BANK OF ENGLAND

Speech

Monetary policy and monetary policy-making

Speech given by

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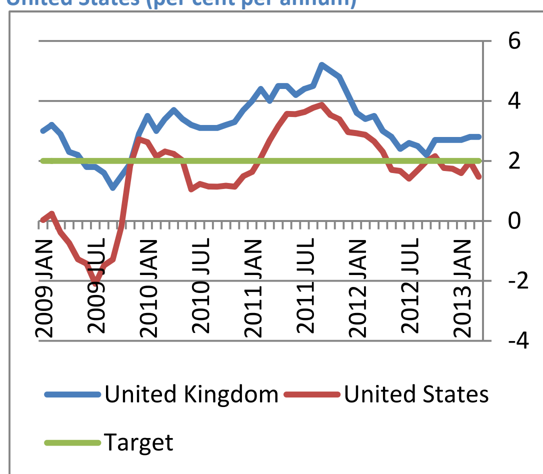
Introduction

Over the last few months there has been considerable discussion about the role of monetary policy and the way in which it can influence the future of the economy. The Chancellor of the Exchequer (HM Treasury, 2013) set out a revised remit for the Monetary Policy Committee and, in a separate monetary development the Bank of England announced an extension to the Funding for Lending Scheme designed particularly to encourage banks to lend to small businesses. I would like to offer my own thoughts on monetary policy-making in the current circumstances. The short-term context is provided by a situation where, notwithstanding recent good news, the performance of the economy leaves much to be desired. Inflation is above target as it has been for most of the past five years, while, apart from the effects of wars, the near-stagnation of output has no real precedent since the industrial revolution. It is now many years since we experienced the problems caused by unstable and high inflation and inevitably the lessons from that get blunted with the passage of time. But the long-term context is certainly one where, without appropriate monetary policy, those problems could return. At the same time policy-makers need to pay attention to actual and prospective pressures on inflation as well as long-run risks.

While monetary mismanagement can certainly lead to inflation, monetary policy cannot influence the growth rate of the economy in the very long run. But policy-makers do have a choice about how rapidly inflationary disturbances are damped down. Rapid damping of inflationary disturbances leads to undesirable fluctuations of output. Slow damping of disturbances may allow a smoother path for output and, at least after above-target inflation, reduce the danger of the medium-term performance of the economy being affected by a sharp squeeze on output. But at the same time it carries the risk that, if it is slow enough, people may, and are indeed likely to question whether monetary policy is being used to control inflation at all.

Chart 1 : Inflation in the United Kingdom and the United States (per cent per annum)



Source: Office for National Statistics and Bureau of Labour Statistics

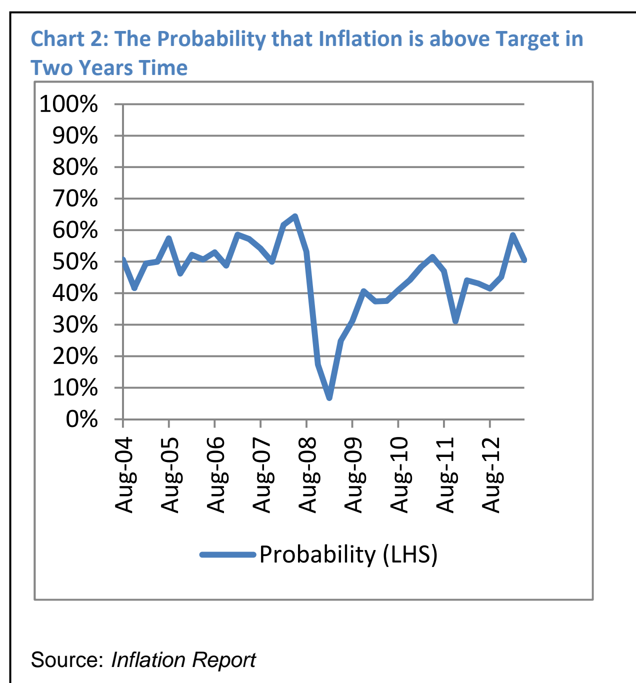
There has been much discussion recently about how the United States' Federal Reserve Board has appeared more willing than the Monetary Policy Committee to focus on stimulating economic growth[1]. The Federal Reserve Board famously has a dual mandate while here the new remit, like its predecessor, makes growth and employment subsidiary objectives. Miles (2013) has argued that the difference between the two is more one of form than of substance and I agree with that. But this makes it necessary to answer the question of why the Monetary Policy Committee appears to have been unwilling to provide more stimulus recently. The obvious and in my

