# Monetary Policy Strategy – remarks by Huw Pill

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# Remarks

Thank you very much to our hosts here at the Cardiff University Business School today.

It is an immense pleasure to be here – as a Cardiffian, close to home – on St. David's Day: a fortuitous combination of timing and geography.

In my remarks this afternoon, I will first discuss the design and performance of the strategy that has guided monetary policy decisions in the UK, both over the past quarter century of inflation targeting and more specifically in the recent more challenging period of elevated inflation and inflation risk. I will then turn to the current policy conjuncture.

## Ten questions on monetary policy strategy

**What is a strategy?** The Oxford English Dictionary defines a strategy as *"a plan of action designed to achieve a long-term or overall aim"*. Those of you who study game theory will likely recognise a richer definition: *"a strategy is a plan that depends on and internalises the impact of actions taken by others".*

**What are the key components of a strategy?** Based on the dictionary definition, there are three key components of a strategy: the 'aim' or *objective* of the strategy; the 'actions' or *instrument* settings taken in pursuit of that objective; and the 'plan' or *mapping* that describes what determines the character, timing and magnitude of these actions.

**How are these key components defined in the UK monetary policy framework?**

*Objective:* The objective of the UK's monetary policy framework is *price stability*, operationalised as the achievement of a 2% target for consumer price inflation. This target holds at all times. The objective of price stability is defined in legislation, while the specifics of the inflation target are established in an annual remit letter sent from the Chancellor of the Exchequer to the Governor of the Bank of England.

*Instrument:* The Monetary Policy Committee (MPC) at the Bank of England is mandated to achieve the inflation target. At a high level, this establishes that *monetary policy* is the instrument within the framework: after all, monetary policy is the 'MP' in 'MPC'.

At the outset of the UK's inflation targeting regime, it was well-established that the operational instrument of monetary policy was a short-term interest rate. In particular, UK monetary policy was implemented by setting Bank Rate – the interest rate paid on the reserve balances held by commercial banks at the Bank of England. By setting Bank Rate,

the Bank of England was able to steer short-term market interest rates and influence a broader set of asset prices and financial conditions in a manner that ultimately swayed the evolution of inflation.

This configuration was challenged in the aftermath of the global financial crisis, as nominal interest rates fell towards what was deemed their effective lower bound. At that point, since Bank Rate could no longer be lowered to ease monetary conditions, the Bank of England started to implement monetary policy through asset purchases financed by the creation of central bank reserves, so-called quantitative easing.

Now that Bank Rate has been increased by more than 5 percentage points from its trough, the MPC has scope both to loosen monetary policy by lowering Bank Rate and to tighten monetary policy by raising Bank Rate. Given this flexibility (as well as the greater clarity, simplicity and experience of focusing on the interest rate), the MPC has re-stated its intention to use Bank Rate as the active tool of monetary policy. Therefore, at the time of writing – and reflecting the current policy discussion, which I will return to at the end of my remarks – we can again conceive of changes in Bank Rate as representing monetary policy actions.

*Mapping:* In designing its mapping from current developments to Bank Rate settings, the MPC needs to take into account how its actions will influence financial conditions, the economy and, ultimately, price dynamics and inflation. This is the *transmission mechanism* of monetary policy. And, on this basis, the MPC then needs to establish how it will calibrate its policy actions in response to developments in the economy and data in pursuit of its objective. This defines the MPC's monetary policy *reaction function*.

The interaction between the transmission mechanism and the reaction function establishes how the MPC will set the Bank Rate in order to achieve its price stability objective as conditions in the economy evolve. This interaction thus lies at the heart of its monetary policy strategy.

A perennial problem in monetary policy analysis is distinguishing between, on the one hand, those changes in the monetary policy stance that are driven by changes in the state of the economy and, on the other hand, those economic developments that result from changes in the monetary policy stance as it is transmitted in the economy: if you like, the difference between the causes and the consequences of Bank Rate changes.

