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# The Monetary Policy Committee: theory & performance.

This Paper looks at the history of the first year and a half of the Monetary Policy Committee. It examines the reasons given for its establishment, describes its actions and assesses its impact.

Timothy Edmonds

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# Summary of main points

This Paper reviews the first 18 months experience of the Monetary Policy Committee [MPC]. Established, first informally and then later by the Bank of England Act 1998, soon after the 1997 General Election, the MPC is responsible for the determination of interest rates, and hence is highly influential in the setting of the overall monetary stance in the economy.

Its membership is drawn from Members of the Bank of England and from outside academics in roughly equal measure. Members' voting records are published as part of the minutes to the meetings. This allows an analysis of the different attitudes and inclinations of the individual members of the MPC. Attitudes have been characterised as being between the 'hawks'- members that are consistently more in favour of higher interest rates than others, and the 'doves' – those who favour a more relaxed policy. The analysis reveals that the Bank representatives have formed into a cohesive homogenous group with Mervyn King (Deputy Governor) emerging as the chief 'hawk'. By contrast the outside representatives are far more likely to disagree with the majority view and one, Dr DeAnne Julius, has emerged as the chief 'dove'.

Inferences about the rationale behind the MPC's decisions can be drawn from the published minutes. During the period a number of issues have been highlighted by the MPC as being the determinants of their decisions. These have included concerns about the need to balance 'nominal demand and the supply potential of the economy' (the output gap) and traditional concerns over the state of the labour market – 'As the May Inflation Report made clear, developments in the labour market are a key determinant of domestically generated inflation'.

Whilst it is too soon to determine the long-term influence of the MPC, certain developments are already worth commenting upon. First, following the MPC's establishment, there was an immediate reduction in long-term interest rates. Ten-year nominal forward rates-fell by about ½ a percentage point to reflect a corresponding fall in measured inflation risk, or, conversely an increase in the credibility of monetary policy.

Secondly, The Committee appears to have conducted its business in an open and harmonious manner and has avoided the disharmony evident in previous experiments of consensual economic policy making.

Finally, the UK's inflation performance over the period is broadly in line with forecasts made before the MPC was created. This has to be seen in the light of the economic downturn in both the UK (largely foreseen), international economies (not predicted) and the general collapse in world commodity prices. Indeed, this has been a period in which background economic conditions have been conducive to low inflation and hence a good performance is not unexpected. However, the power of the MPC to influence the economy through interest rates is one of medium term influence rather than the short term impact that, for example, tax rises can have. Thus any serious conclusion about the impact that the MPC has had in its core area of responsibility will have to be delayed for some time yet.

## CONTENTS

# I Introduction

One of the first acts of economic management taken by the incoming Labour Government in May 1997 was to announce the ‘independence’ of the Bank of England. The idea of a new role for the Bank of England had appeared in the Party’s election manifesto:

> We will reform the Bank of England to ensure that decision-making on monetary policy is more effective, open, accountable and free from short-term political manipulation.

The Chancellor made his announcement even before the House had reconvened and extracts from his press statement of 6 May 1997 are shown below:

> The enemy of growth, and the investment necessary for it, is the instability of short periodic bursts of high growth followed by recession.
>
> So we must break from the short termism of the past - the economic instability that has characterised the British economy not just in recent years but for most of the century. That is why I want British economic success to be built on the solid rock of prudent and consistent economic management, not the shifting sands of boom and bust.
>
> Now is the time for long-termism. This is the time to set the British economy on a new long-term course that will deliver high levels of growth and employment through lasting stability.
>
> Price stability is, as I have said, an essential precondition for the Government's objectives of high and sustainable levels of growth and employment. The question is how to achieve the long-term stability that we seek?
>
> I have also made clear that reform is required to put monetary policy on a stable, long-term footing. In a speech in May 1995 and subsequently in our 1995 policy document, A New Economic Future for Britain, I set out my view of the proper roles of the Government and the Bank of England in economic policy.
>
> Government has a responsibility to the public in setting the objectives of economic policy and that means that the Government rather than the Bank of England must set the targets for monetary policy.
>
> However, as I have repeatedly made clear since 1995, we will only build a fully credible framework for monetary policy if the long-term needs of the economy, not short-term political considerations, guide monetary decision-making. We must remove the suspicion that short-term party political considerations are influencing the setting of interest rates.
>
> I am now satisfied that we can put in place, with immediate effect, reforms of the Bank of England to ensure that it can discharge responsibilities for setting interest rates in an effective, open and accountable way.

