

Who sets our interest rates

Bank of England
Inside the Monetary Policy Committee



The Monetary Policy Committee

This booklet outlines the work of the Monetary Policy Committee which sets our interest rates. Written by Monetary Policy Committee member Richard Lambert, it also answers some simple questions about the procedures the Committee follows, how it reports back and its record to date.





How does the MPC affect us?

Decisions made by the Bank of England's Monetary Policy Committee affect the lives of everyone in the country. The return that savers make on their investments, the cost of mortgages for homeowners, the outlook for jobs and inflation – all these and more are directly influenced by the Committee's decisions every month about the right level of interest rates for the United Kingdom.

The Monetary Policy Committee

Given the broad impact of monetary policy, it's no wonder that the business pages often seem preoccupied with what it might do next. Most people only have a vague idea about how the Monetary Policy Committee (or MPC) goes about its job. Opinion polls show there is a general awareness that the Bank of England – not the politicians – is now responsible for setting UK interest rates. They also show people have come to believe that inflation in this country is likely to continue at a low and stable rate – a far cry from the 1970s and 1980s, when prices rose by more than in the previous 200 years combined.

But few people understand how the MPC goes about its business – or how its decisions get translated into the economy. Professionals in the financial markets know exactly how the MPC operates, and spend a lot of time trying to anticipate its judgements. This guide is not for them. Instead, the aim is to give a wider audience an insider's view of the MPC at work.

The overriding goal of monetary policy is to secure low and stable rates of inflation over the very long term. That job is made much easier if the public trusts the judgement of the people who are setting the policy and knows how they go about their work.

Q. Who is this guide for?

A. Rather than for professionals in the financial markets, this guide is for a wider audience to get an insider's view of the MPC at work.

Q. What is the goal of monetary policy?

A. The goal of monetary policy is to secure low and stable rates of inflation over the very long term.



What is the structure of the Monetary Policy Committee?

Chaired by the Governor of the Bank of England, it has nine members – five full-time Bank executives (the Governor and two Deputy Governors, the Chief Economist and the Markets Director) and four external members, who are appointed for a three-year term by the Chancellor of the Exchequer.



The Committee

The Committee structure

A number of central banks around the world use some form of committee structure when managing monetary policy, and there are good reasons for this. Placing total control for setting interest rates in the hands of a single unelected official would seem like a very risky proposition to most politicians. And there is evidence to suggest that groups of experts make better decisions than individuals when dealing with technical issues such as monetary policy. They can share information and learn from each other, and they can change their minds in the face of sound arguments.

The argument for including external members is that they bring in a wider range of expertise and experience than would be available if the MPC could draw only on the Bank's own staff. And they bring fresh thinking to the Committee since they are only there for a limited period.

The crucial point is that all nine members of the Committee are individually held to account for their decisions. Their separate votes are recorded and published. And they are not there to represent any particular interest – such as business, trade unions, or consumers. They have been chosen for their particular expertise – mostly, but not exclusively, in the field of economics. And their responsibility is to the country as a whole, rather than to any sectional interest.

The inflation rate target

The Committee's objective is set each year by the Chancellor of the Exchequer. From 1997 through to the end of 2003, the target was an inflation rate of 2.5% a year as measured by the retail prices index excluding mortgage interest payments (the RPIX). From 2004, the target was changed by the Chancellor to the Consumer Prices Index, or CPI, and set at 2%. Thanks to the way it is constructed, the RPIX has tended to rise over the long term by a little over half a percentage point a year more than the CPI, so in practical terms the changeover has made little difference to the MPC's work.

Q. Why do we use a committee?

A. There is evidence to suggest that groups of experts make better decisions than individuals when dealing with technical issues such as monetary policy.

Q. How are the members chosen?

A. Members have been chosen for their particular expertise, mainly in the field of economics.

Q. What is the target inflation rate?

A. The current target is 2% as measured by the Consumer Prices Index.

“The essential point is that the inflation target is symmetric, which means that the MPC has to be just as concerned about aiming too low as it is about overshooting the mark.”

Subject to the overriding importance of maintaining price stability, the Committee must also support the Government’s economic policy, including its objectives for growth and employment.

If the only concern were to keep down inflation, the temptation would be to increase interest rates to a level that would hold down prices – but could also damage growth and throw people out of work. So the rules are set in a way that ensures the MPC is not encouraged to push rates up any higher than would be healthy. The essential point is that the inflation target is symmetric, which means that the MPC has to be just as concerned about aiming too low as it is about overshooting the mark.

If the rate of increase in the CPI turns out to miss the target of 2% by more than one percentage point in either direction – down as well as up – the Governor has to write a public letter to the Chancellor explaining what has happened, and the steps that the MPC plans to take to put inflation back on track.

Achieving the target

The MPC has only one instrument with which to achieve this target, which is its ability to change short-term interest rates (see pages 29-31), and this only works with a delayed action. A shift in interest rates has to ripple through the financial markets and out into the economy, and it can be as long as two years before the full impact is felt on the rate of price inflation.

In other words, you can’t fix today’s problems by changing today’s interest rates. Instead, the approach has to be forward looking. The MPC has to do its best to anticipate inflationary pressures over the following couple of years or so, and lean against them by adjusting interest rates in whichever direction seems appropriate in order to meet its target of long-term price stability.

Q. How is the target achieved?

A. Each month the MPC sets short-term interest rates at a level it thinks will deliver 2% inflation.

Q. How long does a change in interest rates take to work?

A. A change in short-term interest rates takes around two years to have its full impact on inflation.

Credibility

The Committee's credibility is all important if it is to influence public expectations. If people believe that it can be trusted to maintain low and stable inflation over a long period of time, they will behave in a different way than they would if they thought that it was not up to the job. Businesses will not feel they have to allow for the risk that prices could run amok. Pay negotiators will be more willing to accept long-term deals. Savers will be confident that their assets are not going to be destroyed by the ravages of inflation.

Credibility takes years to build up, and could be lost in a few months. This thought is always at the front of the MPC's mind. It is the reason why the Committee is anxious to be as open and transparent as possible about the way it comes to its decisions. And it explains why public communication is a critical part of the MPC's role, and something to which it pays an enormous amount of attention.

Q. Why does the MPC go to great lengths to explain its views?

A. Because the MPC knows that credibility takes years to build up, but can be lost in a few months, it aims to be as open as possible.



What is the MPC meeting?

