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A Dynamic Monetary Conditions Index for the UK

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Abstract

Monetary Conditions Indices (MCIs) are weighted-averages of changes in an interest rate and an exchange rate relative to their values in a base period. A few central banks calculate MCIs for use in monetary policy. Although the Bank of England does not calculate such an index, several international organizations as well as financial corporations construct MCIs for the UK on a regular basis. In this article, we survey those indices and compare their performance. We also suggest an alternative MCI for the UK to be used as a coincident indicator of stance, obtained by estimating and simulating a small-scale macro-econometric model over the period 1984 Q4–1999 Q3. To overcome familiar criticisms of MCIs, our measure innovates upon existing MCIs in several respects. In this sense it may be more informative than those in understanding whether an existing level of interest rates, given the existing level of sterling, makes monetary policy ‘tighter’ or ‘looser’ than in previous periods. © 2002 Society for Policy Modeling. Published by Elsevier Science Inc. All rights reserved.

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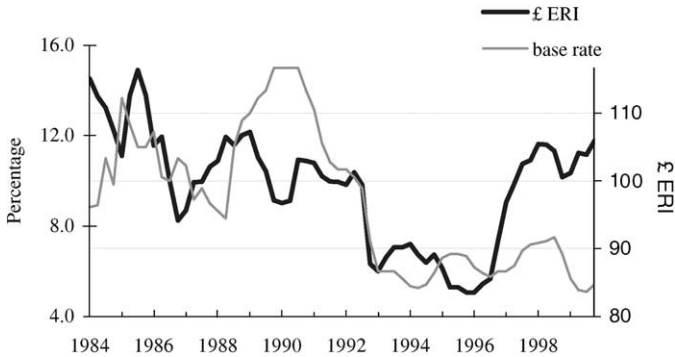


Fig. 1. UK base rate and nominal £ ERI.

1. MCIs as indicators of monetary pressure

Monetary policy affects economic activity and inflation through numerous channels, usually referred to as the transmission mechanism. Changes in the immediate instrument of policy, the official interest rate, affect market interest rates, which in turn affect households' spending and saving plans—by altering the mortgage rate and the cost of consumer credit—and firms' investment and borrowing decisions—by altering the cost of capital. In an open economy, other things being equal, changes in the official rate also tend to produce changes in the value of the domestic currency vis-à-vis other currencies. By influencing the competitiveness of domestic exports and imports, this affects net trade and hence aggregate demand. In addition, because some of the goods consumed domestically are imported, changes in the exchange rate usually also have direct effects on consumer price inflation.

When there are multiple channels of monetary transmission, it may be desirable to consider as many of them as possible to evaluate the general stance of monetary policy. In an open economy like the UK, for instance, the extent of monetary tightening or ease relative to previous periods may best be gauged by looking at both principal channels of transmission, i.e., exchange rates and interest rates. This is particularly true when movements in relative interest rates cannot fully explain movements in the exchange rate.

The logic behind this is that a high level of the exchange rate can reinforce the contractionary effects of the central bank-controlled interest rate, leading to a tighter policy stance than would otherwise have been, were the exchange rate lower, and vice versa.

Fig. 1 above emphasizes this point, showing episodes of simultaneously high interest and exchange rates²—the UK's participation in the ERM between 1990 and 1992 and the long period of sterling appreciation since 1996 Q3.

² In Fig. 1 the exchange rate is measured using sterling's effective exchange rate index (£ ERI).

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