CENTRAL BANK INDEPENDENCE AND INFLATION TARGETING – THE BRITISH EXPERIENCE

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Known as the 'Old Lady' of Threadneedle Street, the Bank of England is the central bank of the United Kingdom. Founded in 1694, the Bank of England is standing at the centre of the United Kingdom's financial system, and is committed to promoting and maintaining monetary and financial stability as its contribution to a healthy economy. In our opinion, it is very important to analyze the Bank of England's monetary policy strategy, starting from 1992 – adoption of the inflation target and the evolution of it's monetary policy strategy, through an important feature – delegating operational accountability regarding the monetary policy in 1997 as well as the appropriate institutional framework. More over, it is important to analyze the Bank of England's performances before and after granting central bank independence.

Keywords: Monetary policy strategy, central bank transparency, central bank accountability, inflation reports, index of central bank independence and inflation targeting

JEL Classification: E50, E52, E58.

1. Introduction

The Bank of England's history is naturally one of interest, but also of continuing relevance to the Bank today. Events and circumstances over the past three hundred years have shaped and influenced the role and responsibilities of the Bank. They have moulded the culture and traditions, as well as the expertise, of the Bank which are relevant to its reputation and effectiveness as a central bank in the early years of the 21^{st} century. At the same time, much of the history of the Bank runs parallel to the economic and financial history, and often to the political history, of the United Kingdom more generally.

In pursuing its goal of maintaining a stable and efficient monetary and financial framework as its contribution to a healthy economy, the Bank has two core purposes: achieving them depends on the work of the Bank as a whole. The Bank of England exists to ensure monetary stability and to contribute to financial stability:

- *monetary stability* – means stable prices and confidence in the currency; stable prices are defined by the Government's inflation target, which the Bank seeks to meet through the decisions delegated to the Monetary Policy Committee, explaining those decisions transparently and implementing them effectively in the money markets;
- *financial stability* – entails detecting and reducing threats to the financial system as a whole; such threats are detected through the Bank's surveillance and market intelligence functions; they are reduced by strengthening infrastructure, and by financial and other operations, at home and abroad, including, in exceptional circumstances, by acting as *the lender of last resort*.

In pursuing of both purposes the Bank is open in communicating its views and analysis and works close with others, including:
- other central banks and international organizations to improve the international monetary and financial system;
- the Treasury and Financial Services Authority, under the terms of memorandum of understanding, to pursue financial stability.

The Bank of England will also play its part in promoting an open and internationally competitive financial centre in the United Kingdom using its expertise to help make the United Kingdom financial system more efficient, where such efforts would be in the public interest and provided that they do not conflict with its primary responsibilities of those of other agencies.

The current governance and accountability is set by the 1998 Bank of England Act, which provides for a Court of Directors, a Committee of Non-executive Directors within the Court and a Monetary Policy Committee.

The Court of Directors is responsible for managing the affairs of the Bank, other than the formulation of monetary policy. The Bank of England has a statutory objective *to contribute to protecting and enhancing the stability of the financial system of the United Kingdom* and the Court, consulting the HM Treasury, will determine the Bank's strategy in relation to that objective. The Court's responsibilities under the 1998 Act include determining the Bank's objectives and strategy, and ensuring the effective discharge of the Bank's functions and the most efficient use of its resources.

The Monetary Policy Committee (MPC) – the Bank of England establishes the MPC as a Committee of the Bank, subject to the oversight of NedCo (Committee of Court consisting of all the Non-executive Directors, with a Chairman appointed by the Chancellor), and sets a framework for its operations. According to the Act, the Bank's objectives in relation to the monetary policy are to maintain price stability and, subject to that, to support the Government's economic policies, including its objectives regarding growth and employment. At least once a year, the Government specifies the price stability target and its growth and employment objectives. The MPC must meet at least monthly; its members include the Governor and Deputy Governors, two of the Bank's Executive Directors and four members appointed by the Chancellor.

