BANK OF FINLAND
DISCUSSION PAPERS

13/95

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Inflation Targeting in the UK Monetary Policy Framework

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ISBN 951-686-452-X
ISSN 0785-3572

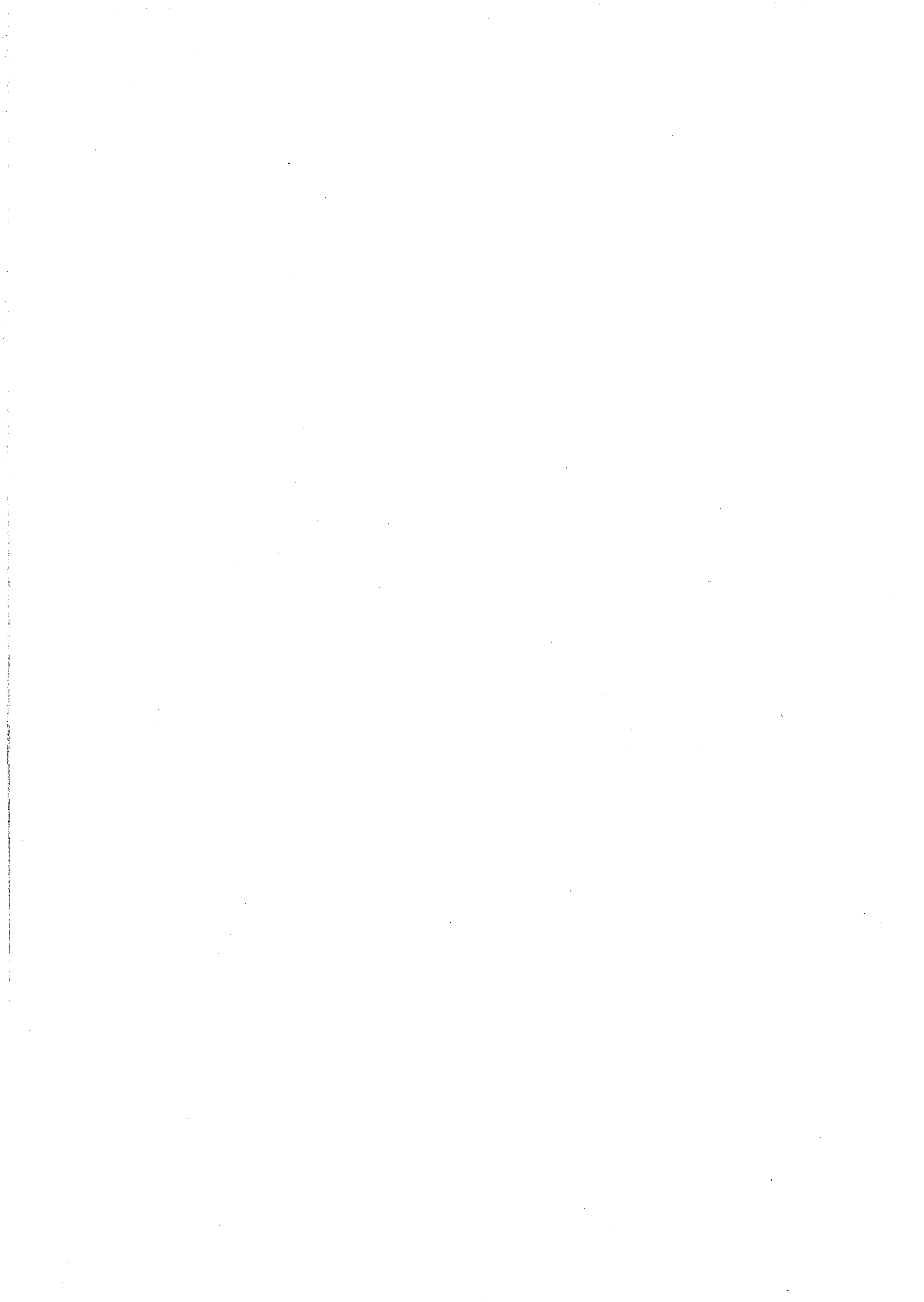
Suomen Pankin monistuskeskus
Helsinki 1995

Seminar lecture

The Governor of the Bank of England presented the following paper at a seminar held at the Bank of Finland on 27 March 1995. The paper discusses monetary policy targeting in the United Kingdom, with special reference to the inflation target and the experiences gained from it.

