



Inflation, Expectations and Monetary Policy

29th April 2008

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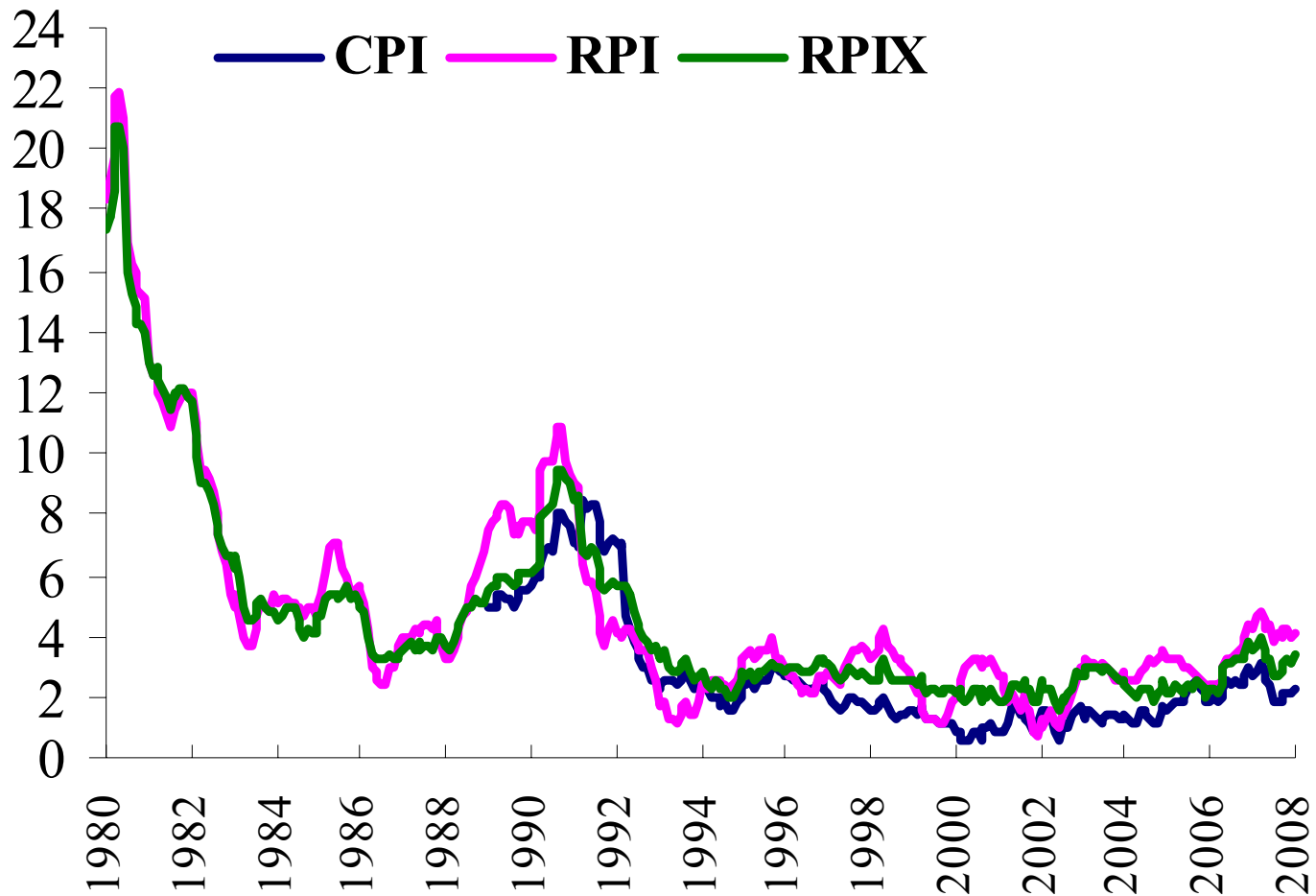
“Good empirical evidence tells its story regardless of the precise way in which it is analyzed. In large part it is its simplicity that makes it persuasive. Physicists do not compete to find more elaborate ways to observe falling apples. Instead they have made progress because theory has sought inspiration from a wide range of empirical phenomena. Macroeconomics could progress in the same way. But progress is unlikely as long as macroeconomists require the armor of a stochastic pseudo-world before doing battle with evidence from the real one”.

- **Larry Summers** (1991), “The scientific illusion in empirical macroeconomics”