The monthly MPC meetings to set interest rates take place on the Wednesday and Thursday following the first Monday of every month, and the pre-MPC meeting is held on the preceding Friday.

The meeting

The pre-MPC meeting

It is early on a Friday morning, and the Bank's economists are gathering for coffee along with the members of the MPC and some of the Bank's regional Agents from around the United Kingdom for the big briefing session which is known as the pre-MPC meeting. In all, there may be as many as 100 people in the room. The idea is to draw out all the important economic news of the previous month and to put it into context. All Committee members attend, so that they can prepare for the following week's policy meeting on an equal footing.

Throughout the weeks since the previous meeting, Committee members will have received scores of emails from the Bank's staff, analysing the latest economic news from around the world. They will also have been sent studies from Bank analysts on topical issues: the outlook for growth and employment; what's happening to wages; growth in the euro area and so on. On the Thursday night before pre-MPC, they will have received a pack of around 500 charts and tables which are updated every month to give a consistent picture of the economic world.

The pre-MPC meeting starts at 8.45 am, and takes place in a small lecture theatre – the Committee sitting in a row at the front facing the people who are going to make the presentation and the rows of their colleagues behind them. In some ways, this is the most daunting moment of the month for Committee members: all those numbers, all those intelligent faces. It is hard to imagine what it must have been like in the early days of the MPC, when the meetings lasted throughout the day. Now, at least, they are over by lunchtime.

The presentations

The meeting takes the form of a series of set-piece presentations by senior Bank staff, each illustrated by dozens of graphics which are projected on to large screens around the room. Each presentation covers a different aspect of the economic landscape, building up a broad picture of the big economic and financial developments over the previous month

Q. When do the meetings happen?

A. The MPC meeting is on the Wednesday and Thursday after the first Monday of the month, and the pre-MPC meeting is held on the preceding Friday.

Q. What is the purpose of the pre-MPC meeting?

A. This puts all the important economic news of the month into context. All Committee members attend.

Q. What happens at the pre-MPC meeting?

A. Committee members, who will have prepared by reading swathes of economic information, sit in a row in the small lecture theatre and are presented to by senior Bank staff on different aspects of the economy.

and concentrating on those elements which are most important to the UK economy.

For a newcomer to the MPC, this is often the first exposure to the scale and quality of the Bank's economic engine room. Graphics fly across the screens. Occasional questions by Committee members are fielded by the presenter or, if he or she wishes to bring in a colleague, a turn of the presenter's head will bring in a swift response from the back row.

Around the country

As well as economic analysis, this meeting also provides the Bank's regional Agents with an opportunity to report on what they have picked up in recent weeks from their business contacts around the country. There are twelve Agents in all, who are in contact with a total of roughly 8,000 businesses large and small. The Agents usually have two slots at the Friday meeting. In one, they give an overview of their discussions with hundreds of business people over the previous month. Key regional and sector differences are highlighted, and comparisons are drawn with what the official data are showing.

In the other, the Agents report back on the special survey which they undertake most months at the request of the Committee. At the end of each rate-setting meeting, the MPC identifies a topical issue about which it would like to learn more: what's happening to profit margins; how tight are conditions in the labour market; what's the outlook for investment? The Agents discuss the month's topic with their business contacts in the next few weeks, and report their findings back to the pre-MPC meeting.

Preparing for the MPC meeting

The days immediately after the pre-MPC meeting provide time for further preparation ahead of the big meeting which is to start on Wednesday afternoon. Committee members receive notes from the Bank staff answering questions raised at the

Q. What part do the Agents play in the pre-MPC meeting?

A. The twelve Agents are in contact with roughly 8,000 businesses. They have two slots: in the first they give an overview of their discussions, in the second they report back on their special survey.



pre-MPC meeting, and analysing the latest economic news. The external members will also consult their own researchers, who are there to help with topical questions as well as to work on longer-term analysis.

It is important to approach the policy meeting every month with an open mind: there can be no foregone conclusions when it comes to setting the interest rate. Members can and do develop their own views about where rates may need to go in the future in order to reach the inflation target. But those views will change in the light of new information, fresh research, a new set of forecasts, perhaps a different view of the risks. And members are influenced by each other's arguments.

Setting the agenda

Early in the week of the policy meeting, MPC members receive an email from Charlie Bean, the Chief Economist. In this he sets out his proposed agenda for the Wednesday afternoon discussion. It is not meant to be an exclusive list of topics for discussion. Instead, it provides a framework for discussing all the main components of the economy in an orderly fashion.

The MPC meeting

The rate-setting meeting starts at 3 pm on the Wednesday afternoon. The setting is suitably impressive: an elegant committee room dominated by a magnificent portrait of Montagu Norman, one of the great Governors of the past, who was painted by Augustus John. It is said that Norman always disliked the picture, and it certainly makes him look somewhat saturnine. The present Governor, Mervyn King, sits in front of the portrait, with Rachel

Lomax – the Deputy Governor responsible for Monetary Policy – on his right, and Sir Andrew Large, the Deputy responsible for Financial Stability, on his left.

Q. What happens after the pre-MPC meeting?

A. Before the MPC meeting starts on Wednesday afternoon Committee members receive answers to questions raised and analyse the latest economic news.

Q. How is the MPC meeting agenda set?

A. The Chief Economist proposes the agenda, which is a framework for discussion.

Q. When and where does the MPC meeting take place?

A. The meeting starts at 3 pm in an impressive committee room. The present Governor sits in front of a portrait of a previous Governor, Montagu Norman, with the two Deputy Governors on either side of him.



“Tales are told about heated clashes in the past, but the mood these days is rather courteous and earnest.”

In all, there are 14 people in the room facing each other at tables set out in the form of a square. Along with the nine members of the Committee, there are four senior Bank staff, responsible for taking the minutes and preparing the quarterly Inflation Report, together with a senior representative of HM Treasury – either the Permanent Secretary or one of his colleagues.

The Treasury person is not there to discuss monetary policy or to vote. Instead, he fields the occasional questions about tax and spending matters and otherwise sits silently, noting the different arguments and no doubt taking private bets with himself about the outcome of the discussion.

Everyone sits in the same place each month: newcomers to the Committee take the space vacated by their predecessor.

