BANK OF ENGLAND

News release

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

26 September 2000

Extracts from a Speech by Dr Sushil Wadhwani at the Financial Services Industry Association, Dublin

In a speech to the Financial Services Industry Association in Dublin today on the UK's monetary policy framework, Dr Sushil Wadhwani, a member of the Monetary Policy Committee at the Bank of England, explained that there is no mechanical link between the two-year-ahead inflation forecast and the policy decision. He argued that, in his personal view, there were a variety of circumstances under which a more rigid relationship would lead to sub-optimal policy.

Some relevant extracts follow.

"There is no mechanical link between the two year-ahead inflation forecast and the policy decision. It is important to recall that we have to attempt to hit our inflation target at all times, not just two years out. Moreover, although there are time-lags between changes in interest rates and inflation, it is plausible that monetary policy has some effect on inflation at time horizons shorter than two years. Also, during a period where structural relationships are changing, one might be more confident about, say, a one year-ahead inflation forecast rather than a two year-ahead inflation forecast.

Setting interest rates today to ensure that our two year-ahead inflation forecast exactly equals the target if interest rates did not change again over the subsequent two years is one possible way of attempting to fulfil our remit. There are alternative time-paths of interest rates which might actually help us fulfil our remit more effectively.

Perhaps the simplest example is one where, say, inflation is expected to undershoot the target for 18 months, but then rise above it at the two-year horizon. Under certain circumstances, one might believe that the Committee has time before it needs to act.

To take a rather different example, if inflation is undershooting the target and the trade-off between inflation and unemployment has been better than expected, it might, under certain circumstances, be better to 'wait and see' rather than adjust policy on the basis of a model-based, two year-ahead inflation forecast, and thereby run the risk of prolonging an inflation undershoot. To take an example which is illustrative of a

different point, if, say, the exchange rate is overvalued and inflation is currently undershooting the target, there might again be circumstances where one does not increase interest rates mechanically now in response to a two-year-ahead inflation projection that is above target, because by doing so, one might end up increasing the overall volatility of inflation.

One could also envisage circumstances where tactical considerations with respect to the likely reaction of the financial markets could play a role in delaying a rate hike even though the Monetary Policy Committee's two year-ahead inflation projection is above its target.

Hence, it is clear that there is a wide variety of circumstances under which the Monetary Policy Committee should not react in a mechanical fashion to its two year-ahead inflation forecast and, indeed, does not."