FRANKFURT OR LONDON? COMPARISON OF THE MONETARY POLICY OF THE ECB WITH THAT OF THE BANK OF ENGLAND

MICHAL KOLESAR

Junior Sophister

Despite the fact that central banks have similar objectives in mind, it does not necessarily imply that the manner in which these are achieved is identical. To demonstrate this, Michal Kolesar compares and contrasts the monetary policy of the ECB with that of the Bank of England. Common goals and targets are identified, as are important differences in the practices and tactics employed. He concludes that inflation expectations are easier formed using the British model due to its recent history of low inflation and clear communication methods.

Introduction

Economic models are like trends in fashion – they come and go, compete with each other, disappear and reappear again in a slightly modified form, only to be replaced yet again due to a new trend in economic thought. Central banking, due to its reliance on economic models, is no different. Rules versus discretion, fine-tuning versus laissez-faire, money growth versus inflation targeting, employment versus price-stability as a policy criterion, role of transparency and credibility, or shapes of Phillips curves have all been (and many of them still are) topics widely discussed among monetary policy-makers, often without reaching a clear consensus. The fashion today seems to be focus on inflation targeting and price stability, clear and careful communication, operational independence, and credibility. By examining these recent fashion trends, concentrating on the Bank of England (BOE) and the European Central Bank (ECB), this essay will try to show that even though central banks may have common objectives and similar ideas on how best to achieve them, it does not mean that their conduct of monetary policy is necessarily similar in practice. In other words, shooting at the same target using similar weaponry does not imply that the shooting technique is the same.

Choosing the Target

Few people dispute the view that price stability should be one of the primary concerns of central banks. It is the main objective of many central banks today, including BOE and the ECB. However, what exactly we mean by price stability is not a clear-cut issue. The Governing Council of the ECB defines price stability as inflation below 2%, measured by the Harmonised Index of Consumer Prices (HICP). In England, price stability definitions have been changed often. At first, inflation was measured by the RPIX (Retail Prices Index) minus mortgage interest payments, and the target was initially (in the period 1992-97) 1–4%. In 1997, this was narrowed to 2.5±1%. In 2003, the chancellor redefined price stability as 2% inflation as measured by the Consumer Price Index (CPI), which is equivalent to HICP. The target is symmetric, which effectively means that the BOE tries to keep inflation between 1% and 3%. The reason for the change was that the RPIX is an arithmetic measure, while CPI is logarithmic. Thus, CPI attaches less weight to stores where prices have been rising the fastest. Since most people switch their consumption away from products in such stores, the new formula is claimed to be superior (King, 2004). As a side effect of the new measure, inflation figures are lower, hence the reason for lowering the target by 0.5% (Lomax, 2004).

The question of whether or not price stability should be the only concern of Central Banks is more controversial. While the Federal Reserve Board of the US gives its priority equal to employment maximisation and maintenance of moderate long-term interest rates, the ECB states clearly that “price stability is top priority” (ECB, 2006:20). Although it does also say that “the ECB should avoid generating excessive fluctuations in output and employment” (ECB, 2004:44), the ECB stresses that it will only do so “if it lies in line with the pursuit of its primary objective”. (ibid) In this respect, the ECB seems to be very monetarist. Indeed, its publication *The Monetary Policy of the ECB* is full of expressions like “what monetary policy can and cannot do” (ibid:41), “monetary policy can only ultimately influence the price level in the economy” (ibid:43), or “inflation is ultimately a monetary phenomenon” (ibid:42). These phrases seem to be taken straight out of Milton Friedman’s famous paper *The Role of Monetary Policy* (Friedman, 1968).

The BOE’s focus is similar. Although the Bank of England Act states that “the objectives of the Bank of England shall be to maintain price stability, and subject to that, to support the economic policy of Her Majesty’s Government, including its objectives for growth and employment” (Bank of England, 1998:25), the Bank maintains that while it can ‘rough tune’ the economy, ‘fine-tuning’ variables other than inflation, such as

employment and output is impossible (Tucker, 2006:8). Firstly, we do not know enough about the underlying structure and properties of the economy and secondly, macroeconomic data are far from perfect and are often revised – we will be as successful as a jeweller repairing a watch with a sledgehammer. Thus, in practice, "the overriding goal is to secure low and stable rates of inflation over the long run" (Lambert, 2006:5).

