An Evaluation of Inflation Targeting in Germany and the UK

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Whatever technical means may exist in this or that climate of public expectation and assumption, in this or that historical era and conjuncture, to prevent or to halt a continuing rise of prices in general (a fall in the value of money), these means will not be applied if they obstruct the vote-gathering purpose of a Government dependent on popular support.

G. L. S. Shackle[1]

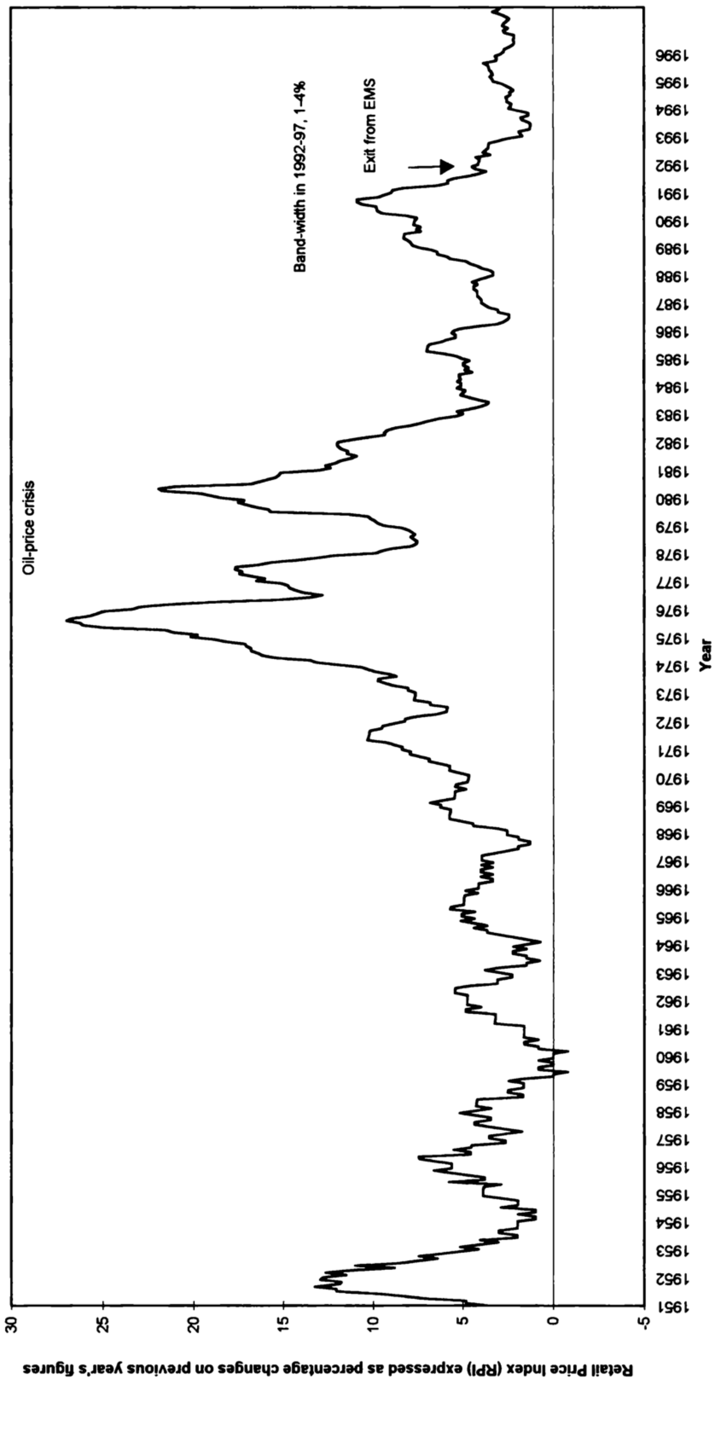
I. Introduction

Maintaining price stability has been the principal goal of the *Deutsche Bundesbank*. Indeed, that is its main mandate under the Bundesbank Law of 1957 (*Gesetz über die Deutsche Bundesbank* of 26 July 1957 which came into effect on 1 August 1957).[2] The planned European Central Bank – based to a large extent on the Bundesbank model – will, according to Article 2 of its constitution, likewise have to ensure monetary stability. By contrast, the UK has had limited success in this respect, despite a shift in policy towards beating inflation since the late 1970s. Political pressure for monetary stability had been less strong in the UK than in Germany, where each of the two world wars was followed by hyper-inflation.[3] In a 1995 article in *The Guardian* newspaper, Will Hutton expressed the opinion that a low inflation rate is not very popular in Britain. "Inflation", he wrote, "was the motor of the economy, which brought about a boom in property prices and investments. Without it everything seems lifeless" (Hutton, 1995).

1 *Shackle,* 1972, 35.

2 For an account of the concept and implementation of monetary targeting in Germany, see *Schmid,* 1995 and 1998.

3 For a defence of price stability on ethical grounds, see *Tietmeyer,* 1993. There are also renewed arguments in favour of price stability by the former Bundesbank President, Helmut Schlesinger (*Schlesinger,* 1996).



UK Retail Price Index
Percentage changes on previous year's figures

Figure 1: Inflation Rates in Great Britain 1951 - 1997

Price instability in Great Britain between the early 1950s and the early 1990s (Figure 1) far exceeded that in the Federal Republic of Germany. The reasons for this are manifold: it certainly was not simply the consequence of a Keynesian short-term demand management policy with high rates of employment and growth as its primary goals. True, the positive end-results – they had, to a large extent, been achieved in the 1950s and 1960s – were often accompanied by higher inflation rates (Hayek, 1974). However, the latter were blamed, at least in part, on the strength and stance of the UK trade unions, which subsequently had their wings clipped under the impact of Thatcherite legislation and economic policies undermining trade union strength. Furthermore, one can trace back the consequences of a monetary and exchange-rate policy determined (especially during election periods) largely by political factors. In the UK, these policies until the election of the Labour government of 1 May 1997 were decided by the government and not, as in Germany, by an independent central bank. Until the recent change of government which in the first few days in office granted independence over base interest rate policy to the Bank of England, Britain suffered from 'stop-go' policies, which led eventually to a deepening and widening of the business cycle. The high wave of inflation of the 1970s in the UK is usually but mistakenly ascribed wholly to the raising of the price of oil by the Organization of Petroleum Exporting Countries (OPEC). This is evidenced by the inflation rate in West Germany, which remained well below that in Britain despite the fact that both economies had been similarly affected.

II. Experiences with Money-Supply Control and Alternative Concepts

In the UK, the first steps in the direction of money-supply targeting were taken in the late 1960s, having been imposed initially by the IMF when granting loans to the UK (Letter of Intent, November 1967). The goal was a reduction in the growth rate of the money supply. In a second Letter of Intent, the British monetary authorities committed themselves to setting a target for the rise in Domestic Credit Expansion in the fiscal year 1969/70. This was linked to a greater flexibility in interest-rate policy. Those first steps were instituted after radical changes to the regulation of the British monetary system, following the Bank of England document *Competition and Credit Control* which was published in September 1971. The goals were twofold: first, to create greater competition amongst British financial institutions by abolishing direct controls and cartel arrangements and, second, to achieve a more effective control over money- and credit-creation. The Bretton Woods system collapsed in 1973 and, with it, the system of fixed exchange-rates. Although this would have enabled an immediate independent monetary policy, money-supply targets were not introduced by the (then Labour) government until 1976, following yet another IMF Letter of Intent that year. The reason for the introduction of money-supply targeting was thus less to do with a convinced monetarist philosophy than with IMF pressure in the form of a pre-condition for the grant of the requested loan. In spite of its limited success, incomes policy remained the preferred instrument for beating inflation. Perseverance with that policy led ultimately to the 'winter of discontent' which led to Labour's defeat in the general election of 1979.

A more convinced monetarist policy was not introduced until May 1979 in an attempt by the newly elected Conservative government to replace the short-term Keynesian stabilization policy with a medium-term anti-inflation policy based largely upon monetary control measures. However, even the Conservative government rarely achieved the set money-supply targets, no matter which monetary aggregate was used (Arestis et al., 1993).

The extensive deregulation and financial innovations, which began in the 1970s and peaked in the late 1980s, led to extended instability in the demand for money, especially in Anglo-Saxon countries, but also in other industrial countries – apart from the Federal Republic of Germany (Buscher and Frowen, 1993). This development deprived the affected countries of the operational basis for any sound money-supply targeting. In the UK, money-supply targeting was rapidly replaced as an intermediate target by an exchange-rate target within the framework of the European Exchange Rate Mechanism (ERM). The expectation was that, thanks to the stability of the Deutsche Mark as the anchor currency, monetary stability could be imported. But the price for this stability – in the form of escalating short-term nominal interest-rates due to the Bundesbank's policy of high short-term nominal interest-rates following the reunification of Germany – was a deepening of the economic recession, which posed excessive and politically unsustainable pressures. When the UK left the ERM in September 1992, therefore, exchange-rate targets were replaced by a single-stage strategy of direct inflationary control by means of pre-announced medium-term inflation targets. In this respect, Britain followed the example of New Zealand, to find itself also in the company of Canada, Sweden and Finland (Leiderman and Svensson, 1995; Ammer and Freeman, 1994; Haldane, 1995 and 1996), but the absence of a largely independent central bank in the UK at the time differentiated it from all of these countries.

