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Speech

Communicating Monetary Policy in Practice

Speech given by

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It is a great pleasure to be here, the third member of the Monetary Policy Committee to have the privilege of speaking in this distinguished Vital Topics lecture series at the Manchester Business School. My links with Manchester and its business community go back around thirty years, to when my late father, Denis Bell, was appointed chairman of the then North Western Electricity Board (Norweb) and my family moved to the area. They still live here, and I have been able to witness Manchester's stunning development and progress of recent years, be it Salford Quays, the new merged University, or the Spinningfields development where The Royal Bank of Scotland has its new offices.

When I accepted Professor John Arnold's kind invitation to give one of this year's Vital Topics lectures, I must confess I had not appreciated that it was to be sponsored by the Manchester Evening News and The Royal Bank of Scotland. So I am surprised and delighted to discover that tonight I have a double pleasure: not only am I honoured to be speaking in this, the first Vital Topics lecture series of the new Manchester Business School, now the largest campus-based business school in the UK, but I am sharing the platform with an old friend and colleague from RBS, Martin Merryman, Director of RBS Financial Markets North.

Aware that I would be approaching the end of a three-year term on the Monetary Policy Committee when I spoke to you this evening, I had considered that it might be appropriate to offer you some reflections on the process and communication of monetary policy in this country. In the

event that seems to have been a felicitous judgement. For it was in May, almost exactly eight years ago, shortly after an historic election victory by the Labour party, that significant changes to the framework of monetary policy in the United Kingdom were announced, which established the monetary policy regime we have today. And it was in a Royal Bank of Scotland dealing room that I heard the news.

In those days interest rate announcements were a big deal and a crew from ITN were standing ready to film the financial markets' reaction to the first interest rate decision of the new Chancellor, Gordon Brown, and to record my comments. But it was not just an interest rate change that was announced. A new Monetary Policy Committee of the Bank of England was to be formed and given operational independence to set interest rates to achieve the Government's inflation target.

Hitherto interest rates had been determined by the Chancellor of the Exchequer following consultation with the Governor of the Bank of England. The shortcomings of this procedure, which had become known as the "Ken and Eddie" show under the previous administration, were contrasted with the new arrangements by then Governor Edward, now Lord, George in a Manchester Business School Vital Topics lecture in February 1998. As he told this audience: "the reflective, interactive, debate within the Monetary Policy Committee is very different (too) from the sometimes exaggerated advocacy of a particular viewpoint which inevitably crept in to the Ken and Eddie show during which the Bank usually had at most an hour in which to persuade a sometimes reluctant Chancellor!¹"

So unexpected was the announcement of Bank of England independence when it came in May 1997 that it took me some minutes to persuade the

¹ See George (1998).

assembled team from ITN that the real story was not the interest rate change (a rise of a quarter percentage point as it turned out) but the new monetary regime, a story which, I believed, should lead the lunchtime news. I was whisked to the studios where I declared that this was an event of historic significance, a brave and progressive move that subsequent governments would be unlikely to reverse.

And so it has proved. In the recent election campaign no major political party proposed any changes to the system in their manifestos. And even the particular choice of inflation target (currently 2% on the Consumer Price Index measure of inflation), a legitimate matter for democratic choice, was unchallenged. The new system is widely perceived to have been a success. Until December 2003 the Monetary Policy Committee was charged with keeping inflation of the Retail Price Index excluding Mortgage Interest Payments (RPI-X) at 2.5%. It averaged almost exactly that, 2.4%, over the period, never deviating by more than one percentage point either side of target. And inflation on the new Consumer Price Index measure is currently close to its 2% target. See chart 1. As an aside, it should be noted that the rather higher rate recently recorded by the RPI is due to higher mortgage costs as the MPC has raised interest rates over the last year. RPI-X, which strips this effect out, is close to its old 2.5% target. Moreover economic growth and employment have been remarkably stable, though one can argue about the extent to which that reflects good luck rather than good judgement.²

For the last three years, as a member of the Monetary Policy Committee, I have had the privilege of being part of that process. Tonight I would like to share with you some reflections.

² See Bean (2005) and Bell (2005).