UK inflation



Monthly % changes in prices on a year earlier

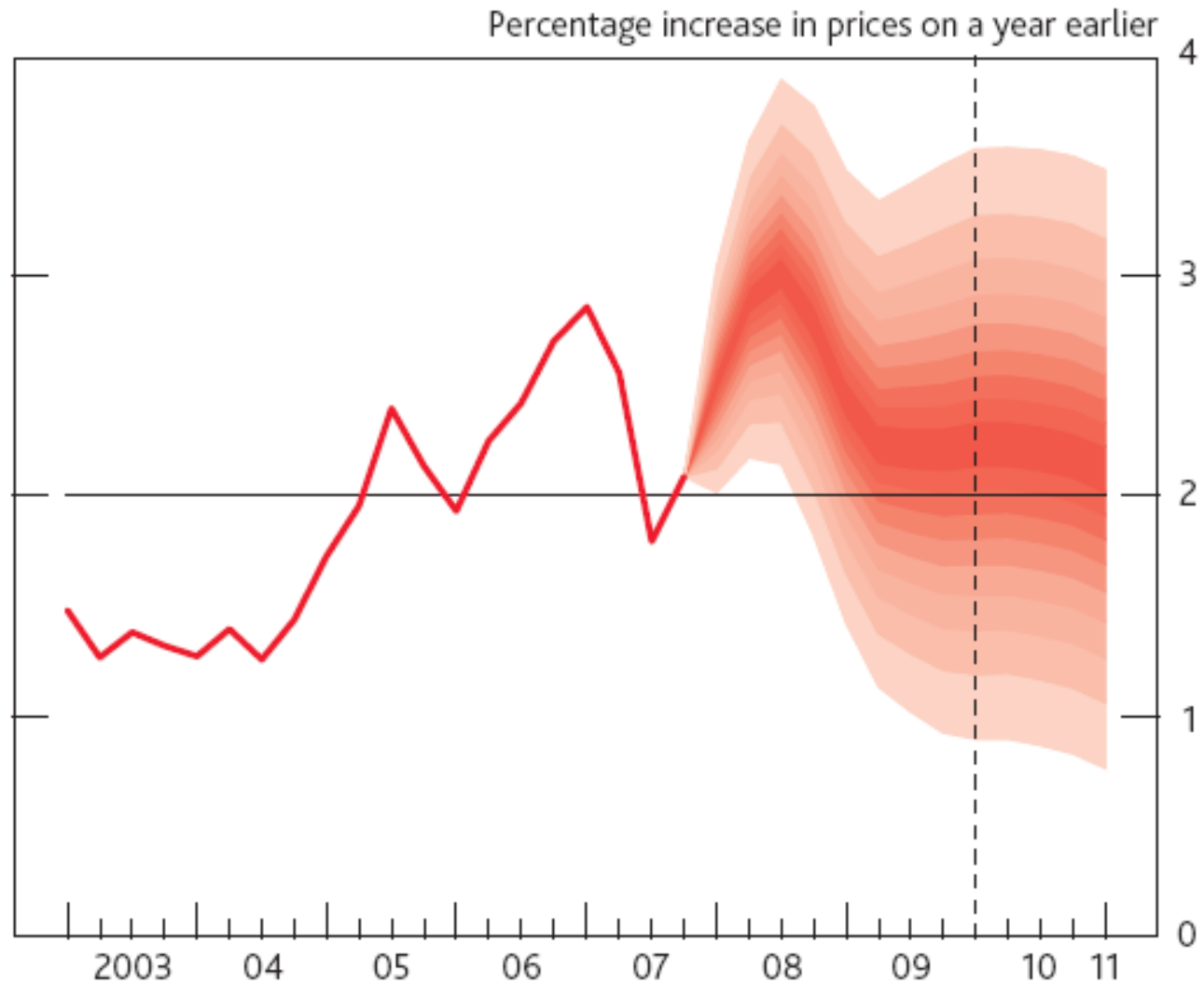


Source: Bank of England

CPI inflation projection



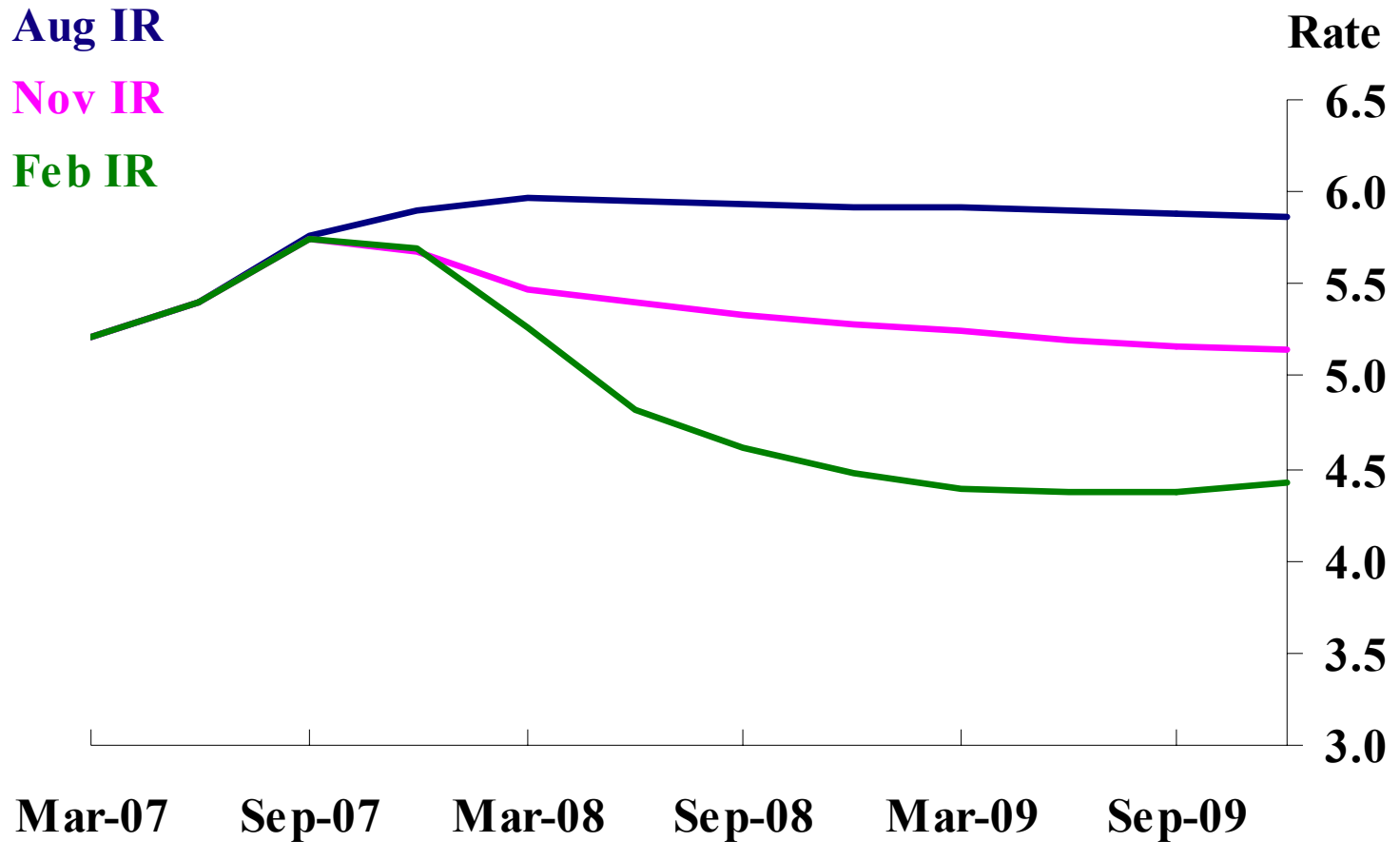
Projection based on **market interest rate expectations**



