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Bank of England: a View from Frankfurt

The 1998 Bank of England Act made the Bank independent to set interest rates in pursuit of its objective as defined in the same Act: to deliver price stability. Ten years on, Hans-Helmut Kotz of the Deutsche Bundesbank presents a personal view of developments at the Bank of England over the past decade.

Keeping inflation at bay has become the (almost) unequivocal target of most central banks. This is a goal which has been largely achieved by the Bank of England (BoE) – with inflation (as measured by the RPIX)[1] hovering at about 2.5% ever since the mid-1990s. Thus, the BoE dutifully met its objective as defined in the Bank of England Act of 1998, that is: to maintain price stability. Keeping promises generates reputation, in this case of delivering a stable monetary environment. And the return on such an accumulation of reputation capital translates into lower inflation premia in long-term nominal interest rates. This is what we saw as well (most of the time) in sterling bond prices: expectations have been rather firmly anchored at the level of the inflation objective the BoE is striving for – at least until very recently. Clearly, monetary policy has become much less exciting and therefore the BoE delivered as well on its promise made at times (and tongue in cheek): namely, to become as unexciting, and possibly even boring, as Keynes' humble, competent dentists.

Against this background, this piece might just as well end here. But there are at least three dimensions in which some excitement can be detected. First, from an historical perspective, this change of tack by the UK towards macro moderation is rather remarkable. And it would be interesting to know where the "nice" (non-inflationary, consistently expansionary) economy features come from.[2] Second, if, as the dominant answers to the first question imply, it is the institutional independence of the BoE as well as its strategy which explain to a significant extent this impressive performance, this would have obvious consequences for monetary policy in general – namely in providing for a sort of best practice.

Fortunately, in the debate on the optimal approach to monetary policy there are still some controversies left – at any rate at a theoretical level. Finally, one might wonder about potential challenges to this gentle boredom. Are there developments, possibly emanating from financial markets, which are likely to threaten the prevailing benign tranquility?

Involuntary Search for New Guiding Principles

Exchange rate crises – more precisely: the unwillingness to give exchange-rate targets priority over domestic objectives – have been instrumental in two prominent cases in the search for monetary strategies: money supply targeting and inflation targeting. The unravelling of the Bretton Woods system of fixed exchange rates led the Bundesbank in the mid-1970s to opt for an intermediate target, a two-staged strategy, that is, to control money supply – pragmatically. The BoE's decision to go, instead, for the *direct* control of the ultimate target – inflation containment – was the result of the UK's leaving the European exchange-rate system on a certain Wednesday in September 1992. Interestingly enough, and with the benefit of hindsight, both approaches produced rather remarkable results. This is notable in particular since both approaches have apparently rather diverse conceptual backgrounds. Appearances can, however, be deceiving, a point to which we will come back.

Two defining characteristics are held responsible for the success of the BoE's monetary policy. The first is instrument independence, which was given to the BoE by the incoming Labour government on 6 May 1997.[3] The second crucial institutional innovation was the new strategy to be pursued – namely, inflation targeting (IT). Of course, IT had been introduced earlier,

* Deutsche Bundesbank, Frankfurt, Germany; paper originally written – in a purely personal capacity – for the Royal Economic Society's "Newsletter", July 2007. The author would like to thank Ben Friedman (Harvard) and Peter Howells (Bristol) for very helpful comments.

[1] All items Retail Price Index (RPI) excluding mortgage interest payments.

[2] Cf. Mervyn King: Innovations and Issues in Monetary Policy, in: American Economic Review, Vol. 94, No. 2, 2004, p. 43.

[3] The BoE is, however, not goal independent: the Chancellor of the Exchequer, in giving the BoE its remit with a precise content, called upon the BoE to strive for an annual rate of increase in the RPIX of 2.5% "at all times". Since December 2003, the RPIX has been substituted for by a CPI target of 2%, in recognition of the fact that the CPI increases are on average 0.5 percentage points below the RPIX. Moreover, mindful of the hierarchical ordering of priorities, the remit challenges the BoE to support growth and employment. With inflation rising in March 2007 above 3 per cent, the BoE's Governor had, for the first time under the new procedures, to write an open letter to the Chancellor, explaining why this had happened and how the Monetary Policy Committee intended to get inflation back towards its target level. The open-letter mechanism should underwrite accountability and inform the public debate. Cf. Mervyn King: Governor's speech, in: Bank of England, Quarterly Bulletin, Q3, 2007, pp. 422-424.