The discussions

The Governor calls the meeting to order, and invites Charlie Bean, the Chief Economist, to update the meeting on any relevant economic news since the previous Friday morning, and to report on what the financial markets are expecting from the meeting. That done, the Committee works its way through the agenda. Each topic is led off by Charlie Bean, who summarises that month’s news, offers his interpretation of what may be happening and – where relevant – gives different sides to the story. The Governor then chairs a general discussion on that theme, which lasts until he feels it is time to move on to the next one.

Members talk about what has happened in the previous month that might have changed their views about the outlook for inflation. They discuss the latest economic data and business surveys, and they report what they have heard from their own contacts about business conditions around the country. They debate longer-term issues: is the economy in the euro area finally beginning to pick up? Could the housing market be on

Q. Who is at the meeting?

A. There are 9 members of the Committee, 4 Bank staff to take minutes and a senior representative of HM Treasury at the meeting. Everyone sits in the same place each month.

Q. What do they discuss?

A. The Chief Economist gives any new relevant economic news and reports what the markets are expecting. Then, going through the agenda, for each topic he summarises the month’s news and offers his interpretation of what might be happening, giving different sides of the story where relevant. The Governor then chairs a discussion on the topic. This is not the time for discussing the interest rate decision itself.

the turn? And they brood about how much weight they should attach in their thinking to a particular piece of information. Can they trust the latest export figures, or are they likely to be revised? How much notice should they take of the surprising weakness in retail sales? Where could things be going badly wrong?

The tone of the discussion depends on the personalities in the room. Tales are told about heated clashes in the past, but the mood these days is rather courteous and earnest. There's the occasional joke along with the serious talk, but not much in the way of verbal violence.

Wednesday is not a time for actually discussing the interest rate decision itself. Rather, it is the moment for exploring the different issues which will help to shape each member's decision the following day. Members never talk to each other at any time about what they are likely to do when the votes are cast on Thursday morning. Instead, they reach their decision in their own way, and in their own minds.

The meeting has generally talked itself out by about 6 pm. There is a dinner in the Bank for those MPC members who wish to attend it: the only rule is that monetary policy is not to be discussed.

The vote

And so to 9 am on Thursday morning. The present Governor handles the meeting in exactly the same way as did his predecessor, Sir Edward (now Lord) George. He normally speaks first, summarising the previous day's discussion in a balanced and neutral way. He may emphasise a couple of questions which he thinks members ought to address in their own presentations, but he does not attempt to direct the outcome of the meeting.



“The announcement has to be made at noon precisely which is when the markets are poised to receive it. This does not give much time to distil the essence of the debate into a couple of paragraphs.”

He then asks Rachel Lomax, as the Deputy Governor responsible for monetary policy, to speak first and to give her view. She will talk for roughly ten minutes, highlighting the issues that she has thought most relevant in the previous weeks and explaining the thinking that has led her to make her decision on the rate, which she announces. The Governor then goes at random around the table and asks each member to give a similar presentation of his or her views followed by their decision on the rate, again lasting for about ten minutes or so, and usually working from prepared notes. Occasionally members will say that they would prefer to hear other people’s views before they cast their vote, and so will hold their final judgement until the end of the discussion. After each person has spoken, the Governor invites questions: he himself speaks, and votes, last.

The decision goes to the majority and there is no attempt to arrive at a consensus: members are individually accountable for their decisions. When everyone has voted, the Governor formally presents the majority verdict to the meeting, and the outcome is confirmed.

Communicating the decision

There are no rules about whether the Committee then issues anything more than a brief press release. But the general practice is that a somewhat fuller statement is made if the rate has been changed, or has not been changed at a time when the markets were strongly expecting a move. Without some kind of guidance from the MPC, the pundits would be left to speculate about what had happened until the minutes were published 13 days later.

If the Committee decides that it does make sense to publish something more than just a bald announcement of the decision, the staff passes around one of the drafts which have been prepared earlier against just about all possible outcomes. The Committee then goes through this word for word, adding and subtracting as it thinks appropriate. It knows that the tone of the financial markets and the press coverage for several days to come will in good measure be set by these few sentences, and it is anxious to avoid any words that could be misinterpreted.

Q. How is the interest rate decided?

A. The Governor normally summarises the previous day’s discussion without directing the outcome. The Deputy Governor then speaks for ten minutes and gives her view on the rate. At random, other members are asked to do the same, with questions asked. The Governor speaks last. Then the vote is taken.

Q. How is the rate communicated?

A. Generally a brief press release is issued but a fuller statement is made if the Committee believes it is necessary. This is carefully worded by the Committee. The announcement has to be made at noon.

Very occasionally, this can be quite a fraught process. The announcement has to be made at noon precisely, which is when the markets are poised to receive it. This does not give much time to distil the essence of the debate into a couple of paragraphs.

Finally the Committee turns to its last task for the morning, which is to agree on the special topic that the Agents will be asked to explore ahead of the next month's meeting.

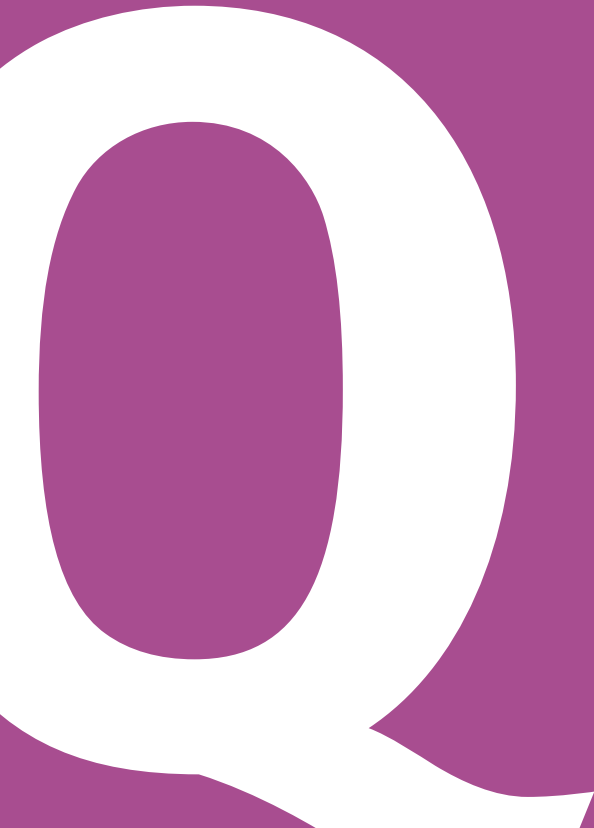
Q. What happens next?

