BANK OF ENGLAND

Inflation Targeting in the UK

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Brazil 2009

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Outline

- UK experience of Inflation Targeting since 1992
- Inflation targeting and quantitative easing
- Challenges for inflation targeters

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Brief history of UK monetary policy

- Before 1972: Fixed but adjustable exchange rates; fiscal policy to manage demand
- 1972-79: Active fiscal policy; inflation control through incomes policy
- 1979-86: Monetary target (MTFS)
- 1986-90: Shadowing the Deutsch Mark
- 1990-92: Exchange Rate Mechanism
- 1992-97: Inflation target; Chancellor sets rates
- From 1997: Inflation target; MPC sets rates

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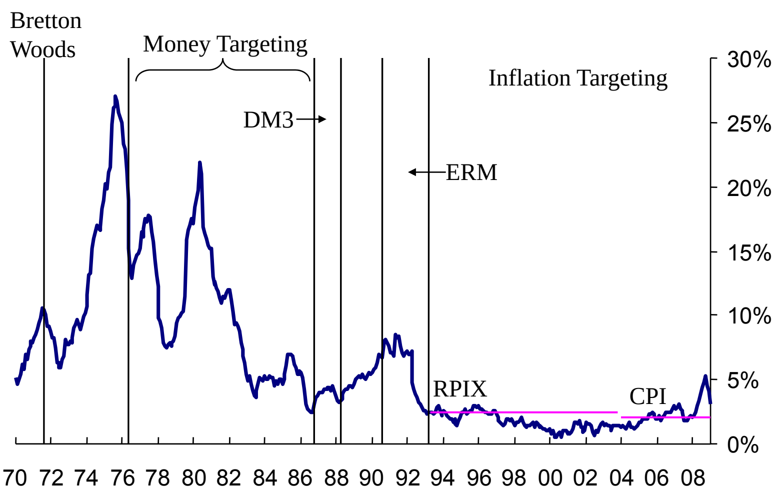
UK monetary policy and inflation 1970-2009



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Current policy framework

<u>Clear responsibilities and objectives</u>

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

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Remit for the MPC

Bank of England Act 1998:

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

…and <u>subject to this objective</u>

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

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Inflation Target

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

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The Monetary Policy Committee

- MPC sets interest rates
- 9 members; 5 internal, 4 external member
- Chaired by the Governor, who has casting vote
- Majority voting, not consensus-seeking
- Members are individually accountable

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MPC's voting record

	2008	2007	2006	2005
Unanimous decision	4 (33.3%)	2 (16.6%)	3 (25%)	4 (33.3%)
Three-way spilt	2 (July & Aug)	0	1 (May)	0
Governor in minority	0	1 (July)	0	1 (Aug)

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Inflation targeting exceeded expectations

- Adoption of inflation targeting surpassed expectations:

  Marked improvement in macro performance:

  1992-2007 saw unparalleled price stability

  and 65 quarters of uninterrupted growth
- Inflation expectations well-anchored
- Exchange rate volatility not as much a problem as we thought: ER has not been independent source of shocks

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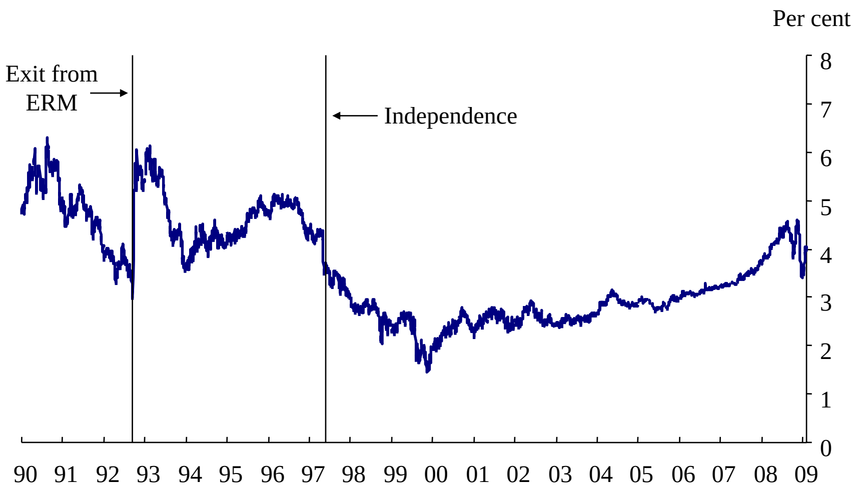
Inflation expectations



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Consumer prices have been more volatile recently