[1] Although, relative to the size of the economy, asset purchases have been larger here than in the United States.

view correct answer is that our circumstances are different. Since the start of 2009 the inflation rate in the United States has been below two per cent for twenty-seven out of fifty-one months while in the UK it has been below two per cent for only six out of the same fifty-one months, as Chart 1 shows. I have certainly felt that this history is a constraint on my freedom of action. So it is with this in mind that I would like to make some observations about policy and influences on policy in the light of the new remit.

The New Remit

The new remit requires us to be clearer about the trade-offs we perceive and also to think rather more about whether there are new techniques we might use to achieve our objectives. The changed remit was widely seen as implying that the Monetary Policy Committee would become relatively less concerned about inflation and relatively more concerned about growth than had been the case with the earlier remit. Indeed, whereas most recent forecasts had suggested that monetary policy had been set so as to bring inflation very close to its target over a two-year horizon, our February forecast suggested that inflation was as likely to be above 2.3 per cent as below it. Many commentators interpreted this as indicating that we had anticipated the change to the remit.



Source: *Inflation Report*

In fact, as Chart 2 shows, this was not the first time that the Monetary Policy Committee gave a probability substantially higher than half to the prospect of inflation being above target in two years time. The risk of this in early 2008 was seen as being much as it was earlier this year[2]. But an important change, which probably follows from the change of remit is that from 2008 to about 2011, as far as I remember, there was surprise that the Committee was not acting faster to bring inflation back to target, while our recent statements were generally well-received.

The change to the remit has, as well as clarifying things for the Monetary Policy Committee, led to a broader and more realistic public understanding of the choices the Committee faces. As it has happened, the pressures which we saw in February as holding inflation above target, even two years ahead, have eased somewhat, so that the risks of inflation being above and below target in two years time are now more or less

[2] Although the modal forecast was slightly higher in February than in early 2008.

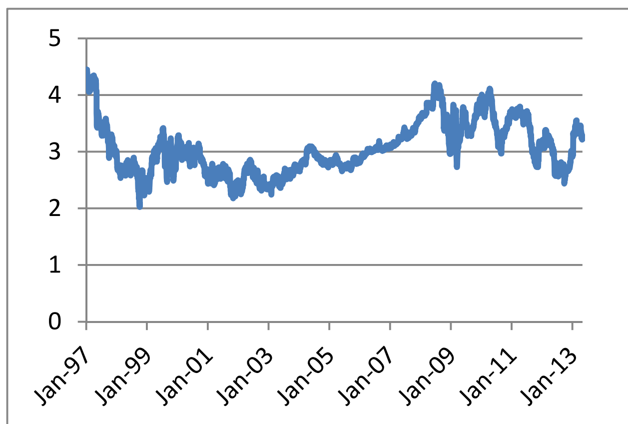
evenly balanced. At the same time, there has been more growth in output than for some time[3]. And the fact that March seems to have been a strong month is also a positive spring-board for the second quarter of this year. No one can be certain but it is possible that the near-stagnation of the past three years is being replaced by a move to modest growth and I welcome this. The sense that the improved growth outlook we have been forecasting throughout my membership of the Committee may now be starting to appear has certainly influenced my voting. But the Monetary Policy Committee's general approach to delivering the inflation target needs to be well-understood whatever the circumstances of the moment.

The flexibility that the remit offers us 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. Our inflation target is supposed to be symmetric and the analysis in the *Inflation Report* is based on that assumption. But the combination of the debate earlier this year and our February forecast might have led to a marked increase in expectations of inflation. People might have concluded that the Monetary Policy Committee was not going to take the inflation target very seriously.

