

## **Spencer Dale: Inflation targeting and the Monetary Policy Committee's forward guidance**

Speech by Mr Spencer Dale, Executive Director, Monetary Policy, and Chief Economist of the Bank of England, at the International Journal of Central Banking Annual Conference, "Inflation targeting and its discontents", Warsaw, 6 September 2013.

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A central theme of this conference has been to highlight potential shortcomings of inflation targeting and to consider potential alternatives.

I believe that the traumatic events in the UK economy over the past five years have, in fact, strengthened the case for inflation targeting. The credibility of the inflation target has played a crucial role in anchoring inflation expectations over the past five years, a period in which inflation has been consistently above target. That credibility has been vital in giving the Monetary Policy Committee (MPC) the flexibility to loosen monetary policy aggressively in order to support growth and jobs.

But while it has not constrained the MPC's freedom to act in support of the economy, the inflation target, on its own, has proved less well suited to addressing some of the exceptional communications challenges posed by the sustained combination of weak growth and elevated inflation. I would highlight two in particular: the need to make clear the central role that monetary policy has played in supporting output and employment; and the need to provide guidance about the Committee's view of the appropriate trade-off between bringing inflation back to target and stimulating the recovery.

The forward guidance provided by the Committee in August can be seen as a response to these challenges. To retain the clarity and credibility of the inflation target but to augment the framework so that monetary policy is better equipped to address the exceptional challenges currently faced by the UK economy. In this talk, I will provide a post-crisis report card for the UK's inflation targeting regime and explain how the MPC's forward guidance responds to some of the areas exposed as having 'room for improvement'. I will also show how a threshold for monetary policy defined in terms of the unemployment rate is particularly helpful in addressing two other challenges currently facing the MPC: the uncertainty surrounding the future path of productivity; and the need to provide greater clarity concerning the setting of monetary policy as the economy recovers.

### **A bit of background**

Before doing so, it is worth highlighting three features of the UK's economic performance over the past five years which should be borne in mind when evaluating the performance of the UK's inflation targeting framework and understanding the Committee's decision to provide forward rate guidance.

First, CPI inflation has been above target for almost this entire period (Chart 1). Fifty four months out of the past sixty to be precise. Over this period, CPI inflation has averaged 3%. And, on the basis of the MPC's central projection in the August Inflation Report, it is expected to remain above target until the second-half of 2015.

Second, notwithstanding the recent encouraging data, the recovery following the crisis has proved exceptionally weak. The level of UK GDP is still more than 3% below its pre-crisis level. This is the weakest UK recovery on record. And with the exception of Italy, the weakest across the G7 (Chart 2).

Third, the sluggish recovery has been accompanied by extraordinary weakness in productivity. The level of private sector productivity has actually fallen over the past five

years: the first time since the late 1800s that productivity has fallen over such a timeframe other than as a result of economic demobilisation following the World Wars (Chart 3).

High inflation, anaemic demand and even weaker supply: an extraordinarily challenging economic backdrop against which to set monetary policy. So how did the UK's inflation targeting framework stand up to this challenge?

### **A post-crisis report card for UK inflation targeting**

In short, a bit like my old school reports: good, but could do even better.

The regime's main success is that inflation expectations have remained well-anchored despite the sustained period of above target inflation. There is no definitive test or measure of the stability of inflation expectations. But evaluating a wide range of expectations measures along a number of different dimensions presents little evidence that the stability of inflation expectations has lessened to any material extent.<sup>1</sup>

This stability is all the more striking given that monetary policy was loosened very aggressively during this period. As has been discussed before by many of my MPC colleagues (see, for example, Bean (2011), Broadbent (2011), Fisher (2013)), to not have done so would have meant presiding over an even deeper recession and an even greater rise in unemployment. Rather than a constraint as some claimed, the inflation target and the credibility it afforded were essential in allowing the MPC to respond as forcefully as we did. The much vaunted flexibility offered by inflation targeting frameworks – to set policy in such a way that mitigates damaging booms and busts in activity as well as controlling inflation – can be exercised only if policymakers' commitment to their target remains credible. Without credibility, there can be no flexibility.

