Rachel Lomax: The MPC comes of age

Lecture by Ms Rachel Lomax, Deputy Governor of the Bank of England, at De Montfort University, Leicester, 28 February 2007.

I am very grateful to Gareth Ramsay for his help in preparing this speech, and also James Proudman, Tony Yates and other Bank colleagues for their help in preparing this speech, and to a number of colleagues at the Bank of England for useful comments.

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1 Introduction

It's a great pleasure to be in Leicester tonight, particularly given my long association with De Montfort University, as a Governor.

Tonight I want to focus my remarks on the Monetary Policy Committee, which is ten years old this year. This is a blink of an eye in the life of the Old Lady of Threadneedle Street as she approaches 313. But UK monetary policy frameworks have lived dangerously and died young. For them, ten years is good going. To mark the occasion the Treasury Committee has launched a special enquiry. An impressive weight of written evidence has already been published, including a detailed review by the Bank of England.

Everyone agrees that the UK has experienced an unprecedented degree of economic stability over the past decade. The average rate of inflation has come down from nearly 10% in the seventies and eighties, to 2.5% since 1993, and the volatility of inflation has fallen very sharply. At the same time, output growth has been higher on average and less volatile.[1] The change has been stunning. To be fair though, it predates the formation of the MPC by several years; and other countries have experienced a similar, if not so pronounced, improvement in performance.

There is considerable agreement that better monetary policy is partly responsible for this better outcome, though there is an ongoing debate about exactly how much was also due to unusually benign global economic conditions, including the impact of globalisation.

Whatever the outcome of that debate, we clearly cannot bank on a trouble-free future. But we can and should look hard at the way our current monetary policy framework is operating, to give it the best chance of coping, if necessary, with a harsher climate. So tonight I want to consider what was so special about the MPC; and ten years on, ask how age and success has changed it; and what we can do to preserve its youthful vigour.

2 Historical background

The MPC has come to personify the monetary policy framework that was put in place when Gordon Brown made the Bank of England independent in 1997. But by monetary policy frameworks, I mean the broader set of rules and procedures for taking decisions about interest rates.

Prior to 1992, such frameworks often took the form of a commitment to maintain a fixed exchange rate, most recently as a member of the ERM. But these proved hard to sustain – sterling was repeatedly devalued, at great political cost to the Government of the day. Perhaps the most controversial frameworks took the form of commitments to meet targets for the growth in the money supply. These were meant to act as rules, which would tie the hands of politicians, but they proved ineffective, not least because the underlying economic relationships broke down. There were also periods – notably the 1970s – when there was no discernible monetary policy framework at all; when monetary policy was in eclipse and Governments relied on incomes polices to control inflation. These, too, were a dismal failure.

[1] Inflation has averaged 2.5% since 1997, with a standard deviation of 0.8%. In the two decades to 1992, it averaged 9.6%, with a standard deviation of some 5.6%. Over the past decade, output has grown steadily, averaging 2.8%, with a standard deviation of 0.7%, compared with an average of 2% and a standard deviation of 2.5% over the seventies and eighties.

All these frameworks suffered from one of two basic problems. They either lacked credibility, or they lacked sufficient flexibility for policy-makers to respond intelligently to events. So it is little surprise that they were associated with two decades of poor macroeconomic performance.

Sterling's exit from ERM in the autumn of 1992 led to an overhaul in the way monetary policy was conducted, with the adoption of an explicit target for inflation, and a number of moves to make the process of policy-making more transparent through the publication of minutes of what was popularly known as the Ken and Eddie show, and a new *Inflation Report*, produced by the Bank.

3 What was special about the 1997 arrangements?

In the event, 1992 marked a break with the past. But while the policy innovations of the 1993-97 years were showing promise, the framework remained relatively informal. And decisions about interest rates stayed in the hands of the Chancellor.

The change in Government in 1997 led to a far-reaching effort to institutionalise and depoliticise monetary policy arrangements. A new Bank of England Act stipulated that the objective of monetary policy should be domestic price stability, and only 'subject to that' to support the Government's objectives for output and employment. The Act left responsibility for setting an annual remit for inflation in the hands of the Chancellor; but it gave the Bank 'operational independence' to set interest rates to meet this target. Interest rate decisions were to be taken by Committee of nine, which was to include four appropriately qualified external members.

