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Does Public Disagreement on Monetary Policy Unsettle the Markets?

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Abstract

Publication of minutes of monthly monetary policy meetings between the Chancellor of the Exchequer and the Governor of the Bank of England was a conspicuous feature of the United Kingdom's inflation targeting framework from 1994 through April 1997. It was intended to reinforce credibility by publicizing the criteria on which policy was decided. On some occasions, however, these minutes revealed disagreement between the participants. This paper examines whether such disagreement unsettled the markets and detracted from credibility.

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SUMMARY

Publication of minutes of monthly monetary policy meetings between the Chancellor of the Exchequer and the Governor of the Bank of England was a conspicuous feature of the United Kingdom's inflation targeting framework from early 1994 through April 1997. On some occasions, these minutes revealed disagreement between the participants: the Chancellor, who was responsible for deciding on interest rate policy, in some instances rejected the Governor's recommendations of preemptive increases in interest rates to keep inflation on track.

Such episodes raise the possibility that publishing the minutes may not have had its intended effect on credibility. On the contrary, by revealing divisions among the authorities' policy positions, it may have unsettled the markets and detracted from monetary policy credibility.

This paper examines the impact on financial markets of the announcement of the initial decision to publish the minutes and of the episodes in which the minutes reflected disagreement. Specifically, it considers the behavior of three indicators of financial markets' reaction to the news: (a) the expected inflation rate as measured by the yield spread between nonindexed and index-linked gilts; (b) the ten-year bond yield spread over Germany; and (c) the sterling-deutsche mark exchange rate. The paper examines the behavior of these variables at the time of the announcement, both in absolute terms and in terms of deviations from the predictions of an autoregressive specification. It concludes that such announcements had no significant and systematic effect on the markets.

I. INTRODUCTION

Increased transparency about the formulation of monetary policy is one of the key ingredients of inflation targeting.[2] Such transparency is especially important given the nature of an inflation target—where the monetary authorities' inflation forecast is used as an intermediate target (Svensson, 1996). By way of comparison, if monetary policy uses the exchange rate or a monetary aggregate as an intermediate target, market participants and the public can in principle assess whether policy is on track through a straightforward examination of current data.[3] With inflation targets, in contrast, any judgement of the appropriateness of policy relies on understanding the determinants of future inflation and how the authorities view these determinants. Inflation targeting thus depends on the dissemination of the data on the basis of which the monetary authorities arrive at their policy decisions, as well as information on how the authorities interpret these data.

In the United Kingdom, an important element of transparency from early 1994 through April 1997 was the publication of minutes of monthly monetary policy meetings between the Chancellor of the Exchequer and the Governor of the Bank of England; these minutes were published at a six-week interval after each meeting.[4] The published minutes, together with the publication since 1993 of quarterly *Inflation Reports* which provide both the relevant data and the Bank of England's inflation forecast, were a conspicuous feature of the inflation targeting framework, intended to focus attention on the economic arguments for a specific course of monetary policy and thus reinforce policy credibility.

On some occasions, however, these minutes recorded disagreement between the participants: the Chancellor, who was responsible for deciding on interest rate policy, in some instances rejected the Governor's recommendations of pre-emptive increases in interest rates to keep inflation on track. Such episodes raise the possibility that publishing the minutes may not have its intended effect on credibility. On the contrary, by revealing divisions among the

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[2]Inflation targeting and the early experience with its implementation are discussed in Ammer and Freeman, 1995; Lane, Griffiths, and Prati, 1995; Leiderman and Svensson (ed.), 1995; and McCallum, 1996.

[3]In practice, of course, this assessment is not so straightforward with monetary targets, as there may be technical reasons for monetary aggregates to miss the targets. This has been discussed considerably in relation to the Bundesbank; see for instance Issing 1996 and comments by Kool.

[4]The new monetary framework announced on May 6, 1997 gives the Bank of England operational independence and thus removes the interplay between Chancellor and Governor. Minutes of monthly meetings of the Bank's newly-established Monetary Policy Committee that is now responsible for interest rate decisions will be published, as before at a six-week interval after each meeting.

authorities' policy positions, it may unsettle the markets and detract from monetary policy credibility.

This paper examines the impact on financial markets of the announcement of the initial decision to publish the minutes and of the episodes in which the minutes reflected disagreement. Specifically, it considers the behavior of three indicators of financial markets' reaction to the news: (a) the expected inflation rate as measured by the yield spread between non-indexed and index-linked gilts; (b) the 10-year bond yield spread over Germany; and © the sterling-deutsche mark exchange rate. Section II of the paper examines the behavior of these variables at the time of each announcement. Section III considers an alternative approach, comparing the behavior of these indicators at the time of each announcement with the predictions of a vector autoregression model. Both approaches confirm that announcements of disagreement between policymakers had no significant and systematic effect on the markets.

