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News release

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The economic impact of sterling's recent moves: more than a midsummer night's dream - speech by Kristin Forbes

Speaking at an event organised by 100 Women in Hedge Funds, at the Canada Imperial Bank of Commerce, Kristin Forbes discusses the impact of the recent appreciation in the sterling exchange rate on the UK economy. She saw Midsummer Night's dream at the Globe last year, and makes various references to it in her speech. For example, while Shakespeare reminds us that 'the course of true love never did run smooth' Kristin warns that 'the same could also be said of the course of UK inflation, when buffeted by large exchange rate movements'.

The main messages of Kristin's speech are as follows:

- The sterling exchange rate appreciated by 14.5% between March 2013 and July 2014. 'The effects of exchange rate movements generally take a substantial amount of time to play out' and therefore this appreciation will continue to have powerful effects on the economy over the next few quarters.
- One consequence of the appreciation is to reduce the sterling value of UK firms' profits, and this has likely contributed to the FTSE's underperformance relative to other major developed countries.
- Model simulation results suggest that the impact of the appreciation of sterling 'on overall employment and economic growth would be meaningful'. Kristin provides detailed estimates in the speech.
- 'The impact on prices and inflation is more substantive'. Econometric evidence suggests that large movements in the exchange rate (greater than 5%) tend to have large effects on import prices and get passed through quickly – within 6 to 12 months.
- Kristin reports simulation results which 'suggests that inflation is about 0.8 percentage points lower today relative to what it would have been if sterling had not appreciated….and by the end of this year inflation could be close to 1 percentage point lower', though she warns 'not to take the point estimate from this exercise as precise'.
- This raises various questions including 'could the extent of pass through… be lower than the simulated results?' 'If exchange rate movements are significantly affecting prices, should we look through these effects?' and 'as this drag on inflation…fades will any domestic inflationary pressures cause prices to increase faster than expected?'
- To understand the extent of inflationary pressure without the dampening effect of the exchange rate, Kristin examines seven different measures of 'domestically generated inflation' – measures of inflation that should be less directly affected by exchange rate movements. These data suggest that domestic price pressures are 'well contained'. Although there are some differences across the indicators, there is little evidence of a recent pickup in inflation. 'These bottom up indicators therefore present a very different signal then implied by the 'top down' estimates of inflation after adjusting for sterling's recent appreciation'.

- Kristin concludes that ‘understanding recent trends in the domestic component of inflation has been challenging’. ‘Has sterling’s appreciation had less of a dampening effect on prices than has traditionally occurred – perhaps due to structural changes in the UK or global economy - which would indicate lower underlying inflation pressures? Or are the measures of domestic inflation understating current inflationary risks – perhaps due to the long lags before timely data is available?’ Given these questions, ‘it is critically important to monitor measures of prospective inflation to determine the appropriate path of monetary policy’.