

Bank of England

Back to 2% Inflation?

The Credibility of Government Policies:
Conference in Honor of Guillermo Calvo,
Columbia University, New York

Silvana Tenreyro

External member of the Monetary Policy Committee

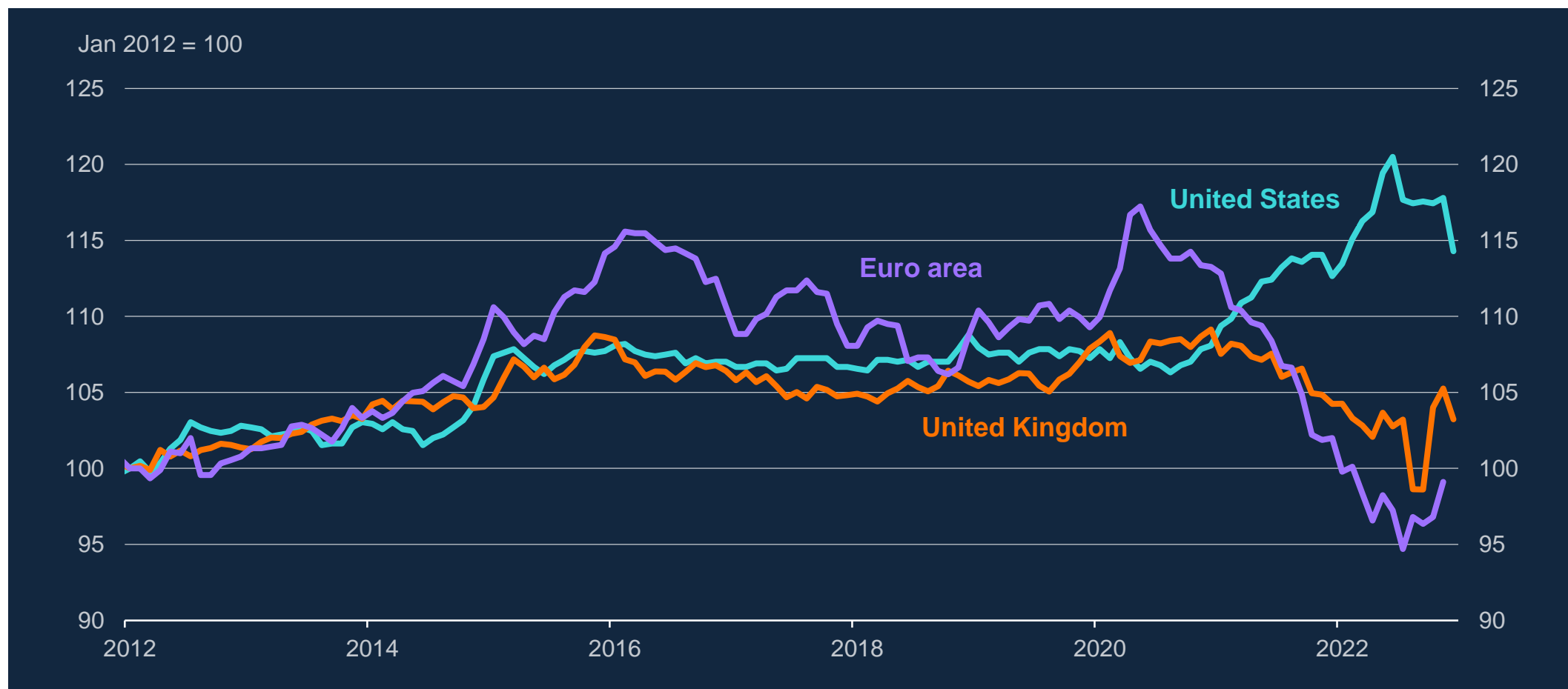


Key Points

- Rise in energy prices was a large terms-of-trade shock.
 - Large cross country differences in effects and required responses.
 - Policymakers, including in the UK, tightened policy sharply.
 - Shape of the shock + policy lags:
 - Limits to how much could be offset.
 - Suggests risks of overtightening (undershooting 2% target in medium term).
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US terms of trade have improved; UK and Euro area have worsened