Seminaariesitelmä

Bank of Englandin pääjohtaja Eddie George piti Suomen Pankissa 27.3.1995 oheisen seminaariesitelmän. Esitelmässä käsitellään rahapolitiikan tavoitteenasettelua Isossa-Britanniassa ja kiinnitetään huomiota erityisesti inflaatiotavoitteeseen ja siitä saatuihin kokemuksiin.



Inflation Targeting in the UK Monetary Policy Framework

Helsinki, 27 March 1995

I am grateful to Governor Hämäläinen for giving me this opportunity to discuss with you the British experience of monetary policy management – past and present. I will speak first about the aims of monetary policy and then about the policy framework and the implementation of policy.

Monetary policy aims

For many years after the Second World War – until well into the 1970s – it would have been very difficult to define the aims of monetary policy in particular; it didn't really have a specific role. Instead, as in many other countries at that time, monetary policy tended to be regarded as simply one of a number of instruments of wider economic policy – including fiscal policy and different forms of direct controls – to be used in combination to achieve the best available short-run trade-off between the conflicting objectives of growth and employment, on the one hand, and price stability and a manageable balance of payments, on the other.

This approach to policy was not particularly successful, resulting in a pronounced boom/bust cycle, which threatened to become explosive - with the rate of inflation becoming progressively higher from peak to peak and unemployment progressively higher from trough to trough. I don't find that experience, in hindsight, surprising. If you come to expect a few fat years to be followed inevitably by a number of lean years, it's predictable that whether you're concerned with wage demands, or pricing decisions, or real or financial investment decisions, you'll tend to grab all that you can while the going is good. It is an absolute recipe for short-termism in personal and industrial, as well as financial, behaviour. Economic decisions in an environment of high and variable inflation are pretty much a lottery anyway, with the outcome of decisions to save or to spend, to consume or invest, and so on, determined by the outcome on inflation far more than on real values. Equally, with high and variable inflation generally, the signals given by relative prices as determinants of resource allocation become obscured, resulting in another dimension of economic inefficiency.

We were not, as I say, alone in this, and there were certainly other, structural, factors affecting the British economy through this period. But it was this disappointing experience, at least as much as the changing international academic perceptions about economic management that brought a radical change in approach over the past 15 years or more.

The broad consensus now is that there really is no trade-off between the growth of output and employment and macro-economic stability in the longer

term — that stability is in fact a necessary condition for growth to be sustained. Both fiscal and monetary policy have as a result been increasingly directed to the medium- and long-term rather than to just the period immediately ahead.

Where the temptation in the past might have been for governments to seek to spend their way out of unemployment, as if that were simply a matter of inadequate demand, without sufficient regard to supply constraints on the economy, the shared understanding now is that unsound public finances — by pre-empting national savings and deterring private investment — would be likely only to make things worse in anything but the short term. Fiscal policy everywhere therefore is being directed to reducing government deficits, not just as a result of the cyclical upswing but also through discretionary tightening to reduce structural deficits. This certainly was the intention — and the effect — of recent budgets in my own country.

Similarly monetary policy almost everywhere is firmly and specifically directed to achieving and maintaining price stability. In several countries recently this has been seen in a greater readiness than in the past to tighten policy pre-emptively before pressures appear in the retail price statistics. The shared understanding here is that excessive monetary expansion cannot affect the productive capacity of the economy in anything but the short term but simply generates inflation; and inflation is more likely to discourage investment by damaging business confidence in the sustainability of the growth of demand, than timely — and, in the end, smaller — increases of interest rates. Here, too, the perception is that if monetary policy were to target unemployment directly, without regard to the supply capacity of the economy, or to the inflationary consequence, that would ultimately only make the problem worse. That's what central bankers mean when they emphasise price stability. It's not that they don't care about unemployment; it is that price stability — a sound monetary framework within which businesses and their customers can plan their affairs for the longer term, without the fear that those plans will be upset by erratic and unpredictable fluctuations in the value of money — is the best contribution that we can make to getting unemployment down in the longer term. In this sense the immediate aim of monetary policy — price stability — is very much a means to the end of higher growth and employment in the medium and longer term, rather than an end in itself; and the central banker's mantra that "price stability is a necessary condition for sustainable growth" is increasingly understood and accepted both across countries and within countries around the world, including in the UK.

