

Remaining Anchored: Monetary Policy in an Unpredictable World. Speech by Andrew Bailey

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Speech

It is a great pleasure to be back in Reykjavík for this excellent conference.

Last year from this podium, I set out how we were building scenarios into our monetary policy processes at the Bank of England in response to the Bernanke Review of our forecasting and related processes during times of significant uncertainty. These scenarios, I explained, would help us explore what might happen if a particular shock were to hit the economy, how a given set of shocks might propagate through to inflation depending on the strengths of different economic mechanisms, and how monetary policy might respond in different states of the world. The use of scenarios, I concluded, would help us build resilience into our inflation targeting framework and help to secure the nominal anchor in a world prone to big shocks to supply as well as demand.

Foresight is precious in an unpredictable world. The conflict in the Middle East has led to sharp increases in global oil and gas prices as transit through the Strait of Hormuz has been curtailed and critical infrastructure in the region has been damaged or destroyed. This is a big negative supply shock to the world economy.

In the United Kingdom, the outlook for inflation has been significantly affected. Before hostilities broke out in February, UK inflation was on track to fall to around the 2% target from April. The task for monetary policy would have been to keep it there. With underlying disinflation, building slack in the real economy and a softening labour market, some further easing of monetary policy was on the cards. Instead, the inflation number for April came in at 2.8% last week – with 0.8 percentage points of upside news to household energy prices relative to our pre-conflict expectations, driven by an increase in fuel prices. And inflation is likely to go higher over this year as utility bills rise and firms pass higher costs through supply chains.

There is nothing monetary policy can do to prevent higher energy prices from affecting businesses and households. For net importers of energy like the UK, the terms of trade have worsened and real incomes will fall. The shock will push up inflation, and weigh on activity. How much will depend on how the situation in the Middle East evolves. A resolution at the source – reopening the Strait of Hormuz and repairing the damage that has been done to the world's energy infrastructure – can reduce the impact of this negative shock to our economies. Equally, the longer the conflict continues, the worse the impact on our economies will become. Regardless of what happens, the task for monetary policy is to ensure that, as the adjustment to the shock happens, inflation does not become embedded – and in the United Kingdom that means returning 12-month inflation in the Consumer Price Index to our 2% target in the medium term.

Since 1694, the Bank of England has worked ‘to promote the publick Good and Benefit to our People’ as set out in our founding Charter. Exactly what that means, has evolved over the centuries. Suffice to say that, since the Bank of England Act of 1998, in respect of monetary policy, the Bank has operated independently of Government with a clearly defined objective to maintain price stability. This objective is further defined in annual remit letters from the Government to the Bank’s Monetary Policy Committee. In turn, the MPC is accountable to Parliament for its actions. For the people and Parliament, delegation to an independent central bank in this way works as a commitment device to reduce incentives to renege on the promise of price stability under the pressures of daily politics.

For monetary policy, the temptation was always to tolerate a little more inflation in the short run to support the real economy. But as economic history has shown, if it is likely that policymakers will deliberately renege on the promise of low and stable inflation, people will factor that into their expectations, driving up inflation without any benefit to the real economy. The promise of an independent monetary policy is that it will not succumb to such temptation.

That is why the MPC’s remit is clear that the 2% inflation target applies at all times. The remit recognises, however, that attempting to bring inflation back to the target too quickly may cause undesirable volatility in output. In some instances, monetary policy must manage a trade-off between the speed with which it brings inflation back to target and the consideration that should be placed on the variability of output. In this sense, the UK inflation target – like other inflation targets around the world – is ‘flexible’ rather than ‘strict’.¹

But exactly how flexible should it be? While the MPC’s remit specifies the inflation target explicitly as 2%, it provides no explicit guidance on the precise weight that should be assigned to output relative to inflation. In the common jargon of monetary economists and central bankers, the remit leaves the value of the parameter ‘lambda’ unspecified, except perhaps implying that it should be strictly positive. As such, the remit can be regarded as an ‘incomplete contract’ between the Government and the MPC.²

This is a feature not a bug. From the point of view of Parliament, the remit is a commitment device. But it is one that leaves the MPC with ‘constrained discretion’.³ This is consistent with a view that the appropriate way of managing a trade-off is state and

