

Assessing Monetary Policy



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Outline

- Monetary policy in the UK
 - historical background
 - the policy framework
- The Record – good luck or good policy?
- What have we learnt? And what are the challenges?

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Monetary policy in the UK - historical background

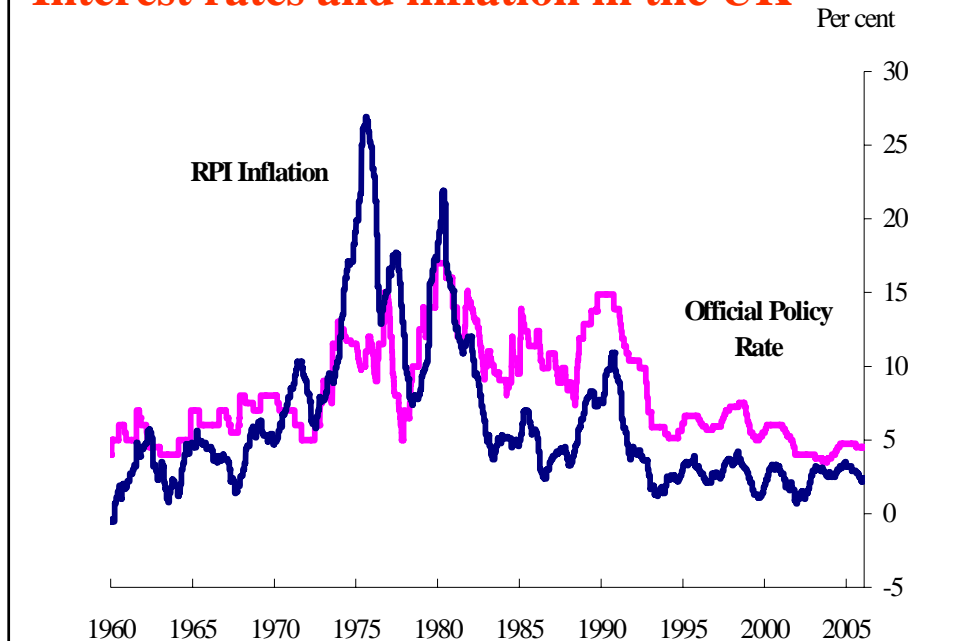
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UK Monetary Policy since the 1970s

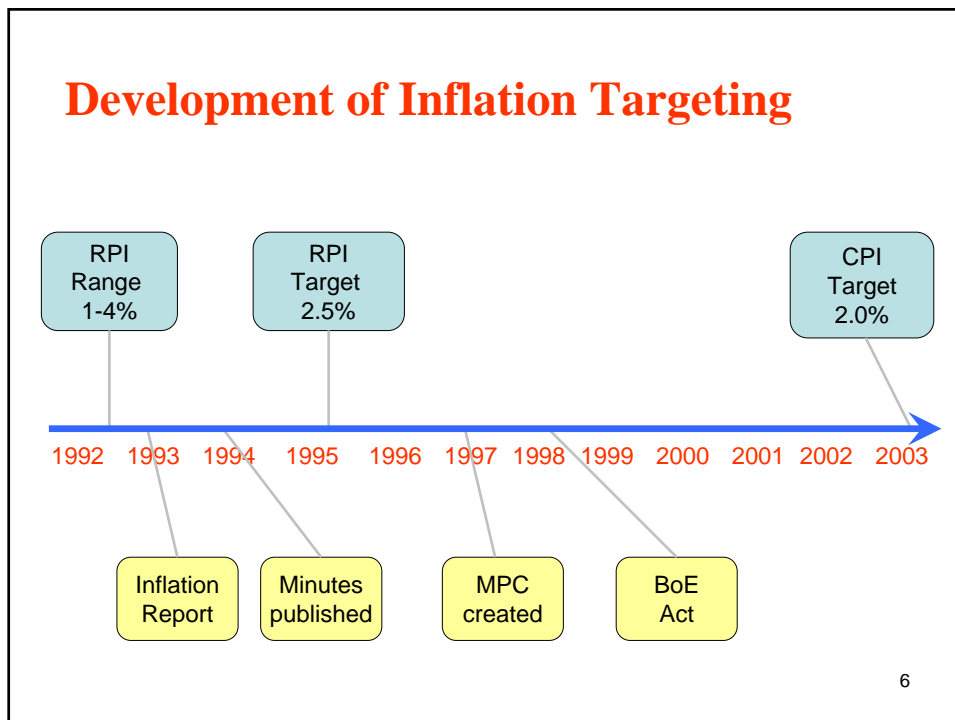
- **1970s:** ‘The Great Inflation’; direct controls and weak monetary policy
- **1980s:** The search for a credible policy framework; monetarism and financial liberalisation
- **1990:** ERM entry
- **1992:** Black Wednesday – UK exits from the ERM
- **From 1992:** development of Inflation Targeting
- **1993- ?:** ‘The Great Moderation’

