INFLATION TARGETING IN THE UNITED KINGDOM (1992 – 2000)

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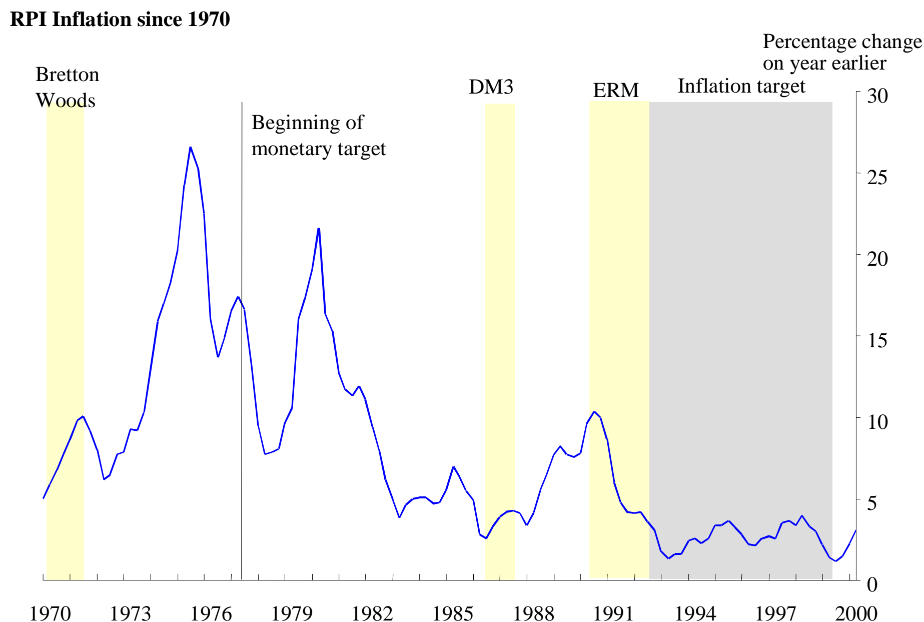
I. INTRODUCTION

The United Kingdom has had an inflation target for the past eight years, since 1992. However, in order to understand its role in the UK's economic development, it is necessary to look at a longer period. In fact, inflation targets represent the latest stage in a longer period of disinflation, which has lasted for a quarter of a century.

The history of inflation over the period since the break-up of the Bretton Woods system is summarised in Chart 1, which shows the rate of inflation as measured by the twelve-month increase in the retail prices index excluding mortgage interest payments, which is the measure which we use for the purposes of the inflation target.

Chart 1



In the first half of the 1970s, monetary policy was regarded as one among a number of economic policy instruments (including fiscal policy, and from time to time incomes policy) which could be used in combination to achieve a number of policy objectives, following the framework articulated by the famous Dutch economist, Jan Tinbergen. It was believed that there was a stable trade off between unemployment and inflation – in other words, a stable short-run Phillips curve. That belief proved to be mistaken, and the targets/instruments approach to economic policy, applied in this way, led to a combination of rising inflation and rising unemployment. Inflation exceeded 25% in 1975, as you can see on the chart.

After this unhappy experience, it gradually came to be increasingly widely understood that low inflation was a necessary pre-condition for the achievement of other economic policy objectives, and not an objective that could be traded off against other objectives. Consequently it had to be assigned top priority among economic policy objectives.

During the quarter century since 1975 the rate of inflation has fallen more than tenfold, from over 25% to below 2½%. As you can see from the chart, the fall in inflation has not been steady or continuous, and we have used, and later abandoned, a number of different monetary policy techniques. The techniques that we have used and then abandoned are as follows:

1 ***Monetary targets.*** Monetary targets were adopted in 1976 and were of great importance for monetary policy in the late-1970s and early-1980s, during which inflation fell, on balance, from over 20% to below 10%. They were adopted for two main reasons:

(i) For the pre-Thatcher Labour administration, monetary targets helped the Treasury (ie the Ministry of Finance) restrain the public spending ambitions of other parts of the government, because a monetary target implied a limit on public sector money creation. In other words the monetary target was a means of co-ordinating fiscal and monetary policy.

