BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
Horse Guards Road
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Dear Chancellor,

In the Monetary Policy Committee's (MPC) latest remit, you asked the MPC to provide its assessment of the case for adopting some form of forward guidance, including the possible use of intermediate thresholds, as well as its view of the trade-off between growth and inflation. The attached document fulfils that request.

In its assessment the MPC has concluded that explicit forward guidance can enhance the effectiveness of the exceptionally stimulative monetary stance in three ways. First, it provides greater clarity regarding the MPC's view of the appropriate trade-off between the horizon over which inflation is returned to target and the speed with which growth and employment recover. Second, it reduces uncertainty about the future path of monetary policy, in particular helping to avoid the risk that market interest rates rise prematurely as the recovery gains traction. Third, it gives monetary policy greater scope to explore the potential sustainable level of employment and output without putting price and financial stability at risk. In these ways, forward guidance can help to secure the recovery that is now in train.

In light of that assessment, the MPC agreed at its meeting on 1st August – and is announcing today – forward guidance about the future path for monetary policy. In essence, the MPC intends at a minimum to maintain the current exceptionally accommodative stance of monetary policy until economic slack has been substantially reduced, provided that this does not put at risk either price stability or financial stability.

In practice, that means the MPC intends not to raise Bank Rate above its current level of 0.5%, at least until the Labour Force Survey headline measure of unemployment has fallen to a threshold of 7%. While the unemployment rate remains above 7%, the MPC stands ready to undertake further asset purchases if additional stimulus is warranted. But until the unemployment threshold is reached, and subject to maintaining price and financial stability, the MPC intends not to reduce the stock of asset purchases financed by the issuance of central bank reserves. Consistent with that, the MPC intends to reinvest the cashflows associated with all maturing gilts held in the Asset Purchase Facility.

The MPC has considered how forward guidance could best be captured in the form of intermediate thresholds. The attached document contains its assessment of the various alternatives. The MPC has concluded that forward guidance is best implemented using an unemployment threshold of 7%. This is not to say that Bank Rate will automatically be increased when the unemployment threshold is reached.

Moreover, it would be wrong to think of 7% as a target for unemployment. The rate of unemployment consistent with price stability – a rate that monetary policy can do little to affect – is likely to be lower than this. So 7% is merely a 'way station' at which the MPC would reassess the state of the economy, the progress of the nascent economic recovery, and, in that context, the appropriate stance of monetary policy.

The threshold is specified in terms of unemployment for two reasons. First, we consider measures of unemployment to be reliable and well understood. Second, an unemployment threshold allows monetary policy to test the scope for a rebound in productivity, while the knockouts ensure that price and financial stability will not be put at risk. As you are well aware, productivity in the UK is currently significantly below its pre-crisis trend, and there is considerable uncertainty around the degree to which that shortfall will unwind as the recovery gains strength. The unemployment threshold is robust to this uncertainty. If productivity growth accelerates as output recovers – such that unemployment falls only slowly – there would be more scope for the economy to expand without generating inflation. Consistent with that, our forward guidance makes clear that Bank Rate would then be held at its current low level for longer than otherwise. The opposite is also true.

The guidance will cease to apply if material risks to price stability or financial stability are judged to have arisen. In that event, the unemployment threshold would be 'knocked out'. Again, this would not be a trigger for raising Bank Rate; it would simply be a prompt for the MPC to reconsider the appropriate stance of policy. The price stability knockouts allow the threshold guidance to remain in place only if, in the MPC's view, CPI inflation 18 to 24 months ahead is more likely than not to be below 2.5%, and medium-term inflation expectations remain sufficiently well anchored. The design of the financial stability knockout – in which the Financial Policy Committee (FPC) is asked to judge whether the stance of monetary policy poses a significant threat to financial stability that cannot be contained through the considerable supervisory and regulatory policy tools of the various authorities – takes advantage of the new institutional structure put in place by the Financial Services Act. These price stability and financial stability knockouts ensure that our forward guidance is consistent with the MPC's primary objective of ensuring price stability, and the requirement in its remit to have regard to the policy actions of the FPC.

The MPC's current assessment is that, with Bank Rate remaining constant at 0.5% during the three-year forecast period ending in 2016 Q3, it is as likely that unemployment will reach the 7% threshold sometime beyond the three-year forecast horizon as before. It is important to be clear, however, that forward guidance does not mean the MPC is promising to keep interest rates low for a particular period of time. The path of Bank Rate and asset purchases will, as always, depend on economic conditions. Instead, we are setting out the conditions that will need to be met before we consider increasing Bank Rate or reducing our stock of asset purchases.

The introduction of forward guidance adds to the MPC's policy toolkit. It is part of a mixed strategy that includes Bank Rate at a historic low, asset purchases – with scope for further asset purchases possible should conditions warrant – and the Funding for Lending Scheme. Our strategy is also complemented by the use of the Bank's other policy tools, in particular, the recent actions taken to increase the resilience of the UK banking sector.

The introduction of forward guidance will reinforce the Bank's efforts to secure a sustainable recovery in the UK and return inflation to the target. Much is at stake. A recovery in productivity driven by an increase in demand will boost real incomes. A fall in unemployment from its current level of 7.8% to 7% would mean more than a quarter of a million additional jobs, even if the labour force did not grow.

Allowing for expected labour force growth over the next three years, that figure would become well over three-quarters of a million.

In the face of considerable headwinds created by the global financial crisis, UK monetary policy is currently providing an extraordinary degree of support to the British economy. The decision to adopt forward guidance will further enhance the effectiveness of monetary policy so that it fully plays its part in securing a sustainable recovery over the medium term.

Yours sincerely,