II. Episodes of Disagreement

Chart 1 shows daily data on three market indicators of monetary policy credibility: the expected inflation rate as measured by the yield spread between non-indexed and index-linked gilts; the 10-year bond yield spread over Germany; and the exchange rate of sterling against the deutsche mark.

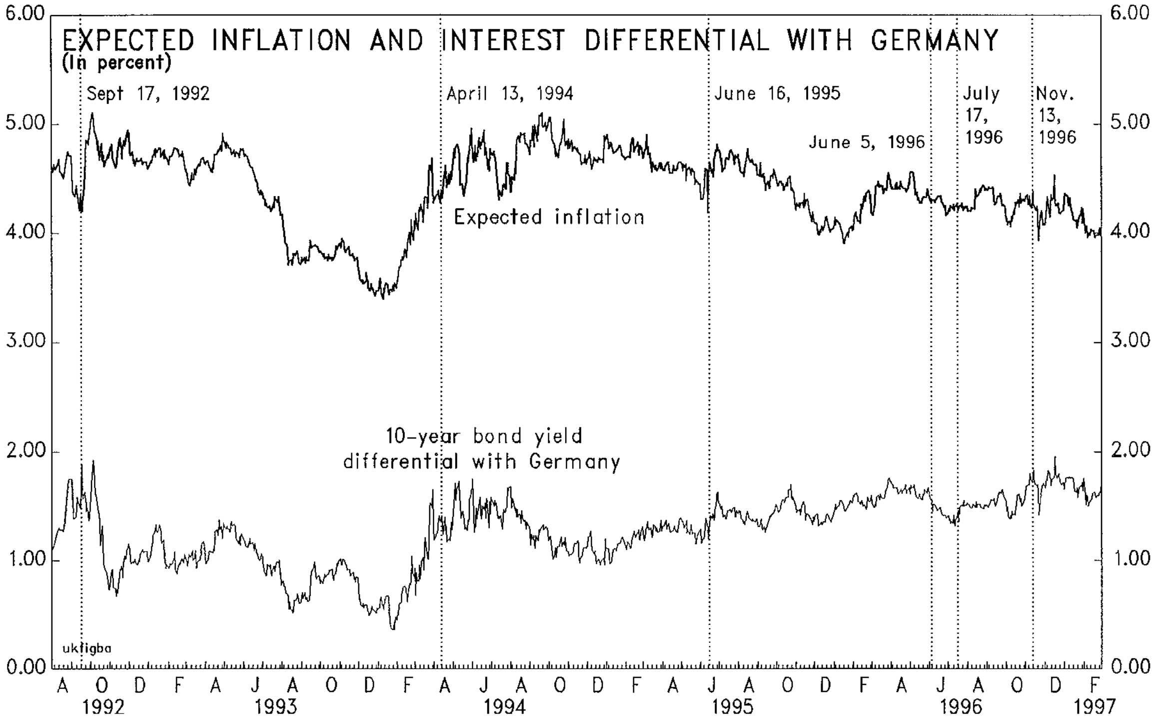
The top panel of the chart shows that since April 1994, when the practice of publishing the minutes began, expected inflation and spreads against Germany have both generally been higher than previously. Since then, spreads against Germany have remained quite stable at around 150 basis points, while expected inflation has declined modestly. The widening of spreads in the first half of 1994, however, **preceded** the decision to publish the minutes; it mainly reflected international trends following the Federal Reserve's February 1994 move. Sterling, after its sharp drop following exit from the ERM, fluctuated around a gradual upward trend during 1993; then it began to depreciate again beginning in early 1994, falling more precipitously in early 1995, with a cumulative depreciation of some 15 percentage points from peak to trough; then, beginning in late 1995 through the early months of 1997, sterling appreciated again, gaining about 25 percent against the deutsche mark.