Which price index to use in such inflation targeting remains a controversial issue. It is basically an economic problem, and an international working-group of statistical experts has been probing into this area with the aim of developing a harmonized consumer price-index which can be used also when discussing convergence criteria relating to monetary stabilization.

III. Government versus Central Bank: Responsibility for UK Monetary Policy until May 1997

As is well known, the Bank of England, as the central and note-issuing bank of the UK, did not until recently enjoy the autonomy of the Bundesbank in the area of domestic monetary policy. (There is no Bundesbank autonomy in the field of international monetary agreements, and its autonomy in exchange-rate policy is restricted (Kath, 1995, 61 - 62).) The final decisions about monetary and exchange-rate policy in the UK rested with the British government, which had to defend those policies before Parliament via the Chancellor of the Exchequer. The Chancellor presented policy decided upon or to be proposed in his Annual Financial Statement. This contained the framework of his monetary policy along with recommendations about taxes and government spending. The idea behind monetary and fiscal policy being decided upon by government is that this should prevent conflict between monetary and fiscal policies, thereby avoiding difficulties such as those experienced by Germany after reunification.

The link between monetary and fiscal policy is a complex issue. How far can a tight monetary policy accompany and counteract loose fiscal policy? What are the consequences? Does the German situation provide an answer? As Tony Cramp of Emmanuel College, Cambridge, has pointed out in his much-appreciated comments on this paper: "...those links surely underlie/reflect a political reality – that, whatever the institutional central bank format, some kind of accommodation/reconciliation of fiscal/monetary objectives must always be found." Cramp is unsympathetic to the idea of central bank 'independence' as, in his view, it cannot be real: "if the political authorities permit the central bank to pursue its objectives, it is because they share them." This may apply at the time independence is granted to a central bank but, at a later stage, the objectives of fiscal and monetary policy may well diverge for political reasons, with the government pursuing an expansionary fiscal policy which is then counteracted by a tight monetary policy pursued by the central bank. The question then arises as to how far tight monetary policy can accompany loose fiscal policy. This is certainly possible in the short- to medium-term, but can scarcely extend beyond a five (maximum seven) year period. Current account deficits would cause a deterioration in the net foreign-asset position, and the public debt would rise through budget deficits. Initially, the latter are themselves the result of increased government spending; subsequently, they are due increasingly to the central bank's tight monetary policy, and lead to higher interest rates, a decline in economic activity, and an increase in unemployment.

Conflicts of this type have indeed arisen in Germany, and the Bundesbank's monetary measures have at times been in direct conflict with the policy objectives of the Federal government. This was possible as the Bundesbank's primary mandate to maintain the stability of the Deutsche Mark supersedes its mandate to support the government's general economic policy. The lack of opportunity to use monetary policy for political reasons, and the skillful use made of its independence by the Bundesbank and its policy-making Central Bank Council (whatever misjudgements may have occurred at times), are certainly the cornerstones on which the credibility of German monetary policy rests. But to say that price stability necessitates central bank independence would be going too far. There is the example of stability-minded Japanese governments achieving a high degree of monetary stability without an independent central bank (Kath, 1995).

In the UK, the so-called 'monetary authorities' to which reference is often made included the Treasury, the Bank of England and, sometimes, the Prime Minister. The functions of the Bank of England in this respect were twofold: first, it acted as advisor to the government and, second, it had the responsibility of carrying out government monetary policy. It is also worth noting that, in contrast to Germany, Great Britain does not possess a decentralized central banking system. Nevertheless, the regular meetings between the Chancellor and the Governor were not bilateral, but were attended by a variety of directors and officials from each side.

It was not until the early 1990s that the British government took the first steps to grant a greater degree of independence to the Bank of England as part of its (the government's) anti-inflation policy. Of decisive importance in this development were the recommendations of the Treasury and Civil Service Committee in its 1993 report on the role of the

Bank of England. By far the most important recommendation was that the Protocol of the monthly meetings between the Chancellor and the Governor of the Bank of England be made public 14 days later, the aim being to increase the transparency both of monetary policy and of responsibility for monetary policy decisions (Treasury and Civil Service Committee (1993), *The Role of the Bank of England,* Vol. I, para. 104 iii).

IV. Innovations in British Monetary Policy

Far-reaching innovations in British monetary policy began in September 1992 when Britain left the Exchange Rate Mechanism (ERM). The high short-term nominal interest-rates which were necessary to keep the exchange rate stable as against the Deutsche Mark were, as noted above, held to some extent responsible for the deepening British economic recession and had disadvantageous political consequences for the then Conservative government. In this way, within the framework of a monetary policy innovation, the exchange-rate target was replaced by an inflation target. This new development was introduced in part with the hope that expected price rises and other undesirable consequences could be reduced without creating negative consequences for the growth rate and rate of unemployment.

In particular, it was decided to introduce:

- a duty to publish detailed reports in the Press of changes to the official interest-rates (start-date October 1992)
- the publication of a monthly report on monetary policy by the Treasury, appearing on the same day as the monthly discussions between the Chancellor and the Governor (start-date December 1992, but ceased in December 1995)
- the publication of the minutes of the meeting between the Governor and the Chancellor, appearing after an interval of six weeks (occurred between April 1994 and the arrival of the new Labour Government in May 1997. This was no doubt the biggest transparency innovation since the last framework was put in place).
- the publication of a quarterly report on inflation by the Bank of England (start-date February 1993); since November 1993, the *Inflation Reports* have been presented to the Treasury in their definitive form so that the latter has no opportunity to make changes.

It may also be noted that, although decisions about changes in the rate of interest remained in the hands of the Chancellor of the Exchequer, decisions about the exact timing of the changes in the rate of interest have, between November 1993 and May 1997 lain with the Bank of England, which announced the new interest rate.

The goal of the then British government was simply to keep the underlying rate of inflation, measured in terms of the Retail Price Index less the Mortgage Interest Rate, within a range of 1 - 4 %. The actual target was the lower reaches of this band (between 1 % and 2.5 %). That was eventually achieved, and Great Britain had its lowest rate of inflation for 30 years. A new inflation target – 2.5 % or less by the end of the last Parliament – was affirmed in the UK in June 1995.[4] However, the continual weakness of the pound on the foreign-exchange markets had been one of the factors at the time leading to a new rise in inflation which the Chancellor of the Exchequer, contrary to the advice of the Governor of the Bank of England, did not seek to reduce by raising interest rates.[5] There were two reasons for this, both political.

First, there were signs of the beginning of a weakening of the economic upswing, and the then Conservative government – suffering a downturn in popularity – wanted to avoid another recession in the run-up to the general election of May 1997. Second, the majority of the British are burdened with high mortgages. As a consequence of the collapse of the British property market since the end of the 1980s, the value of the mortgage had in many cases become higher than the value of the property ('negative equity').[6] Up until then, the high rates of inflation had led to sharp rises in property prices, spurred in part by negative real interest-rates. This development led to a portfolio adjustment of enormous size and caused a considerable rise in credit, covered by the increasing nominal value of property. This credit was then used to purchase other assets, including consumer durables, stocks and shares, and liquid assets (Flemming, 1992, 123 - 125). Moreover, these trends also boosted aggregate investment on capital goods.

In the first half of the 1990s, as a result of the property-market collapse, every rise in the official rate of interest, leading as it does to a rise in mortgage interest-rates, carried a high political risk (despite the moderate recovery of the housing market) which the then Chancellor of the

4 See *King,* 1995, for a review of this policy.

5 By October 1996, the headline inflation rate had in fact risen to 2.7 %, and the Labour Chancellor of the Exchequer increased the base rate to 6.25 % within days of taking office in May 1997, and it was raised further to 6.5 % in June by the Monetary Policy Committee at its first meeting.

6 At the end of September 1995, 1.12 million households came into this category.

Exchequer, facing an election, naturally wished to avoid. The advice of the Governor of the Bank of England – the 'Voice of Reason' – was scarcely listened to at such a time. It is well documented that, since the middle of 1995, the views of the Governor and the then Chancellor did on a number of occasions diverge over decisions on interest rates: although they themselves have repeatedly described the difference between them as no more than a narrow and technical one, events subsequently resolved that difference in the then Chancellor's favour. Hence, the Bank of England revised its advice to raise interest rates from the autumn of 1995. In fairness, it should be stressed that all the most recent interest-rate adjustments up to the Labour victory had been jointly agreed. Nevertheless, there has always been in our view a deep need – arguably a necessity – for a monetary policy which is free from the influence of political considerations. Such a policy would, of course, be most efficiently pursued by an independent central bank, otherwise all innovations in the areas of British monetary policy and inflation targeting would have been in danger of being wrecked by political pragmatism. It is therefore with some satisfaction that we noted the granting to the Bank of England of control over base interest rates by the incoming Labour Government.