Choosing the Arsenal

Two principal instruments to maintain price stability can be used. The first is monetary targeting, advocated by the Monetarists, whereby the Central Bank targets the rate of growth of money supply. Their argument was that if the demand for money function is stable, then the velocity of money V is also stable. By the quantity equation $M V = P Y$, through controlling the money supply M, we can control the price level P. However, in practice, "monetary targeting can hardly be considered a success – targets were often missed" (Eiffinger and de Haan, 2004). In EU countries, for the period 1975-98, the average success rate (the percentage of cases when the target was not missed) was only 31%. The reason for such a low success rate was that the claim made by Friedman and Schwarz (1963) that the stability of the money demand is "another example of stability of basic monetary relations" is too strong. Some authors (Bofinger, 2001) go as far as saying that money demand is "notoriously unstable in the short run". Thus, monetary targeting was replaced in some countries by inflation targeting, i.e. targeting price level growth directly.

The two-pillar approach of the ECB combines these two instruments. The first pillar comprises a 'weak' form of monetary targeting; it uses M3 as an indicator of medium-term risks (Bofinger, 2001). The ECB avoids the use of the word 'target', so more precisely; it compares the money growth to a 'reference value' of 4.5% (Eiffinger and de Haan, 2004). There are two reasons for including monetary targeting into ECB's framework. First is the strong influence of monetarist Bundesbank. Second, some studies have shown that money demand is relatively stable in the euro-zone, especially compared with the national demand (Browne et al., 1997). However, since there is still a lot of uncertainty regarding the issue of money demand stability, a second pillar, which comprises assessment of the outlook of price developments, is also included (Eiffinger and de Haan, 2004). Some economists dislike the two-pillar approach on the basis that it is not clear what to do when the two pillars give contradictory signals (Boffinger, 2001). However, since the rate of growth of M3 has constantly been overshooting its reference value since 1999 (apart from a brief period in 2000-01), it is

questionable how seriously ECB takes the first pillar – one might ask why the ECB does not get rid of it completely.

Bank of England uses a much simpler framework. After monetary targeting (1979-86), shadowing of the Deutschmark (1986-90), and the ERM (1990-92) failed to deliver low inflation and output stability, with the ERM dubbed 'Eternal Recession Mechanism' due to recession in the early 1990s, it adopted inflation targeting in 1992. Since there is a lag of up to two years between the change in interest rates and its effect on prices, "inflation forecast targeting" is probably a better name (Tucker, 2006:3). Consequently, the role of expectations is very important, as the Bank needs to know what inflation will be in one or two years' time, given today's interest rates. Inspired by the new classical school, it uses a "forward-looking rational expectations" (ibid:6) model to estimate it. A big advantage of this approach is that it is resistant to structural changes in the economy, as it focuses on the ultimate policy goal. A policy regime based around an intermediate target, such as monetary targeting would need to be modified whenever the structure of the economy changes (Bean, 2002).

Credibility

It is now widely believed that in order for monetary policy to be successful, a central bank needs to be credible. If people believe that, say, the Bank is committed to bringing inflation down, they will adjust their inflation expectations accordingly, and lower their nominal wage increase demands, which makes it much easier for the Bank to succeed. There are several ways to improve a Bank's credibility, hence the shooting technique and shooting efficiency: history of low inflation, transparency and clear communication, and independence. Let me examine each of them in turn.

A History of Low Inflation

A Bank of England study (Lombardelli and Salaheen, 2003) found that young people (who do not remember the high inflation period of the 1970s) expect, on average, lower inflation than their parents. Due to a good inflation record in the last decade, inflation expectations implied from bonds hardly budged in the UK after the oil price increases in 2004 (Bean, 2002), since it was believed that the Bank would contain price level increases – which it did, also thanks to low inflation expectations. This contrasts starkly with a similar scenario during the OPEC crisis in the 1970s. Thus, by succeeding to keep inflation at bay, the Bank's credibility was boosted, which in turn helps to maintain the inflation record (Lomax, 2004). On the other hand, since the

ECB is a relatively young institution, it cannot take advantage of its historical record.

Transparency and Clear Communication

It is easier for markets to form interest rate expectations if they know how the Bank determines them. Similarly, it is easier to adjust their inflation expectations if the Bank explains at length why it has (or hasn't) changed the interest rate. This explains the focus on transparency and accountability in the institutional design of BOE. The 9-member Monetary Policy Committee (MPC), which since 1997 has determined the interest rate, is technocratic, rather than representative, as is the case in Australia, for example. This helps to foster the belief that the members of the MPC know best how to maintain the inflation target. The minutes of the MPC meetings are published and contain information on the votes of individual members, who are publicly accountable for their decisions. In 1997, the 1–4% interval inflation target was changed to a symmetric point target of 2.5 ± 1% so as to make communication more straightforward (Tucker, 2006); if inflation is above 2.5%, but within the band, the Bank will probably try to reduce it; if it is outside the band, the Bank will certainly take measures to bring it back inside.

The ECB, on the other hand, does not score as well. Although its president, J.C. Trichet maintains that "a central bank should not only do what it says, but also explain what it is doing" (ECB, 2006:3), the unclear target of 'below 2% inflation', and failure to explain constant monetary target overshooting are not exactly examples of effective communication. It is also unclear why it has included the first pillar in its policy framework, after having seen it fail in many countries, most notably the UK in the 1970s and 1980s.

