# Rachel Lomax: Inflation targeting - achievement and challenges

Speech by Ms Rachel Lomax,[1] Deputy Governor of the Bank of England, to the Bristol Society at the University of the West of England, Bristol, 18 February 2004.

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Ladies and Gentlemen, it is a great pleasure to be here in Bristol tonight.

Bristol and the Bank go back a long way. Our Agent in the South West, the late Michael Knight, was a founder member of this Society. And nearly two centuries ago - in 1827 to be exact - Bristol was one of the first branches that the bank established outside London. Not that it was plain sailing. The Bank's first Agent in Bristol, Mr John May, resigned after only a few years complaining of the unhealthy situation of the branch premises, situated as they were next to the City Poor House and a pool of stagnant water, at risk of cholera and - this was the time of the great Reform Bill - riots and fire. By these standards, our present Agent, Kevin Butler, has no grounds for complaint.

My subject tonight is a more recent episode in our economic history: the improvement in economic performance associated with the adoption of inflation targets just over a decade ago. I'll look first at why this approach to monetary policy seems to work, and then consider what challenges remain for policy makers.

## Historical overview

One of the more dramatic developments in the final decades of the last century was the sharp fall in inflation worldwide. This remarkable phenomenon brought inflation almost everywhere to levels not seen for the best part of fifty years. Set against the long sweep of history, it is the 1970s and 1980s that now stand out - as a major, but time limited, episode of high global inflation.[2] In the UK, the period since 1992 has seen a shift to low and stable inflation combined with sustained economic growth, and steadily falling unemployment. Slightly miraculous as these developments may still seem to the generation that came of age during the Great Inflation of the 1970s - remember 'stagflation'? - the happy fact is that for anyone in their mid-thirties, low inflation, steady growth and low interest rates are the norm.

Success has many parents, and the trend to low inflation is no exception. But there is a broad consensus that better monetary policies run by more independent and more open central banks can claim a significant share of the credit. The Short History of Twentieth Century Monetary Policy goes roughly as follows. For the first time since the collapse of Bretton Woods - arguably since the Gold Standard - after decades of unhappy experiments with fine tuning, incomes policies and monetary targets, buffeted by the explosive growth of financial markets and often misled by economic dogma, governments have finally found an approach to monetary policy that seems to work. And it works by setting clear limits on the role of governments themselves.

This is of course a caricature. But it is certainly true that the 1990s were a period of considerable reform and innovation in central banks across the world; many new central banks were established and many established central banks were given greater independence from their governments, often in exchange for a clear commitment to meet specific targets for inflation. From the time when we left the Exchange Rate Mechanism in 1992, the UK has led this wave of change. Looking back, the adoption of formal inflation targets in 1992 marks a decisive break with the past.

The other key date is 1997, when the Bank of England was granted operational independence; the institutional framework then put in place entrenched and enhanced the credibility of inflation targeting, and has been widely admired. Moreover, in the UK, as in many other inflation targeting countries, a

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[1] I would like to thank Jens Larsen for research support and Luca Benati, Melissa Davey, John Power and Sally Srinivasan, whose work I have drawn on extensively. I have also benefited from comments from many colleagues at the Bank, especially Peter Andrews, Charlie Bean, James Proudman and John Keyworth. The views expressed here are mine, and do not necessarily reflect those of the Bank of England or the Monetary Policy Committee.

[2] Rogoff, K (2003), 'Globalization and global disinflation', paper prepared for the Federal Reserve Bank of Kansas City conference on 'Monetary Policy and Uncertainty: Adapting to a changing economy'.

track record of success, built up over more than a decade, has progressively reinforced the credibility of these targets. As a result, people and firms have increasingly come to expect inflation to stay close the official target - a belief which itself helps to keep it there.

Clearly the world has changed. For sure, there is still much we do not understand both about the ebbing of global inflationary pressures over the past decade and about the impact of low inflation on the way that people behave. And there have been crises, such as the stock market crash and September 11. By past standards, though, modern monetary policy is a less melodramatic affair.

Has policy making become easier? I don't think so, though I suspect it looks that way. But let met give a fuller answer by setting out how the present approach to setting interest rates works; and outlining some of today's challenges.

**The policy framework**

I'll start with inflation targeting, as it has been implemented in the UK since 1997.