Inflation rose in 1995 as a result of the overheating of the economy in 1994. However, the economy cooled down in 1995 in response both to the tight fiscal and monetary policies adopted and to the deceleration of economic activity in Europe and the US. The recently announced (September 1996) revisions of national income accounts from the beginning of 1996 show that the economy grew at around potential output throughout 1996. All indicators suggest that it has become overheated in 1997 as consumer confidence increased and the saving ratio fell. Inflation bottomed and started to climb again (see Figure 10 for a recent update of inflation in the UK). This has enhanced the case of the Bank of England for monetary tightening and the then Chancellor increased rates to 6 % from October 30 1996, and the new Labour Chancellor endorsed a further increase to 6.25 % immediately after taking office.

Looked at objectively, the strive for flexibility by the Chancellor has the advantage that external factors, such as higher raw material prices, or a weakening in the pound's exchange value, do not require an immediate change to interest rates. Without this possibility of the absorption of "supply-side price shocks", the "tendency towards inflation" of politicians (especially before an election) could, in the case of an independent central bank, easily develop into a "tendency towards recession" (Leiderman and Svensson, 1995). And this – as feared by some left-wing Labour MPs, and not least by the previous Conservative Chancellor – could constitute an inherent danger of Bank of England control over base interest rates.

One has also to remember that, in Great Britain, a rise in interest rates in the short term could actually raise the inflation rate if increased mortgage interest payments lead to higher wage demands, while at the same time weakening industrial investment and thereby the rate of expansion of productive capacity at a time when capacity is already utilized to its fullest extent.

V. The Monetary Policy Framework since May 1997

Mr Gordon Brown, the new Labour Chancellor of the Exchequer, in his letter to the Governor of the Bank of England outlining the new monetary framework, stated that "price stability is a pre-condition 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", thereby bringing in line the UK with the view repeatedly expressed by the Bundesbank (see e.g. Tietmeyer 1993, 1996; Frowen and Pringle 1998). For the Bank of England to deliver price stability as defined by the government's inflation target, his surprise move was to grant independence to the Bank of England over operational responsibility for setting short-term interest rates. The inflation target itself will be confirmed by the UK Government in each Budget Statement.

In line with the Bundesbank the Bank of England, too, will have to support the government's economic policy including its objectives for growth and employment. However, the Chancellor has not made explicit what would happen if these targets are conflicting. In the case of Germany the Bundesbank will support the objectives of growth and employment, but only to the extent that this will not jeopardise its primary goal of price stability.

As far as accountability is concerned the Bank of England will have to justify its monetary policy actions by the publication of minutes of proceedings and votes of the Monetary Policy Committee. If the Bank fails to meet the new inflation target of 2.5 % by more than ±1 %, then it would have to explain and state the policy action proposed to be taken in a letter to the Treasury. The Bank of England will continue to justify its overall view of the economy in its quarterly Inflation Reports and by submitting special reports to and giving evidence to the Treasury Select Committee of the House of Commons. Openness of decision-making will be strengthened by regional representation at the Court of the Bank of England whose tasks include a review of the preformance of the Bank of England, including the Monetary Policy Committee.

The new Monetary Policy Committee would be responsible for operational decisions on interest rate policy, except in exceptional circumstances in which the decision will remain with the UK Government subject to parliamentary approval. The committee will consist of the Governor, two Deputy Governors, and six members with each member having one vote and the Governor having a casting vote. All members will be appointed for a three year period. Two of them will be appointed by the Governor, after consultation with the Chancellor, and the other four by the Chancellor himself.

The Treasury will have the right to be represented at the monthly meetings of the Committee in a non-voting capacity. This latter arrangement, too, is in line with Bundesbank practice whereby the Federal Government is entitled to be represented at the meetings of the policy-making Central Bank Council, again with no voting right, but with the right to postpone the implementation of any policy measure for a fortnight.

The UK Government will remain responsible for determining the exchange rate regime, but will continue to use the Bank of England as its agent for intervention in the foreign exchange markets. However, the Bank of England's previous role held for over 300 years as the government's agent for debt management, the sale of gilts, oversight of the gilts market and cash management will be transferred to the Treasury.

VI. British Inflation Indices

The Retail Price Index (RPI) is the headline measure and includes all items. Since 1992, the inflation target of the British government relates to RPIX; this is the RPI over a 12-month period, excepting mortgage interest payments. RPIX forms the basis of the government's inflation target which for the Conservative government until May 1997 was a band of 1 - 4 %[7] to be replaced by the new Labour Government by a fixed inflation target of 2.5 % with a margin of ±1 %.

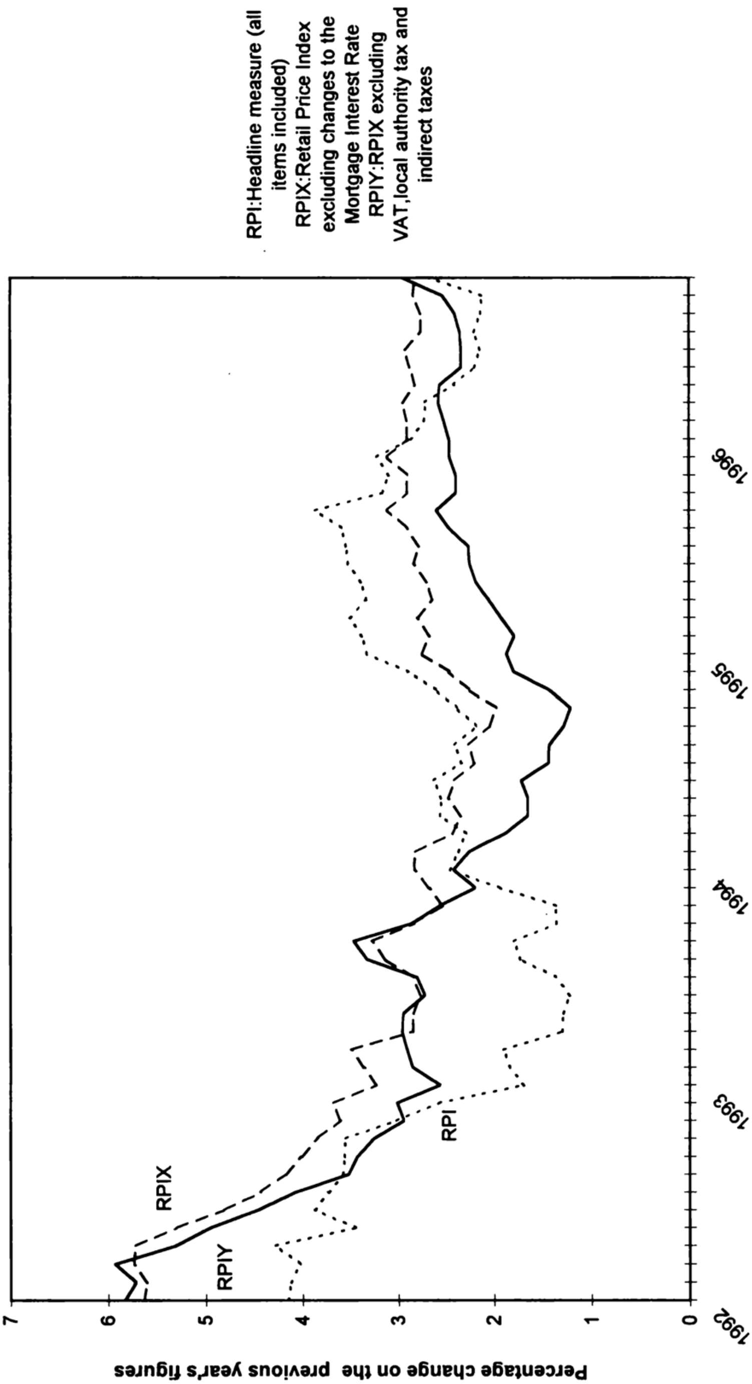
[7] A fuller discussion of UK inflation indices is provided in the Bank of England's *Inflation Reports*.

For the government, the choice of RPIX as the inflation target has one major advantage. The exclusion of mortgage interest payments means that a rise in interest rates does not immediately affect RPIX (as opposed to the RPI). In the words of Charles Goodhart: “Varying interest rates in response to an RPI which had itself varied because of a prior movement of interest rates would be an own goal” (Goodhart, 1992, 145). This implies that RPI overstates the true inflationary pressures compared with the RPIX when the government in an effort to reduce inflation is raising interest rates. Conversely, when interest rates are falling RPI is understating the inflationary pressures in the economy compared with RPIX.

The favoured price index of the Bank of England is RPIY; this excludes VAT, local authority tax, and indirect taxes. RPIY therefore measures the so-called ‘underlying rate of inflation’, which stands at a level lower than RPIX inflation during periods when VAT, indirect taxes and local authority taxes are rising (Figure 2). The justification for the Bank’s preferred measure is that it cannot be influenced by government manipulation of indirect taxes. The latter may be significant for electoral reasons, but it does weaken the worth of the chosen inflation target.

Since 1994, a sub-division of RPIY into ‘tradeable’ and ‘non-tradeable’ shows a reduction in the inflation differential for these two groupings, with rising inflation in the former and falling inflation in the latter (Figure 3).

