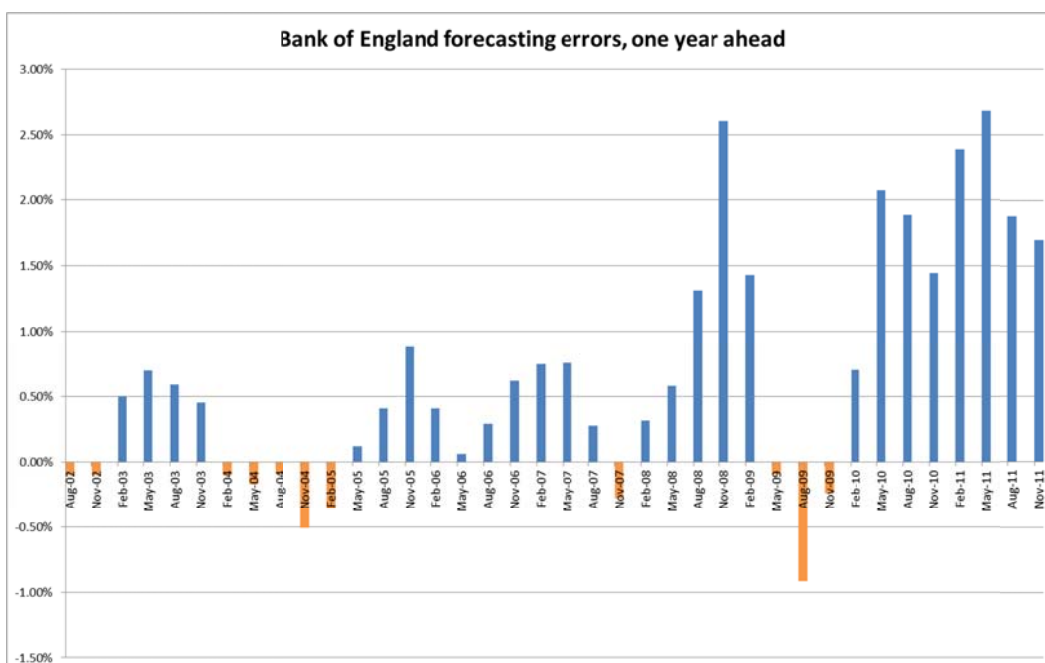




UPDATE: The recent history of MPC inflation forecasts

- The Bank of England’s Monetary Policy Committee (MPC) claims it is targeting future CPI inflation with its interest rate decisions. That is the justification for today’s low interest rates despite inflation being 5.1%, over double its 2% target. But if inflation targeting is to be plausible, surely the MPC should be able to demonstrate a successful track record of forecasting inflation?
- 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. 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.
- Since then, the Bank’s average forecast for inflation a year ahead has been 2.0%, and outturn inflation has been on average 3.4%. This represents a much larger average error of +1.4 percentage points.
- The average error of forecasts one year ahead for the past four quarters has been even worse, at +2.2 percentage points (an average forecast of 2.0% compared to average outturn of 4.2%).
- Therefore, the Bank has become worse at forecasting inflation over time, and has significantly underestimate inflation 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 +1.3 percentage points since August 2007.
- The Bank’s current analysis suggests today’s inflationary pressure is driven by temporary factors, giving it permission, through ‘on-target’ inflation forecasts, to maintain ultra-low base rates. It is forecasting that inflation will fall next year to 3.1% by August 2012 (still well above the upper band of the target)
- Ultra-low interest rates are not, however, politically neutral. While they may help to maintain some degree of business and consumer confidence, they certainly punish savers. On the other hand, banks and the government – the two most indebted sectors of the economy – both benefit from high inflation as it allows real depreciation of very high levels of debt.
- Similarly, those in work are punished by high inflation while those on benefits are protected: for those in work, nominal current earnings growth is 2.3% a year. In real terms, wages are falling. Conversely most benefits are inflation-linked, so most welfare recipients will see their income maintained in real terms.



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