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News release

29 March 2011

Uncertain uncertainty - speech by Martin Weale

In a speech to the Institute and Faculty of Actuaries in London, Martin Weale - External Member of the Monetary Policy Committee (MPC) - discusses the nature of the uncertainty surrounding macroeconomic forecasts and describes how it might be represented.

Although economic forecasting is far from an exact science, Martin Weale begins by describing its necessity. He says: ".since policy moves such as interest rate changes take some time to have an effect, it makes more sense to set policy not with reference to the current state of the economy but with reference to where it is expected to be or, more explicitly, where inflation would be expected to be at any given interest rate setting". For that reason, the MPC normally aims to set monetary policy so as to achieve the inflation target in about two years' time. He adds that: ".if the MPC aimed to achieve the inflation target too quickly, the process might well match that of someone trying desperately to adjust a shower to the right temperature. By failing to take account of the lag between turning the taps and variations in the temperature of the water that comes out, the bather is condemned to a sequence of water which is too hot followed by water which is too cold and so on. Only a degree of patience can deliver a comfortable shower."

Given that economic forecasts are a necessary part of the policy process, Martin Weale argues, those forecasts need to be in the public domain. But because they are in the public domain, he says ".it is important that producers of forecasts should help outsider users of them to understand their limitations. In particular users need to understand that forecasts are neither right nor wrong; they are simply the best that forecasters can do with the information available".

Martin Weale goes on to discuss how the uncertainty surrounding forecasts might best be described. The MPC's Inflation Report forecasts are presented as fan charts, rather than point estimates, summarising the assumed probabilities of various outcomes occurring. But even those probability estimates are themselves uncertain. He illustrates that with an example of the uncertainty surrounding estimates of the probability of a recession that can be derived from their historical frequency, noting that: "There must be some businesses which would pay more attention to the risk of recession if they thought there was a reasonable chance it could be a one in ten year event rather than if they assumed the risk was not much more than half of that". So, Martin Weale continues by describing how the principle of 'uncertain uncertainty' might be applied to the

MPC's economic forecasts. As a contribution to the debate, he provides a range of possible alternative depictions of the MPC's forecasts that might help users understand more about the nature of the uncertainty faced by the MPC about the economic outlook. Whether or not those ideas would prove useful to users, he concludes, discussion of them does draw attention to the importance of communicating uncertainty as clearly as possible and interacting with users about how this might be done.

Key Resources

Uncertain uncertainty – Full speech