FACT SHEET

Monetary Policy in the United Kingdom

One of the Bank of England's key responsibilities, as the central bank of the UK, is the conduct of monetary policy. The Bank's role is to deliver price stability (as defined by the Government's inflation target) by setting short-term interest rates. The purpose of this Fact Sheet is to explain some of the background to monetary management in the UK and set in context the discussions of policy that appear in successive issues of the Bank's *Inflation Report* and *Quarterly Bulletin*. The focus is mainly on how monetary policy is made and then put into effect.

The objective of monetary policy is price stability - to maintain the value of money - or, to put it another way, to restrain inflation or the general increase in the prices of goods and services. Uncertainty about inflation - and thus about future price levels - is damaging to the proper functioning of the economy. With a stable general price level, individual price signals can be read more clearly, and more rational decisions taken about whether to save or to borrow, how much to invest and to consume, and what and when to produce. In this way, price stability can help to foster sustainable long-term economic growth.

Monetary policy operates by influencing the cost of money, i.e. the short-term rate of interest. The Bank sets an interest rate for its own dealings with the market and that rate then affects the whole pattern of rates set by the commercial banks for their savers and borrowers. This in turn will affect asset prices (e.g. shares and property), consumer and business demand and, ultimately, output and employment. Broadly speaking, the objective is to keep aggregate demand as far as possible in line with the productive capacity of the economy. If rates are set too low this may encourage the emergence of inflationary pressures so that inflation is persistently above target. If they are set too high there is likely to be an unnecessary loss of output and employment, and inflation is likely to be persistently below target.

THE POLICY FRAMEWORK

The current framework for monetary policy is provided by the 1998 Bank of England Act which formally gives the operational responsibility for setting interest rates to the Bank of England. Under these arrangements, the Bank's monetary policy objective is to deliver price stability (as defined by the Government's inflation target) and, subject to that objective, to support the Government's economic policy, including its objectives for growth and employment. The Government's inflation target will be confirmed in each Budget Statement. In June 1997, the Chancellor announced that he was setting the Bank a target of 2.5% for retail price inflation excluding mortgage interest payments (RPIX).

Decisions on interest rates are normally made by the Monetary Policy Committee (MPC) of the Bank which was established by the 1998 Bank of England Act. The MPC consists of the Governor and the two Deputy Governors of the Bank, two members appointed by the Bank after consultation with the Chancellor, and four members appointed by the Chancellor. A representative of the Treasury attends meetings in a non-voting capacity.

The MPC meets monthly. Decisions are announced immediately after the meeting and the minutes are published two weeks later (though there are provisions for delaying publication of information on market intervention by the MPC in certain circumstances). Increased accountability to Parliament and the public is achieved through the publication of the minutes, and the continued publication of the Bank's Inflation Report, as well as through appearances by MPC members before the Treasury Select Committee of Parliament and through the Bank's Annual Report. The Governor is also obliged to write an open letter to the Chancellor if inflation deviates more than 1% on either side of the 2.5% target. Under certain circumstances, the Bank of England Act allows the Treasury to give instructions to the Bank in the field of monetary policy for a limited period of time. These powers can only be used if the Treasury is satisfied that they are required in the public interest and only by 'extreme economic circumstances'.

TECHNIQUES

Operations in the domestic money market

The main instrument of monetary policy is the short-term interest rate. Central banks have a variety of techniques for influencing interest rates but they are all designed, in one way or another, to affect the cost of money to the banking system. In general this is done by keeping the banking system short of money and then lending the banks the money they need at an interest rate which the central bank decides. In this country such influence is exercised through the Bank of England's daily operations in the money markets.

The Bank of England is banker to the UK banking system. Transactions between commercial banks are finally settled between accounts held at the Bank of England by banks - 22 at present - which are members of the wholesale clearing systems. These *settlement banks* are expected to hold positive balances on their accounts at the Bank each day. The commercial banks' total funds are altered by transactions between themselves and the Bank, and between themselves and the Government accounts at the Bank. Transactions between banks merely redistribute funds between themselves. Payments from the private sector to the government are finally settled by a transfer of funds between the settlement banks' accounts at the Bank and the Government's accounts. Thus, by managing the money flows the Bank can affect the size of the settlement banks' balances with itself.

