BANK OF ENGLAND

# News release

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## The MPC: Some Further Challenges - Speech by Sushil Wadhwani

In a speech to be delivered at the National Institute of Economic and Social Research Governors' Seminar, Dr Sushil Wadhwani, Member of the Monetary Policy Committee at the Bank of England discusses some further challenges that are likely to confront policymakers.

### Summary

### The Performance of the New Monetary Framework

The new system appears to have made an encouraging start so far with inflation expectations having come down at a time when unemployment has continued to fall. The combination of steady growth and low inflation witnessed in recent years would have been the envy of previous generations of policymakers.

### The MPC's Forecasting Performance

Despite this favourable combination, the MPC has, in the past, been criticised on account of its forecasting performance. I note that the actual outturn for inflation has always been lower than the MPC's two-year ahead forecast, with an average error of up to around 0.5%. A failure to allow for a fall in the level of unemployment consistent with stable inflation appears to have been an important contributory factor. Purely for illustrative purposes, I present some evidence based on a simulation exercise conducted on the Bank of England's core macroeconometric model suggesting that if interest rates had been held modestly lower over the MPC period, then, inflation would have been closer to target, the level of output would have been a little higher, and the path of output and inflation would have been more stable over the last three years. These are just the results of a mechanical exercise carried out on one model, and the time period considered is short. I would not wish to take the precise estimates too literally, but they are suggestive of gains had policy been a little less tight. Of course, one should not exaggerate the significance of these findings - it is always possible, with the benefit of hindsight, to see how one could have done better. Nevertheless, to the extent that policy was held too tight because of a biased forecast, a challenge for the future is to ensure that one learns any relevant lessons from the past.

**Changes in the New Inflation Process?**

Theoretically, as an inflation-targeting central bank acquires credibility, one would expect the nature of the inflation process to change. I present statistical evidence suggesting that -

(i) Changes in inflation now tend to be temporary, while, previously, they tended to be long-lasting.

(ii) Cost shocks like changes in oil prices or exchange rates appear to have a smaller effect on inflation than is implied by historical relationships.

This raises particular challenges for inflation forecasting and monetary policy-setting. A conjunctural example where these issues are relevant is attempting to assess the impact of the Budget on inflation.

**The UK Budget and Monetary Policy**

Since one cannot rely on historical relationships when assessing the impact of cost shocks like higher National Insurance contributions on inflation, the effect of the recent Budget is particularly uncertain. In my judgment, the central projection embodied in the May 2002 Inflation Report probably assumes a higher pass-through into prices than is likely, and too large a 'balanced budget stimulus' to demand growth next year.

**Asset Prices and Inflation Targeting**

Asset price misalignments are likely to pose a rather different kind of challenge. An inflation-targeting central bank might improve macroeconomic performance by reacting to asset price misalignments over and above the deviation of, say, a two-year ahead inflation forecast from target. I believe that a clear signal from monetary policymakers that they would, other things being equal, react to a housing market bubble if one clearly emerged, would make the continuance of strong house price growth less likely now.

**Key Resources**

The MPC: Some Further Challenges - Full Speech
**http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2002/speech171.pdf**