2. Central Bank Independence

Over the last few years many central banks have made significant strides towards greater accountability and transparency. There has been a dilution of what Karl Brunner (1981, p.81) once called `peculiar and protective political mystique` that has traditionally surrounded central banking. Central banks in countries which have recently adopted inflation targets have all become more open about the formulation and presentation of their monetary policies (Haldane, 1995). Similar movements have been evident among central banks recently granted greater independence through legislative changes; and in the United States the debate regarding replacement of the Humphrey-Hawkins Act – and its multiple objectives – with a single objective of price stability, and on the publication of the full transcripts of Federal Open Market Committee (FOMC) meetings. *How might we best explain this shift towards greater accountability and transparency? One answer is that greater accountability has run hand – in – hand with moves towards greater central bank independence: greater accountability is the government's quid pro quo for granting greater central bank autonomy. This is because independence delegates responsibility for monetary policy to an ultimately unelected authority – the central bank. So making this authority accountable for its actions insures against a democratic deficit.*

The logic of central bank independence can be noticed by looking at the different views of elected politicians and of central bank decision makers. Democratic leaders run for office promising change and improvement rather than continuity and stability, whereas an incoming head of a central bank will almost certainly want to continue the policies of a successful predecessor and will enhance his or her commitment to do so. Political independence and non-partisan monetary policy provide the promise of monetary policy stability over time, which in turn stabilizes expectations on the asset market. Such stability and continuity are essential for a successful monetary policy (Dumiter, 2009 p. 26).

Central bank independence requires that the head of the bank has a term of office long enough to prevent government revision of the monetary policy decisions. However, such structural features of central bank's institutional design are only the starting point for central bank independence. If the government publicly attacks the central bank's policy, then the independence will certainly be incomplete (Dumiter, 2009 p. 26-27). The tenures of the British Governors starting with 1901 are presented in table 1.

Table 1 Former Governors of the Bank of England (1901 - Present)

Chairmen	Date of term
Sir Augustus Prevost	1901 – 1903
Samuel Hope Morley	1903 – 1905
Alexander Falconer Wallace	1905 – 1907
William Middleton Campbell	1907 – 1909
Reginald Eden Johnston	1909 – 1911
Alfred Clayton Cole	1911 – 1913
Walter Cunliffe	1913 – 1918
Sir Brien Ibrican Cokayne	1918 – 1920
Montagu Collet Norman	1920 – 1944
Lord Catto of Cairncatto	1944 – 1949
Cameron Fromanteel Cobbold	1949 – 1961
The Earl of Cromer	1961 – 1966
Leslie Kenneth O'Brien	1966 – 1973
Gordon William Humphreys Richardson	1973 – 1983
Robert (Robin) Leigh – Pemberton	1983 – 1993
Edward Allan John George	1993 – June 2003
Mervyn Alister King	2003 - Present

Source: By Author's.

In our opinion it is very important to measure central bank independence and inflation targeting with the *Index of central bank independence and inflation targeting (Dumiter, 2009)*. The index has three main pillars: Political and legal central bank independence (PLCBI), Central bank governance and conduct of monetary policy (CBGCMP) and Central bank transparency and

accountability (CBTA). Measuring central bank independence and inflation targeting in the United Kingdom was made by analyzing the central bank website, the central bank laws and statute, different norms and regulations and other publications and studies available on the central bank website and on the real practices of the development central bank in the period 1980 – 2009. Regarding the first pillar PLCBI, the Bank of England has a high score (8.33 points out of 10 points), which means that the central bank has a high degree of political and legal independence due to the five years term of the central bank Governor, a lower level of the turnover rate of the central bank Governor (0.10) and a non - political vulnerability. However, we can identify some weaknesses regarding this pillar: the three years tenure of the MPC members and the authority of the Queen in the appointment procedures of the central bank.
With a total score of 7.13 points out of 10 maximum possible of the second pillar, Central bank governance and conduct of monetary policy of the Index of central bank independence and inflation targeting, the Bank of England has no authority in establishing the annual inflation target, we can observe the government prevalence over the monetary authority regarding a policy conflict. However, the most important features regarding this criterion are: price stability – the major objective of monetary policy, inflation targeting as monetary policy strategy, a high degree of instrument independence establish by the 1998 charter, the central bank authority in establishing and managing the interest rate, the central bank autonomy in establishing, deciding and regulating foreign exchange operations and the explicit interdiction of government lending.
Central bank transparency and accountability has a total score of 8.37 points out of 10 maximum score, which means that the Bank of England has a high degree of transparency and accountability due to the explicit prioritization of the price stability objective, explicit institutional arrangements between government and central bank, the public availability of the time series for the main macroeconomic indicators and the model of the economy, publishing the Inflation Report, an important document designed and established by the Bank of England, which contains information about future projections of inflation and output, public explaining and justifying to the society the monetary policy decision and actions as well as the auditing of the central bank financial situations by external auditors.