- Open letters;
  - April 2007 (CPI 3.1%)
  - June 2008 (3.3%)
  - September 2008 (4.7%)
  - December 2008 (4.1%)
  - March 2009 (3.2%)

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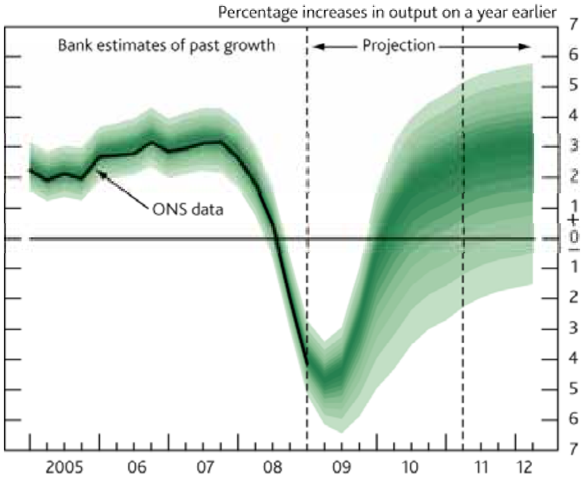
GDP projection May 2009



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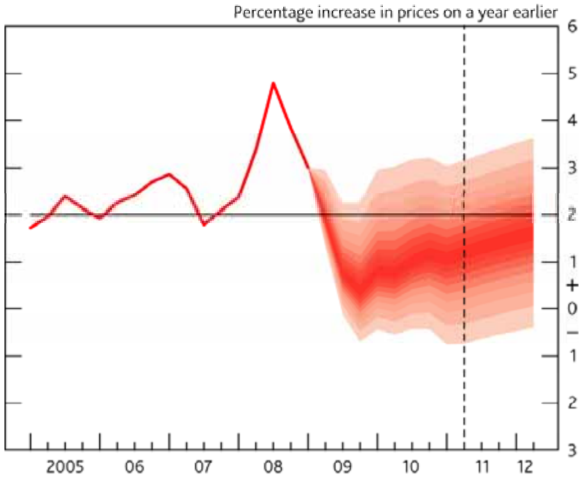
CPI projection based on market rates May 2009



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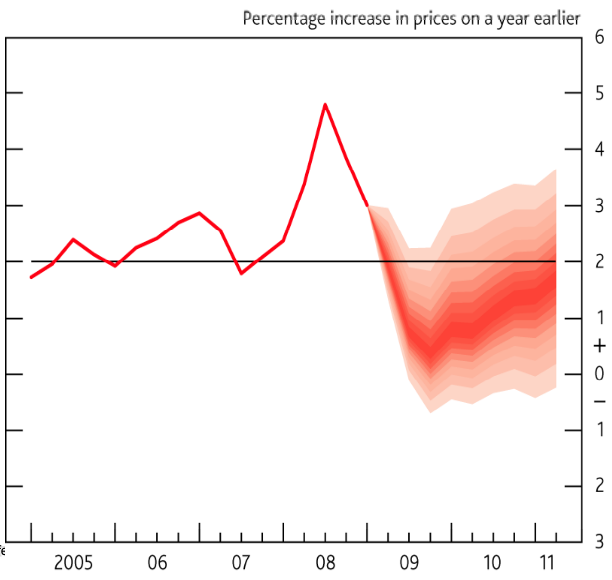
Inflation Report, May 2009

CPI inflation projection based on constant nominal interest rates



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See footnote to **Chart 2**.

What has been done?

- Fiscal expansion
- 5 point plan to support banks (19 Jan)
  - Capital; funding; mortgages; corporate lending' APF
- Bank rate reduced from 5% to 0.5%

Plus

- Big depreciation of sterling
- Fall in commodity/oil prices

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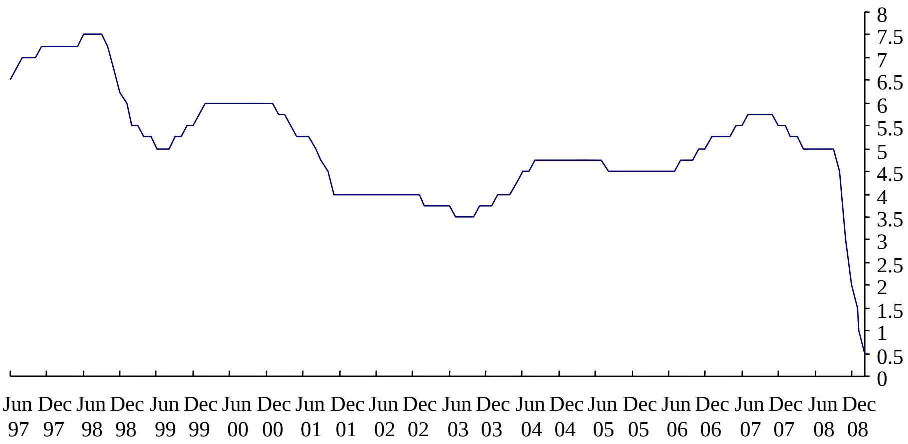
UK policy interest rate since 1997