Figure 1
Consumer Prices in the UK

YoY retail prices; 1960-1975: RPI; 1976-2006: RPIX (RPI less mortgage interests)

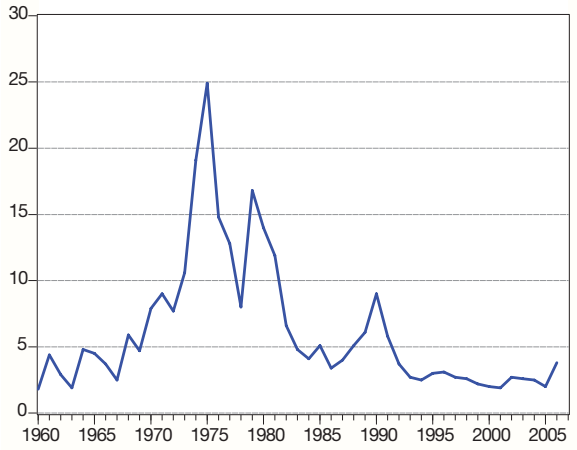
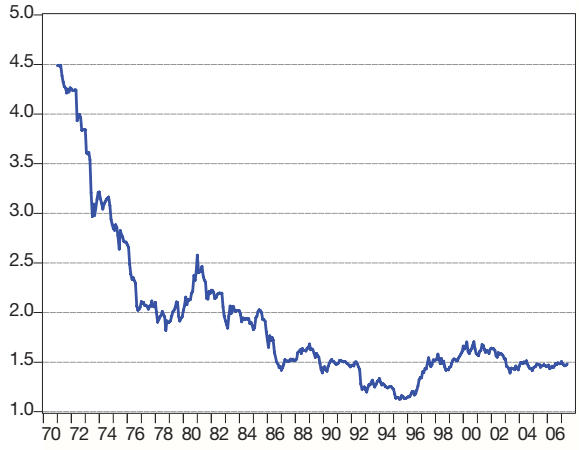


Figure 2
Sterling Exchange Rate

EUR per GBP (DEM before 1999, fixed conversion rates)



in October 1992. While all of this is barely noteworthy from today's angle, in the mid-1990s both innovations were publicly controversial. Essentially, the case had to be made that macro stability is conducive to medium-run growth. This was particularly forcefully reasoned by a young journalist in a pamphlet of the Fabian society – Ed Balls.[4] Ultimately, this argument, frequently raised by economists, meandered its way into the platform of the Labour party.

Focusing primarily on inflation control was not at all generally accepted in the mid-1990s. At that time the dominant view held that the mandate of central banks also included providing for maximum output and hence supporting employment. Seeing the purpose of central banks mainly in underwriting monetary stability therefore was, in the words of Stanley Fisher, a recent phenomenon: "(C)entral banks have increasingly come to emphasize the fight against inflation and to deemphasize the possibility that monetary policy can affect the level of output."[5] Indeed, this is a recurring topic. The US Fed, of course, has such a dual mandate. And during the French presidential campaign it became evident that similar views on reducing output fluctuations (and fostering trend growth) also have a positive resonance amongst important EMU countries.

Neither was it conventional wisdom 10 years ago to render monetary policy to an autonomous institution, be it only for the instrumental dimension. However, influential academic papers produced convincing evidence – in the sociologists' lingo very much performative – on the positive correlation between degrees of independence and price stability performance since the late 1980s only. It is interesting to note that in the UK's case IT was introduced to support the BoE in its advisory capacity to the Treasury, which at that time ultimately bore responsibility for the conduct of monetary policy.[6] Since, as the French say: *comparaison n'est pas raison*, it is nonetheless important to understand where the support for a stability oriented policy actually comes from. After all, correlation is not causation. Thus, while independence is helpful without any doubt, the public perception on what monetary policy can really achieve is of the essence. Adam Posen correctly made the point that in the German case an important underlying explanatory variable was the general public's strong dislike of inflation. This inflation aversion buttressed the Bundesbank's position substantially – over and above its legal independence.