Not only does this challenge complicate the empirical estimation of transmission mechanism of monetary policy and monetary policy reaction function – the economists among us will recognise this as an 'identification problem' – it also has the potential to confuse policy communication. When making statements about the inflation outlook, the MPC always needs to reflect on how its assessment depends on possible policy actions in

the future, when future policy actions are themselves influenced by the same economic developments upon which the inflation outlook is formed.

**Why does the MPC need a strategy?** Benjamin Franklin famously said: *"If you fail to plan, you are planning to fail"*. A strategy provides the framework for planning for future contingencies and preparing tools and actions to respond to them.

Just as it makes sense for a firm's manager to think about how her pricing, marketing and production decisions would respond to changes in the behaviour of her competitors, suppliers, customers, employees and colleagues; and it makes sense for a student to think about what questions are likely to come up on an exam, and amend their revision plans accordingly; so it makes sense for the MPC to think about what the evolving outlook for the economy implies for its monetary policy decisions.

But the rationale for the MPC adopting a monetary policy strategy goes beyond this simple ambition to be organised, prepared and capable. By setting out its stall in the form of a strategy, the MPC not only describes how it is likely to respond to future challenges. It also seeks to influence the behaviour of others in a way that supports achievement of its own objectives. This is the essence of the second game theoretic definition of strategy that I mentioned earlier.

To illustrate: if the MPC can convincingly and credibly establish that inflation will remain at the 2% inflation target, then this will shape firms' pricing decisions. A marketing manager who believes competing firms will raise prices by 2% will be reluctant to raise his own prices by more for fear of losing market share. And should the same marketing manager believe that his suppliers will be raising their prices by 2%, then he will expect that doing likewise with be sufficient to protect margins and maintain profitability.

These considerations not only affect the behaviour of individual firms. They also influence the behaviour of the economy as a whole. After all, one firm's prices are another firm's costs – and *vice versa*. It is through such interactions among individual firms that setting prices in line with the MPC's 2% inflation target becomes a self-reinforcing process at the aggregate level.

**Why make your strategy public?** The MPC therefore has a strong interest in designing and publicising a monetary policy strategy that credibly, robustly and convincingly delivers UK inflation at the 2% target. In doing so, it coordinates individual private pricing behaviour on a favourable social outcome. The question then becomes how to establish this credibility and strengthen the self-reinforcing, stabilising behaviour.

One starting point would be to conceive of the strategy as a comprehensive list of how monetary policy should respond to different economic events and disturbances as they emerge. Each contingent policy action would be justified on the basis of that it would

efficiently return inflation to target. By setting out an exhaustive 'play book' ahead of time, the central bank would allow observers to assess whether the strategy was being followed, and thus whether appropriate policy actions were being taken that would return inflation to target.

But it is impossible to create such an exhaustive list of possible circumstances. We cannot contract for all contingencies: it is the *"unknown unknowns"* that threaten the greatest instability and are thus most challenging to manage. My experience on the MPC over the past few years – punctuated by unprecedented events, such as the Covid pandemic and the Russian invasion of Ukraine – provides ample evidence in this direction.

Rather than try to pre-contract for all eventualities, an effective strategy needs to set out a 'principle-based approach' that underpins *robust* monetary policy choices in the pursuit of the price stability objective, even when the uncertainty being faced by policy makers is substantial and profound. In other words, a good strategy is one that seeks to ensure inflation returns to 2% on a lasting and sustainable basis across a variety of possible circumstances that may be difficult to distinguish among in real time, rather than one that seeks a highly engineered optimal response within a very specific (and therefore inevitable somewhat fragile) view of the economy and economic conjuncture.

**What role does the strategy play in the MPC's decisions?** The preceding discussion points to the benefits of making the monetary policy strategy known to and understood by key stakeholders.