Terms of trade

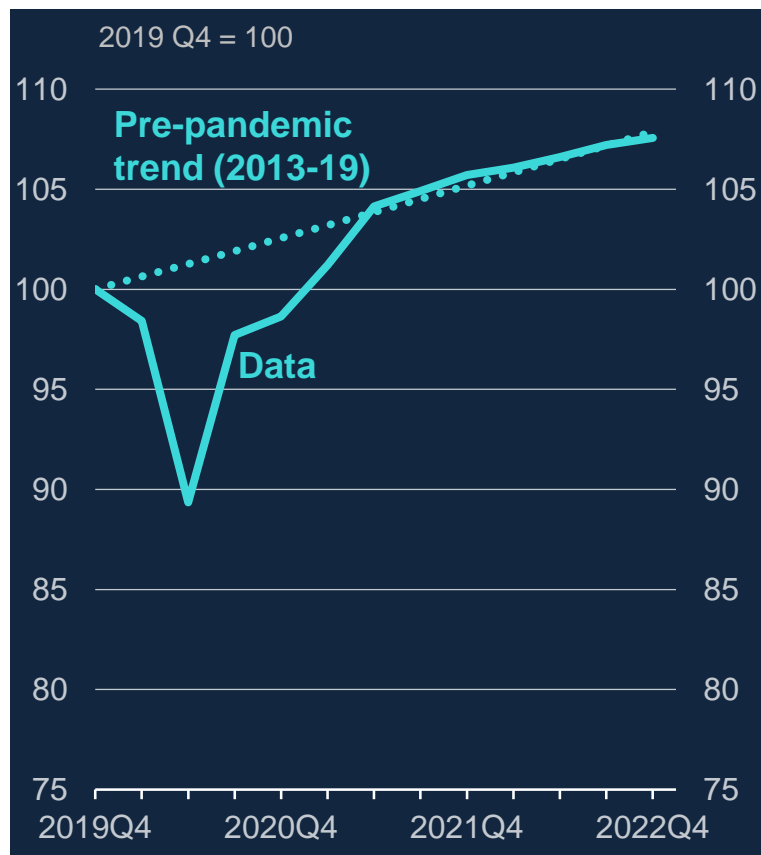


Sources: US Bureau of Labor Statistics, Eurostat, ONS and Bank calculations.

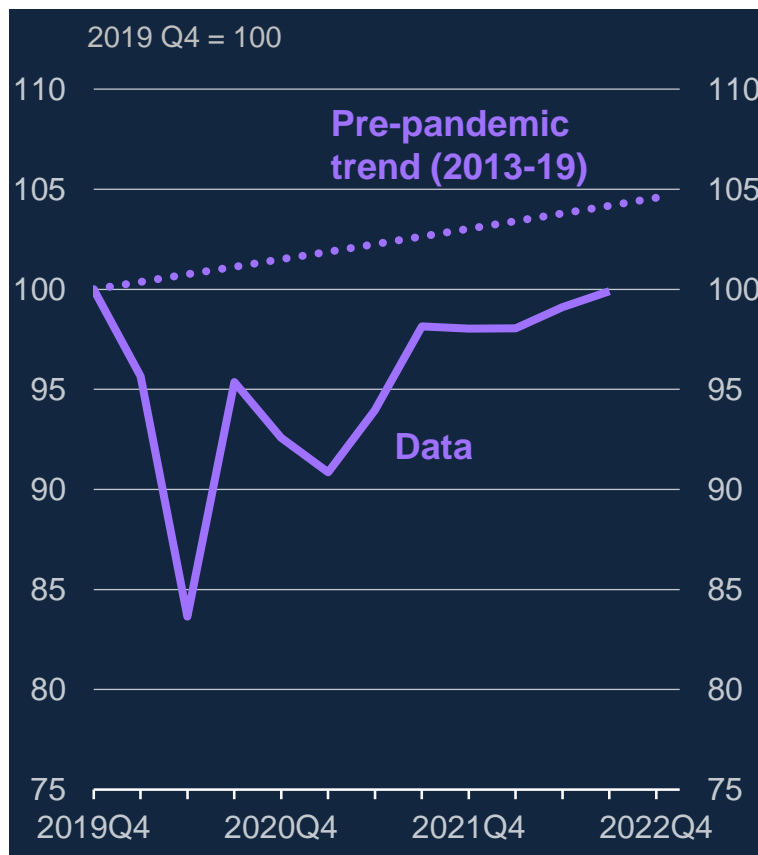
Terms of trade patterns reflected in household consumption

