

# Inflation Targeting in the United Kingdom



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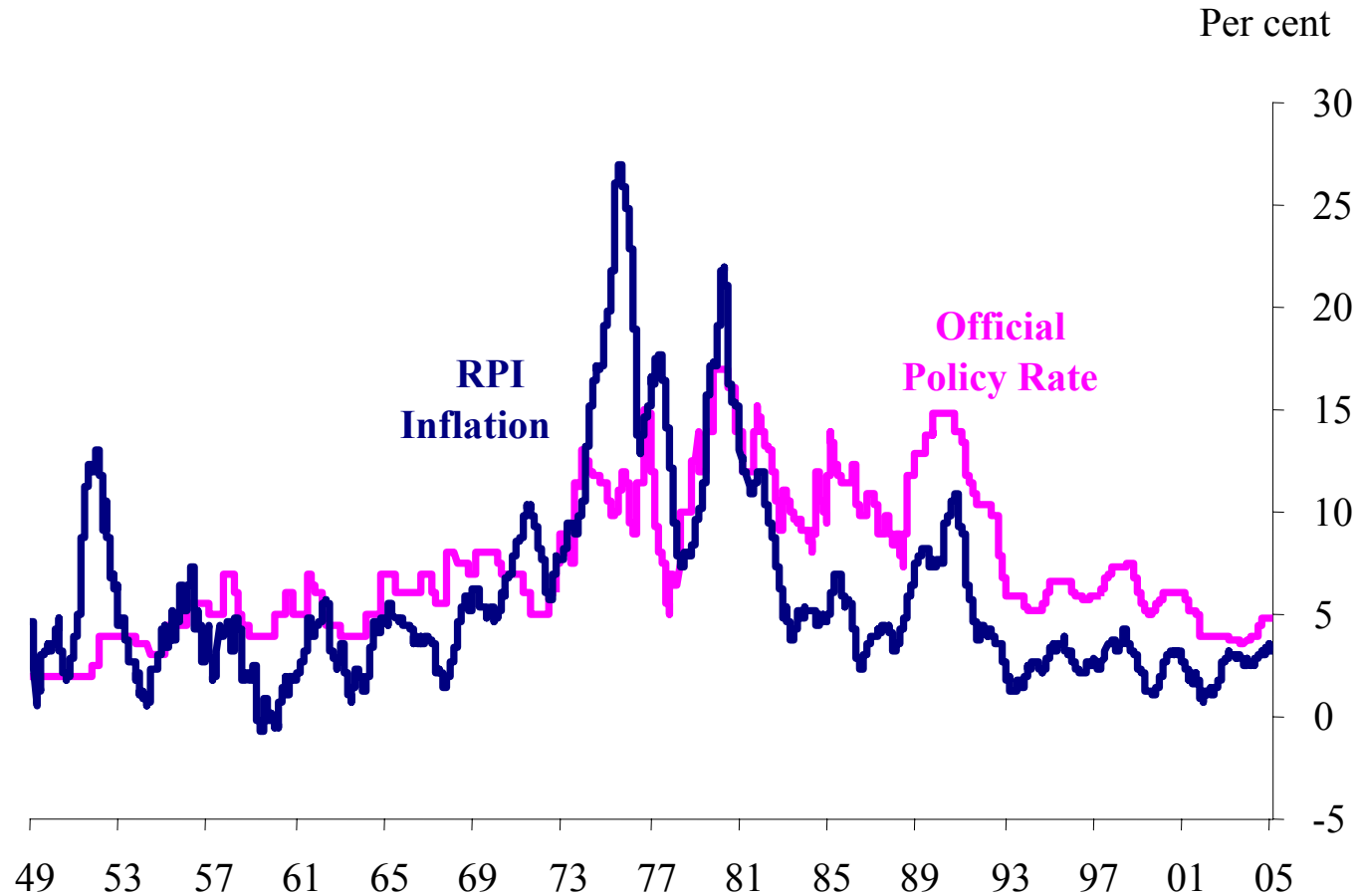
National Bank of Romania, 30 March 2005

# Outline

- Historical background
- The policy framework
  - Key features
  - Relationships with Government and Parliament
  - Press and public relations – educating the public
- The record
- Key lessons