(ii) Monetary targets lent some credibility to the government's claims that it was serious about reducing inflation. This was vitally important at a time when monetary policy had very little credibility. The Thatcher administration, which was elected in 1979, was happy to continue with the monetary targets established by the previous administration because it believed that the relation ship between monetary growth and inflation was stable and reliable.

In the early-1980s it became clear that the relationship between monetary growth and inflation was not stable or reliable, and that monetary targets were not a good guide to monetary policy. Inflation was falling even though the monetary targets were being overshot. The monetary target was re-designed and re-specified, but in practice it came to have little influence on actual decisions about monetary policy.

2 ***Exchange rate targets.*** The UK had two periods of exchange rate targeting during this period.

(i) For a year, in 1987-88, the pound (which was in strong demand at that time) was prevented from appreciating above DM3 by a combination of heavy purchases of foreign exchange and reductions in interest rates. This policy (which was never officially announced) was based on the belief that if the sterling/Deutschemark exchange rate was stabilised, then in the long run UK inflation would converge to the level prevailing in Germany. During 1987-88, however, the UK economy was experiencing a cyclical upswing, with domestic demand growing rapidly and house prices increasing sharply. Monetary policy was pre-occupied with stabilising the exchange rate, and therefore acted procyclically by aggravating the strength of domestic demand and the rise in house prices. The policy was abandoned in March 1988, but it was probably responsible for the rise in inflation to around 10% (see chart).

(ii) At the point in 1990 when inflation and interest rates were at their highest, the United Kingdom exercised its right to join the European Exchange Rate Mechanism. Inflation fell rapidly – partly because the economy moved quickly into recession after the preceding boom, but also because membership of the ERM helped to bring down inflationary expectations, as I will show later on. Interest rates fell also, but they could not fall below comparable German interest rates because it was clear that international investors would prefer to hold Deutschemarks rather than sterling if the interest rates on offer were equal. Therefore, without an interest rate premium over the DM, sterling could not stay in the ERM exchange rate band.

Following the reunification of Germany in 1990, German interest rates needed to rise to contain demand pressures there, and that meant that the scope for UK interest rates to fall became progressively less and less. With the economy in a serious recession, there was a dilemma for monetary policy that financial market participants clearly identified, and sterling was forced out of the ERM in September 1992.

These two experiences of exchange rate targeting have the common feature that in both episodes there was a conflict between domestic and exchange rate objectives, and in both episodes the conflict was resolved in favour of the domestic objective, by abandoning the exchange rate objective.

Those are the two techniques that we used and then abandoned. I do not mean to suggest that, because we abandoned them, it was a mistake to have used them in the first place. It is up to the historians of the future to make that judgment.

II. INFLATION TARGETS

The UK's departure from the European Exchange Rate Mechanism in 1992 was a shattering event. It did enormous damage to the public credibility of the Conservative government and helped to ensure its defeat at the next general election, and it did enormous damage also to the credibility of monetary policy. Although short-term interest rates fell by 400 basis points in the five months after the UK left the ERM, bond yields increased, showing that longer-term inflationary expectations had gone up by well over 1%.

There was therefore an urgent need for a new monetary policy strategy to rebuild the credibility of monetary policy and bring down inflationary expectations. The United Kingdom was not the first country to use an inflation target: New Zealand began in 1989 and Canada in 1991. A recent survey conducted by the Bank of England Centre for Central Banking Studies shows that in 1998, as many as 55 countries (out of a survey of 93) used inflation targets in any way or another.[1]

In 1992, decisions about monetary policy in the UK were made by the Chancellor of the Exchequer – the equivalent of the Minister of Finance. The role of the Bank of England was to give advice and to implement the Chancellor's decisions. In order to restore monetary policy credibility, the Chancellor announced a strategy with two main elements.

