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News release

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Inflation targeting and the MPC's forward guidance - speech by Spencer Dale

In this text, summarising remarks made at the recent International Journal of Central Banking Annual Conference, Spencer Dale asks how the UK's inflation targeting regime has stood up to the extraordinary challenges posed by the recent prolonged period of high inflation, anaemic demand and weak supply. He goes on to explain how the lessons learned informed the design of the MPC's forward guidance.

Spencer contends that the "traumatic events in the UK economy over the past five years have...strengthened the case for inflation targeting". The credibility of the MPC's commitment to an inflation target has kept inflation expectations anchored through a protracted period of high inflation during which the Committee injected an exceptional amount of monetary stimulus in support of growth and jobs. "The inflation target and the credibility it afforded were essential in allowing the MPC to respond as forcefully as it did", Spencer argues. "Without credibility there can be no flexibility". Had the MPC not exploited the credibility it had earned to the full, the recession would have been deeper and longer. The UK's inflation target "has passed this test with flying colours".

But while inflation targeting's report card reads well in terms of the MPC's policy actions – supporting the economy while keeping inflation expectations under control – Spencer sees the regime as having "room for improvement... in addressing some of the communications challenges posed by the sustained period of weak growth and high inflation".

An exclusive focus on inflation fosters anti-inflation credentials, but it risks being a "double-edged sword" if it gives the false impression that the MPC are not pulling out all the stops to support the recovery. "The control of inflation is important but so too is the creation of jobs, as unemployment rose to its highest level for almost twenty years". Spencer argues that maintaining people's trust in inflation targeting and its democratic legitimacy requires the MPC to "make clear the central role monetary policy has played in supporting output and employment".

Spencer goes on to identify the key to understanding UK monetary policy decisions over recent years as the MPC's attempt to juggle two risks. "If we attempt to return inflation to target too quickly, by withdrawing monetary stimulus", he explains, "we risk undermining the fledgling recovery. But returning inflation to the target too slowly might cause people to question the MPC's commitment to keep inflation close to 2% in the medium term." The vocabulary of inflation targeting speaks to "only one half of this trade-off". The

Committee should be clear about its view of the appropriate trade-off so that we can be challenged and held to account. “The stakes are high”, Spencer emphasises, “our management of the trade-off between returning inflation rapidly to target and supporting the recovery directly affects businesses and families up and down the country.” “Moreover, by making clear its view of the desired trade-off, the MPC [can help] to make our monetary policy more predictable. This enables financial markets, companies and families alike to make more informed decisions and so improve the effectiveness of policy.”

The MPC’s forward guidance – making clear its intention not to consider raising interest rates at least until unemployment has fallen to 7%, so long as it poses no risks to inflation or financial stability – augments inflation targeting for the exceptional circumstances that we face to “meet those challenges head on”.

Expressing the MPC’s guidance in terms of a rate for unemployment helps to address two further challenges facing the Committee: the uncertainty around how much productivity will rebound as demand increases; and the need to clarify how monetary policy is likely to respond as the economy recovers. Movements in unemployment will provide a guide as to how productivity is responding through the recovery. That means it will also give a steer as to what will need to happen to interest rates. And the focus on unemployment helps to reinforce the message that its levels of spare capacity that matters for the MPC, not growth. “The level of GDP is still below its pre-crisis level; there are almost one million more people unemployed. We need to see a sustained period of robust growth before the economy moves back into anything resembling balance. It’s levels that matter”.

Nonetheless Spencer is keen to stress that “targeting a particular level of the unemployment rate is not a job for monetary policy.... we can’t generate higher output or employment [in the long run] simply by printing more money”. Nor is unemployment a sufficient measure of slack in the economy on which to base our policy... When we reach the 7% unemployment threshold, the Committee will reassess the state of the economy based on all available information and, on that basis, decide whether it should start to withdraw the current extraordinary levels of stimulus.” “An unemployment rate of 7% is not our intended destination. Nor even is it necessarily the first turning on the way to our final destination. Rather, it is a conveniently located lay-by at which we can pull over, study our economic map in detail, and work out whether we are anywhere close to our first turning.”

Overall, Spencer concludes that “the MPC’s forward guidance builds on the clarity and credibility of the inflation target” and “increases the effectiveness of monetary policy”.