> This is the time to take the tough decisions we need for the long-term interests and prosperity of the country. I will not shrink from the tough decisions needed to deliver stability for long-term growth. I have therefore decided to give the Bank of England operational responsibility for setting interest rates, with immediate effect. The Government will continue to set the inflation target and the Bank will have responsibility for setting interest rates to meet the target. The Government's policy is set out in a letter I sent to the Governor yesterday, the text of which I am releasing now.
>
> But there is, as I have suggested today, a more long-term context. In the last century, Britain was industrially pre-eminent. The history of this century has been one of economic decline, not least because of short termism and the pursuit of stop-go economics. I am determined that we make the right preparations for long term national economic success, as we look to the century that lies ahead, so that we can move forward again economically. I am therefore setting in place a long-term policy for long-term prosperity. The ultimate judgement of the success of this measure will not come next week , or indeed in the next year but in the long- term. I am convinced that this radical reform, together with measures we will announce to equip our economy for the challenges ahead, creates the platform of stability upon which Britain can build

The outcome of this announcement, which was confirmed later in a statement to the House,[1] was the creation of a new organisation, one that would be responsible for the setting of monetary policy: the Monetary Policy Committee (MPC).

It is too soon to test the contribution of the MPC to the long term objectives outlined above however, even now one can gain an impression of how the MPC works, analyse what influences it appears to recognise and the degree to which its membership hold convergent views.

# II The Monetary Policy Committee in action

## A. The MPC: organisation and remit

Although well known it is worth reiterating the organisational structure and the basic target of the MPC.

The relevant provisions of the Bank of England Act 1998 formally set out the role and constitution of the MPC. Section 11 states that:

> In relation to monetary policy, the objectives of the Bank of England shall be –
> (a) to maintain price stability, and

[1] HC Deb 20 May 1997 vol 294 cc 507 - 11

(b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

The Government reviews and announces the inflation target for the Bank at the time of the Budget. The target that the MPC is currently required to meet is a 2½% increase, over the previous twelve months, in the retail prices index excluding mortgage interest payments. Mortgage interest payments are excluded since they 'confuse' the underlying trend of prices. A direct consequence of a rise in interest rates is to increase mortgage costs and these feed through into the rate of inflation. Thus the very thing that the Bank tries to prevent does so automatically if mortgage costs are included in the index. The Bank has operational freedom how it meets the inflation target.

Decisions on what actions need to be taken to achieve the target will be taken by the MPC, on the basis of a majority vote. The membership of the Committee is set out under Section 13 of the Act. It includes the Governor and the two deputy Governors of the Bank, two members appointed by the Governor after consultation with the Chancellor and four outside 'expert' members appointed by the Chancellor.

The MPC has a two-day meeting on a monthly basis and all decisions on interest rates are announced immediately after the last day. The proceedings of the meetings, including votes, are now published within two weeks.

## B. Membership of the MPC

Ten individuals have served on the MPC. Brief biographical details of the current membership are shown below.

### 1. Bank of England Representatives

Eddie George

Eddie George is the Governor of the Bank of England and the Chairman of the MPC.

Mervyn King

Mervyn King is the Deputy Governor of the Bank of England and Vice-chairman of the MPC. His responsibility within the Bank is for monetary stability and he is in charge of the monetary analysis and statistics division of the Bank.

David Clemanti

David Clemanti is the other Deputy Governor of the Bank of England. His main responsibility is for the stability of the financial system. Mr Clemanti joined the MPC in September 1997 following the departure of a previous Deputy Governor, Howard Davies, who became the Chairman of the Financial Services Authority.

John Vickers

John Vickers is an Executive Director at the Bank responsible for monetary analysis and statistics. He was previously Drummond Professor of Political Economy at Oxford University.

Ian Plenderleith

Ian Plenderleith is an Executive Director at the Bank responsible for the stability of the financial system.

## 2. Outside Academics

Professor Charles Goodhart

Charles Goodhart, CBE, FBA is the Norman Sosnow Professor of Banking and Finance at the London School of Economics. Before joining the LSE in 1985, he worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. Earlier he had taught at Cambridge and LSE.

Dr DeAnne Julius

Dr DeAnne Julius is one of two non-UK nationals on the MPC (the other being Dr Willem Buiter- see below). She was educated at the University of California at Davis (Ph.D, 1975) and Iowa State University (B.Sc, 1970). She has been Chief Economist of British Airways plc since 1993 and before then Chief Economist at the Royal Dutch Shell Group from 1989-93 and Director of the International Economics Programme at the Royal Institute of International Affairs from 1986-89. From 1975-82 she worked in a number of capacities at the World Bank in Washington DC and then was Managing Director of Logan Associates Inc a small consulting group advising business and governments on investment strategy and pricing.

Sir Alan Budd

Sir Alan Budd has been Chief Economic Adviser at the Treasury since 1991. The Treasury announced last year that his initial 5-year contract had been extended to his retirement. He was previously Group Economic Adviser at Barclays Bank from 1988-91 after 14 years at the London Business School during which time he was Director of the Centre of Economic Forecasting (1980-88), Professor of Economics (1981-88) and Director of the Senior Executive Programme (1985-87).

He joined the MPC in November 1997, having previously attended its meetings in the post of Treasury observer.

