1 An Introduction

Sean Holly, Michael McMahon, Stephen Millard and Anna Watson

The year 2022 marked 25 years since the Bank of England was given operational independence for the conduct of monetary policy. The aim of this monograph is to provide an overview of some of the key features of the UK's monetary policy framework during the last quarter of the century, their evolution over time as well as lessons learnt and the ways in which these lessons can inform the challenges ahead. The volume includes several chapters first presented at an MMF/NIESR workshop at Gresham College, London, in March 2022. It was then augmented by a special session at the Annual Conference of the Money, Macro and Finance Society at the University of Kent in September 2022, where both Mervyn King, a former Governor of the Bank, and Paul Tucker, a former Deputy Governor, provided their thoughts on the history and future of the Monetary Policy Committee (MPC). It was then enlarged further to provide a broader perspective by the addition of chapters commissioned later from Bill Allen, David Cobham and Petra Geraats.

The book is organised loosely around a number of themes – the scale and scope of the communication that the Bank uses to inform the public of its intentions; the objectives of the MPC and the Bank of England more widely, together with the tools needed to achieve these objectives, including the use of unconventional instruments in response to the effective lower bound to interest rates that appeared after the Global Financial Crisis (GFC); and, finally, the decision-making process by which the operationally independent bank decides on the monetary stance.

Before going on to these themes, the book starts with **Petra Geraats** providing an international perspective on MPC independence. The Bank was not the first to move to an inflation-targeting regime. New Zealand and then Canada were there first. Indeed, the adoption of inflation targeting in New Zealand was part of a greater reform to the conduct of public policy. The time of inflation targeting had come. Within two years it spread to Sweden, Australia and Spain, and by 2015 it had spread to almost 40 central banks.

When the operational independence of the Bank was announced by the new Labour government in 1997, this came as a complete surprise to the financial markets. Just as economic theory would suggest, an unanticipated switch to operational independence that was credible led to an immediate fall in long-term interest rates as expected inflation fell.

In the period after 1997, the Bank was widely regarded as a beacon for openness and transparency. According to the Eijffinger-Geraats index, in 1998 the Bank of England was ranked first on transparency among nine central banks. However, by the time the revised version of the index was published in 2022 (as the Dincer-Eichengreen-Geraats index) it suggested that the Bank had stagnated, while many other central banks had improved their transparency.

Geraats also dwells on the 2015 reforms to the communication of the Bank triggered by the Warsh Report. From a process of a drip feed of information, it went to a deluge when large amounts of news were provided on the same day (Super Thursday). This provides a good introduction to the first theme tackled in the book: central bank communication.

Transparency and Communication

In the original remit for the MPC in 1997 the Bank was made accountable to the government in the form of an open letter but also to the Houses of Parliament by appearing in front of select committees and to the public by means of the published minutes of MPC meetings and a regular *Inflation Report*. **Stephen Millard** puts this in the context of how the accountability of central banks changed radically from the end of the 1980s. Before 1989, the general practice was to regard monetary policy as a matter of private concern for wise central bankers. The more there was a 'monetary mystique' associated with the actions of central bankers the better.

But what was most striking about the adoption of inflation targeting in New Zealand was that the Governor of the Reserve Bank of New Zealand was obliged to communicate with the financial markets and the public. The main argument for imposing this was one of democratic accountability; in other words, voters had a right to know what their central bank was up to and why. But it could also be argued that monetary policy itself was more effective if *financial market participants* understood what central banks were up to and why as then financial markets would move in a predictable way for central banks. Inflation targeting with the corresponding need for public communication quickly spread to other central banks around the world. But it was not just the requirement for central banks to be democratically accountable. Open and transparent communication was a way of affecting expectations of future inflation. Anchoring inflation expectations became a cornerstone of the architecture of modern monetary policy.

Taking this idea further, central banks have increasingly adopted 'forward guidance' as a monetary policy tool. The idea is to communicate where interest rates are likely to move over the medium term. But, as **Ben Broadbent** reminds us, it is impossible to give markets any certainty as to the path of interest rates given the economy is constantly being buffeted by shocks. The best policymakers can do is to give statements about the path of interest rates conditional on other variables. At the same time, market practitioners need to remember that these statements are conditional and still adjust their expectations of future interest rates in response to economic shocks, rather than assume that such statements represent a firm commitment to the interest rate path.