Two Procedural Innovations

Nonetheless, the institutional innovation has born fruit rather rapidly: inflation risk premia fell out of bond prices within a short period of time. The anchoring of inflation expectations hence was rapid and tight indeed. And this most plausibly had to do with procedural innovations as well. Two are particularly relevant – and still under debate.

[4] Edward Balls: Euro Monetarism: Why Britain was ensnared and how it should escape, London 1992, Fabian Society.

[5] Stanley Fischer: Modern Approaches to Central Banking, NBER Working Paper No. 5064, 1995, p. 2. With an expectation-augmented Phillips curve unemployment only impacts on the change in inflation. The level of unemployment (or potential output) is purely supply determined.

[6] See Andrew Haldane: Inflation targets, BoE, in: Quarterly Bulletin, August 1995, pp. 250-274; and Charles Bean: Inflation targeting: the UK experience, in: Perspektiven der Wirtschaftspolitik, Vol. 5, 2004, pp. 405-21.

Aiming at the ultimate objective directly was – as the debate about intermediate targets had shown – prone to substantial difficulties. Therefore, somehow out of frustration about the controllability of the final objective(s) (inflation and, possibly, output) directly, goal variables in between were introduced. It was believed that the monetary authorities could achieve their ultimate objectives more effectively by exploiting the information content of those intermediate indicators.[7] In actual practice, the BoE did not dispense with intermediate information variables. But, through its Inflation Report, it intended to give a disciplined and structured evaluation of the transmission mechanism – including inevitable uncertainties in evaluation. Thus one could state that "(t)he Bank's inflation projection – when taken alongside the other intermediate variables which make up the inflationary assessment – influences monetary policy decisions in much the same way as does any other intermediate variable."[8]

Moreover, monetary policy was to be decided on by a committee of individually accountable members.[9] This was an innovation in at least two dimensions: the Monetary Policy Committee (MPC) was not assumed to decide by consensus (which, by the way, does not mean unanimity) but by majority vote – to lay bare opposing views in the light of possibly diverging perspectives on the same data (the publishing of, for sure, edited minutes and voting records included). Moreover, in the Inflation Report, of which the MPC, i.e. the decision-makers, took ownership, uncertainty about the possible trajectory of inflation was openly admitted. The fan chart made the risks to the central forecast, which was ultimately guiding an explicitly forward-looking monetary policy, transparent.

Best Practice?

All of the above would suggest that the BoE's approach has become *the* best practice way of doing things in central banking. But not everyone shares this view. The European Central Bank (ECB) does not conduct monetary policy in the light of an IT approach. And the US Federal Reserve is still rather reluctant.

The ECB's two pillar approach, with its particular emphasis on money supply, has been developed explicitly taking note of the experience with money supply targeting on the one hand and inflation (forecast) targeting on the other. Issing et al. emphasise that, "in spite of the rigidity of theoretical monetary targeting and inflation targeting, judgment has been a crucial component of both monetary strategies". And they add that the ECB's two-pillar strategy (a short-horizon, broadly based economic analysis, as well as, in a cross-checking mode, a long-term oriented monetary analysis) has been conceived to face "the high degree of uncertainty and imperfect knowledge prevailing at the beginning of Stage Three of EMU".[10] Flexibility here means that the monetary framework should allow for supply (or financial market) shocks in order to contain output instability.[11] This is why the ECB's inflation norm is to be honoured not at any moment in time but over the medium run.[12]