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Interest rates and inflation in the UK



Development of Inflation Targeting



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The UK policy framework – key features

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The current policy framework

Clear responsibilities and objectives

- Price stability is a legal requirement
- Government sets objectives: MPC sets interest rates
- Precise inflation target is set annually, at Budget time

MPC is accountable – to Government, Parliament, public

Transparency

- Votes
- Minutes
- Inflation Report
- Public letters

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The Remit

Bank of England Act 1998:

...to deliver price stability (as defined by the Government's inflation target)

...and, subject to this objective, to support the Government's economic policy, including its objectives for growth and employment

Current annual remit :

- 2% CPI inflation 'at all times'
- Escape clause – open letter if inflation below 1% or above 3%

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The Monetary Policy Committee

- MPC sets interest rates monthly
- 5 internal, 4 external members
- Externals are experts – mostly academics, ex-government and business economists
- Members are *individually* accountable
- Chaired by the Governor – but he can be outvoted

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Accountability

- MPC Members are accountable to Government, Parliament, and the public
- Chancellor appoints members of MPC for fixed terms
- Treasury Select Committee (TSC) conducts hearings but has no formal role in appointments
- TSC holds quarterly sessions on monetary policy, and makes regular reports
- The Bank's Court has a duty to review MPC processes and use of regional and industrial data

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Transparency – communication

- Press statements – substantive, when rates change
- Published minutes – after two weeks – disclosing individual votes
- Published forecasts in *Inflation Report* every quarter with press conferences, fronted by the Governor
- All members give on the record speeches and interviews

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Wider communication

Talking to local businesses

- Network of 12 Regional Agents
- Monthly surveys of 8000 business contacts
- Regional visits by MPC members

Educational initiatives

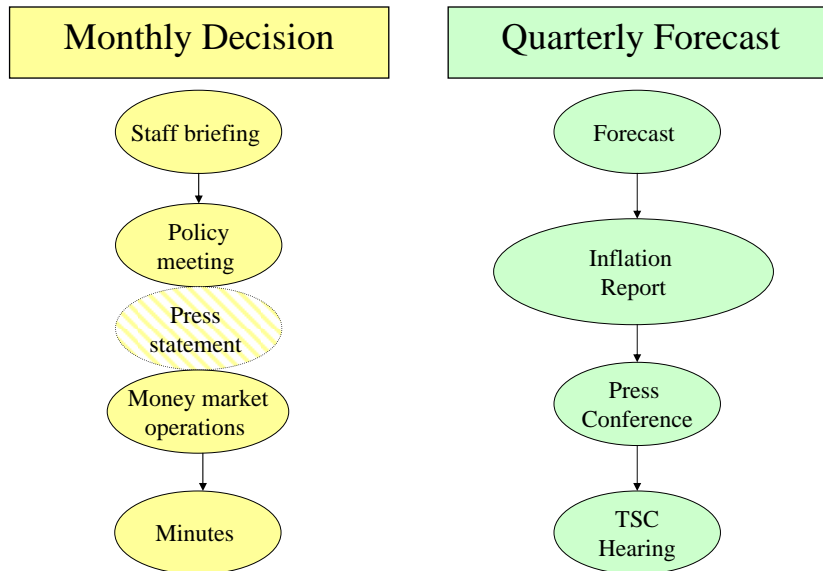
- Bank of England/*Times* Interest Rate Challenge
- Teaching packs and videos for schools
- Website

