BANK OF ENGLAND

News release

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

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Monetary policy and monetary policy-making – speech by Martin Weale

In a speech delivered at the British-American Business Council Transatlantic Conference, Martin Weale – External Member of the Monetary Policy Committee (MPC) – sets out his thoughts on monetary policy-making in the current circumstances. He looks at the new remit, in particular the trade-off between controlling inflation and avoiding undue fluctuations in output, and considers how this is currently impacting the actions of the MPC. He concludes that "a reasonable trade-off between inflation volatility and output volatility means that, in making our policy decisions, we are very conscious that policy affects output as well as inflation and that periods of below-normal output have very substantial costs associated with them."

Martin Weale begins by reviewing the back-drop over which the MPC has been setting policy over the past few years: "Since the start of 2009 the inflation rate...in the UK...has been below two per cent for only six out of...fifty-one months...I have certainly felt that this history is a constraint on my freedom of action." Looking at the MPC's remit, he notes that "The flexibility that the remit offers us can be can be used safely only while there is general confidence that the Monetary Policy Committee is committed to keeping inflation close to its target in the medium term."

Martin Weale refers to the Chancellor's request that the MPC be much more explicit about the trade off between controlling inflation and avoiding undue output volatility. He states that: "While there is long-run confidence that policy will focus on delivering the inflation target, it is...possible for policy-makers to accommodate short-term fluctuations in inflation with the benefit that short-term variations in demand are reduced and so output is more stable." However, he also reiterates that a long period of above-target inflation may lead to people losing confidence in the policy. And says: "Failure to damp sufficiently any new shock pushing up on inflation would result in inflation expectations becoming more entrenched. That, in my view, limits the scope we have to support demand at the current juncture." Analysing the trade-offs between inflation and output volatility, he concludes that: "the correct thing for policy-makers to do would be to accept a modest degree of entrenchment of raised inflation expectations as a price worth paying for a smoother output path." He continues: "In broad terms this suggests that the Committee has been right to accept some modest increase in inflation expectations during a period of elevated inflation...It is not enough for us to take our remit seriously; we have to explain that we take it seriously. If we undertake this task effectively, there should be very little entrenchment of inflation expectations, while if we are poor at it, the effect may be substantial."