The experience of the UK economy over the past 5 years has provided a real-time examination as to how long inflation can remain above an explicit policy target without the credibility of that target being undermined. Thus far, the UK's inflation target has passed this test with flying colours. And, in so doing, it has enabled the MPC to provide vital support to our economy.

But although inflation targeting scored highly against its primary objective – anchoring people's inflation expectations – there was, as my teachers used to say, some room for improvement. For me it was spelling. For inflation targeting, at least as operated in the UK, it was in addressing some of the communications challenges posed by the sustained period of weak demand and elevated inflation.

### **Room for improvement: explaining our policy choices**

The public emphasis that we, as inflation targeters, place on achieving outcomes for inflation plays a key role in underpinning the MPC's anti-inflation credentials. But this focus can be a double-edged sword, in that it can give the false impression that inflation is the sole focus of our monetary policy.

In fact, over recent years nothing could have been further from the truth. Indeed, inflation has been above target for the vast majority of the period since the financial crisis. Yes: some of this inflation overshoot might be the result of poor forecasting. For much of this period, the Committee expected inflation to fall back to target more quickly than it actually did. But much more important was the recognition that a lower profile for inflation was possible only by tightening monetary policy at the expense of an even deeper recession and an even greater rise in unemployment. Throughout this exceptionally challenging period, monetary policy has

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<sup>1</sup> See Bank of England *Quarterly Bulletin* 2013 Q2 and recent Inflation Reports for a detailed analysis of recent movements in inflation expectations.

consistently been set to ensure that inflation remains on track to return to the 2% target in the medium term. But, subject to that, we have done everything in our power to support the UK economy through the aftermath of the financial crisis, using the flexibility afforded to us by the inflation targeting framework and by our own credibility to the full.

But the nature of our inflation targeting framework – with the primacy it attaches to the control of inflation – means it is not well suited to explaining our role in supporting growth and jobs. Policy actions have typically been explained solely in terms of inflation: for example, reducing the risk that inflation will undershoot the target in the medium term or extending the horizon over which we intend to return inflation to target. Although, technically accurate, such explanations don't speak to the distress of businessmen and women worrying about the future of their companies or to the anxiety faced by families unsure as to whether they will still be in a job next week.

Make no mistake: inflation targeting provides the flexibility for policy to respond to such anxieties. And we have fully exploited that flexibility over recent years. But it doesn't provide a natural framework – a ready vocabulary – in which this flexibility can be clearly communicated.

This almost exclusive focus on inflation in our communications didn't matter for much of the first 20 years of inflation targeting in the UK. Indeed, arguably it was one of its attractions. Prior to the introduction of inflation targeting in 1992, the UK had searched – in vain – to find a credible anchor for monetary policy and inflation expectations. The simplicity and clarity provided by a numerical target for inflation helped to establish the credibility of monetary policy and was instrumental in fostering the period of stable growth and low inflation enjoyed in the decade or so prior to the financial crisis.

But in the aftermath of the crisis and faced with five years of almost no growth, it is natural for people to ask what monetary policy is doing to help get the economy going. The control of inflation is important but so too is supporting the creation of jobs as unemployment rose to its highest level for almost twenty years. There was a real risk that this would start to erode the trust and support of inflation targeting; to damage its democratic legitimacy. This was arguably evident earlier this year in the discussions in the media and amongst some commentators as to whether the framework of monetary policy should be altered, say to adopt a nominal GDP target or for the MPC to have an explicit objective for growth. A subtext of that discussion was that the inflation target was in some way acting as a constraint on the support that monetary policy could provide to the faltering recovery.

To repeat: such criticism is misplaced. The credibility provided by the inflation target is a prerequisite for monetary policy to be able to respond so aggressively to the fallout from the crisis. And with inflation being above target almost consistently over this period, it is hard to argue that monetary policymakers have somehow been fixated by inflation.