# **Historical background**

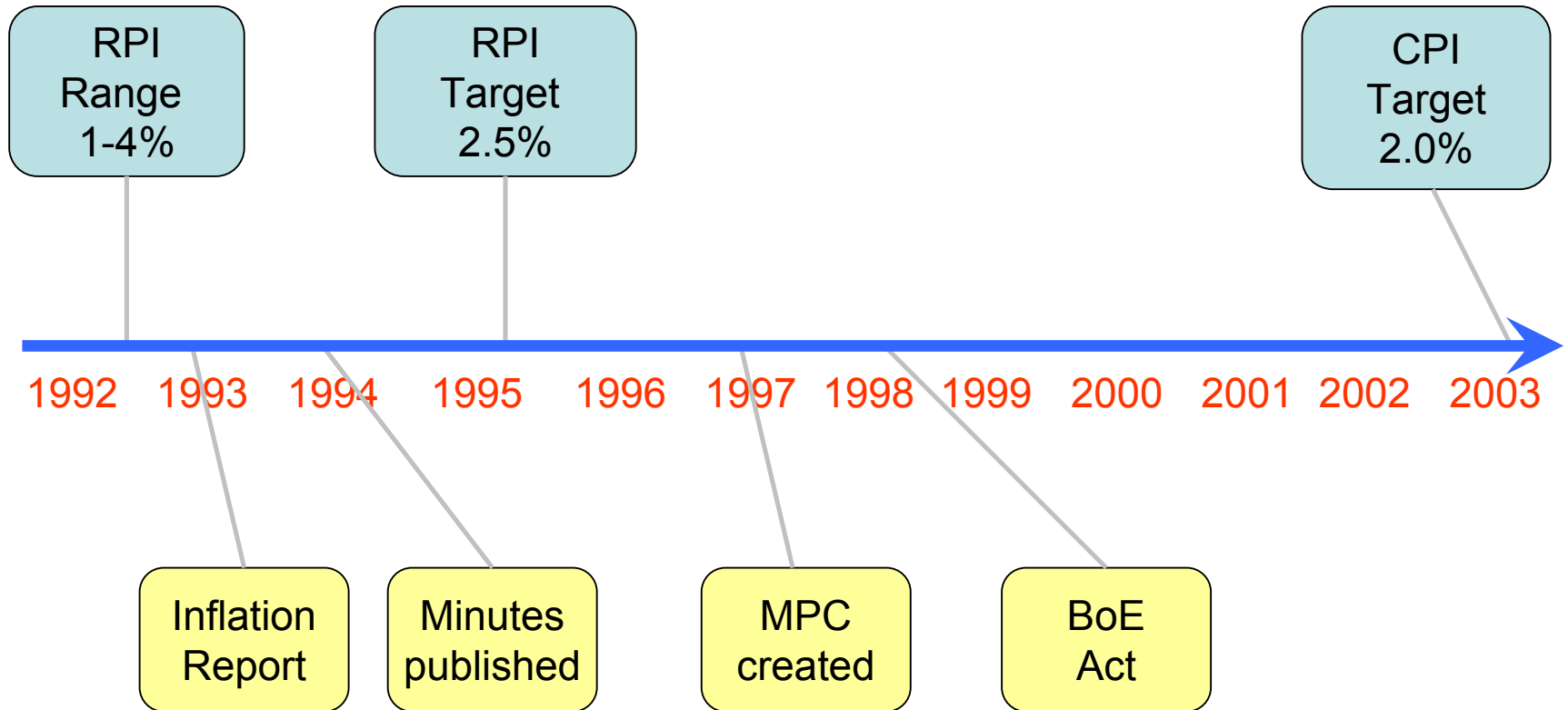
# Interest rates and inflation in the UK



# UK Monetary Policy since the 1970s

- **1970s:** ‘stagflation’; weak monetary policy; controls
- **1980s:** shift to tighter monetary policy; financial liberalisation; absence of credible framework
- **1990:** ERM entry
- **1992:** Black Wednesday – UK exits from the ERM
- **From 1992:** development of Inflation Targeting

# Development of Inflation Targeting



# **The policy framework – key features**

# The current policy framework

## Clear responsibilities and objectives

- Price stability is a legal requirement
- Government sets objectives: MPC sets interest rates
- Precise inflation target is set annually

