Inflation Targeting—The U.K. Experience

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The United Kingdom has been conducting monetary policy by reference to an inflation target since late 1992, just after we had left the European exchange rate mechanism (ERM). The institutional arrangements are ably described in Lafrance's paper in this volume. Our experience with inflation targeting has been confined so far to the expansionary phase of the business cycle: the economy has grown in each of the 20 quarters from 1992Q2 to 1997Q1, inclusive. The expansion has been notable for the lowness of inflation; the average rate of inflation since 1992Q1 has been 2.9 per cent, the lowest recorded in the United Kingdom over any period of 20 quarters since that of 1959Q3 to 1964Q2.

In the early stages of the current recovery, low inflation could reasonably be attributed to the depth of the recession of the early 1990s and to the monetary policy we pursued while in the ERM. If it is true, however, that it takes two years for acts of monetary policy to have their full effect on inflation, then it follows that the lowness of the rate of inflation since late 1994 can be credited to the monetary policy pursued under the inflation target regime.

Just as significant is that a clear political consensus has emerged in the United Kingdom in support of a monetary policy guided by inflation targets. In the election campaign just ended, the desirability of inflation targets was one of the issues on which the main political parties agreed, and the Labour party manifesto contained a commitment to continue the existing inflation target.

The relationship between low inflation and exchange rate stability has been famously controversial for decades, especially in Europe in the last few years. The Continental European view (though it is not held by everyone in Continental Europe), and one of the arguments for fixed exchange rates, is that fixing exchange rates is a good way of conducting monetary policy in pursuit of low inflation. It is a view that appeals particularly to countries with large neighbours, though not all such countries share it. Another view, often held in countries that have had problems with fixed exchange rates, is that fixing exchange rates can lead to conflicts with domestic objectives—even with a domestic objective of low inflation. In that view, it is better to allow the exchange rate to float and to address monetary policy directly to domestic objectives. Many adherents of that view also believe that low inflation can be expected to lead to exchange rate stability, or at least to minimal exchange rate instability. The United Kingdom has had much experience with floating exchange rates in the last 20 years or so, and it is interesting to see what light this experience throws on the relationship between inflation and exchange rate stability.

One can identify four periods of four to five years each since the early 1970s when sterling was floating (there were intervening periods when it was temporarily fixed). These are identified in Table 1. The rate of inflation in the United Kingdom has been lower in each period than in its predecessor, falling from 15.9 per cent in the 1972-76 period to 2.8 per cent in the period since 1993. Inflation in other countries, too, has generally fallen. It is possible to detect in the data a downward trend in measures of exchange rate volatility. But it is not very dramatic. For example, the standard deviation of monthly percentage changes in the exchange rate of sterling against the German mark fell from 3.1 percentage points in 1972-76 to 2.1 percentage points in the latest period—a fall of about 30 per cent, compared with falls of over 80 per cent in U.K. inflation and over 50 per cent in German inflation.

In any case, the evidence is far from decisive. In effect, it is based on only four observations. Moreover, the greater stability of exchange rates in the 1990s has not prevented an appreciation of 18 per cent in sterling, according to the exchange rate index, over the period from late July 1996 to late April 1997. The appreciation has been far from uniform across foreign currencies; for example, the pound has appreciated by about 22 per cent against the German mark since the end of July 1996, but by no more than about 5 per cent against the U.S. dollar.

In fact, what we have had is a large change in asset prices—that is to say, reductions in the prices of all those assets denominated in foreign currencies. Changes in asset prices can pose difficult problems for monetary policy, as our Japanese central banking colleagues can testify. And indeed,

Table 1

Inflation and Exchange Rate Stability

	30 June 1972 to 31 December 1976	31 December 1977 to 31 December 1982	31 December 1982 to 31 March 1987	31 December 1992 to 31 March 1997
U.K. inflation				
Mean 12-month per cent increase in RPIX[a]	15.9	11.8	4.6	2.8
German inflation				
Mean 12-month per cent increase in cost of living	6.0	4.7	1.8	2.6
£/DM exchange rate				
Mean of end-month levels (£/DM)	5.89	4.15	3.61	2.41
Standard deviation as per cent of mean	17.7	7.7	10.2	5.8
Standard deviation of monthly per cent changes	3.1	3.1	2.9	2.1
£ exchange rate index (1990 = 100)				
Mean of end-month levels	136.5[b]	119.1[b]	109.2	88.0
Standard deviation as per cent of mean	12.2[b]	7.5[b]	7.0	4.3
Standard deviation of monthly per cent changes	1.7[b]	1.9[b]	2.6	1.7

a. RPI until 1974. (RPI is the retail prices index; RPIX is RPI excluding mortgage interest payments.)

b. Monthly averages or changes in monthly averages.

