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Speech

Monetary Policy in the UK – The Framework and Current Issues

Speech given by

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Greetings.

It is a great pleasure for me to have been invited over to discuss with you our approach to monetary policy in the UK. The UK system is still relatively young – just coming up to its eighth birthday. The key changes made in 1997 were to give the Bank of England operational independence to conduct monetary policy, and to specify a point inflation target. Initially somewhat controversial, central bank independence is now strongly and widely supported. Today, after a brief description of the key features of our framework, I will discuss some issues related to inflation targeting, and also look at the implications for monetary policy of recent trends in UK productivity.

The UK's inflation targeting framework

The monetary policy framework put in place by the newly-elected Labour Government in May 1997 leaves the Government to set the inflation target, which is confirmed or changed annually in the finance minister's Budget. It is a point target (presently 2%), and symmetric, so that we place equal weight on deviations in either direction. Decisions about the repo rate are taken monthly by a Monetary Policy Committee of nine individually accountable members. Each of our votes carries equal weight, and the votes are made public within two weeks of the policy announcement.

In considering the rationale for this structure, it is important to take account of the background. From the mid-1970s, UK monetary policy pursued an unsteady course (Chart One), at different times based on money supply targets (variously defined), and on exchange rate targets (formal and informal). In 1992 sterling was forced out of the European Exchange Rate Mechanism, and subsequently a target was introduced to reduce inflation over the course of the 1992-97 parliament. This policy period was quite successful, but had some key drawbacks. Most significant among these was the continued suspicion that interest rate decisions, taken by the finance minister after consultation with the Bank of England Governor, reflected political considerations.

The 1997 framework was a big step forward - clearly set up with permanence in mind, as demonstrated by the passing of the Bank of England Act. Previous monetary frameworks had changed at short notice, raising problems of time inconsistency (the suspicion that

governments will renege on monetary policy commitments for reasons of political expediency). The operational independence of the Bank is therefore crucial, but the need to ensure wide spread public support for central bank independence underpinned the decision, also welcome on other grounds, to retain political control over the target itself.

Having a symmetric point inflation target means that there is now little room for uncertainty about what the MPC is seeking to achieve, making it relatively straightforward for us to be held to account by the Government, parliament more widely, and the public in general. For the business community, there is clarity over the background relevant to their own price and wage-setting. So this has been a sound framework within which the MPC has been able to establish and retain credibility. The evidence from financial market inflation expectations is that these fell sharply in 1997, and subsequently have remained broadly consistent with achieving the target (Chart Two). The MPC has been successful in meeting the target; over the 79 months in which our target was 2.5% based on the UK retail prices index excluding mortgage interest payments (RPIX), the average inflation rate was 2.4%. Also, inflation has never moved more than 1% either side of the target in any month (this is perhaps surprising, as more variability in inflation might have been expected due to supply shocks, and would not have indicated a policy failure). This success has been supported by a strong focus on transparency and communication.

At the end of 2003, the MPC's target was changed to 2%, but now based on the consumer prices index. Formula differences in the calculation of the CPI means that it is about 0.5% below RPIX. If this were all, there would be no effect on monetary policy even in the short-term. But it is a little more complex than that, as there are coverage differences, in particular that the CPI excludes housing costs, and over the long-term the difference is around 0.7%. The changeover has been successfully handled, and the fact that this was not a matter of much economic significance is well understood in financial markets.

What are the issues for policymakers of operating with an inflation target?

The use of inflation-targeting is certainly not without its critics – either generic criticisms of the whole approach, or relating to the particular remit and approach of an individual central bank. The following comments on some key points in this debate are based only on the framework and experience at the Bank of England, and in the time available cannot do full justice to the complexity of the question.

Inflation and output trade-off

Initially, a criticism from both business and the wider public was that the primacy of the inflation target puts too little weight on output and unemployment. However, one success of our communication is that many businesses at least now understand better that in the long-term real variables will not be affected by the course of nominal developments. But of course since 1997 the UK economy has experienced continuous growth - whether this understanding would prove durable through any future period of sharp downturn is not clear.