In the US, which comes from the exactly opposite direction, IT on the other hand has been advocated as "a framework, not a rule" to allow for "constrained discretion". US Proponents of IT deemed it important to highlight its flexibility, in particular by pointing out that IT is not "falling on the rule side of the traditional dichotomy" (between rules vs. discretion).[13] This point has been stressed not only in order to allow for the inevitable "judgmental content" of monetary policy (the "art" part). Highlighting the discretionary option was (is) important in the US context to suggest that IT would not prevent appropriate responses to shocks. Otherwise, IT's compatibility with the dual mandate, which Congress has given to the Fed, would be in doubt, making it clearly politically unpalatable. Almost a quarter of a century ago James Tobin wrote with admirable conciseness, "… monetary policy cannot be governed by irrevocably fixed rules blind to actual outcomes, … policies responsive to events cannot be prescribed fully in advance but ultimately depend upon discretion, monetary authorities cannot escape responsibilities for real economic outcomes of significance to the society".[14] Interestingly, Bernanke and Mishkin dealt in their article with the question whether nominal GDP targeting, "which can be thought of as

[7] Benjamin Friedman: The Value of Intermediate Targets in Implementing Monetary Policy, in: Fed Kansas: Price Stability and Public Policy, Jackson Hole 1984, pp. 169-171; and Victoria Chick: The Theory of Monetary Policy, Oxford 1973, Basil Blackwell, pp. 8-13.

[8] Andrew Haldane, op. cit., p. 252.

[9] Alan Blinder (in his Quiet Revolution, Yale, YUP 2004), declares the movement away from benevolent dictators to committees (as was the Fed's or the Bundesbank's concept) as one of the hallmarks of today's substantially changed monetary institutions.

[10] See Otmar Issing et al.: Monetary Policy in the Euro Area. Strategy and Decision-Making at the European Central Bank, Cambridge 2001, CUP, pp. 104-105.

[11] Against the backdrop of the debate on the possible use of the natural rate of interest as a policy guiding device, Axel Weber has made clear why "a detailed analysis of the real and monetary forces relevant for the identification of risks to price stability" is mandatory. Cf. Axel Weber: The role of interest rates in theory and practice, Shackle Memorial Lecture, Cambridge 2006, G.L.S.

[12] For a very concise and convincing explanation of the ECB's strategy cf. Lucas Papademos: The role of money in the conduct of monetary policy, ECB 2006.

[13] Ben Bernanke, Frederic Mishkin: Inflation Targeting: A New Framework for Monetary Policy?, in: Journal of Economic Perspectives, Vol. 11, No. 2, 1997, pp. 97-116, here p. 104.

[14] James Tobin: Monetary Policy: Rules, Targets, and Shocks, in: Journal of Money, Credit and Banking, Vol. 15, No. 4, 1983, p. 517.

'velocity corrected money growth' ", could not also be a sensible goal variable. And they answered in the affirmative – namely that nominal income targeting, which was at that time incidentally the favourite of many US economists, was "generally consistent with the overall strategy for monetary policy as discussed in this article".[15]

Do IT and Independence Matter?

We wrote these lines (on July 5th) a few hours before the BoE decided on policy rates. In putting themselves into the MPC members' shoes, analysts as well as investors (cf. implied interest rates) were betting on a tightening move of 25 basis points. (And they were proven right!) These expectations are anchored in the BoE's communication, which has been highlighting the underlying dangers of inflation remaining stubbornly above the medium-run objective. Markets, in other words, take their cue from the economic environment as if they were reading the world through an Inflation Report perspective. Though there have been two surprises of late, the BoE is so transparent that interest-rate expectations are fairly robust – the low level of implied volatility testifies to this point.

Now, while conceptual differences between approaches are frequently sharply stressed, it is interesting to see whether policies, as actually practised, really do show such a variance in actual implementation. This is perhaps the point where a postmodern linguist (à la one of David Lodge's characters) could be helpful. In deconstructing and re-interpreting the wording one could, of course, rather easily render, for example, the Bundesbank's policy approach as implicit inflation targeting – as Bernanke et al. have done. The "unavoidable inflation" (or later: the "price norm") as a core part of monetary policy formulation as well as implementation makes distinctions arbitrary to some minds. In fact, on the conceptual level one could assert that the Bundesbank's "pragmatic monetarism" has stressed the qualifier more than the noun. In pondering a very concise and instructive explanation by Helmut Schlesinger, the former Chief Economist and later President of the Bundesbank, of the Bundesbank's money supply targeting (which at that time was still central bank money-, not M3-oriented) Alan Blinder came to the conclusion that "(i)t is hard to imagine a clearer description of a purely discretionary regime … (y)et no one doubts the Bundesbank's anti-inflationary zeal".[16]