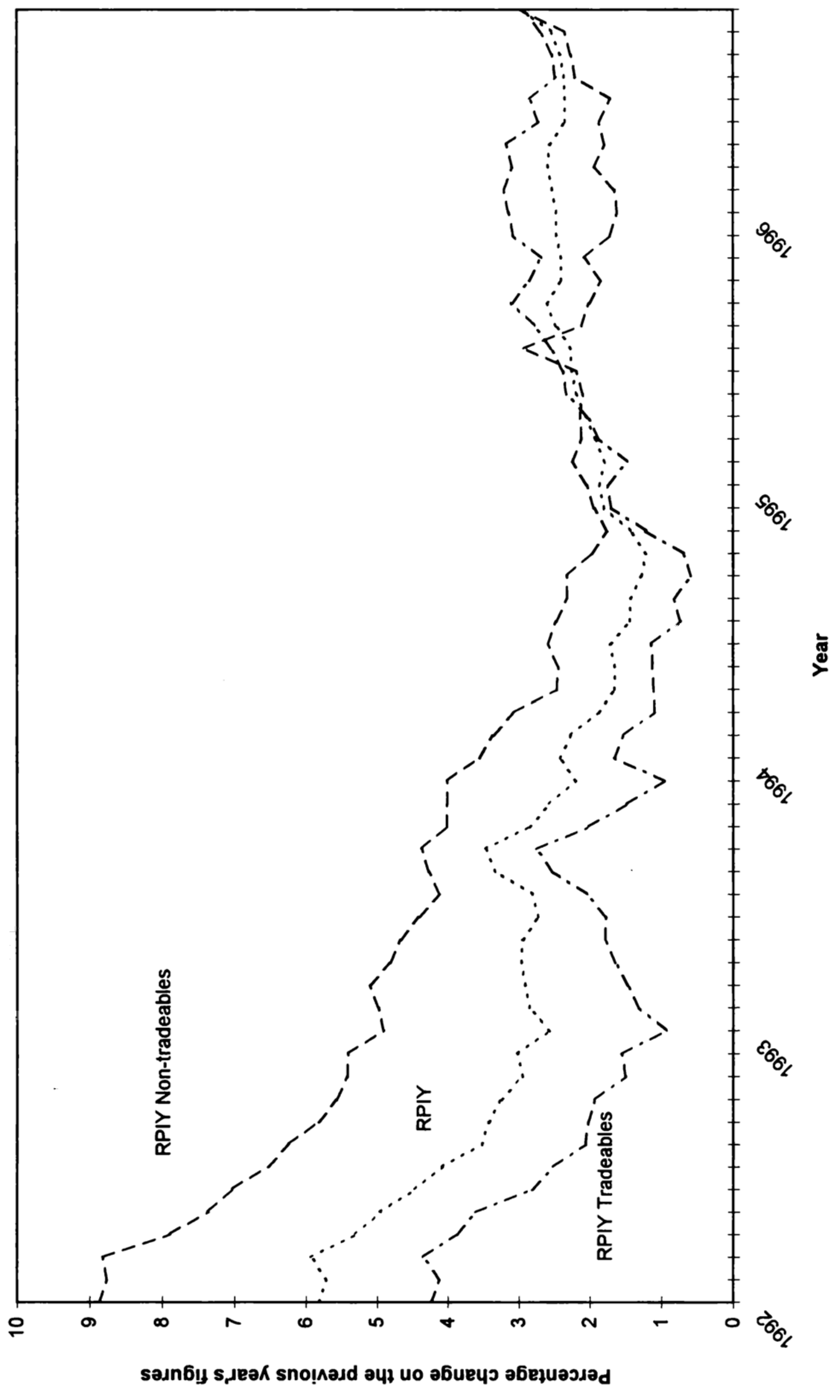
Two further inflation indicators are taken into account in the case of RPIX and RPIY. First, the cost of mortgages for houses and flats, whose indicators bear the abbreviations RPIX (HARP) and RPIY (THARP) respectively. Partly because of the considerable drop in property prices, there were times during the first half of the 1990s when both of these adjusted indexes showed a considerably lower rate of inflation (Figure 4). Second, both RPIX and RPIY are based upon prices which are subject to strong variations or large price changes over irregular time-spans; the solution to this problem is to use the so-called ‘median inflation rate’, which is a weighted median of price rises of all components of the RPI over a 12-month period. A ‘trimmed-mean measure’ is also used, from which the largest and smallest 15 per cent of price changes are removed before calculating the average change in price of the remaining components. Whilst the curve of the ‘trimmed mean inflation rate’ since 1992 followed that of the RPIY, the ‘median inflation rate’ was liable to large shifts and, in 1994, lay considerably below the RPIY index (Figure 5).



PRIX: Retail Price Index excluding changes to the Mortgage Interest Rate
PRIY: RPIX excluding VAT, Local Authority Tax and indirect taxes

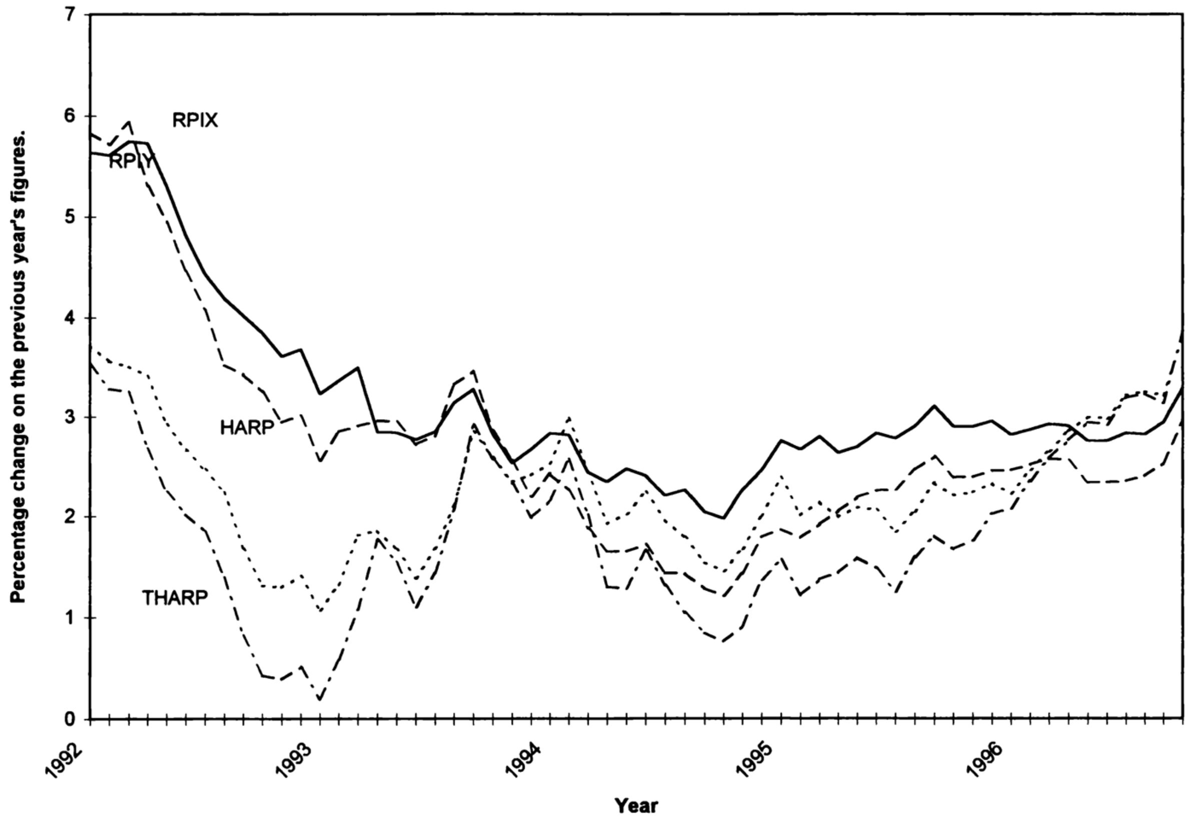
Source: Central Statistical Office and Bank of England calculations.

Figure 2: Inflation Rates in Great Britain 1992 - 1997



Source for British figures: Central Statistical Office and Bank of England.