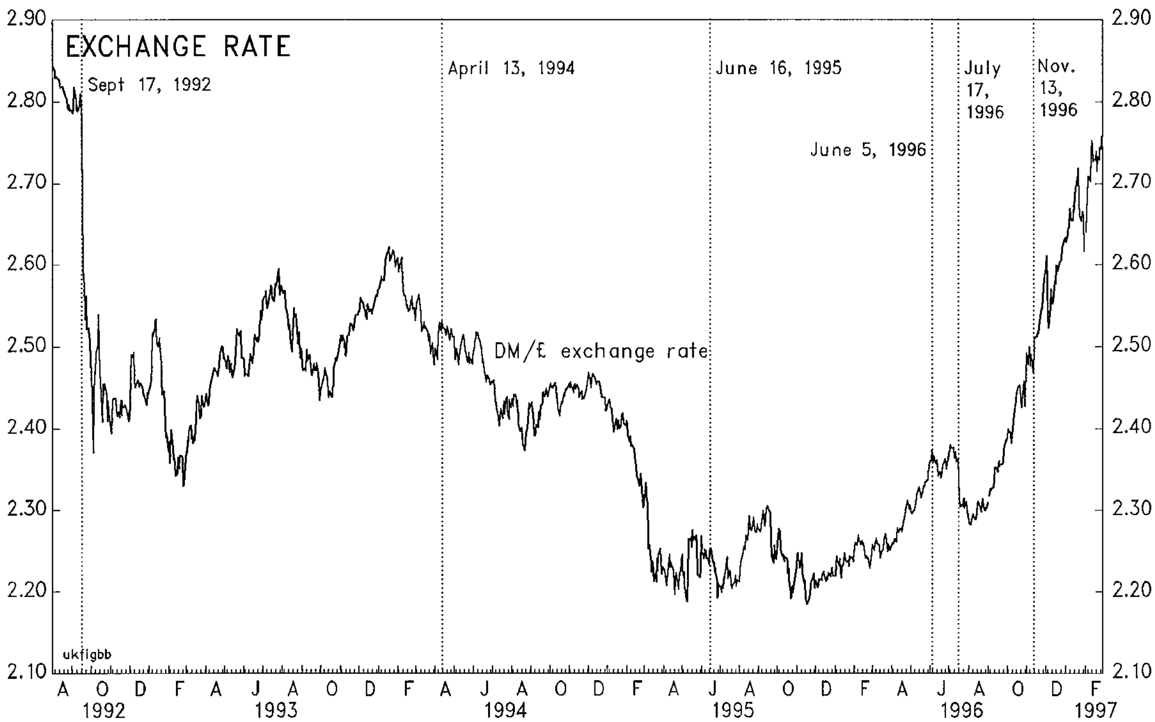
In order to assess the possible impact of the publication of the minutes, it is thus necessary to focus more narrowly on some key dates:

1. On **April 13, 1994**, the new policy of publishing the minutes was announced. On that day, expected inflation and the yield spread rose slightly (by 6 and 2 basis points, respectively), but the same time, sterling strengthened by 0.2 percent. Two days later, however, both expected inflation and the yield spread were lower, while sterling was slightly weaker than before the initial announcement.

CHART 1
UNITED KINGDOM

SELECTED MONETARY INDICATORS





Sources: Bloomberg News Services; and IMF, Treasurer's Department.

2. **June 16, 1995** was the first occasion on which minutes were published indicating disagreement between Chancellor and Governor (at the May 5 meeting). The minutes showed that the Governor had recommended an increase in the base rate while the Chancellor had decided to hold it constant. Thus the disagreement may have been news to most market participants on the day of publication. On that day, both expected inflation and the spread over Germany increased, by 6 and 7 basis points, respectively, while sterling appreciated by less than one-tenth of a percentage point against the deutsche mark.[5]

3. On **June 5, 1996**, the next date on which there was disagreement at the monthly meeting, the Chancellor decided to cut the base rate by 25 basis points, contrary to the Governor's advice. Market participants were well aware of the disagreement on the day of the meeting, as the decrease went against the Governor's previous public statements and the Bank of England's published *Inflation Report.* On that day, expected inflation rose but the spread over Germany decreased, but both by only 1 basis point; on the same day, sterling depreciated against the deutsche mark by 0.2 percent. On the day of publication **(July 17)**, expected inflation fell 5 basis points and the spread over Germany 9 basis points, while sterling depreciated by 0.1 percent. (The continuation of the disagreement in minutes published in subsequent months also had no noteworthy effect on the spreads.)

4. On **November 13, 1996**, minutes were published indicating that, at the September 23 meeting, the Chancellor had again ignored the advice of the Governor that interest rates should be raised to check excessively rapid expansion of the economy. In between the meeting and the publication of minutes, however, the Chancellor did decide to raise interest rates, by 25 basis points, on October 30. On the date of publication, expected inflation increased by 20 basis points, while the yield spread over Germany widened by 9 basis points, but sterling appreciated against the deutsche mark by 0.8 percent. In the following few days, the increases in expected inflation and the spread over Germany were reversed (in the latter case more than reversed) while sterling strengthened further.

These episodes do not display any systematic pattern, and the changes in any case were so small and transient that they were most likely coincidental. Only the June 1995 episode is consistent with the view that a published disagreement undermines monetary policy credibility. The June–July 1996 episode is consistent with the opposite conclusion: that publishing the minutes reassures the markets that the participants' divergent views on the appropriate interest rate need not imply any weakening of their commitment to the inflation target. This evidence in any case confirms that publishing the minutes, even when they recorded small disagreements between the participants, did not seriously unsettle the markets.