With these changes, the UK had a fully articulated, credible domestic monetary policy framework, underpinned by statute, which gave the Bank, through the Monetary Policy Committee, an independent role in meeting an explicit inflation target.

What was the defining characteristic of this approach to policy, and other broadly contemporary frameworks developed by countries like Canada, New Zealand and Sweden? The best short answer is encapsulated in a term originally coined in 1997 by two US academics, Ben Bernanke and Frederick Mishkin (now Chair and member of the FOMC respectively). It is 'constrained discretion'[2].

Bernanke described this as "an approach that allows monetary policy-makers considerable leeway in responding to economic shocks, financial disturbances, and other unforeseen developments. Importantly, however, this discretion of policy-makers is constrained by a strong commitment to keeping inflation low and stable."[3]

In the UK, the Government is constrained by the institutional framework, which is set in statute. And the MPC is constrained by the need to meet the inflation target. But while the MPC are told <u>what</u> to do, they are not told <u>how</u> to do it. At the operational level, there is a lot of discretion.

The commitment to meet the inflation target is fundamental, as a matter of law and economics. As long as it is credible, such a commitment will help to anchor people's expectations about future inflation, and stabilise their response to unexpected shocks. But the scope to exercise discretion about how long temporary inflation disturbances will be tolerated is critically important too, for the performance and long term credibility of the framework. Of course it must be used with integrity – saying one thing and doing another, for short term advantage, is toxic.

This approach was reflected in the Open Letter procedure, which was an explicit part of the 1997 arrangements. This recognised that the MPC would not attempt to bring inflation back to the target immediately following a large shock, but required the Governor to write a letter to the Chancellor if, as a result, inflation deviated from the (then) 2.5% target by more than one percentage point.

As Ed Balls commented in a lecture in 2001[4]:

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2 "Inflation Targeting: A new framework for monetary policy?", Ben Bernanke and Frederic Mishkin, *Journal of Economic Perspectives*, 1997.

3 "Constrained Discretion and Monetary Policy", remarks by Ben Bernanke before the Money Marketeers of NY University, New York, February 2003.

4 "Delivering Economic Stability", Oxford Business Alumni Annual Lecture by Ed Balls, June 2001.

"Some have assumed it [the requirement to write an open letter] exists for the Chancellor to discipline the MPC if inflation goes outside the target range. In fact the opposite is true…… In the face of a supply-shock, such as a big jump in the oil price, which pushed inflation way off target, the MPC could only get inflation back to 2.5 per cent quickly through a draconian interest rate response – at the expense of stability, growth and jobs. Any sensible monetary policymaker would want a more measured and stability-oriented strategy to get inflation back to target. And it is the Open Letter system which both allows that more sensible approach to be explained by the MPC and allows the Chancellor publicly to endorse it."

Constrained discretion also provides much needed room for learning. Monetary policy remains more art than science, and its practice is riven with uncertainties and risks. As the present Governor put it in a lecture delivered in 1997[5]: 'Inflation targets are a practical response to the fact that knowledge increases over time.'

So a framework of constrained discretion combines much needed scope to implement policy flexibly, in the light of both circumstances and experience, with the credibility benefits of committing policy-makers to secure a pre-determined outcome for inflation. That, in essence, was the key difference from the failed experiments of the past.

4 The development of the MPC

The MPC got off to a good start. It inherited an inflation rate that had been low for the past 5 years. And the financial markets welcomed it by reducing the risk premia on UK assets.

No one had very clear expectations about how it would behave or how it might think. While it inherited some technical features of the previous regime, the new Committee had quite a lot of scope to define its own operating procedures and intellectual framework. If not a blank sheet of paper, it was a book with many pages still to fill. As time has gone by, whole volumes have been filled. The Committee's procedures and thinking have matured. It has acquired patterns of behaviour and earned a name for itself.

There have been a number of stages in the Committee's development. Early on the MPC took steps to set out the intellectual framework within which it would be operating, to promote public understanding and enhance credibility. Over time, the Committee's thinking has evolved, as members have rotated on and off the group, and as the Bank has struggled to understand developments in the wider world. And, as a result of taking more than 100 policy decisions, the MPC has acquired a track record, which has allowed others to draw their own conclusions about its likely behaviour in different circumstances.

Practice in other central banks has developed too, as inflation targeting has spread, and all central banks have become more transparent in their communications. This has raised the bar for a central bank that wants to stay at the leading edge of monetary policy practice.