If on a particular day more funds move from the private sector to the Government's accounts than vice versa (for example because banks' customers are paying their taxes), then the banking system will be short of the funds needed for the settlement banks to maintain positive balances on their accounts at the Bank. If the overall movement of funds is in the other direction, then the banking system will have surplus funds. Normally the operation of the Government accounts, including money market operations, results in the settlement banks starting each day with a prospective shortage of funds.

The Bank, through its daily operations in the money market, supplies the funds which the banking system as a whole needs to achieve balance by the end of each settlement day. It is in setting the interest rate for these operations that the Bank influences the general level of interest rates across the economy. Traditionally, in these operations the Bank has bought Treasury bills, and other eligible local authority and bank bills. In addition the Bank now operates in gilt repo. A gilt repo is a sale and repurchase agreement eg 'A' sells gilts to 'B', with a legally binding agreement to repurchase equivalent gilts from 'B' at a pre-determined price and date. In effect gilt repo is a cash loan with the gilts used as security.

The Bank's daily operations to relieve the shortage are conducted through a group of counterparties which can include banks, building societies and securities firms. They are invited to apply for funds either by the sale of bills or by bill or gilt repo to the Bank. Depending on the size of the expected shortage, up to four rounds of operations may be held each day. If these operations are not sufficient to relieve the liquidity shortage there is a late repo facility for settlement banks.

Interest rates in the wholesale money market will generally be closely influenced by those at which the Bank conducts its operations. The decision by the MPC on the rate of interest is announced immediately after the monthly meeting and any change will normally be reflected quickly in the money market in general, and in banks' base rates i.e. the rates they use to calculate their customers' rates.

Operations in the foreign exchange market

In addition to their direct effects on the domestic economy, movements in interest rates influence the value of sterling in terms of other currencies. If interest rates on sterling assets rise in relation to rates on other currencies, then (other things remaining equal) money will flow into sterling and sterling's exchange rate will rise. The exchange rate will also reflect market expectations about economic, financial and political developments here and abroad, so that a change in interest rates may not always result in a proportionate effect on the exchange rate.

The Bank can attempt to influence the exchange rate through direct market intervention, using the country's foreign exchange reserves. When sterling is weak the Bank can enter the market and buy sterling in an attempt to halt its decline or

THE EFFECTS OF INTEREST RATES — Box 1

A change in interest rates will affect the economy through a number of routes. First, a change in the cost of borrowing will affect spending decisions. Interest rates affect the relative attraction of spending today as against spending later, as a rise in rates will make savings more attractive and borrowing less so, and this will tend to reduce present spending, both on consumption and on investment.

Second, a change in rates affects the cash flow of borrowers and creditors. A rise or fall in interest rates affects the cash flow of those with floating interest rate assets or liabilities. For example, many households have floating interest rate deposits in banks and building societies. Floating interest rate debtors include households with mortgages, and companies. Fluctuations in cash flow may affect spending.

Third, a change in interest rates affects the value of certain assets, notably housing and stocks and shares. Such a change in wealth may influence people's willingness to spend.

Fourth, a particular pressure on prices comes through the exchange rate. For example, a rise in domestic interest rates relative to those overseas will tend to result in a net inflow of capital and an appreciation of the exchange rate. A rising pound will reduce prices for imports, thus increasing competitive pressures and supplementing the downward pressure on inflation arising from weakened demand.

All of these influences on demand are likely to affect prices and inflation. A rise in short-term interest rates can be expected to restrain demand for UK output in the way described. That in turn is likely to put downward pressure on UK prices and the rate of inflation.

can sell sterling if it is perceived to be too strong. Experience shows that such intervention may be helpful in resisting short-term fluctuations provided it is in line with the underlying trend of the market. The UK's exchange reserves used to be held solely in the Exchange Equalisation Account owned by the Treasury. This was operated by the Bank on behalf of the Government. As part of the changes introduced by the passing of the 1998 Bank of England Act, the Bank can now manage its own pool of foreign exchange reserves, separately from those managed on behalf of the Treasury. These reserves are now available for use in operations related to monetary policy, subject to limits authorised by the Bank's Court of Directors.

