget Report in December, it was always clear that clarity in communications would be especially important at the changeover period.<sup>4</sup>

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<sup>4</sup> This issue is discussed in more depth in two speeches by King (2004) and Nickell (2003).

We were moving from a measure which at the time was above the central inflation target and falling to one which was below the new CPI target, and projected to rise. We were convinced that the changeover had few implications for inflation prospects in the medium-term and thus the actual conduct of policy, but in these potentially confusing circumstances it seemed important to set the change in a broader context.

Finally, the broad policy message was rather obvious. With interest rates standing as they did in October at 3.5 per cent, policy clearly was accommodative. The Bank's publicly stated view was that inflationary pressures would continue to build over the two-year horizon if economic growth continued above trend. So there was little risk attached to suggesting that other things being equal, rates would probably edge upwards.

I would argue that these have been rather unusual circumstances and that we are probably now moving towards a different set of communications challenges. Rates have edged higher without a dramatic impact on consumption growth so far, and inflation expectations appear to be consistent with the new target.

For the MPC, perhaps the biggest domestic uncertainty now is about the outlook for the housing market over the next year or two. Our job is to target inflation, not asset prices, but the Committee will need to explain with great care the impact that house prices can have on consumption and inflationary pressures, and how in turn that influences its policy decisions.

The Committee's traditional position has been that every month represents a fresh decision, and this approach seems to me to make sense. As Rachel Lomax put it earlier this year:

“Every month I have a fairly well developed view not just about this month's interest rates, but about where interest rates are likely to need to go in the future to achieve the inflation target. But that view may – indeed should – change in the light of new information, better research, another set of forecasts, perhaps a different view of the risks.”

As a relative newcomer to the MPC, I think I am allowed to say that the Bank has done a good job over recent years in communicating its strategy to the public. Inflation expectations are well anchored to the target level: one way of measuring this is to look at the inflation rates implied by the gap between the yields on index-linked and nominal bonds. These, as well as surveys of professionals' inflation expectations, have for some time been consistent with the Bank's inflation target.<sup>5</sup>

While some opinion polls suggest that a proportion of the public may still overestimate the current and likely path of inflation, this has not been reflected in the subdued rate of earnings growth in recent years. Given the choice, a good majority of people would prefer to opt for a higher rate of interest than a faster rise in prices.<sup>6</sup> This implies a healthy awareness of the real dangers of inflation.

The goal set – only half in jest – by the Governor, Mervyn King, is that the decisions of the MPC should come to be deemed seriously boring by right-thinking people. That would imply that the Bank had achieved its goals of low and stable inflation, and that it could always be trusted to do the right thing – the ultimate aim of monetary policy.

Does this mean that the Bank's monthly decisions would become utterly predictable? The Committee-based approach of the Bank means this is unlikely to be the case. Members learn from each other in frank and open discussions during policy meetings. And the resources that the Bank dedicates to analysing the economy also add value. So while people may have a better understanding of the Bank's likely reaction to developments in the economy, it may still spring surprises from time to time.

By most measures, the Bank of England is already one of the most transparent central banks in the world, but the market can still be surprised by its decisions.

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<sup>5</sup> For an illustration, see 'The sensitivity of the economy to changes in interest rates' February 2004 *Inflation Report* p.10-11.

<sup>6</sup> This question is asked in survey conducted by NOP on behalf of the Bank. The responses for the 2003 survey can be found in 'Public Attitudes to Inflation', *Bank of England Quarterly Bulletin*, Spring 2003.

So should it seek ways of lifting yet more veils, in the hope of achieving that virtuous state of boringness?

This could be risky. A bank's ability to influence expectations in the way that it wants depends on its credibility, and in today's markets – as I've suggested – credibility requires a greater degree of transparency than seemed necessary in the 1970s and 1980s. But it would be possible to confuse the markets, and damage credibility, by publishing too much information.

To take an extreme example, if MPC members published their thoughts about the economic outlook on a day to day basis, you would soon be lost in a tangle of revisions and discrepancies. Better to concentrate on the big picture and to co-ordinate the communications process in an orderly fashion.

But there might be room for building yet more public support for price stability by seeking to communicate with audiences outside the financial markets. Most of the Bank's publications are technical in nature – which is necessary for financial analysts but is less effective for informing the broader community.

In my own experience, few business leaders have much idea about how the MPC operates and the general public is probably even less well informed. There are already excellent initiatives such as the annual schools competition "Target 2.0", which are aimed at sending the message out to a wider audience. Maybe there could be more.

As new generations grow up with no memories of what inflation did to society in the 1970s and 1980s, the Bank will continue to have to work hard to build the constituency for low inflation. Its long-term approach to communications will remain a critical part of this exercise.

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