But the success of central bank accountability depends critically upon how well communication works. How good have central banks been in communicating effectively? **Delia Sih Chien Macaluso and Michael McMahon** examine some recent evidence. It is clear that the formal adoption of inflation targeting helped reducing inflation expectations. However, it was only after the Bank gained operational independence in 1997, when expectations of inflation fell back close to the inflation target. This can be thought of as a low-frequency form of communication but with a higher frequency of communication with financial markets who take a more day-to-day interest in the plans and intentions of the Bank. However, the demands made on the style of communication changed over the 25 years. After the GFC of 2008, a loss of confidence in central banks changed the way in which the Bank communicated with the public as well as those in financial markets. Communicating directly with households became more important as they account for the majority of economic decisions. Then this quickly grew into a further need to educate households more in the terminology of economics that mattered for what the Bank does.

Objectives and Tools

The remit that the Bank was given by parliament was initially to pursue an inflation target of 2.5%, using the Retail Price Index (RPI) which excludes mortgage interest payments, with a margin of error of plus or minus 1 percentage point. In 2003 this was changed to a target of 2% based on the Consumer Price Index (CPI) but still with a margin of error of 1 percentage point. A value of inflation of 2% or thereabouts has turned out as the de facto target for most central banks around the world. However, there is a potential problem with a low inflation target because of the risk of hitting the effective lower bound of short-term nominal interest rates when monetary policy needs easing in response to a large negative shock. **Tony Yates** reviews the arguments for raising the inflation target. After explaining the origins of the now widely adopted 2% target for inflation, he provides an overview of the macroeconomic developments since the target's inception and the resulting challenges associated with the marked decline in interest rates after the GFC. The potential costs and benefits of changing the inflation target are then considered alongside alternative measures to address the problem of the lower bound.

There are many other features of the Bank remit that also deserve reconsideration. **Jens Larsen** draws attention to the apparent expansion of the remit of the MPC over time. In the original letter that the then Chancellor of the Exchequer wrote to the Bank in May 1997 the remit was very clear. Price stability is a precondition for high and stable levels of growth and employment. The monetary policy objective of the Bank is to deliver price stability and, without prejudice to this objective, to support the government's economic policy, including its objectives for growth and employment. The exceptional clarity and coherence of the remit were instrumental in providing a transparent accountability framework and a strong foundation for the new regime and the delegation of monetary policy to an independent central bank.

In 2013, following a major rethinking of the macroeconomic policy framework in the aftermath of the GFC, the remit was significantly expanded. In March 2021 the MPC's primary objective is still to stabilise the price level. However, the MPC now has more flexibility in dealing with inflation deviations from the target; more choice in terms of instruments; and a significant role in maintaining financial stability, even if it is secondary to the Financial Policy Committee (FPC). The government's economic policy objectives, which the MPC is obligated to support, are now also defined more broadly and include an extra commitment to achieving a net-zero economy.

Some may regret the loss of clarity of the remit: not only is it now too long and too complex for a non-technical audience to appreciate, but there is also a view that the expansion of the role of the MPC, and more generally of the Bank, poses substantial democratic challenges and ultimately threatens the Bank's independence and capacity to do well what only it can do: ensure price stability. However, there is also a strong argument for the remit to acknowledge the complex challenges faced by the macroeconomic policymakers today and to recognise explicitly the role that the MPC and the Bank now de facto play in the allocation of resources and the management of risk.

The global pandemic proved a particularly challenging time for monetary policymakers. **Charlotta Groth** argues that central banks were able to re-deploy the unconventional policy tools developed during the GFC but were also able to add new and even less conventional policies. This involved loosening policy aggressively and working with many different instruments simultaneously to maximise policy impact. One could argue that the episode has shown that monetary policy can also be effective in a low interest rate environment if central banks are willing and able to deploy multiple measures with scale and speed. But there are also several caveats. In particular, since the root cause of the lower bound on the interest rate is the issuance of paper currency, the development of Central Bank Digital Currency (CBDC) offers a potential solution to the problem and could allow for a return to more conventional monetary policy.