¹ In the terminology of Professor Lars Svensson, see e.g. [Svensson, L.E.O. \(2010\): “Inflation Targeting”, *Handbook of Monetary Economics*, Vol 3.](#)

² See [Bean, C. \(1998\): “The new UK monetary arrangements: a view from the literature”, *The Economic Journal* 108\(451\).](#)

³ See [Bernanke, B. S. and F. S. Mishkin \(1997\): “Inflation targeting: A new framework for monetary policy?”, *Journal of Economic Perspectives* 11\(2\).](#)

shock dependent and so is not something that can be predetermined.⁴ For example, to the extent that it is appropriate to ‘look through’ temporary price level shocks, the appropriate value of lambda – the weight on output when managing a trade-off – when such shocks arrive may be very high. Equally, in the face of risks to the anchoring of inflation expectations, a very low value of lambda may be more appropriate. On this view, the remit encodes delegation of lambda selection to the MPC depending on the situation it is facing. The remit recognises that there are times when the MPC is likely to be faced with more significant trade-offs that need to be managed, but it also prescribes additional public scrutiny in those circumstances. Whenever inflation moves away from the target by more than 1 percentage point, the Governor of the Bank is required to send an open letter to the Government – to the Chancellor of the Exchequer to be precise – to set out the outlook for inflation and the action the Monetary Policy Committee is taking to return inflation to the 2% target. In response, the Chancellor can opine on whether the government views the balance that the MPC is striking in managing any trade-off as appropriate or not.

An article published as a ‘Bank Insight’ on the Bank of England website today describes these issues in greater detail.⁵

Let me add that any monetary policy regime involves ‘constrained discretion’ in some form. Even under the Gold standard, when central banks were highly constrained by the task to maintain the convertibility of their currencies into gold, managing the system required considerable discretion at times. In the 19th century, for example, the Bank of England had to manage a trade-off between convertibility and the needs of commerce and trade. And there is a long history of debate, familiar to people in this room, about how much monetary policy should be constrained by ‘rules’ and how much ‘discretion’ should be left to central bankers.⁶ Reflecting that debate, different jurisdictions have arrived at somewhat different answers to how constrained discretion should operate within inflation targeting frameworks.

For example, the Bank of England’s monetary policy remit bears many similarities to frameworks with a ‘dual mandate’. Given the widely held view that money is neutral in the long run, both involve a focus on inflation stability in the long run. In the short run, both involve balancing inflation volatility with a concern for output volatility. And both lend themselves to be formalised in terms of a quadratic loss function – which is where the Greek letter lambda comes into the story.⁷

⁴ See [Lambda - speech by Mark Carney](#) (16 January 2017).

⁵ See Bank Insight [The MPC’s remit and trade-off management, Richard Harrison and Matt Waldron](#)

⁶ See e.g. [“Constrained Discretion” and Monetary Policy – speech by Ben S. Bernanke](#) (3 February 2003).

⁷ See, for example, a [Revolutions and Evolution in Central Bank Communication – speech by Janet L. Yellen](#) (13 November 2012).

There are subtle differences between them, however, of which I would highlight two.

The first is in the clarity with which the MPC's remit acknowledges that achieving the inflation target is the best and only contribution that monetary policy can make in the long run. The primacy of price stability in the remit makes clear that there are times when the focus should be squarely on returning inflation to target and that there are limits to how high λ should be. It is more constrained in this sense.

But second, and subject to the first, the MPC's remit affords more flexibility over how management of a trade-off should be approached than a dual mandate which, almost by definition, can be taken to suggest that a balanced approach should be taken.⁸ This additional flexibility can be useful in allowing monetary policy to approach trade-offs in different ways depending on the circumstances. Explicit language on how trade-off should be managed gives clear directions for how the choice should be approached, however, and a clear framework for accountability for it to Parliament.

So how does the MPC's remit suggest we should respond to the recent rise in energy prices caused the conflict in the Middle East?

Monetary policy generally looks through the direct effects of energy prices on inflation. It takes time for changes in interest rates to affect the economy and inflation, so higher interest rates might only push inflation below target once the energy price shock has passed, resulting in undesirable volatility in both inflation and activity. And even if the lags in the effects of interest rate changes were shorter, offsetting the direct effect of an energy price shock would require pushing down core inflation by generating additional slack in the economy. Looking through the direct effects of an energy shock avoids such output volatility, as the MPC's remit calls for. In other words, a high value of λ is appropriate with respect to the direct effects of an energy prices shock.