Professor Willem Buiter

Professor Buiter has been Professor of International Macroeconomics at Cambridge University since 1994. He previously held professorial positions at Yale University (1985-1994), the London School of Economics, where he was Cassel Professor of

Economics with special reference to money and banking from 1982-85, and the University of Bristol.

Professor Buiter has been a consultant to the World Bank and the Inter-American Development Bank, as well as a visiting scholar at the International Monetary Fund. . He was an Adviser to the office of the Chief Economist of the European Bank for Reconstruction and Development since 1995 and is a member of the Council of the Royal Economic Society. He was a Specialist Adviser to the House of Commons Select Committee on the Treasury and Civil Service. Professor Buiter was born in 1949 in the Netherlands.

## C. Decisions taken by the MPC

The policy instrument controlled by the MPC is a key money market interest rate now referred to as the repo rate. Up to the end of 1998 the MPC took nineteen interest rate decisions. Of these eight changed the rate. On five occasions the rate was raised and reduced three times. On six occasions the change was a one-quarter of one per cent change; twice it has been a half point change. The history of rate changes is shown in more detail on the table on the following page.

**Monetary Policy Decisions** — **Base/Repo Rate**

| Date of decision | | Change made | New rate per cent |
|---|---|---|---|
| 1997 | *May 6* | *last decision made by the chancellor* | *6.25* |
| | Jun 6 | 1/4 % increase | 6.50 |
| | Jul 10 | 1/4 % increase | 6.75 |
| | Aug 7 | 1/4 % increase | 7.00 |
| | Sept 11 | no change | |
| | Oct 9 | no change | |
| | Nov 6 | 1/4 % increase | 7.25 |
| | Dec 4 | no change | |
| 1998 | Jan 8 | no change | |
| | Feb 5 | no change | |
| | Mar 5 | no change | |
| | Apr 9 | no change | |
| | May 7 | no change | |
| | Jun 4 | 1/4 % increase | 7.50 |
| | Jul 9 | no change | |
| | Aug 6 | no change | |
| | Sept 10 | no change | |
| | Oct 8 | 1/4 % decrease | 7.25 |
| | Nov 5 | 1/2 % decrease | 6.75 |
| | Dec 10 | 1/2 % decrease | 6.25 |
| 1999 | Jan 7 | 1/4 % decrease | 6.00 |

*Source:Bank of England*

## D. 'Hawks' & 'Doves'

The membership of the MPC is outlined above (see pages 9 to 11). Since the voting record of the membership is published as part of the minutes to the meetings there has been some interest in the voting record of the individual members of the MPC to see if some members – 'hawks'- are consistently more in favour of higher interest rates than others - 'doves' - who favour a more relaxed policy. The full voting record is displayed in a stylised way in the table on the following page.

Each recorded vote is given a 'score'. A vote for the majority view is given a score of one. A vote for a rate of interest higher than the majority view has a score of two and a vote for a rate of interest lower than the majority view has a score of zero. Hence a 'hawk' will have a number of 'twos', whereas a 'dove' will have some zeroes.

The table reveals a few interesting features. As might be expected the Bank representatives have formed into a cohesive homogenous group. Although on three occasions Mervyn King has voted for higher interest rates, than the other Bank representatives.[2] By contrast the outside representatives are far more likely to disagree with the majority view. On two occasions, May and August 1998, votes have been recorded for all three options, i.e. raising interest rates more and less than the majority view. This may confirm the popular perception of the propensity of economists to disagree amongst themselves.

Constructed in this way the table above can be used to determine the 'hawk' – 'dove' index. In the table below the Committee Members' average score is determined.

**Monetary Policy Committee**
**'Hawk' Index 1997-1998**

| Member | Number of votes taken | Average 'score' |
|---|---|---|
| **Bank Representatives** | | |
| Mervyn King | 19 | 1.16 |
| Eddie George - Governor | 19 | 1.00 |
| David Clemanti | 17 | 1.00 |
| Ian Plenderleith | 19 | 1.00 |
| John Vickers | 7 | 1.00 |
| Howard Davies | 1 | 1.00 |
| **Outside Representatives** | | |
| Sir Alan Budd | 13 | 1.31 |
| Professor Charles Goodhart | 19 | 1.16 |
| Professor Willem Buiter | 19 | 1.11 |
| Dr Deanne Julius | 16 | 0.69 |

*Source: MPC Monthly Minutes various*

[2] Although outside of the time frame of this Paper another Bank member – Ian Penderleith – has subsequently dissented during the January 1999 meeting.