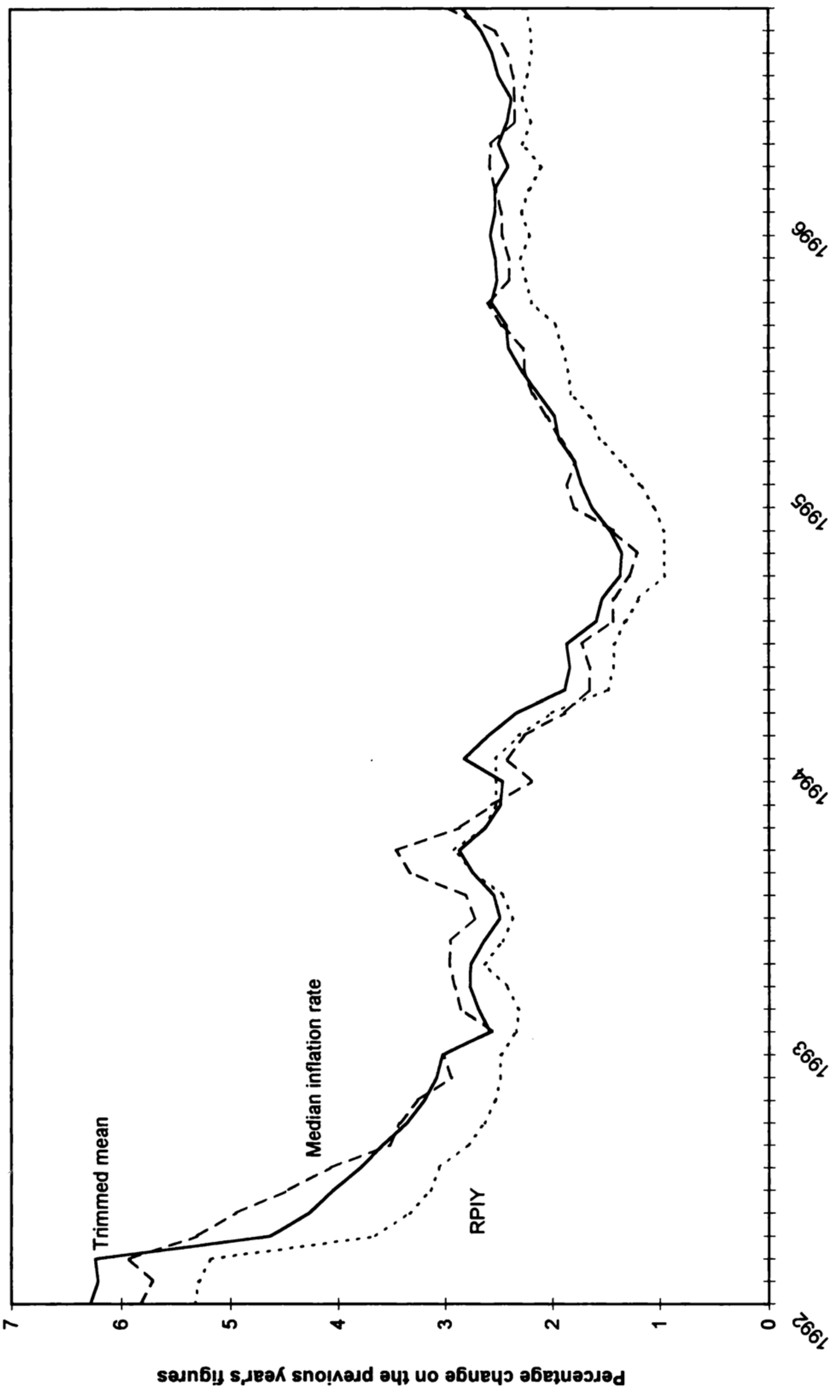
Figure 3: RPIY Inflation for Tradeables and Non-Tradeables in Great Britain, 1992 - 1997



HARP: Housing adjusted Retail Price Index applied to RPIX
THARP: Housing adjusted Retail Price Index applied to RPIY

Source: Central Statistical Office and Bank of England.

Figure 4: Housing Adjusted Inflation Rates 1992 - 1997



Source: Central Statistical Office and Bank of England.

Figure 5: Alternative Inflation Measures 1992 - 1997

By comparison with the RPI, the Gross Domestic Product (GDP) deflator is an all-embracing measure of inflation but, because of its greater susceptibility to revision, is not necessarily more accurate than the RPI. It has a wider basis and takes into account the special government services, thereby covering the whole economy. The RPI, by contrast, merely measures that which affects the majority of the population. The tendency to overstate the true rate of general price changes applies to *all* inflation indices.

VII. Basic Principles of British Monetary Policy in the 1990s

After giving up the exchange rate as an intermediate variable in the early 1990s, the single-stage strategy of direct steering of the final goal of monetary (that is, price) stability was introduced. This principle was developed in the 1970s by B. M. Friedman in his "optimal control theory" (Friedman, 1975). The main instrument of monetary policy for achieving inflation targets is the official short-term nominal interest-rate. As there is a time-lag before changes in the rate of interest impact the rate of inflation, decisions about interest rates today depend upon the expected rate of inflation in one to two years' time. The estimate of the expected rate of inflation itself is based upon a range of sources, and takes account of the following indicators:

- *monetary and other indicators of the financial sectors*
  - the growth rate of the narrow money supply (M0) – bank-notes and coins in circulation, plus the lending banks' central bank deposits
  - the growth rate of the broad money supply (M4) – notes and coins plus all retail and wholesale deposits, including those held with building societies
  - movements in the exchange rate
  - movements in the price of assets (e.g. property)
- *indicators of economic activity*
  - wage- and price-settlements of firms and employees
  - decreases in excess capacity, rising retail sales and a shortage of labour (these are signs that total demand is in excess of productive capacity and can, therefore, be read as indicators of a rise in inflationary pressures)
- *cost indicators directly influencing final prices*
  - wages
  - raw materials prices.

The rate of inflation in an open economy is heavily dependent upon changes in the exchange rate. The exchange rate plays an important part in an inflation-targeting system because it influences import and export prices and, by this means, the final price of goods as well as wages. Nobody can correctly predict the external and other influences on the rate of inflation for a period 18 to 24 months ahead, and movements in the exchange rate play a decisive role when considering interest-rate changes or alternative measures. The Bank of England projections of inflation are, of course, conditional upon the explicit assumption that official interest-rates are maintained at current levels; the uncertainties and risks attached to these projections are then assessed in detail in its *Inflation Reports*.

VIII. Existing Problems of Interest-Rate Determination and Interest Structure

The official rate of interest of the Bank of England is to be set according to the new framework – as noted above – by the newly established Monetary Policy Committee of the Bank of England. This rate constitutes the rate of interest that the Bank of England is prepared to pay on short-term securities with a maturity of one month or less. The effectiveness of this interest-rate policy arises from the convention that each of the clearing banks sets its own Base Rate – upon which its debit and credit rates depend – in such a way that the clearing banks follow closely the movements in Dealing Rates of the Bank of England. In theory, difficulties could arise when the longer-term rate of interest (for example, the 3-month rate) exceeds the Base Rate. It could then become profitable for bank customers to 'borrow short and lend long'. To prevent this, the clearing banks would have to raise their respective Base Rates and, as a consequence, the differential between the clearing banks' Base Rates and the Bank of England's own Dealing Rate would rise correspondingly. In order to reduce this differential, the Bank of England would be inclined to raise its Dealing Rate. Thus the official interest-rate would rise without this having been a deliberate step to fight inflation; rather, the rise in the official rate would have been forced upon the Bank of England by financial markets. All this emerged as a major problem in the early 1970s after the implementation of the recommendations of *Competition and Credit Control* (see above). However, none of this yield-curve pivoting appears to be evident in the differential between Base Rates and the Bank of England's Dealing Rates nowadays; it does, nevertheless, occur between long- and shorter-term money-market rates. But even then it presents no operational problem in the setting of monetary policy because the Bank is fixing (say) 1-month rates, and it is very short-term rates (overnight rates, for example) which bear the brunt of the pivoting.

IX. Price Stability as a Final or an Intermediate Goal?

That price stability, at the end of the day, is not the final goal of British monetary policy, has been stated repeatedly by the Governor of the Bank of England in monetary-policy speeches. He quite clearly regards the final goal of monetary policy not as the control of inflation, but as the improvement of welfare and the achievement of a higher standard of living. In his opinion, price stability and control of inflation are merely important prerequisites for achieving those objectives. On this view, inflation targets now to be set by the Treasury would be no more than intermediate goals of monetary policy. The emphasis on economic growth as the direct final goal and as a means of combating unemployment, he sees as leading once again to the dangers of the stop-go policies of earlier periods of the post-war years.

Meanwhile, the deviation between expected inflation and the target has narrowed significantly over the inflation-target period, and credibility has improved. However, if the statements by Bowen (1995) of a deviation of the long-term anticipated inflation-rates from the set targets should prove correct in the future, the possibility that, in due course, the search will be on for a new nominal anchor should not be underestimated.

It must be hoped that earlier indications, partly economic and partly political, that the UK may not be successful in pursuing its anti-inflation policy over longish periods will prove to be unfounded under the newly elected Labour Government. To be firmly based, such a policy necessitates the same degree of public support for price stabilization as the Bundesbank has enjoyed throughout the post-war era and hopefully the new UK Government will encourage. It can be argued, of course, that any country with inflation-fear on the scale of that in Germany would be able to pursue a price-stabilization policy even in the absence of an independent central bank, as in fact happened in Japan (Kath, 1995). Unfortunately, this has not so far been the situation in the UK. Thus price stabilisation even more urgently required an independent central bank, now created to everybody's surprise by the Labour Government. Nevertheless, the policy of reliance upon the greatest number of economic indicators is likely to continue under the Labour Government – a form of multi-indicator-system or, as Otmar Issing calls it, *"Multiindikatorenansatz"* (Issing, 1994, 690) – with the final goals being a level of growth the economy can afford and a maximum level of employment. Such a policy, flexibly constructed, will require a wide range of intermediate goals, among which price stability must play a significant role if the final objectives of a high level of growth and employment are to be ensured in the long run. Such an approach would also help to meet the criteria for possible UK membership of the European Monetary Union.

