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MPC in the dock – speech by Spencer Dale

In a speech made at a conference today, Spencer Dale - member of the Monetary Policy Committee and Chief Economist - makes the case for the defence of the MPC on four counts: Why is inflation so high? Why has inflation been so much higher than we expected? Could inflation remain high? And how is the current stance of policy consistent with the inflation outlook? He also explains the reason for his vote at recent MPC meetings to raise Bank rate to 0.75%.

A series of large price level shocks - to oil and other commodity prices, to VAT, and to the sterling exchange rate - can account for a rise in the level of consumer prices since the beginning of 2007 of between 8-12%. As Spencer Dale points out, "This dwarfs the extent to which inflation has exceeded the 2% inflation target over the same period." He goes on to point out that the remit of the MPC recognises that trying to keep inflation at target in the face of large shocks and disturbances 'may cause undesirable volatility in output' and that "The foremost task of monetary policy over the past few years has been to ensure that the financial crisis did not lead to a prolonged depression. To have offset these price level shocks would have meant presiding over an even deeper recession."

On the second count, the source of the inflation surprise in 2009 was different from that in 2010. In February 2009, amidst the general view which had emerged amongst many academics and commentators that pass-through in many major economies had fallen close to zero, the MPC's initial judgement was that around 40% or so of the increase in import prices resulting from sterling's depreciation would be passed through into consumer prices. Spencer Dale admits, "However, that judgement now looks woefully optimistic compared to the degree of pass-through we think has occurred, which is closer to 100%." The 2010 surprise stems from the sharp pickup in import price inflation seen more recently, driven by the surge in commodity and world trade prices.

Could inflation remain high? Although Spencer Dale's broad view of the inflation outlook is similar to that described in the February Inflation Report, he says, "The simple answer to this question is - I'm afraid - yes" and he highlights two risks in particular. The first is that global price pressures might continue to add to domestic inflation through a number of channels. He makes the point that "...inflation is home made...raising

Bank rate will not directly dampen global inflation. But it can ensure that it does not lead to high and persistent domestic inflation."

The second risk is if the prolonged period of above target inflation erodes the public's confidence that the MPC will keep inflation close to target. In this respect Spencer Dale is cautious about how much comfort can be drawn from measures of medium and long-term inflation expectations. He worries that a "...binary approach to monetary policy credibility - credible or not credible, anchored or de-anchored - misses the key risk to inflation expectations." He thinks it is more likely that some people could wrongly infer that the Committee had become more tolerant of deviations of inflation from target and therefore expect inflation to return to target more gradually. Inflation expectations 2, 3 or 4 years ahead may increase but are almost impossible to measure. He adds, "The credibility gains associated with the move to inflation targeting and an independent policymaking committee in our country led to a reduction in the persistence of inflation...We need to guard the gains in credibility built up over the past 15 years or so."

And finally, in reviewing whether the current monetary stance is consistent with the inflation outlook, Spencer Dale explains that "Policy needs to remain highly accommodative in order to support spending and income and so reduce the risk of inflation significantly undershooting the target in the medium term." He explores some of the uncertainties around future inflation and says "The huge disruption in Japan and the uncertainty associated with events in Libya are likely to dampen global demand, at least in the short run. But the accompanying increases in energy prices are likely to add to domestic inflation."

He goes on to explain his vote at the last MPC meeting to raise Bank Rate to 0.75% - that it was not driven by "nice" reasons but, "Rather, my vote to raise rates was driven by a concern that - despite a relatively weak outlook for growth - the risks to the inflation target in the medium-term were to the upside. Nasty reasons rather than nice ones."

Spencer Dale concludes, "We can explain why inflation has been above target for much of the past few years. We think we understand - albeit with the benefit of hindsight - why we have been surprised by the strength of inflation. And we have learnt from those episodes. I can't say that monetary policy will perfectly anticipate every twist and turn of the economy. We will continue to be surprised by events and need to adjust policy accordingly. But I can assure you that the MPC remains as committed and as focused as ever in our determination to hit the inflation target."

Key Resources

MPC in the dock – Full speech