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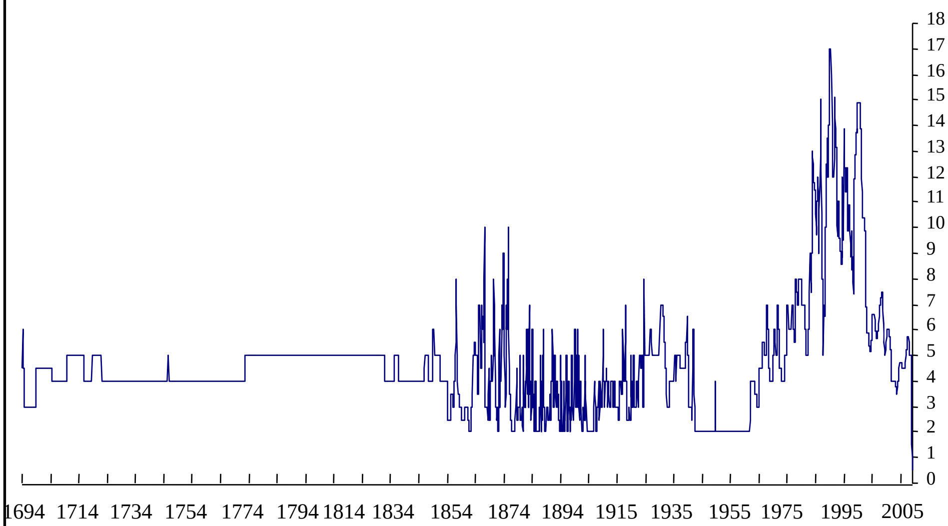
Lowest rate since 1694



Inflation targeting and quantitative easing

- QE has been incorporated into IT framework
  - Exchange of letters between Governor and Chancellor on APF (5 March 2009)
  - Unchanged objective; inflation target of 2%
  - MPC makes decisions each month
- IT framework provides clear guidelines for unconventional monetary policy
- And will also steer exit strategy

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Quantitative easing

- March 5; MPC cut Bank Rate to 0.5% and announced a programme of asset purchases of £75 billion, financed by the issuance of central bank reserves, in order to meet the inflation target.
- May 7: asset purchase programme increased to £125bn
- Bank is buying both corporate and government debt
- Activity should be boosted by providing liquidity to private sector and easing credit conditions.
- Early signs have been positive

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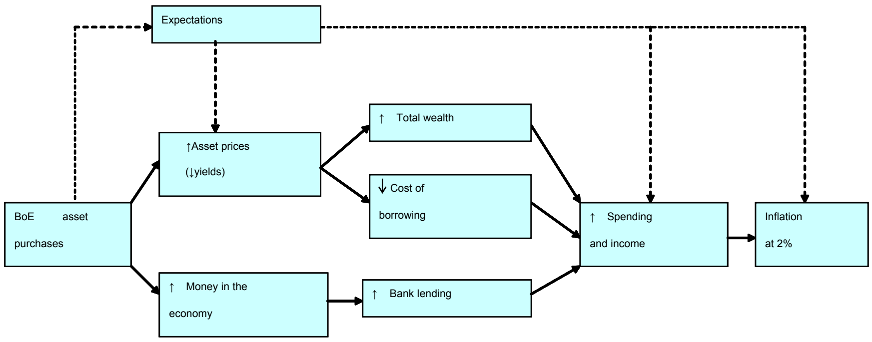
How does QE work?



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UK experience; conclusion

- Adoption of inflation targeting was followed by sustained period of macro-economic stability
- Inflation targeting was successful in anchoring inflation expectations
- Inflation targeting framework provides clear guidelines for unconventional monetary policy.
- But new challenges ahead

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Challenges for inflation targeters

- Challenges to the framework
  - Target measure
  - Do we need more instruments?
  - How we think about markets and models

- IT so far has been flexible enough to respond to new challenges

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