BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

10 March 2015

Oil price falls – what consequences for monetary policy?

In a speech today at Durham University Business School, MPC member Ian McCafferty considers the factors contributing to the recent fall in the oil price, the impact on inflation and its likely persistence and how, given this analysis, UK monetary policy should respond.

Ian argues that as with the oil price falls seen in 1985 and 1998, 'there is merit in examining recent oil price developments, and the implications for the outlook for the oil market, through the prism of hog-cycle theory.' As with the livestock markets hog cycle theory is based on, short term elasticity of oil supply is low but the longer-term elasticity substantially higher. As a result the main adjustment to price falls comes from changes in investment plans which in turn impact productivity and supply in the longer term.

This analysis shows that 'the lag in the supply response means that for a while, even after the initial price fall, supply continues to exceed demand, such that inventories continue to build.' As the market balances and inventory levels fall back 'the market tightens and prices begin to rise, encouraging supply to recover. But here too, there are noticeable lags – first, it will require a period of higher prices to encourage producers to commit to new investment, and geographical, geological and political issues mean that the lead time to new supply is relatively lengthy.'

Ian suggests that 'we can expect oil production to ease in the second half of the year' and for demand for oil to increase due to the net positive impact to global demand, estimated by Bank staff to stand at around 0.8%, which in turn will support greater demand for oil. 'Overall, it is reasonable to assume that, by the end of 2015, supply and demand for oil will be coming back into balance, although inventories will remain high for a further period. This should translate into more stable yet still relatively low prices,' though further out 'prices might be expected to recover'.

The fall in oil prices, and their predicted persistence, has important implications for both the likely path of inflation and the appropriate response of monetary policy. While the immediate direct effect is clearly disinflationary, detracting 'a bit more than half a percentage point from headline inflation for the rest of the year' indirect effects could emerge in both directions. The fall in the oil price could generate inflationary pressure by boosting demand and with little effect on potential supply in the economy. Conversely, the risk of

falling inflation expectations feeding through to lower wage settlements could create further disinflationary pressure.

‘How should monetary policy respond to such a sharp oil price shock? As always in monetary policy, the answer depends on the source of the shock.’ As it is supply rather than demand that has ‘been the dominant factor behind the recent fall in the oil price… it should be treated primarily as a simple cost or price-level shock’. This would mean looking-through the temporary impact on inflation as the MPC has done previously when rising oil prices pushed inflation well above target.

‘But how temporary is temporary? Policymakers need to consider not just the source of the shock but also its persistence.’ In doing so they should, Ian suggests, refer to the ‘optimal policy rule’ which states that ‘looking through an undershoot of inflation, even a prolonged one, is more justified if the real economy is operating at or above full capacity’.

This, combined with the likely path for spare capacity set out in the *Inflation Report* and Ian’s view that ‘there may be less spare capacity left in the labour market’ than the MPC’s collective judgement, would suggest that it would be right to ‘look through’ the current low level of inflation.

This, however, is complicated by the potential for the persistent, depressing effect on annual inflation to constrain a growth in pay by causing inflation expectations to become de-anchored. ‘Judging the scale of this downside risk is difficult. Some measures of inflation expectations have fallen but others suggest that inflation expectations remain well-anchored, and there are no signs at present that anything approaching deflationary psychology is likely to take hold.’ Nonetheless, it is not a risk the MPC can dismiss, ‘at least while inflation remains close to zero’. This, Ian concludes, is why he decided not to vote for an increase in Bank Rate at the January and February policy meetings.

ENDS