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News release

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Inflation: Finely balanced risks

In a speech today at the City and Islington Sixth Form College, MPC member Dr Martin Weale, explains why he is confident that the MPC can return inflation to target and why, for him, 'despite the international concern about very low inflation', the decision of whether or not to tighten policy is 'finely balanced'.

Martin explains that while 'it is likely that inflation will fall below zero at some point in the next six months' this is not something to which the MPC could or indeed should respond: 'Our work suggests that a change to Bank Rate takes about two years to feed through fully to inflation. The implication of this is that we should not try to keep inflation very close to target all the time; if we did that, we could be sure that interest rates would be extremely volatile, in a way that no one would find very helpful.' Instead, the effect from oil will begin to drop out in less than a year and 'the rate of inflation will gradually recover towards our target'.

Given this, Martin seeks to explain the current low level of expected future rates which are 'much lower than they were a year ago. To give an example, the expected rate up to 2026 averages less than three per cent', this 'just about makes sense' if inflation is on average at its target and economic growth is materially below one per cent over the period. 'The first assumption is eminently reasonable… The second point is, perhaps, open to more debate. To grow at only one per cent for the next ten years would be extremely disappointing', not least because the UK has a growing workforce and is expected to see a pick-up in productivity.

However, 'there are two other interpretations' of long term interest rates 'beyond very low inflation and weak growth'. One is that low rates reflect the returns investors are prepared to take in exchange for greater certainty. The other is that some people may not share his confidence in the monetary framework and 'they may be assuming not only that growth will be weak, but also that inflation will remain persistently below its target.'

Martin then explains why he is 'confident that the Monetary Policy Committee can return inflation to target' given the tools at its disposal. The Committee has made clear that, should downside risks materialise, it could consider a further reduction to Bank Rate. It also has the option of making further asset purchases, a policy which Martin's research suggests 'remain a practical means of pushing inflation up towards target'.

Nonetheless there are both upside and downside risks to the current inflation target. On the downside there is a possibility that ‘expectations of low inflation may become entrenched’ which would have consequences for both wages and prices. The most recent data did show a fall in inflation expectations ‘but it might simply be that expectations – even of inflation in two years’ time – are overly affected by the experience of current inflation’ and ‘we might reasonably anticipate that inflation expectations to pick up’ as oil and other commodity prices recover.

There is also a risk of further price shocks; ‘inflation shocks, even more than buses, rarely seem to come on their own’. The MPC’s inflation fan chart ‘has built some of this effect in over the next year’ and Martin acknowledges that ‘the recent recovery of the oil prices makes it perhaps less of a worry’ than he may have thought in January. Nevertheless Martin’s view is it continues to pose a risk, and he wonders ‘whether a rising exchange rate might be the next of these shocks.’

The upside risk is provided by the recent performance of the labour market. ‘The unemployment rate has been falling rapidly, and we have also seen the employment rate reach a record high.’ Vacancies are back to pre-crisis levels and ‘pay is now growing at its fastest rate since before the crisis’. Martin notes that, while these figures are volatile, ‘with unemployment continuing to fall… inflationary pressure seems to me to be at risk of building.’ While the effect of this on inflation may be ‘damped’ because of the make-up of the CPI basket and the response of firms’ profit margins, it is seen by Martin as the main upside risk.

These risks, both to the upside and the downside, make the situation ‘a finely balanced tug of war’ in which ‘pulls in both directions have intensified’. Martin explains that ‘compared with the Autumn, when I was voting for an increase in Bank Rate, the fall in oil prices has certainly provided some unexpected breathing space. It is, however, at present no more than that.’ He concludes by saying ‘if wage growth continues to accelerate over the next few months, especially in the absence of a pick-up in productivity, then for me it strengthens the case for a rise in Bank Rate. As always, however, I will decide how to cast my vote in the light of economic developments.’

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