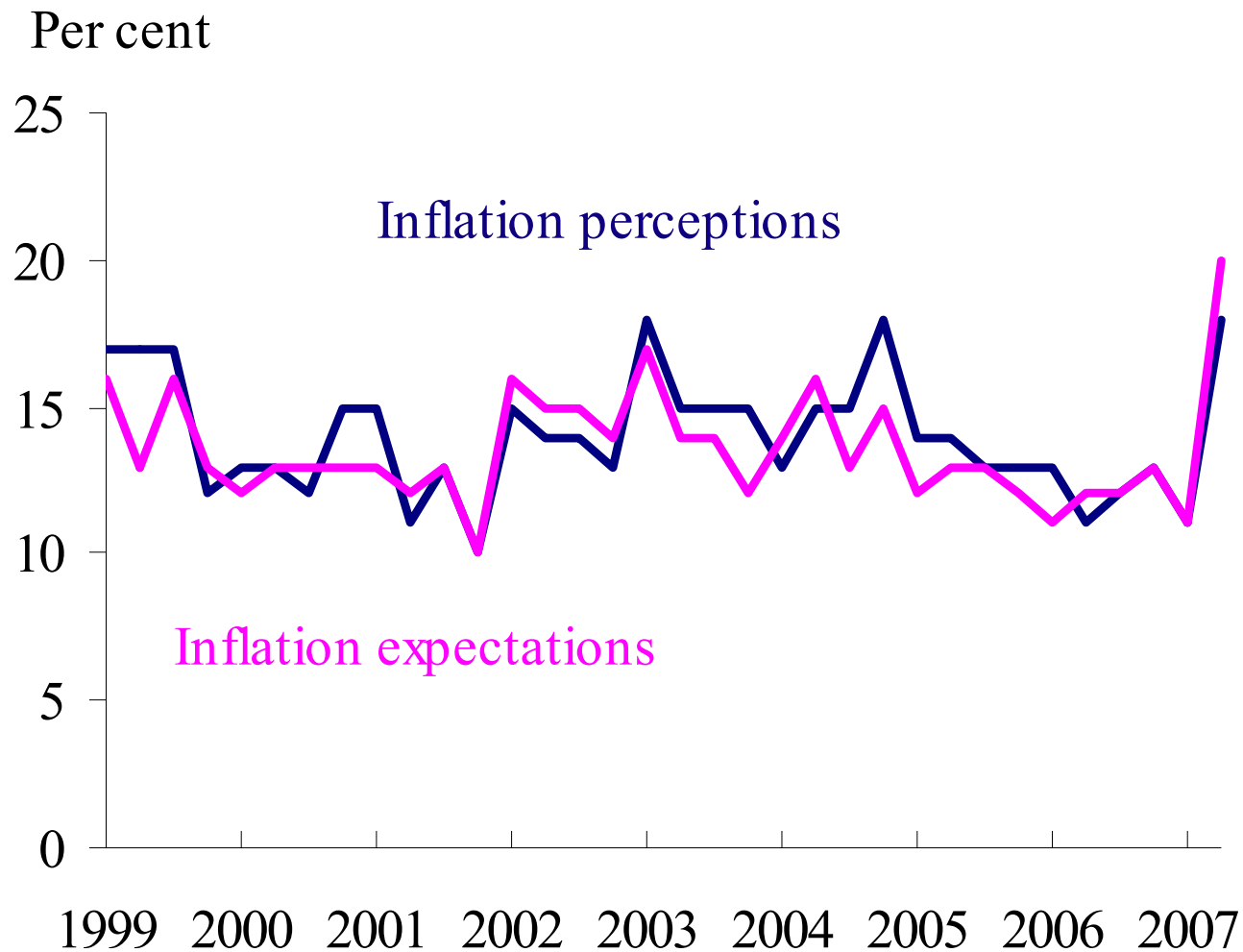
Market expectations of Bank rate



Expectations are implied by market yields



Non-response rates in surveys of inflation