Now I have to admit to you that this proposition is maddeningly difficult to prove. There are studies of both historical and cross-country experience seeking to correlate economic performance and price stability — but, as with most empirical studies in economics, they are typically not conclusive. You can read into them more or less what you choose to reinforce your prejudices though there really is not much support at all for the contrary proposition — that inflation actually promotes growth in anything but the short term.

Some people do nevertheless argue that price stability is not necessary to sustained economic growth. So long as there was reasonably low and reasonably steady inflation, they say, that could surely produce most of the benefits with less short-run pain. And so it might, if we knew how to achieve reasonably low and reasonably steady inflation. But we don't. The idea that inflation below 5 % would do, was a major element in our very serious monetary policy mistake in 1987/88. Within months inflation was back in double digits as we went through another cycle of boom and inevitable bust. The trouble is that inflation is a behavioural, not a mechanical, process; and if people believe that there is a tolerance of inflation — a readiness to take risks with inflation — in the interest of faster growth in the short term, then that perception will influence behaviour in ways which ensure that inflation does, in fact, accelerate, and the expansion will then need to be reined back. And the correction will need to be more violent the longer the problem is left untreated. Conversely, a growing economy is quite compatible with price stability if people really believe that the policy will be sustained, and base their behaviour on that assumption.

The successful pursuit of policies aimed at stability therefore involves changing behaviour, by influencing people's expectations. The UK, like other countries, grew used to living with inflation. But I recollect very well that it took us some time to do so. Money illusion eroded only gradually — which helps, I think, to explain why inflation tended to pick up more and more rapidly during the boom phases in the 1960s and 1970s (and sadly the 1980s) and why the booms were progressively shorter lived. We are bound, I think, to see a similar lag in the behavioural response as we adjust to a world of low inflation. It will take time before people really believe it — before inflation really is no longer a factor in economic decision-making. Of course I understand that. It will take a longish period of delivering low inflation before we can hope to get to that position. But the sooner behaviour does adjust, the lower the economic cost of the adjustment to low inflation will be — obviously in the case of pay settlements, perhaps less obviously in the case, say, of investment management or of business behaviour. That is why the credibility of the policy is so important.

So, to sum up on the aim of monetary policy, it is how to achieve and maintain price stability — as a means to the end of higher and more sustained economic growth and employment in the medium and long term. The aim in particular is to avoid boom and bust — and the social and economic damage that it causes. That doesn't mean, of course, that we can hope to eliminate the economic cycle altogether, or that we can eliminate all internally or externally generated shocks to the economy. But we certainly can attenuate rather than aggravate the cycle, and we can provide assurance of a predictable response to shocks, which will enable the economy to get back on to a sustainable path by focusing on stability over the medium and long term. The aim within this is to encourage longer-term decision-making and more effective resource allocation so that the economy functions more productively.

Monetary policy — implementation

The aim of monetary policy in something like these terms has been widely accepted in the United Kingdom for some time. The debate, since the later 1970s, has in fact been less about the aim of monetary policy than about its implementation. So let me now turn to that. I will speak mainly about the framework of policy.

When I first joined the Bank of England, in 1962, we operated within the Bretton Woods framework of fixed but adjustable exchange rates — supported by exchange controls. And when that eventually failed we operated without a formal framework at all, with decisions taken, as I say, on the basis of the short-run trade-off between growth and stability. The only point I would make about this whole period is to note that the decisions about policy generally — including monetary policy — were intrinsically discretionary political decisions, and while the central bank might typically have argued in favour of stability it had no clearly established locus from which to do so. The Bank of England's statutes did not define its role or objectives, and they did provide for the Chancellor of the Exchequer to give the Bank directions.

As the emphasis of monetary policy shifted towards stability during the 1970s, we, together with a number of other countries, moved to a policy framework of monetary targets. These were set by the Government — in effect as a policy rule to limit the Government's own discretion — in a deliberate attempt to distance monetary policy from short-term political influences and so to improve its credibility.