MPC is accountable – to Government, Parliament, public

## Transparency

- Votes
- Minutes
- Inflation Report
- Public letters



# The Remit

## **Bank of England Act 1998:**

*...to deliver price stability (as defined by the Government's inflation target)*

*...and subject to this objective*

*...to support the Government's economic policy, including its objectives for growth and employment*

## **Current inflation target:**

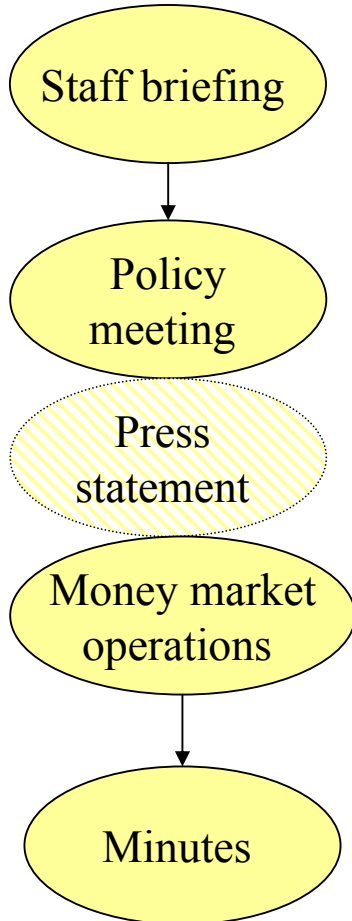
- 2% CPI inflation 'at all times'
- Open letter if inflation below 1% or above 3%
- Symmetric

# The Monetary Policy Committee

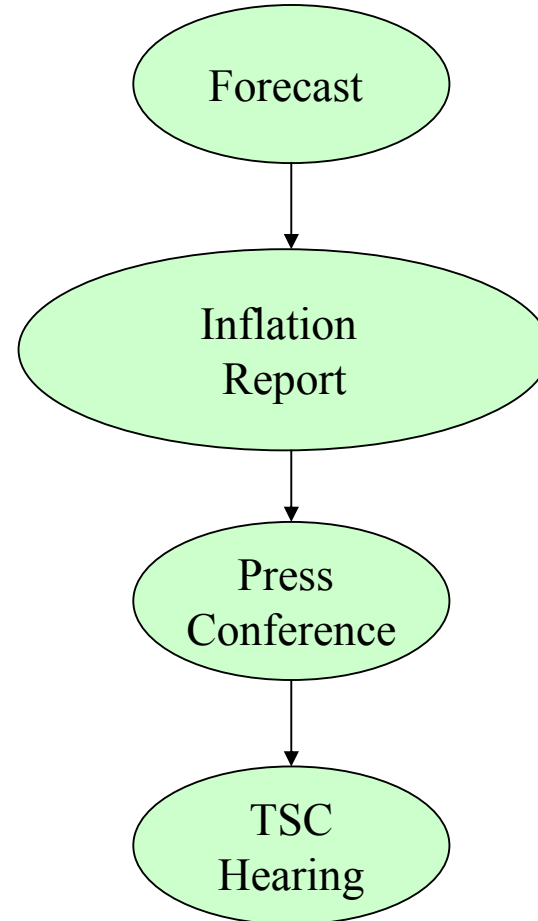
- MPC sets interest rates
- Members are individually accountable
- Chaired by the Governor
- 5 internal, 4 external members
- Externals are experts – not representatives
- 19 past and present members – mostly academics, government and business economists

# Setting interest rates – how it works

## Monthly Decision



## Quarterly Forecast



# Accountability

- MPC Members accountable to Government, Parliament, public
- Chancellor appoints members of MPC for fixed terms
- Chancellor also appoints Court – supervisory Board of Bank
- Court has a duty to review MPC processes and use of regional and industrial data
- MPC regularly gives evidence to parliamentary committees
- MPC has a duty to explain its thinking to the public

# Transparency

- Press statements
- Published minutes – after two weeks
- Published forecasts in *Inflation Report* every quarter with regular press conferences
- Disclosure of individual votes
- All members give on the record speeches and interviews