Real household consumption

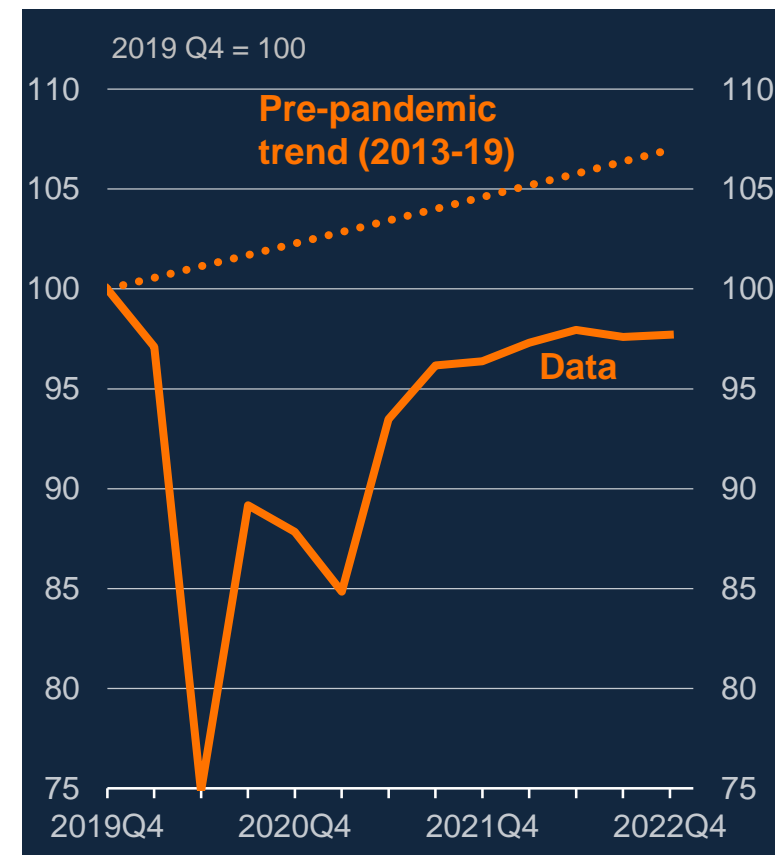
United States



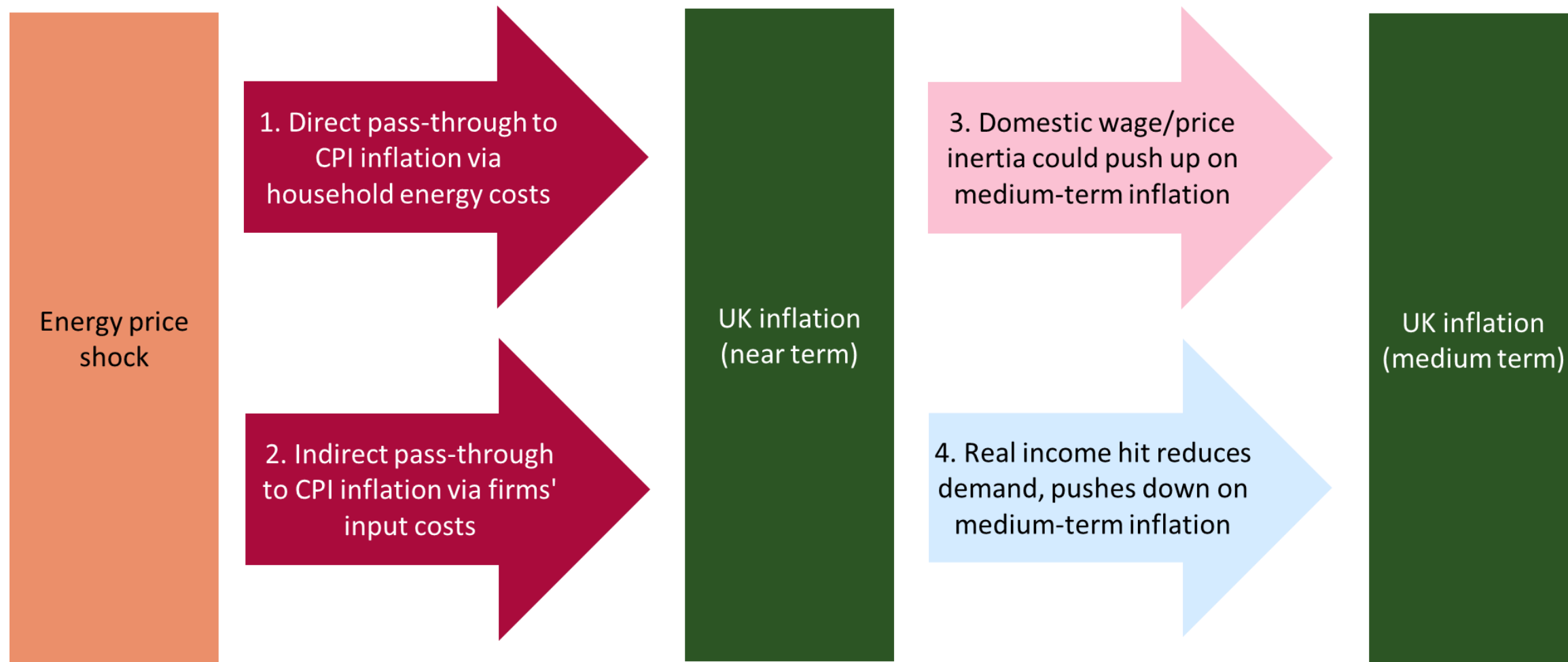
Euro area



United Kingdom