The UK framework and the MPC's approach also enables output volatility to be taken into account when that is desirable. By tackling the remit in a forward-looking manner, focussing on prospects for inflation for the medium-term, we are able to allow the first-round, direct effects from shocks (such as big rises in the oil price, or changes in indirect taxation), to feed through to inflation, directing our focus at the possibility of second-round effects if the jump in the price level impacts on wages. In the instance of a deviation from target which is more than 1 percentage point away in either direction, the Governor is required to write to the Government setting out the MPC's strategy for returning to target, providing an opportunity in these circumstances to clarify that we were seeking to avoid unnecessary output volatility (where this applies with smaller deviations a similar point would be made in the published minutes of the policy meeting).

More technically, it is argued that the focus on inflation-targeting reduces flexibility and implies that real objectives are not incorporated in an optimal manner¹. Certainly the MPC's approach aims to be appropriately flexible, rather than overly rule-based. The response to a medium-term central forecast for inflation which is away from the target in either direction (based on the Committee's views of the most likely economic projection), is not an automatic change in the repo rate. Rather, the risks to the outlook, and the question of whether a change should be delayed, will be considered. Often this will be embodied in the mean of the inflation forecast being away from the mode over the medium-term, as indeed it was during the February 2005 forecasting round. But my view would be that the MPC should be prepared to contemplate the mean of the forecast, around the two-year horizon, being away from the target if this were due primarily to a supply shock, and if the interest rate response needed to bring inflation to target more quickly would lead to significant output volatility.

¹ See, for example, Woodford (2004)

Can these trade-offs, and the role of goals other than inflation, be communicated clearly within the inflation targeting approach?² It is argued that lack of clarity could weaken claims to policy transparency, and risks an undue focus on inflation as the only quantified target. With regard to the former, the variety of possible economic conjunctures and their associated risks make any attempt to specify trade-off rules in general terms a rather fruitless exercise. But the onus is indeed on the MPC to account for how and why output concerns have affected any particular decision. And while the latter is certainly a theoretical possibility, the distinction of demand and supply shocks in our thinking suggests that in the UK we are very conscious of the need to strike an appropriate trade-off.

Potential conflicts with minimising output fluctuations

There is another issue which might be thought of as a disadvantage of a precise target. In general, it is the case that one result of successful inflation targeting is to limit output fluctuations away from trend. But it is possible to imagine some conflicts. For example, in the UK, CPI inflation was more than 0.5 percentage points below target between July and October 2004. At the same time the economy was growing broadly around trend, and unemployment was at a historically low level. Evidence from business surveys of capacity utilisation chimed with the conclusion of model-based estimates in suggesting that the economy was operating at around full capacity. One of the reasons for this low inflation was the weak trend in import prices. If these circumstances had persisted, then it was possible that the only way in which inflation could be returned to target would have been to allow the rate of growth to be above trend for a time.

Allowing the economy to run above trend to stimulate higher inflation and then slowing it in order to prevent a target overshoot seems rather unattractive. It implies considerable confidence in the ability of monetary policy to fine-tune developments, and runs the risk that it will be more difficult than expected to brake the rise in the inflation rate once it is underway. This risk can however be lessened by seeking to return inflation to the target rather gradually. And if inflation expectations are based around the target, and the monetary authorities are credible, then there will be some momentum towards the target in price and wage-setting. But to retain this valuable credibility, it is important both that the target is regained, and that monetary policy is clearly set to achieve this. In fact, in the UK,

² Faust and Henderson (2004)

subsequent events have changed the picture. One is that the CPI has in any case moved up towards target over the past three months. Another, discussed further below, is the possibility that capacity may be a little less tight.

However, it is in principle correct to be concerned about inflation being below target, even if the level of output seems to be close to trend, in order to demonstrate the importance attached to the symmetry of the inflation target. In the UK, influenced by the lengthy period of economic history dominated by a concern to control high and volatile inflation, it is argued that there were signs over the late 1980s and 1990s, of a precautionary bias in policy in favour of low inflation, rather than economic expansion.³ It is important to demonstrate that such asymmetries no longer exist.