As Lord George recognised, in that first MPC Vital Topics Lecture in which he described the new arrangements, a key element of the UK's monetary policy framework is its transparency. Under the Bank of England Act 1998, the goal of monetary policy is clear. It is to achieve price stability as defined by the government's inflation target, reconfirmed to the Committee each year at Budget time, and, subject to that, to support the government's economic policy objectives. We are lucky; not all monetary policymakers have such a clear objective. The transparency of the target buttresses the credibility of monetary policy, helping inflation expectations to remain anchored and making it easier to bring inflation back to target in the event of shocks. A clear understanding of the policy process builds confidence and mitigates sudden surprising moves in interest rates which can unsettle real economic behaviour.

The Committee communicates its policy in several ways. Many of the tools it has at its disposal are an integral part of the policy framework, enshrined in legislation and detailed in the Chancellor's annual letter to the Governor setting out the MPC's remit. First, there is the monthly interest rate announcement itself, sometimes with an accompanying statement. Two weeks after the meeting to which they refer minutes are published. A quarterly Inflation Report gives a detailed assessment of the economic conjuncture and the Committee's forecasts for growth and inflation, detailing the uncertainties and risks to the central projection, and is followed by a televised press conference by the Governor. Individual members of the Committee are regularly called before parliamentary committees, the Treasury Select Committee of the House of Commons and the Economic Affairs Committee of the House of Lords, and they give media interviews and speeches, working with the twelve Agencies of the Bank around the regions and nations of the United Kingdom. No doubt many of you will be familiar with the Bank's

Agent in the North West of England, John Young, and his two deputies, Graeme Chaplin and Neil Ashbridge.

Of course under the framework the Committee has another tool of communication at its disposal that it has in fact not so far been able to use in practice. Should inflation deviate from target by more than one percentage point the Governor is required to write the Chancellor an open letter explaining why, outlining the steps the Committee proposes to take in response, the period within which inflation is expected to return to target, and how this approach meets the government's monetary policy objectives. A further letter is to be sent after three months if inflation remains more than one percentage point away from target. Some commentators have interpreted this system as the Committee's punishment for failure if inflation falls outside an acceptable target range. It is not. The target is a symmetric point target. The MPC is required to achieve 2% CPI inflation at all times. But it is recognised that "the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output" and employment³. In other words, in the event of a substantial shock the letter provides a public opportunity for the Committee and Chancellor to engage in an open debate about the desirable strategy for bringing inflation back to target. As the Chancellor noted when setting out the MPC's remit: "In responding to your letter, I shall, of course, have regard for the circumstances prevailing at the time."

So how good is MPC communication in practice? How transparent are we? In my experience the MPC is straightforward in its communications. The MPC doesn't spin. Nor are we disingenuous. For instance, if MPC members say they are not targeting house prices, that means they are not

³ See Bank of England (2005b).

targeting house prices. This doesn't always make interesting copy and there is sometimes a tendency to look for hidden messages. But the truth is often more simple. We are even more boring than you might think.

Unfortunately for headline writers, however, the stuff of monetary discourse is risk and uncertainty, the nuanced probabilistic language of possibilities and likelihoods. As the present Governor, Mervyn King, likes to point out, the probability that our central projections for output and inflation will be realised is close to zero. That is why the forecasts are presented in the form of fancharts representing the Committee's collective view of the likely probabilities of a range of different outcomes. But, as the Governor also reminded us recently, public debate in many policy areas deals poorly with issues of risk and uncertainty: "The reluctance to give adequate prominence to risks may reflect the fact that many of us feel uncomfortable with formal statements of probabilities."⁴ Perhaps as a result, commentators may be inclined to over-simplify and over-interpret MPC comment. A speech or interview is rarely a direct hint about the next vote. It would be a foolhardy hostage to fortune if it were.