Finally, the MPC has acquired an enviably high reputation as a result of its overall performance and the unprecedented stability of the economy over the past decade.

In short, the world has moved on, and the MPC has acquired a past and an identity.

Ten years is too soon for a mid-life crisis, but middle-aged members of the audience will readily recognise the pressures that advancing years can bring. Sometimes we are tempted to bask in past success, whether or not it is fully earned. In our better moments, we reflect on all that we have learnt, through bad times as well as good. But there are days when we peer in the mirror and ask anxiously whether we have lost our freshness and drive. Have we become too set in our ideas and in our ways? Have others stolen a march on us? Have we become, to a degree, prisoners of our own past Maybe even victims of our own perceived success?

The only way to deal with such fears is to confront them. That is a far larger task than I can do justice to tonight, and it needs to be part of a continuing effort to improve our performance. But let me try and give you an overview of some of the main issues in the remainder of my remarks.

[5] "The Inflation Target five years on", lecture delivered by Mervyn King at the London School of Economics, October 1997.

Intellectual development

I want to start with the MPC's intellectual development.

As the world around us changes, it throws up new policy challenges which force us to examine old ideas and develop new ones. So the MPC has been on an intellectual voyage of discovery since it was established.

The formation of the MPC unleashed a ferment of intellectual debate and activity inside the Bank. It was a thrilling time for those who were closely involved. The Committee had to set out how it thought about the world, first of all for itself, and then for the outside world. You can still see evidence of all this activity on the Bank's website – in speeches describing how the MPC saw the world, and in books which set out the MPC's models of the economy.

But the world does not stand still. Over the last decade, the Committee, and the Bank staff who support it, have had to confront some enormous changes in the economic environment. The Committee's thinking has had to evolve to meet this challenge.

Without going into detail – that would require another speech – let me give you a flavour of some of the questions with which we have been grappling during my own time on the Committee alone.

First, we have had to understand the implications of some very big movements in asset prices, both domestically and globally. House prices have risen steadily, tripling since 1997, to reach record levels relative to household incomes and rents. Share prices soared in the run up to the millennium, then slumped, but have subsequently recovered. There has been a long running debate among central bankers about how they should respond to asset price booms – and possible busts – with some arguing that there is a case for taking pre-emptive action, over and above what might be warranted to meet the inflation target over the normal two to three year horizon. There have been members of the MPC on both sides of this argument.

Second, there has been an acceleration in the pace of globalisation. The entry into the global market economy of China, India and Eastern Europe is effectively doubling the world economy's supply of workers – from 1.5bn to 3bn. This is having pervasive effects on wages, prices and, potentially, economic relationships in developed countries in ways we need to understand in order to set interest rates.

Third, the last few years have seen the largest recorded entry of foreign workers to the UK. This has increased the supply capacity of the economy, as well as boosting demand, but the precise scale and likely duration of these effects are very hard to judge. How is migration changing the ground rules by which we set policy? If labour shortages were to cause more migration, rather than higher wages, we would be in a rather different world from the one we are used to.

Finally, there has been a major surge in energy prices in the past three years – first a doubling in global oil prices, and then an even larger rise in natural gas prices which was specific to the UK. Up until now at least, the UK and the global economy appear to have weathered the impact of these major cost shocks remarkably well. But precisely because the world has moved on so much since the 1970s, it has not been straightforward to predict or understand the impact of higher energy prices on the inflationary process. (I will return to this subject later in my remarks).

The MPC tackles challenges like these all the time: you will see these questions discussed in the minutes of our policy meetings, in our speeches, and in the quarterly *Inflation Report*. We also commission research into these questions, which we publish in academic papers. This is not research for its own sake; it is carried out to help Committee members, present and future, do a better job. We need to keep refreshing our intellectual capital. Half a century ago, Governor Cobbold famously said that the Bank of England is a bank, not a study group. Nowadays, the best central banks have something of the study group about them.

Anniversaries are a good moment to take stock. So the TC enquiry and other events will prompt us to review what we have learnt, and to identify where there are gaps in our knowledge.

Procedures and communications

The 1997 institutional reforms did more than take political considerations out of interest rate decisions. They were intended to convince people that the inflation target regime was here to stay. The idea was to align expectations of future inflation more closely to the target, by putting monetary policy in the hands of technocrats whose behaviour would epitomise professionalism. The pre-announced monthly cycle of meetings, regular quarterly *Inflation Report* forecasts, and set briefing routines, were very much part of the package. The goal of these new arrangements was to make the system understandable and predictable to outsiders.