# Wider communication

## Talking to local businesses

- Network of Regional Agents
- Monthly surveys of 8000 contacts
- Regular briefings and pamphlets

## Educational initiatives

- Bank of England/*Times* Interest Rate Challenge
- Teaching pack and video for schools

# The role of the forecast

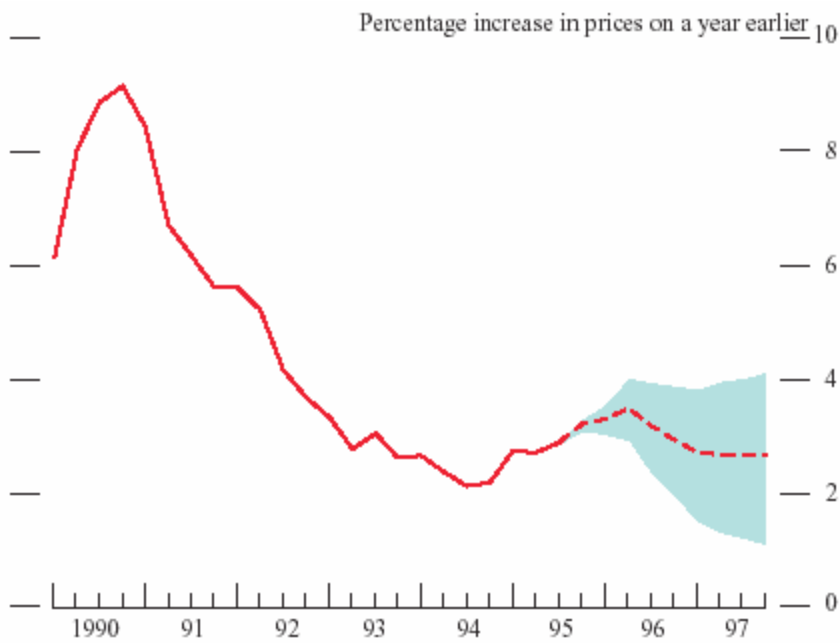
## Dual Role

1. To help the Committee make decisions
2. To explain the MPC's views on the economy

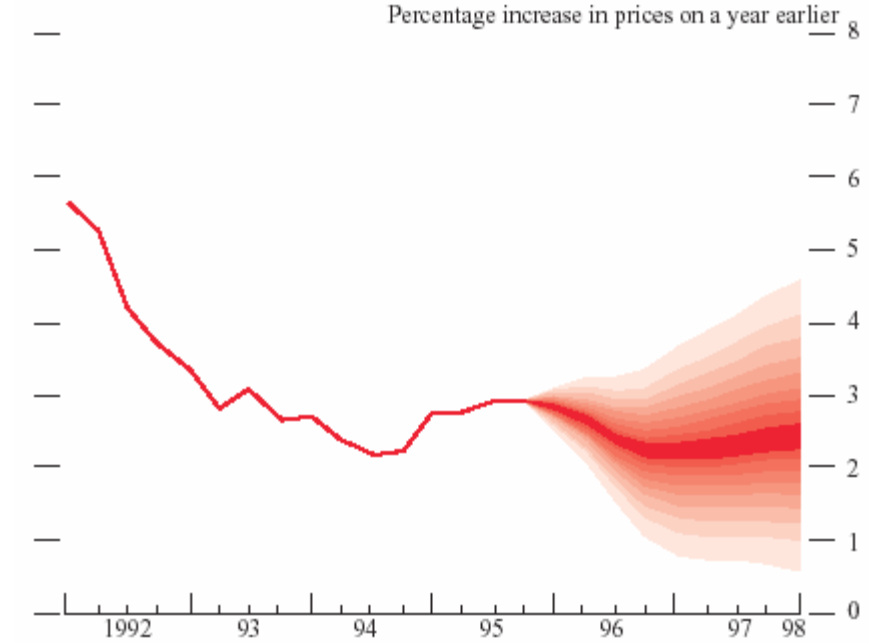
Forecasting is technically sophisticated, but fallible

# Handling uncertainty

‘Trumpet chart’



‘Fan chart’