A. The Committee sets the special topic for the Agents to explore for the next meeting.



What are the minutes?

A critical part of the process gets under way in the following few days. The minutes of the meeting provide the mechanism by which the Committee explains its thinking to the financial markets and the public at large.



The minutes

Producing the minutes

The minutes are essential to the MPC's goals of openness and transparency, and thus to the credibility of the system. And since the decision is the result of individual members exercising their own judgements, every member has a real interest in ensuring that the minutes fairly represent his or her views.

Although individual votes are recorded, comments and viewpoints are not attributed by name to particular members in the minutes. The view is that such attributions would change the tone of the debate, making it more constrained and less free-flowing. But even though they are anonymous, members do want to see their particular ideas captured in the record.

The staff usually send out the first draft of the minutes, running to about a dozen pages (excluding a summary of the previous month's economic data) by the Tuesday after the meeting. This is a demanding timescale. Summarising several hours of discussion, some of it quite discursive in character, can be a real challenge for the minute writers. MPC members then have a couple of days to suggest changes to the style and content of the document.

The minutes meeting

The following Monday, the Governor chairs a meeting of all members, at which the proposed changes and the final draft of the text are discussed in great detail. Do the minutes capture the overall shape and tone of the discussion? Do they contain adjectives or adverbs that might be misinterpreted? Could the argument be expressed more simply or clearly? These words will be read with an eagle eye in the financial markets, and an ill-judged word or phrase could damage the Bank's hard-won credibility.

So the minutes meeting can last for quite a time, and nothing is changed in the text after it has concluded. On Wednesday morning at 9.30 am the text is available for everyone on the Bank's website.

Q. What are the minutes for?

A. The minutes are essential to the MPC's goals of openness and transparency and therefore the credibility of the system. Each member's vote is recorded.

Q. When does the first draft come out?

A. The dozen or so pages of the first draft usually come out by the Tuesday after the meeting. MPC members then have a couple of days to suggest changes.

Q. What happens next?

A. The Governor chairs a Committee discussion of the minutes.

“Are they hawks, who want to take no risks with inflation and so are prepared to drive interest rates higher, or are they doves, who are more inclined to keep interest rates down?”

Hawks and doves

One endless source of fascination for outside commentators when the minutes are published is to see which way individual members have cast their votes. Are they hawks, who want to take no risks with inflation and so are prepared to drive interest rates higher, or are they doves, who are more inclined to keep interest rates down? Can we guess which way particular votes are likely to go under particular circumstances?

Sitting on the Committee, however, it does not seem so easy to categorise colleagues in this way. Several of the longer-serving members have in their time been identified in the press as both hawks and doves – willing to push rates up at one stage and down at another. The fact is that each member of the Committee has the same objective, and will be held personally accountable for his or her judgement about the level of interest rates necessary to meet the inflation target. Members learn from each other and from their own experience as time passes. It makes no sense to believe that a judgement made in one set of circumstances will be repeated at a very different time.

Small steps

One thing that is clear, however, is that the MPC does seem to prefer small incremental moves in interest rates to larger, bolder steps. Between 1997 (when the Committee was established) and the summer of 2005, interest rates were changed on 30 occasions. Of these changes, 26 came in the form of quarter-point changes in either direction, and the rest were half-point changes. During this period, the Committee never raised rates by more than a quarter of a percentage point: its cuts of half a point came in November and December of 1998, February 1999 and November 2001.

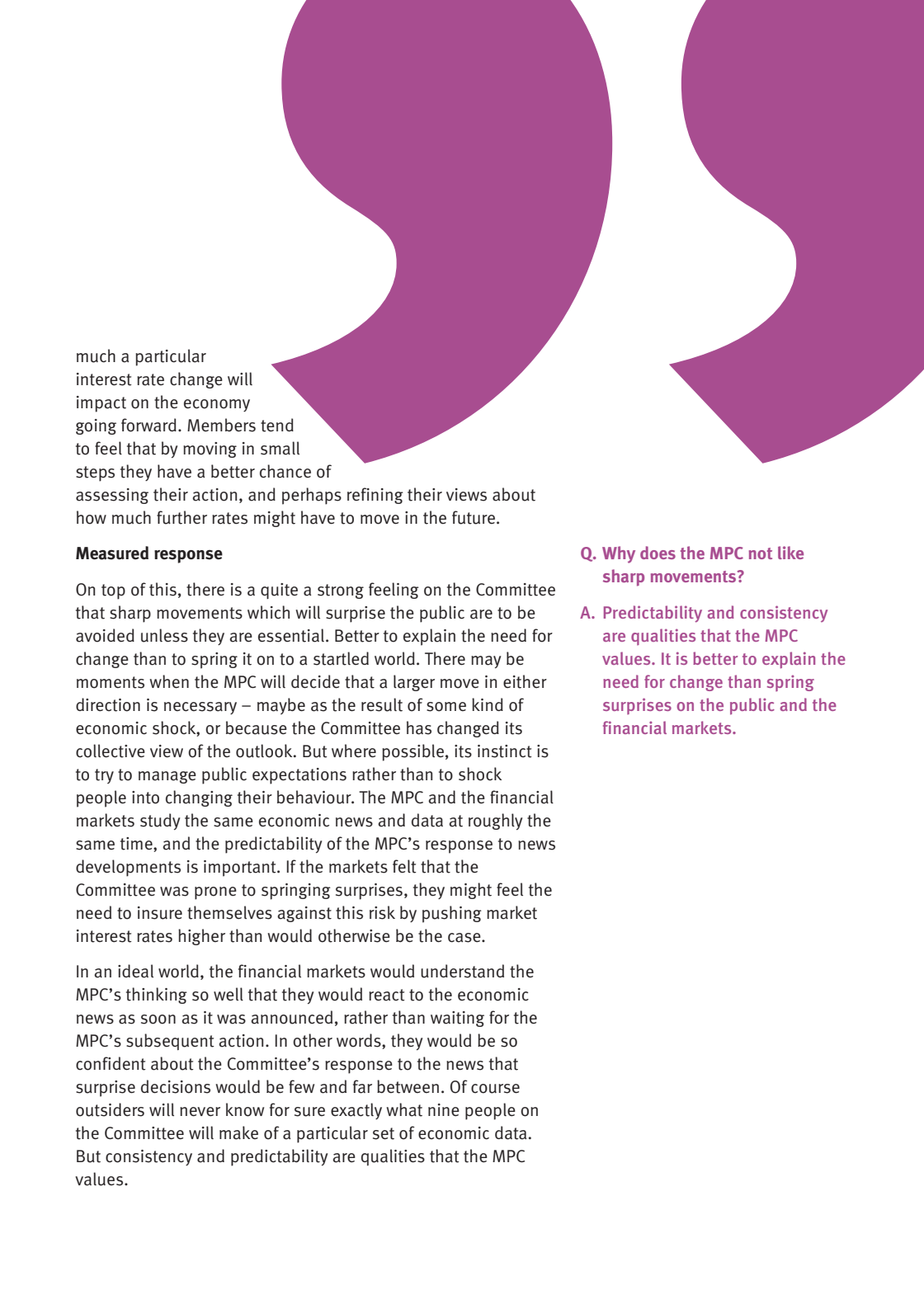
There are several reasons why the MPC likes to take small steps in the same direction, as opposed to making a leap. One is to do with uncertainty. Despite all the staff work, members are aware that their knowledge of the economy is far from perfect. The data are often subject to revision, and new information is coming in all the time. There is also room for doubt about how