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The policy framework – in practice

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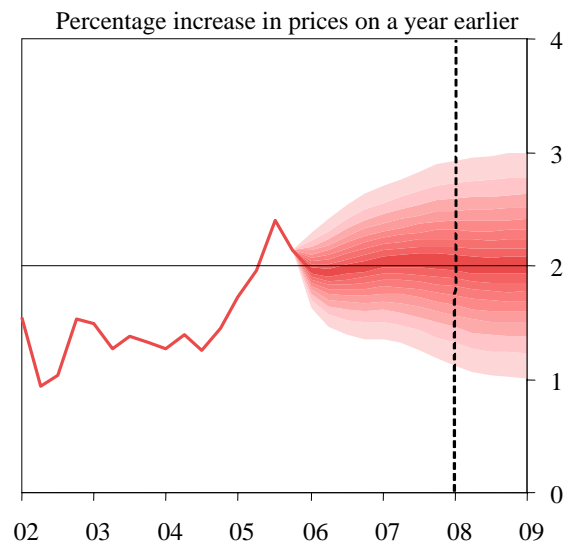
Setting interest rates – how it works



Communication

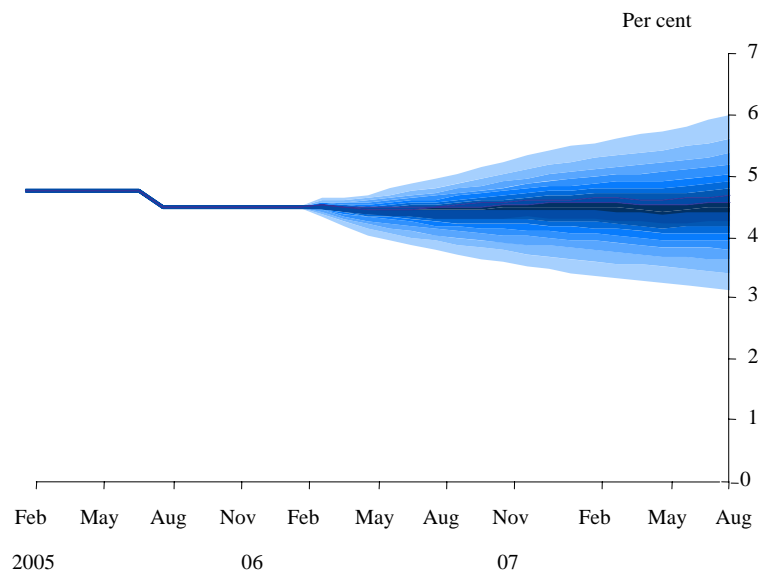
- What makes for good communication?
 - Clarity
 - Reliability
 - Predictability
 - Context and circumstances matter
 - How much information should an inflation targeting central bank provide?
 - How much numerical detail should you publish?
 - What interest path should the forecast be conditioned on?
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How much detail should you publish?



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What interest rate path?



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The Record – good luck or good policy?

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What was IT supposed to deliver?

- A credible framework for monetary policy directed at achieving price stability:
 - Target provides the nominal anchor
 - The institutional framework provides credible commitment
- Policy credibility was expected to improve
 - resilience to inflationary shocks
 - short run output inflation trade off
- Price stability was expected to improve the working of the real economy