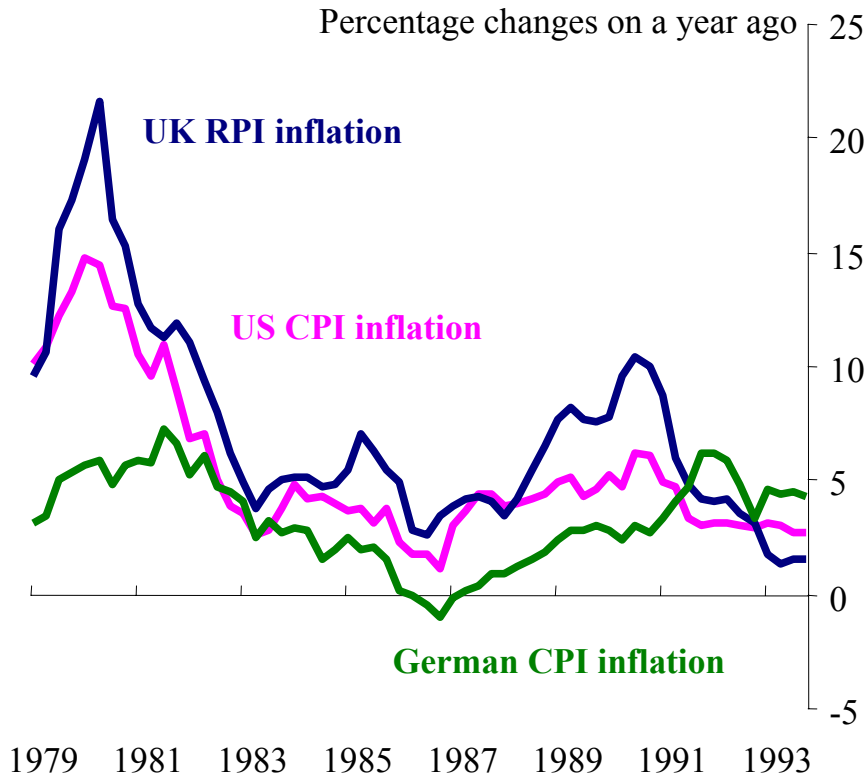




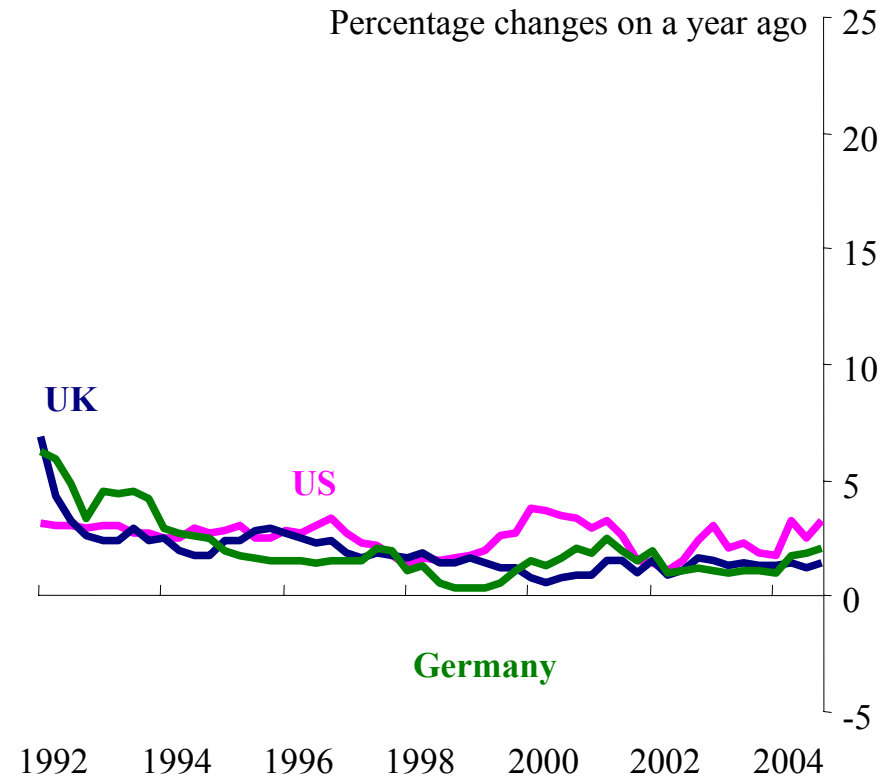
# **The record**

# The record: inflation 1979-2004

## Pre-Inflation target