The asset price issue

While questions about trade-offs and communication are important, a criticism that would be more significant if justified is that central banks do not pay enough attention to asset prices. In the four years since I joined the UK's MPC, we have been criticised for allowing the exchange rate to remain too strong, and more recently for permitting a bubble to develop in the housing market (several commentators remain concerned that there is a risk of a widespread downturn when this possible bubble bursts). In general, I consider there are good reasons for not acting to offset movements in asset prices per se. The first is the considerable uncertainty about whether or not a bubble exists – and if it does, how serious it is.

For example, while UK house prices are certainly at historically high levels at present, relative to incomes, there are factors which support an increased equilibrium price: lower interest rates lowering the initial cost of a mortgage; low long-term real interest rates (which have increased the asset value of housing); an inadequate supply of new build; increased use of housing as a savings vehicle for pensions. There are some signs which might indicate a housing bubble – increased private buying of housing for letting with the expectation of capital gain, and parents using equity from their own homes to assist children with deposits – but it is not clear how far these may have contributed to higher prices. So it would also not be clear what scale of adjustment in house prices monetary policy should seek to achieve.

³ Cukierman and Muscatelli (2002)

More importantly, a shift to targeting asset prices might result in significant changes of interest rates away from the level which would be appropriate to achieve the inflation target. This is likely to create uncertainty about what the aims of monetary policy are, and lead to volatile inflation expectations. In particular, there is a risk that the central bank would end up chasing one asset price after another, with real costs in terms of uncertain strategy – similar indeed to the problems experienced in the UK in the 1970s and 1980s.

Concluding that asset prices should not be targeted does not of course mean that their impact on the economy and the related risk of volatility can be ignored. As suggested by fellow MPC member Charlie Bean, concerns about major economic volatility which could result from a bubble deflating is a factor which should be taken into account in discussing risks around a central forecast, and therefore could have some effect on current decisions⁴. In practice this means giving a bit more weight to possible major deviations from the inflation target which might be beyond the usual policy horizon of around two years ahead.

The worry about house prices reflects a view that the low level of inflation over the past few years is partly due to external factors (the strong exchange rate and very weak world goods price inflation). The consequent low nominal interest rates may have encouraged consumers to increase debt burdens to unsustainable levels, due to unrealistic income expectations. In the UK the household savings rate has declined from around 9-11% in the early 1990s to around 6% in 1998, below the 8% average since 1963. But since 2000 it has remained broadly stable, and consumer spending has moved generally in line with income growth. It seems equally likely that most of the rise in debt has resulted from more stable economic conditions in the UK, with strong competition among loan providers enabling more effective consumption smoothing for those with sound long-term income prospects. Alongside this there are a number of low income households whose debt levels pose real problems.

A current question: is recent low UK inflation related to a productivity improvement?

A central question faced by any monetary policy regime in considering the appropriate trade-off between inflation and output variability is identifying structural change. So in considering how to respond to the recent surprisingly low rate of UK inflation discussed above, it is necessary to identify the cause. Distinguishing between candidate explanations remains

⁴ Bean, 2003

difficult, but one possibility is that the UK is now experiencing the kind of improvements in productivity that the US saw around a decade earlier. This was not evident to policymakers in the (official) US productivity data at the time, but became clear through subsequent data revisions. However, on the basis in particular of higher ICT investment, improving profit margins, and anecdotal and survey evidence from business, a number of FOMC members argued that there were signs of a favourable productivity shock, some time ahead of confirmation from the data.

To what extent, picking up on a description of the US economy in the late 1990s, might it be true that Goldilocks has acquired a holiday home? In the UK, GDP growth over the past eight years has averaged 2.8% - above the average of the previous 25 years. Yet inflation has remained low, and surprisingly so, even when account has been taken of factors such as subdued import price inflation. Data on UK productivity (Chart 3) suggests some pick-up in private sector output per head in the late 1990s, with a slowdown in 2001-02. Over the past year, labour productivity per head and per hour have picked up quite sharply, but this is a very short period from which to draw conclusions about a change of trend. Is there any reason to believe that there have been some similar measurement issues, and the recovery in productivity was present earlier?

