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Risks around the forecast

In a speech to the London & Partners dinner on Thursday 22 January external MPC member Kristin Forbes explained that MPC members' votes are often driven by their individual analysis of what they each perceive to be key risks around the forecast. This makes it 'difficult to classify many of us as perennial hawks or doves'. To illustrate this Kristin outlined what she perceives to be the five key risks around the MPC's central forecast, and models their implications using the November *Inflation Report's* projections as a baseline.

The first of these risks is stronger global growth, and in particular US growth, than has been forecast. US growth for the third quarter of 2014 was revised up from 3.5% to 5.0% on an annualized basis as of December 2014. 'Although US growth is unlikely to continue at this pace in the fourth quarter, the United States appears to be on a stronger footing for at least the end of 2014 and early 2015 than in our baseline forecast… this growth should support exports and demand in a number of economies.' Modelling the potential impact of this stronger US growth combined with a boost to global growth from lower oil prices, Kristin shows this would result in higher than forecast inflation over the medium term, exceeding the 2% inflation target in 2017.

Secondly, Kristin looked at the implications of oil prices staying low for longer than forecast. 'We are currently analysing how lower oil prices affect different aspects of the UK economy… and this analysis will be incorporated in our updated projections for the February *Inflation Report.'* But, for the purposes of this discussion 'it is useful to highlight the most immediate effect of lower oil prices - on UK import prices and CPI inflation'. This would cause an immediate drag on inflation that would drop-out after about a year.

A third risk is the speed and magnitude of pass-through from Sterling's appreciation. Kristin suggests these effects could have been stronger and faster than currently incorporated into forecasts. The implications of this for inflation projections could be significant. Kristin's indicative simulations suggest that if this risk materialised, CPI could fall 'as much as 0.5 percentage points lower in the start of 2015 than in the November baseline. Inflation then bounces back faster, however, so that by the end of 2016 it would be higher than in the baseline and above the 2% inflation target.'

Kristin also considers the outlook for labour supply. The MPC made upward revisions over the summer to its assumptions about labour supply, but ‘the magnitude of the adjustment to our assumptions may have been too optimistic.’

Offsetting this, Kristin sets out reasons to be optimistic about the outlook for productivity. ‘Key forces which may have been holding back productivity growth may now have faded, such as: low business investment during the crisis; a weak banking system that was inefficiently allocating capital; and limited labour market mobility which inefficiently allocated workers.’

Kristin models the possible implications of both these scenarios before concluding that although it is impossible to know whether any of the above scenarios will play out, if any of them do they could have important implications for monetary policy. Several ‘imply an earlier increase in interest rates than currently expected, especially in order to ensure that any subsequent interest rate increases are slow and gradual.’

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