Inflation Expectations and Financial Markets

One measure of inflationary expectations is provided by looking at the difference between yields on nominal government bonds and yields on indexed bonds. For much of last year these were distorted by the possibility that the calculation of the Retail Price Index would be changed in a way which made statistical sense but which would have the effect of disadvantaging bondholders. Chart 3 shows that there has been some increase in inflation expectations. They remain above what was normal for the first ten years in which the Monetary Policy Committee was responsible for achieving the inflation target. But, after allowing for the effects of the decision by the National Statistician about the calculation of the Retail Price Index, they are broadly in line with experience since the start of the financial crisis. They do not suggest that the recent debate had an adverse effect on expectations. Nor, too, does the recent movement of the exchange rate.

Chart 3: Market Expectations of RPI Inflation in Five Years Time (% p.a. Five year on five year)

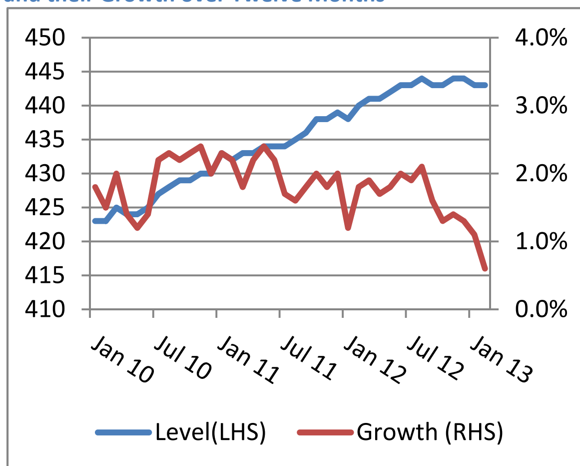


Source: Bank of England

[3] Excepting, of course, the sharp movements which resulted from the winter weather of late 2010, Royal Wedding of 2011 and the Diamond Jubilee and Olympic Games last year.

Wage Inflation

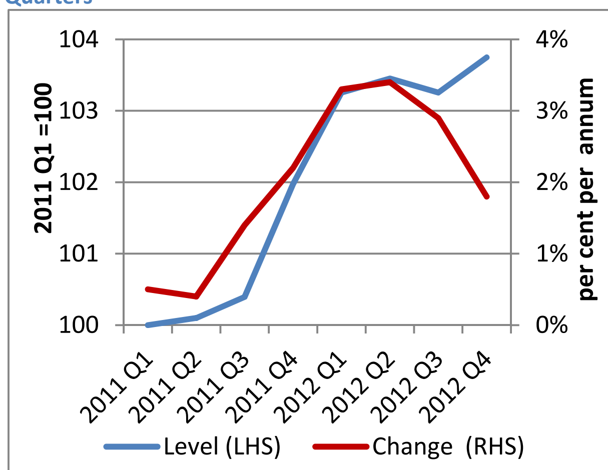
Chart 4: Average Weekly Earnings (Regular Pay £ per week) and their Growth over Twelve Months



Source: Office for National Statistics: series KAI7

But the financial markets should not be seen as providing the only indicator about inflation prospects. Wage negotiations are typically conducted with an annual horizon, unlike the five-year on five year expectations looked at above. But movements in wages can also tell us about inflation expectations. Any sign of wage inflation picking up sharply might well be an indication of higher expected inflation in a part of the economy where it matters a great deal. Chart 4 shows the growth in average weekly earnings measured over the last twelve months together with the level of Average Weekly Earnings.