The institutional framework is set out in some detail in the 1998 Bank of England Act. This is extremely clear both about the aims of monetary policy and about the respective roles of the Government and the Bank. On the one hand, the Bank of England is required set interest rates so as 'to maintain price stability and subject to that to support the economic policy of HM Government, including its objectives for growth and employment'. On the other, the Government is required to specify what its economic objectives are, including what is meant by price stability. The remit of the Monetary Policy Committee (MPC) must be set out in writing at least annually and it must be published.

The remit has always had important elements of flexibility. For example, while the MPC is directed to aim for the target 'at all times' and to treat deviations from target symmetrically, it is not expected to react mechanically. Instead, if inflation deviates from target by more than 1%, the Governor is required to write to the Chancellor explaining the circumstances and setting out what action the MPC considers necessary to return to target. No letter has been written so far, but only because circumstances have not warranted it.

There is an explicit understanding that operational independence must be accompanied by transparency and clear accountability to Parliament and the general public as well as to Government. The Bank's forecasts are published in the quarterly *Inflation Report*, the minutes of MPC meetings are published within two weeks, and the nine members of the MPC appear regularly in front of Parliamentary committees as well undertaking between them some 50-60 regional visits a year to different parts of the UK.

The Committee has a distinctly individualistic bias, in contrast to the consensus seeking traditions of many other central banks. It includes four external members who are appointed for their expertise, not as representatives of interest groups; and all members are individually accountable for their votes, which are made public with the minutes. Both the markets and the press take a keen interest in the pattern of voting, and members will often find a way to explain their thinking in more detail.

All this adds up to a powerful set of incentives for members of the MPC to focus on maintaining price stability; to pay attention to all relevant information; to weigh up the risks; to take timely decisions; and to explain them clearly. Moreover, clarity about the aims of policy and the transparency of the decision taking process give the MPC significant scope to influence the longer term interest rates set by the market. It's a far cry from previous policy regimes, when the main players faced very different incentives. Prior to 1997 the key decision makers were politicians, who both set objectives for monetary policy and took responsibility for the technical judgements needed to meet them. Politicians can rarely afford the luxury of focussing on one objective to the exclusion of all others. Attempts to win credibility by constraining their discretion, notably through setting monetary targets, were a fairly comprehensive failure.

Interest rate decisions have been the subject of some famous tussles between Number 10 and Number 11 Downing Street under successive Governments. Here is Chancellor Denis Healey, writing in his memoirs[3] about a spat with the Prime Minster of the day:

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[3] Healey, D (1989), *The time of my life*, Michael Joseph London.

> ‘At this time my own relations with Jim were shaken by an incident just after the Party Conference. On October 6 I had asked him to let me raise interest rates by another 2 per cent to the then unprecedented level of 15 per cent…He refused. I said I wanted to take the matter to Cabinet that morning. ‘All right’ he replied ‘but I will not support you.’ Nevertheless I insisted…’

In the event this did not prove necessary: Callaghan backed down, leading Healey to comment wryly that

> ‘This was the only time I have ever used the threat of resignation to get my way.’

The new framework has taken the politics out of interest rate decisions without sacrificing democratic accountability or oversimplifying the policy process. It is an elegant institutional solution to the lengthy debate between those who favoured untrammelled discretion and those who advocated rules (such as monetary targets); one, moreover, which manages to respect the constitutional priorities of a parliamentary system.

### Achievements

Performance over the six years since the Bank became independent has been impressive. Against the target of 2.5% for RPIX which ran from 1997 until December 2003, average inflation was 2.4%. For 68 out of the 79 months, inflation was within 0.5 percent of the target - below it for 42 months, above it for 30, and on target for the remaining seven. Notwithstanding the stock market crash and the slowdown in world activity, the UK economy has continued to grow steadily and employment has remained strong.

On a longer term view, the decade of inflation targeting since 1992 looks remarkably stable by post-war standards.[4] The recent slowdown has been exceptionally mild compared with all previous slowdowns since the beginning of the 1970s, and since 1992 growth in both real GDP and consumer spending has also been significantly less volatile, with 46 quarters of positive growth, and no significant downturn in consumption since mid 1994. Prior to the 1970s, recessions were virtually absent, but real GDP was much more volatile than it has been in the past decade.

