



BANK OF ENGLAND

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Some Reflections on the MPC

In a speech delivered to the National Association for Business Economics' Conference on "Monetary Policy and the Markets" in Washington DC, Bank of England Monetary Policy Committee Member, Dr Sushil Wadhvani argues that -

(i) The new monetary framework in the UK has made an encouraging start, with inflation expectations having come down at a time when unemployment has continued to fall.

(ii) However, the inflation target has been undershot for the last two years, and inflation is only expected to rise to target in around two years. An undershoot that persisted beyond our two-year forecast horizon might, at some point, come to damage the MPC's credibility. It will, therefore, remain important for us to respond to changes in structural relationships that underlie the forecasting process.

(iii) Over the last four years, the evidence suggests that the Bank of England's interest rate decisions appear to have surprised the markets by more than the corresponding decisions by other central banks. More reassuringly, our performance in this regard has been broadly in line with other central banks over the last two years, so it might have taken time for the markets to learn how the MPC operates. However, we shall continue our endeavour to explain our actions better.

Summary

1. The New UK Monetary Framework

The new monetary policy framework in the UK has made an encouraging start as inflation expectations have fallen to around target. This does not, at first sight, appear to have come at the cost of growth, as the unemployment rate has continued to fall, and output growth has been slightly above its average rate.

2. Are we Biased Towards Undershooting the Target?

Inflation has been below target for the last two years and is projected to remain below 2½% for much of the next two years as well. A critical feature of our framework is that it specifies a symmetric target. If we were persistently to undershoot the target for well beyond the current anticipated duration, this might, at some point, come to damage our credibility. Therefore, it will remain important for us to make sure that we continue to respond to the possible changes in the structural relationships that underlie our forecasting processes.

3 Transparency and Predictability

It is generally acknowledged that UK monetary policy is more transparent than in many other countries. Somewhat unexpectedly, there is some evidence which suggests that our interest rate decisions have, on average, surprised the markets more than the corresponding decisions by other central banks over the last four years. This might be the price one pays for a system of individual accountability, since it is less easy to 'guide' markets in advance of our decisions. However, it is also possible that these empirical results are distorted, because, in the early years of the MPC, the markets were trying to learn how we would react to developments in the economy. Somewhat reassuringly, the average market surprise associated with our decisions over a more recent period is broadly in line with other major central banks. Of course, we should continue to endeavour to explain our actions better.

Key Resources

Some Reflections on the MPC - Full Speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2001/speech129.pdf>