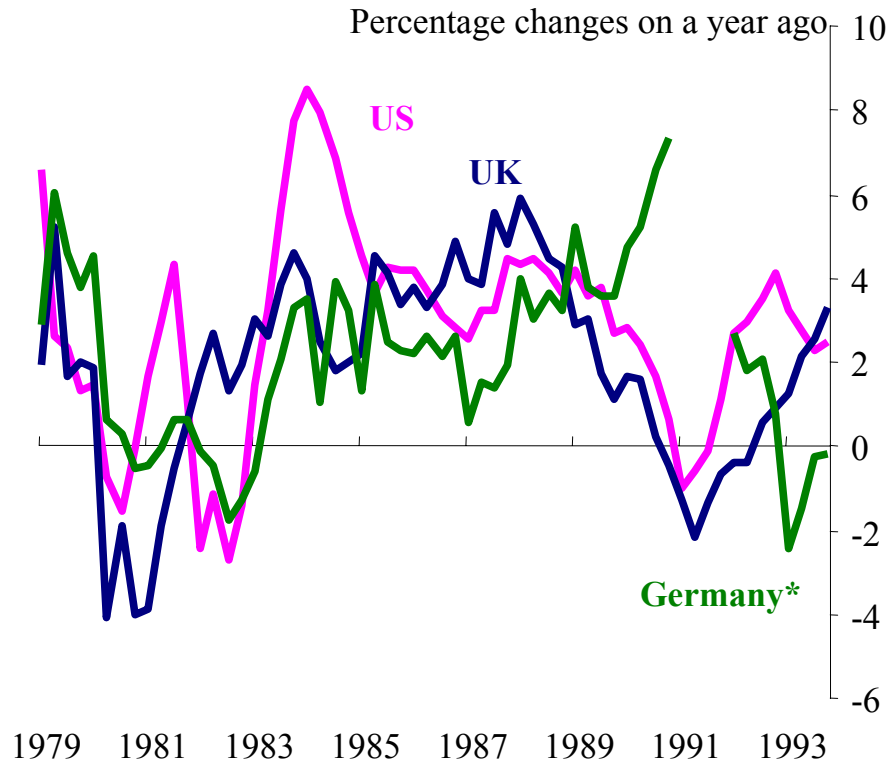


## Post-Inflation target

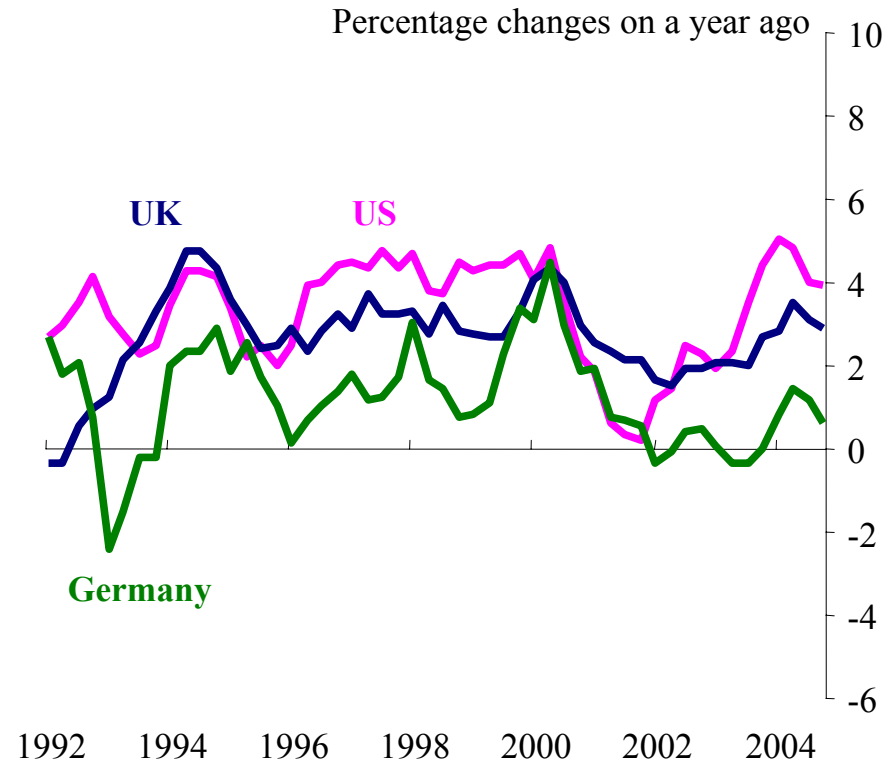


# The record: GDP growth 1979-2004

## Pre-Inflation target



