

The Bank of England forecasts for inflation

There is something badly wrong with the Bank of England's forecasts for inflation. The absence of money and credit from their thinking seems to guarantee they get it wrong. Because they get the forecasts wrong they get the policy wrong.

Their aim is to show inflation will be around the target of 2% in two years time. Quite reasonably they allow themselves some shorter term flexibility around this longer term target. Their problem includes an overwhelming tendency to lurch based on what has just happened to inflation. I call it rear view mirror driving, when what they need is a better view of the road ahead to avoid a crash.

Let us take the last two years. In May 2021 the Bank concluded that inflation in two years time would reach 2%. Because immediate past inflation was below target they decided to carry on with an interest rate of 0.1% and with printing more money to buy up bonds. The more bonds they bought the higher the prices went so the lower the longer term interest rates went. It was an invitation to a credit party where the credit was so cheap. Some of us at the time warned against more money printing and further lowering of longer term rates, pointing to the already visible recovery in the economy and the increases in money and credit. "I see no inflation coming" meant they were looking the wrong way.

By May 2022 the inflation was already well set. It hit 5.5% before the invasion of Ukraine, and then went higher as the energy and food price consequences of that came in. The Bank set an interest rate of just 1% and said rates might in future need to get up to 2.5%. On that basis they forecast inflation would be back down to 2% by 2024 and below target at 1.3% in 2025. Some hope.

This May they decided to hike interest rates by an additional 25bp or 0.25% to 4.5% and continue with a large bond selling programme designed to cut money and credit further and drive rates higher. On that basis they forecast 2% inflation by 2025 which may be nearer the mark. Unfortunately it comes with the price of overdoing the tightening meaning a bigger real income squeeze and a big slowdown in growth. They are now mesmerised by the inflation they have created and unable to see that the dramatic money tightening they have undertaken will come through. So they now want to do too much too late. The rear view mirror tells them to slam on the brakes when the vehicle is scarcely moving.