

Box C MPC communication: the case for taking back control of financial conditionsRichard Barwell¹

Expectations about the decisions that central banks will take in the future matter. Any change in the level of the short-term policy rate or the stock of asset purchases will have a negligible impact on asset prices and ultimately inflation if investors expect that change to be soon reversed. Central bankers have become more comfortable talking about the future path of policy in order to anchor those expectations. Nonetheless, the current conversation about the future path of policy in the United Kingdom still falls a long way short of ‘complete forward guidance’ (Barwell and Chadha, 2013).

Complete forward guidance involves disclosure of all relevant aspects of the internal policy debate, simultaneously reducing uncertainty within financial markets and the accountability deficit with politicians and the general public (Giles (2019)), and includes the following seven key elements:

- 1 Publish ‘optimal’ modal paths for each of the policy instruments – that is, paths that are considered the most likely to deliver the best possible economic outcomes (according to central bank’s mandate) given the central bank’s (inevitably) uncertain understanding of the current state and structure of the economy;
- 2 Place those modal policy paths within probabilistic statements (such as a fan chart) that illustrate the range of possible outcomes for the policy instruments and are internally consistent with the probabilistic statements about macroeconomic variables that central banks currently publish;
- 3 Release a detailed exposition of the strategy debate that highlights key points of uncertainty and critical judgements and their quantitative importance on the policy decision, and then illustrates that uncertainty by describing the alternative scenarios that are discussed within the internal policy debate (including the corresponding shifts in the policy path);
- 4 At moments such as these, when the policy setting is far from “normal”, publish an exit strategy that describes how the central bank expects to return the policy instruments to normal settings, including details on the pace and sequencing of exit and how that might depend on economic and perhaps calendar considerations, as well as estimates of what constitutes “normal” for the policy rate and the balance sheet;
- 5 Provide a regular quantitative update on the policy committee’s evolving understanding of the structure of the economy – again, with an emphasis on probabilistic statements not point estimates – and with a particular focus on timeless issues in the strategy debate, such as the slope of the short-run Phillips Curve, the transmission mechanism of policy instruments and the location of constraints on those instruments;
- 6 Produce a detailed description of the loss function that ultimately guides the entire policy debate which can then be used to evaluate alternative policy paths in a given circumstance and explain how the ‘optimal’ path was selected.
- 7 Wherever disagreements exist within policy committees, those differences should be disclosed – for example, each committee member should publish his or her understanding of the optimal paths, consistent with his or her beliefs about the state and structure of the economy.

There is no disputing the claim that the Bank of England’s current communication strategy falls short of this limiting case. The extent to which that matters depends on the uncertainty of the audience. If the audience is well informed and already knows what the Bank would say if it were to deliver complete forward guidance then the message would be redundant. Those circumstances might be a reasonable approximation to reality at certain points in a typical business cycle. Unfortunately, it is almost certainly not the case now. The direction of travel is particularly unclear – whether the next move in policy will be to tighten or loosen – and more unusually still, it is unclear *how* the Bank of England would tighten or loosen.

If the width of the MPC’s inflation fan chart is anything to go by then there is always massive uncertainty about the future path of rates given the likely size of the interest rate multiplier. According to the Bank’s own forecasting platform, a surprise 25 basis point increase in interest rates knocks around 10 basis points off inflation (Burgess et. al., 2013). If there is a roughly one in three chance of inflation being 100 basis points or more above or below

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the target two to three years from now as the fan charts imply then there is a distinct possibility that a very large correction in the policy stance might soon be warranted in either direction.

It seems reasonable to conclude that the uncertainty over the macro outlook is particularly elevated at this juncture as the economy unlocks after a year of social distancing restrictions. Indeed, there seems to be considerable disagreement within the Committee, particularly with regards to the medium-term trajectory of inflation. The external members have argued that: “we should not forget that disinflationary pressures predated Covid” (Tenreyro, 2021); it will probably “take longer to close the output gap than forecast in the February MPR” (Saunders, 2021)); and there is “relatively little risk of sustained above-target inflation” as demand recovers in 2022 (Haskel, 2021). Meanwhile, the Chief Economist has argued that “there is a tangible risk that inflation proves more difficult to tame, requiring monetary policymakers to act more assertively than is currently priced into financial markets” (Haldane, 2021). But as is almost always the case, that material dispersion of views is not reflected in a material dispersion of votes (Barwell, 2016 and 2019): all of these people voted for exactly the same stance in March.