## Monetary Policy Committee

### Membership Voting Record 1997-1998

| Decision | $^1/_4$ % increase | $^1/_4$ % increase | $^1/_4$ % increase | no change | no change | $^1/_4$ % increase | no change | no change | no change | no change | no change | no change | $^1/_4$ % increase | no change | no change | no change | $^1/_4$ % decrease | $^1/_2$ % decrease | $^1/_2$ % decrease |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Date of announcement | Jun 6 | Jul 10 | Aug 7 | Sept 11 | Oct 9 | Nov 6 | Dec 4 | Jan 8 | Feb 5 | Mar 5 | Apr 9 | May 7 | Jun 4 | Jul 9 | Aug 6 | Sept 10 | Oct 8 | Nov 5 | Dec 10 |
| Revised rate | 6.50 | 6.75 | 7.00 | | | 7.25 | | | | | | | 7.50 | | | | 7.25 | 6.75 | 6.25 |
| | **Voting record** | | | | | | | | | | | | | | | | | | |
| **Bank Representatives** | | | | | | | | | | | | | | | | | | | |
| Eddie George - Governor | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Mervyn King | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| David Clementi | 1 | na | na | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Ian Plenderleith | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| John Vickers | na | na | na | na | na | na | na | na | na | na | na | na | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Howard Davies | na | 1 | na | na | na | na | na | na | na | na | na | na | na | na | na | na | na | na | na |
| **Outside Representatives** | | | | | | | | | | | | | | | | | | | |
| Sir Alan Budd | * | * | * | * | * | na | 1 | 2 | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Professor Willem Buiter | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 2 | 2 | 2 | 2 | 1 | 1 | 2 | 0 | 0 | 0 | 0 |
| Professor Charles Goodhart | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Dr Deanne Julius | na | na | na | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 0 | 0 | 1 | 0 | 0 | 0 | 1 | 1 |

Notes: 1, vote was in accordance with majority view
2, vote was for a rate of interest higher than the majority view
0, vote was for a rate of interest lower than the majority view
*, attended as Treasury observer - no vote
na, did not attend or was not appointed at that date

*Source: MPC Monthly Minutes various*

The results are not very surprising. With the exception of Mr King, all the Bank representatives score straight 1.0s. The outside representatives vary from the most hawkish of all members – Sir Alan Budd (with a score of 1.31), to the least – Dr Deanne Julius (with a score of 0.69). Within these overall averages one might note that Prof. Buiter has the fewest scores of one. For the first five months of 1998 he consistently voted for rates of interest higher than those proposed by the majority. Since September, however, he has as consistently voted for interest rates below those decided upon by his fellow members.

# III What determines the MPC's decisions?

## A. Introduction

This section looks at thinking behind the decisions taken by the MPC. It will be recalled that the policy outlined in the Labour Party manifesto was:

> We will reform the Bank of England to ensure that decision-making on monetary policy is more effective, open, accountable and free from short-term political influence.

Part of the commitment to openness is the publication of the minutes of the MPC meetings. From these it is possible to gain an impression of the importance attached to various economic factors that determined the Committee's final decision.

## B. The decisions

Extracts from the Bank's press releases issued when interest rates were changed are shown below together with various contextual comments. Comments shown in **bold** are the author's emphasis.

Date: June 1997.
Decision: Interest rates raised by 0.25% to 6.50%.

> The Bank's Monetary Policy Committee has reviewed the latest monetary and economic data. It concluded that the latest evidence is consistent with the outlook described in the Bank's Inflation Report published on 13 May. Notwithstanding the strength of the exchange rate, which is expected to restrain retail price inflation temporarily in the near term, the Report concluded that "the central projection for inflation, and the risks surrounding it, suggests that, on the present evidence, there is still likely to be a need for some further moderate tightening of policy in the months ahead."

This tells us little other than the fact that, on the Bank's view; inflationary pressures were building in the economy at the time of the 1997 General Election.

Date: 10 July 1997
Decision: Interest rates raised by 0.25% to 6.75%

> The combination of rapid expansion of domestic demand led by consumption and the further appreciation of sterling has sharpened the dilemma for monetary policy. **The Monetary Policy Committee's task is to aim to balance nominal demand and the supply potential of the economy, in order to meet the inflation target and create the conditions for sustained growth of output and employment.** Continued growth of output at well above trend rates would be unsustainable.
>
> The Committee reviewed the latest monetary and economic data against the background of the Bank's Inflation Report published on 13 May and the 0.25% rise in official interest rates announced on 6 June. It concluded that the latest month's evidence - notably the upward revision of estimated output growth in the fourth quarter of 1996 and recent developments in monetary growth and retail sales - indicated that a further tightening of monetary policy was necessary, notwithstanding the further appreciation of the exchange rate and the contractionary effects of the recent Budget.

If there is one persuasive factor in this analysis it is the position of the UK economy above its trend growth pattern. The Committee clearly held a view that whatever other influences were coming into play the most important factor was the growth rate of the economy.

Date: 7 August 1997
Decision: Interest rates raised by 0.25% to 7.0%

> The Committee [ ] recognised that the appreciation of the exchange rate over the past year is putting severe pressure on businesses exposed to international competition.
>
> Nevertheless, in the light of the prospect for domestic demand and on the basis of all the evidence currently available, the Committee judges that today's rise is necessary to put the economy on track for achieving the inflation target of 2½% looking two years ahead. Although the present strength of sterling reflects in large part factors outside the influence of UK monetary policy, upward pressures on the exchange rate should be reduced by the perception that interest rates have reached a level consistent with the inflation target.