Q. What are ‘hawks’ and ‘doves’?

A. Sitting on the Committee, it does not seem so easy to categorise colleagues in this way.

Q. Why does the MPC prefer small moves in interest rates?

A. MPC members are aware their knowledge of the economy is not perfect – new information is coming out all the time. There is doubt about how much a change will impact on the economy. Moving in small steps enables them to assess the impact better.



much a particular interest rate change will impact on the economy going forward. Members tend to feel that by moving in small steps they have a better chance of assessing their action, and perhaps refining their views about how much further rates might have to move in the future.

Measured response

On top of this, there is a quite a strong feeling on the Committee that sharp movements which will surprise the public are to be avoided unless they are essential. Better to explain the need for change than to spring it on to a startled world. There may be moments when the MPC will decide that a larger move in either direction is necessary – maybe as the result of some kind of economic shock, or because the Committee has changed its collective view of the outlook. But where possible, its instinct is to try to manage public expectations rather than to shock people into changing their behaviour. The MPC and the financial markets study the same economic news and data at roughly the same time, and the predictability of the MPC's response to news developments is important. If the markets felt that the Committee was prone to springing surprises, they might feel the need to insure themselves against this risk by pushing market interest rates higher than would otherwise be the case.

In an ideal world, the financial markets would understand the MPC's thinking so well that they would react to the economic news as soon as it was announced, rather than waiting for the MPC's subsequent action. In other words, they would be so confident about the Committee's response to the news that surprise decisions would be few and far between. Of course outsiders will never know for sure exactly what nine people on the Committee will make of a particular set of economic data. But consistency and predictability are qualities that the MPC values.

Q. Why does the MPC not like sharp movements?

A. Predictability and consistency are qualities that the MPC values. It is better to explain the need for change than spring surprises on the public and the financial markets.



What is the Inflation Report?

One of the Committee's most important tools for explaining its thinking about the economy and the outlook for inflation is a document that it publishes every three months: the quarterly Inflation Report.

The Inflation Report

The two functions of the Inflation Report

The Bank started to produce this back in 1993, shortly after sterling had been ejected from the Exchange Rate Mechanism and inflation targeting had first been introduced. It remained a central part of the system after the Bank was granted independence in 1997, and it serves a double purpose.

First, the period leading up to publication is when the Committee discusses most intensively how the various pieces of the economic jigsaw all fit together. It builds these discussions around forecasts for growth and inflation which it updates every three months, and which provide the framework for its forward-looking policy decisions. The quarterly round is thus an opportunity to stand back from the daily news agenda and think about longer-term trends. It is for this reason that interest rate changes in the past have often come in the month when the Inflation Report has been published: members of the Committee have spent many hours thinking together about the outlook for inflation, during the course of which they may have decided to modify their views.

The second role of the Inflation Report is as a communications tool – a full and detailed explanation of the thinking behind the interest rate decisions. Some critics have complained that the Report contains everything but the Bank’s kitchen sink, but a lot of detail is necessary when it comes to spelling out the outlook for the years ahead.

A broad view of the future

The Report publishes forecasts for both economic growth and inflation over a three-year period, in order to help set the context in which interest rate decisions are made.

But there are two important caveats to emphasise here. The first is the enormous amount of uncertainty which surrounds any attempt to forecast the future. Business conditions change, exchange rates rise and fall, consumers feel more or less confident about spending their money. Because of the time lag between a change in interest rates and its impact on the economy, the MPC is obliged to peer into the fog of the future

Q. What does the Inflation Report do?

A. It sets out the MPC’s forecast for growth and inflation.

Q. Why is it so difficult to produce economic forecasts?

A. Business conditions change, exchange rates rise and fall, consumers feel more or less confident about spending their money.

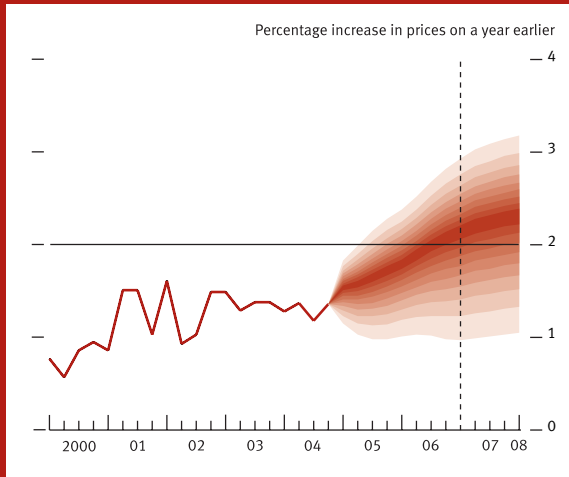


Chart 1 CPI inflation projection in the February 2005 Inflation Report based on market interest rate expectations.

The fan chart depicts the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan charts are constructed so that outturns of inflation are also expected to lie within each pair of the lighter brown areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan chart on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 Inflation Report for a fuller description of the fan chart and what it represents. The dotted line is drawn at the two-year point.

and do its best to capture the broad trends as they appear at any particular moment. But it is always aware that what seems likely today may look way out of line tomorrow. This is why it publishes its view of the future not as a simple forecast but in the form of a broad spread of probabilities – the so-called fan charts (Charts 1 and 2). It's also why the news is reappraised every month, and the projections are drawn up afresh every three months. Forecasts are made to be adjusted.

