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News release

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Business Challenges in a Low Inflation World: How can Monetary Policy Help?

Extracts from a speech by DeAnne Julius, delivered at The University of Wales in Bangor

In a wide-ranging lecture to the new School of Business and Regional Development, Dr Julius discussed the current prospects for the British economy, the key factors that have influenced the Committee's recent decisions to leave interest rates unchanged, and the value she places on diverse indicators such as a new Dynamic Monetary Conditions Index (DMCI) to help assess the effect of shocks to the exchange rate or oil prices on the economy. The following extracts from her speech cover these points.

"Prospects for the near term are good. The projections in our August Inflation Report paint a picture of steady growth with low inflation over the next two years. RPIX inflation is projected to increase from below the target now to just above it by the end of our forecast, while growth is expected to remain at or above its long run average of 2.5%.

Some commentators have asked why we have not raised rates if we expect inflation to be above our target in two years' time. Are we falling 'behind the curve' given the lags between a rise in interest rates and a fall in inflation? I don't think so – for 3 main reasons. First, our forecast is based on an assumption of constant interest rates. Even if we thought an interest rate rise might be necessary at some point to cool inflationary pressures, the forecast does not imply it should happen immediately. With inflation below target for the past 17 months, and inflation expectations firmly anchored around 2.5%, we can afford to wait and see how demand develops and how much constraint is still being applied by our past rate rises and the strong pound.

Second, although there is a consensus that sterling is overvalued against the euro and that this is likely to unwind at some point, it is not possible to predict when or how quickly that might happen. In the meantime, in the midst of the current dollar/euro overshoot in the foreign exchange markets, there is a risk that higher interest rates here would simply drive sterling higher and thereby exacerbate the undershoot of inflation relative to our target.

Third, and most important, we know our forecasts aren't perfect. We do the best job we can and the result is a forecast that represents the centre of gravity around which the diverse views of Committee members are

anchored. But there cannot be a one-for-one mapping from the inflation forecast to the policy vote. There is always a judgment to be made by each of us over how much weight to put on the forecast and how much to put on other indicators of inflationary pressures .

To inform this judgment we monitor our forecast performance. The MPC has too short a history to make this a very scientific exercise. But when we compared our forecasts made between August 1997 and May 1999 with the actual outturns, we found that inflation has turned out rather lower than our forecast, while growth has been rather higher.(1) This is, of course, good news. Just how good depends on the reasons behind it.

There could be many explanations. One obvious candidate is that the pound has been stronger than we built into our forecast assumptions, and this will depress inflation, other things equal. This would not be particularly good news since sterling strength is reversible and could turn from deflationary to inflationary. Another possibility is supply-side improvement in the economy. The stronger competitive pressures that many of you in business have told us you are facing may be driving cost reductions, greater efficiency and more flexibility in labour and product markets that are not yet apparent in economy-wide productivity statistics. Such supply-side improvements could enable us to sustain a somewhat stronger rate of growth than in the past – or assumed in our forecasting model - without provoking higher inflation. Only time will tell which of these explanations is the dominant one.

In the meantime, and because all forecasting models are fallible, I find it helpful to look at a broad range of indicators. Different ones are useful at different times, depending on the issues at hand. Two particularly difficult issues for monetary policy at the moment are the sharp movements we have seen in exchange rates and in oil prices. Will they persist and, if so, what effect are they likely to have on UK inflation?

To help address the exchange rate question, I asked two economists working in the External MPC Unit at the Bank of England to review the set of Monetary Conditions Indices (MCIs) that have been developed for the UK by international organisations and economic commentators. MCIs are used by some other central banks to measure the effect of different combinations of exchange rates and interest rates on economic activity and inflation. The idea is simple: rather than look at the interest rate in isolation as a measure of the relative 'tightness' or ‘ease’ of monetary policy, an MCI combines interest rates and the exchange rate into a composite measure of the policy stance. This is most relevant for an open economy with a large trading sector, such as the UK (or Canada or New Zealand) where changes in the exchange rate will have larger effects on demand and prices than in, say, the United States or the Eurozone as a whole.

There are well understood risks in using MCIs as targets for monetary policy or as operational rules. In an inflation targetting regime such as ours, they can play no such role. However, I find them potentially useful as indicators, both of inflationary pressures and of the monetary policy stance.