But the forward guidance provided by the MPC makes that support explicit. The primary objective of monetary policy remains the 2% inflation target. The sanctity of that objective is guarded by the two price stability knockouts. But subject to those knockouts and the knockout pertaining to financial stability, our guidance clearly signals the Committee's intention to maintain a highly stimulatory stance of policy until the economy returns to something closer to normality.

Abstracting from the precise details of the thresholds and knockouts, the message to businesses and families should be clear. The MPC intends to keep interest rates low until we have seen a sustained period of strong growth, rising incomes and higher employment, as long as that does not pose risks to either price stability or financial stability. To be clear: that is no different to the approach underlying our policy over the past five years. But forward guidance provides a framework and a language in which that intention can be made plain.

A closely related issue is the policy trade-off currently faced by the MPC. With inflation well above target and the level of output still depressed, the Committee has to balance the speed

with which it returns inflation to target and the support it provides to output and employment. If we attempt to return inflation to target too quickly, by withdrawing monetary stimulus, we risk undermining the fledgling recovery. But returning inflation to the target too slowly might cause people to question the MPC's commitment to keep inflation close to 2% in the medium term.

Again, the issue here is to do with the transparency and accountability of policy, rather than its actual setting. The need to juggle these two challenges – returning inflation to target and supporting growth – has been the single most important determinant of our monetary policy decisions over recent years. But an inflation target, on its own, is not well suited to explaining the judgements and rationale underlying the Committee's approach. Put bluntly, it speaks to only one half of the trade-off.

The stakes are high. Our management of the trade-off between returning inflation rapidly to target and supporting the recovery directly affects businesses and families up and down the country. It is only right that the Committee be clear about its view of the appropriate trade-off so that we can be challenged and held to account. Indeed, a noteworthy addition to the MPC's remit when it was renewed by the Chancellor earlier this year was a request that "... the Committee should promote understanding of the trade-offs in setting monetary policy to meet a forward-looking inflation target while giving due considerations to output volatility." The forward guidance announced by the Committee clarifies its view of the appropriate trade-off. The primacy of the inflation target makes clear that the long-run objective for monetary policy hasn't changed, and the inflation forecast knockout provides information about the minimum speed at which the Committee judges it acceptable to bring inflation back to target. At the same time, the unemployment threshold provides guidance about what the MPC is trying to achieve in terms of real activity as the economy gradually normalises.

Moreover, by making clear its view of the desired trade-off, the MPC helps to make our monetary policy more predictable. This enables financial markets, companies and families alike to make more informed decisions and so improve the effectiveness of policy.

Let me summarise where we have got to so far. The inflation target served us well during the financial crisis. Straight A's for preserving credibility and for anchoring inflation expectations. But the aftermath of the crisis has posed particular challenges of communication and accountability that, on its own, an inflation target is ill equipped to address. The MPC's forward guidance is designed to help us to meet those challenges head on.

### **The role of unemployment in our forward guidance**

It is important to be clear what role unemployment is – and is not – playing in the setting of monetary policy. If you remember just one thing from this talk, I would ask that you remember this: targeting a particular level of the unemployment rate is not a job for monetary policy. Monetary policy can't control the level of unemployment in the long run: we can't generate sustainably higher output or employment simply by printing more money. That way lies the horrors of the high and variable inflation rates of the 1970s and 80s. We forget those lessons at our peril. Monetary policy continues to have only one target: the 2% inflation target. Nor is unemployment a sufficient measure of slack in the economy on which to base our policy. The 1970s and 80s also taught us the foolishness of trying to control inflation by responding to movements in a single intermediate target. When we reach the 7% unemployment threshold, the Committee will reassess the state of the economy based on all available information and, on that basis, decide whether it should start to withdraw the current extraordinary levels of stimulus.<sup>2</sup>

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<sup>2</sup> Some (eg Taylor 2013) have suggested that the use of an unemployment threshold, together with an inflation target, might mark the beginnings of a transition to the setting of monetary policy according to some form of quasi-Taylor rule. But that misunderstands the role being played by the unemployment threshold. Monetary

An unemployment rate of 7% is not our intended destination. Nor even is it necessarily the first turning on the way to our final destination. Rather, it is a conveniently located layby at which we can pull over, study our economic map in detail, and work out whether we are anywhere close to our first turning.