In addition, the MPC faces a challenge in communicating policy that is not faced by many other central banks. Monetary policy in the UK is not formulated collectively by the Committee, but individually. The policy decision each month is taken by majority vote and each member is individually accountable to the government, parliament and the public at large for his or her decisions. The votes, and the arguments which inform them, are published in the minutes. If I have formed one overwhelming impression from my years on the MPC it is of the importance of individual accountability, and of the respect accorded to the integrity of Members' individual views among the staff of the Bank and within the

⁴ King (2004).

process itself. The individual accountability of members of the Monetary Policy Committee is paramount. And the procedures originally established by Governor George and the then Chief Economist, now Governor, Mervyn King, respect and safeguard individual accountability. You can see this in the influence individual members have on the research agenda and the willingness of the staff to pursue minority interests. You can see it in the complete absence of pressure to vote in a particular way for, while issues are discussed in great depth, there is no advance disclosure of voting intentions, no deals struck in cabals or smoke-filled rooms (in fact since Sir Edward ceased to be Governor we have had no smoke-filled rooms at all). And you can see it in the care the Governor takes, as his predecessor did, always to be the last to give his policy recommendation, after the rest of the Committee have spoken, so as not to exercise any undue influence on the vote.

This is important. There is evidence that committees make better decisions⁵, not just reflecting majority voting, but also because the pooling of individual knowledge among committee members “means that a group can be more than just the sum of its parts”⁶. Some commentators have argued that dissent on the Monetary Policy Committee, as measured by the frequency of split votes, appears to have diminished and that might mean the Committee is less effective. But what appears to matter to the effectiveness of committees is the exposure to a diversity of view, the wide-ranging nature of discussion, the willingness to consider all possibilities. The persistence or otherwise of minority voting tells us little about the diversity of opinion expressed. Having disagreed with and voted against the majority on the Committee, as I have on several occasions, I have been happy to find that real engagement has enabled me to vote with the majority again, at least for a while. Indeed two MPC

⁵ See Blinder and Morgan (2000), Lombardelli, Proudman and Talbot (2002) and Surowiecki (2004).

⁶ Lombardelli, Proudman and Talbot (2002).

colleagues, Lomax (2005) and Lambert (2005), have noted the importance of the lengthy discussion that takes place on the Committee in formulating the Inflation Report projections, and indeed it appears that Committee members are individually more likely to alter their views in Inflation Report months, suggesting that the process has informed their views⁷.

In fact the financial markets appear to recognise that the discussion can be as informative as the vote. Analysis undertaken at the Bank of England finds that on average the MPC Minutes contain as much news for the financial markets when the vote is unanimous as when it is split⁸. But it is important that both the Minutes and the Inflation Report adequately reflect the breadth of debate and views on the Committee. There can be many routes to the same conclusion. At least one observer has suggested that concentration on the voting record might encourage individual members to raise their profile by dissenting⁹. That would be unfortunate.

It has been supposed that individual accountability might confuse the clear communication of monetary policy. The Committee does not coordinate a communications strategy. If we all speak at once it may tell you something about the common pressures on our diaries, but not that we have a strategy to get a collective message across. In any case speeches are usually arranged too far in advance for that to be practicable. To form expectations of the future course of interest rates, therefore, observers need to understand the thinking not of one but of nine, and not

⁷ In her speech Rachel Lomax (Lomax,2005) showed that “since 2001, almost two thirds of rates changes taking place in Inflation Report months, compared with the one third that would be expected if rate changes were evenly spread over the year.” We can see a similar pattern in changes to the level of interest rates that members individually voted for. On average, members changed the level of interest rates they voted for 48% of the time in all Inflation Report meetings, compared to 37% of the time for all meetings.

⁸ I am grateful to Rachel Reeves and Michael Sawicki for this analysis.

⁹ See Gerlach-Kristen (2003).

just on the central view but also on the attendant risks and uncertainties. Might a multiplicity of voices speaking about monetary policy make it harder to understand? In the early days of the Committee I had feared that it might and that there might be a tension between individual accountability and effective communication¹⁰.

So what are the features of a transparent monetary policy regime against which the performance of the MPC can be assessed? First, there is credibility. On this the current policy framework scores highly. After the new framework was announced in 1997 inflation expectations in the financial markets, which had generally exceeded the old target, quickly came in line with the new target. See Chart 2. Expectations have remained anchored at target since, suggesting that the new regime is more credible than the old.