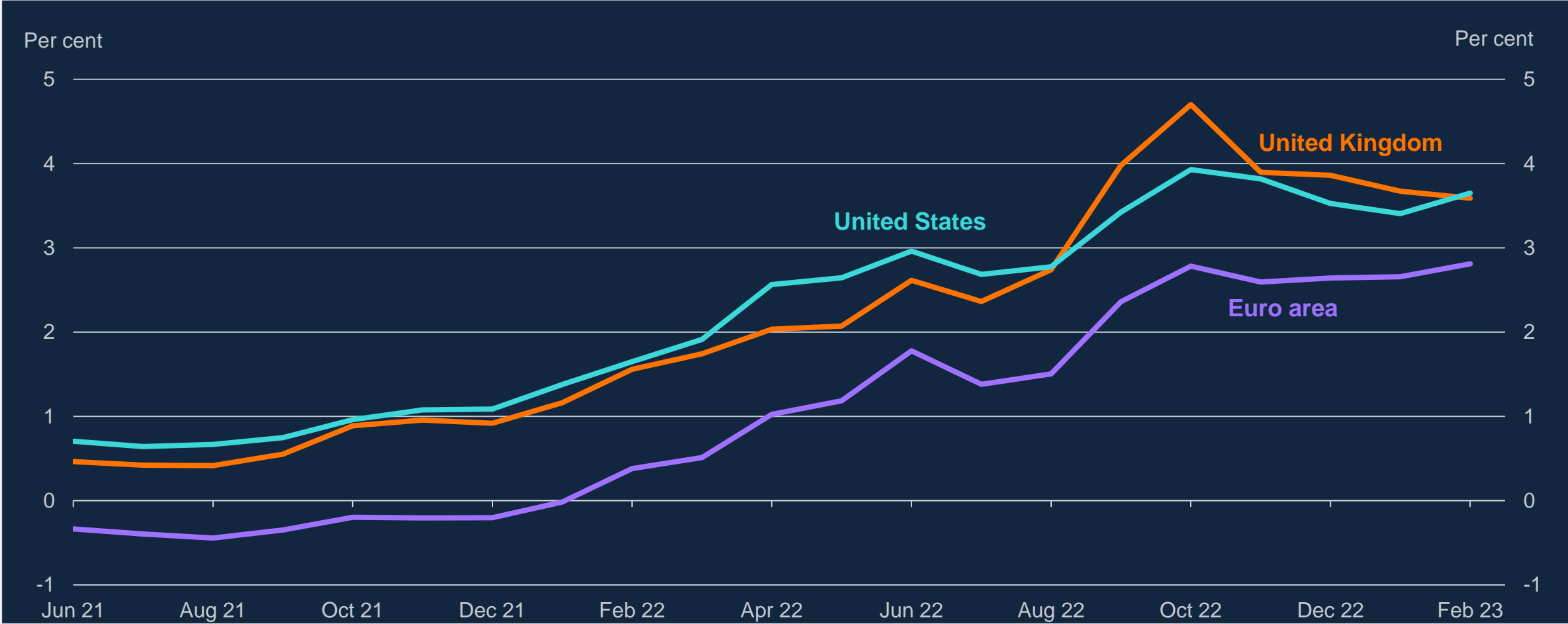


Stylised transmission of global energy price shock to UK inflation



Policy and financial conditions have tightened rapidly and materially