More generally, any policy strategy has two aspects: it provides a framework for internal analysis and discussion of the available data within the central bank that leads efficiently to timely and effective monetary policy decisions; and it creates a structure for the presentation of those policy decisions and their rationale to external audiences (the general public, corporate leaders, financial market participants, *etc.*).

Transparency plays a central role in ensuring the strategy is understood by these audiences. A natural definition of the transparency of the policy process is the extent to which the external presentation of decisions corresponds to the internal preparation of those decisions. Full transparency entails that the external framework for presentation perfectly replicates the internal framework for decisions. But internal analysis is necessarily complex, perhaps especially in the often detailed and controversial discussions surrounding the economic outlook and monetary policy. The information to be assessed is voluminous and complicated. At times, thorough discussions go further than what turns out to be important for the monetary policy decision.

Moreover, successful policymaking requires a healthy confrontation of different views and allowing for vigorous debates to test the robustness of individual decisions. The UK legislation establishing the MPC emphasises this view, by making members of the

Committee individually accountable to Parliament for their published individual vote on the monetary policy stance. But if that internal discussion is to be fruitful, some parts of this discussion may need to be confidential, so as to provide the safe space sometimes necessary to make provocative or controversial arguments that can help advance the debate. An MPC member may be reluctant to 'play devil's advocate' in a policy discussion if they thought that were to become public, even if such advocacy may lead to a better outcome.

So, the benefits of transparency have to be read in a broader context. A purist approach to transparency may hinder the internal policy process on which good decision relies. And, at least for some audiences, the communication of the final policy decision and its rationale may benefit from being clear and simple, even if some of the underlying complexity is obscured as a result.

After all, what ultimately matters are *effective* policy decisions, and thus effective policy communication. By nature, communication is a two-sided process: it can only be judged effective if it is understood by the recipient in the way the sender intended. The danger of central banks 'talking past' some of their audiences is all too real, and potentially costly. An intelligent reading of transparency is required.

**What are the key features of the UK's monetary policy strategy?** On the basis of the discussion thus far, a few key features of a successful monetary policy strategy can be identified.

The strategy has to define a *systematic* response of monetary policy to developments in the economy. If monetary policy makers are perceived as behaving opportunistically rather than systematically, then the potential benefits of shaping other actors' behaviour in a way that supports monetary policy objectives may be lost. As another famous American historical figure – Abraham Lincoln on this occasion – said: *"you can fool some of the people all of the time, and fool all of the people some of the time; but you cannot fool all the people all of the time".* Behaving consistently through time and across circumstances in the pursuit of price stability is crucial.

At the same time, in the face of profound uncertainty (and the inevitable 'unknown unknows' that policy makers will have to confront), the strategy must allow some *flexibility* to deal with changing circumstances. Hard wiring responses in changing circumstances can handcuff policymakers in situations when they need to be nimble.

Achieving an appropriate balance between behaving systematically and behaving flexibly thus lies at the heart of a well-designed strategy.

One characterisation of the MPC's inflation targeting strategy is that it allows monetary policy makers *'constrained discretion'.* Transparent policy decisions can be judged by the

standards of whether they serve the price stability objective but are not pinned down in a way that hinders agile and timely actions when unexpected circumstances dictate.

Approaching the same issue from another angle, one might think of a strategy being *rule-based but not rule-bound:* governed by clear principles that ensure decisions are taken to support the price stability objective, but not mechanically determined by some simple automatic algorithm that fails to recognise changes in the economic environment sufficiently.

Owing to the well-known “long and variable” (and crucially not fully predictable) lags in the transmission of monetary policy actions to inflation, the monetary policy strategy also needs to be *forward-looking*. The MPC needs to take decisions about Bank Rate today recognising that the largest impact of those decisions will take place somewhere between 12 and 24 months into the future. As a result, the MPC will need to form a view about where inflation will be at that horizon, so that it can calibrate its Bank Rate decisions to have the appropriate influence at that point once the lags in policy transmission unwind. One way of ensuring this necessarily forward-looking orientation of monetary policy is to construct macroeconomic forecasts, in particular of inflation.