It might also be expected that movements in official interest rates would be fully anticipated in a totally transparent monetary policy regime in which the policymakers' so-called "reaction function" was fully understood. Although expectations of the future course of interest rates would respond to economic developments, the public would know how the policymakers would process the information and the interest rate moves themselves would be anticipated. Monetary policy would indeed be boring. However in an early study using data from January 1994 up to June 1999 Clare and Courtney (2001) found little change in the market reaction¹¹ to interest rate announcements following independence. In other words interest rate decisions appeared to still surprise as much after independence as before. Lasaosa (2005) extended this study to June 2001 and found that not only could interest rate announcements still surprise after 1997 but that macroeconomic data announcements surprised the

¹⁰ See Bell (1999).

¹¹ Relative to average volatility.

markets less in the post-independence period, and interest rate changes about the same or more. This was the opposite of what might have been expected. Moreover, at least up until mid-2001, it did not appear that surprises were diminishing, as might have been expected had it taken the markets time to learn how the new regime worked.

How should we make sense of this finding? Could this imply that the UK regime is not so transparent and well understood after all? Or might there be aspects of transparency which could raise the likelihood of surprises? First, it should be noted that these studies compare data post-independence with the period 1994 to 1997, whereas in fact some aspects of the current regime, such as an inflation target, publication of the Inflation Report and the minutes of the (albeit very different) monetary policy meeting were in place by 1994¹². Indeed Chart 3¹³, which shows the extent to which financial markets have been surprised by interest rate decisions since 1986, appears to suggest that surprises had diminished by 1994 compared to the earlier period, although the extent of earlier surprises might have been exaggerated in a less liquid market. Second, Lasaosa (2005) uses data up to mid-2001 and it is possible that more recent evidence taken from the last four years could show that the incidence of surprises has diminished.

Moreover, in a forthcoming paper, Lavan Mahadeva of the External MPC Unit shows that if monetary policy announcements contain new information on the state of the economy, and hence the likely future

¹² Important changes which were implemented since September 1992 were the quantification of an inflation target in October 1992 by Chancellor Lamont; the publication of a quarterly Inflation Report since February 1993; the formalisation of the role of the monthly meetings between the Governor and the Chancellor; the publication of the minutes of these meetings; and the issuance of a press notice outlining the reasons for the change. See, for example, Bowen (1995).

¹³ The data used are on the three-month LIBOR interest rate futures contracts traded on the London International Financial Futures and options exchange (LIFFE). A three-month constant horizon implied forward rate is derived from adjacent contracts by linear interpolation. The chart shows the daily (9am to 6pm) surprise on days that the policy rate was changed since 1986. Rate changes were not always implemented according to a pre-announced timetable of days or times for this period. Hence we use the daily surprise.

stance of policy, then transparency might increase the extent to which financial markets react to policy announcements. This might occur if the policymakers are better placed to interpret what news means for inflation and output, and for policy. Policy announcements would then act as a beacon, helping the private sector understand the economic conjuncture. This would suggest that we might expect the relative incidence of surprises to have increased following Bank of England independence, reflecting both the increased transparency of the decision-making process and the role of experts in setting the policy rate.

In an attempt to understand the reasons for the persistence of surprises in the new policy regime we have examined the events and market behaviour leading up to the four occasions on which the financial markets appear to have been most surprised by an interest rate announcement. These are the occasions when the move in the implied three-month interest rate three-months forward¹⁴ from 15 minutes before an interest rate announcement to 45 minutes after it has been the largest. See Chart 4. The four occasions are June 1998, September 1999, August 2001 and February 2003. In all cases it was a decision to change the official interest rate that surprised, rather than an unexpected no-change decision and longer dated expectations (for three-month interest rates six and twelve months hence) also recorded significant moves, suggesting that the interest rate surprise was more than simply one of the timing of a rate move that was otherwise anticipated. The two most recent surprises were in Inflation Report months, perhaps reflecting the intensity of the Committee debate in those months.