The second caveat is that the fan charts are not themselves a mechanism for setting interest rates: they are simply intended to help the MPC form its judgements. In other words, there is no mechanical link between the central projection as published in the Report and the level of interest rates. For example, there could be circumstances in which the Committee decided that it would make sense to let the central projection stray above the 2% target for a while, allowing the economy some extra time to get back into balance.

It is easy for commentators to assume that if the central projection for inflation is in line with the target, the MPC is going to be relaxed about the outlook for interest rates. But that's not how it feels on the Committee at all. Instead, the MPC constantly worries about uncertainties and risks, and is ready to move at any time if it feels that things are not working out as expected.

The Bank of England forecasts

A number of central banks around the world produce economic forecasts to help them come to a decision about policy. But what

Q. What are fan charts?

A. These show the MPC's view of the future in the form of a spread of probabilities, redrawn every three months. These are merely a guide, not a prescription for future interest rates.

Q. How are these forecasts different to those of most other central banks?

A. They are produced after extensive active debate by the Committee members themselves, rather than by other staff from the central bank.

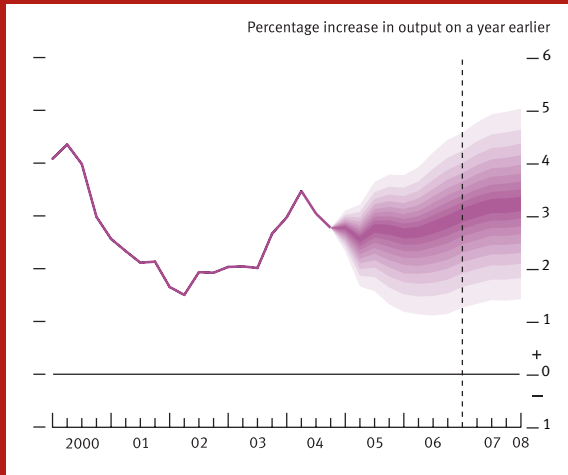


Chart 2 GDP projection in the February 2005 Inflation Report based on market interest rate expectations.

The fan chart depicts the probability of various outcomes for GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that GDP growth over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outcomes of GDP growth are also expected to lie within each pair of the lighter purple areas on 10 occasions. Consequently, GDP growth is expected to lie somewhere within the entire fan chart on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 Inflation Report for a fuller description of the fan chart and what it represents. The dotted line is drawn at the two-year point.

is different about the Bank of England process is that the forecasts are the direct responsibility of the Committee itself. They are not projections that are produced by the staff for the MPC to think about: instead, they are the result of active debate by the Committee members themselves.

The whole process runs on over a couple of months, and involves a great deal of discussion and paperwork. Around eight weeks before publication date, the Bank's staff report to the MPC about research that has been commissioned at the end of the previous forecast round. The Committee agrees on how the results of this work should be taken into account in constructing the forecast during the following few weeks.

Around four weeks before publication, the staff presents what it calls its benchmark forecasts for both the world and UK economies, and explains how the analysis might have changed since the previous Inflation Report. This benchmark forecast is drawn out of a range of economic models, which are managed and calculated both inside and outside the Bank.

On the basis of the benchmark, the Committee agrees on the key issues which it wants to discuss in more detail in subsequent meetings. It seeks to identify topics about which members have different views – there is no point in debating something about which everyone agrees. And it is looking for issues that might make a significant difference to the projections. Rather than wasting time with peripheral matters, the Committee wants to focus on the big stuff.

Q. How long does it take to produce the forecasts?

A. The whole process runs on over a couple of months, and involves a great deal of discussion and paperwork.

Q. What is the 'benchmark'?

A. Four weeks before publication, the Bank's staff presents its 'benchmark' forecasts for the world and UK economies, drawn from economic models calculated inside and outside the Bank. The MPC then agrees key issues it wants to discuss in more detail, identifying topics that members may disagree on and which may make a difference to the projections.

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The key issue meetings

Next comes a series of key issue meetings, each usually lasting for about three hours. The staff provides detailed background notes on each issue ahead of the event, and presents the possible range of choices to the meeting in the form of graphics. Chaired by the Governor, the Committee decides what judgement to take on each issue, and considers the risks involved. The aim is to reach a view that represents the thinking of most, if not all, of the Committee. If that is not possible, a vote may be taken – and there is space in the Inflation Report to record the views of dissenting members.

The draft forecast

These judgements of the majority are then incorporated in a revised set of projections, known as the draft forecast, which is presented to the Committee a few days before that month's MPC meeting. Up to this point, the forecast has been put together on an issue-by-issue basis, looking at the individual influences on the economy and seeing how they all add up. But now the time has come to take a look at the big picture, and to judge if what is being put forward seems to make sense.

To help with this exercise, the staff presents the draft forecast alongside detailed comparisons with the work of outside analysts, and invites the MPC to take an overview of what has been put together. Does it really believe that house price inflation is going to slow down as quickly as implied in the forecast? Are the forecasts for US growth just too optimistic? Is it plausible that inflation will hit the target so neatly?

Depending on this discussion, further adjustments may be made in order to arrive at the Committee's best collective judgement.

Q. What happens at the key issue meetings?

A. The staff provides notes on each issue ahead of the event, and then presents the possible choices to the meeting, chaired by the Governor. The MPC decides what judgement to take on each issue, and considers the risks involved. A vote may be taken.

Q. What is the draft forecast?

A. The judgements of the majority are incorporated into a revised set of projections, the 'draft forecast', which is presented to the MPC a few days before that month's MPC meeting.

“The quarterly round is thus an opportunity to stand back from the daily news agenda and think about longer-term trends.”

That final view will have been the result of six or seven substantial meetings of MPC members, normally all chaired by the Governor. And the MPC has this analysis at its fingertips by the Wednesday afternoon when it has to start the discussion on that month’s rate decision.

Finalising the Inflation Report

The quarterly forecast round is now drawing to a close. The final step is to approve the text of the Inflation Report itself. There is not usually much debate about the main body of the Report, which is produced by staff and gives a detailed perspective on recent developments in the economy. But the introductory overview, and the final section describing the Committee’s latest assessment of the outlook for growth and inflation, are another matter. These are meant to capture the MPC’s latest thoughts about policy, and it is enormously important to be as clear and straightforward as possible – and to avoid careless phrases.

Chaired by the Governor, the Committee picks its way through every line. Sometimes, the process breezes along. Occasionally, it can last for many hours.

