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Inflation Targeting - Achievement and Challenges – Speech by Rachel Lomax

In a speech today to the Bristol Society at the University of the West of England, Rachel Lomax - Deputy Governor responsible for monetary policy and a member of the Monetary Policy Committee - discusses the improvement in economic performance since the adoption of inflation targets and the challenges that policy makers now face.

Speaking of the period since 1992, she comments that "Slightly miraculous as these developments may still seem to the generation that came of age during the Great Inflation of the 1970s ... the happy fact is that for anyone in their mid-thirties, low inflation, steady growth and low interest rates are the norm." Monetary policy in the UK is now "a less melodramatic affair". The new framework has "taken the politics out of interest rate decisions without sacrificing democratic accountability". But the Deputy Governor doubts whether policy making has become easier. "Inflation targeting provides a credible framework within which ... complicated issues can be considered ... but it does not change the need to make judgements or ... make [them] any easier."

Commenting on the decision to increase the official interest rate in February, Ms Lomax says this "reflected a top line view that inflationary pressures were likely to build over the next couple of years. While this has been the emerging picture for some months now, we have been surprised by a number of developments ... [and] we have also had an opportunity to reconsider earlier judgements". But "March will be another month. There can be no foregone conclusions when it comes to setting interest rates ... every month is a fresh decision."

Effective communication is a key challenge. The change in target has involved lengthy explanations to get across "one simple message: that the change in target in no way weakens the commitment to price stability". It has been "harder work" to explain the Committee's thinking on the strong growth in household spending and its relationship with house prices and household debt. Ms Lomax says "Bad memories of boom and bust in the late 80s and 90s get in the way of more nuanced explanations which try to reflect how the world has changed in the past decade." Although there are reasons why house prices might have risen relative to incomes, she says "current levels definitely stretch the imagination. Are people behaving irrationally? Hard to say ... it is not obviously misguided to base decisions on a view of the future which reflects the record of macro economic stability. What clearly is irrational is to assume that current levels of house price inflation will

continue indefinitely." The Deputy Governor denies that house price inflation and borrowing are "the targets that dare not speak their name" but says that the MPC pays them close attention as "... part of the wide range of evidence we review monthly in assessing the outlook for inflation. They have also been important in shaping our view of the balance of risks."

Ms Lomax also discusses how the MPC tries to understand new economic forces. In particular, she asks what role intense retail competition and new technology are playing in driving down consumer prices and boosting household spending power. And she raises the question of whether the UK can expect to see a pick up in productivity in delayed response to the surge in ICT investment in the late 1990s, as seems to have happened in the US.

She comments "As anyone who has ever run a business knows, investment in ICT must be accompanied by changes in the way the job is done. Managing change is a notoriously costly and disruptive business. So some temporary slowdown in productivity growth in the wake of heavy investment in ICT is not surprising." The February Inflation Report does not assume that there is an ICT led productivity miracle in the making. "But we could easily be wrong ... one thing is for sure: we can't afford to sit back and wait for the data to tell us the answer. By the time we have that degree of certainty policy will have moved on."

Ms Lomax concludes that the MPC has always been "very open about uncertainty and about the disagreement that is likely to go with it ... The big prize is long term credibility, and nowadays there is no credibility without openness."

Key Resources

Inflation Targeting - Achievement and Challenges - Full speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2004/speech215.pdf>