We had a mixed experience with this framework of monetary targets. At times, particularly in the first half of the 1980s we were relatively successful in achieving the end-objectives of policy, notably in lowering the rate of inflation, even though we were never very successful in achieving the intermediate monetary targets themselves. This caused us to experiment with a number of different monetary aggregates — starting with a measure of broad money (M3) as our single target variable, but ranging up to four simultaneous target aggregates, two narrow and two broad. The essential problem was that none of the relationships between the different measures of money and nominal income proved to be sufficiently reliable to serve as the basis for a robust monetary rule. And this problem became worse, as far as broad money measures were concerned, as a result of the extensive financial deregulation that took place in the UK in the first half of the 1980s. What we found was that despite the better performance on inflation, the credibility of policy was constantly undermined by our failure to achieve the monetary target, so that we needed constantly to explain why we had failed. Nor was credibility helped by the repeated changes in the target aggregates as we searched for a more robust money/nominal income relationship.

We finally abandoned monetary targets in the UK in the mid-1980s because, as a practical matter they were not providing us with a clear guide to policy and were actually damaging policy credibility. Of course that

didn't mean that we stopped monitoring the monetary (and credit) aggregates. The fact that they did not provide a clear guide to policy, did not mean that they were devoid of useful information. They remained — and still remain — full of useful information on the state of and prospects for the economy, but they have to be very carefully interpreted — in conjunction with all the other information available to us on the state of the economy. They can't be taken at their face value. We still today announce monetary guidelines or "monitoring ranges". But it is a measure of the difficulty we have: that our range for M4 (broad money) is as wide as 3 to 9 %; and we have actually just effectively overridden our 0—4 % range for M0 (narrow money) because we cannot sensibly estimate the effect of the shift since 1992 to permanently much lower inflation and lower interest rates on narrow money velocity.

We lost control over inflation in the later 1980s and some people certainly argue that this was a result of not at that time having any monetary policy rule — policy was again discretionary. I don't myself share that view. Certainly we made a very costly mistake, and, as always, there were a number of elements in that. One important factor was that after a sharp depreciation in sterling's exchange rate in 1986 from DM3.56 to DM2.82 to the pound — we then locked in that depreciation by capping the exchange rate, when it started to recover, at DM3, holding interest rates down in order to do so. This gave a very powerful inflationary impetus to the economy which certainly contributed to the unsustainable boom of the late 1980s. But the relevant point here is that none of this was the inevitable consequence of the absence of a monetary rule. It certainly was not the intention to abandon stability at that time — though there was no explicit objective for inflation and it may well be that inflation below 5 % was acceptable. The fact that inflation was allowed to take off was simply a failure of implementation, a mistake — which may indeed have been compounded by a hankering after an alternative rule, in this case an exchange rate rule.

We subsequently moved to an explicit exchange rate rule, as the framework for monetary policy, when we joined the ERM in October 1990. I am sure I don't need to remind anyone here of the eventual outcome! There are two main — and not necessarily mutually exclusive — explanations for what happened. Some argue that we originally entered the ERM at too high an exchange rate, and it is certainly true that our interest rates were still very high — both relatively and absolutely — when we joined the ERM because we were still in the process of restoring stability after the late 1980s boom, and that would have been a factor making the exchange rate cyclically strong. But I am more impressed by the tension which only really began to emerge in the spring of 1992 and which resulted from a divergence between the domestic policy needs in Germany as a result of reunification, on the one hand, and the domestic policy needs elsewhere, including notably the UK which had meanwhile moved into deep recession, on the other. That quite exceptional tension was bound to produce severe strain on the exchange rate even if the sterling rate had initially been fixed somewhat

lower, and this was perhaps demonstrated by the generalised pressures within the ERM in 1993 even though the cyclical divergence in other cases may have been less extreme.

The ERM of course had a broader purpose than to serve as an external anchor for the domestic monetary policies of member countries. It sought exchange rate stability in its own right, as a support to the more effective functioning of the single market, and as the precursor to EMU. But the rather obvious lessons that I would draw from our own experience, in relation to larger countries — at least — using the exchange rate as an external monetary policy anchor, are:

- that it works perfectly well so long as there is consistency between the domestic policy needs of the countries involved

- but that it is vulnerable to divergence, whether as a result of external shocks, cyclical or structural differences, or differences in the fiscal/monetary policy mix.