Publication

The Inflation Report is finally ready for publication. On the Wednesday morning following the MPC’s monthly meeting to set interest rates, the Governor holds a press conference at the Bank for economic journalists who take the opportunity to probe him about all aspects of monetary policy. Accompanied by the Chief Economist and the Markets Director, Mervyn King seeks to provide as full and as clear a set of answers as he can to everything that gets thrown his way. The questioning is usually polite but firm, and quickly gets into matters of fine detail.

It’s all very different from the time, not so long ago, when the stated objective of the Bank’s press officer was to keep the Bank out of the press, and the press out of the Bank.

The quarterly press conference is a very important moment for holding the Bank accountable to the public – but there are others.

Q. How is the Inflation Report put together?

A. The final view is the result of six or seven substantial meetings of MPC members. The MPC very carefully checks the introductory overview and the final section describing its latest assessment of the outlook for growth and inflation. The main body of the Report, produced by the staff, gives a detailed perspective on recent developments in the economy.

Q. When is it published?

A. On the Wednesday morning following the MPC’s monthly meeting to set interest rates, the Governor holds a press conference at the Bank for economic journalists.

Who watches over the MPC?

The Treasury Committee of the House of Commons holds a watching brief over the MPC, which it exercises with vigour. Newly appointed members are quizzed by the Treasury Committee, which has not always been above using a little rough stuff on the hapless appointee.

Accountability

The Treasury Committee also invites the Governor and three or four other MPC members to a public meeting every three months to discuss monetary policy developments.

Around the UK

In addition, MPC members spend time travelling around the United Kingdom, visiting companies and talking to business people and others about how the economy is doing. These visits, which usually include interviews with local newspapers and broadcasters, are set up by the Bank's regional Agents and are typically spread over a couple of days. In all, about 60 or so of them are undertaken in any given year.

They serve two purposes. The first is to find out what is actually going on at the coal face of economic life. You can read all the data in the world and still not fully understand the issues which are keeping business people awake at night.

The second is to explain why the Committee has acted in the way that it has, and to give people a chance to express their views about the way that monetary policy is being managed. To build their credibility, its members need to get out and about and pay serious attention to the views of as wide a slice of the community as possible.

The Court of Directors

Finally, the Committee is also accountable to the governing body of the Bank of England, which is called the Court of Directors. It's the Court's job to make sure that the process is working effectively, to check that the MPC has collected the regional, sectoral and other information necessary to formulate policy, and to see that the MPC has the resources it needs to do its job.

What all this shows is that setting interest rates is not just a question of meeting once a month, and sticking a finger in the air. It takes a significant slice of time for the Governor and his executive colleagues. And the external members of the Committee are usually committed to three or four days work a week.

Q. Why do MPC members spend time round the country?

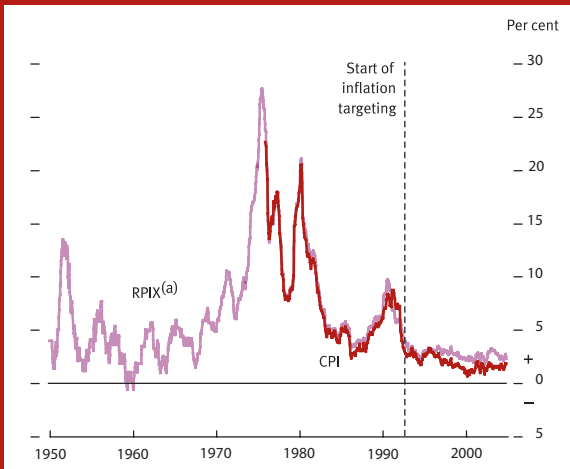
A. The Bank's regional Agents set up about 60 regional visits a year for MPC members. This is to see what is going on at the coal face of economic life, to explain why the Committee has acted in the way that it has and to give people a chance to express their views.

Q. What is the Court of Directors?

A. The MPC is also accountable to the Court of Directors – the governing body of the Bank of England. The Court ensures the process is working effectively, checks the MPC has collected the regional, sectoral and other information necessary to formulate policy, and sees that the MPC has the resources it needs.

The track record so far has been impressive. Chart 3 shows the rate of inflation in the United Kingdom over the past 50 years.

Chart 3 UK inflation experience.



(a) Based on RPI before 1975

Track record

A period of low inflation

The years of inflation targeting, which started after sterling left the Exchange Rate Mechanism in 1992 and was institutionalised when the Bank became independent in 1997, stand out as a period of low inflation. Inflation has also been much less volatile than in previous decades, and inflationary surges have died away more quickly than they did in the past.

This performance cannot be explained simply by the adoption of an inflation target, or by the work of the MPC. Big changes in the labour and product markets were carried out first by the Conservatives under Mrs Thatcher, and then consolidated in the following years by both political parties. And the rate of inflation has declined throughout the world as other countries have managed sound monetary policies and the impact of globalisation and increasing competition has made its mark on prices everywhere.

Benefits to the economy

Improved price stability has brought broad benefits to the British economy. The long-term cost of borrowing has fallen relative to that in other countries. Output growth in the economy has picked up a little relative to its long-term average, and has been much more stable both than it was in the past and than it has been in most other developed countries in recent years. And alongside this sustained growth, unemployment has fallen to much lower levels.

In a speech back in 1992, Robin Leigh-Pemberton – then the Bank’s Governor, and now Lord Kingsdown – argued that it was vital ‘to demolish the image of the UK as a second-rate, inflation-prone economy.’ Arguably, that job has now been done. So far, inflation has come out very close to the MPC’s target. Between 1997 and 2003, the average rate of inflation as measured by the RPIX came out at an annual rate of 2.4%, compared to the 2.5% target. The Governor has not yet had to write a letter to the Chancellor explaining why the target has been missed by more than a percentage point. No doubt that

Q. Why have the years of inflation targeting also been years of low inflation?

A. This is not all because of the inflation target or the work of the MPC. Big changes in the labour and product markets and a decline in the inflation rate throughout the world have made their mark on prices everywhere.

Q. How is the improved price stability beneficial?

A. The long-term cost of borrowing has fallen compared to other countries. Output growth in the economy has picked up a little and has been more stable, and unemployment has fallen to much lower levels than in the recent past.