Certainly, ICT capital investment did pick up in the UK during the 1990s. Oulton and Srinivasan⁵ suggest that ICT capital does boost productivity growth, though with a lag. But they argue that successful implementation of ICT projects requires costly reorganisation which obscures the productivity benefits for a time. This might support the idea that the recent pickup is the fruition of this ICT capital, and the recent strong relative performance of UK distribution sector productivity might suggest that this sector has reaped these gains earlier (Chart 4). But there are also reasons to be cautious. Work by McKinsey⁶ tentatively suggests that IT investment is less important to productivity than management capabilities, and further that the UK has not, in general, been quick to adopt innovative management techniques.

Unlike the US, where the profit share was strong in the mid-1990s, in the UK private sector gross operating surplus was declining during the late 1990s. It has picked up since 2001, but

⁵ Oulton and Srinivasan (2005, forthcoming)

⁶ Casserley (2004)

remains below the mid-1990s peak. Of course, it is possible that any productivity stimulus in the UK is coming from a different source. Rather than arising from better use of ICT investment, as in the US, firms might have been through a period of increased competitive pressures (due both to globalisation and to more intense domestic competition policy). Ultimately the companies that survive this period will seek to improve margins, in order to earn adequate returns.

Nor has the UK experienced any particular discrepancy with regard to productivity growth between the real-time official data and company comment – except possibly as regards manufacturing, where anecdote about productivity has been stronger than the data for some time. And business survey data on capacity utilisation accords with the view that capacity utilisation is at fairly high levels, as has been the case broadly since 1995.

While the UK evidence does not indicate the same statistical discrepancy as in the US, productivity measurement remains uncertain in the service sector, and there is always a possibility that future data improvements will produce a different picture of the past few years. The most recent period, based on current data, does show a pickup in output per hour, and there are factors which might support a continued improvement, including a lagged response to ICT investment, or the stimulus of stronger competition. Both of these explanations could lie behind the gains in distribution sector productivity, which began in 2002. However, 2004 has also been a recovery period, with rising hours worked suggesting more intensive use of labour. It is likely to be several quarters yet until it is possible to distinguish a cyclical pickup from a trend improvement – although equally the latter cannot be ruled out.

The rise in hours worked (average hours per week for all workers have risen by around 0.5 hours from a low point in mid-2004) prompts a slightly different question. Since 1998, hours have generally been declining, and this reversal might indicate that a greater part of the recent decline reflected cyclical factors rather than a structural trend. In this case, the labour market might be a little less tight, and the supply capacity of the economy somewhat better.

Conclusion

The framework for monetary policy put in place in the UK in 1997, with operational independence for the central bank, has won widespread acceptance and support. It has

weathered some economic squalls, although it is perhaps true to say that it has not yet been tested by a serious storm. The key features of the regime – the symmetric inflation target, the forward-looking nature of decision-taking, and a committee of independently accountable individuals – have all played a part in marking a considerable improvement from the previous history of UK monetary policy decision-taking.

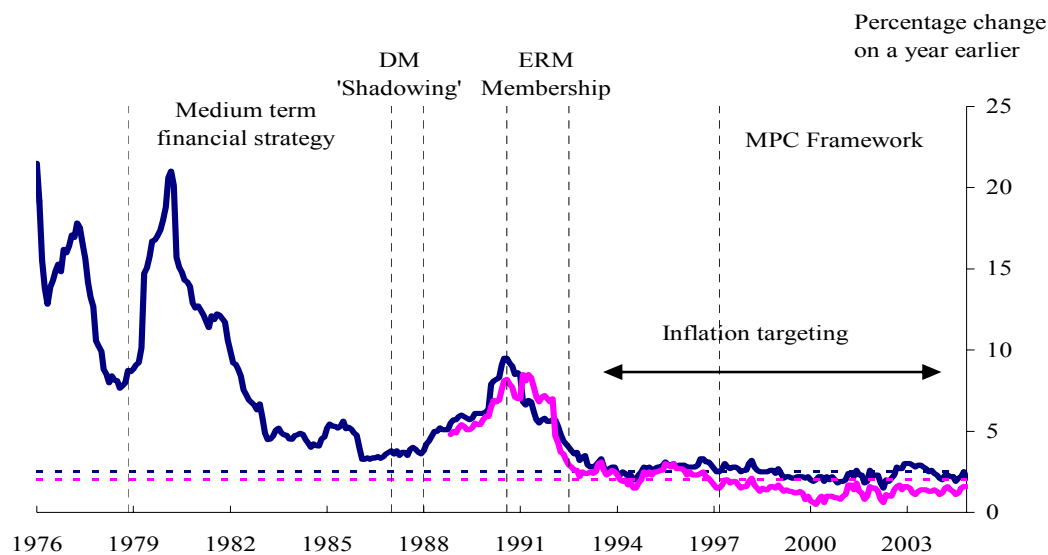
In this context, point inflation targeting has been helpful in communicating clearly about the new regime, and anchoring inflation expectations. There have been criticisms of the framework – in particular that there is insufficient focus on stabilising output, and that insufficient attention is paid to asset prices. But I believe that the practice of UK monetary policy, and the MPC's communication of it, mean that these criticisms are misplaced. For a policymaker, stress on practice is crucial – we know our forecast will not be exactly right, and that the economy may not respond to policy changes quite as we expect. In these circumstances, precise rules about trade-offs are not helpful, but clarity about our objective is.