It does therefore involve risks, and it can impose large economic costs in the dependent country, at least in the short term.

Since our exit from the ERM the UK's monetary policy framework has been based upon an explicit target for inflation itself. This target, set in November 1992, is for inflation (defined precisely as the RPI less mortgage interest payments) to be kept within a range of 1—4 %, and to be in the lower part of that range (ie 1—2½) by the end of the present parliament (ie mid-1997 at the latest). In addition the Bank of England was requested to produce a wholly independent, quarterly, assessment of where we are and where we think we are headed in relation to the inflation target, which we publish as our "Inflation Report". The Bank was also given discretion over the timing of interest rate changes. And subsequently the Chancellor of the Exchequer has agreed that the minutes of his monthly meetings with me, to review the stance of monetary policy, should also be published — six weeks in arrears, in order to avoid unnecessary market disturbance.

I have to tell you that I regard these steps taken together, as an enormous advance on anything by way of a monetary policy framework that we have had before. They provide the clearest possible focus for monetary policy, which is explicitly directed to price stability. They define precisely the Chancellor's responsibility for the policy decisions that are taken and our own responsibility for the policy advice — and they make us openly and independently accountable to the public at large. That is uncomfortable — but very healthy! They ensure definitively that decisions are based on technical considerations bearing on stability rather than on any wider, short-term, political considerations, which is in total contrast to the intrinsically political monetary policy process of the 1960s and 1970s. And, as a bonus, in the relatively short period during which we have been operating within this

framework, the quality of the public debate about monetary policy has noticeably improved.

Of course targeting inflation is not — technically — easy. We know that monetary policy operates with long and variable lags, so that what we have to try to do is to anticipate what will happen to inflation 1½–2 years ahead. In part that involves a macro-economic forecast — and few people who have worked at all with forecasts are under any illusions about how unreliable they can be. The forecast can only be a part of the process, which also involves judgements based upon all the information about the state of the economy that we can obtain — statistical and financial data, anecdotal and survey information, and impressions from the financial markets. This includes, certainly, as I said earlier, monetary and credit data, as an important part of the information that we look at, but it is still only part and has to be looked at and interpreted in the context of all the other information. The prospect of course is rarely clear-cut, and, in the end, the policy process comes down to assessing the balance of risks. The significance of the inflation target, in our context, is that it marks a clear determination that risks should not be taken on the side of inflation.

The results of the new monetary policy framework

The initial results of the new monetary policy framework of targeting inflation directly have been encouraging.

Retail price inflation fell progressively until the latter part of last year to the lowest rate for a generation — to below 1½ % on an underlying basis. In important part, this was simply a delayed consequence of the recession and of the very tight monetary policy that continued through our period in the ERM. Indeed there has been some pick-up in retail price inflation in the past six months, as the economy has grown, and under the impact of rapidly rising world commodity prices, and more recently a weakening exchange rate as a side-effect of the international currency turmoil. Even so we are encouraged by the extent to which home-grown — or domestically-generated — inflation has been contained so far through the upswing, and by the extent to which external cost pressures have been absorbed in the production/distribution chain.

Output and employment meanwhile have strengthened substantially. Gdp growth last year was around 4 % and unemployment, on our national statistics, fell from a peak of 10.5 % in December 1992 to just below 8½ % now. And the composition of demand — with exports and investment increasingly providing the impetus to growth has been unusually favourable. Again, I would not claim that all this is attributable to monetary policy — the tightening of fiscal policy has had a great deal to do with it — especially with the favourable pattern of demand. But I would claim that our experience over the past couple of years contradicts suggestions that low inflation is incompatible with economic expansion. And I would claim, too,

that the expectation that the expansion will be sustained over the next few years — a common feature of all the macro-economic forecasts — is in part to be explained by a developing confidence that monetary policy will indeed continue to be directed at controlling inflation.

I believe that if we persist in our present policies, and with our present monetary framework, we have a better opportunity now than at any time in my 30 odd years as a central banker to achieve sustained growth with low inflation. It is up to us now, of course, to deliver.