### **Why unemployment?**

There are two other challenges facing the UK economy and the MPC which the Committee's guidance also helps to address: the uncertainty as to why productivity has been so weak and the extent it will rebound as demand increases; and the need to clarify how monetary policy is likely to respond as the economy recovers. Defining our guidance in terms of a threshold for unemployment is helpful in both cases.

### **Giving supply a chance**

When considering the appropriate trade-off between bringing inflation back to target quickly and supporting the recovery, by far and away the biggest judgement facing the Committee is the extent to which productivity is likely to recover as demand increases.

If you speak to some economists they are quite optimistic and suggest that productivity growth is likely to rebound relatively robustly as growth picks up. They note that productivity is strongly pro-cyclical. They also point to evidence that some companies have retained employees in anticipation of the recovery, while others have had to use resources more intensely to generate the same level of orders given the weakness of demand.<sup>3</sup>

But other economists are less upbeat. They highlight the role an impaired banking system may have played in contributing to the weakness in productivity. And to evidence that suggests that a failure to reallocate resources from less to more productive firms has had a pronounced effect on productivity growth. Such factors may persist even as demand recovers, suggesting that any rebound in productivity growth may be more muted.<sup>4</sup>

Both sets of arguments are very plausible. Indeed, it is likely that both played some role in the weakness of productivity. The challenge for the Committee is weighing up the relative importance of these different factors. And this judgement is central to the setting of policy. Too optimistic and we risk stoking up excessive demand that will feed through into higher inflation and a potential loss of credibility. Too pessimistic and our nation's resources will remain underutilised for an even longer period, with potentially damaging effects on the long-run health of our economy.

The design of the forward guidance – in particular the combination of the unemployment threshold and the knockouts – makes the setting of monetary policy more robust to this uncertainty, allowing the Committee to learn about the responsiveness of supply as the economy recovers, without needing to work out the precise cause of the productivity weakness up front.<sup>5</sup>

Let me explain.

If productivity picks up strongly as the recovery gathers pace - as the more optimistic reading of the evidence would imply – this means that we are likely to have a relatively prolonged

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policy is not being set with particular reference to the unemployment rate; rather the threshold simply provides a convenient point at which to reassess the stance of policy. Monetary policy continues to be set on the basis of a wide range of variables affecting the outlook for growth and inflation.

<sup>3</sup> See, for example, Miles (2012 and 2013) and McCafferty (2103).

<sup>4</sup> See, for example, Broadbent (2011, 2012, 2013).

<sup>5</sup> My fellow MPC member Paul Tucker recently referred to this as a “probing strategy” (Tucker 2013).

period of strong growth, and a relatively prolonged period of low interest rates, before unemployment reaches the 7% threshold. But if, even as the recovery gathers pace, productivity growth remains relatively muted, unemployment will likely fall more quickly and the Committee will need to raise rates sooner.

A threshold defined in terms of the unemployment rate is particularly well suited to dealing with this uncertainty. As demand picks up, those companies that can use their existing workforces more intensely or can shift employees to more productive activities are likely to do so before hiring additional staff. This suggests that to the extent that productivity picks up in response to increasing demand it should largely do so before unemployment falls materially. As such, the Committee can remain largely agnostic about the extent to which productivity is likely to pick up and instead respond to the signal provided by movements in the unemployment rate.<sup>6</sup> At the same time, the three knockouts make clear that the Committee will continue to pursue such a policy only if it does not pose a risk to price or financial stability.

### **Its levels that matter**

The second challenge relates to the need for the Committee to explain how monetary policy is likely to evolve as the economy recovers.

The good news is that after several years of virtual flat-lining, a recovery appears to be taking hold. The UK economy grew by over 1% in the first half of this year, more than in the previous two years put together. And it looks set to grow even more quickly in the second half of this year. The most recent indicators and business surveys suggest that the economy may currently be growing at an annualised rate of between 3% and 4%.