“It needs to be trusted to do a good job of managing the nation’s monetary policy. And it has to go on earning that trust – every day.”

will be necessary at some point. If, for example, something happened to push inflation way off target – a huge increase in the oil price, for example – the MPC could decide that it would be better to get inflation back on track in a measured fashion rather than slamming up interest rates in a way that could threaten stability, growth and jobs. The open letter would allow the MPC to explain this approach, and the Chancellor publicly to endorse it.

In other words, missing the target might be the result of a deliberate decision rather than a policy error.

Two things are critical for the MPC to be able to achieve its mission. One is a shared understanding across the country of the value of low and stable inflation. As memories of the 1970s and 1980s start to fade, it will be all the more important to get this message across.

The other is for the MPC to be as clear and as open as possible about why and how it goes about making its decisions. It needs to be trusted to do a good job of managing the nation’s monetary policy. And it has to go on earning that trust – every day.

Q. How close has inflation been to the MPC’s target?

A. So far, inflation has come out very close to the MPC’s target.

Q. How can we help the MPC achieve its targets?

A. With an understanding across the country of the value of low and stable inflation. The MPC needs to be as open as possible about how it makes its decisions. It needs to be trusted to do a good job of managing the nation’s monetary policy.

How the Bank sets interest rates

When the MPC decides to change the official interest rate, it is attempting to influence the overall level of activity in the economy. If the demand for goods and services rises at a faster rate than the economy can supply them, inflationary pressures begin to build. But if for some reason the level of demand falls to a point where unemployment starts to rise and businesses start to close, the economy may slip into reverse and inflation may start to weaken.

By changing the rate of interest, the MPC seeks to keep a healthy balance between supply and demand across the UK economy. A reduction in interest rates makes saving less attractive and borrowing more so – and thereby helps to stimulate spending and investment. This will eventually feed through into the level of output, employment and inflation. Lower rates may also leave sterling less attractive to foreign investors, thereby lowering its value relative to other currencies. This will make it easier for British businesses to export goods and services, but will also tend to push inflation higher over time as the prices of imported goods start to rise. Increases in interest rates, of course, have the opposite effect. All this takes time to unfold, which is why the Committee always has to peer into the future in its approach to monetary policy.

The MPC sets the interest rate at which the Bank of England is prepared to lend short-term money to financial institutions – the so-called official repo rate. That in turn affects the whole range of short and longer-term interest rates set by commercial banks, building societies and other institutions for their own savers and borrowers. In addition, it tends to affect the prices of shares and bonds, as well as the exchange rate.

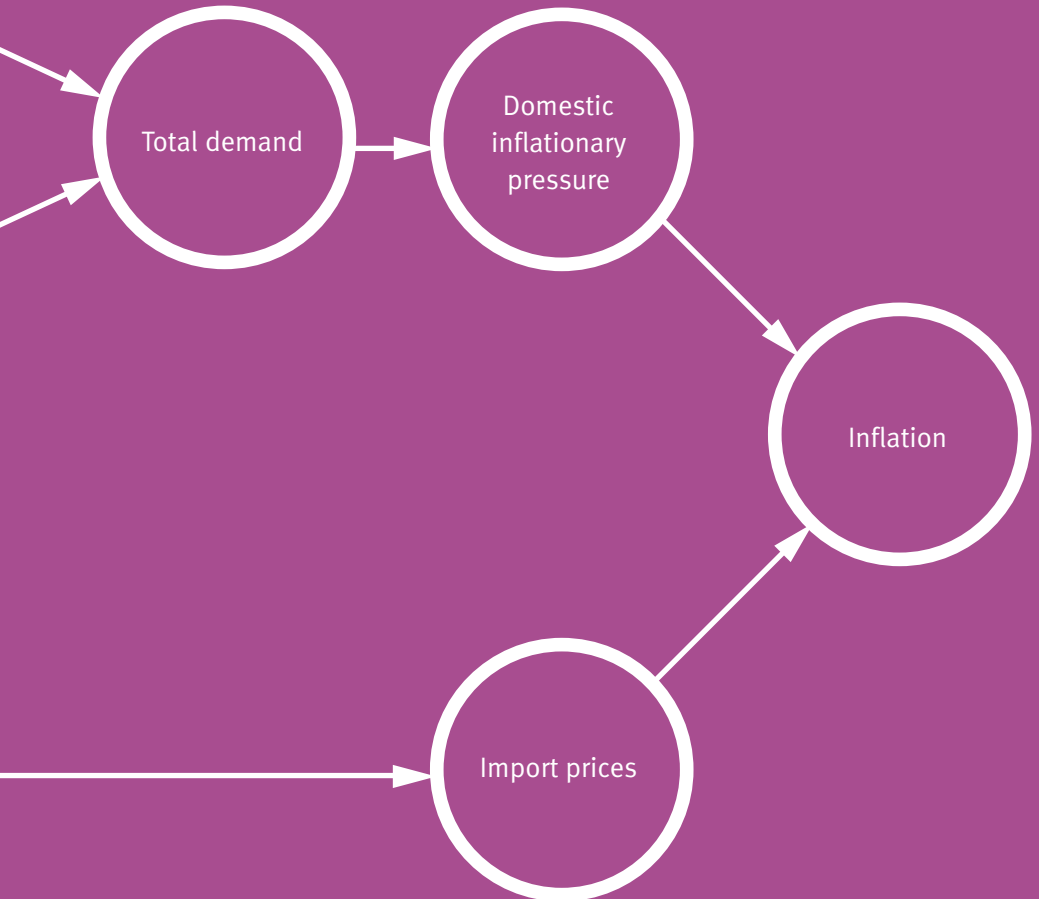
If investors and borrowers believe that inflation is going to be low and stable for years ahead, the MPC's decisions will also have an impact on long-term interest rates. Twenty years ago, people were very unwilling to lend money to UK businesses for the long term because they feared that the value of their repayments would be eaten away by inflation.

Today, the picture is very different. Companies can borrow money for the long term at a rate not much higher than they have to pay for short-term borrowing. This is a sign that the markets are prepared to trust the MPC to do its job.

The transmission mechanism of monetary policy



“By changing the rate of interest, the MPC seeks to keep a healthy balance between supply and demand across the UK economy.”



The Bank of England sets interest rates to keep inflation low, issues banknotes and works to maintain a stable financial system.

For further information

Tel: 020 7601 4878

Email: enquiries@bankofengland.co.uk

www.bankofengland.co.uk

Public Information and Enquiries Group,
Bank of England, Threadneedle Street,
London EC2R 8AH