After a sharp burst of activity in the late 1990s, the processes and procedures surrounding monetary policy have now settled down. We still use much the same internal processes and means of communicating with the outside world as we did a decade ago.

But the outside world has not stood still, in at least two respects.

First, over time the MPC has established a track record of actions and communications which people have, as intended, learnt to parse with great precision. There is a cottage industry in interpreting its every utterance, in the light of its past behaviour, in order to predict its next actions. Any deviation from past behaviour is assumed to be deliberate and considered.

A topical example is the market reaction to the latest interest rate rise. The formal position has always been that the MPC may change rates at any one of its policy meetings. And in the early days of the Committee that's pretty close to what happened. But since 2001, as a matter of fact, rates have been much more likely to change in the months when we publish a new quarterly *Inflation Report*. That was why the January rate rise caused such surprise even though commentators were fully expecting a rate rise to accompany the February *Inflation Report*. Indeed, such was the surprise that the market immediately revised up its expectations for future interest rates. And there was a measurable increase in uncertainty, as different interpretations of the Committee's unusual action were debated across the wires.

This episode highlights the difficult balance which the mature Committee needs to strike between innovation and predictability. Today's Committee members – only one of whom has been there since the beginning – quite reasonably do not want to be unduly constrained by the habits of their predecessors. But the passage of time has given 'the Committee' a collective personality. So changing established patterns of behaviour requires at least as much care and explanation as in the early days of the framework.

Second, even if we have not changed our procedures very much over the past decade, other central banks have. They have become much more transparent. And the debate about how much central banks should communicate – and how – has moved on, among academics, central bankers and central bank watchers.

For example, a long-standing issue is how much central banks should say about their expectations of future interest rates. The traditional concern has been that commentators would mistake a projection for a commitment, the risk being that when interest rates did not change as projected this would be damaging to credibility.

However, in recent years other central banks have moved increasingly towards giving indications about the likely path of interest rates, given their forecast for the economy. Some inflation targeting central banks – Norway, New Zealand and Sweden – are now publishing charts which show how they expect to change policy rates to achieve their targets[6].

Should the MPC follow this trend? If you follow press reports of our regular *Inflation Report* forecasts, you might be forgiven for thinking we already have. But actually no: our forecasts take market expectations for interest rates as their starting point, and we leave commentators to draw their own inferences. We have maintained the position that we do not give hints about future interest rate changes. Naturally we are looking closely at what happens elsewhere and we will want to learn from their experience – though of course, since the MPC is not a consensual body, it would be a significant complication to get it to agree an explicit path for interest rates.

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6 In addition, the Bank of Canada now includes text in its monetary policy report which indicates whether or not rates will have to change from their current level to meet the inflation target.

Have we become prisoners of our past success?

Let me come, finally, to the biggest, and most difficult of the issues I want to raise tonight – namely the extent to which the stability of the past decade has conditioned expectations of what the MPC can and should do, in ways which may be both helpful and unhelpful to its ability to do its job.

The so-called Great Stability of the past decade has bestowed on the MPC the great gift of credibility – a golden halo which eluded monetary policy-makers in the UK for most of the twentieth century.

What part has the MPC played in its own success? It's difficult to say. But it is hard to believe that luck played no role. My own view is that the MPC has benefited from a virtuous circle. As we have kept inflation close to target, people have increasingly come to expect us to do so in the future, and to act on the assumption that inflation will stay low. These expectations have underpinned the wages they have bargained for, and the prices they have set. And that behaviour has helped us to keep inflation under control in the face of destabilising events.

However, the unusual degree of stability, and the prestige it has conferred on central bankers, may also have bred some less helpful attitudes: such as complacency about the ease with which the economy can absorb shocks, and unrealistic expectations about what monetary policy can achieve. Just to be clear: monetary policy can pin down average inflation over the medium term. It can not deliver inflation at target at all times and in all circumstances, and certainly not in combination with rock-steady growth in output.

Let me illustrate these points by looking more closely at one of the key challenges I mentioned earlier, the impact of higher energy prices over the past two years.