Of course, better monetary policy and low inflation are only part of this story. It matters that monetary policy has been supported by fiscal discipline. Just as important are the many labour and product market reforms that, over a long period of time, have given us a more flexible and competitive economy, which is capable of adapting quickly to sudden change without prolonged periods of unemployment and under-utilised capacity.

### Attitudes towards inflation

American economist Alan Blinder once said: “Price stability is when ordinary people stop talking and worrying about inflation”. Has low inflation entered our bloodstream yet? This is a hard one but there are some clues.

Expectations about future inflation seem to have fallen steadily over the past decade and are now clustered around the Bank’s target. This is supported by survey evidence, including surveys of trade union officials, and evidence drawn from financial market prices. A recent Bank of England survey of the general public[5] pointed to interesting though small differences across age groups, with younger people expecting lower inflation on average than their parents. When it comes to inflation, people have very long memories.

The evidence also suggests that firms and wage bargainers are now more disposed to expect inflation to revert to target if something happens to throw it off course: in that sense inflationary expectations are better anchored. This should make the task of policy makers easier. After all, if wage bargainers and firms themselves act *as if* the Bank will take action to offset any potential disturbance to inflation, the need for the Bank itself to *actually* change interest rates will be that much less. This, in a nutshell,

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[4] Benati, L (2004), ‘Investigating Inflation Persistence across monetary regimes’, Bank of England Working Papers, forthcoming.

[5] Lombardelli, C, and Salaheen, J, (2003), ‘Public expectations of UK inflation’, *Bank of England Quarterly Bulletin*, Autumn.

is the intuitive reason why a credible policy regime should help to produce more stability in output as well as inflation.

### Challenges

Inflation is low, expectations are well anchored, and the real economy works better as a result. These achievements are important and they were hard won. We mustn't take them for granted. But nor can we live in the past. So what are today's challenges? I see these in three main areas: assessing current economic developments; effective communication; and understanding the new trends that will shape the future.

#### *(i) Assessing current developments*

Broadly speaking, the task for the MPC is to control inflationary pressure by ensuring that the level of aggregate demand in the economy is more or less in line with aggregate supply. The first and most basic challenge comes in translating this deceptively simple idea in to practice.

It is hard enough to estimate how fast demand is growing now from incomplete, preliminary or just plain puzzling information. It is harder still, and even more important, to look ahead over the two or three year horizon relevant to setting interest rates. But that's only part of the story. The rate at which demand can be allowed to rise without leading to an upturn in inflation depends both on how much spare capacity there is in the economy now and on factors that determine the future growth in supply, such as productivity and labour availability. And finally, we need to consider what effect our own actions will have on longer-term interest rates and through them on the wider economy.

Inflation targeting provides a credible framework within which these complicated issues can be properly considered. That's important, but it does not change the need to make judgements, or even make the judgements any easier. Data get revised; models over simplify; forecasts are fallible. It's essential to invest in state of the art techniques; indeed the Bank has just introduced a new macro economic model. But progress depends just as much on recognising all the uncertainties and allowing for them in a systematic way.

The monthly interest rate decision requires a complex assessment of all the evidence. We need to be both sceptical and open minded, if we are to avoid major error: sceptical when it comes to interpreting the data, but alert for signs that we may be getting it wrong. The decision to raise rates in February, while inflation was still well below the new target, reflected a top line view that inflationary pressures were likely to build over the next couple of years. While this has been the emerging picture for some months now, we have been surprised by a number of developments pointing in different directions, which have needed careful evaluation - notably, the resilience of household spending and the strength of the exchange rate. We have also had an opportunity to reconsider earlier judgements, especially about the amount of spare capacity and the likely growth in potential supply. That is the nature of the exercise.

March will be another month. There can be no foregone conclusions when it comes to setting interest rates. Every month I may have a fairly well developed view not just about this month's interest rates, but about where interest rates are likely to need to go in the future, to achieve the inflation target. But that view may - indeed should - change in the light of new information, better research, another set of forecasts, perhaps a different view of the risks. In that sense every month is a fresh decision. What doesn't change is what we are trying to achieve. This clarity about aims is what gives us the flexibility to learn, so important if we are to avoid major error.