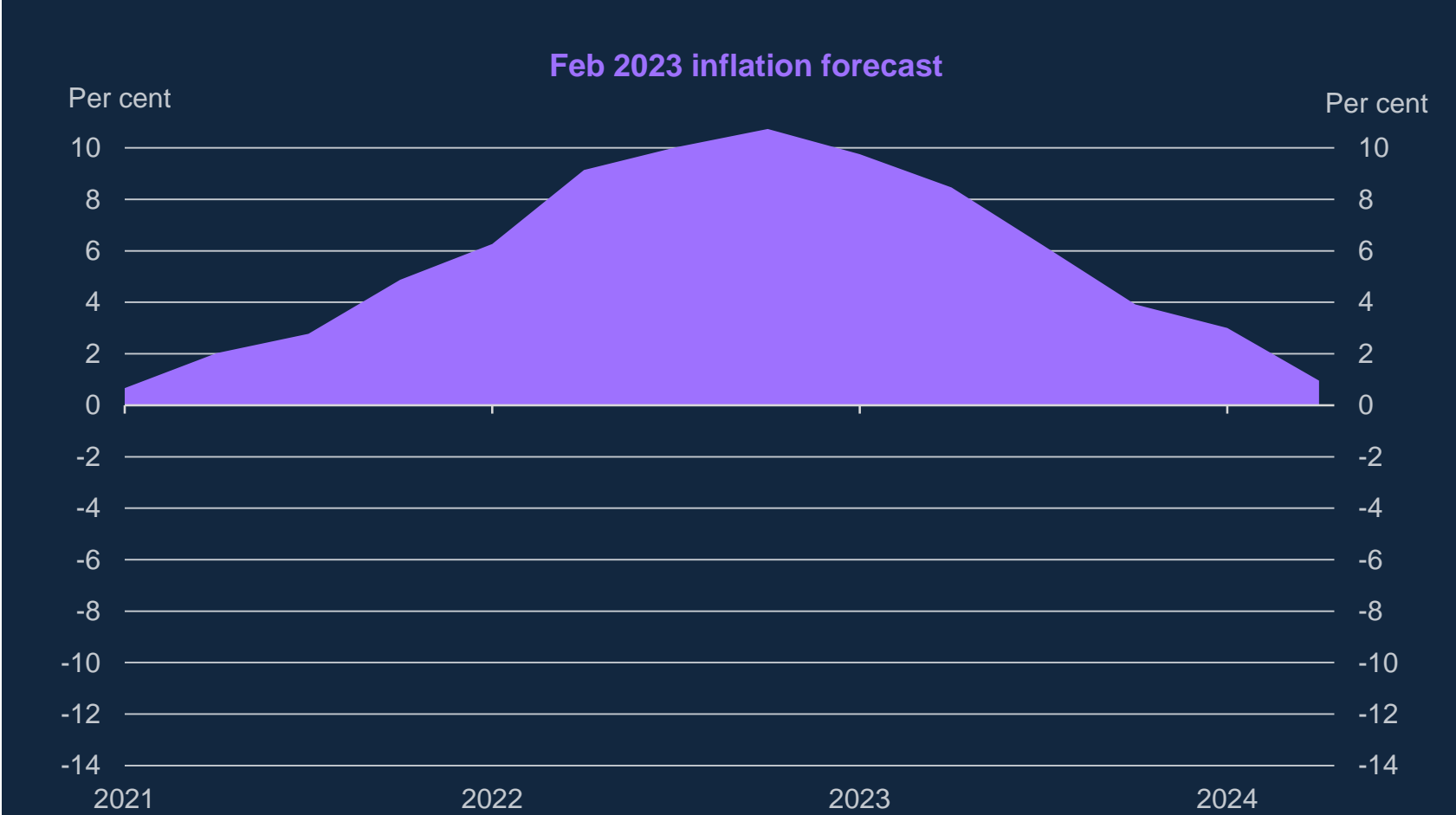
5-year OIS rates, monthly averages



Sources: Eikon Refinitiv and Bank calculations. Data to 20 February 2023.