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[5]On the day of the meeting, expected inflation declined slightly (1 basis point), while the spread over Germany rose (6 basis points).

III. VAR ESTIMATES

In order to test more rigorously whether disagreement at the monetary meetings may have had an impact on monetary policy credibility, we estimate a three-equation VAR system for the three indicators of monetary policy credibility, incorporating the possible effect of disagreements using dummy variables. The purpose of the regressions is to estimate the effect of the disagreements on the dependent variables rather than provide thorough explanations for daily movements in the variables.

Unit-root tests indicate that while the level of the interest rate differential is an I(0) variable, the exchange rate against the mark and expected inflation need to be differenced once in order to obtain I(0) series.[6] As a result, we run the regressions on the level of the interest rate differential, the change in expected inflation, and change in (the logarithm of) the exchange rate as the dependent variables. Among the independent variables we include lagged values of all the dependent variables and intercept dummies for each day that a major disagreement was reported, as well as for the day that followed it.

The results are reported in Table 1 (excluding estimates for lagged dependent variables which are not of interest in our analysis). They confirm the conclusion arrived at by the visual inspection of the series: disagreements at the monetary meetings do not seem to systematically influence credibility as measured by the indicators used in this note. This is implied by the relatively small number of significant dummies in the regressions, and, more importantly, the haphazard manner in which they enter the estimated equations. In particular, none of the dates on which one or more of the indicators moved significantly once the effects of lagged dependent variables are taken into account (i.e., the dummy variables had significant coefficients) is associated with consistent movements of the indicators in the right direction. Following the June 5, 1996 meeting the spread over Germany actually fell by 10 basis points (on the following day), after the effect of other factors is taken into account. On July 17, when the full text of the discussion in the June meeting was revealed, the exchange rate depreciated by 0.8 percent, given other factors, but the spread over Germany fell by 12 basis points and expected inflation did not change significantly. Finally, on November 13, 1996, when the disagreement in the September meeting was announced, expected inflation rose by 15 basis points, given other factors, but the interest rate differential did not change significantly and the exchange rate moved in the wrong direction: it appreciated by a cumulative 1.5 percent. The dummies are not significant for the other dates included in the regressions.

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[6]ADF tests on the levels of the interest rate differential, the exchange rate, and expected inflation gave values of -3.87, -0.34, and -2.93, respectively, compared with a 95 percent critical value of -3.41. The values of the ADF tests for the first difference of the exchange rate and expected inflation were -27.11 and -30.74, respectively.

Table 1. Estimates of Intercept Dummies from the OLS Estimation of an Unrestricted VAR on Monetary Indicators 1/

	Rate of Change in the Exchange Rate	Interest Rate Differential	Change in Expected Inflation
D0413	0.22 (0.61)	0.03 (0.58)	0.06 (1.34)
D0616	0.11 (0.30)	0.83 (1.72)	0.07 (1.41)
D0605	-0.24 (-0.65)	-0.004 (-0.09)	0.01 (0.22)
D0717	-0.78 (-2.12)	-0.12 (-2.52)	-0.05 (-1.08)
D1113	0.84 (2.29)	0.09 (1.94)	0.15 (3.09)
D0413(-1)	-0.38 (-1.04)	-0.07 (-1.49)	-0.002 (-0.04)
D0616(-1)	-0.19 (-0.52)	-0.004 (-0.08)	-0.03 (-0.58)
D0605(-1)	-0.45 (-1.23)	-0.10 (-2.01)	-0.01 (-0.28)
D0717(-1)	-0.39 (-1.06)	0.14 (2.91)	0.15 (0.30)
D1113(-1)	0.76 (2.05)	0.04 (-0.92)	-0.09 (-1.86)
R	0.03	0.98	0.01
S.E. of Regression	0.37	0.05	0.05
χ (1) test for serial correlation [prob]	0.57 [0.45]	0.11 [0.74]	1.36 [0.24]

1/ Order of lags is two in all the equations; the number of observation is 1852, covering the January 1, 1992 to January 29, 1997 period; t-ratios are in parentheses; Dxxyy is equal to one on the yyth day of the xxth month and is zero otherwise, while Dxxyy(-1) is one on the following day and zero otherwise; the estimates of other parameters are available from the authors.

IV. Conclusions

The results presented show that publishing the minutes of monetary meetings displaying disagreement between the Governor and the Chancellor had no significant effect on market indicators of credibility. A possible explanation is that the disagreements reflected relatively small differences of opinion—whose policy implications amounted to a mere 25 basis points—while confirming that the policy debate between HM Treasury and the Bank of England were still bound into a common framework with common goals. To some extent, it may also have reflected the fact that the disagreements were not a surprise to the markets, but rather were seen as the predictable consequence of the players' institutional roles.

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