Chart 5: Unit Labour Costs and their Growth over Four Quarters



Source: Office for National Statistics: series LNNL

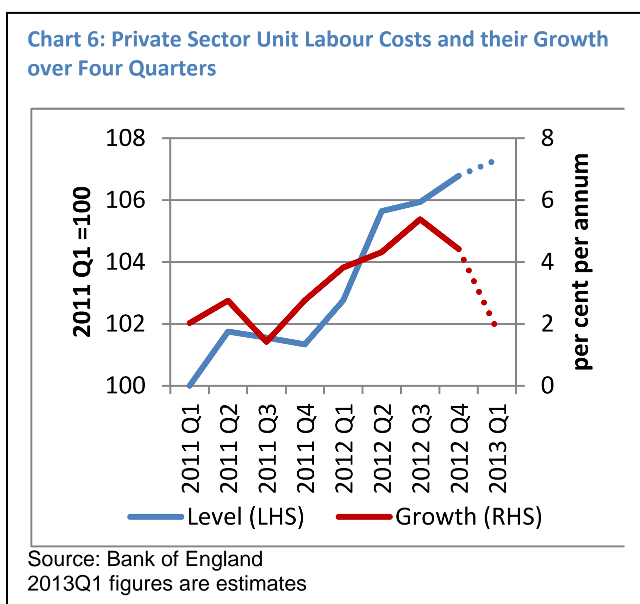
A reasonable interpretation is that, so far there is not much to worry about. Indeed, in the summer of last year wage growth came to a complete halt, despite the fact that the year on year change has tailed off only gradually. This does not, of course tell us that wages will continue to stagnate. I very much hope that people will see some growth in their real wages resume at an early stage. It is also worth making the point that other data continue to suggest that pay settlements are in still in the region of two per cent[4]. Nevertheless, unless one discounts the evidence from the Average Weekly Earnings series almost completely, it might seem that, from the perspective of controlling inflation, things have become somewhat more straightforward.

While increases in wages may be a precursor of inflation, what matters from our perspective is not so much what is happening to wages as much as what is happening to unit labour costs, the labour costs of producing a given amount of output. Here too the picture looks much better than it did, as Chart 5 shows. The growth rate over the last year has subsided from nearly 3½ per cent to under 2 per cent. But the chart suggests that costs have been much more stable for most of 2012. Between the first and fourth quarters of last year,

[4] AWE and AEI were, ahead of the crisis, not closely correlated with measures such as pay settlements, wage data from the Labour Force Survey or the Report on Jobs. See Weale (2008)

labour costs rose at a rate of less than 1 per cent per annum. Data for the first quarter of 2013 have not yet become available. A rough calculation based on the data we do have suggests, however, that unit labour costs have increased very little and may even have fallen.

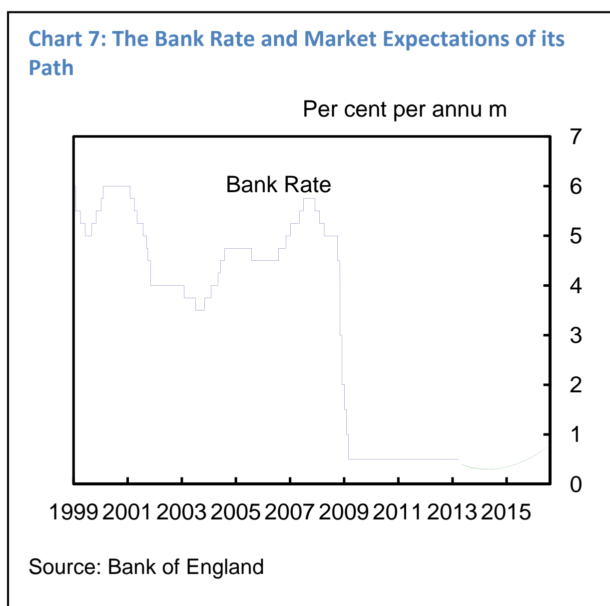
However this may be somewhat misleading. The data for unit labour costs in the economy as a whole reflect movements in both public and private sectors. Measured public sector unit labour costs have fallen sharply; the public sector has cut employment while output, measured in terms of output indicators such as numbers of children taught in schools and numbers of operations carried out in hospitals has risen slightly. Movements in private sector unit labour costs are much more relevant to inflation because public sector output is, after all, not included in the Consumer Price Index.



Source: Bank of England
2013Q1 figures are estimates

As Chart 6 shows, the recent movement in private sector labour costs has been much less benign. The evidence on average wages, output, and hours worked, which are available at present only until February, points to only a very modest increase in the first quarter of this year. But even then, over the last four quarters that implies growth at a rate of just under two per cent. Looking only at 2012Q4 and my estimate for 2013Q1, that suggests growth in unit labour costs at an annual rate of just under one and a half per cent. Without other pressures, that on its own would point to below-target inflation. But the Monetary Policy Committee has stressed the impact of administered and regulated prices, which may contribute as much as one percentage point to inflation even in two years time. Furthermore, because recently, as Chart 6 shows, unit labour costs have been rising very rapidly, margins have become compressed. Businesses are likely to use low growth in labour costs as a means of rebuilding margins, at least in the near term. So my own judgement is that a further easing of the rate of growth of cost pressures is necessary before I feel we are in danger of undershooting the inflation target. Such an easing may be in prospect if wage growth remains very weak while productivity performance improves.