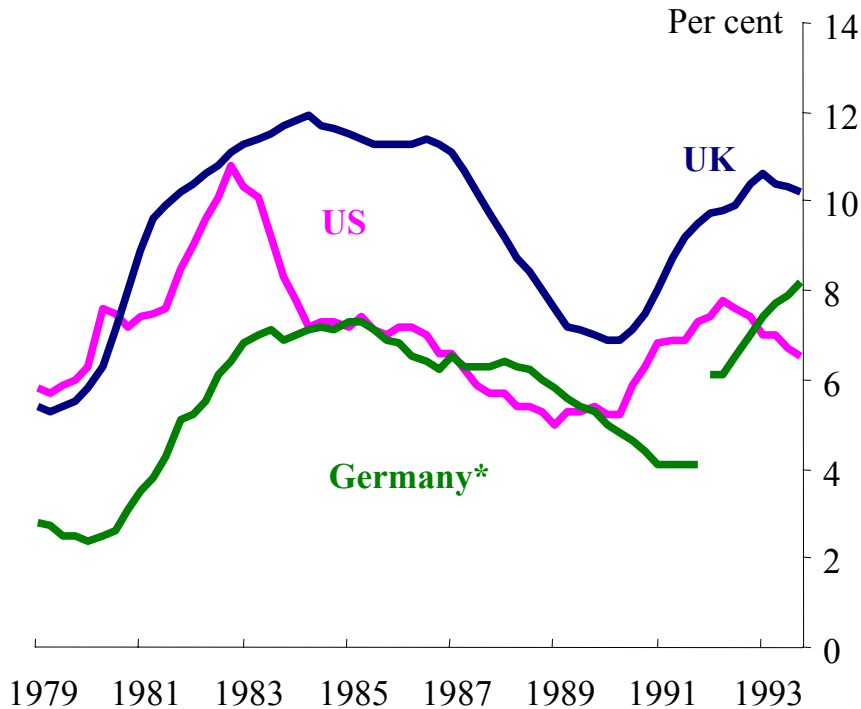
## Post-Inflation target



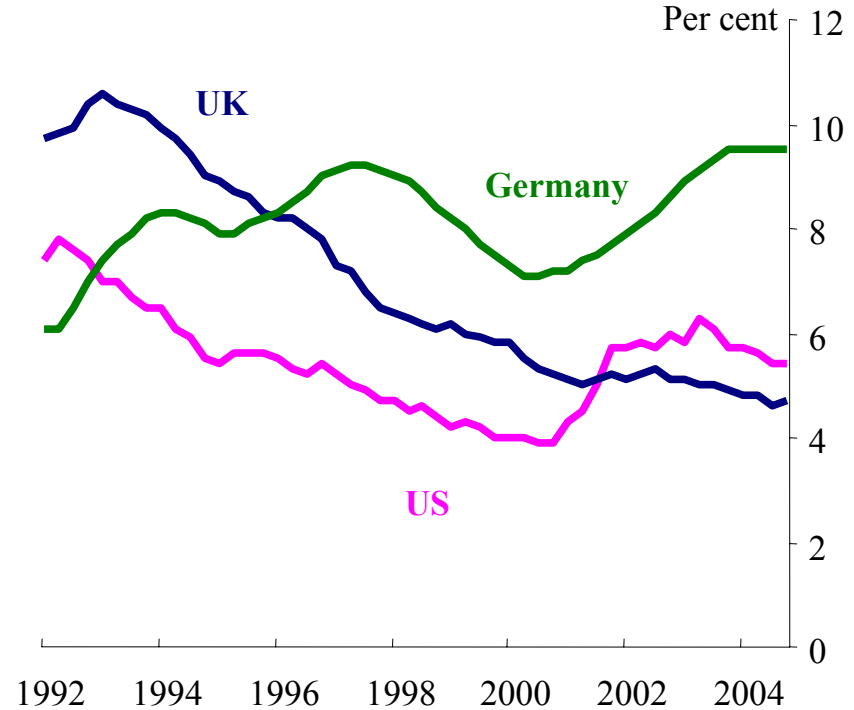
\*West Germany before 1991 - break in the series due to reunification.