There does not appear to be a consensus within the Committee on the marginal tool for easing the monetary stance. There is a consensus that QE is the answer in the event of stress in core wholesale financial markets. However, it is debatable whether emergency interventions of that kind should be considered conventional monetary operations and in any case, it would be surprising (and concerning) to learn that MPC members perceived that the probability of this stress arising was sufficiently high such that more QE was “the marginal tool” for this reason.

There does not appear to be a consensus that more QE is the answer when inflation is expected to under-shoot the target in the medium-term. Vlieghe (2021) observes that “when long term yields are already very low (close to the effective lower bound on the policy rate (ELB)) and there is ample liquidity in markets, there is little QE can do to add further stimulus to the economy”. Indeed, there does not appear to be a consensus within the Committee about how QE works, even if there tends to be a consensus within the Committee on how much QE to do (Barwell, 2020). This is an example of where the Bank could benefit from a more sophisticated communication strategy, which links theory and evidence on QE to views and votes on the Committee (BoE IEO, 2020).

There also appears to be a disagreement over the obvious alternative to more QE: negative rates. The external members appear to see some merit in cutting below zero and Tenreyro and Vlieghe have helpfully provided some quantification on how far: both have suggested that Bank Rate could be cut to as low as -0.75 per cent. How low Bank Rate can ultimately go – or perhaps more precisely, how low for how long – will depend on the complimentary measures that the authorities are willing to take to mitigate the side effects, including some radical measures (see Grady (2019) for a detailed exposition) but it is unclear how far Bank thinking has progressed on these issues. Indeed, several members of the Committee were willing to delay the contingency planning that was announced in February and thereby forgo the option of being able to cut into negative territory in August just to avoid any risk of sending a signal that the MPC intended to cut below zero. Revealed preference suggests that those individuals may need a lot of persuading to vote for negative rates.

The debate over the marginal tool to tighten policy was settled under Governor Carney: raise Bank Rate until there is once again scope to materially cut rates and then, and only then, begin to reduce the balance sheet. However, this Governor has expressed the view that “it may be better to consider adjusting the level of reserves first without waiting to raise interest rates on a sustained basis” (Bailey (2020)). The February policy statement confirmed that the exit strategy is now officially under review although it is unclear whether this refers to the threshold for Bank Rate at which balance sheet run-off can begin or the entire sequencing of rate hikes and run-off.

In short, the interaction between the unprecedented macro back-drop and the Bank’s communication strategy has resulted in considerable uncertainty about both the direction and instruments of policy. Indeed, there is a sense that as the toolkit expands, guidance retreats with the Governor insisting: “We have been quite clear these toolkit decisions should not be interpreted as a signal about the future path of monetary policy” (Bailey, 2021). Meanwhile, expectations about the future path of policy implicit in market prices have shifted: the expected path of Bank Rate has moved higher and other asset prices – notably the currency – have moved in sympathy.

There is no debate over whether that this adjustment in the expected rate path and the concomitant correction in financial conditions matters or not, irrespective of whether the Committee believes it is warranted or not. It is the expectations of market participants embedded in asset prices that drive activity and ultimately inflation, not the counterfactual constellation of asset prices that is consistent with the beliefs in policymakers’ heads. Failure to communicate clearly in an environment of pervasive uncertainty delegates partial control of the monetary stance

to the collective beliefs of market participants. Those beliefs may not be anchored on reality. If the MPC will not talk then it will have to act – changing policy to change market prices – or face the consequences for activity and inflation. Concrete progress towards complete forward guidance seems a wiser course of action.

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