Perhaps the most important feature of this notice is the subsidiary influence (despite the laboured – and subsequently inaccurate hint to the markets at the end of the notice) of the exchange rate at a time when sterling was at its highest level for almost a decade.

Date: 6 November 1997
Decision: Interest rates raised by 0.25% to 7.25%

> Inflation has not moderated as much as expected in the light of sterling's appreciation since the autumn of 1996. Domestic demand has remained robust, and the expected impact on external trade, lowering export volumes and raising import volumes, has yet to materialise, so that **GDP has continued to grow at an unsustainable rate. The labour market has tightened further, with skill shortages increasingly reported.**
>
> Looking ahead, the economy is expected to slow down next year as both domestic demand and net external trade moderate, under the combined impact of past tightening in monetary and fiscal policy, the strength of sterling, and a smaller impact of windfalls on consumption. This will help to reduce inflationary pressures. But, in the Committee's judgement, the balance of risks implies that a modest further increase in interest rates is necessary to meet the inflation target of 2½% in the medium term.

This was the first of several press releases to mention labour market conditions as indicators of inflationary pressure. Again the main issue of concern appears to have been the 'unsustainable' rate of growth in the economy. 'Windfalls' refers to the sums accruing to individuals when, typically, a building society converted into a bank and compensated its previous members with generous payments.

Date: 4 June 1998
Decision: Interest rates raised by 0.25% to 7.25%

> In the May Inflation Report, the Committee said that: "In the central projection, inflation is expected to remain close to its target throughout the forecast period after the temporary increase in the second quarter of this year. But there are major uncertainties which mean that the outlook for monetary policy remains finely balanced."
>
> The central issue for monetary policy remains whether aggregate demand will slow sufficiently quickly to bring down domestically generated inflation before the restraining price effects of the earlier increase in the exchange rate and falls in commodity prices wear off. As the May Inflation Report made clear, **developments in the labour market are a key determinant of domestically generated inflation**. Evidence has emerged over the past month that the cumulative tightening of the labour market has resulted in a rate of private sector earnings growth that jeopardises achievement of the inflation target over the medium run. Moreover the sterling exchange rate has remained about 3% lower than in the central projection of the May Inflation Report. While there are increased uncertainties in the external environment, inflationary pressures appear greater than in the May projection, and the need for a slowdown in domestic demand growth has become more pressing.

This month too saw explicit reference to the labour market as a “key determinant” of the Committee’s decision. However, it emerged later that the figures for average earnings produced by the Office of National Statistics were unreliable and publication of the series was suspended soon afterwards.

Date: 8 October 1998
Decision: Interest rates reduced by 0.25% to 7.25%

> The international economic and financial environment has deteriorated since the Committee met in September. In the domestic economy, surveys and reports from the Bank's Regional Agents have indicated a decline in business and consumer confidence. The outlook for demand and output has therefore weakened. Despite continuing tightness in the labour market and the fall in the exchange rate, the Committee judges that the risks of inflation falling below the target of 2.5% have increased and that a reduction in interest rates of 0.25% is now appropriate.

This was the first release to make specific mention of regional influences. The Bank’s Regional agents are a historical throwback to the days when the Bank had a regional branch network to deal with the failures of local note-issuing banks. Over time and after several initiatives and reorganisations the agents developed an industrial liaison role. Their work was described in an article from the Bank of England Quarterly Bulletin as being:

> To maintain contact with industry and commerce and to report on the economy as seen by those based in the area. The Agencies play an important part in enabling the Bank to collect ‘proper regional and sectoral information for the purpose of monetary policy formation’ (as required by the Chancellor’s letter to the Governor of the 6 May 1997).[3]

For some considerable time there had been calls from industry for help with the problems that they were experiencing following the high value of sterling. One channel through which these calls could flow would be the contacts that industry had with the regional agents.

Date: 5 November 1998
Decision: Interest rates reduced by 0.5% to 6.75%

> Since the August Inflation Report was published, news about the international environment and the prospects for domestic activity have led the Committee to moderate its forecast for growth next year and to revise downwards its projection for inflation over the next two years. As a result, the Committee concluded that a

3 *Bank of England Quarterly Bulletin*, November 1997, p 424

> reduction in interest rates of 0.50% was appropriate in order to maintain a path for inflation consistent with the target.

The reference to the international environment appears to refer to the collapse of the Russian economy following the floating of the rouble in the August, a deepening of the recession in Japan and the substantial falls in equity markets around the world: the FTSE 100 fell by over 22% between May and October 1998.[4]

Date: 10 December 1998
Decision: Interest rates reduced by 0.5% to 6.25%

> Since the November Inflation Report, the prospect for global activity appears to have weakened and commodity prices have fallen further. In the UK, GDP growth in the third quarter was revised down, and surveys of activity have continued to indicate deterioration across the economy, although the labour market is still tight and monetary and financial indicators remain relatively strong. The Monetary Policy Committee judged that the downside risks to both activity and inflation have increased, and therefore reduced interest rates by 0.50% to keep prospective inflation on track to meet the 2.5% target.