(i) There would be an inflation target of 1-4%, and meeting it would be the single objective of monetary policy. He added that it would be the Government's objective for inflation to be in the lower half of the

[1] See "The Use of Explicit Targets for Monetary Policy" in Monetary Policy Frameworks in a Global Context, ed L Mahadeva and G Sterne, Routledge, 2000.

range – that is, below 2½% - by the end of the then-current Parliament.

(ii) The Bank of England would publish each quarter an Inflation Report, setting out its views on the current state of the economy and inflation and including a forecast of the future rate of inflation.

The second element of the strategy invited the central bank in effect to comment publicly on the monetary policy decisions made by the Chancellor. It represented a big change in the relationship between the Bank of England and the Treasury, which had previously been a very discreet one. It also represented a big increase in the openness and transparency of monetary policy, because for the first time an official body was able to comment publicly and candidly on monetary policy judged against a pre-announced target. And there was some moderation in longer-term inflationary expectations, even in the few months immediately after the strategy was announced.

Later, the strategy was developed further. The meetings between the Chancellor of the Exchequer and the Governor of the Bank of England at which they discussed monetary policy before the Chancellor made decisions about interest rates were put on to a regular, publicly-announced schedule. Not only that, but the minutes of the meetings, including the full text of the Bank of England's advice to the Government, were published after the meeting had taken place. Thus it was made completely clear to the public and to financial markets whether or not the Government had taken the Bank of England's advice.

It did not, however, mean that the Chancellor always took the Bank of England's advice: there were several occasions on which he overruled it.

This strategy continued until the general election of 1997, in which the Conservative government was defeated by the Labour opposition. The first act of the newly-elected Labour government was to develop the strategy further. The new strategy was implemented in its essentials immediately after the election, and it was legislated into statute in 1998. The main features are as follows:

(i) It is recorded in statute that the objective of monetary policy is to maintain price stability. This represents a much stronger institutional commitment to price stability.

(ii) The Government decides, each year, what is the operational definition of price stability for the purposes of monetary policy. Since the strategy began, the government has decided that the operational definition of price stability is a target of 2½% inflation.

(iii) The Bank of England has autonomy to determine the level of short-term interest rates, in pursuit of price stability as defined by the Government.

(iv) If, and only if, it does not prejudice price stability, the Bank of England should take account, in setting interest rates, of the Government's economic policy objectives, including its objectives for growth and employment.

(v) Decisions on interest rates are made by a Monetary Policy Committee of nine members, by majority voting. If there is a tie, the Governor has the casting vote. The Committee meets once a month to make decisions about interest rates and its minutes are published, two weeks after the meetings. The minutes record all the arguments put forward, both for and against the decision actually taken, and record individually the votes of the Committee members.

(vi) The members of the Committee are:

- The Governor of the Bank of England – appointed by the Government for 5 years.
- Two Deputy Governors – appointed by the Government for 5 years.
- Two Executive Directors – appointed by the Governor, subject to approval by the Government, for 3 years.
- Four external members – appointed by the Government for 3 years.

In addition, a representative of the Treasury attends each meeting but does not vote. The voting members can be re-appointed at the end of their term of office.

(vii) The quarterly Inflation Report, containing forecasts of inflation and output growth, is published each quarter and represents the views of the Committee.

(viii) Members of the Committee are subject to questioning by Parliamentary committees, including the Treasury Select Committee of the House of Commons.

Perhaps I could make a few remarks about this structure and how it works.

First, I should make clear that it is not compatible with the requirements of the Maastricht Treaty for membership of the European single currency. For one thing, the operational objective of monetary policy – currently the inflation target – is chosen by the government, and not the central bank. And for another, the terms of office of the MPC members are not long enough to meet the Maastricht

requirements. There would need to be a change before the United Kingdom could join the single currency.