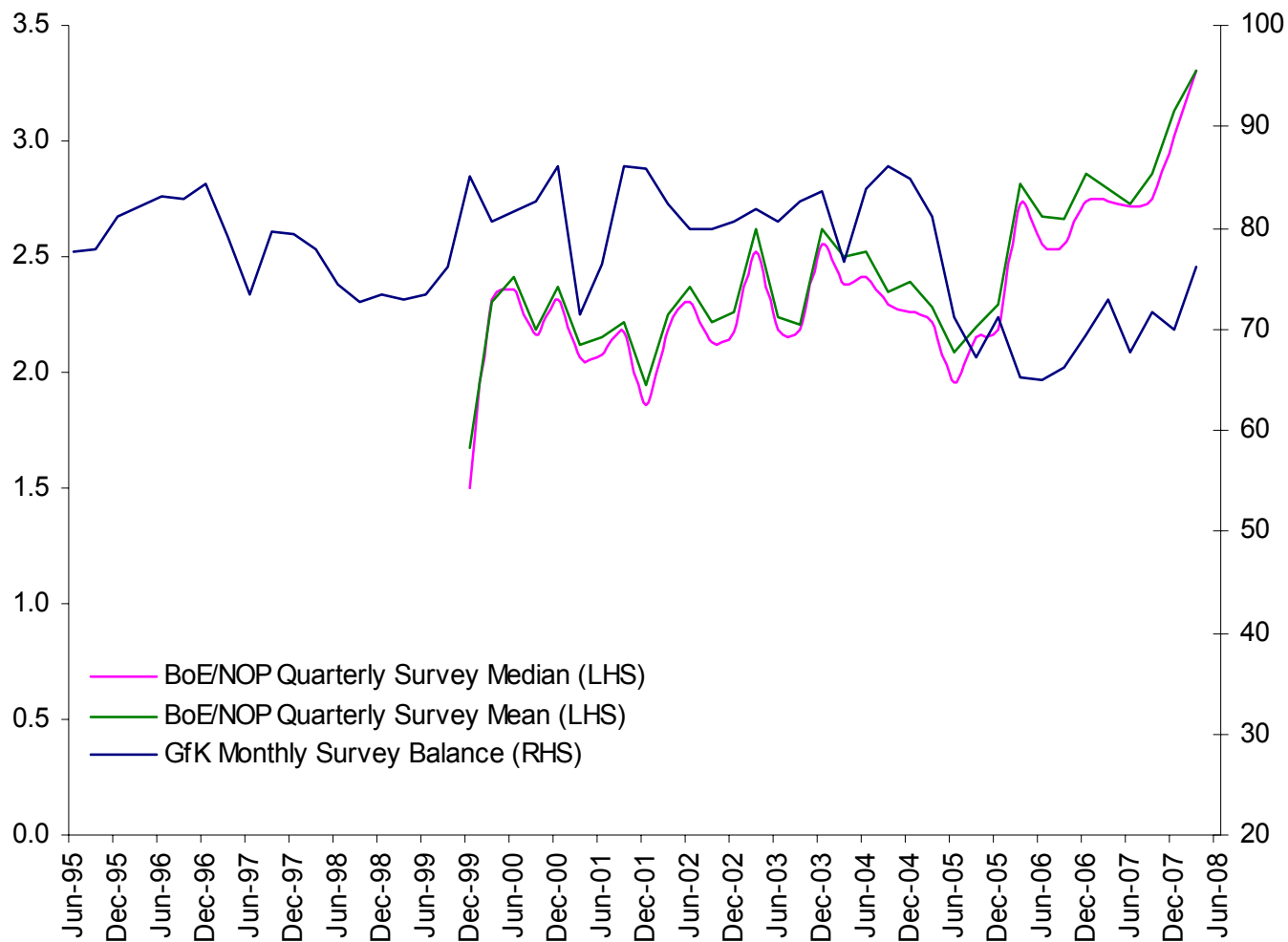


Source: Bank of England/NOP, GfK

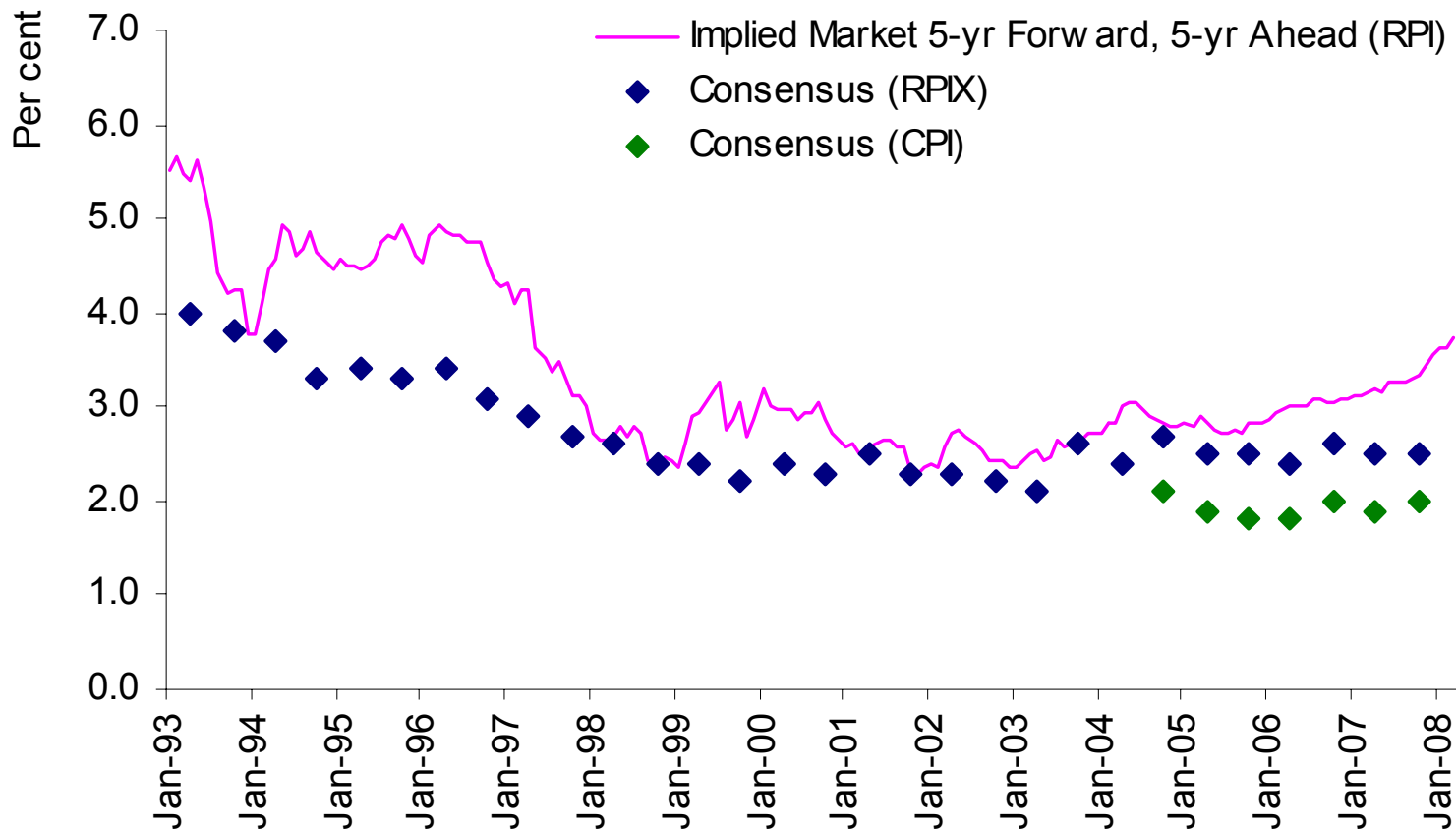
Consumer inflation expectations