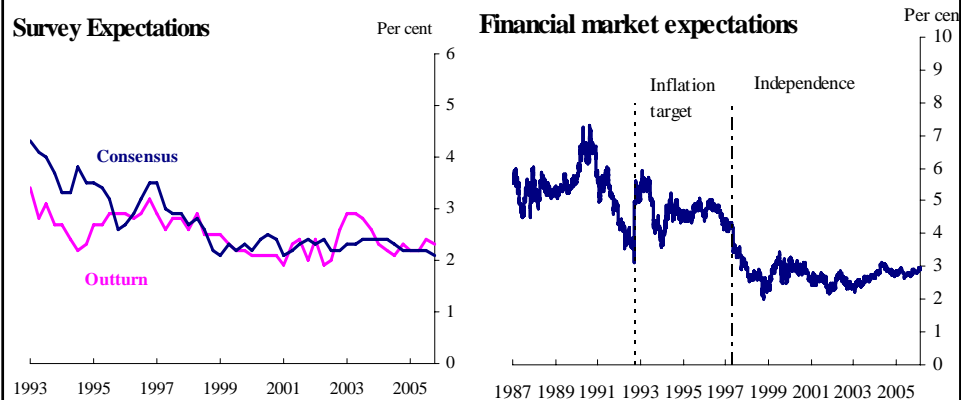
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Assessing the UK Record

- Inflation has been low and stable
- Inflationary shocks die away very quickly
- Inflation expectations have fallen and seem well anchored round the target

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Inflation expectations



- Inflation expectations certainly look stable BUT
- How far does that reflect experience rather than the MPC's credibility?

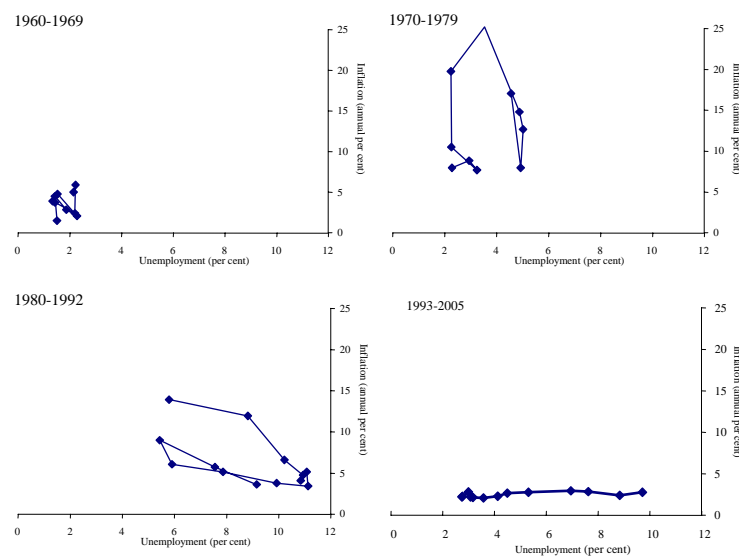
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Assessing the UK Record

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- The short run trade off between output and inflation has improved compared with 70s and 80s