Second, the process of making decisions about interest rates is very open and transparent. There is no attempt to build a consensus in the MPC before the meetings and no pressure is put on any members to vote in any particular way. As a result, there have been some very close votes – out of the 41 meetings so far, the Governor has had to use his casting vote twice and the result has been determined by a majority of only one on three other occasions. Nobody, not even the Governor, knows what the outcome of an MPC meeting will be when it begins. This has added to the credibility of the process, because it is obvious that members decide how to vote only on the basis of what they think is needed to hit the inflation target, and that there are no hidden undeclared objectives. There has been no tendency for the five internal members of the committee to vote together, as a bloc.

Third, there has been considerable turnover among the Committee members, particularly the external ones. Of the four original external members, three have reached the end of their terms of office and none of them was re-appointed. It is not yet clear whether frequent turnover of members will be an enduring feature of the Committee.

Fourth, the function of the Treasury representative is mainly to ensure that the Committee are fully informed about fiscal policy. He does not express any view about interest rates or try to influence the interest rate decision. His presence ensures co-ordination between fiscal and monetary policy. This is an important issue, highlighted in a recent paper by Gulbin Sahinbeyoglu of the Central Bank of the Republic of Turkey which she wrote while on secondment at the Bank of England Centre for Central Banking Studies.[2]

It is recognised in the UK that fiscal policy decisions can have implications for monetary policy, and the Treasury representative on the MPC keeps the Committee fully informed of the government's fiscal plans.

Monetary policy has implications for fiscal policy too – but not mainly because short-term interest rate changes affect the cost of government debt servicing. Most government debt in the UK is longer-term and the impact of changes in short-term interest rates is small and slow to emerge. However, if monetary policy were to succeed in reducing the amplitude of business cycle

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[2] Gulbin Sahinbeyoglu: "Monetary Transmission Mechanism: A View from a High Inflation Environment", September 2000.

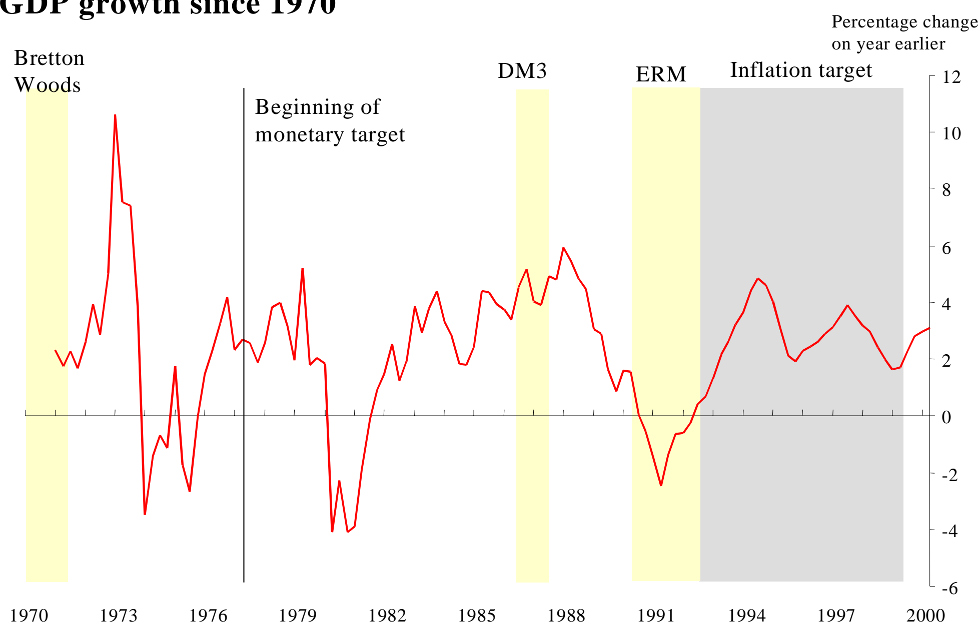
fluctuations as a by-product of achieving price stability, than actual output might be expected to be closer to potential output on average over time, and tax receipts might be expected to be higher on average over time.