3. Inflation targeting

The United Kingdom followed Canada in adopting inflation targeting, but under quite different circumstances. Canada came to inflation targeting gradually, through a process of experimentation and discussion. In contrast, British adoption of the inflation targeting approach was provoked by a crisis, namely the foreign-exchange crisis of September 1992, which resulted in the floating depreciation of the pound. Inflation targeting was adopted in Britain largely as a means of restoring the credibility of monetary policy lost in the speculative crisis and to provide an alternative nominal anchor.
The key features of inflation targeting in the United Kingdom are:
- The United Kingdom adopted inflation targets in the aftermath of a foreign exchange crisis, in order to strengthen the credibility of monetary policy and restore a nominal anchor. Like other countries, the United Kingdom's adoption of targets also followed a period of successful disinflation, which made hitting the initial targets relatively easy.
- Monetary policy in the United Kingdom under inflation targeting remains relatively flexible, an approach more akin to that of Canada than to that of New Zeeland, where the central bank has somewhat less discretion in the short run. In particular, the monetary policy in the United Kingdom has responded to fluctuations in output and employment.
- The inflation target in the United Kingdom is defined in terms of the annual change in retail prices excluding mortgage interest payments, or RPIX. Attention is also paid to the price index RPIY, which is RPIX less the first-round effects of indirect taxes. Both RPIX and RPIY include food and energy prices, so that the target index has in practice been a compromise between

headline inflation and a measure of `core` or `underlying` inflation. The agency responsible for constructing these two indexes (Office for National Statistics) differs from the agency that assesses whether the target has been met (Bank of England).

- Initially, the United Kingdom set a target range for inflation. Since May 1997 the target has been expressed as a point, but with `thresholds` on either side. If inflation breaches a target threshold, the Bank of England is required to provide a formal explanation to the government.
- Before the Bank of England achieved independence following the May 1997 election, it had little independent control over the instruments of the monetary policy; control was exercised instead by the Chancellor of the Exchequer. Under the pre-1997 targeting regime, the activities of the Bank were substantially limited to forecasting inflation and assessing past inflation performance. Rather that being a fully active policymaker, to a considerable degree the Bank functioned as the Chancellor’s `counter-inflationary conscience`.
- In part because of its weak position before May 1997, the Bank focused its inflation-targeting efforts on communicating to the public its monetary-policy strategy and its commitment to price stability. In doing so, it relied heavily on publications such as the *Inflation Report,* an innovation that has been emulated by other inflation-targeting countries.

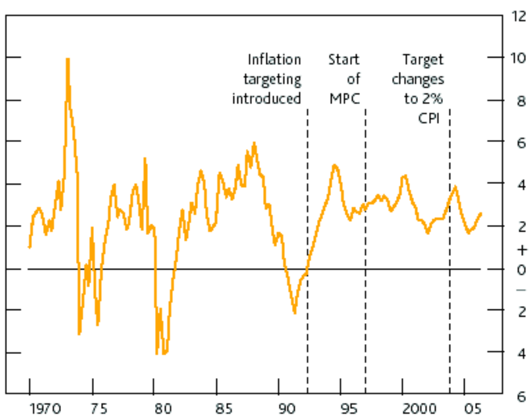

Figure 1 GDP evolution in the United Kingdom (standard deviation from previous year)