Comparing the UK with the German situation we find that in Germany, too, inflation targeting in reality appears to have played a greater role than money supply targeting. In the words of former Bundesbank President, Helmut Schlesinger, one can regard this concept of monetary control based on a wide range of indicators as "pragmatic monetarism" which, according to Jürgen von Hagen (1995), the Bundesbank has pursued all the time in spite of its own concept of money-supply targeting. Bofinger (1995), too, expresses the view that the Bundesbank has in practice followed a strategy of "inflation targeting" similar to that of the Bank of England today. Thus, the Bundesbank's credibility has been depending heavily on its successful anti-inflation policy through unannounced inflation targets rather than on its money-supply targets which, more often than not, were exceeded (Bofinger, 1997, 218). Nevertheless, Otmar Issing maintains that "in the longer run there is a fairly close link between the monetary aggregate M3 used by the Bundesbank as an intermediate target and the price level" (Issing, 1993, 46). This is confirmed by empirical studies carried out by the Bundesbank (Deutsche Bundesbank, 1992).[8] In the short run control of the German money supply is increasingly carried out through open market operations using repurchase facilities and the "repo" rate. Consequently, the importance of the discount and Lombard rates and minimum reserve requirements have diminished.

The best method by which to compare the widely differing experiences with inflation targeting as between Germany and the UK appears to be the 'optimization approach' to economic policy formulation. The theoretical framework of this approach is outlined below, and is followed by a

[8] For further details of the concept and implementation of monetary targets in Germany, see *Schmid,* 1995. There is also a defence of money-supply targeting for Germany by Reinhard Pohl, who maintains that the alternative method of inflation targeting can anyhow not do without intermediate variables (*Pohl,* 1996).

detailed discussion of the results obtained when the experiences of Germany and the UK are compared.

X. The Theoretical Framework for Comparison of Inflation Targeting

Basically we can think of two types of monetary control, one in which policy is conducted by an autonomous central bank which is obliged by law to follow a policy of a stable value of money, and the other in which the monetary authorities, consisting of the decision-making fiscal authorities assisted by an advisory central bank, follow a policy in which higher inflation is temporarily acceptable (within reason), provided that in the short run (and hopefully in the long run too) it will have a positive effect on growth and employment.

In this context the German and the UK experience can be compared both *between* business cycles and *within* a cycle. The former involves comparing the same point of the cycle between the two countries, whereas the latter involves a comparison of monetary policy between the same phase of each cycle. Figure 6 illustrates the relationship between inflation and growth in the course of the business cycle. The natural course is an anti-clockwise movement but exogenous shocks, such as a sharp increase in the price of oil or a change in policy, may disrupt the natural course so that the economy may move much faster from one phase to another, or move clockwise, especially when the policymakers want to engineer soft landings.

At point A, the economy is growing at the rate of potential output, inflation is at the core rate, unemployment is at the natural rate, and monetary and fiscal policies are neutral. At point B, the economy reaches the peak of the business cycle in terms of activity (the highest growth rate). At C, inflation peaks. At D, the economy reaches the trough of the recession and, at E, inflation bottoms. In Phase I, both growth and inflation are rising. In Phase II, growth declines but inflation continues to rise. In Phase III, both inflation and growth are falling, while in Phase IV growth is rising but inflation continues to fall. Finally, in Phase V, the economy returns to its long-term path of potential output, with growth and inflation rising gently to their long-term trends.

In this stylized business cycle, the optimal monetary policy is to be neutral at A, tight in Phases I and II, easy in III and IV, and to return to a neutral stance in Phase V (Figure 7). This optimality reflects a change

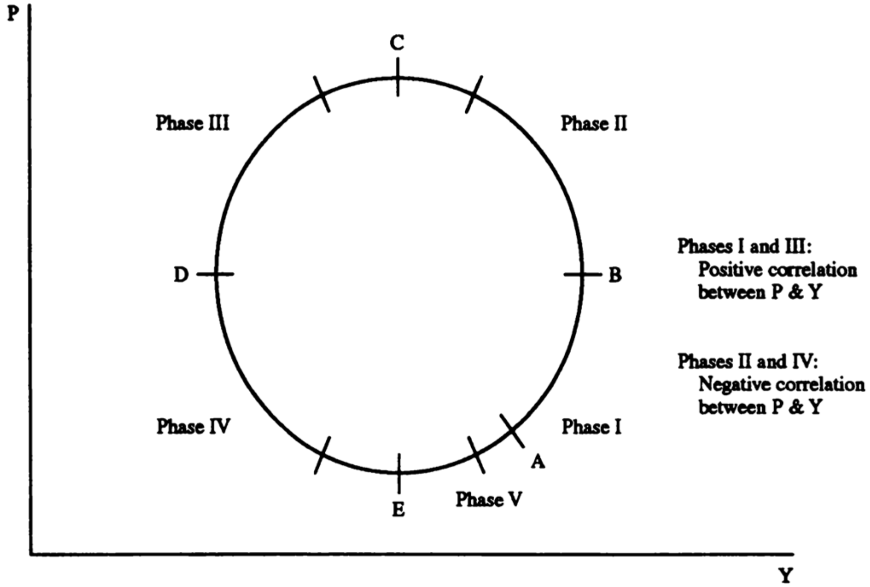


Figure 6: Inflation and Growth in the Business Cycle

in relative priority as between inflation and growth (or unemployment) in the course of the business cycle. The priority on inflation increases in relation to growth in Phases I and II and is reduced in Phases III and IV. In Phase V, the relative priority returns to normal. Hence, short-term interest-rates, which are the instrument of monetary policy, should rise from E to C and should fall from C to E if the central bank is following an optimal monetary policy. At A, monetary policy is neutral, and thus a comparison of A as *between* business cycles will reveal the dynamic evolution of the relative priority of inflation to growth. In other words, one can tell whether or not the policymakers are changing through time to become tougher. Moreover, as between the UK and the German policymakers, a comparison of A for more or less the same cycle will reveal whether the latter are tougher in relation to the former since the comparison is being made when both sets of policymakers are in 'normal' conditions.

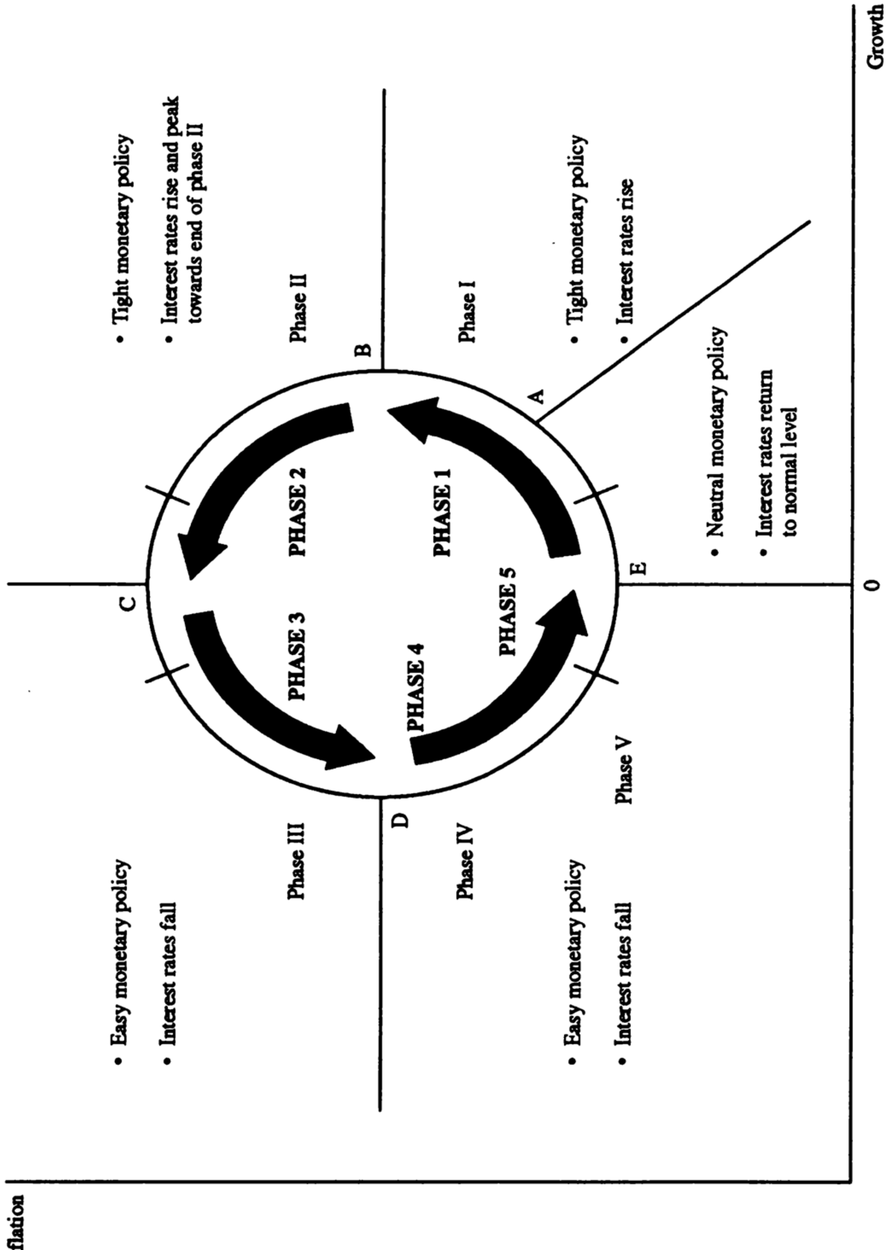


Figure 7: Central Bank Behaviour in the Business Cycle

XI. The Results

Figures 8 and 9 show the last three business cycles for Germany and the UK respectively. Both economies suffered a recession in the early 1970s, early 1980s and early 1990s. The first two business cycles were caused by the two oil shocks, known as OPEC I and OPEC II, in which the price of oil quadrupled in 1973 - 1974 and doubled during the period 1979 - 1981. These were supply-driven business cycles, whereas the third was demand-led in both countries.