#### *(ii) Effective communication*

Maintaining this clarity through effective communication is critical. The MPC aims to be as open and straightforward as possible. Sometimes this involves lengthy explanations of rather arcane issues. A recent example is the change in the inflation target. As you probably know, in January the Chancellor replaced the target of 2.5% as measured by the RPIX by a 2% target as measured by the new CPI. We have used speeches, Parliamentary appearances and short articles to set out as clearly as possible the nature of this worthwhile but essentially technical change, in order to underline one simple message: that the change in target in no way weakens the commitment to price stability, and indeed has no material implications for monetary policy.

It has been harder work to explain our thinking about the altogether more newsworthy subject of the strong growth in household spending, and its relationship with escalating house prices and household debt. Bad memories of boom and bust in the late '80s and early-'90s get in the way of more nuanced explanations which try to reflect how the world has changed in the past decade. The truth is that the present situation is rife with uncertainties. For example, while it is not difficult to think of reasons why the level of house prices relative to income might have risen significantly in recent years, at no less than 40% above their long average, current levels definitely stretch the imagination. Are people behaving rationally? Hard to say - individuals are notoriously prone to over-optimism about their own prospects, but it is not obviously misguided to base decisions on a view of the future which reflects the record of macro economic stability I described earlier. What clearly <u>is</u> irrational is to assume that current rates of house price inflation will continue indefinitely.

It has also been a challenge to explain how house price inflation and borrowing fit within an inflation targeting framework. One commentator has claimed that they are 'the targets that dare not speak their name'. This is not so. True, the Committee has debated endlessly how far a strong housing market can explain the resilience of household spending, and the risk that a sharp correction in house prices will dent consumer confidence, and administer a nasty deflationary shock. Inevitably such questions do not have clear cut answers - for example, the relationship between house prices and consumer spending, never well defined, has shown tantalising signs of weakening over the past few years.

But the message we have tried to get across is that house prices and borrowing are part of the wide range of evidence we review monthly in assessing the outlook for inflation. They have also been important in shaping our view of the balance of risks. They do not have a special role, as targets, in driving interest rate decisions.

### *(iii) Detecting future trends*

Let me come to my final set of challenges: understanding the new forces that are shaping the future, or, if you prefer, detecting the bends in the trends. This is what successful businesses have to do, and we need to share their insights. There is an important role here for the Bank's regional Agents. Their most valuable input to the MPC can be the stories that illuminate their regular surveys of their 8000 contacts around the country and bring to mind Nobel prize-winner George Stigler's quip that 'The plural of anecdote is data'.

Let me give you an example. Since the 1996, the National Accounts have painted a picture of a boom in household spending, with the volume of personal consumption growing by 3 ¾ per cent a year on average, compared with real GDP growth of 2 ¾ per cent. But for the past couple of years at least, the Bank's Agents have been talking about a much tougher world 'out there', with demanding shoppers on a ceaseless 'search for value' using new technology to search out bargains as well as to make purchases, driving an endless round of discounting across a wide range of consumer goods.

It's a fact that in *value* terms, the growth in household spending has been slowing since the middle of 2000. Much of the strength in the *volume* of consumption reflects lower prices which have boosted consumers' spending power, for given incomes. Since 1998 the price of durables has fallen by 14%, while the price of other goods and services has continued to rise. The falls have been spread across a range of categories, including cars, clothing and sports goods, though the fall has been particularly marked in IT/audio visual goods. So it is not surprising that spending on durables accounts for virtually all the growth in the volume of consumption - an average of over 8 per cent a year compared with around 2 per cent on other goods and services.

The interesting questions are why this has happened, how far it will go and how long it will last.

We know that the UK's terms of trade have improved substantially since the mid 1990s, as the price of our imports has fallen more than the price of our exports, boosting domestic spending power. But this seems to be partly an IT story, much of it concentrated in capital rather than consumer goods; and lower prices may be related to exchange rate changes, which could be temporary.

Clearly new technology *is* playing an increasing part in helping consumers to search out bargains as well as to make purchases. While the total value of on-line sales remains relatively small, it is clearly growing very rapidly. Comprehensive data is still hard to come by, but one source suggests that on-line sales have risen more than ten fold over the last four years. Several recent reports have pointed to a sharp acceleration in the second half of last year, as the habit of e-shopping spreads. Structural changes within the retail sector are also part of the story. High street retailers are facing stiff competition from the major supermarket groups across a wider range of products.

