

ECONOMIC FORECASTERS REMAIN CONFIDENT IN THE BANK OF ENGLAND'S ABILITY TO CONTROL INFLATION

When the Bank of England was given operational independence to set monetary policy in 1997, it quickly gained the credibility to fight inflation and thereby reduced economic uncertainty. That is the central finding of new research by Dr **Gianna Boero**, Dr **Jeremy Smith** and Professor **Kenneth Wallis**, published in the July 2008 issue of *The Economic Journal*.

What's more, the report shows how, after an initial period in which the Monetary Policy Committee (MPC) gained credibility, the Bank of England was perceived by independent forecasters as being more credible than the US Federal Reserve about its commitment to tackling inflation.

As inflation reaches levels not experienced for several years, the MPC's credibility to meet its inflation target will be tested. But this report shows that forecasters still trust the central bank to tackle inflation. In the Bank's most recent quarterly survey (May 2008), expected inflation remains within the range experienced over the last nine years.

The report shows how expected inflation does not respond to actual levels of inflation but remains close to the Bank of England's target. This means that the City (and others) believe that the MPC is committed to fighting inflation. If so, the MPC may not need to raise interest rates to bring inflation back to its target of 2%.

This is important since if inflation expectations are moderate, then wage claims and price increases will be less severe than they would otherwise be. So controlling inflation expectations is crucial to controlling inflation itself.

Since 1996, the Bank of England has carried out a quarterly survey of economic forecasters from the City and independent think-tanks. This assesses how they think inflation will develop in the future, and summary results are published in the Bank's quarterly *Inflation Report*.

Because the survey asks respondents for their views on the probability that inflation will be within a variety of different ranges (for example, between 1% and 1.5%, 1.5% and 2%, etc.), it can be used to assess uncertainty about future inflation.

The report uses individual responses to the Bank's survey from 1996-2005. It shows how the MPC, newly established following Labour's victory in the May 1997 general election, quickly obtained credibility.

Figure 1b below shows how the survey average forecast of inflation two years ahead stayed close to the official inflation target, irrespective of the actual inflation being experienced at the time the forecast was made. (The inflation variable shown is the official targeted variable at the time: the retail prices index, RPIX, target 2.5%, until end-2003; and the consumer prices index, CPI, target 2%, thereafter.)

The new findings and survey-based measures of uncertainty reported in this article extend the evidence. Figure 2b shows how the uncertainty about inflation prospects

two years ahead was sharply reduced after an initial period of learning and gaining credibility on the commitment of the MPC, and has been remarkably undisturbed since the turn of the century.

Comparisons with a similar source of data on US inflation expectations show that, after this initial credibility-gaining period, UK uncertainty about inflation prospects is below the US level.

This provides further evidence that 'inflation targeting has helped to confer tangible benefits', as argued by the Governor of the Bank of England in his 2005 Mais lecture. He cites the falling volatility of expected UK short-term nominal interest rates over this period, relative to the United States, as evidence that inflation expectations are better anchored under inflation targeting than they were before.

Although the actual report is based on a period that ends in November 2005, the figures below use the most recent information available (up to May 2008). They show no diminution in the forecasters' confidence in the MPC's ability to control inflation.

Over the last seven surveys, up to the survey reported in the May 2008 *Inflation Report*, Figure 2b shows a tendency towards increasing uncertainty, but this remains within the range experienced over the last nine years.

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Notes for editors: 'Uncertainty and Disagreement in Economic Prediction: The Bank of England Survey of External Forecasters' by Gianna Boero, Jeremy Smith and Kenneth Wallis is published in the July 2008 issue of *The Economic Journal*.

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