Expectations on inflation for 12 months ahead



Market forecasts of inflation



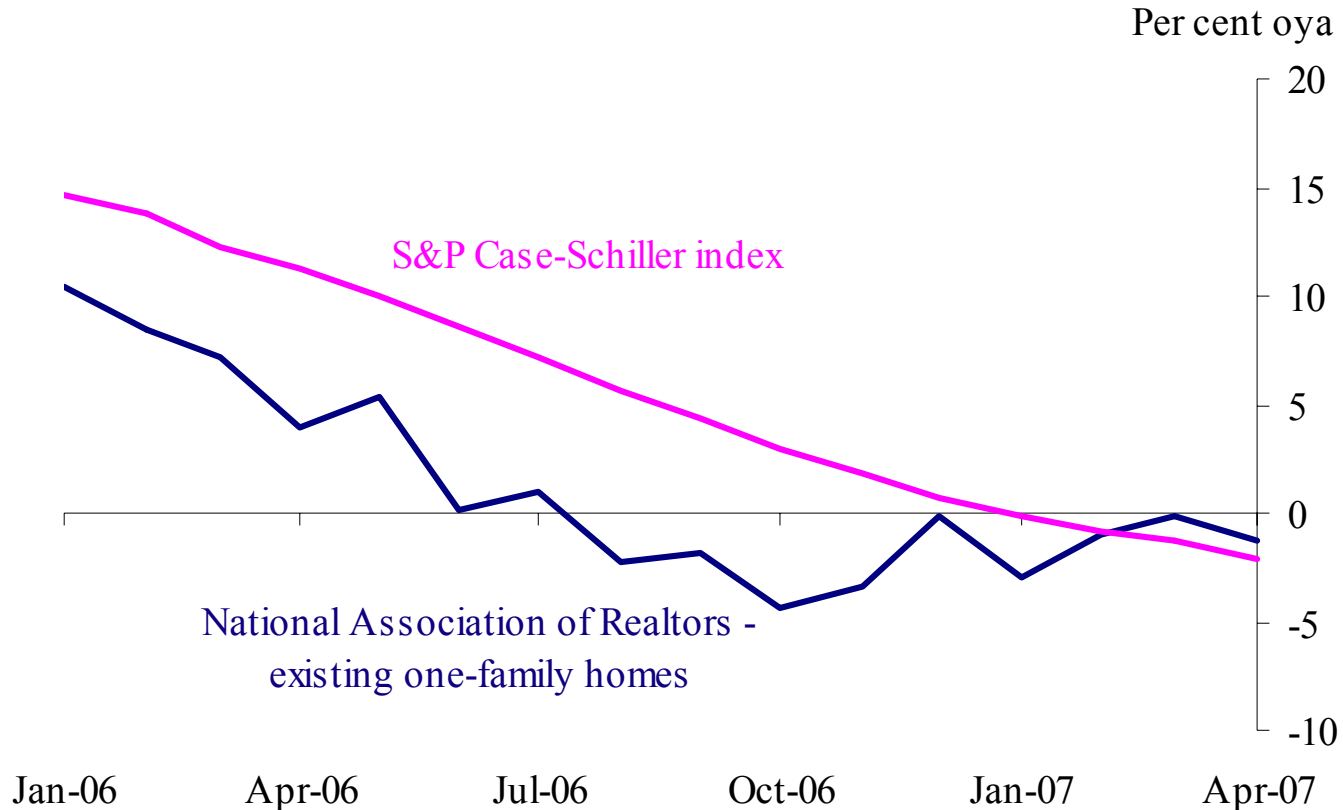
Source: Consensus Economics and Bank of England