Some even claimed that the Fed under Alan Greenspan followed the IT approach, quoting his famous (though characteristically vague) remark from 1989 that the Fed would try to control monetary policy in order to produce "price levels sufficiently stable so that expectations of change do not become major factors in key economic decisions".[17] Such a proposition, however, would somehow amount to a reduction of IT *ad absurdum*. Nonetheless, since actual monetary policy, when perceived to be located on a spectrum between the poles of art and science, inevitably has a substantial judgmental or arts part, conceptual differences can easily be overestimated. Jürgen von Hagen and Manfred Neumann, in our eyes correctly, hold that, "IT, like other monetary policy strategies, must be seen in the context of (economic) culture and traditions … Giving the central bank's commitment to price stability and its willingness to bind its policy to an intermediate target … the choice between an inflation target or a monetary policy aggregate then is probably more a question of culture than economic principles."[18] Empirically, in other words, it is impossible to tell the difference. In the dark of the night all cats appear to be grey.

In any case, IT and instrument independence, the two 1990s institutional innovations, did matter in the UK's case. They contributed, over and above structural factors (competition as a result of an ever larger reach of markets, substantial productivity improvements), to the great macro moderation. As a result of the observational similarities between pragmatic monetarism, IT and the two pillars they do, however, face the same challenges.

Here, in concluding, we would like to briefly allude to two of these challenges: first, Benjamin Friedman forcefully argues against IT because, in the US context, it would, in his eyes, dilute the dual mandate, "the objectives beyond price stability". Moreover, and this is relevant for the UK (or, to a degree, the EMU case), Friedman holds that words should matter and he criticises "that under inflation targeting policymakers normally reveal to the public only one of their multiple targets" – which would obviously undermine transparency.[19] Purportedly, Friedman once remarked that he mainly liked what the ECB does, but did not at all appreciate how it phrases this. This is the whole issue of communication and transparency, which, of course, has existed for a while. In any case, Friedman posits

[15] Ibid., p. 112. Bernanke and Mishkin confessed a mild preference in favour of IT (relative to nominal income targeting) for mainly three reasons: timeliness and availability of inflation data, substantial inherent flexibility of IT and the public's better understanding of the concept of inflation.

[16] Alan Blinder: The Rules-versus-Discretion Debate in the Light of Recent Experience, in: Weltwirtschaftliches Archiv, Vol. CXXIII, 1987, pp. 399-413.

[17] Cited in Otmar Issing et al., op. cit., p. 69.

[18] Jürgen von Hagen, Manfred Neumann: Does inflation targeting matter?, in: Fed St Louis, Quarterly Review, July/August 2002, p. 145.

[19] Benjamin Friedman: What Objectives for Monetary Policy, paper presented at a conference of the Centre Cournot, Paris, November 2006.

that predictability would be clearly buttressed if all the reasons underlying policy formation were laid out. In former, i.e. decidedly opaque, times central bank watchers have been less exacting. Paul Samuelson, for example, argued more than a decade ago: "For fifty years the Fed has not seemed to me mysterious or perverse. Like the old farmer who found his donkey by asking himself, 'Where would I go if I were a jackass?' I could mostly guess in which direction the Fed would move. This despite its own talk."[20]

Second, in trying to gauge the transmission of its impulses, monetary policy still focuses very much on its impact on bank balance sheets. With the ever increasing importance of financial markets, in particular markets in pricing of credit risk,[21] accounting for the consequences of endogenously created liquidity becomes ever more important. This is, admittedly, in particular a problem for a money supply oriented concept. On the other hand, carefully looking at growth rates of money and credit or, in a more general sense, broad liquidity is of the essence for "anyone who believes that default, risk aversion and income constraints matter … such interpretation will be an art. Nevertheless it is an art worth attempting."[22]

Meanwhile, and this brings us in a way back full circle, one hears voices out of the BoE that money and liquidity might again bear some consideration. If appearances are not completely deceiving, here we are talking about "pragmatic monetarism", somehow reminding us of the Frankfurt implicit IT variety.