# IV Has the MPC worked?

## A. Introduction

It is too soon to be able to judge whether or not the MPC has fulfilled the broad aims set out for it by the Chancellor:

> Now is the time for long-termism. This is the time to set the British economy on a new long-term course that will deliver high levels of growth and employment through lasting stability.
>
> Price stability is, as I have said, an essential precondition for the Government's objectives of high and sustainable levels of growth and employment. The question is how to achieve the long-term stability that we seek?[5]

Clearly, 18 month’s experience can hardly be described as the long term. However, it is still possible to look for what has been achieved by the MPC.

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4 *Financial Statistics*, table 7.1G
5 Chancellor’s statement, Treasury press release 6 May 1997

## B. Achievements

Perhaps the first achievement is that the Committee appears to have conducted its business in a harmonious manner. Differences of opinion and emphasis are acknowledged within the minutes of the discussion, however, there has been no obvious sign of public, off-the-record, briefings by disenchanted members or sudden acrimonious resignations. One can contrast this with what happened during the previous attempt at consensual advice giving by a group of economists and government, namely the Treasury's group of 'wise men' that gave advice to the Chancellor on the management of the economy. This group was set up in 1992 in the aftermath of the UK's exit from the ERM. It developed into a body with no coherent view and ended after some highly public rows between some of its members.

No less important in terms of the Committee's prestige and authority was the move taken in October to reduce the period between the date of the meeting and the publication of the minutes to just two weeks instead of the permitted six weeks delay. This move improves the transparency of the Committee's decisions and makes the job of the market in interpreting it and predicting future moves that much simpler.

One immediate benefit that was derived from the establishment of the MPC was a reduction in the long-term interest rate following the announcement of the Bank's operational independence. Investors, it is argued, require a rate of return (interest) that will take into account the expected rate of inflation. If this falls then the rate of interest required by investors also falls. In the case of overseas investors they also consider any relative movement between the value of their domestic currency and the currency in which the investment is denominated. In its May 1997 Inflation report the Bank noted that:

> The immediate reaction of financial markets to the Chancellor's announcement (which was accompanied by a $^{1}/_{4}$% rise in official interest rates) was marked (see the table). That was most evident in long-term bond yields, which reflect expectations of inflation, real interest rates and risk premia. Long gilt yields fell by around 30 basis points. And, ten-year nominal forward rates-fell by about 50 basis points. Because real forward rates were broadly constant, this implies a corresponding fall in measured inflation expectations, the inflation risk premia or both. It seems likely that the changes to the UK monetary framework announced by the Chancellor have, at least for the moment, improved the credibility of monetary policy.

**Change in UK financial market measures**

| | Fri 2 May (a) | Tues 6 May (a) | Change (b) |
|---|---|---|---|
| £ Effective exchange rate | 99.71 | 100.56 | 0.85% |
| DM/£ | 2.80 | 2.82 | 0.82% |
| $/£ | 1.62 | 1.64 | 1.17% |
| Ten-year nominal forward rate | 7.83 | 7.31 | -0.52 |
| Ten-year implied forward inflation rate | 4.17 | 3.70 | -0.47 |
| Ten-year zero coupon rate | 7.39 | 7.07 | -0.32 |
| Three month Libor (c) | 6.53 | 6.53 | 0.00 |
| FF-SE 100 index level | 4,455.60 | 4,519.30 | 1.43% |

(a) Close of business.
(b) Percentage points, unless indicated. Data are between close of business on Friday 2 May and close of business on Tuesday 6 May.
(c) 8.30 am rate, following business day.

On the key point of whether the MPC has actually hit its stated inflation target the news is less good. The inflation target that the MPC is required to meet is a 2½% increase, over the previous twelve months, in the retail prices index excluding mortgage interest payments. Over the period covered by this Paper the following monthly inflation rates, on the stated basis, have been recorded:

**RPI(X)**
**Annual Changes**

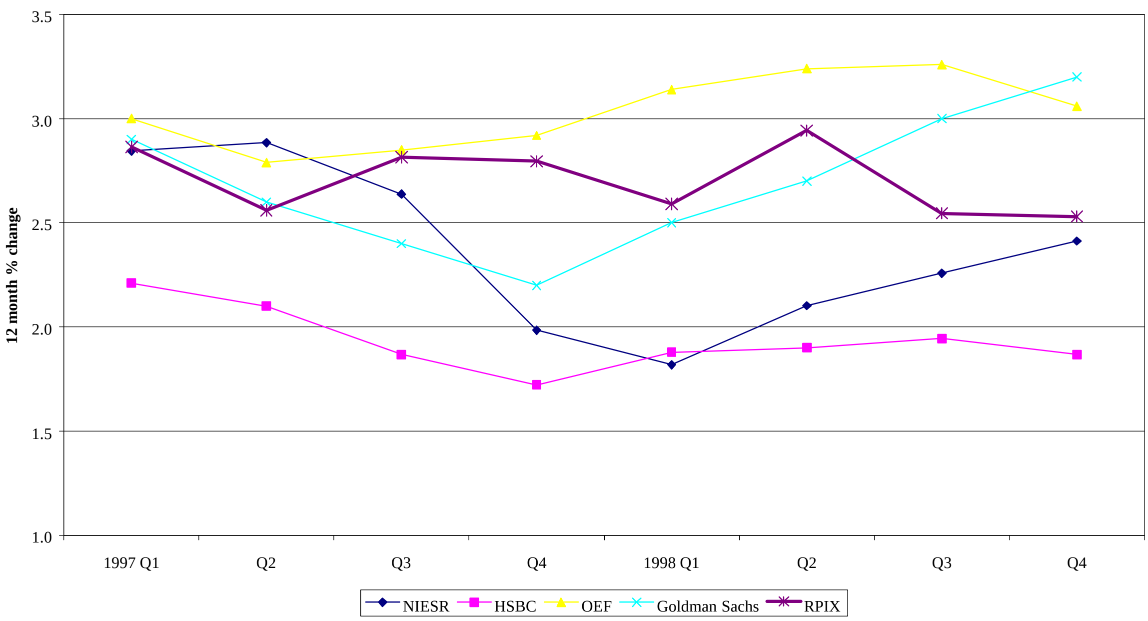
| | | per cent | Meets target? | over/under target |
|---|---|---|---|---|
| 1997 | June | 2.7% | no | 0.2% |
| | July | 3.0% | no | 0.5% |
| | Aug | 2.8% | no | 0.3% |
| | Sept | 2.7% | no | 0.2% |
| | Oct | 2.8% | no | 0.3% |
| | Nov | 2.8% | no | 0.3% |
| | Dec | 2.7% | no | 0.2% |
| 1998 | Jan | 2.5% | yes | 0.0% |
| | Feb | 2.6% | no | 0.1% |
| | Mar | 2.6% | no | 0.1% |
| | Apr | 3.0% | no | 0.5% |
| | May | 3.2% | no | 0.7% |
| | June | 2.8% | no | 0.3% |
| | July | 2.6% | no | 0.1% |
| | Aug | 2.6% | no | 0.1% |
| | Sept | 2.5% | yes | 0.0% |
| | Oct | 2.5% | yes | 0.0% |
| | Nov | 2.5% | yes | 0.0% |
| | Dec | 2.5% | yes | 0.0% |

*Source: ONS*

Is this good or a bad performance? On the one hand only five out of the nineteen rates meet the target. But, four of those that have are in the most recent period. Even when the target has been missed the discrepancy has been very small. All the inflation rates are good by historical standards, however, in the light of the downturn in both the UK and international economies and the general collapse in world commodity prices this has been a period in which background economic conditions have been conducive to low inflation.

One final way to compare the performance of the MPC is to compare inflation over the period with what had been the forecast immediately prior to its establishment. In the chart on the following page the actual quarterly inflation rate RPI (X) is compared to the average of four medium term forecasts (themselves influenced by their state of knowledge about the then government's inflation target which was a 1 - 2½% target range) made by independent groups.[6]