In the midst of this long awaited growth, there is the risk that people may overreact and expect the MPC to start raising Bank Rate relatively quickly. Such an overreaction would risk dampening the recovery, pushing up longer-term interest rates and, more generally, causing companies and families to pullback from investment and spending decisions for fear of an imminent rise in borrowing costs.

And based on past experience, there would be good reason for people to behave in such a way. During the so-called Great Moderation in the 15 years or so prior to the financial crisis, there was a close relationship between changes in Bank Rate and the growth of GDP. Indeed, my colleague Ben Broadbent, in his former life as a city commentator, used to draw attention to the startling correlation between the behaviour of the MPC and movements in growth implied by business surveys.<sup>7</sup> The self-same surveys that are currently pointing to quarterly GDP growth of around 1%, a rate which in the past would have signalled the MPC was likely to tighten policy.

That type of relationship during the Great Moderation is perhaps not that surprising. During much of that period, the economy was close to balance and the job for monetary policy – absent worrying longer-term trends or significant cost or price shocks – often boiled down to keeping GDP growth close to trend. But this time is different. We start with significant slack in the economy: the level of GDP is still below its pre-crisis level; there are almost one million more people unemployed. We need to see a sustained period of robust growth before the economy moves back into anything resembling balance. Linking the future path of monetary

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<sup>6</sup> The Committee can't remain entirely agnostic since its forecast for inflation will be affected by its judgement of the degree of economic slack and the speed with which that slack is likely to close as the economy grows. But the Committee updates its inflation forecast on a regular basis and so the forecast can be adjusted and revised as the Committee learns about the responsiveness of productivity to a pickup in demand.

<sup>7</sup> Indeed, Ben drew attention to this relationship, and why it is not likely to hold in the current environment, in a speech last month (Broadbent 2013).

policy to the level of unemployment makes that clear. Its levels not growth rates that matter. Likewise, those expecting to see the close synchronisation between UK and US policy rates that held during much of the Great Moderation to reassert itself as rates begin to normalise need to remind themselves about the differences in the extent of the recoveries in the two countries to date. The US economy has been growing for almost 4 years; the UK for barely 6 months. The level of US GDP is 5% above its pre-crisis level; UK GDP is 3% below. Its levels not growth rates that matter.

I don't know how quickly Bank Rate will begin to rise. That will depend critically on the extent to which productivity recovers as demand increases. But the MPC's forward guidance makes clear that, after the worst recession in post-war history and the weakest recovery on record, this time is likely to be different. Its levels not growth rates that matter.

## **Conclusion**

The financial crisis and its aftermath provided a tough examination of the UK's inflation targeting regime. And the results slip reads pretty well. In particular, the inflation target was instrumental in anchoring the credibility of policy, without which the MPC would not have been able to respond so aggressively. Without credibility, there can be no flexibility. And the MPC has used that flexibility to the full, providing extraordinary levels of stimulus to support growth and jobs.

But the nature of the inflation targeting framework meant that it dropped a few marks in terms of helping the MPC to communicate the role monetary policy played in supporting the recovery. That risked undermining the democratic legitimacy of inflation targeting. Likewise, the inflation target on its own was less suited to explaining the MPC's view of the appropriate trade-off between the speed with which inflation is returned to target and the support provided to the fledgling recovery.

The forward guidance announced by the Committee retains the primacy of the inflation target while allowing the Committee to more effectively tackle these communication challenges. In so doing it enhances the transparency and accountability of monetary policy. The guidance also provides a robust framework in which the MPC can explore the scope for economic expansion and helps to provide greater clarity about the likely path of monetary policy as the economy recovers.

The inflation target remains front and centre in the conduct of UK monetary policy. Price stability remains the primary objective of monetary policy. The MPC's forward guidance builds on the clarity and credibility of the inflation target to address some of the exceptional challenges currently facing our economy. And in so doing it should help to increase the effectiveness of monetary policy.

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**Annex: Charts**