III. ECONOMIC EXPERIENCE UNDER INFLATION TARGETS

Economic experience under the inflation target regime has been very favourable. As you can see from the chart, inflation has remained low and stable, and close to the 2½% target. The past eight years have been the longest sustained period of low inflation in the UK since the late 1950s and early 1960s.

The other main feature of economic experience since 1992 has been that economic growth has been much faster than the historic UK average as Chart 2 shows. Growth since 1992 has averaged 2.7% a year compared with the longer run average of 2¼% a year. Economic theory has yet succeeded in identifying the ultimate causes of economic growth, so it is not possible to explain exactly why we have enjoyed such a long period of above-average growth. However, it is relevant that the economy was in a severe recession in 1992, and productive resources were much under-utilised. For example, unemployment in 1992 on the ILO definition was over 10% of the labour force. After 8 years of continuous strong growth, unemployment is down to 5.3%.

Chart 2
GDP growth since 1970



One of the major surprises of the past eight years has been that the short-run trade-off between output and inflation has become more favourable, so that inflation has risen much less than expected as the economy has grown and as the pressure of demand on productive capacity has steadily increased. Thus there has been a persistent tendency for the Bank of England Inflation Report, like other forecasts, to over-forecast inflation; and inflation has in the past couple of years been persistently a little below the 2½% target.

There are a number of possible reasons for the favourable shift in the short run trade-off between output and inflation:

(i) Successive governments since the 1980s have tried, through a range of reforms, to make markets function more efficiently at the micro-economic level. For example, eligibility for unemployment compensation has been greatly tightened up.
(ii) The downward shift in inflationary expectations means that wage negotiators are much less sensitive to the rate of unemployment than in the past, because they are confident that strong demand for labour will not lead to faster inflation in the future.
(iii) It is possible that the Internet has made it easier for consumers and buyers to compare prices demanded by competing suppliers, so that there has been downward pressure on prices.
(iv) More generally, a culture of price sensitivity has emerged. Retailers report that they cannot raise prices to consumers without a serious loss of sales, and this inability to raise prices has filtered down the production chain.

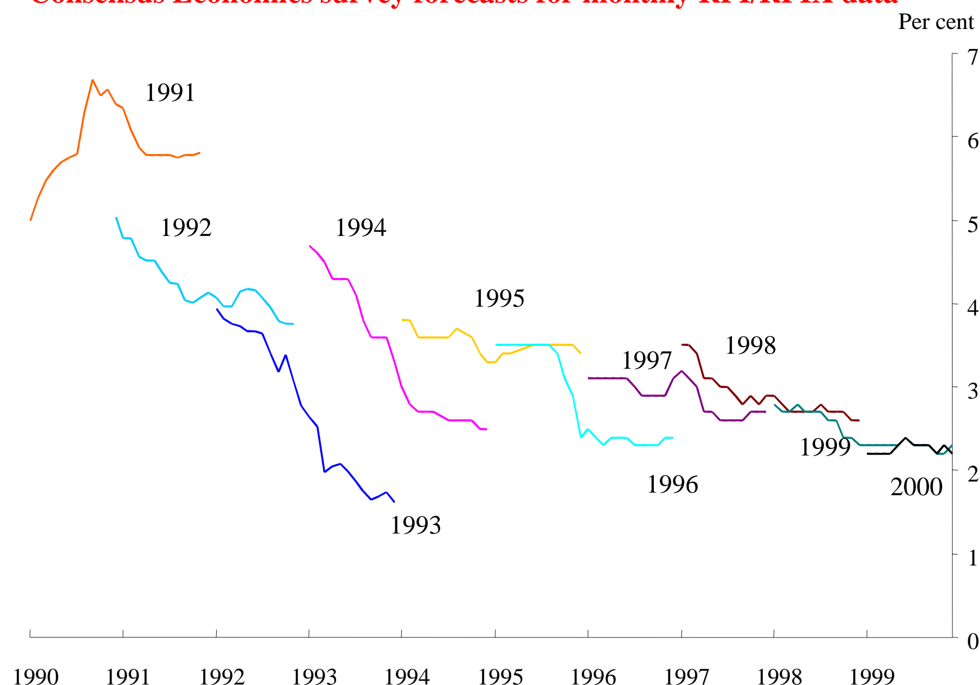
Not surprisingly, the causes of the favourable shift in the trade-off are the subject of active debate in the MPC.