Finally, is the UK now set to enjoy a period of a Goldilocks economy, in which strong productivity enables faster growth to be combined with achieving the inflation target? The evidence is building, but cannot yet support optimism similar to that of the US in the mid-1990s. While the latest data has suggests some productivity improvement, it is too early to reject the alternative explanation that this is simply a cyclical rise. Further, given some signs of relatively poor adoption of best practice management techniques in the UK, a degree of scepticism about productivity gains from ICT seems justified. However, over the coming quarters it will be necessary to look hard at this question, and remain open to the possibility of a structural improvement. A different reason to reconsider the judgement about the present and prospective supply capacity of the economy is the possibility that the recent rise in average hours worked suggests a stronger trend in hours, and that the labour market is not quite as tight as presently estimated.

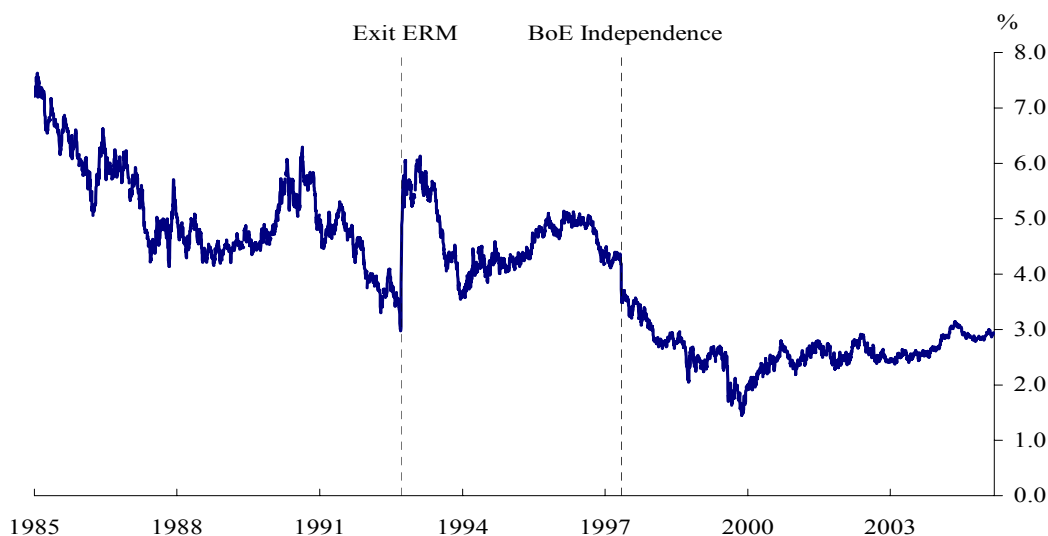
Over coming months, the MPC will no doubt continue to reflect on these and other issues. And I hope we will continue to examine suggestions for improving policy communication and transparency with an open mind.