All four surprises seem to have resulted from a difficulty in identifying turning points. Three occurred well into the cycle, when many of the economists surveyed by Reuters had thought that rates had already

¹⁴ See footnote 13.

peaked or troughed; in September 1999 it was the timing of the first rate rise that surprised. The prevalence of surprises at turning points would seem to be consistent with the rate decision having provided a signal to help the private sector understand policy and interpret the current conjuncture. Moreover, the Minutes of the meetings reveal that several of the surprises seem to stem from an asymmetric interpretation of economic data by the Committee and the private sector, which would also suggest that the rate decisions played a role in signalling the monetary policy implications of economic news. The Committee's concern about the strong average earnings figures in June 1998 is the most striking example of this, but differences in interpretation of data also appears to have played a role in the September 1999 and the August 2001 surprises.

None of the rate decisions were unanimous. But in all but one instance, the previous month's meeting had seen a minority voting for the move made the following month¹⁵. This is consistent with Petra Gerlach-Kristen's finding that minority voting is informative about subsequent interest rate moves¹⁶. However on two occasions there had been a three-way vote in the previous month, with a minority also voting for a move in the opposite direction¹⁷. On each occasion there had been one or more speeches, and also interviews, by MPC members in the month leading up to the decision. On the first two occasions this included members who didn't support the rate move. On the last occasion, February 2003, a speech by Governor George was incorrectly interpreted by some observers as ruling out a cut. However, although this may have reinforced prevailing interest rate expectations, there is no evidence from financial market prices that this speech altered expectations. In the event, the

¹⁵ In the case of the June 1998 rate rise the minutes for the prior meeting had not yet been published but the last published minutes revealed several members voting for a rise.

¹⁶ See Gerlach-Kristen (2004).

¹⁷ Although on the first such occasion, in June 1998, that would not have been known at the time. See footnote 15.

Governor voted with the majority in favour of a cut in rates. This evidence suggests that a multiplicity of individually accountable voices speaking in the period leading up to the interest rate decisions could have led to a misinterpretation of the majority position and been a factor contributing to the four interest rate surprises we have examined.

Conclusion

So it would seem that no matter how clear the MPC might be in communicating, asymmetric information and knowledge will mean that surprises cannot be entirely eliminated. Moreover the complex nature of the subject matter, the range of potential outcomes, the risks and uncertainties can militate against simplistic expressions of the outlook for growth, inflation and interest rates.

The inevitable tension between the expression of individual opinion and the expression of a clear message is another ingredient that can complicate communication. But individual accountability is an important factor in the strength of the current framework. It would be folly to interfere with it. But it is important that the full range of argument and diversity of opinion be expressed in the Minutes and the Inflation Report. Financial markets and the media have shown that they have the sophistication to deal with it. Of course, interviews and speeches can further elucidate individual viewpoints. But the expression of an individual view between meetings has to be regarded as just that – an individual view.

What is clear, however, is that while individuals on the Committee may differ on the outlook, the risks, or the policy implications, they all remain committed to achievement of the inflation target. So you can be sure of

one thing; whatever the economic weather, there are nine individuals committed to ensuring that CPI inflation stays close to 2%. That message at least is simple.

Appendix of Tables

Table 1a. Surprise of 04/06/98¹⁸

| Date of surprise | Size of intraday surprise on implied 3 month LIBOR forward rate at a constant horizon of... | | | Monetary policy speeches and published press interviews in prior month | Meeting vote | Previous vote | Reuters Poll summary |
|------------------|---|----------|-----------|---|---|--|--|
| | 3 months | 6 months | 12 months | | | | |
| 04/06/98 | 0.238 | 0.250 | 0.204 | Speeches: MAK (27/05/1998); EAJG (28/05/98). Press interviews (date done): DC (08/05/98); DJ (13/05/98) and MAK (15/05/98). | 8:1 vote for a rise of 25bp to 7.5%. Dissenter: DJ (cut). | Minutes released on 10/06/1998. 6:2 vote for no change. Dissenters: WB (rise), DJ (cut). | 25 out of 27 economists predicted no change, 2 predicted a rise. |

¹⁸ Source: Bank of England, LIFFE and Reuters. The surprise is measured as the difference between 11.45am and 12.45am values. See footnote 13. Christopher Allsopp (CA); Charles Bean (CB), Kate Barker (KB); Willem Buiter (WB); David Clementi (DC); Sir Edward George (EAJG); Charles Goodhart (CAEG); DeAnne Julius (DJ); Mervyn King (MAK); Sir Andrew Large (AL); Ian Plenderleith (IP); Stephen Nickell (SJN); Paul Tucker (PMWT) and Sushil Wadhvani (SW).