Interest Rate Prospects



What does this mean for the interest rate? The yield curve suggests that interest rates are expected to stay low into the medium term with the first increase in Bank Rate not expected until 2016 (see Chart 7). This path for the Bank Rate was that assumed by the Monetary Policy Committee in producing its most recent forecast which, as I mentioned, shows the risk of above target inflation in two years time being close to half. My view is that this chart, on its own, provides a strong steer on future interest rates. The point is not that it is the market's view, but rather that the Monetary Policy Committee has concluded that this implied path for the Bank Rate is consistent with its remit, at least in current circumstances.

The Chancellor (HM Treasury, 2013) has, of course, asked the Monetary Policy Committee to report, in August, on a possible role for forward guidance as to the path for interest rates, as an additional monetary policy tool. Studies of the United States (e.g. Campbell, Evans, Fisher and Justiano, 2012) show that statements of this type have influenced markets over and above the effects of actual policy decisions. Carney (2013) shows that the same was true in Canada. As you might imagine a considerable amount of work on this issue is underway at the Bank at the moment, and I do not want to anticipate its conclusions.

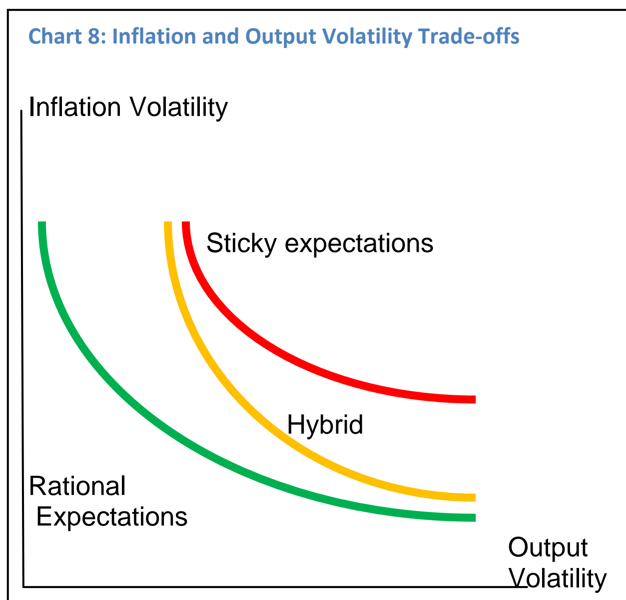
The Trade-off between Inflation and Output Volatility

Forward guidance is one of the issues to which, as I have made clear, we are devoting considerable thought over the next three months. Another issue which the Chancellor asked us to be much more explicit about is the trade-off between controlling inflation and avoiding undue fluctuations in output, a topic first analysed by Taylor (1979). The question is highly pertinent and both the minutes of our meeting in February and the May *Inflation Report* carried a discussion of the issue.

A central bank run by "inflation nutters" would focus almost exclusively on keeping inflation close to target, although even it would find it impossible to ensure that deviations from target lasted no more than a few months. While there is long-run confidence that policy will focus on delivering the inflation target, it is, however, 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. Provided that prices are inherently sticky- so that they do not all react immediately to movements in demand- this can be done even if people correctly anticipate the deviations of inflation from target which result from the use of policy in the aftermath of shocks hitting the economy (so-called rational expectations). Many studies (e.g. Bean, 1998)

suggest that, for a wide range of choices, inflation variability is not very sensitive to the degree to which monetary policy tries to smooth output. On any reasonable trade-off between inflation volatility and output volatility, the benefits of not being an inflation nutter far outweigh the costs.

Chart 8: Inflation and Output Volatility Trade-offs



But, as I have mentioned, a sustained sequence of upward shocks to inflation may lead to people losing confidence in the policy. If, as a result, they base their expectations of inflation on previous experience, the trade-off can change very markedly. After a sequence of inflationary surges, inflation can be brought back to target only by a sustained period of weak demand and weak economic growth. So the costs of controlling inflation are very much higher than they would be if people had confidence in the inflation target. This is illustrated in Chart 8. In a stylised analysis the green curve shows the trade-off which would exist if, after a shock, people correctly anticipate the path of prices that policy would, in the absence of further disturbances, deliver; the red line shows what the trade-off would be if everyone bases their expectations of future inflation on recent experience of past inflation.

