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

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Forward guidance and its effects - speech by Martin Weale

In a speech given to the National Institute for Economic and Social Research, Martin Weale, member of the Monetary Policy Committee, explained some of the theoretical issues around forward guidance and offered his initial thoughts on what its impact has been so far in the UK.

He outlined the strengths of the state-contingent forward guidance adopted by the MPC over a simpler time-contingent version with which Bank Rate would be held down for a fixed period. In particular, he argued that the fact people cannot be certain about when the relevant state – in the case of the MPC, the 7 per cent unemployment threshold – will be reached is a strength of the policy. He said: “The future is uncertain and no one can change that. What is important is that the MPC reacts appropriately to events as they evolve.”

Making the point that models best seen as tools for organising thoughts, Martin used a simple New Keynesian framework to explore the effects of forward guidance. He demonstrated that simple models suggest that the strongest impact of the policy should be seen at the start of the period of forward guidance. However, he noted that the strength of the response to guidance implied by simple models – predicated on the assumption that Bank Rate would remain a ¼ point below where it otherwise would have been for up to three years – is questionable and sensitive to the assumptions made about the structure of the economy.

He said: “I find it inconceivable that, without forward guidance, I, or any of my colleagues, would have already voted to raise Bank Rate and that the only thing that has stopped us is forward guidance…If forward guidance has done no more than to codify what people had expected the Monetary Policy Committee to do anyway, then its effects on the profile of expected future rates, and thus on output and inflation, should be expected to be small.”

To investigate this impact, Martin first looked at market rates. He said he saw was no obvious impact on expected future rates immediately after the announcement of forward guidance – although he noted that the discussion of forward guidance prior to August may have already been reflected in market expectations. Since August expected future rates had risen appreciably. However, Martin argued this reflected improved growth prospects: “It does not tell us anything about the effects of forward guidance.”

Next, he turned to an analysis of the impact on uncertainty. Studying the volatility of Libor options, Martin found that the policy appears to have brought about a marked reduction in uncertainty at the shorter end of the market, at around 3-6 months. He said: “This reduction in uncertainty, which has persisted to the end of November, suggests that the policy achieved the aim of reducing uncertainty. This is likely to have provided some stimulus to the economy, but given that only near-term uncertainty has been affected, it is difficult to believe the effect is large.”

Finally, he discussed the market intelligence he had gathered on the impact of guidance, which indicates that, while there is a range of views, people working in financial markets believe in broad terms that the profile of expected future rates is about ¼ percentage point lower, up to two years ahead, than it would be in the absence of forward guidance. Martin said that his own model indicates that the impact of delaying a rate rise from one year ahead to two years ahead has a substantial impact at the present, raising output by between ½ and ¾ of one percent and the inflation rate by just over ¼ of one percent. However, he argued that these numbers were very much upper limits. The effects of the policy would depend on how far it was understood by businesses and households understanding the policy sufficiently well and that its impact might be slowed by other lags in the system.

He said: “We do not, as yet, have any firm information on how well the policy has been understood. But, unless people have taken an unusual interest in what my colleagues and I have said about policy, it seems to me likely that the initial effects will be appreciably smaller than the numbers above.”

While Martin remained concerned about the current levels of medium-term expectations, he found no evidence to suggest that forward guidance had affected businesses short-term expectations of their own price increases.

Discussing what might happen when unemployment falls to seven per cent, he concluded: “Markets have an understanding that policy can remain very supportive of the economy even if Bank Rate is, at some point, slightly higher than it is now. I do not want to speculate on when that might happen and limit myself to the obvious point that, other things being equal, good news on underlying inflation reduces the case for tightening while rapid economic growth and, more especially, rapidly-falling unemployment strengthens it.”