Table 1b. Surprise of 08/09/99

| Date of surprise | Size of intraday surprise on implied 3 month LIBOR forward rate at a constant horizon of... | | | Monetary policy speeches and published press interviews in prior month | Meeting vote | Previous vote | Reuters Poll summary |
|------------------|---|----------|-----------|---|--|--|--|
| | 3 months | 6 months | 12 months | | | | |
| 08/09/99 | 0.293 | 0.309 | 0.199 | Speeches: MAK (27/08/1999) Press interviews (date published): DJ (02/09/99) and SW (02/09/99). | 7:2 vote for a rise of 25bp to 5.25%. Dissenters: DJ and SW(no change) | Minutes released on 18/08/1999. 9:0 vote for no change. | All 23 economists predicted no change. |

Table 1c. Surprise of 02/08/01

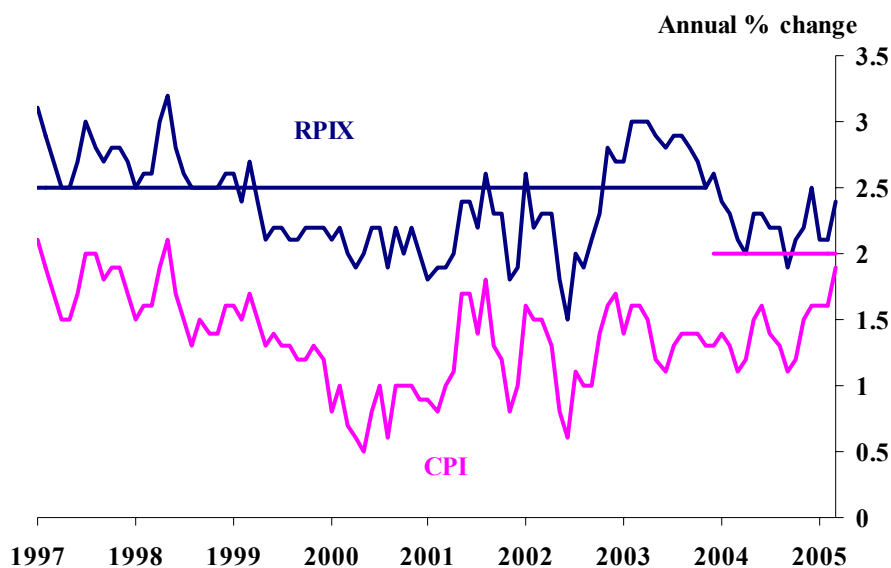
| Date of surprise | Size of intraday surprise on implied 3 month LIBOR forward rate at a constant horizon of... | | | Monetary policy speeches and published press interviews in prior month | Meeting vote | Previous vote | Reuters Poll summary |
|------------------|---|----------|-----------|--|---|---|--|
| | 3 months | 6 months | 12 months | | | | |
| 02/08/01 | -0.207 | -0.141 | -0.196 | Speeches: SW (24/07/01). Press interviews (date published): CB (18/07/01) and (21/07/01); EAJG (20/11/01); DJ (23/07/01) and (01/08/01); SJN (23/07/01), (26/07/01) and (27/07/01); SW (20/07/01) and (25/07/01). | 6:3 vote for a cut of 25bp to 5%. Dissenters: DC , MAK, and IP (no change) | Minutes released on 18/07/2001. 8:1 vote for no change. Dissenter: SW (-25bp). | All 28 economists predicted no change. |

Table 1d. Surprise of 06/02/03

| Date of surprise | Size of intraday surprise on implied 3 month LIBOR forward rate at a constant horizon of... | | | Monetary policy speeches and published press interviews in prior month | Meeting vote | Previous vote | Reuters Poll summary |
|------------------|---|----------|-----------|--|---|---|--|
| | 3 months | 6 months | 12 months | | | | |
| 06/02/03 | -0.202 | -0.241 | -0.250 | <p>Speeches: CB (29/01/03); and EAJG (20/01/2003). Press interviews (date published): KB (17/01/03), (18/01/03), (19/01/03), (23/01/03); and EAJG (21/01/03).</p> | 7:2 vote for a cut of 25bp; rate at 3.75%. Dissenters: AL and PMWT (both no change). | Minutes released on 22/01/2003. 7:2 vote for no change. Dissenters CA and SJN (-25bp). | All 28 economists predicted no change. |

Appendix of Charts

Chart 1. Annual Inflation



Source: Office of National Statistics.