Operations in the Government securities market

The weekly tender in Treasury bills is used to help manage the money market as well as raising cash for the Government. The Public Sector Net Cash Requirement (PSNCR) is, however, funded mainly through the sale of gilt-edged securities which are long-term investments used to finance the shortfall between Government revenues and expenditure. Prior to 1 April 1998, the role of managing the Government's debt was undertaken by the Bank of England. On this date, however, the responsibility for the management of the Government's debt and the oversight of the gilt market passed to a new Debt Management Office (DMO) which is an executive agency of the Treasury. The DMO also provides policy advice to the Treasury on the annual gilt programme, makes decisions concerning the initiation of sales of gilts and liaises with market participants.

THE DEVELOPMENT OF POLICY

Monetary policy has occupied a steadily more prominent role in economic management in the UK over the last 25 years. For much of the 1950s and 1960s, monetary conditions were seen essentially as a by-product of other policies which included, from time to time, a number of direct controls on, for example, wages, dividends and prices.

Monetary policy, too, depended on direct controls. For example, there were restrictions on consumer credit and bank lending in general. Mortgages were effectively rationed throughout the period. This was also a period in which the UK had restrictive exchange controls (abolished in 1979) and adhered to the Bretton Woods regime of generally fixed exchange rates against the dollar. The collapse of Bretton Woods in 1971, and the world-wide inflationary conditions of the 1970s, led to much closer attention to monetary policy in all countries.

In 1971, the UK moved to a more market-related monetary environment under a policy known as Competition and Credit Control. The former quantitative ceilings on bank lending were lifted and interest rates were allowed a larger role in the allocation of credit. This coincided with a period of fiscal expansion and rapid growth of demand in the economy, and monetary expansion was also rapid as banks increased their lending and competed in the interbank market for deposits.

A form of quantitative control was reintroduced in 1973 in the form of the Supplementary Special Deposit Scheme, also known as the 'Corset'. It imposed penalties on banks whose interest-bearing deposits grew faster than a pre-set limit. The Corset was abolished in 1980.

For a period beginning in the late 1970s, monetary policy was conducted by reference to targets for broad money - and indeed in 1980 the new Government's Medium-Term Financial Strategy set out broad money targets for several years in the future. Although the aim (price stability) and the instrument (the short-term interest rate) have remained virtually unaltered since, the framework in which monetary policy is conducted has undergone several changes.

It became clear in the early 1980s that broad money was sending misleading signals because its relationship to national income had changed quite significantly during the period, reflecting the liberalisation of the financial system and the particular strains of the recession. So by the mid 1980s monetary policy had become based on an assessment of a range of indicators rather than a single domestic money aggregate. Targets for broad money ceased in 1986 though its importance, along with a narrow money target, continued to be stressed. Narrow money (M0) came to be used as an indicator of economic conditions as it related to current consumer behaviour.

THE MONETARY AGGREGATES — Box 2

Official estimates of the money stock have been published since 1966. The earliest definition of the money supply was a broad one covering notes and coin held by UK non-banks and deposits (in both sterling and foreign currency) held by UK residents with banks in the UK. From 1970 onwards, this definition has been amended and supplemented on a number of occasions, reflecting developments in the financial system and policy.

Common practice amongst central banks is to construct monetary aggregates from a list of monetary assets by adding together those that are considered to be likely sources of monetary services.

M0 = Notes and coin in circulation + bankers' balances (banks' non-statutory deposits with the Bank of England)
M4 = Notes and coin held by the private sector
+ Private sector £ non-interest bearing sight bank deposits
+ Private sector £ interest bearing sight and time bank deposits
+ Private sector holdings of £ certificates of deposit
+ Private sector holdings of building society shares and deposits and £ certificates of deposit
Building society holdings of bank deposits and bank certificates of deposit and notes and coin.

M4 can be analysed either in terms of its components - cash and deposits - or of its counterparts, which represent the other side of the banks' and building societies' balance sheets (and must, as an accounting identity, sum to the same). These counterparts include banks' and building societies' lending to the private sector and their transactions with the public sector and with overseas residents.

