

[REDACTED] 92 [REDACTED]
MEETING ON THE NEW MONETARY FRAMEWORK, HELD IN [REDACTED] ROOM
AT 9.30AM, FRIDAY 2 OCTOBER

Those present:

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Discussion at the meeting was arranged under the following four headings:

- the case for and possible form of an inflation target
- intermediate objectives
- how indicators would be used in forming judgements on monetary policy
- the extent to which the way interest rate decisions are taken should be exposed in public.

Inflation target

2. The following points were made on the subject of an inflation target:

- A medium-term inflation target, and the public justification of all interest rate decisions in terms of that target, might improve the credibility of policy by making the way in which discretion was used more transparent. The problem with targeting intermediate variables was that they could easily give wrong signals - either signalling a policy change when none

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was needed or failing to signal policy change when it was needed; ignoring the indicators in such circumstances tended to damage credibility even though it was warranted by the ultimate policy objective.

- Given the past variability of inflation and the size of forecast errors, the target range might have to be quite large - probably 4 percentage points wide - to have a high probability of achieving an outcome with the range. But setting a range which went as high as 4 per cent would seem to indicate tolerance of inflation rates with which the authorities could not really be comfortable. It might be possible to describe the target in such a way that a firm central objective was distinguished from the outer zones of the target range.
- The centre of the target range might be based on the objective of price stability or on the achievement of the Maastricht inflation convergence condition.
- Missing the target would not necessarily damage credibility if the failure was clearly due to an external shock: so the width of the target range might not need to be set to provide for such shocks.
- The target might be defined in terms of the RPI excluding mortgage interest payments, or possibly excluding all housing components. One approach would be to try to exclude terms of trade effects, though the case for this was debatable.
- Although there was some support for publishing a target inflation path to the medium term goal so as to reduce the scope for discretion, it was also argued that inflation would never in practice proceed monotonically to its medium term goal; annual inflation assumptions would, of course, be required for the Public Expenditure Survey.

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Intermediate objectives

3. The assessment of progress to the medium term inflation target might be based on all of the following:

- Forecasts from macroeconomic models
- Single equation forecasts of inflation
- Looking separately at the behaviour of a series of indicators, which would also presumably be included in the single equation and in the macroeconomic models.

It was agreed that the inflation assessment could not simply be based on macro model forecasts even though all the information from the indicators should, in principle, be included in the forecasts derived from macro models.

4. The questions then were:

- What indicators should be used, and
- What public use should be made of the indicators: whether they should be given ranges, and if so whether these should have target or merely indicative status.

5. Variables proposed for consideration as indicators included M0, M4, M2, Divisia money, M4 lending, house prices. None of these was felt, on its own, to have a very close relationship with future inflation. If we did specify ranges for one or more indicators, we might, in the event, have good reasons for overshooting (or undershooting) one or all of these ranges. But if ranges were not specified in advance, it would be difficult to justify policy decisions, particularly in circumstances where policy was not being changed in response to bad news on current inflation because there were good reasons to believe that the

medium-term inflation target was not under threat. In internal assessment, the exchange rate might well be a very important indicator; but it would hardly be possible to publish an indicative or target range for it. Variables that were actually believed to play a role in the transmission mechanism were more suitable candidates for target ranges than mere coincident indicators.

6. The Bank and/or Treasury might publish technical working papers on the various indicators used and their relation with inflation. But these papers would not in themselves explain at what point the behaviour of the indicators would begin to call for policy response. One possibility, stopping short of quantified ranges, would be to describe in words the expected behaviour of an indicator: eg. we might say that the velocity of M4 was expected to fall, but less fast than in the 1980s.

Making interest rate decisions

7. There was some concern that in the past there had been rather a slow response to signals for interest rate change. Typically, rates had been increased in steps of 1 or 2 percentage points and brought down in $\frac{1}{2}$ percentage point steps: the reason for the larger steps in the increases was that they were often made in response to sudden falls in the exchange rate. Taking more account in the past of other countries' interest rates in setting our own rates might have reduced the need for sharp changes in response to the exchange rate: for example, the increases in the second half of 1981 and in 1984 and January 1985 had been necessary because unsustainable differentials between UK and foreign interest rates had undermined sterling. The short run inflationary impact of exchange rate changes meant that one could never ignore the exchange rate and simply focus on the behaviour of domestic monetary aggregates.

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Openness

8. There were various suggestions for improving the credibility of policy by making the assessment process more transparent:

- technical working papers on the indicators
- a monthly or quarterly report on monetary conditions published by the Treasury - or perhaps a joint publication with the Bank: probably monthly rather than quarterly, reflecting the frequency of decisions. This would not have a concluding page saying that interest rates should/should not go up/down; but would need to be capable of supporting such conclusions.
- consideration could be given to publishing the Bank's monthly letter on interest rates; but it would be a major political decision to publish Bank advice which has in the past always been kept confidential.

9. Analogies with the US Federal reserve (which publishes its analysis of monetary conditions - 'Beige Book' - eight times a year, some six weeks after the Open Market Committee meeting at which it is considered) should not be pushed too far. The Fed acts on its interest rate judgements; Treasury and Bank officials merely give advice. Delay in publication also has drawbacks: it means having to defend both the present and past decisions at the same time.

10. Another possibility, suggested by the Humphrey Hawkins procedure in the US, would be for the Chancellor to publish a twice yearly document on progress made towards the inflation target, which he would defend at TCSC.

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Circulation

5 October 1992

Those present

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