If positive and negative shocks to inflation have been intermingled, so that inflation has never been far from its target for long, then the red and the green lines will nearly overlap, with little role for expectations. But following the successive inflationary shocks which have affected the British economy since 2008, the two lines could be some distance apart. The repeated and persistent nature of these shocks would make the trade-off with sticky inflation considerably less satisfactory than that with rational expectations. Attempts by the Monetary Policy Committee to smooth output at the cost of taking longer to bring inflation down when faced with shocks like those we have recently experienced might therefore lead to the economy moving from the green line to the red line, with a substantial cost. Both output and inflation would be more volatile than it had hoped and the Committee's ability to respond to future disturbances would be much reduced.

Starting from the position we are in, where does this leave my thoughts on the trade-off between output volatility and inflation volatility? A reasonable assumption is that if inflation is always kept close to its target, so that inflation volatility is low, then most people will have considerable confidence in the policy framework and the trade-off will be more or less that represented by the relevant part of the green line. But after a sequence of inflationary shocks such as those we have experienced over the last five years, an increasing proportion of people may well doubt the Monetary Policy Committee's commitment to bringing inflation back

to target, and plan their affairs on the assumption that raised inflation is here to stay[5]. Once this is the case, the trade-off will be represented by something closer to the relevant part of the red line. These observations point to the relevant trade-off being a hybrid which is close to the green line when inflation is kept close to target and close to the red line if policy focuses substantially on smoothing output at the cost of inflation volatility. I have represented this hybrid by the amber line on the chart.

This illustrates a pitfall for any policy-maker who assumes that the green curve is relevant when in fact the amber line is. Someone who set out to deliver a low level of output volatility would find higher inflation volatility than they had expected if the economy were represented by the amber line rather than the green line. 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.

But further points follow from the analysis. One would have to be very concerned about inflation volatility indeed to choose the region where the amber and green lines are close to each other. In the more plausible region, closer to the centre of the graph, 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. 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, perhaps not so different from that shown in Chart 3. At the same time, of course, the position of the amber line, and its distance from the green line depends on how effective the Monetary Policy Committee is at communicating that we will meet our remit. It is not enough for us to do our job 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.

There are two additional important issues which are not reflected in this diagram but which I would like to mention. I see the policy problem as being largely symmetric. We should react to below-target inflation with much the same considerations as we have in mind when responding to above-target inflation. But deflation may pose risks of its own, because it has the effect of raising the real rate of interest in a way which cannot be offset by movements in Bank Rate. So one might want to respond more vigorously if deflation appeared to be a real risk. Equally, Britain's own experience suggests that high long-term unemployment results in people leaving the labour market with damaging effects on supply. This needs to be, and has been, taken into account by the Monetary Policy Committee in setting monetary policy.

[5] For a full discussion of how inflation expectations may adapt to circumstances see Branch (2004) and Brazier, Harrison, King and Yates (2008).

Conclusion

This is a conference on the future of the economy. No member of the Monetary Policy Committee can make wide-ranging predictions about the future and even limited attempts at forecasting have their pitfalls. Over the period since the crisis what seemed to be gloomy forecasts about the economy in successive *Inflation Reports* turned out to be too optimistic for both growth and inflation.

So what can I say about the future? We have had some good news recently. But, after a long cold spring, we need to see more than one swallow before being sure that summer has come. While prospects look better than they have for some while, the future is always uncertain. Nevertheless, the fact that the Monetary Policy Committee is focused on delivering outcomes consistent with the Chancellor's remit, means that, while there will of course be further shocks to inflation, the future is a low inflation future. Secondly, the market signal pointing to low interest rates for some time to come is certainly at present consistent with the way I see the outlook for the economy and the balance of risks affecting inflation and output. Thirdly and finally, I should say that while we have to be awake to rises in inflation expectations, 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 long periods of below-normal output have very substantial costs associated with them.

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