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Inflation and Unemployment

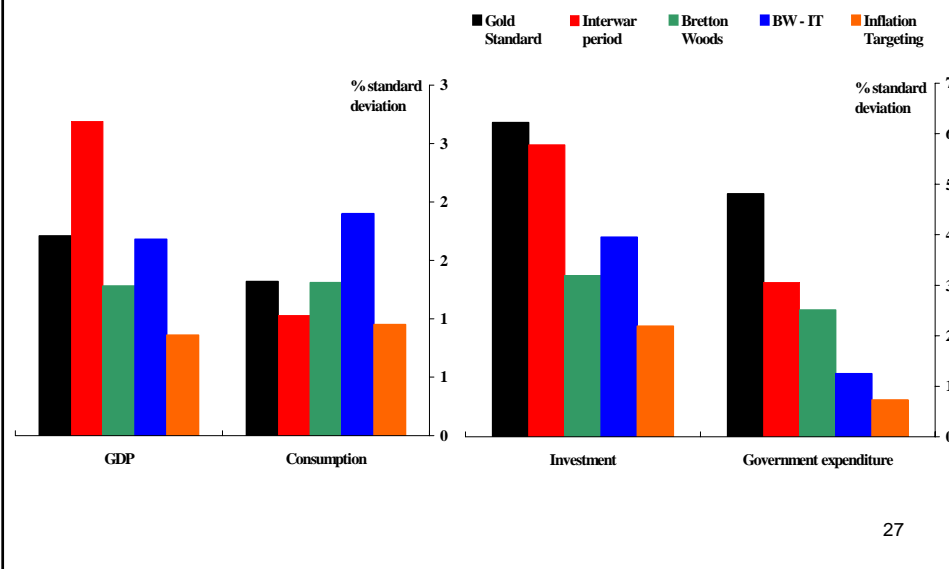


Assessing the UK Record

- Inflation has been low and stable
- Inflationary shocks die away very quickly
- Inflation expectations have fallen and seem well anchored round the target
- The short run trade off between output and inflation has improved compared with 70s and 80s
- The volatility of *real* variables may have been lower than at any time in the Bank of England's history

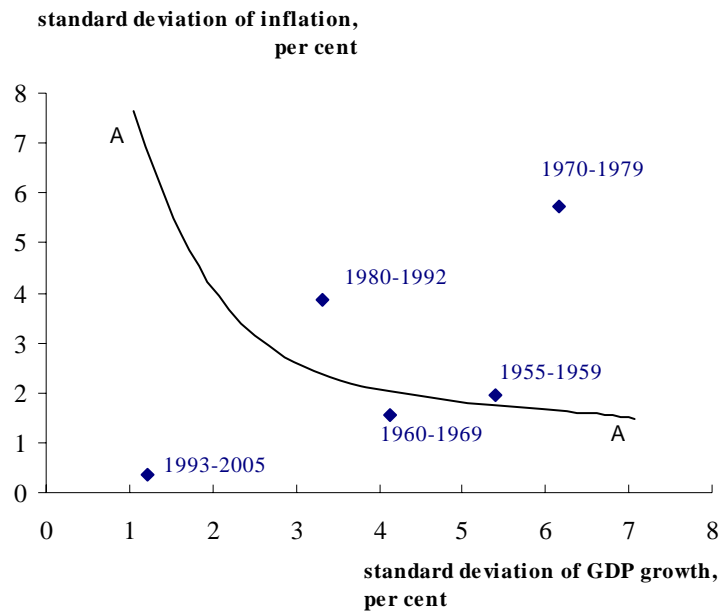
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Volatility of real economic variables



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Inflation and output – variability



What are the challenges?

What are the challenges?

- The acid test of monetary policy frameworks will be how they cope with more turbulent times
 - Has a period of unprecedented stability bred unrealistic expectations about what monetary policy can deliver?
 - How securely are inflation expectations anchored?
- Understanding of how the global economy is changing as a result of the interaction of
 - Emerging low cost economies, new technologies, greater openness to trade, low world wide inflation

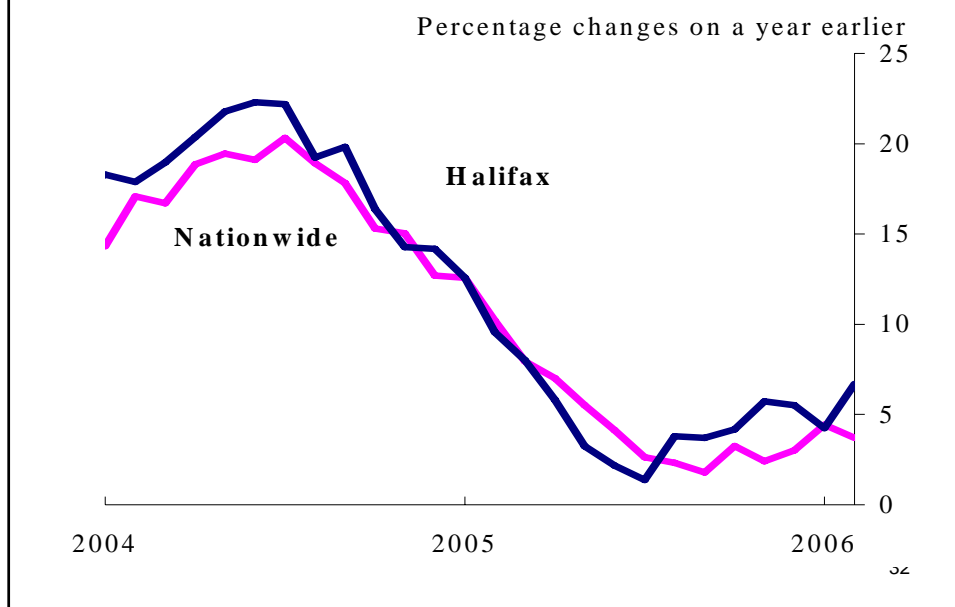
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A bump in the road?