David Cobham links the development of these new tools to changes in the objectives of the Bank since the original remit given to the MPC in 1997. He notes that the MPC started out with one clear objective: price stability. At the same time, they had one instrument: the policy rate. Since then, the MPC has found itself being asked to consider other objectives including financial stability and output volatility. As a result, it needs additional instruments, in particular, quantitative easing (QE) – purchasing government bonds in exchange for a deposit at the central bank (expanding the balance sheet of the central bank), with the intention of lowering the longer end of the term structure – and macroprudential policy. (Although the FPC is charged with carrying out macroprudential policy, it does need to coordinate with the MPC.) He argues for some recasting of the role of the MPC and the way in which it operates. More specifically, he suggests that welfare might be improved if the MPC could adopt a broader set of goals while retaining the primacy of price stability: 'inflation targeting plus'.

When the Bank of England was first established at the end of the seventeenth century, its immediate purpose was to raise funds for the government. From its inception it therefore played a major role in government debt management. But the advent of QE has made this much more complicated. **Bill Allen** examines the complex relationship between monetary and debt management policies before and after the creation of the MPC, with a particular focus on the period of the Bank's operational independence. He shows how, during the last quarter of the century, the GFC and the resulting introduction of unconventional monetary policy tools have led to significant changes in the relationship between monetary policy and government debt management, which became much closer over time. While in the first decade of the MPC there was little need for coordination, with the adoption of QE, government debt management has been subordinated to monetary policy. This change has not only had a major impact on the conduct and effectiveness of monetary policy but has also led to a concerning shift in the maturity structure of the government's financial liabilities and has been associated with significant risks for both public finances and monetary policy objectives, which call for quantitative tightening (QT) as a matter of priority.

Decision-Making Process

The Bank has a specific remit from the government, with the MPC playing a key role in decision-making. The decision-making by committees is not identical. Broadly speaking, they fall into two categories: individualistic, where every member votes and these votes are then revealed; and collegial, where all members forge a consensus without attributing votes. The Bank of England and the Federal Reserve System are both prime examples of the former. The European Central Bank (ECB), by contrast, is a collegial-based system, where the decision reached is presented as that of the whole decision body. The emphasis is on communicating one view and therefore claiming ownership by all who participate.

Nevertheless, the individualistic approach might still offer the possibility of groupthink. **Richard Barwell** suggests that dissenting by only 25 basis points may be evidence that MPC do not in practice dissent enough. MPC members are individually and publicly accountable for their votes. Disagreement among the committee is inevitable; it is also desirable because it represents the individual judgements of members rather than an attempt to create a false consensus. It is a source of strength. MPC dissent is much more frequent than with other central banks and is not just token. It is argued that you get better decisions if you ask the nine people to say what they really think, instead of asking them to sit around and try and come to a consensus. Nevertheless, dissent seems to be rather limited, given that the many speeches given by MPC members suggest that there is significant disagreement on the economics of what the MPC is doing.

Mervyn King's contribution is from the perspective of someone who has voted at 194 meetings of the MPC. Moreover, as chief economist at the Bank from 1991 he presided over the publication of the Inflation Report in 1993 and the introduction of the fan chart in 1996. With the intellectual climate turning towards the importance of central bank independence, the Bank was quietly preparing itself for independence. Yet when operational independence was introduced in 1997 with the new Labour government, it was still a surprise to everyone. Over most of the 25 years the MPC has proved to be a success in achieving its target for inflation and in making the setting of interest rate a systematic and technical process rather than reflecting a political decision. Nevertheless, King believes that a mistake was made in 2020 and 2021, when – along with many other central banks – the Bank believed that the large fall in output resulting from the pandemic could predominantly be thought of as another form of a business cycle downturn that should be responded to by a major monetary impulse. But it was not a usual business cycle because potential supply had fallen as well.

The last contribution is by **Paul Tucker**, who retired as Deputy Governor of the Bank of England in 2013, had spent 33 years in total at the Bank, and served as a member of the MPC for 11 years. Tucker sets out a dozen propositions designed to underpin and, perhaps, revitalise the MPC and the monetary regime entrusted to it. Among other things, the propositions call for the reassertion of the primacy of the price stability objective, the clarification in legislation of the role of the lender of last resort facility and the simplification of the remit from the Treasury back to what it was in 2013. Tucker also urged a move back from the excesses of Super Thursday; provided an injunction on the members of the MPC to explain how exactly QE (and indeed QT) works in practice, to make a clear distinction between QE/QT and market making of last resort; and finally clarify how forward guidance works with a committee that decides policy by majority voting.