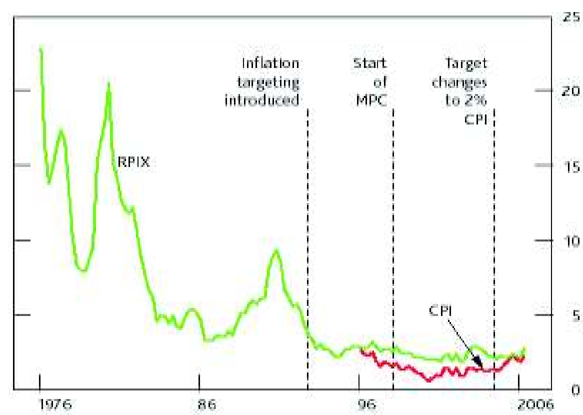

Figure 2 Inflation in United Kingdom (standard deviation from previous year)

Source: Bank of England (2008).

The Bank of England’s policy objective is to deliver price stability – low inflation – and, subject to that, to support the Government’s economic objectives including those for growth and employment. Price stability is defined by the Government’s inflation target of 2%. The remit recognises the role of price stability in achieving economic stability more generally, and in providing the right conditions for sustainable growth in output and employment. The Government’s inflation target is announced each year by the Chancellor of the Exchequer in the annual Budget statement. The 1998 Bank of England Act made the Bank independent to set interest rates. The Bank is accountable to parliament and wider public. The legislation provides that if, in extreme circumstances, the national interest demands it, the Government has the power to give instruction to the Bank on interest rates for limited period.

The inflation target of 2% expressed in terms of an annual inflation based on the Consumer Prices (CPI). The remit is not to achieve the lowest possible inflation rate. Inflation below the target of 2% is judged to be as bad as above the target. The inflation target is therefore symmetrical. If the target is missed by more than 1 percentage point on either side – i.e. the annual inflation rate of CPI inflation is more that 3% or less that 1% - the Governor of the Bank

must write an open letter to the Chancellor explaining the reasons why inflation has increased or fallen to such an extent and what the Bank proposes to do to ensure inflation comes back to the target. A target of 2% does not mean that inflation will be held at this rate constantly. That would be neither possible nor desirable. Interest rates would be changing all the time, and by large amounts, causing unnecessary uncertainty and volatility in the economy. Even then it would not be possible to keep inflation at 2% in each and every month. Instead, the Monetary Policy Committee's aim is to set interest rates so that inflation can be brought back to target within a reasonable time period without creating undue instability in the economy.
Since 1992, the economic performances of the British economy have been improved (Figures 1 and 2), inflation recorded stable and lower level around the target. By adopting the inflation targeting regime, the RPIX inflation has been in average 2.6 % and the RPI inflation and average of 1.8 %. The Monetary Policy Committee (MPC) was created in June 1997, where the RPIX inflation was 2.4% and the PRI inflation was 1.4%, with a deviation of maximum one percentage point from the target. This fact represents a high performance of the British economy, and expected to happen once the institutional arrangements will be applied: the economic data from that period suggested that inflation will be 40% of the time with more than one percentage point above the target. More over, the inflation projection figures show a higher risk for inflation deviation from the target, more than one percentage point.

4. Conclusions

Improving the institutional arrangements (central bank independence) for the economic policy will be given a high priority by the British Government in order to deliver long term economic stability and rising prosperity. The Bank of England Manifesto commitment is to *ensure that decision – making on monetary policy is more effective, open, accountable and free from short - term political manipulation.* Within the overall responsibility for economy policy, including stability, growth and employment, and for setting the inflation target, The Government has been delegated the Bank of England operational responsibility in setting interest rates. Price stability is a precondition for high and stable levels of growth and employment, which in turn will help to create the conditions for price stability on a sustainable basis. To that end, the monetary policy objective of the Bank of England will be to deliver price stability (as defined by the Government's inflation target) and without prejudicing this objective, supporting the Government's economic policy, including its objectives for employment and growth.

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