**UK Inflation 1997 - 1998: predictions v outcome**

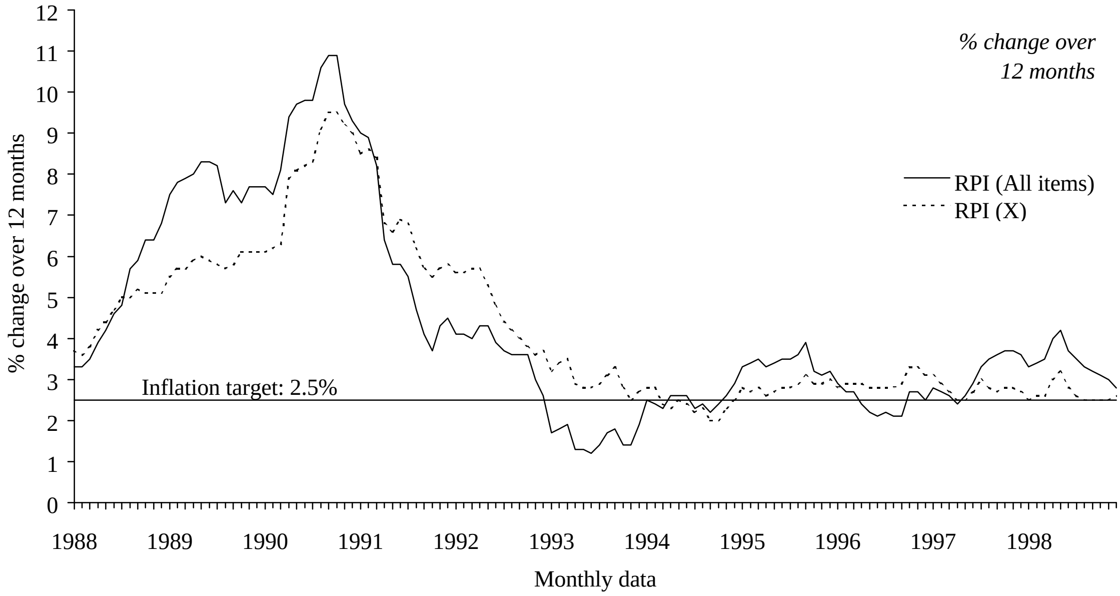


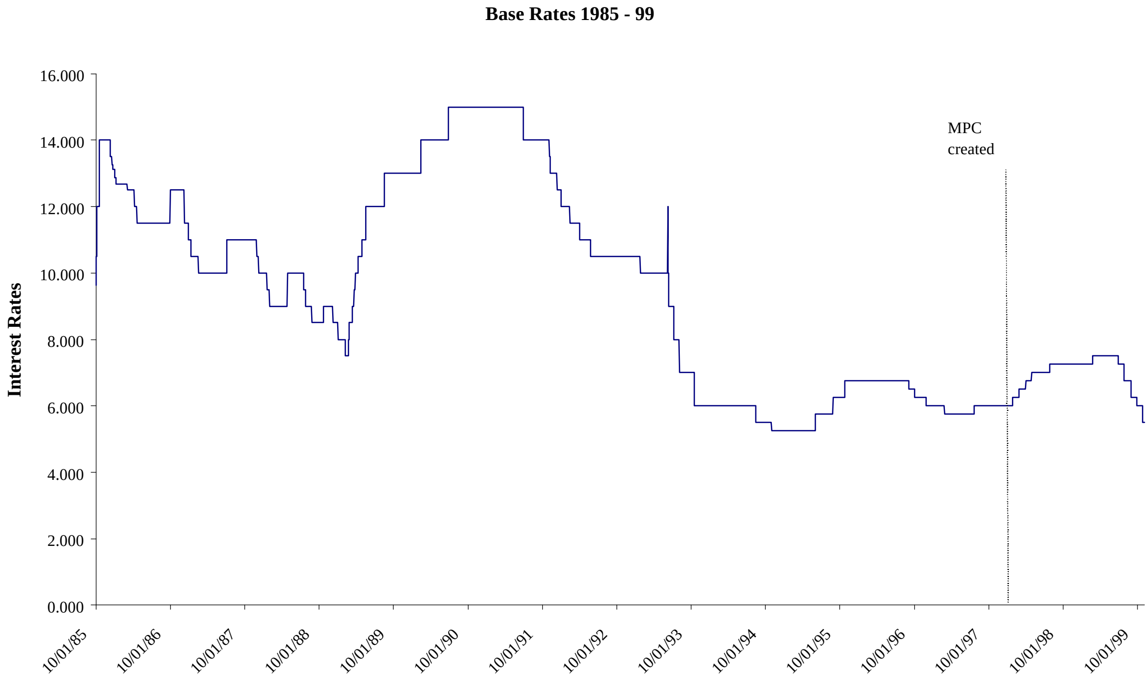

The chart confirms the view that despite a period in which inflation has been in excess of what was expected it is now where economists, two years ago, thought it would be. Of course this comparison is as much a test of the predictive abilities of a particular group of economists as it is of the MPC, indeed, perhaps, a greater test. The power of the MPC to influence the economy through interest rates is one of medium term influence rather than the short term impact that, for example, tax rises can have. Thus any serious conclusion about the impact that the MPC has had in its core area of responsibility will have to be delayed for some time yet.

6 NIESR (April 1997), HSBC (May 1997), OEF (Spring 1997) and Goldman Sachs (May 1997)

# Appendix I: Inflation & Interest Rates

Indicators of long term inflation and interest rate performance are shown in the charts below:



# Appendix II: Further Reading

Members interested in further analysis of the operation of the MPC and the determination of monetary policy in general may find the following references helpful.

### Bank of England material

- Speech by Eddie George '*The objectives and current state of monetary policy*', printed in the *Bank Of England Quarterly Bulletin*, November 1998

- Speech by Sir Alan Budd '*Economic Policy, with and without forecasts*', printed in the *Bank Of England Quarterly Bulletin*, November 1998

- Speech by Mervyn King '*Monetary Policy and the labour market*', printed in the *Bank Of England Quarterly Bulletin*, February 1999

### Treasury Committee proceedings

- Budgetary & Monetary Issues, HC 169 1997/98

- Bank of England Monetary Report HC 379 1997/98

- Monetary Policy Committee confirmation hearings, HC 822 1997/98