Since 2004, global oil prices have more than doubled, a far sharper rise than at any time since the 1970s, when as some of you may recall, inflation took off, eventually peaking at 25%. Then, last winter, UK wholesale gas prices surged, as a result of supply and storage problems that were, in large part, specific to our market. The resulting increases in household gas and electricity bills have had a large direct impact on inflation. By December, they alone were directly contributing 1pp to the measured inflation rate.

These energy price shocks are now starting to unwind, at least for now. The oil price has fallen back, although the outlook remains uncertain – the thin margin of spare capacity continues to make oil prices unusually sensitive to all kinds of news, from politics to weather and supply. We can have more confidence that the gas price shock is ebbing. The temporary supply and storage issues which caused the price spike last winter have been addressed. Together with a milder winter, this has helped to bring wholesale prices back to where they were two years ago, and retail prices have started to fall back.

So, just as energy price increases have boosted inflation over the recent past, it now seems likely that energy price falls are going to reduce it – possibly quite sharply – over the year ahead. Indeed we expect inflation to fall below the target by the end of 2007.

Let me make two observations about this episode.

First, looking back over the past three years, the big picture is that inflation has stayed surprisingly low, and output growth remarkably stable, given the scale of these cost increases. Inflation has never deviated by more than 1 percentage point from the 2 per cent target.

But second, judging by the media and public reaction to the rise in inflation over the past few months, it is clear that even a small deviation in inflation from target can now look very significant after the stability of the past decade.

This illustrates both the helpful and unhelpful legacy of a decade of remarkable stability for the UK economy.

On the helpful side, there is no doubt that a highly credible monetary policy framework has helped to contain inflation, in the face of a very large cost shock. The UK has become a low inflation economy since the 1970s and people expect the MPC to keep it that way. That affects the way they behave when they take decisions about wages and prices.

The less helpful legacy is that even a small movement in inflation away from target – one percentage point – has prompted some highly coloured media coverage, and may have unsettled people's expectations about where inflation is headed in the short run.

How does this less helpful legacy affect the policy debate?

Remembering the earlier discussion of constrained discretion, a temporary spike in inflation, as a result of a large cost shock like the recent rise in energy prices, is exactly the sort of shock to which policy-makers should be able to react flexibly within an inflation targeting framework. That enables them to avoid excessive volatility in output and employment, as long as public expectations of inflation over the medium term remain pegged to the inflation target.

On the other hand, the MPC can never afford to ignore evidence that medium-term inflation expectations are becoming dislodged: anchoring these expectations is fundamental to the success of the framework. But direct evidence of inflation expectations is very hard to come by; the measures we have are patchy and poor.

So there is a difficult dilemma here, which the MPC has been grappling with over the past few months. And it has left me with a nagging worry. My concern is this. If the price of maintaining the public's confidence is that we have to try to keep inflation within a whisker of the target at all times – even in the face very large shocks – the flexibility that is such an important feature of our present arrangements may get significantly eroded[7].

That is why the Open Letter procedure remains important – and why it is a great pity that it has been widely misrepresented as a punishment, rather than as an opportunity for the MPC to explain itself.

Our monetary policy framework can only offer flexibility as long as it remains credible. But our credibility needs to reflect reality. It is important that the unprecedented stability of the past decade does not lead people to believe that central banks can walk on water. They can't. When that becomes clear – as at some stage it will – I see some risk that people will be excessively disillusioned.

So let me end by being very clear about what I regard as reality. The MPC cannot keep inflation exactly on target, at all times and in all circumstances. Large price shocks will sometimes drive us away from target, and we need to be able use our judgement in deciding how to react. But we can and will keep inflation close to target on average. Short run deviations from the target should not leave anyone in any doubt about that.

Conclusions

The stability of the period since 1992 has been almost as unexpected as the falling of the Berlin Wall, and every bit as welcome. It remains something of a puzzle and we cannot assume it will continue indefinitely.

We do not know quite how big a part the MPC has played in achieving this outcome. But it has certainly been shaped by it. Success – however earned – has its price. It may have bred expectations of the MPC and what monetary policy can deliver which are frankly unrealistic – and unsustainable in the longer term.

In the original concept, the defining characteristic of inflation targeting and the MPC was the scope it offered for exercising constrained discretion. We need to hang on to that big idea.

[7] I would have a similar concern if people came to believe that the MPC could keep output growing steadily, quarter by quarter, irrespective of wider economic circumstances.