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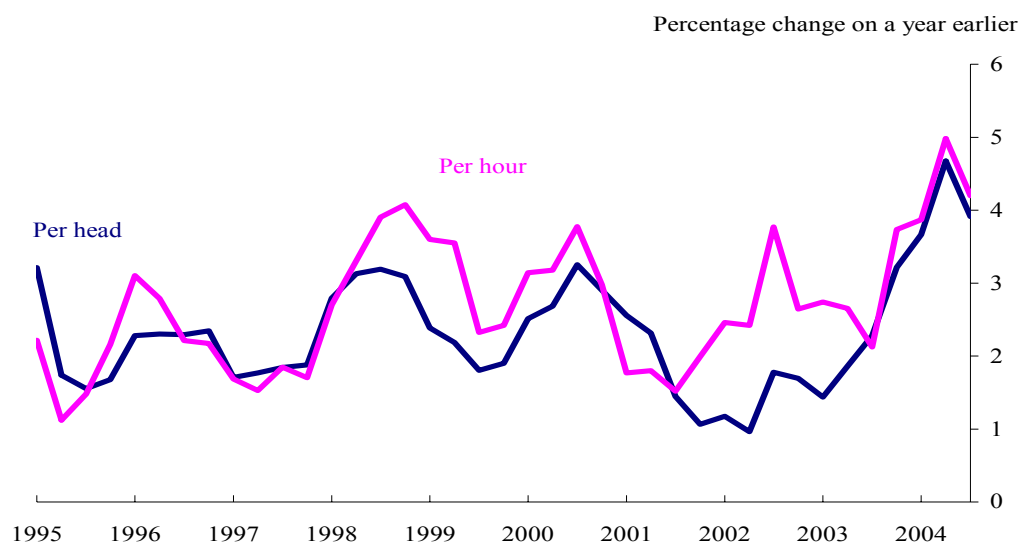
Chart 1: The history of UK inflation

Note: The solid blue line in this chart shows the annual rate of RPIX inflation. The target for RPIX was 2.5% from June 1997 to December 2003 and is shown by the dashed blue line. The solid pink line shows the annual rate of CPI inflation. The target for CPI inflation has been 2.0% since December 2003 and is shown by the dashed pink line.

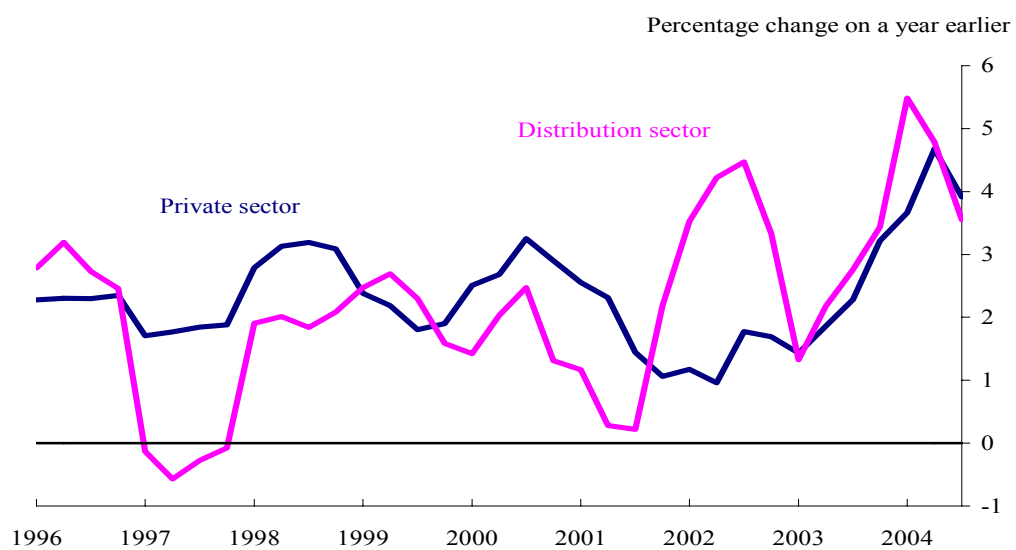
Chart 2: Market expectations of RPI inflation

Note: 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.

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. Part of 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.

Chart 3: Private sector productivity

Note: Data on private sector output are measured in chained volume terms, defined as GDP minus the output of public administration, education and health sectors. Data on private sector heads and hours are based on LFS microdata.

Chart 4: Productivity growth per head

Note: Data on private sector output are measured in chained volume terms, defined as GDP minus the output of public administration, education and health sectors. Data on private sector heads are based on LFS microdata. Labour productivity in the distribution sector is defined as gross value added at basic prices divided by employment.