BANK OF ENGLAND

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Risk Uncertainty and Monetary Policy Regimes - Speech by Paul Tucker

In a speech today to the UK Asset and Liability Management Association, Paul Tucker - Executive Director for Markets and a member of the Monetary Policy Committee - explores how option prices can shed light on the risks in the current financial environment, including uncertainty about the expected path of monetary policy.

Mr Tucker says that, although financial markets have recovered considerably over the past year, the environment for financial firms is not hazard-free. Future exchange rate movements and the path of global interest rates are the main current uncertainties. Looking at options prices and what they might reveal about market uncertainty, Mr Tucker suggests that, although there is evidence that monetary policy has become more credible than in the past, there is also evidence of greater uncertainty about the path of future nominal interest rates, especially in the United States. Mr Tucker says there is likely to be modestly greater uncertainty when official interest rates are materially away from their neutral level, when there is "not only that uncertainty about future shocks but also uncertainty about how, absent shocks, the central bank would return to neutral".

In relation to the UK position, Mr Tucker says "the recent position here has been that if the economy proceeds along the path implied by our November 2003 Inflation Report projections, the MPC's repo rate will need gradually to rise to keep inflation in line with the target" - a point reported in the minutes of recent MPC meetings. He says there have been few periods over the short life of the MPC when policy has "proceeded to unwind its response to past shocks and so return the official rate towards 'neutral' along a smooth path". So "there have been few opportunities for market participants and others to observe how the MPC would choose to return rates back to around 'neutral'.

Market uncertainty seems not to have been influenced by the change in the Government's inflation target, set for the MPC. Mr Tucker says "bond-market indicators strongly suggest that the change in the inflation target has not affected uncertainty about the future path of policy or the credibility of the regime. Nor should it." Mr Tucker says "…it really cannot be argued that the new target of 2% CPI is inconsistent with price stability". He adds that the switch in the target "does not have material implications for the near-term path of policy because…the MPC expects the wedge between the two measures to narrow on the basis of our view that house prices will decelerate over the next year or so".

Key Resources

British Hospitality Association Annual Luncheon
Speech by Paul Tucker at the UK Asset and Liability Management Association, Egham on 29 January 2004
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2004/speech214.pdf