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News release

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Inflation targeting and flexibility - speech by Ian McCafferty

Speaking at an event hosted by The Wall Street Journal, Ian McCafferty sets out his views on the MPC's remit and emphasises their commitment to the Inflation Target.

Ian McCafferty notes that "anyone under the age of about 45 will not have an adult memory of high inflation. "That is proof that the inflation genie has been successfully kept in the bottle. But it also means that there is a risk that the low and stable inflation of the past two decades is now being taken for granted". He thinks that "would be a mistake.....it is important that we as a nation do not lose that understanding of the importance of low and stable inflation, which would leave us in danger of repeating the mistakes of the past."

Looking over recent history, he believes that "since the early 1990s and in contrast to the 1980s, there has been an inverse relationship between energy and import inflation on the one hand and domestic non-energy inflation on the other. This strongly suggests that, when inflation expectations are anchored, the response of domestic prices to cost shocks tends to be muted." "The crucial difference between the 1970s and the experience of recent years is that, this time round, the commitment of policymakers to low and stable inflation was well-established before the cost shocks hit the economy. It is this inflation-fighting credibility that gives the MPC the flexibility to look through the short-term inflationary impact of such cost shocks without dislodging long-run inflation expectations."

Nevertheless Ian McCafferty notes that "inflation ....has been persistently above the 2% target for the past three years and...we expect that on balance it will remain above the 2% target until at least the end of next year." "Short-term inflation expectations have picked up ... and there is evidence that longer-term market-derived inflation expectations have become more responsive to ... news about consumer price inflation". "That greater sensitivity to short-term inflation news could suggest that expectations are becoming less anchored than they have been, and that markets perceive that the MPC has become more tolerant of inflation. This is certainly not the case ... In this environment, I believe it is important to continue to be mindful of the need to keep expectations well-anchored when setting policy."

Ian McCafferty notes that in February, the MPC "chose to maintain the large amount of stimulus already in place in spite of our forecast that inflation was likely to exceed the target until well into 2015. We judged that removing it to bring inflation back to the target within two years would both risk derailing the recovery as well as risking undershooting the target further out." He suggests that "accommodating relative-price shocks is a suitable monetary policy response only if the first-round impact on headline inflation does not unhinge inflation expectations and lead to second-round inflationary changes in wages and prices." He points out that that "in the United Kingdom in recent years, such second round effects have been remarkably absent. Nominal pay growth has been muted and profit margins have been squeezed." "That is proof that our flexible approach to inflation targeting has not jeopardised our credibility. This is crucial for our ability to continue to achieve price stability in the future. We are well aware that a loss of credibility would effectively amount to a loss of flexibility. So it is paramount for us to continue to ensure that inflation expectations do not drift up and feed through to wage and price-setting behaviour."