What is driving these changes? No doubt there are many factors at work, but I find the Agents' picture of an increasingly demanding consumer quite thought provoking. We live in a consumer society, and shopping, in one form or another, is what many people do much of the time; helped by technology, why wouldn't they learn to do it rather well? And indeed one of the benefits of low inflation is that price signals carry more information, making price comparisons worthwhile.

Understanding what is happening is relevant to monetary policy. To the extent that a fierce competitive struggle is squeezing retail margins, it is likely to affect the shortrun outlook for inflation. While such a squeeze won't have an effect on inflation in the longer term, it could herald a lasting improvement in productivity across the sector as a whole.

This brings me to my final issue: whether productivity in the UK will accelerate as it seemingly has in the US.[6] Since 1995 the growth of US productivity has doubled and the improvement has been sustained through the stock market crash. This is directly relevant to current thinking about US monetary policy. If faster productivity has indeed helped to create a high level of spare capacity and contributed to a higher growth in underlying supply, holding interest rates at historically low levels for some time should not add to inflationary pressures, even if demand grows rapidly. This is a key reason why the Fed believes it can be 'patient' in raising interest rates.

The US evidence does seem to suggest that productivity has accelerated and that ICT has played a substantial role in raising productivity in non ICT sectors. This answers one puzzle, neatly posed by US economist Robert Solow when he commented that 'You can see computers everywhere but in the productivity statistics'. But it also raises the equally interesting question of why no such acceleration has yet been detected in the UK (or continental Europe) despite huge ICT investment in the late 1990s.

The possible answers to this question cover the full range from the *pessimistic* - it is never going to happen because there are institutional and other barriers to realising the benefits of ICT, in the shape of regulations, planning restrictions, or restrictive labour practices - to the *optimistic* - it will definitely happen given time, but the lags are long and variable.

The truth is, of course, that we don't really know, despite much research both in the US, here and elsewhere. For what it is worth, I take it as read that realising the benefits from investment in ICT is about much more than buying kit. As anyone who has ever run a business knows, investment in ICT must be accompanied by changes in the way the job is done. Managing change is a notoriously costly and disruptive business. So some temporary slowdown in productivity growth in the wake of heavy investment in ICT is not surprising.

If that's right, the questions for monetary policy makers become harder: namely, when, where and by how much will productivity growth eventually pick up? What's the likely impact on potential supply? As it happens the projections in the February *Inflation Report* do project a pick up in supply over the next few years, but that reflects improved labour availability rather an assumption that there is an ICT led productivity miracle in the making. But we could easily be wrong. Given recent experience, there is clearly some risk of undue pessimism, though it has to be said that past policy errors have more often been the result of too much optimism. One thing is for sure: we can't afford to sit back and wait for the data to tell us the answer. By the time we have that degree of certainty policy will have moved on. So productivity will remain a key issue for us over the coming years.

### Conclusion

Which brings me to my final challenge for policy makers: how to handle uncertainty in taking and presenting policy decisions.

The MPC has met this challenge head on from the beginning. Within the discipline imposed by a shared inflation target, the Committee has been very open both about uncertainty and about the disagreement that is likely to go with it. Published MPC forecasts have explored rather than glossed over risks and uncertainties. The individual accountability of MPC members reduces the incentive to search for consensus. MPC members have always voiced their different views in public, and while this

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[6] Basu, S, Fernald, J G, Oulton, N, and Srinivasan, S (2003), 'The case of missing productivity growth: Or, does information technology explain why productivity accelerated in the United States but not the United Kingdom?', forthcoming in Gertler, M and Rogoff, K (eds) *NBER Macroeconomic Annual 2003*, MIT Press. Available from the NBER website: www.nber.org.

is not without risk to the clarity of the message, and has occasionally led to an uncomfortable personalising of decisions, I see it as an inherent part of system not a quirk of particular personalities.

The big prize is long term credibility, and nowadays there is no credibility without openness. This is what gives the present framework the flexibility to respond to changing circumstances, and allows members of the MPC to change their minds in the light of experience. And in an uncertain world this openness to learning is a precondition for success under any policy regime.