United States – Phase 1



January 2006 - April 2007

House price inflation



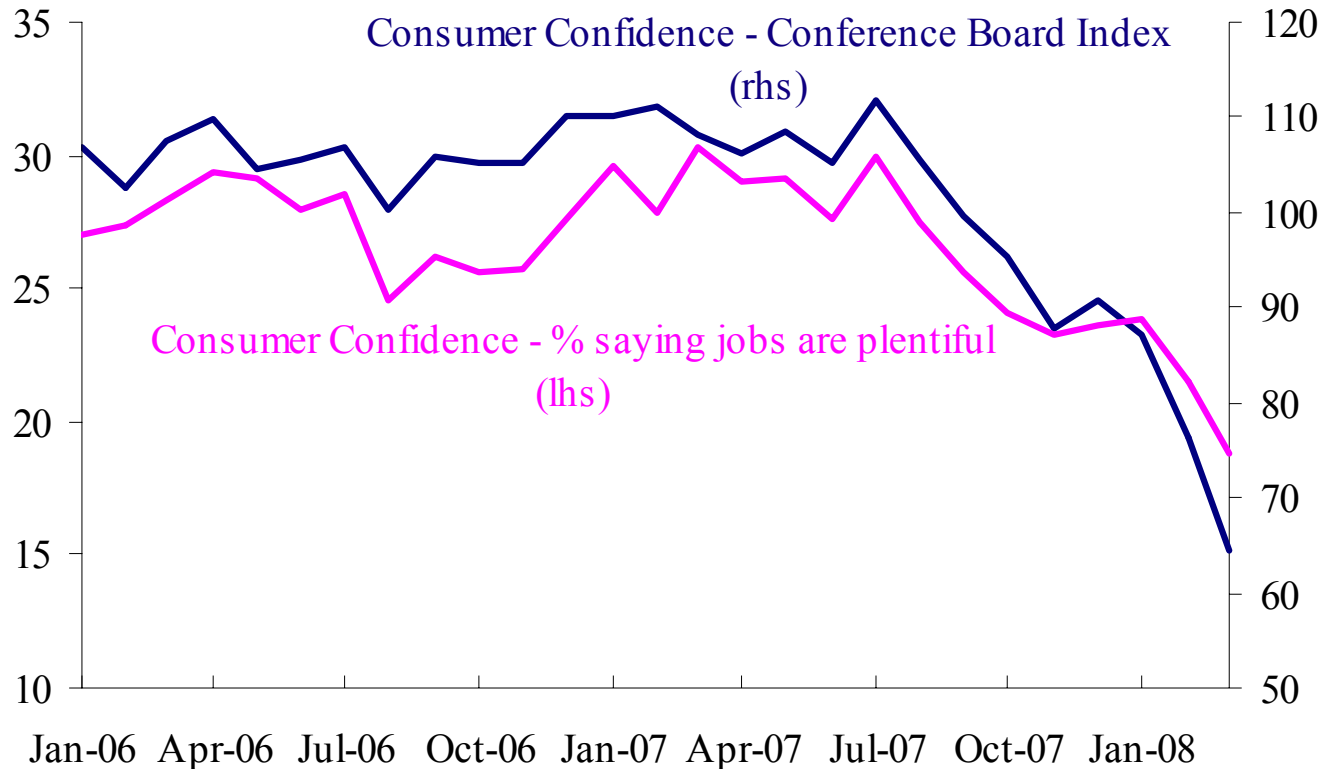
The **housing market starts to slow** from its peak around January 2006 (columns 1 and 2). Negative monthly growth rates in house prices start to appear from the Autumn of 2006.

United States – Phase 2



May 2007 – August 2007

Consumer confidence

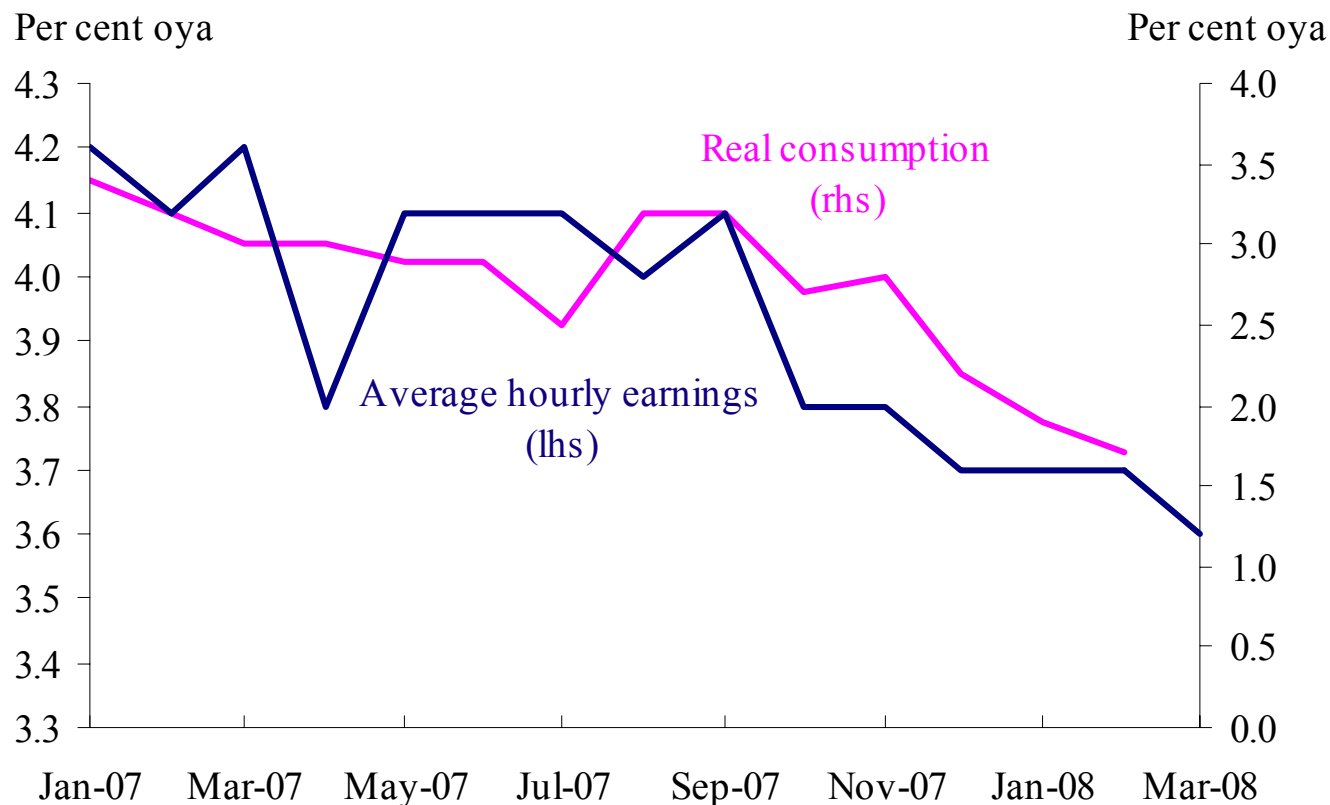


Substantial monthly falls in house prices and housing market activity. **Consumer confidence** measures and **qualitative labour market indicators** started to drop precipitously from around Sept 2007.