- UK housing market stalled in mid 2004, following 125 bps rise in interest rates....

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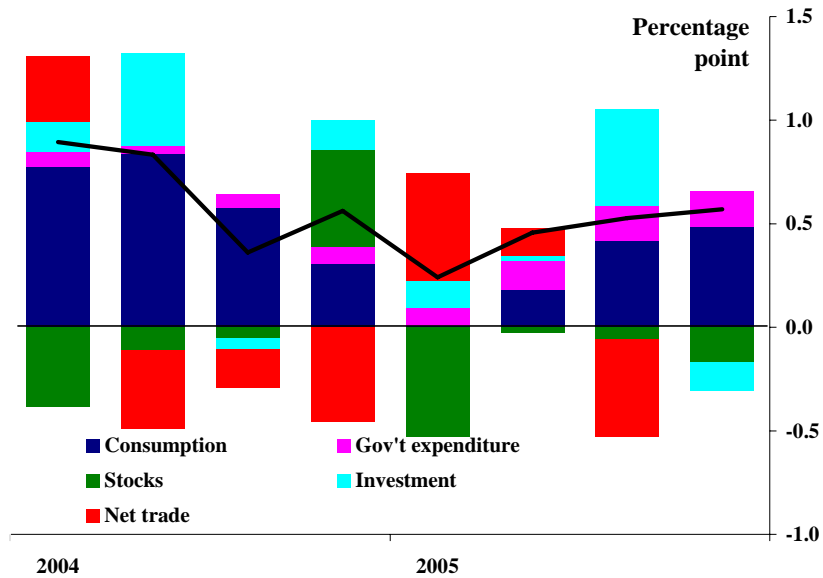
The housing market slowdown



A bump in the road?

- UK housing market stalled in mid 2004, following 125 bps rise in interest rates....
- ..and personal incomes were squeezed by higher energy prices and higher taxes
- Consumer spending slowed sharply leading to a shallow slowdown in GDP growth