The long and variable lags in policy transmission also imply that a monetary policy strategy must be *medium-term oriented.* As we have seen in recent years, should inflationary shocks hitting the UK economy pass through to the consumer price index at shorter horizons than those associated with the transmission of monetary policy, then even an immediate monetary policy action in response to that shock cannot hope to offset its inflationary impact fully. In this context, there is some irreducible shorter-term volatility in price developments that monetary policy cannot hope to suppress entirely.

Rather than embark on a perhaps well-intentioned but ultimately futile attempt to fine-tune inflation developments at a high frequency (an approach that might threaten to add volatility into the system rather than reduce it), the MPC needs to recognise the blunt – even if powerful – character of its monetary policy tool, and focus on ensuring that those underlying, lower frequency components of inflation over which it can (and must) exert influence remain lastingly and sustainably consistent with achievement of the 2% inflation target.

**What has been the distinctive feature of the MPC’s approach?** I have already mentioned a number of distinctive elements of the UK monetary policy framework: the inflation target is set by the government rather than by the central bank, and members of the policy committee are individually accountable for their policy votes, rather than collectively held to account for the final decision. But these elements are established in legislation, and therefore lie in the domain of Parliament rather than the MPC.

Focusing here on those elements of the monetary policy strategy that fall to the MPC, the more central role accorded to its inflation forecast in the formulation and communication monetary policy decisions stands out. The centrality assigned to the inflation forecast and fan chart distinguish the MPC from its peers at other central banks, where a wider set of analyses and simulations enter the policy discussion and presentation in the form of external communication.

As regards the internal analysis underlying monetary policy decisions, the MPC forecast has been characterised as a single funnel into which the assessment of rich set of indicators, models and judgements has to be poured. On this reading, analysis and data are weighted in coming to a policy decision on the basis of how much they affect the inflation forecast (including the risks around the central case) at the policy-relevant 12 to 24 month horizon. Based on my experience at the MPC in recent years, this stylised characterisation is overdone: the Committee is presented with analysis beyond the inflation forecast and fan chart, and that additional analysis does influence policy decisions. But the central role of the inflation forecast in the discussion, and the assignment of relevance to indicators on the basis of their marginal influence on that inflation forecast, ring true.

Turning to the external presentation of monetary policy decisions, the MPC's inflation forecast fan charts remain one of the key tools at our disposal. Over a long period following the establishment of the inflation targeting regime, the media, market participants and the general public have all been encouraged to look to the inflation fan chart both to provide a justification of the most recent policy decision and an implicit guide to future policy choices. If the MPC's assessment of the economic situation, the rationale for its Bank Rate decision and any guidance about future rate moves could not be discerned from looking at the fan chart as a 'summary statistic', then the response was to 'look harder'!

This set-up maintained an elegant symmetry between the characterisation of the internal decision-making process and the presentation of decisions to the public. In turn, this bolstered the MPC's reputation for transparency, and served the Committee well in a more benign inflation environment than we have faced in recent years.

**How has the MPC's strategy performed in recent years?** As has been well documented, the MPC has faced significant challenges in forecasting the outlook for UK inflation in the past few years, at least when judged by forecast errors. Many other central banks and forecasters have faced similar challenges, so the MPC is not unique in this case. Given the central role accorded the forecast in its policy framework, this has created its own set of strategic and communication challenges.

To be sure, in large part, these forecast errors and policy challenges stem from unforeseen circumstances. Over the past decade and a half, the UK has experienced a series of economic shocks: most notably the Covid pandemic, the Russian invasion of Ukraine, *etc.* Of course, shocks are nothing new: as I have already suggested, one conception of a monetary policy strategy is as a description of how the MPC should respond to the inevitable economic disturbances to the UK economy, so as to meet the inflation target. But recent shocks have been both distinctive in character and large in magnitude, creating stresses in the existing forecasting and policy framework.

