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Telling tails of oil and global inflation

In a speech given today to the AIECE Conference in London, Martin Weale discusses two key issues for the inflation outlook in the UK: the impact of oil price moves on the UK inflation forecast, and the degree to which international prices feed through into the outlook in this country.

Weale's arguments derive from models he believes offer a more realistic sense of the probability of relatively extreme movements in prices occurring than implied by more popular methods in economics – a lesson economists should have learned from the financial crisis. He states: "It might seem like a technical point, [but] it is in fact fundamental: if you seriously underplay the chance of relatively extreme events happening, then not only will you be more surprised when they do happen, but you may be tempted to read too much into them."

Weale's model for the impact of oil prices on the macroeconomy – drawing on long run data beginning in 1970 – indicates there is a risk that the impact of the oil price fall we have witnessed will be somewhat stronger in the near term than the MPC has predicted. The result, he concludes, would be that growth for 2015 would prove a little stronger, and inflation a little weaker, than expected.

However, Weale states that the risk of a slightly weaker profile for inflation has little impact on his outlook for policy, as the effect will have dissipated within two years – the relevant point for policymaking.

Turning to the international context, Weale investigates how far inflation in the UK is determined independently of what happens in other advanced economies.

Weale notes that the correlation between inflation in the UK and other OECD countries has been relatively high since 2008 – and more so over the past eighteen months.

However, he finds that there is relatively limited statistical evidence that the correlation is strong over the longer-run. Using data from 1993 to the present, he notes that the variability of core inflation in other rich countries can account for only about a seventh of the variability of UK core inflation.

Summing up, Weale states that the MPC must weigh the need to respond to these international factors, against the desire to provide some stability in the level of interest rates and output.

He adds: “I think the Committee is quite right to let the short-term effects of external shocks feed into inflation, even if this pushes it far from target, whether on the downside as now, or on the upside as in the crisis. To do otherwise, and tighten or loosen aggressively, would do little to help inflation in the short term, but would risk a lot with unwanted gyrations in output.”

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