Our researchers, Batini and Turnbull, found a number of flaws in the existing measures of MCIs for the UK.(2) Few were derived from a full model, some relied on model estimates that were not empirically sound,

and none captured the different dynamics of how interest rates and exchange rates affect the economy at different speeds. They therefore developed an alternative 'Dynamic Monetary Conditions Index' (DMCI) which overcomes most of these flaws. Of course, it too is subject to the general pitfalls of any model-specific summary measure and our usual inability to pinpoint the source of shocks. But provided it is interpreted with care, the DMCI can provide useful additional insight into the current stance of policy and how much restraint or stimulus is 'in the pipeline' from past and current levels of interest rates and exchange rates, relative to some benchmark period. I commend their paper to you.

What does the DMCI tell us about the current situation? Monetary conditions were easing in the economy from 1993 until late 1997 when they began to tighten, mainly because of the lagged effect of the interest rate rises by the new MPC beginning in the Spring of that year. Conditions continued to tighten gradually over the following two years, followed by an easing over the past year. We are now at the inflection point where the combined effect of recent interest rate increases and the past strength of sterling are turning conditions in a more contractionary direction.

More generally, Batini and Turnbull found that exchange rate changes have smaller but more protracted effects on output than changes in interest rates. This finding accords with the evidence that exporters initially have to absorb exchange rate movements in their profit margins and only gradually attempt to adjust their (foreign) prices if the change looks persistent. Exchange rate volatility and spikes in rates that are soon reversed seem to have little effect. This implies that the sustained strength of sterling against the euro since 1996 is still having a restraining effect on output, but neither the upward spike in sterling in April/May nor its subsequent reversal had much effect. The recent fall in sterling against the dollar has been almost fully offset – in terms of its effect on the UK economy – by the delayed impact of sterling's sustained strength against the euro. Finally, the DMCI suggests that much of the rise in interest rates over the past year has yet to be felt. Indeed, if interest rates and the exchange rate remained constant at current levels, monetary conditions as measured by the DMCI would continue to tighten gradually for the next two years.

The other current issue for monetary policy is whether the high oil price is a temporary phenomenon or will prove to be more persistent. The strength of world demand suggests some persistence. Much will depend on the supply side and whether OPEC can achieve their stated aim of stabilising the oil price within a range of \$22 to \$28 dollars per barrel. That is one possible scenario. But, as I learned during my time as Chief Economist at Shell, the dynamics of this market mean that we should be equally prepared for another ride on the oil price roller-coaster over the next couple of years.

If oil prices remain volatile, then measured inflation will also be more volatile. Under such conditions, we may need to pay more attention to measures of so-called 'core' inflation which attempt to strip out the temporary effects of volatile prices such as fuel or seasonal foods from the reported measures. Both the US Federal Reserve Board and the European Central Bank use core inflation measures as indicators of underlying inflationary pressures. Work is currently underway in the External MPC Unit to develop and test alternative measures of core inflation for the UK.

Expanding our tool-kit in this way, by developing additional indicators to inform our judgment, can help us deal with the inevitable uncertainties that we face. One thing that monetary policy can not do is eliminate economic disturbances. Shocks to the oil price and exchange rate volatility are part of life, both for business and for policy makers. However, monetary policy can help to create a more stable macro environment in which business can plan and invest with more confidence, even in this uncertain world."

Notes to Editors

The August 2000 Inflation Report and fan charts are also available on the Bank of England's web site www.bankofengland.co.uk/inflationreport/infrep.htm

1. See box on "The MPC's forecasting rec ord", Inflation Report, August 2000, page 63-65.

2. See Nicoletta Batini and Kenny Turnbull, "Monetary Conditions Indices for the UK: A Survey", External MPC Unit Discussion Paper No. 1, September 2000
   This Discussion Paper series reports on research carried out by, or under the supervision of, the external members of the Monetary Policy Committee and their economic staff. Papers are made available as soon as practicable in order to share research results and stimulate further discussion of key policy issues. Their publication is authorised by the MPC member who commissioned the research. However, the views expressed are those of the author(s) and do not represent the views of the Bank of England or necessarily the views of external members of the Monetary Policy Committee.