Inflationary shock has a steep profile and expected fall

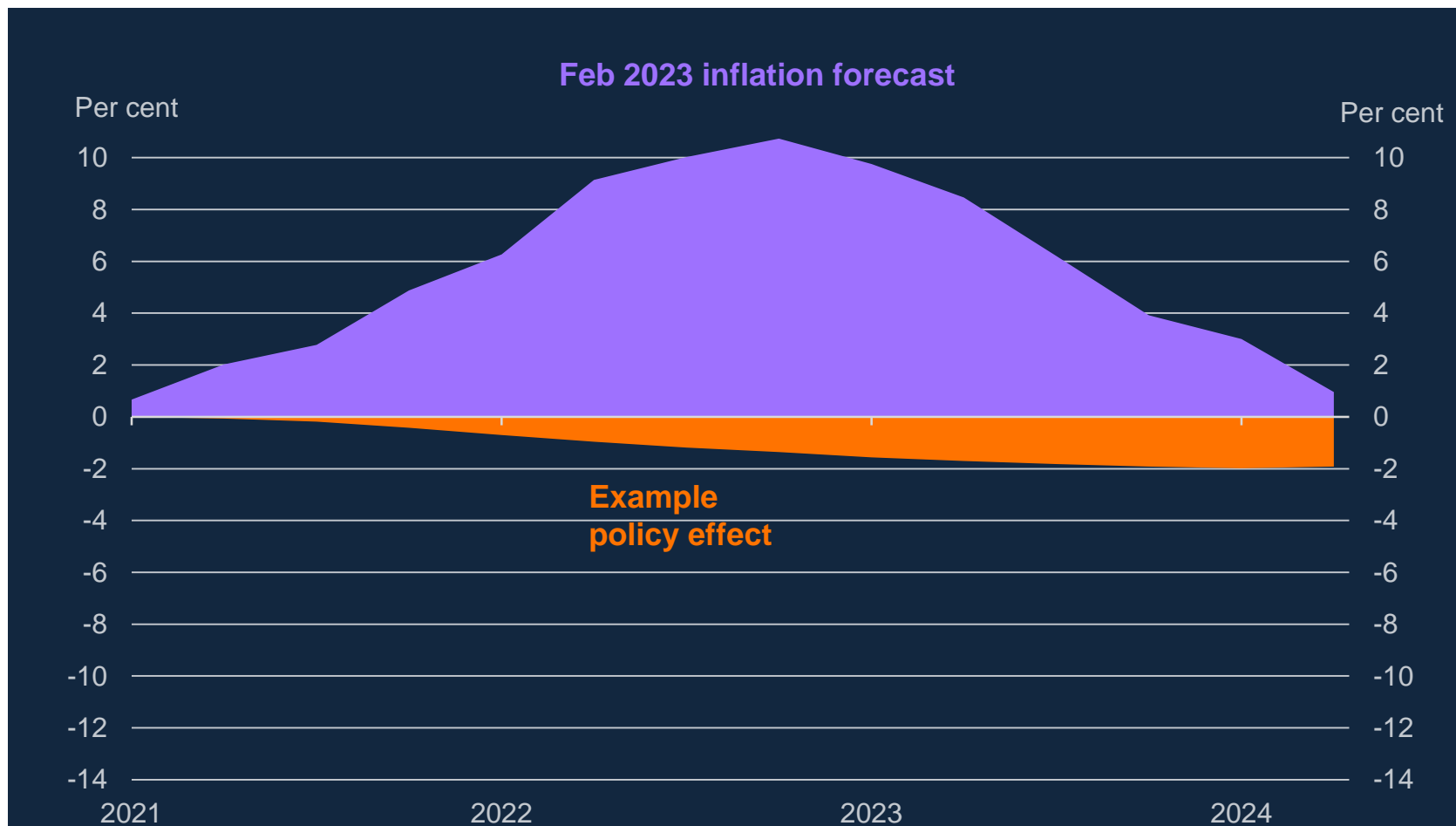
UK CPI inflation, February 2023 MPR modal forecast (to 2024 Q2)



Sources: Bank of England and Bank calculations.

