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News release

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Monetary Policy in the UK - The Framework and Current Issues - Speech by Kate Barker

Speaking in Washington DC today at the National Association of Business Economics Policy Conference, Kate Barker, a member of the Bank of England's Monetary Policy Committee (MPC), briefly describes the UK's monetary policy framework and the recent history of its development. She then goes on to outline the main issues surrounding its focus on inflation targeting and considers how far recent low UK inflation could be related to a productivity improvement.

Ms Barker notes that ".the operational independence of the Bank is therefore crucial, but the need to command wide spread public support for central bank independence underpinned the decision .to retain political control over the target itself" and, she adds, "...Having a symmetric point inflation target means that there is now little room for uncertainty about what the MPC is seeking to achieve."

Key criticisms of the UK framework and its application by the Committee are described and countered by Ms Barker. These are: that inflation targeting puts too little weight on output and unemployment; minimising output fluctuations away from trend (one result of inflation targeting) can lead to conflicts in interest-rate decisions, and the focus on inflation diverts attention from asset prices.

Amongst her responses, on the first she says, "By tackling the remit in a forward-looking manner.we are able to allow first-round, direct effects from shocks (such as big rises in the oil price, or changes in indirect taxation), to feed through to inflation, directing our focus at the possibility of second-round effects if the jump in the price level impacts on wages". And on asset prices she says "there are good reasons for not acting to offset movements in asset prices per se. The first is the considerable uncertainty about whether or not a bubble exists - and if it does, how serious it is.More importantly, a shift to targeting asset prices might result in significant changes of interest rates away from the level which would be appropriate to achieve the inflation target. This is likely to create uncertainty about what the aims of monetary policy are and lead to volatile inflation expectations."

Finally, Ms Barker says, ".point inflation targeting has been helpful in communicating clearly about the new regime and anchoring inflation expectations. There have been criticisms of the framework..but I believe that the practice of UK monetary policy and the MPC's communication of it, mean that these criticisms are misplaced."

Ms Barker then asks how far recent low UK inflation could be related to a productivity improvement. She looks to recent experience in the US for clues as to whether the UK might also be about to enjoy a 'Goldilocks' economy. She says, "The evidence is building, but cannot yet support optimism similar to that of the US in the mid-1990s. While the latest data has suggests some productivity improvement, it is too early to reject the alternative explanation that this is simply a cyclical rise. Further, given some signs of relatively poor adoption of best practice management techniques in the UK, a degree of scepticism about productivity gains from ICT seems justified. However, over the coming quarters it will be necessary to look hard at this question, and remain open to the possibility of a structural improvement. A different reason to reconsider the judgement about the present and prospective supply capacity of the economy is the possibility that the recent rise in average hours worked suggests a stronger trend in hours, and that the labour market is not quite as tight as presently estimated."

She concludes, "Over the coming months, the MPC will no doubt continue to reflect on these and other issues. And I hope we will continue to examine suggestions for improving communication and transparency of our policy with an open mind."

Key Resources

Monetary Policy in the UK - The Framework and Current Issues
Speech by Kate Barker at the National Association of Business Economics Policy Conference on 21 March 2005
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2005/speech243.pdf