Addendum, early December 2007: As mentioned, this paper was written to evaluate the BoE's independence in light of its performance in achieving price stability. And it was in particular written before financial dislocations erupted in August. With the task of underwriting financial stability largely allocated to the specialised Financial Services Authority (FSA), the BoE, rather remarkably, responded (initially) differently from the ECB or the Fed, for that matter. Conceptually, the BoE based its response towards liquidity provision with an eye to preventing moral hazard. Relying on an Akerlof-Stiglitz asymmetric information argument, it deemed markets capable, if delayed, of telling the difference between good and bad. With this "separating equilibrium" not appearing, in September the BoE then was forced to change course, implicitly accepting a "run on liquidity" diagnosis. If one took one's cue, however, from a Diamond and Dybvig reading of developments, one would have responded differently to begin with. As the ECB did, that is with a substantial provision of liquidity, significantly above benchmark allotments.

While this is not the place to go deeper into this issue, an old question – about the appropriate role of central banks in underwriting financial stability – reappeared over the last couple of months with a vengeance. This question had been intensively debated in 1997, the year when the Chancellor of the Exchequer also substantially reconfigured financial supervision in the UK, forming a "mega regulator"[23] and conceiving, somehow inadvertently, a new role model. The German government, in reallocating supervisory functions in 2001, was strongly inspired by the FSA approach, resting its case on the purportedly inexorable trend towards Allfinanz. The evolution of the subprime crisis and the subsequent disruptions, in particular in interbank money markets, have, indeed, not strengthened the case for this approach. Stephen Cecchetti for example recently wrote that as a result of the events of summer and autumn 2007, "there is now an even stronger argument for placing supervisory authority inside of the central bank. As events unfolded through August and September it became increasingly clear that having bank supervisors separated from the liquidity provider placed added stress on the system."[24] Admittedly, for functional reasons we never found this separation convincing. In a most interesting article Joe Peek, Eric Rosengreen and George Tootell had already shown empirically in 1999 the complementarity between monetary policy and bank supervision.[25] With the distinction between bank and market financing, largely as an upshot of credit derivatives, becoming ever more blurred, this case has of course been buttressed. In such an environment, central banks might even be forced to act, at times, as "market-makers of last resort".[26] But again, this debate needs more than the place available in an addendum.

[20] Paul Samuelson, Panel Discussion, in: Jeff Fuhrer (ed.): Goals, Guidelines, and Constraints Facing Monetary Policymakers, Fed Boston, 1994, p. 231.

[21] Jan Pieter Krahnen: Der Handel von Kreditrisiken: Eine neue Dimension des Kapitalmarktes, in: Perspektiven der Wirtschaftspolitik, Vol. 6, No. 4, 2005, pp. 499-519.

[22] Charles Goodhart: Whatever became of the Monetary Aggregates?, Lecture in honour of Maurice, Lord Peston, 2007.

[23] Cf. Charles Goodhart et al.: Financial Regulation. Why, how and where now, London 1998, Routledge, p. XIV and pp. 142-188. The "where now" part of the subtitle confers the message that policy analysts were taken somehow by surprise, the long-planned conference taking place three weeks after the Chancellor had taken his decision.

[24] Stephen Cecchetti: Subprime Series, part III: Why central banks should be financial supervisors, in: VOX (http://www.voxeu.com/index.php?q=node/755), 30 November 2007.

[25] Joe Peek et al.: Is bank supervision central to central banking?, in: Quarterly Journal of Economics, Vol. 114, No. 457, May 1997, pp. 629-653.

[26] Cf. Wim Buiter, Anne Sibert: The Central Bank as the Market Maker of Last Resort, in: VOX (http://www.voxeu.org/index.php?q=node/459), 13 August 2007.