United States – Phase 3



September 2007 – December 2007

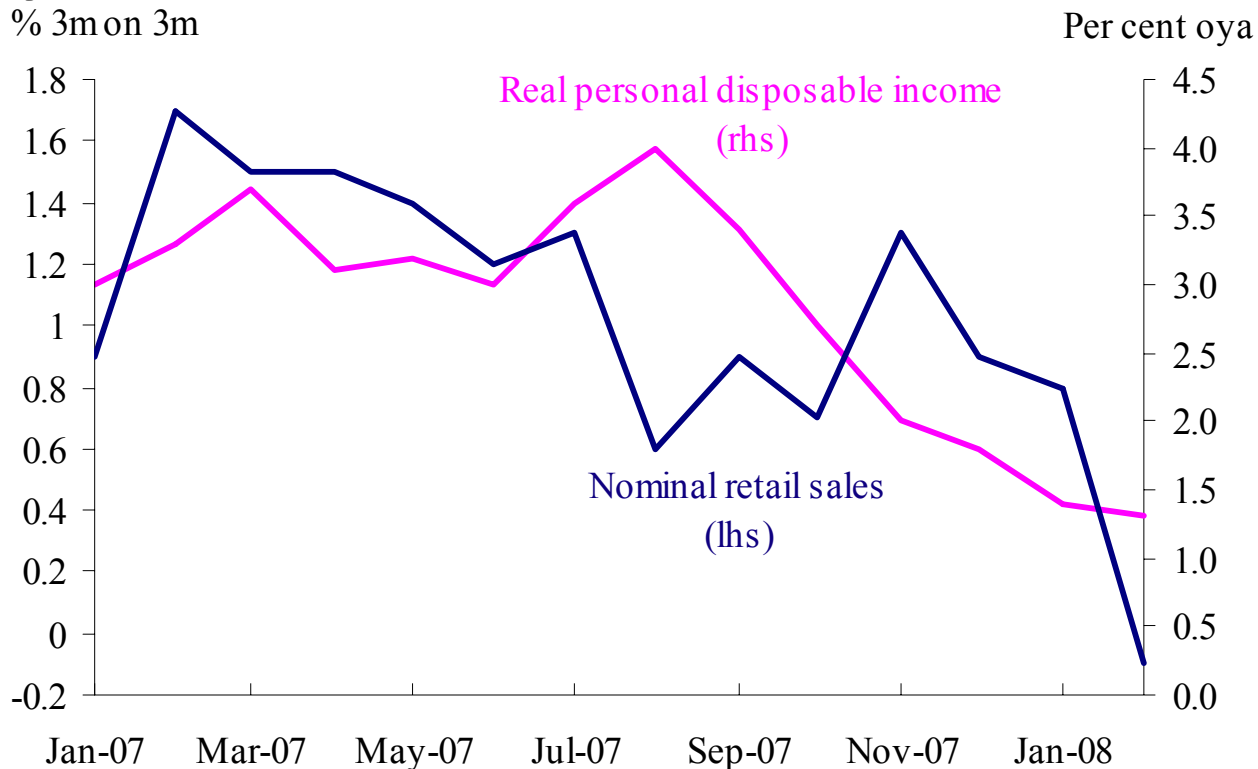


Slowing in **average hourly earnings** growth, **real consumption** growth, and **private non-farm payrolls** growth. House price and activity declines speed up.