Moreover, the MPC has had to form judgements over how these shocks will propagate through the economy, noting that they may interact with one another in novel and potentially complicated ways, thereby changing economic behaviour and rendering forecasting models estimated in more benign circumstances less reliable guides to the outlook. In sum, all this has made the MPC's traditional macro forecasts less useful – and thus less central – to the development and communication of monetary policy than was the case in the past, in particular relative to the halcyon days of inflation targeting in the late 1990s and early-to-mid 2000s.

Put very simply: when forecasting inflation becomes more difficult, a monetary policy strategy that places an inflation forecast at its heart becomes strained. The existing policy framework is therefore subject to challenge.

It was recognised from the outset that the inflation targeting strategy adopted by the Bank of England in the mid-1990s (and subsequently institutionalised in the legislation creating the MPC) embodied a number of vulnerabilities. For example, the framework could be disrupted by large terms of trade shocks (comparable to the infamous 1970s 'oil shocks'); it was exposed to difficulties in forecasting inflation, should the structure of the economy, inflation process and/or monetary policy transmission mechanism change rendering forecast models unstable; it risked a potential neglect of monetary and financial developments; and it was to a large extent dependent on the anchor or the inflation target remaining credible, with the magnitude and character of disturbances to the economy not being too large.

These vulnerabilities notwithstanding, the inflation targeting strategy proved extremely successful over a long period, delivering inflation admirably close to target and marking a clear regime change with the poor performance of the 1970s and '80s. It remains an open question as to whether the vulnerabilities I have listed were overstated or whether they simply did not materialise during what can be now seen as the halcyon days of inflation targeting, from the mid-1990s to the global financial crisis in 2008.

One interpretation of recent experience is that a 'perfect storm' of shocks struck the UK, which collectively exposed vulnerabilities already inherent to the inflation targeting strategy

– or at least in its practical manifestation that placed inflation forecasts at the centre of the MPC's analysis and communication. On this basis, a case can be made for riding through the storm until those shocks recede. But in my view, recent experience points to a need for more extensive change, aiming to improve the robustness of the policy framework in an environment where the prospect of larger, more interrelated and more supply-driven shocks to the UK economy looms larger than in the past few decades.

**What changes could be considered?** For sure, we should not throw the baby out with the bathwater. Core elements of inflation targeting have served us well, not only during the 'Great Moderation' but also in recent, more challenging times. As I have tried to establish: monetary policy independence; a quantitative definition of price stability in the form of an explicit inflation target; a forward-looking and medium-term oriented framework for setting the policy stance; a systematic approach to Bank Rate decisions – these are all features we should retain.

But I am sceptical whether the prominence given to the current macroeconomic forecast in the MPC's approach – and especially the focus placed on the inflation forecast fan chart in both presenting the rationale for policy decisions and signalling the outlook for future policy decisions – is well placed in the current environment. Developing a richer and more robust analysis is key. That entails working harder to think not just about the central case, but also address the 'what if' questions around monetary policy that are central to managing risks to achieving the inflation target.

At the time of writing, Ben Bernanke is finalising his review of the MPC's forecasts and their role in policy process. Whatever recommendations he makes, publication of his report can be a catalyst for change in the MPC's monetary policy strategy – change which would be welcome in my view.

The Bernanke Review will offer a once in a generation opportunity to renew and improve the MPC's framework for monetary policy.

Not because the existing framework has failed. On the contrary, it has kept consumer price inflation remarkably close to the 2% target over the bulk of the past three decades.

Nor because the existing framework has been tested to destruction by the challenges of the past few years. On the contrary, not only has the MPC now demonstrated its ability to contain inflation and steer it back towards target in difficult circumstances, but key elements of the policy framework – notably the nominal anchor provided by the quantitative inflation target itself and an independent central bank given the mandate to pursue that target – have helped to prevent the destabilisation of longer-term inflation expectations that proved so costly in the 1970s.