Another surprise has been that the sterling exchange rate has appreciated sharply since 1996. We do not fully understand the reasons for the appreciation, and have been surprised that it has not been reversed. The appreciation has had a major adverse effect on industries exposed to international competition, notably agriculture and manufacturing, though, as I mentioned earlier, growth of the economy as a whole has been at above-average rates. It has certainly contributed to lowering the rate of inflation. Some MPC members have been concerned that the appreciation of the exchange rate can have only a temporary effect on inflation, and that when the effect wears off, inflation will rise. They have drawn attention to

measures of domestically-generated inflation – that is, inflation arising from domestic sources rather than exchange rate movements – which for a long time was higher than the 2 ½% inflation target. However, the most recent data shows that domestically generated inflation has fallen back to below 2 ½%.

Chart 3

Consensus Economics survey forecasts for monthly RPI/RPIX data



It is interesting to trace the fall in shorter-term inflationary expectations over the past ten years. Chart 3 shows how they have fallen over that period in the UK. Specifically, it shows how consensus expectations for each year's inflation outcome have evolved through time. Inflation in 1990 was close to 10%, so that there was a big fall in inflationary expectations in 1991, and again in 1992, when the UK was still in the European Exchange Rate Mechanism. There was not much of a rise in shorter-term inflationary expectations after we dropped out of the ERM in 1992, no doubt because the economy was in recession, though as mentioned above, longer term inflationary expectations increased. As in other industrial countries, inflationary expectations did pick up in 1994 as the economy recovered, but they subsided again as the recovery continued without any take-off in inflation. More recently, and particularly since 1997, when the Bank of England was made independent in the way I have described, inflationary expectations have become much more stable still. This must reflect public confidence in monetary policy.

I said at the beginning that the UK's experience with inflation targets has to be looked at as part of a 25-year period of disinflation. As you can see from the chart, the progress of disinflation was rather unsteady. You may ask why, if inflation targeting is so successful, it was not introduced much earlier in the disinflation process. I think there are a number of reasons.

(i) If inflation targets are to succeed, they must reduce inflationary expectations. That means that the public, and financial market participants, have to be convinced that meeting the inflation target not only is the sole objective of monetary policy but will continue to be its sole objective. I do not think that they could have been convinced of that in the 1970s, because there was at that time still a residual belief in a long run Phillips curve – a long run trade off between output and inflation.

(ii) Exchange rate targets seemed the most promising means of "locking in" the relatively low rate of inflation that had been achieved by the mid-1980s, and there was a very serious discussion about the UK joining the European Exchange Rate Mechanism in 1985. Although that came to nothing, we had a period of "shadowing" the Deutsche Mark in 1987-88, which was unsuccessful; and sterling was a member of the ERM from 1990-92 – a period during which inflationary expectations fell very sharply but which ended in a currency crisis. Inflation targeting was not tried until exchange rate targets had failed.

Conclusion

I have tried in this presentation to describe the whole of the UK's disinflation process – which has lasted 25 years and has not been smooth or steady. Happily, we appear in the last 8 years to have found a means of "locking in" low inflation while at the same time enjoying a period of strong economic growth. Our monetary policy thus appears to have reached a kind of equilibrium, and we hope that it will endure.

I know that in this country you are at an earlier stage in your ambitious disinflation programme. I wish you well with it and hope that our own experiences may be of some use to you.