For a period in 1987-88, monetary policy was constrained by the objective of holding the sterling exchange rate below DM3=£1. However, the low interest rates needed to maintain this were in place at a time of high domestic demand and thus inflation increased rapidly. In October 1990, the UK entered the European Exchange Rate Mechanism (ERM). The UK was obliged to keep sterling within pre-set limits relative to the other member currencies. To begin with this was helpful in bringing down both interest rates and inflation. However, exchange rate pressures grew as the contrast between the post-reunification boom in Germany and the recession in the UK persisted, and the UK was forced by market pressures to suspend its membership of the mechanism in September 1992.

On leaving the ERM, the Government adopted for the first time an explicit inflation target measured by the Retail Price Index excluding mortgage interest payments. Originally set at an inflation rate of 1-4%, with the objective of being in the lower half of that range by the end of the 1992-1997 Parliament, the target was subsequently revised to 2.5% or less. Although decisions on changes in interest rates remained with the Chancellor of the Exchequer, the Bank gained autonomy in publishing its economic appraisals (the *Inflation Report,* which has been published quarterly since February 1993) and in deciding the timing of interest rate changes. The monthly monetary meetings to review the level of interest rates were formalised and the minutes of the meeting were published two weeks after the subsequent meeting took place. These arrangements continued until May 1997 when the Chancellor announced the changes detailed on page 1. The Bank of England Act 1998 (which came into force on 1 June 1998) put the changes on a statutory footing.

SOME ALTERNATIVE TECHNIQUES

Over the years a range of possible alternative techniques of monetary control have been suggested.

Monetary base control

The money supply is given by the deposit liabilities of the banking system, and it is tempting to suppose that if there were a stable relationship between some or all of these liabilities and the "base money" requirements of the banking system (that is the system's holdings of balances at the Bank of England, and notes and coin), then the authorities might be able to control the money supply by controlling the amount of base money. There was an extensive debate on monetary base control in 1980-81. The conclusion was that not enough was known about the stability of the demand for base money to make a firm conclusion about the merits of monetary base control possible, but it was not clear that it would provide a more effective means of monetary control than was provided by management of short-term interest rates.

Direct controls on lending

Direct controls on credit are often suggested as an alternative to reliance on interest rates. However, as was demonstrated in the 1950s and 1960s, they introduce rigidities and reduce competition in the financial system. In today's world of deregulated and sophisticated international financial markets, borrowers and lenders would almost certainly be successful in avoiding such controls. Not surprisingly under these circumstances, most monetary authorities world-wide which used to rely on credit controls have either ended them or are in the process of doing so.

Reserve requirements

In some countries banks are required to place a proportion of their liabilities as deposits, often non-interest-bearing, with the central bank. These requirements can help to create liquidity shortages through which the central bank influences interest rates. When they are non-interest bearing they also affect the size of the margin above money market rates that the banks need to charge on loans to their customers. To the borrowers, the effect is indistinguishable from that of a higher general level of interest rates. However, the Bank has no difficulty in creating the shortages of liquidity necessary for its money market operations without the use of reserve requirements. The Bank does have the facility to call for special deposits; these would be interest-bearing, but no call has been made since 1979. There is also a requirement on the banks and building societies to place a small proportion - currently 0.15% - of their liabilities with the Bank of England on a non-interest bearing basis. This has no monetary policy purpose - the intention is simply to secure the income and resources of the Bank, and the ratio is revised from time to time in the light of that requirement alone.

Further reading

"The Bank of England Act", Peter Rodgers, Bank of England Quarterly Bulletin (BEQB), May 1998.
"Changes at the Bank of England", Peter Rodgers, (BEQB), August 1997.
"Financial Statement and Budget Report", HM Treasury, March 1998.
"The Bank of England's operations in the sterling money markets,(BEQB), May 1997.
"The Conduct of Monetary policy", CAE Goodhart, The Economic Journal, June 1989.
"Monetary Policy in the Second half of the 1980s", Lecture given by The Governor of the Bank of England, BEQB, May 1990.

The Inflation Report and the Bank of England Quarterly Bulletin may be obtained from the Publications Group, Inflation Report Division, Bank of England, Threadneedle Street London, EC2R 8AH (Tel: 0171 601 4030).
This Fact Sheet is one of a series published by the Bank of England. Copies (and copies of the quarterly "Bank Briefing") may be obtained from the Secretary's Department, Bank of England (Tel: 0171 601 4012).

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