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News release

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The MPC's Policy Dilemma - Speech by Charles Bean

In a speech to the Association of British Insurers 2011 Economics and Research Conference, Charles Bean - Deputy Governor for Monetary Policy and member of the Monetary Policy Committee (MPC) - focuses on the sources of above-target inflation in the United Kingdom, whether it is likely to persist and what monetary policy should seek to do about it.

In light of the margin of spare capacity in the economy caused by the recession, Charles Bean asks why inflation is so far above the MPC's 2% target, and higher than the MPC expected. He points to three factors: strong global price pressures, particularly for energy and other commodities; the depreciation of sterling following the onset of the financial crisis; and the increase in the main VAT rate to 20%. He goes on to describe how these factors are likely to have affected inflation, and by how much.

He notes that most commodity prices have recently seen sharp price increases, and that the rebound in global demand following the recession is likely to have been a common factor. But there are significant differences in supply conditions, he argues. For agricultural commodities, extreme weather events have restricted supply, pushing up their prices. "But barring further weather shocks, larger harvests can be expected to lead prices to fall back", he adds. On near-term oil price prospects, Charles Bean notes that oil stocks and OPEC spare capacity are "...more than enough to meet any shortfall resulting from the withdrawal of Libyan supply from the market...". But prospects for the medium to longer term depend on how quickly new sources of supply can be brought on stream to meet higher future demand, particularly from emerging market economies. He concludes that oil and metals prices are likely to remain elevated, "And there must be a risk that continued turmoil in the Middle East and North Africa results in a substantial oil price spike, present OPEC spare capacity notwithstanding".

Charles Bean argues that the impact on inflation of sterling's depreciation has been larger than the MPC had initially anticipated. He says: "In part, that may reflect the recognition by market participants and businesses that a substantial decline in the real value of sterling was necessary to re-balance the economy and the fall was consequently likely to be permanent."

What are the implications of these factors for monetary policy, Charles Bean asks. "Economists and monetary policy makers have long understood that there is generally no conflict between stabilising inflation and stabilising output when the economy is subject to adverse demand shocks. But that there is a real choice to be made when there are adverse cost shocks: inflation can be stabilised, but only at the cost of volatility in output", he notes. Overall, the three 'costs shocks' that Charles Bean discusses - sterling's depreciation, and increases in commodity prices and VAT - are likely to have raised the price level by 9-13% since 2007. That compares with the 5% increase in the price level which has occurred in excess of that implied by the 2% inflation target, suggesting that the MPC has "...ended up accommodating around half the impact of the shocks on inflation".

Looking ahead, Charles Bean argues that inflation is likely to fall back during 2012, as the temporary impacts of those cost shocks dissipate, and given the continuing drag from the margin of spare capacity in the economy. But there are a number of uncertain factors that will determine the speed with which inflation will return to target, he says. First, "Profit margins have been squeezed during the recession and businesses are likely to want to rebuild these as the recovery proceeds. But the real purchasing power of wages has also been severely squeezed and employees may also seek to recoup some of that". And second, he says, "Consistently above-target inflation, whatever its cause, may also lead people to believe that it will remain high in the future. That in turn may lead them to set higher wages and prices to compensate and thus to the elevated level of inflation persisting". Given these factors, Charles Bean's view is that, if anything, inflation may prove a little more persistent next year than embodied in the MPC's latest Inflation Report projections. But, he concludes: "Allowing inflation to come back gradually towards the target would allow the margin of spare capacity to close more rapidly, and would be in line with our remit that tells us that temporary deviations of inflation from the target are permissible if they help to avoid excessive volatility in output".

Key Resources

The MPC's Policy Dilemma – Full speech
Accompanying slides