But rather because the MPC and Bank of England seek to learn the lessons of recent experience and evolve accordingly to make their monetary policy framework more robust and effective.

We must be alive to this opportunity and be prepared to resource and empower those seeking to deliver against it.

## The outlook for inflation and the monetary policy stance

I will conclude with a few comments about the current monetary policy discussion.

As I am sure you all know, at its most recent meeting the MPC decided to keep Bank Rate unchanged at a level of 5¼%. I was one of the Committee members who voted in support of this decision.

My decision was based on an assessment of the economy consisting of three key elements.

First, while economic activity remains weak in the UK – with real GDP contracting in the second half of last year according to the latest vintage of data – I attribute a significant part of this weakness to developments on the supply side.

Second, I expect to see headline consumer price inflation continue to fall in the coming months, and likely to approach or even fall below the 2% inflation target this spring. Of itself, that is good news. But the drivers of this decline in annual headline inflation are a combination of base and external effects. We need to guard against being lulled into a false sense of security about inflation developments over the medium term by the mechanical effects of high monthly inflation a year ago dropping out of the calculation of annual rates and / or the impact of downside surprises in international commodity prices, notably for energy and food.

Third – and reflecting this last point – in coming to a view on monetary policy, my focus remains on the persistent component of consumer price inflation. It is this persistent component that will still be there at the 12-to-24-month horizon when monetary policy decisions taken today have their greatest impact on inflation.

I continue to assess the persistence of UK inflation primarily through developments in the three key indicators of inflation persistence identified by the MPC: services price inflation, pay growth and the tightness of the UK labour market. But I interpret the data on these indicators in a broad sense. Especially at a challenging time for data collection and quality, it is unwise to rely solely on any one measure of wage growth or labour market slack: I am drawing a view from a wider set of individual series. And recognising the high frequency

noise in these series, I am focused on extracting the lower frequency signal in underlying measures rather than the news in any single monthly release.

On this basis, while I recognise that we are now seeing early signs of a downward shift in the persistent component of inflation dynamics, those signs thus far remain tentative. In my view, we have some way to go before such evidence becomes conclusive.

While that persistent component of inflation continues to threaten the lasting and sustainable achievement of the 2% inflation target, the MPC will need to maintain a degree of restrictiveness in its monetary policy stance to squeeze this persistent component out of the system.

Even if we were to become more confident that the persistent component of inflation is easing, that does not imply the MPC would no longer need to maintain its restrictive stance. On the contrary, the easing in the persistent component of inflation is a result of the policy stance. As the MPC stated in its February Monetary Policy Report: restrictiveness will need to be maintained *"until the risk of inflation becoming embedded above the 2% target dissipates".*

Maintaining restrictiveness does not necessarily mean leaving Bank Rate unchanged. For one thing, real interest rates – which may be more relevant for some economic decisions and thus for the transmission of monetary policy – will rise as inflation and shorter-term inflation expectations ease. The MPC will need to take this into account in setting Bank Rate. And what's more the overall monetary policy stance can remain restrictive – even if less so than previously – even after a Bank Rate cut. A change in the Bank Rate can still leave the level of Bank Rate in restrictive territory.

Nonetheless, in my baseline scenario the time for cutting Bank Rate remains some way off. I need to see more compelling evidence that the underlying persistent component of UK CPI inflation is being squeezed down to rates consistent with a lasting and sustainable achievement of the 2% inflation target before voting to lower Bank Rate.

It is that view that led me to vote to keep Bank Rate unchanged in February.

I look forward to our discussion.

The views expressed in these remarks are not necessarily those of the Bank of England or the Monetary Policy Committee.

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Opinions (and all remaining errors and omissions) are my own.