Because they take longer to come through, the argument for looking through the indirect effects is weaker, and protracted indirect effects could keep inflation above target for too long unless monetary policy responds. This suggests a moderate value of λ for the indirect effects.

By leaning against indirect effects, monetary policy may also reduce the risk that higher inflation becomes embedded through higher inflation expectations and second-round effects. Such effects could arise, for example, if a rise in inflation expectations leads workers to bargain more strongly for wage increases, and firms raise wages to maintain real pay for their employees – which in turn would increase their costs and could lead them

⁸ For example, the [FOMC 2026 statement on longer run goals and monetary policy strategy](#) states that: "The Committee's employment and inflation objectives are generally complementary. However, if the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them ..."

to set higher prices. Monetary policy should not look through such effects. For second-round effects, the appropriate value of λ is low, consistent with the primacy of price stability in the MPC's remit.

But the size of any second-round effects – in addition to the direct and indirect effects – is highly uncertain. And in addition to being highly uncertain, second-round effects build more slowly than direct and indirect effects. That leaves monetary policy with a difficult judgement call. Because interest rate changes take time to take their effect, monetary policy cannot wait for conclusive evidence of the strength of second-round effects. But responding too early may generate undesirable volatility in output – and inflation may drop below the 2% target in the medium term – if second-round effects turn out smaller than anticipated. This speaks to the desirability of a state-contingent approach, including with respect to the choice of λ , in another sense. Given the context of softness in the real economy and uncertainty around the scale and duration of the shock, tolerating temporarily above target inflation to provide some support for the real economy is an appropriate way to approach the trade-off. But that tolerance would weaken if signs of second-round effects begin to emerge.

This takes me back to the scenarios. In the Monetary Policy Report we published in April, we presented three scenarios – A, B and C – for possible outcomes for the UK economy and inflation over the next three years, without any one being designated as a central projection as we would normally do, and without assigning any probability weights to them. This is not because we expect this to be the norm for the future. It reflects the uncertainty we face with an unpredictable situation in the Middle East. As and when we can be more confident about how world events will unfold, we can return to presenting a central projection, one that the MPC agrees is reasonable baseline, using scenarios as vehicles for exploring the inevitable risks around it and exploring differences of views on the MPC.

But for now, the scenarios give us a better way to think about our policy decision. The reality of the situation we are in is that there is a range of possible outcomes – and we have to be ready to respond to all of them. Using scenarios is part of being ready to respond whatever happens. And it allows us to set policy now with a clear sense of the risks we have to balance.

The scenarios are designed to capture the key questions that are relevant for our policy decision. How long will this conflict go on? What will be the scale of the effects on energy prices? And particularly important for us, could it lead to second-round effects and inflation persistence? The scenarios are not exhaustive of what can happen. But they are meant to illustrate the range of possible outcomes.

While we are ready to adjust course as needed depending on how the situation evolves, our decision to hold our policy rate – Bank Rate – at 3.75% at our most recent meeting was an active choice given the range of possible outcomes.

Having taken expected cuts off the table for now, we have already tightened policy considerably in response to the shock relative to what had been expected by markets. And that is already affecting the economy. Key quoted rates on mortgages have increased since the onset of the conflict. The decision to hold reflected a judgement that continued weakness in the UK activity and the labour market is likely to lessen the strength of second-round effects from higher energy prices, while recognising that these effects are likely to be stronger, the larger and more persistent is the rise in global energy prices. Uncertainty about the strength of second-round effects means that monetary policy needs to balance the costs of leaning too little against these effects against the costs of responding too much, and the right balance is likely to change depending on how events unfold and how the economy reacts.

That means that we have to monitor the situation in the Middle East and how it affects the UK economy and inflation very closely and adjust policy as required.

Whatever happens, the use of scenarios and the flexibility we have built into our processes following the Bernanke Review has prepared us well for responding to events as they unfold to return inflation to our 2% target in line with our remit, for the good of the people of the United Kingdom.

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