Chart 2. Ten-year ahead inflation expectations (market-based)

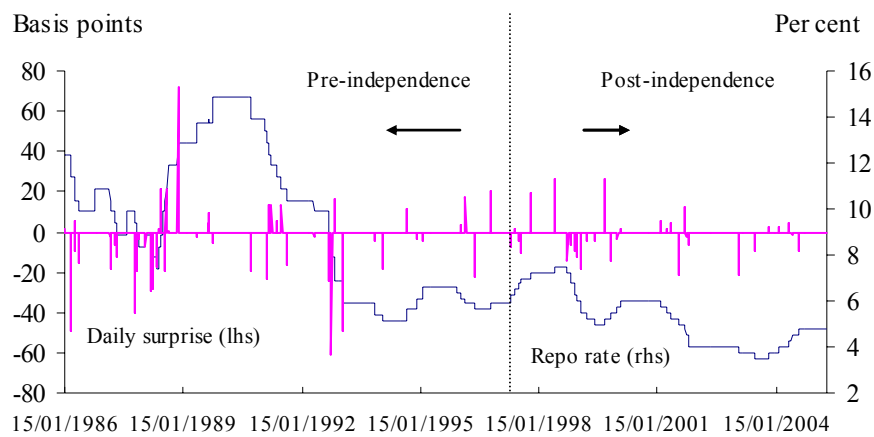


Note: a) This chart shows the ten-year ahead annual inflation forward rate, defined as the difference between the ten-year ahead annual nominal rate and the ten-year ahead annual real rate, as calculated from nominal and index-linked government bonds.

b) RPI is the measure of inflation used for index linked bonds, but is not the target measure for inflation in the UK. RPI will differ from both RPIX and CPI. In part, these differences reflect the coverage of the index. For example RPI includes mortgage interest payments. In addition, RPI will typically be higher than CPI due to a formula effect, as the CPI uses a geometric mean rather than an arithmetic mean to aggregate individual prices within each expenditure category.

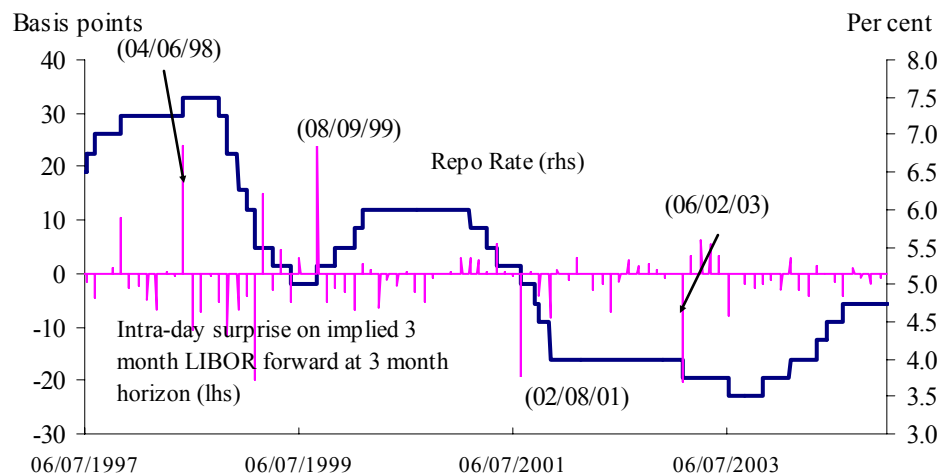
Source: Bank of England

Chart 3. Daily Surprise on Policy Rate Change Days (1986-April 2005)



Source: Bank of England and LIFFE. See footnote 13.

Chart 4. The Repo Rate and Intradaily Surprises on MPC Decision Days



Source: Bank of England and LIFFE. See footnote 13.

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