# The record: Unemployment 1979-2004

## Pre-Inflation target



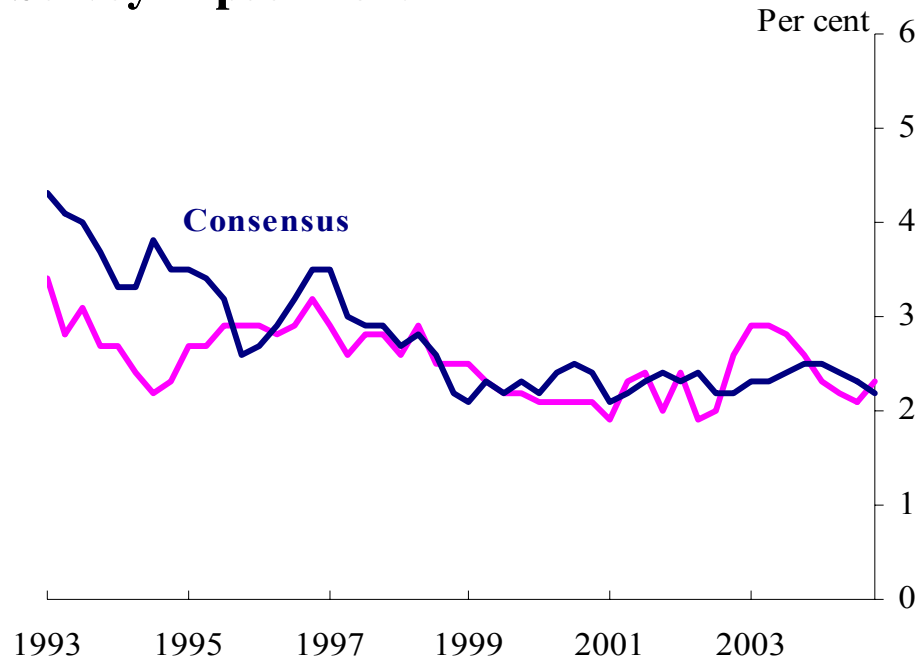
## Post-Inflation target



\*West Germany until 1991 - break in the series due to reunification.

# Inflation: what people expect

## Survey Expectations



## Financial market expectations



## What people say:

- Which central banks in ... represent the best international practice in inflation targeting? In my view, the Bank of England and Sveriges Riksbank are obvious candidates (Lars Svensson, Princeton)
- ...voters no longer assume that the Government will play politics with interest rates and screw up the economy as a result (Larry Elliot, journalist)
- The framework we currently have is not far from being as good as can be achieved (Michael Howard, leader of the opposition)
- ...my main worry is that the Bank has done far too well (Hamish McRae, journalist)

# **Key lessons**

# UK experience – key features

- IT was introduced *gradually*
- Inflation Targeting was introduced *after* inflation had started falling
- Credibility was grounded in a *track record* of success
- Key to *keeping* inflation low and stable is transparent and credible policy framework



# Inflation target – not a magic cure...

- Disinflation is still costly
- Good monetary policy still requires:
  - Thorough analysis and considered judgment
  - Being honest about the uncertainties
  - Transparency and openness
- Asset prices pose a challenge
  - We do not target asset prices...
  - ...but take account of impact on real economy

# Key benefits

- MPC arrangements took the politics out of setting interest rates without sacrificing democratic accountability
- Inflation targeting provides ‘constrained discretion’ – discipline and flexibility
- Policy decisions are more forward looking – regime provides powerful incentives to take timely decisions
- Better communication has improved credibility
- Above all – IT has delivered much better outcomes for inflation and growth

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