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Inflation, Inflation, Inflation - Speech by Spencer Dale

In remarks made at the Cardiff Business School, Spencer Dale - member of the Monetary Policy Committee and Chief Economist - says he makes "...no apology for focussing on inflation...our future prosperity will depend on our maintaining an environment of low and stable inflation". He explores several questions: what factors have caused inflation to be above the 2% target for much of the past four years; why inflation was higher than expected for much of this period; and how should policy respond?

Spencer Dale describes talk of the UK returning to its old ways of depreciating the exchange rate and inflating its way out of trouble as "dangerous talk". He says: "The evils of inflation are well known...dangerous talk has perhaps been partly fuelled by the behaviour of inflation in recent years. CPI inflation has averaged close to 3% over the past four years...Lest we forget, this is a long, long way from the high and volatile inflation of the 1970s and 80s." He notes that some may have started to ask if the MPC has gone soft on inflation and whether this a conspiracy with the Government to deflate away some of its debt? He stresses: "The answer to both these questions is emphatically "No". The MPC remains as committed as ever to meeting the inflation target."

Spencer Dale then goes on to review the factors which determine inflation and specifically looks at developments in input costs, capacity, margins and inflation expectations. He does not think there is any great puzzle surrounding the period of above-target inflation seen over the past few years: "Our economy has been affected by a number of large shocks - to energy prices, the level of VAT, and the value of sterling - which have caused prices to increase." These are "more than sufficient to explain the strength of inflation." Moreover, "Some of these shocks were not predictable in advance. And even if they were, trying to use monetary policy to offset short-run movements in inflation is likely to have amplified output volatility."

Looking to see what can be learnt from the behaviour of inflation, Spencer Dale says: "My current assessment is that changes in the structure of the economy, the nature of the financial crisis, and the different role played by policy all affected the behaviour of inflation during the downturn. And it is important that we learn from those developments to help set policy in the future."

Reviewing where this leaves policy, Spencer Dale notes that: "Monetary policy is at extraordinarily loose and a small tightening would still leave policy hugely stimulatory...But it is not as straightforward as that - there are significant risks to both sides of the inflation outlook." He argues: "We lose our credibility at our peril ... The response to a possible loss of credibility is clear - monetary policy would need to tighten, possibly aggressively so. But I think this risk remains just that - a risk. Despite the dangerous talk, most measures of inflation expectations still appear broadly consistent with hitting the inflation target in the medium term." He explores the significant downside risks to inflation - spare capacity and factors that contributed to the surprising strength in inflation starting to fade. He also says that "The downside risks to the growth outlook, stemming in particular from the substantial fiscal consolidation now in train and the continuing constraints on the supply of bank lending, add materially to the downside risks to inflation".

Concluding, he says: "The job of monetary policy is to try to balance these upside and downside risks to inflation...what is different is that the current risks to inflation are unusually large." His central view is that: "...these risks should gradually lessen as the temporary effects pushing up on inflation wane and the economic recovery continues. But it is possible that some of the risks will crystallise and policy will need to react." He notes: "It is quite likely that in hindsight, once we see how the economy evolved and which risks materialised, that the current stance of policy will be criticised for having been too tight or too loose. But we cannot set policy with hindsight. All we can do is set policy in such a way that balances the opposing risks to inflation and be ready to change policy decisively in either direction as this balance of risks alters. I do not know when policy will next change or in what direction. But I can assure you that when making this decision, the objectives of policy will be clear and unchanging: inflation, inflation, inflation."

Key Resources

Inflation, Inflation, Inflation – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech448.pdf