BANK OF ENGLAND

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Monetary policy-making and forward guidance – speech by Martin Weale

In a speech given to A-Level students at Quintin Kynaston Community Academy in London, Martin Weale, Member of the Monetary Policy Committee (MPC), outlines the modern history of monetary policy in the UK – from the 1970s to the present day.

Martin explains the principles of forward guidance, the latest development in UK monetary policy, and the role of the 7% unemployment threshold under the framework, noting the MPC has not said that Bank Rate will be raised at that point, but only that it will review the situation. He adds: "In deciding what to do we will need to take account of how fast unemployment is falling. If unemployment is falling rapidly, e.g. much faster than our central forecast, we will need to consider the risk of holding rates too low for too long. Even with inflation close to target, it is unlikely to be appropriate for rates to remain at their current level until all spare capacity in the economy has been used up."

Martin also emphasises the importance of the MPC's 'knockout' over medium-term inflation expectations. Referring to his own experience working in a shop in 1975, when a customer bought a coat as an investment given high inflation prevailing at the time, Martin says: "The lady thinking of buying a coat as an investment in the 1970s was doing so not because prices had risen by twenty-five per cent over the previous twelve months but because she was expecting something similar in the future."

While assessments of medium-term inflation expectations have always been important for monetary policymakers, Martin argues that the second knockout of the forward guidance framework has made this indicator even more critical. He states: "Our policy of forward guidance has transformed medium term inflation expectations, at least for me, from being one of the issues I take into account, to a key influence on the way I vote. In that sense, of course, the policy of forward guidance reduces the flexibility available when voting. The bar to not responding to any given increase in medium-term inflation expectations is higher than it was without forward guidance."

Taking a range of indicators for medium term inflation expectations, Martin states that there appears to be an average increase of 0.15 per cent at present. He says: "I would regard a movement of 0.5 per cent in such an indicator as extremely important. Indeed, I would be very concerned by a movement as large as 0.25 per cent." However, he adds that he would have to be convinced that the upward movement would persist, as it would be “quite wrong” to react to a short-term movement. He also said that further work is underway at the Bank how best to interpret these data.

Martin also notes that the most recent figure for inflation was appreciably lower than the MPC had anticipated in August. However, Martin says that this has been partly driven by the rise in sterling, which worsens his own concerns about the balance of payments.

He concludes: “I am comfortable to stick to the guidance we have offered, instead of claiming too much insight about the future. Nevertheless, it is perfectly possible that, as time moves on, the right thing to do will be to keep the Bank Rate at ½ per cent even when unemployment has dropped below our seven per cent threshold. As my colleagues have explained, a rise is not automatic. We will do what we have always done; look at the state of the economy and take the most appropriate decision in the light of that.”