Source: Inflation data are from the U.K. Office for National Statistics; exchange rate data are from the Bank of England.

in the United Kingdom monetary policy has in the past not always responded successfully to exchange rate developments. As the academic literature points out, the key is to interpret the change in asset prices, and identify the causes, because the right response depends on what the cause was.

That means, for the United Kingdom now, that before we can make a good policy decision we must make an explicit judgment as to why the exchange rate has appreciated. At one extreme, for example, many people think that there has been a flight from currencies expected to participate in the European economic and monetary union (EMU), perhaps because of concerns that the European Central Bank will not be as effective an inflation fighter as the Deutsche Bundesbank. They also think that the United Kingdom is unlikely to participate in the EMU, at least in the first wave. If we believed that that phenomenon were responsible for the entire appreciation of the pound, we might expect it to have a quite severe depressing effect on U.K. output and, if we thought the appreciation likely to be sustained, would think it right to take that into account by recommending a lower level of interest rates than we would otherwise have done. But other explanations are possible. If we thought, for example, at the other extreme, that the appreciation resulted entirely from an increase in demand for U.K.-produced goods and services (for example, because of perceived higher quality), there would be *no* adverse implications for output, nor any obvious need for an adjustment of monetary policy. I do not want to suggest that we think that *either* of these developments is responsible on its own for the appreciation that we have had, but just to make the point that the appropriateness of the policy response depends on the accuracy of the diagnosis of the cause.

Calculating and using a monetary conditions index, consisting of a weighted average of interest and exchange rate changes, would involve making an implicit judgment about the cause of exchange rate movements. The judgment would be implicit in the choice of the weights, and it would apply to all exchange rate movements. Many of the mistakes made in U.K. monetary policy since the 1970s have come from assuming that unexpected exchange rate movements have been exogenous—unrelated to the domestic economy, a bit like the weather—and we think that a monetary conditions index could expose us to making the same kind of mistakes again.

Of course we have to accept that our judgment about the cause of the exchange rate appreciation can only be an informed guess. We have to acknowledge and take account of the risks to the forecast that arise from the probability that our guess, though informed, is also wrong. In the present case, one obvious suspect is the changes in the profile of current and expected future short-term interest rates. In the United Kingdom, the profile has risen over the period from late July 1996 to late April 1997, whereas in Germany, for example, it has fallen. Such fluctuations are normal cyclical phenomena, and the disjunction between the United Kingdom and Germany simply reflects the fact that the business cycles in the two countries are not very closely aligned.

However, exchange rate changes arising from cyclical developments of this kind are presumably themselves inherently cyclical—in other words, they are not expected to be permanent. It appears, though, that most of the recent appreciation of sterling *is* expected to be permanent: while the spot exchange rate of sterling against the German mark has appreciated by 22 per cent, the 10-year forward rate has appreciated by 18.5 per cent. Another promising suspect is fiscal policy. There has been a substantial fiscal tightening in Continental Europe, undertaken partly in order to meet the Maastricht convergence criterion for European monetary union. The

U.K. budget deficit has fallen as well, but the extent of fiscal tightening has been greater on the Continent. That could help to account for the depreciation of the core ERM currencies against the pound.

It is possible to think of other theories as to why there might have been a permanent appreciation, and the possibilities have been discussed in successive issues of our *Inflation Report*. They include the rise in oil prices, the possibility that there have been shocks to productivity in the United Kingdom, and the two possibilities mentioned above—a flight from currencies thought likely to participate in the first wave of European monetary union, and a rise in demand for U.K. products. Typically the evidence for and against individual theories is pretty thin. Nevertheless we think it is essential to stick to the discipline of trying to understand the reasons for the exchange rate move. This is the biggest challenge for inflation targeting and monetary policy in the United Kingdom at present.