Typical monetary policy effect is lagged and gradual

UK CPI inflation forecast and example extra policy tightening beginning in 2021 Q2

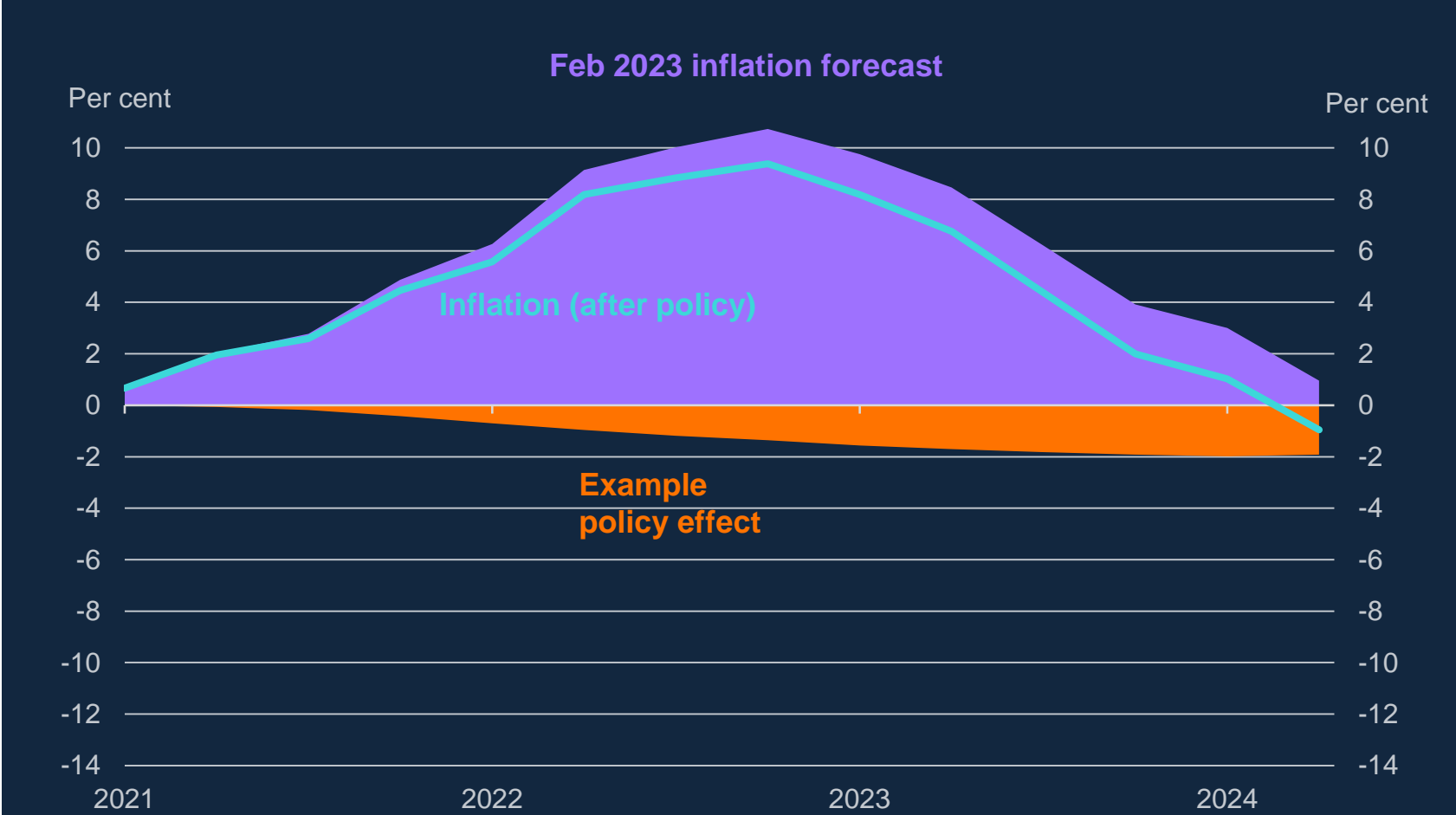


- Scenario has around 5 percentage points of additional rate increases over 2022.
- Raises Bank Rate to a peak of over 8%.

Notes: Policy effect calculated as the difference between market rate and constant rate inflation forecasts in the MPC's November 2022 *Monetary Policy Report*, linearly scaled to the size needed to bring inflation to 2% in 2023 Q4.

