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News release

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Inflation Targeting In Practice: Models, Forecasts and Hunches - Speech by Rachel Lomax

In a speech today to the 59th International Atlantic Economic Conference in London, Rachel Lomax - Deputy Governor for Monetary Policy and a member of the Monetary Policy Committee (MPC) - discusses the role of economic models and forecasting within the UK's monetary policy framework.

Ms Lomax says that "no monetary policy-maker can avoid taking a view on the future. That view needs to be coherent and disciplined. But it also needs to reflect ..the massive uncertainties inherent in any forecast." She explains how forecasts help to organise, inform and focus the MPC's discussions, and provide transparency about the MPC's thinking.

She stresses that "No model can do everything.The trick is to identify an appropriate degree of simplification for the task in hand. So the Committee has never been prepared to rely on one model." For that reason, the Committee uses a suite of models that complements the Bank's new Quarterly Model, BEQM. This model "provides a greater degree of discipline on Committee members and staff [than the previous model], who are now forced to confront the full implications of their judgements more explicitly."

Ms Lomax also describes how uncertainty and disagreement are handled within the forecast process and amongst nine individually accountable economists. "The MPC's approach to constructing fan charts can help the members come to an agreement on the substantive issues, while retaining their individual views. This is because the risks are often where the major differences of opinion amongst members lie."

She asks how influential the forecasting process is when it comes to the actual business of taking decisions about interest rates and notes that "since 2001 the Committee has displayed a preference for changing rates in Inflation Report months". The evidence also suggests that interest rate "surprises" have become significantly smaller in the post-2001 period than previously, consistent with improved policy predictability. But she emphasises that "the observed tendency for interest rate changes to coincide with the publication of an Inflation Report does not imply that interest rate changes are tied in any mechanical way to the central projection for inflation. The assessment of risks is always a material factor in determining policy".

Ms Lomax concludes that "published forecasts have come to play a key role in formulating and communicating interest rate decisions. The strength of this approach is that ..a good forecast paints a picture that is worth a thousand words. And that counts, both when it comes to organising the debate between nine experts, and when it comes to explaining the basis of policy to a non-expert public.

But forecasts are highly fallible, so our forecast centred approach to inflation targeting has gone hand in hand with a determined effort to illustrate the wide range of uncertainties around any central projection and a systematic attempt to factor the Committee's own judgements about the risks into decision taking. That, for me, is a key reason for resisting recent calls by the IMF and others for the Bank to 'publish numerical projections for a broader range of key variables'. Detail is seductive - but it can also be highly misleading, and a committee that spent its time debating the details of the forecast rather than using it as a tool to address big picture issues would be at risk of losing its way.

Forecasts are indispensable - but they should be handled with care."

Key Resources

Inflation Targeting In Practice: Models, Forecasts and Hunches
Speech by Rachel Lomax to the 59th International Atlantic Economic Conference in London on 12 March 2005
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2005/speech242.pdf