## Banks inflation forecast now credible but inconsistent with policy action.

During 2009 and 2010 these notes argued that the Bank of England's inflation forecasts were much too low. The Bank's latest predictions, by contrast, are realistic and possibly even too high in the short term – see below. The issue now is the glaring contradiction between the Bank's forecast of a prolonged inflation overshoot and its refusal to begin normalising interest rates, given the requirement of its remit to target 2% "at all times" and to assign this objective priority over supporting growth and employment.

A key reason for the Bank's greater realism appears to be a reassessment of the size of the "output gap" (i.e. the shortfall of GDP relative to normal supply capacity) and its role in the inflationary process. The February 2010 note argued that the output gap was then about 2% rather than 5-7%, as claimed by various official forecasting bodies (e.g. the OECD, IMF and UK Treasury). The Bank does not disclose its estimates but seemed to share the latter view, judging from MPC communications. Partly for this reason, the February 2010 Inflation Report predicted that CPI inflation – then more than 3% – would fall to 1.1% and 2.2% respectively in the first quarters of 2011 and 2012 (mean or risk-adjusted forecast assuming unchanged policy).

The official bodies have since significantly reduced their output gap estimates, which currently cluster around 3%. The Bank, of course, never admits that it was wrong but a comparable reassessment is implied by a sizeable upward revision to its medium-term inflation forecast. The mean projection in the May 2011 Inflation Report based on unchanged policy shows CPI inflation rising to a peak of 5.0% in the third quarter of 2011 and subsiding only gradually, with the two-year-ahead number (i.e. for the second quarter of 2013) still well above target at 2.5%.

The February 2010 note described an inflation forecasting model incorporating a range of other influences, including monetary growth, as well as the output gap. (The model uses the broader domestic expenditure deflator rather than the CPI but the two measures are closely correlated.) In contrast to the Bank's then forecast, the model suggested that inflation would rise further during 2010 and early 2011, reflecting both a lower estimate of the gap and the lagged impact of exchange rate weakness and monetary strength. Its current predictions, however, are similar to the Bank's. Based on the Bank's GDP growth projections and assumed stability of the exchange rate, indirect tax rates and monetary growth, the model forecasts a 2011 peak in inflation followed by a slow decline, with an annual increase in the deflator of 2.6% in the second quarter of 2013.

The Bank's near-term inflation projections, indeed, may be too high. The chart compares the Bank's latest profile with a "bottom-up" forecast based on the following assumptions:

- "Core" prices – defined here as the CPI excluding unprocessed food and energy – rise at a 2.25-2.5% annualised rate, in line with an estimate of the trend leading into the recent VAT hike.
- 90% of the VAT rise has been passed onto consumers, consistent with evidence from the Bank of England agents' survey – higher pass-through implies a larger mechanical fall in inflation next year as the impact drops out.
- Household energy bills rise by 7.5% over the next 12 months.
- Unprocessed food inflation peaks at an annual 5% in mid 2011 and slows to 3.5% in 2012.
- Undergraduate tuition fees add 0.2 percentage points to inflation from late 2012.

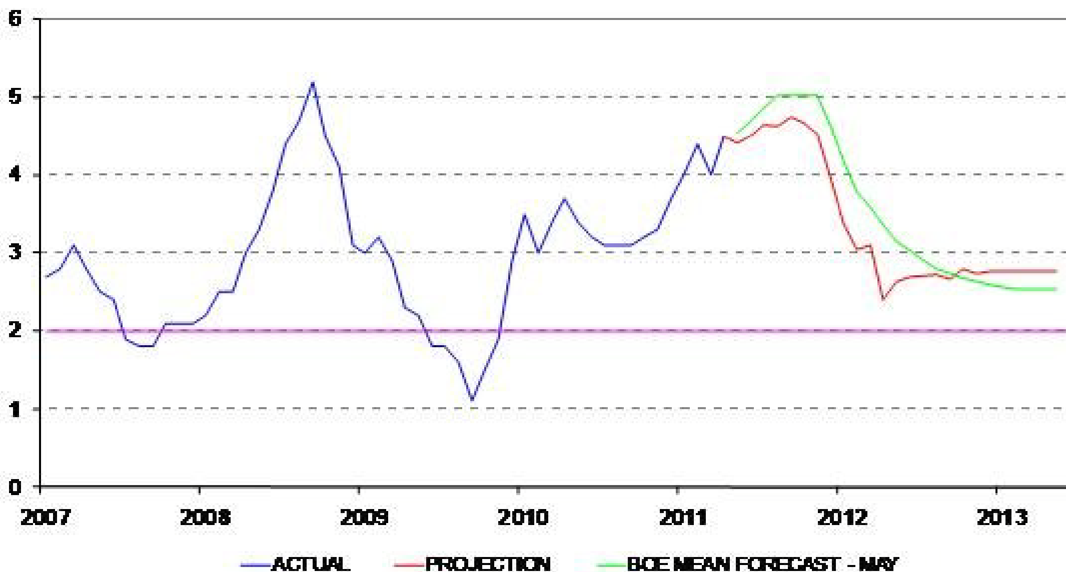
On these assumptions, inflation is projected to peak at 4.7% later this year before falling back below 3% in spring 2012. The average in the year to June 2012 is 0.5 percentage points lower than in the Bank's forecast. The profile, however, is higher from late 2012, with inflation stabilising at about 2.75% versus the Bank's 2.5%.
Reasons for these differences include:

- The Bank's forecast incorporates a larger rise in household energy bills, of about 12.5% rather than 7.5%. The latter takes account of the recent correction in wholesale energy prices and assumes that slower emerging-world growth will relieve upward pressure over the remainder of 2011.

rlcm®
royal london cash management

- The Bank assumes lower VAT pass-through of about 75% rather than 90%, despite the evidence from its own agents, resulting in a smaller favourable base effect on inflation in 2012.
- The Bank's lower forecast from late 2012 probably reflects an assessment that the output gap, while smaller than previously thought, will persist and exert some downward influence on core inflation. The view of these notes, by contrast is that the gap is now only about 1% and will close next year if GDP follows the path predicted by the Bank.

While inflation is likely to remain above the target for the foreseeable future, a significant fall next year should contribute – with rising wage growth and employment – to a rebound in household real income, in turn supporting prospects for consumer spending and GDP expansion. Such a scenario would, presumably, finally satisfy the MPC doves and allow a normalisation of interest rates to begin. The risk, of course, is that high inflation has by then become entrenched in expectations and wage- and price-setting behaviour, implying a need for aggressive policy tightening to enforce a return to target, with attendant painful economic consequences.




**Disclaimer**: The information in this communication is directed at Professional clients only. Information about past performance is not a guide to future performance. The investor may not get back part, or all, of the amount originally invested. The value of your investment and the income from it is not guaranteed and can fall as well as rise due to interest rate movements. Source: RLCM as at 31st August 2010, unless otherwise stated.

Royal London Cash Management Limited is a company incorporated in England and Wales (registration number 1963229) and is authorised and regulated in the UK by the Financial Services Authority (registration number 121844). RLCM is a subsidiary of the Royal Londo Mutual Insurance Society Limited which is registered in England and Wales with the registration number 00099064 and has its head office at 55 Gracechurch Street, London EC3V 0UF.

rlcm®
royal london cash management