Figure 8 shows the behaviour of the Bundesbank in these three business cycles. On each occasion, the German central bank responded by lowering short-term interest-rates after point C (when there was a clear trend that inflation was falling). Hence, the priority of the Bundesbank on inflation has not changed through time, but has remained time-invariant.

The decision to raise interest rates in the late 1970s was also optimal in that it coincided with point E (the moment inflation bottomed). In the

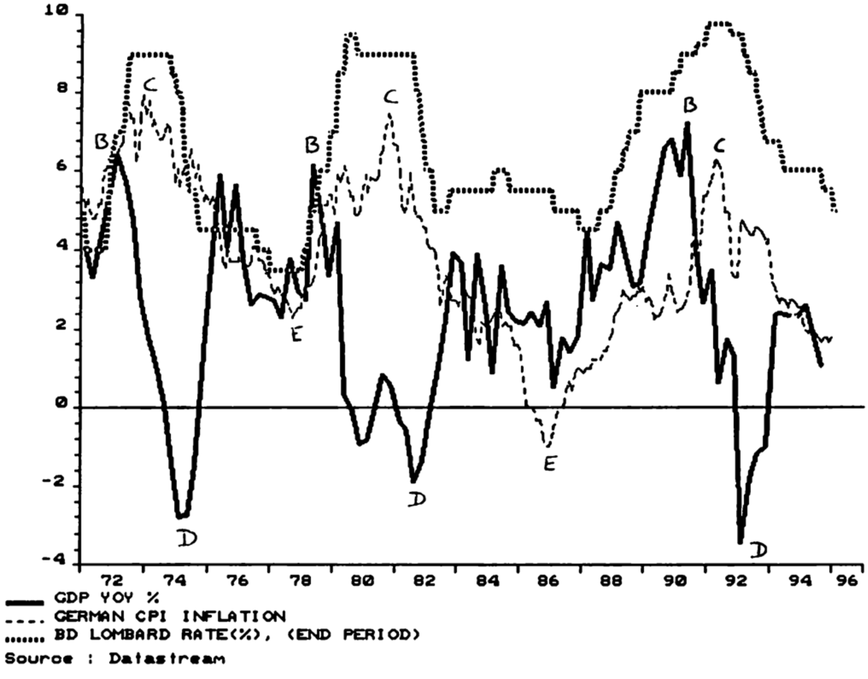


Figure 8: German Business Cycles, Inflation and Lombard Rate (5/2/96)

late 1980s, it seems as if the central bank became wet because it raised interest rates in mid-1988, while inflation had bottomed at the end of 1986. However, such a conclusion is erroneous. From mid-1983, the Bundesbank tightened monetary policy despite falling inflation, and despite the economy fluctuating around potential output without becoming overheated. What prompted this tightening was the soaring US dollar which reached unprecedented heights until the Plaza Accord at the end of 1985. The Bundesbank tried to protect the value of the Deutsche Mark, and tightened when domestic conditions did not warrant such a tight stance in monetary policy. This tight stance is to a large extent responsible for the high unemployment in Europe in the 1980s, and is an alternative explanation to the 'Eurosclerosis' which attributed the high unemployment to rigidities in the labour market.

The tight stance of monetary policy in the 1983 - 1986 period is also reflected in the fact that such a policy delivered negative inflation from the beginning of 1986 until the end of 1987. However, tight monetary policy was not solely responsible for the negative inflation. Part of the reason was the collapse of OPEC in 1985 which resulted in a sharp fall in oil prices. Hence, the easing by the Bundesbank from the end of 1986 till the autumn of 1988 was a delayed reaction to the over-tight stance between 1983 and 1986. This episode may be considered as a policy error on the part of the Bundesbank, but one in which the central bank erred on the side of caution: the stance it adopted was not too easy, as the data would suggest when read at face value, but too tight.

Figure 9 shows the behaviour of the UK policymakers in the same three cycles. In the early 1970s cycle, the UK authorities (Labour government) were wet. This is obvious from the fact that interest rates were cut the moment the economy entered the recession. If the policymakers had been tough they would have kept interest rates high for another 18 months, until inflation peaked (point C). This easy stance on monetary policy (and also on fiscal policy which is not shown here) was to a large extent responsible for the unprecedented rise in inflation to 27 %. This can be contrasted with the peak of inflation in Germany at 8 % which occurred at roughly the same time, since both were attributable to the same cause (the price of oil). By being wet, the policymakers in the UK allowed a huge wage-price spiral to be built. Thus, inflation not only rose by more than three times that in Germany, but also peaked two years later.

In the early 1980s recession, the UK authorities cut interest rates at point C. Therefore, by comparing the 1970s with the 1980s recession,

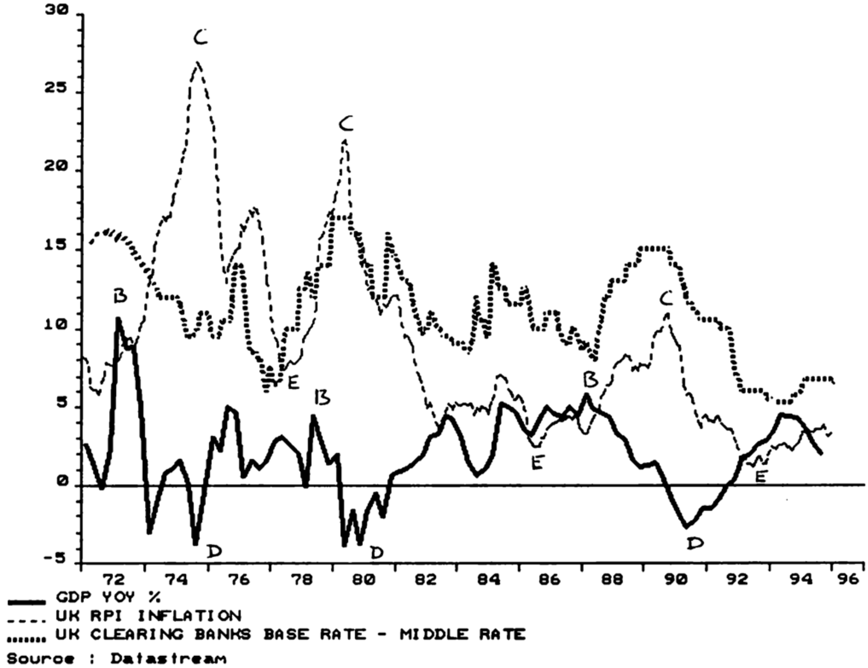


Figure 9: UK Business Cycles, Inflation and Base Rate (5/2/96)

there was a substantial change in relative priority as between inflation and growth. Hence, the UK authorities became much tougher in the 1980s recession. Such a tough approach was maintained in the 1990s recession. Interest rates peaked at point C.

Interest rates bottomed at the end of 1977, a few months before inflation bottomed, in the neighbourhood of point E. The UK policymakers had thus become tough long before the Thatcher government of 1979 took over from Labour. In the second business cycle, in the 1980s, interest rates bottomed two years after inflation hit bottom, the former in mid-1988 and the latter in mid-1986. Hence, the policymakers again became wet.

A number of factors contributed to this change in the relative priority of inflation. First, prior to the elections of 1987, the government stimulated the economy in order to maximize its prospects of re-election. Second, the October 1987 stock-market crash raised concerns in policymakers all over the world that this presaged the development of a depression on the scale of that in the 1930s. In an attempt to avert such an adverse outcome, the UK authorities (in line with the Bundesbank, the US Federal Reserve System (Fed), the Bank of Japan and all other major central banks) pumped liquidity into the system and cut short-term interest-rates. However, such easing was unnecessary and added a stimulus to an already overheated economy. It is worth noting that the Fed realized this error and started to tighten from the beginning of 1988. This policy error was caused by a lack of understanding of how the wealth-effect operates.