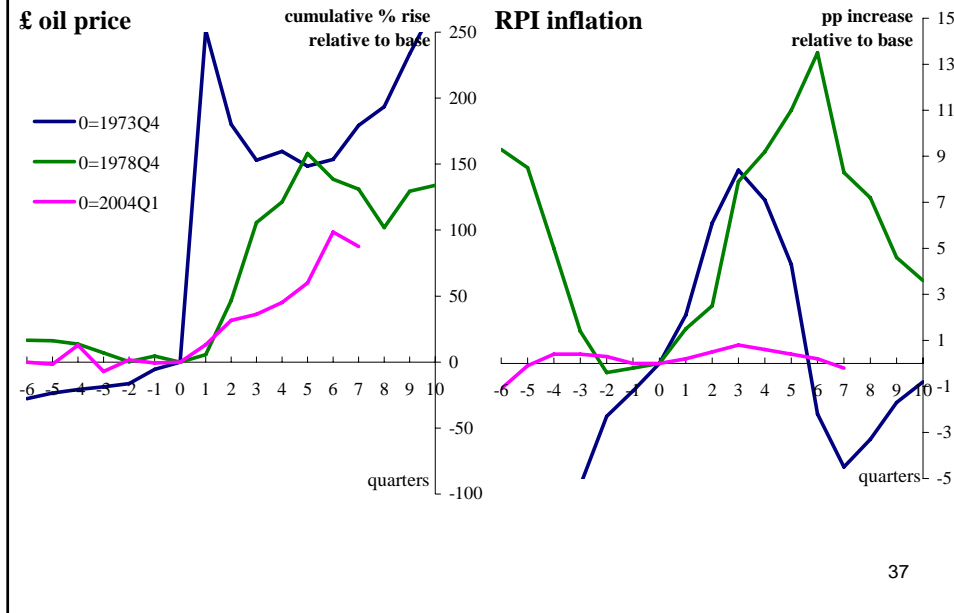
The slowdown in consumption and output



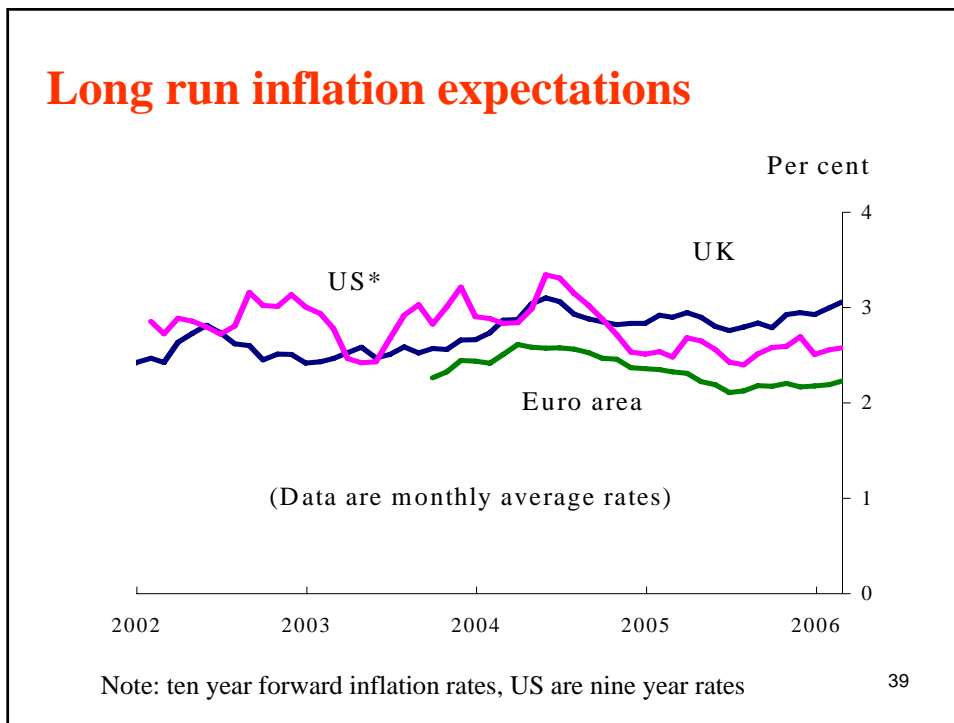
A bump in the road?

- UK housing market stalled in mid 2004, following 125 bps rise in interest rates....
- ..and personal incomes were squeezed by higher energy prices and higher taxes
- Consumer spending slowed sharply leading to a shallow slowdown in GDP growth
-leading some commentators to ask if the wheels have come off the economic miracle

The impact of oil price shocks



Long run inflation expectations



A puzzling global picture...

- What led to the Great Moderation?
 - Did it reflect favourable supply shocks (globalisation, low cost economies)?
 - Or was it due to good policy?
- How long will investors go on financing the US current account deficit?
 - And what happens next?
- Why are long term interest rates so low? And risk premia so compressed?
 - What are the risks of a sudden correction?

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What have we learnt ?

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What have we learnt?

- Advances of past decade have been operational rather than theoretical
- Key features of a good policy framework now widely understood and implemented
 - clear mandate
 - operational independence
 - accountability
 - clear communication
- ‘Constrained discretion’ provides a good framework for handling major uncertainties about the economy and the world

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