Independence

Another important aspect of the Bank's credibility is its independence from political influences. A politician cannot abuse monetary policy by, say, slashing the interest rates to boost the economy before an election, and thus jeopardising the Bank's low inflation commitment. Here the ECB cannot improve much. Since the Maastricht Treaty does not define what is meant by price stability, the governing council of the ECB formulates its monetary policy, which gives the ECB full goal independence (Eiffinger and de Haan, 2004). The executive board, in turn, has full responsibility in its implementation. Since neither the EU parliament, nor any other body can influence the board's decisions, "the ECB must not seek or take instructions (from anybody)" (ECB, 2006:14), it also has full operational independence. This makes it the world's most independent central bank (Salvatore, 2002).

The Bank of England also gained operational independence in 1997, when the Chancellor ceased to have the power to influence the Bank's interest rate decisions. The Bank of England Act (1998) still retains a clause that, under special circumstances, the government has the power to give instruction on interest rates to the Bank for a limited period, although it is questionable how this power can be used in practice. However, BOE does not have goal independence – it is up to the Chancellor to define what is meant by price stability.

Summary

We have seen that, in broad terms, both the objectives and the instruments of the ECB and the BOE are similar; price stability is the primary objective, defined as HICP of about 2%, achieved primarily by inflation targeting. However, there are some technical differences. While the BOE has a symmetric point target, it is debatable what exactly the ECB means by less than 2% inflation. 1.9%? Or perhaps 1.7%? Secondly, it is also unclear why the ECB retains its first pillar when the targets are constantly overshot.

These communication problems become more acute, however, if we look at them from the credibility and communication perspective. It is certainly easier for businesses to form rational inflation expectations about the British rather than the eurozone economy. As the BOE's inflation record since 1997 shows, it is then much easier to control inflation if the public's inflation expectations mirror the Bank's.

Bibliography

Bank of England (1998) *Bank of England Act (1998).* Viewed at www.bankofengland.co.uk/about/legislation/1998act.pdf accessed on 20/03/2007.

Bean, C.R. (2002) 'Monetary Policy in an Uncertain World', *World Economics 2005*, 6:1. Viewed at http://www.world-economics-journal.com/PDFViewer.asp?Id=199 accessed on 21/03/2007.

Bofinger, P. (2001) *Monetary Policy, Goals, Institutions, Strategies and Instruments*. Oxford: University Press.

Browne, F.X., Fagan, G. and Henry, J. (1997) 'Money Demand in EU Countries: A Survey'
European Monetary Institute Staff Paper, No. 7. Viewed at http://econwpa.wustl.edu/eps/mac/papers/0503/0503004.pdf accessed on 21/03/2007.

ECB (2006) *The European Central Bank, the Eurosystem and the European System of Central Banks.* Viewed at www.ecb.int/press/key/date/2001/html/sp010518.en.html accessed on 21/03/2007.

ECB (2004) *The monetary policy of the ECB*. Viewed at www.ecb.eu/pub/pdf/other/monetarypolicy2004en.pdf accessed on 21/03/2007.

Eiffinger, S.C.W. and de Haan, J. (2000) *European Monetary and Fiscal Policy*. Oxford: University Press.

Friedman, M. (1968) 'The Role of Monetary Policy' *The American Economic Review* 58:1.

Friedman M. and Schwarz A.J. (1963) *A Monetary History of the United States*, 1867-1960. Princeton: University Press.

King, M. (2004) 'The Governor's Speech at the Annual Birmingham Forward/CBI Business Luncheon', *BOE Quarterly Bulletin*, Spring 2004, p74-77. Viewed at www.bankofengland.co.uk/publications/quarterlybulletin/2004.htm accessed on 21/03/2007.

Lambert, R. (2006) *Who sets our interest rates?* BOE. Viewed at www.bankofengland.co.uk/publications/other/monetary/inside_mpc.htm accessed on 21/03/2007.

Lomax, R. (2004) Inflation Targeting – Achievements and Challenges, *BOE Quarterly Bulletin,* Spring 2004. Viewed at www.bankofengland.co.uk/publications/quarterlybulletin/2004qbcon.htm accessed on 21/03/2007.

Lombardelli, C. and Salaheen, J. (2003) 'Public expectations of UK inflation', *BOE Quarterly Bulletin*, Autumn 2003.

Salvatore, D. (2002) 'The Euro, the European Central Bank, and the International Monetary System' *Annals of the American Academy of Political and Social Science*, Vol. 579.

Tucker, P. (2006) 'Reflections on Operating Inflation Targeting' *BOE Quarterly Bulletin*, Summer 2006.