But the UK continued with easy monetary policy until the end of the first half of 1988 for a third reason. The then Chancellor, Nigel Lawson, pursued a policy of targeting the Deutsche Mark at DM 3 to the pound. Financial markets anticipated that interest rates would rise because the economy was overheated and that the policy would therefore prove unsustainable. This led to an appreciation of the pound which the Chancellor resisted by cutting interest rates. Such an easing exacerbated the existing inflationary pressures, and prolonged Phase II of the cycle so that it lasted from the beginning of 1988 to November 1991 – almost four years (see Figure 8).

With the exception of this episode in 1987-1988, the UK policymakers have been much tougher than in the 1970s. In the mid-1990s, they again showed their tough stance against inflation: they tightened fiscal policy in 1993 and, on evidence that the economy was overheating, monetary policy too was tightened from September 1994 until the end of 1995. Of course, the pre-emptive tightening of fiscal policy was triggered also by the goal of reducing the huge budget deficit of almost £50 billion and balancing it by the end of the decade. Nonetheless, a tight fiscal policy was also suitable for dealing with the overheated economy in case it produced a resurgence in inflation as, indeed, turned out to be the case in 1994.

XII. Conclusions

The German policymakers have been very systematic and very pragmatic in their conduct of monetary policy. Their priorities between inflation and growth have remained time-invariant *between* business cycles and have changed very consistently *within* cycles, with the exception of 1983 - 1986 when monetary policy was too tight. Monetary policy is formulated through explicit monetary targets, but Bundesbank pragmatism has meant that, in cases in which the money supply was distorted, policy

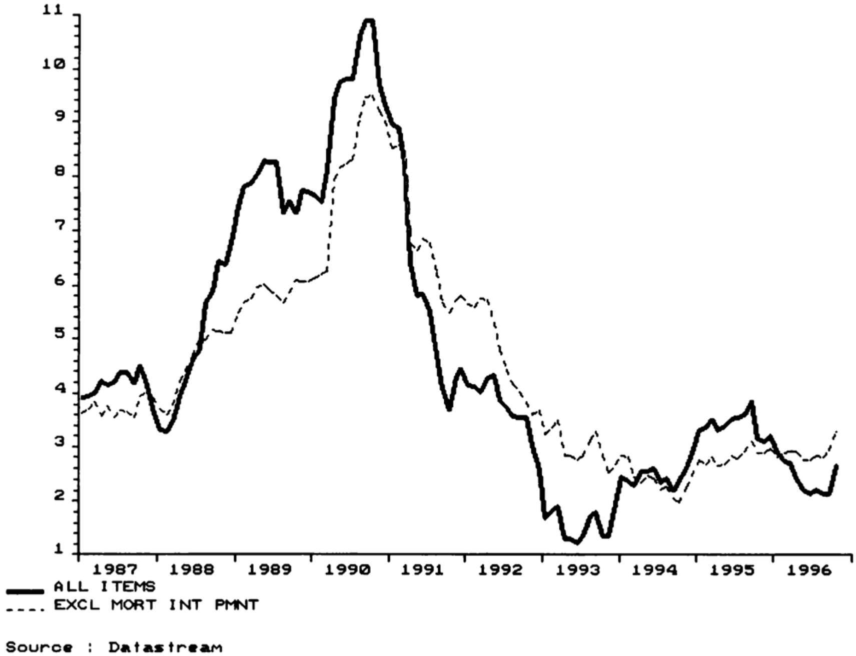


Figure 10: UK inflation (3/12/96)

decisions were based on other, wider, indicators of monetary policy. Overall, the Bundesbank deserves designation as a tough, or hard nosed, policymaker.

The UK authorities have been less systematic and probably *too* pragmatic in their conduct of monetary policy. In the 1970s, the policymakers were wet, and this explains why inflation soared by more than three times the rate in Germany. From 1976 onwards, the priorities of the UK authorities shifted towards a much tougher stance against inflation. However, there have been periods in which the policymakers again became wet, as in 1986 - 1988. In spite of this shift in priorities, the inflation differential with Germany has not vanished although it has been dramatically reduced. Part of the reason is the monetary policy regime.

The UK authorities have changed the *modus operandi* of monetary policy much too frequently to be able to influence embedded inflation expectations. Implicit monetary targets in the late 1970s were replaced with explicit ones in the early Thatcher years. These were subsequently complemented by exchange-rate targets. In the mid-1980s, the authorities relied exclusively on exchange-rate targets. They flirted briefly with nominal GDP targets before replacing them with an exchange-rate target (the ERM) which lasted for only two years. Finally, the authorities abandoned an explicit targeting of intermediate objectives in favour of ultimate ones. This frequent change of the monetary regime has contributed to a persistent inflation differential with Germany which has not vanished after twenty years since the shift in policymakers' priorities from wet to tough. What the UK policymakers have failed to grasp, but which lies at the heart of German monetary policy, is that continuity in policy helps to reduce embedded inflation expectations. There is no doubt that, in spite of a certain lack of public support for a tough and consistent anti-inflation policy in the UK, the degree of independence now granted to the Bank of England will be of very special importance in helping to reduce the inflation differential with Germany even further. Fortunately, the new Labour Government wasted no time in taking this plunge which some hope and others fear will also be a step in the direction of joining the European Monetary Union.

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Summary

An Evaluation of Inflation Targeting in Germany and the UK

The authors compare the policies and results of the British and German authorities towards the control of inflation since the 1950s. They contrast and explain the long-term emphasis on price stability in Germany with the variable experiences in Britain which have resulted from political pressures, a less stringent and less consistent attitude towards price stability until the 1990s, and the different status of the central bank. The trends in monetary policy and implementation problems in Britain since leaving the ERM in 1992, including the new framework of monetary policy announced by the Labour government elected on May 1 1997, are reviewed, and the authors offer a theoretical framework for comparing inflation targeting, supported by detailed figurative analyses.

Zusammenfassung

Bewertung des Inflation-Targeting in Deutschland und im Vereinigten Königreich

Die Autoren vergleichen die Geldpolitik der britischen und der deutschen Währungsbehörden und die bei der Eindämmung der Inflation seit den 50er Jahren erzielten Ergebnisse. Sie erläutern das langfristige Abstellen auf Preisstabilität in Deutschland und setzen den deutschen Fall in einen Gegensatz zu den unterschiedlichen Erfahrungen in Großbritannien, die auf die Ausübung politischen Drucks, eine weniger stringente und weniger konsequente Haltung zur Preisstabilität zumindest bis zu den frühen 90er Jahren und auf die bis Mai 1997 unterschiedliche Stellung der britischen Zentralbank, der Bank of England, zurückzuführen sind. Es werden die Tendenzen in der Geldpolitik und Durchführungsprobleme in Großbritannien seit der Abkehr des Landes vom Europäischen Wechselkursmechanismus im September 1992 untersucht. Die Autoren behandeln ebenfalls den Rahmen der von der im Mai 1997 gewählten Labour-Regierung eingeführten neuen Geldpolitik, die der Bank of England Unabhängigkeit in der Zinspolitik gewährt und die bisherige Inflationshöchstgrenze durch ein vom Schatzamt bestimmtes Inflations-Target von zunächst 2,5 % ersetzt hat. Darüber hinaus bieten die Autoren einen theoretischen Rahmen für einen Vergleich des Inflations-Targeting in Deutschland und im Vereinigten Königreich auf der

Grundlage eines Optimierungsansatzes an sowie ein detailliertes Zahlenwerk, aus dem hervorgeht, wie weit es Deutschland und Großbritannien gelungen ist, im Verlaufe bestimmter Nachkriegszeiträume eine optimale Geldpolitik zu verfolgen.

Résumé

Une évaluation de l'objectif d'inflation en Allemagne et au Royaume-Uni

Les auteurs comparent la politique monétaire des autorités britanniques et allemandes ainsi que les résultats obtenus en réduisant l'inflation depuis les années 50. Ils expliquent l'insistance sur la stabilité des prix à long terme de l'Allemagne et mettent en contraste le cas de l'Allemagne avec les différentes expériences faites en Grande-Bretagne. Celles-ci ont résulté de la pression politique, d'une attitude moins rigoureuse et moins conséquente envers la stabilité des prix, du moins jusqu'au début des années 90 et du statut différent jusqu'en mai 1997 de la Banque Centrale britannique, la Banque d'Angleterre. Les tendances de la politique monétaire et les probèmes d'implantation en Grande-Bretagne depuis le retrait du mécanisme européen des taux de change en septembre 1992 sont analysés dans cet article. Les auteurs traitent également le cadre de la nouvelle politique monétaire introduite par le gouvernement travailliste élu en mai 1997 qui octroye à la Banque d'Angleterre l'indépendance dans la politique des taux d'intérêt et qui a remplacé le plafond inflationniste existant jusque là par un objectif d'inflation de 2,5 % d'abord déterminé par le Trésor. Les auteurs proposent en outre un modèle théorique pour comparer l'objectif d'inflation en Allemagne et au Royaume-Uni. Ce dernier se base sur une approche d'optimisation et s'appuye sur des analyses chiffrées détaillées qui montrent à quel point l'Allemagne et la Grande-Bretagne sont arrivées à poursuivre une politique monétaire optimale au cours de certaines périodes de l'après-guerre.