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Monetary Policy - from Stability to Financial Crisis and Back? - Speech by Kate Barker

In a speech to the National Institute of Economic and Social Research in London today, Kate Barker draws lessons from her nine years as an external member of the Bank's Monetary Policy Committee (MPC). She suggests these might inform the Committee over the "difficult" years immediately ahead. Ms Barker steps down from the Committee on 31 May this year.

Her central theme is "... whether the approach to policy should be somewhat different in the more uncertain economic environment we face today, compared with the relatively tranquil period of the MPC's first ten years." In this context, she considers issues around the role of the output gap and around the appropriate policy horizon.

Ms Barker suggests that modifications to the way it assessed the output gap ie "... the implications for inflation of the pressure of demand on the economy's supply capacity ... " in the past "... were pragmatic responses by the MPC to changes taking place in the economy." She describes uncertainties about the size, interpretation, and even the definition, of the output gap, and the additional factors contributing to difficulties in its measurement at the current conjuncture. She notes "... that although from time to time it is criticised for too much reliance on one model, the MPC ... is fully aware that different circumstances point to different challenges. At present, neither the extent of excess capacity nor the impact of capacity pressures on inflation are easy to assess ... It therefore makes sense to look at a range of estimates both of the gap and of its effect in order to give some guidance to the range of likely economic outcomes. Implicitly, such a range is contained within the fan charts of GDP and of CPI inflation published quarterly in the *Inflation Report*." She concludes that, "... the MPC could consider using a range of different plausible estimates of the output gap and its effect on inflation as a part of the methodology of constructing the growth and inflation fan charts."

On the length of the policy horizon, Ms Barker first expresses reservations about the proposition that the MPC should have had higher interest rates during the mid-2000s to control credit growth but concedes "... it is possible that it would have been preferable to have taken a more long-term view of the risks to inflation

from economic instability.” In the present context, Ms Barker finds “... a strong argument for continuing to focus on the two-year horizon is that it would encourage policy to aim at a rate of growth in the short term which would reduce the scale of excess capacity in the economy as fast as possible.” However, she suggests, “... it might also be useful to reconsider the merits of looking to inflation prospects beyond the normal forecast horizon, to ensure any future risks to economic stability are taken fully into account.” She also takes the opportunity to praise the work of the Bank’s Agents, and the impact of Committee members’ regional visits, in enhancing the Committee’s credibility.

Key Resources

Monetary Policy - from Stability to Financial Crisis and Back? - Full speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech426.pdf>