BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

17 May 2005

Monetary Policy: Practice Ahead of Theory – Speech by Mervyn King

In the Mais lecture, delivered this evening at the Cass Business School, City University, London, Mervyn King, Governor of the Bank of England, argues that inflation targeting is the natural way to conduct monetary policy when there is a great deal about its effects that we do not understand and when monetary theory is continuing to evolve.

He says that to find a way through the minefield between monetary policy rules, on the one hand, and pure discretion in setting interest rates, on the other, "we need to think more carefully about the nature of decision-making in a complex world where the central bank and economic agents alike are learning about their environment."

He argues that "The great attraction of an inflation target is that it is a framework that does not have to be changed each time we learn about aspects of the economy such as the velocity of money or the underlying rate of productivity growth, as was the case in the past with frameworks based on targets for money aggregates or nominal GDP growth. It is a framework designed for a world of learning."

Mr King says: "Inflation targeting is a framework for making and communicating decisions. It is not a new theory of the transmission mechanism of monetary policy. It does not reflect a new understanding of the laws of economics. But, by anchoring inflation expectations on the target, it can alter the transmission mechanism by reducing the persistence of inflationary shocks. And it does so without pretending to commit to a rule that is incredible because it is not expected to last." He adds that a reputation for communicating openly and honestly about the range of possible outcomes matters, because it makes it more likely that people will continue to listen.

Mr King says that the most immediate challenge for inflation targeting in the future stems from its very success: "Although it is now widely accepted that there is no long-run trade off between inflation and output, the ability of monetary policy to affect output in the short run means that there is, in principle, a permanent trade off between the volatility of inflation and the volatility of output…. The choice of a horizon over which to bring inflation back to target is equivalent to choosing a point on this volatility trade off. The striking change, however, is the remarkable improvement in the trade-off that followed the introduction of inflation targeting. The volatility of both inflation and output growth were much lower than in earlier periods."

He adds: "So the challenge ahead is that if a shock, larger than we have experienced recently but not large relative to historical experience, were to move inflation significantly away from target, then inflation expectations might become dislodged from the target. The behaviour of expectations and so the economy as a whole would change. So far there is little sign that the shocks we have experienced have detached inflation expectations from the target, and that is a source of comfort. But the MPC will continue to pay particular attention to the evidence on inflation expectations. Many of the problems of the past resulted from the failure to take action before expectations had started to drift upwards, and the cost of that inaction proved to be high. When the time comes for me to write an open letter to the Chancellor because inflation has deviated by more than one percentage point from target – and it is very surprising that such a letter has not been required in the eight years since the MPC was set up – I will welcome the opportunity to explain how we expect to bring inflation back to target and over what horizon. Such letters are an integral part of the policy framework, not an indication of its failure."

Mr King concludes: "From those perspectives inflation targeting appears a natural way to conduct monetary policy. And experience of inflation targeting suggests that a managed monetary standard can lead to stability – of both inflation and the economy as a whole – without the straitjacket of a gold standard, currency board or rigid fixed exchange rate target. Inflation targeting anchors inflation expectations, yet allows a flexible response to economic shocks."

Key Resources

Speech by Mervyn King, Governor, given at the Mais Lecture at the Cass Business School, City University in London on 17 May 2005
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2005/speech245.pdf