Statistical Factsheet 6

Centre for Policy Studies

Publication date: 31 May 2011

Next update: November 2011

From spot on to inaccurate: the recent history of MPC inflation forecasts

- The Bank of England's Monetary Policy Committee (MPC) claims it is targeting future inflation with its interest rate decisions. That is the justification for today's low interest rates despite inflation being over double its 2% target.

- But if its inflation targetting is to be plausible, then the MPC must demonstrate a successful track record of forecasting inflation.

- Between 2001 and 2007 the Bank tended to forecast inflation relatively well. In the 12 quarterly inflation reports from August 2001 to May 2004, the Bank's average forecast for inflation a year ahead was 2.2% p.a. whilst eventual outturn inflation was 2.3%. Therefore, there was an average error of just +0.1 percentage points. The forecasts were almost spot on.

- In the 12 quarterly inflation reports from August 2004 to May 2007, the Bank's average forecast for inflation a year ahead was 1.9% p.a. with outturn inflation of 2.3%. This average error was therefore +0.4 percentage points – less accurate but still within normal forecasting margins.

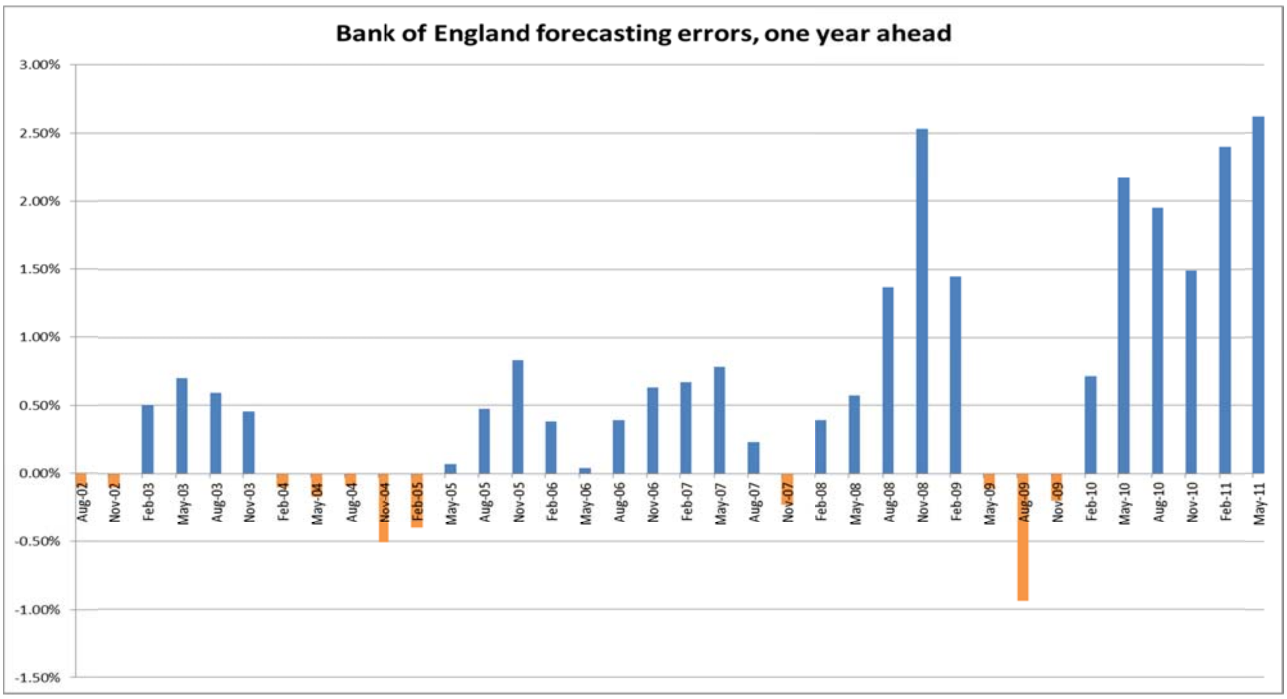
- However, in the 12 quarterly inflation reports from August 2007 to May 2010, the Bank's average forecast for inflation a year ahead was 1.9%, and outturn inflation was 3.2% p.a. This represents a much larger average error of +1.3 percentage points.

- Therefore, the Bank appears to have become worse at forecasting inflation over time, and has tended to underestimate inflation significantly over the last four years.

- Forecasts two years ahead follow the same pattern: with average errors of -0.3 percentage points for forecasts made between August 2001 and May 2004, +0.8 percentage points for August 2004 to May 2007, and +1.0 percentage points since August 2007.

- By giving a heavy weighting to an excess capacity factor in its inflation forecasting models, the Bank has given itself permission, through 'on-target' inflation forecasts, to maintain ultra-low interest rates.

- Ultra-low interest rates, however, are not politically neutral. Of course, they help to maintain business and consumer confidence. But they also punish savers. And they allow real depreciation of very high levels of debt in the two most indebted sectors of the economy: the banks and the government.



Source: Bank of England median inflation forecasts and outturn ONS RPIX and CPI inflation data