Far tighter policy worsens medium-term inflation undershoot

UK CPI inflation forecast and counterfactual scenario with extra policy tightening



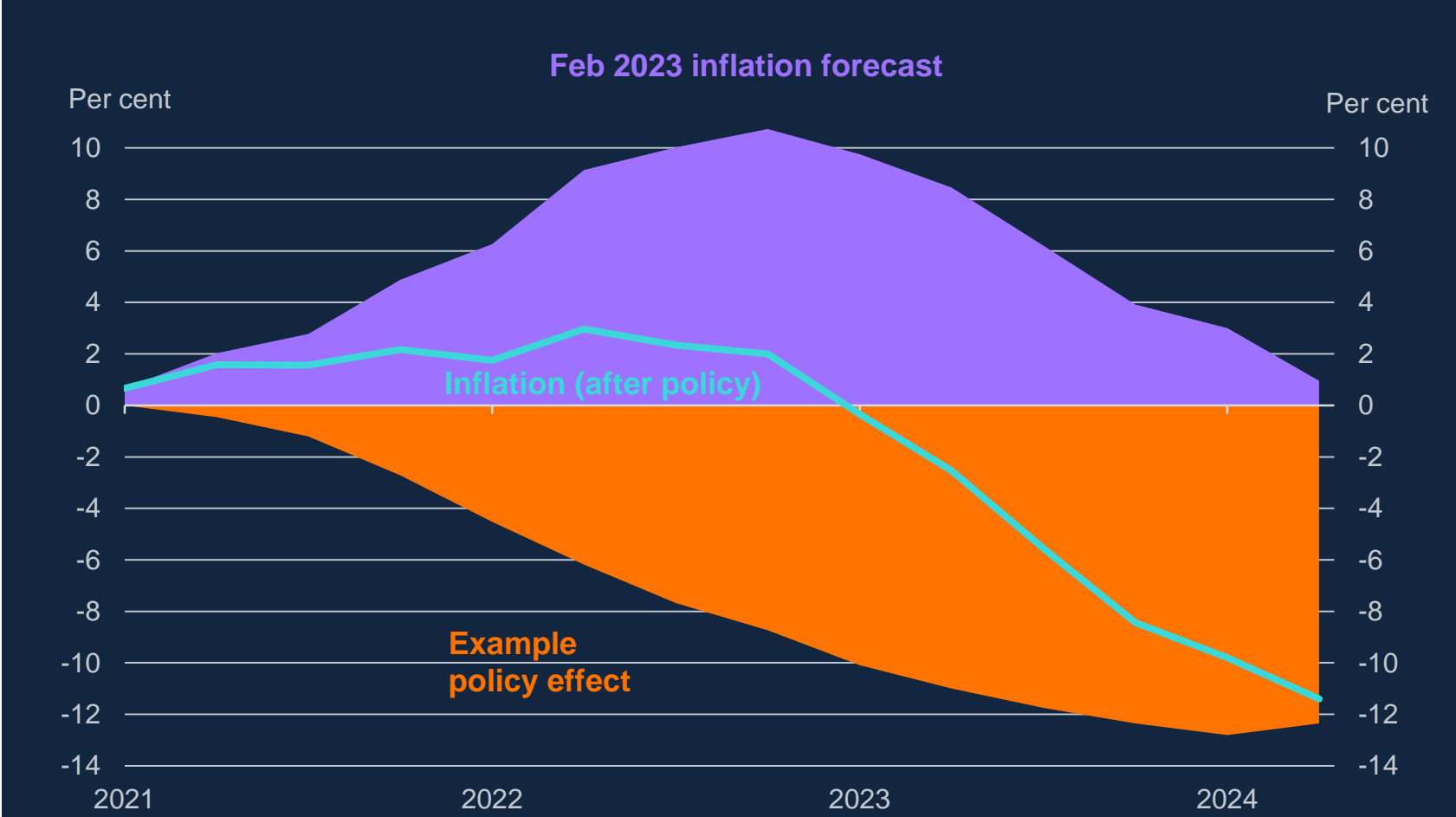
- Scenario has around 5 percentage points of additional rate increases over 2022.
- Raises Bank Rate to a peak of over 8%.
- Unemployment around 3 percentage points higher.

Notes: Policy effect calculated as the difference between market rate and constant rate inflation forecasts in the MPC's November 2022 *Monetary Policy Report*, linearly scaled to the size needed to bring inflation to 2% in 2023 Q4.

Sources: Bank of England and Bank calculations.

Far tighter policy worsens medium-term inflation undershoot

UK CPI inflation forecast and counterfactual scenario with extra policy tightening



- Scaling up to reach 2% inflation in 2022 would imply policy rate above 30%.
- Implied medium-term inflation would be extremely far below 2%.

Notes: Policy effect calculated as the difference between market rate and constant rate inflation forecasts in the MPC's November 2022 *Monetary Policy Report*, linearly scaled to the size needed to bring inflation to 2% in 2022 Q4.

Sources: Bank of England and Bank calculations.

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