BANK OF ENGLAND

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09 October 2012

Twenty years of inflation targeting – speech by Mervyn King

Mervyn King – Governor of the Bank of England – gives a personal assessment of the inflation targeting regime over the past twenty years.

The Governor's Stamp Memorial Lecture, at the London School of Economics, marks the twentieth anniversary of the introduction of inflation targeting. He characterises the period as "fifteen years of stability and five years of turbulence – the Great Stability and the Great Recession". He notes that over the past twenty years, price inflation in the United Kingdom averaged 2.1% - well below inflation in the preceding decades. But he asks "did we pay too high a price for this achievement?" noting that "the past five years of financial crisis and turmoil in the world economy have raised serious questions about the adequacy of inflation targeting". So the main theme of his lecture is to ask "should monetary policy go beyond targeting price stability and also target financial stability?"

The Governor argues that the substantial benefits of targeting price stability should not be forgotten. The anchor provided by the inflation target has allowed the UK "to absorb the largest depreciation of sterling since the Second World War, as well as very large rises in oil and commodity prices, with an increase in inflation to an average of only 3.2% over the past five years and without dislodging long-term inflation expectations".

The Governor then goes on to describe some of the shortcomings of the standard intellectual foundations of inflation targeting. He sets out three potential arguments for why meeting an inflation target in the short run might, in theory, increase the risk of financial instability in the longer term.

First he argues that economic developments can be driven by "misperceptions" of households, firms and banks, for example on the future rate of economic growth. These "misperceptions mean that unsustainable levels of spending, and associated levels of debt, can build up over many years. When those misperceptions are eventually corrected, they lead to sudden large changes in asset values, a synchronised de-leveraging of balance sheets, a large downward correction to spending and output, and defaults".

Second, he considers the possibility that the experience of unprecedented stability in the fifteen years since 1992 may have "bred complacency about future risks". Partly as a result, "the leverage of our banking system rose to unprecedented levels".

Third, he considers the possibility that monetary policy itself may affect financial sector risk taking. "Short-term policy rates, especially when they are, as now, exceptionally low, may encourage investors to take on more risk than they would otherwise wish as they 'search for yield' ".

The Governor argues that monetary policy cannot fully offset the effects of financial crises after they have happened and asks "should interest rates have been higher...to mitigate some of the growth in credit, rise in asset prices and increase in the leverage of the banking system?" He notes that between 1997 and 2007 GDP growth was close to its long run average and that the MPC's policy rate was higher than in any other G7 country. He also notes that early on in that period, the sterling exchange rate had risen by 25% which was 'not entirely explicable'. That had led to serious imbalances in the UK economy, including a pattern of growth that was not sustainable, with, for example, too high a level of consumption.

The Governor suggests that a strategy of persistently higher interest rates "might have brought some benefits for financial stability" but he argues that those benefits would have been limited because the financial crisis was global in nature. He also notes that "We might still have experienced a banking crisis because ... lending to the UK real economy contributed only a small share of the rise in leverage of the largest UK banks."

He describes how the effect on the real economy of a strategy of persistently higher interest rates would have depended on what happened to the exchange rate. It might have "jolted down" expectations of growth and so the long run path of the exchange rate. But higher interest rates might have led to a stronger exchange rate, which would have worsened the imbalances in the United Kingdom. The Governor concludes that "Everything would have hinged on the ability of the strategy to bring down the expected equilibrium level of sterling....to avoid a damaging recession". So such a policy would have been a "big gamble".

In view of that, the Governor argues that it would have been better to alleviate the risk of a crisis with macroprudential tools rather than interest rates. He says that "With hindsight, before 2007 there should have been a cap on the leverage of banks. And the cap should have tightened as asset prices increased and the likely exposure to losses increased. That is why we now have a macro-prudential policy regime in the UK." But he notes that "macro-prudential tools deal with symptoms rather than the underlying problems of misperceptions and mispricing" and that "it would be optimistic to rely solely on such tools to prevent all future crises." As such, the Governor argues that "it would be sensible to recognise that there may be circumstances in which it is justified to aim off the inflation target for a while in order to moderate the risk of financial crises."

The Governor concludes that “the case for price stability is as strong today as it was twenty years ago” and that “we shall learn a great deal about the appropriate allocation of responsibilities to monetary policy, on the one hand, and macro-prudential policy, on the other, over the next twenty years” but that “we should not throw out the baby with the bathwater” because “low and stable inflation is a pre-requisite for economic success”.

Key Resources

http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech606.pdf

Full speech by the Governor