United States – Phase 4



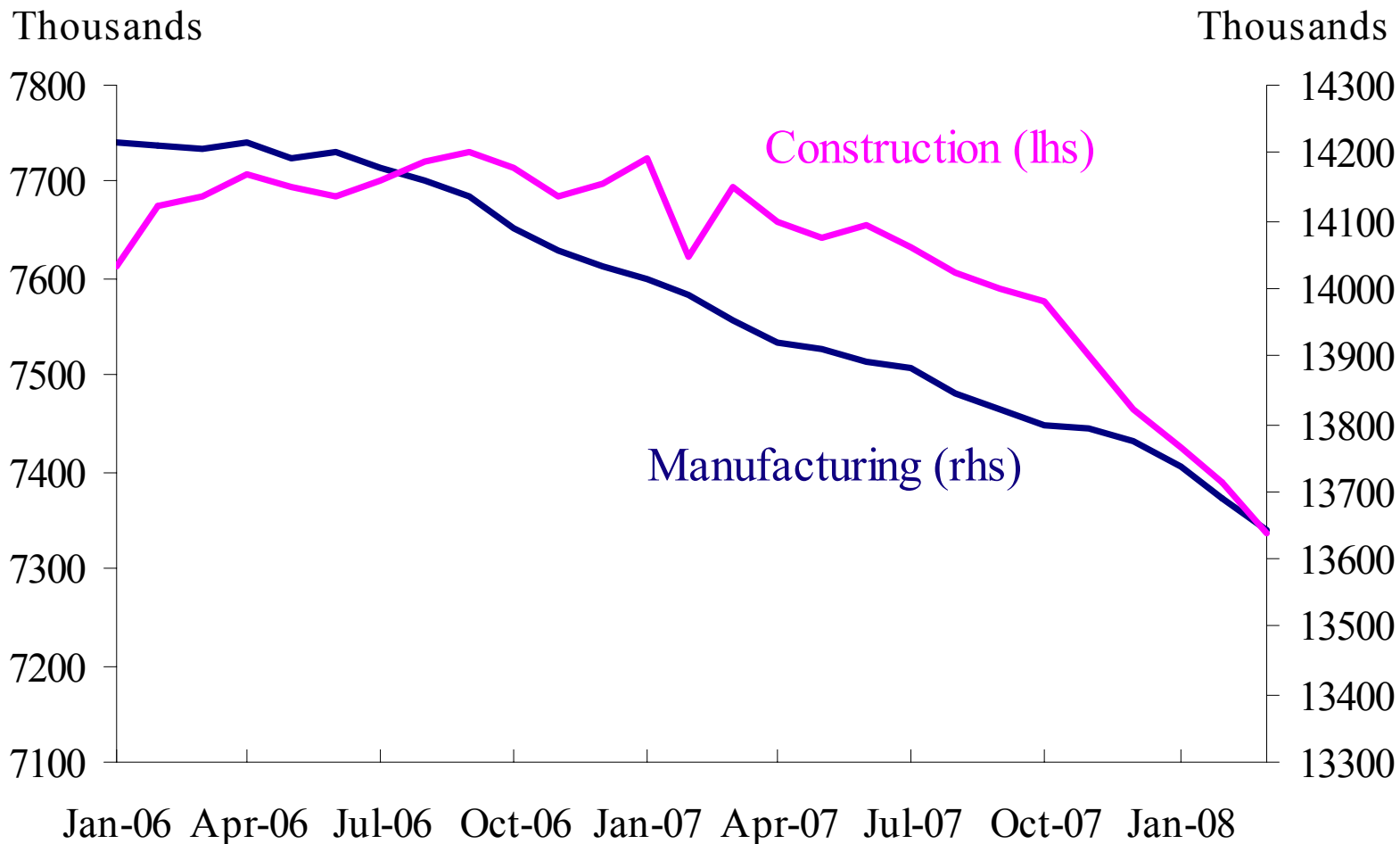
January 2008 –



The housing market problems have spilled over into real activity.

Nominal retail sales and **real personal disposable income** have both fallen sharply since January. Real annual GDP growth in 2007 Q4 was 0.1%, down from 1.2% in 2007 Q3.

US – manufacturing and construction employment

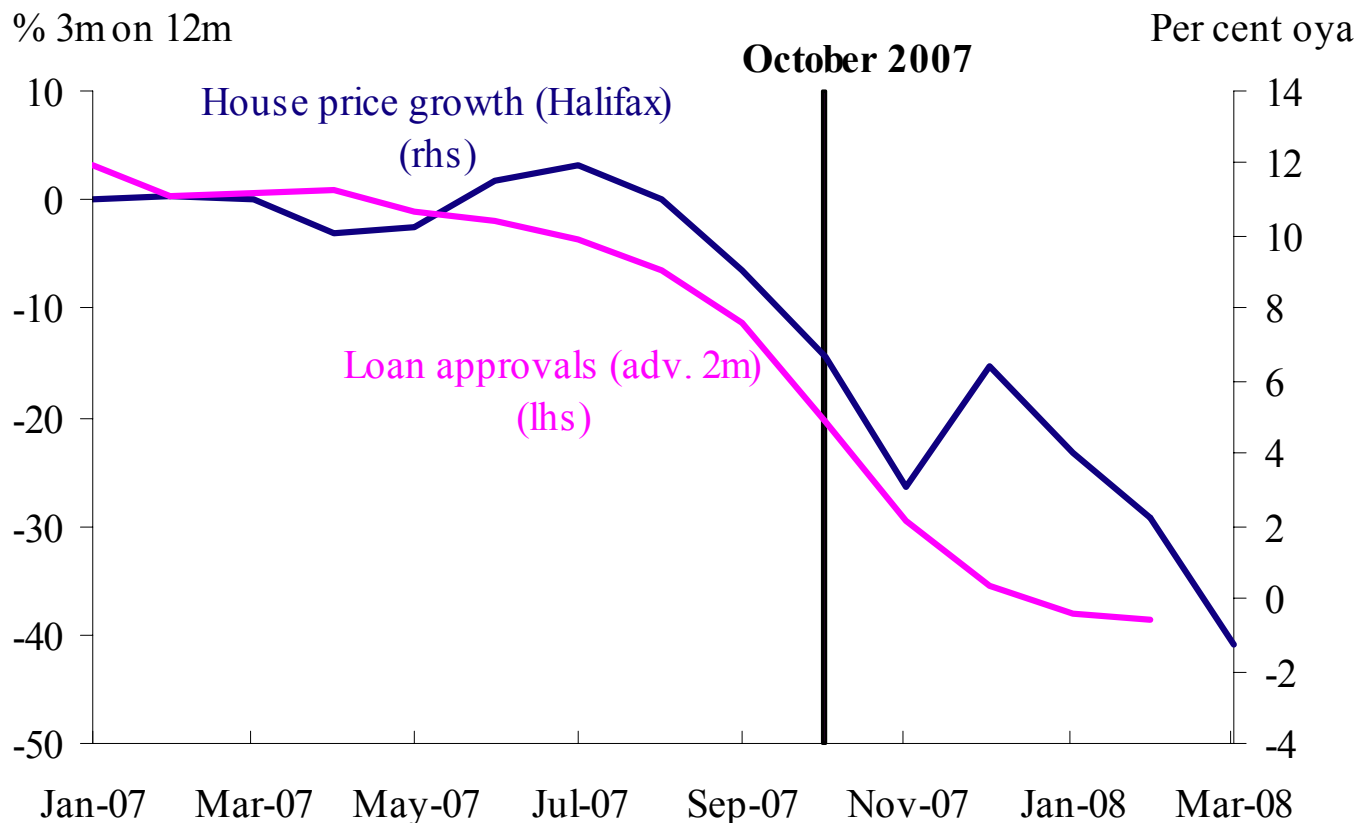


Source: US Bureau of Labour Statistics

United Kingdom – Phase 1



August 2007 – October 2007



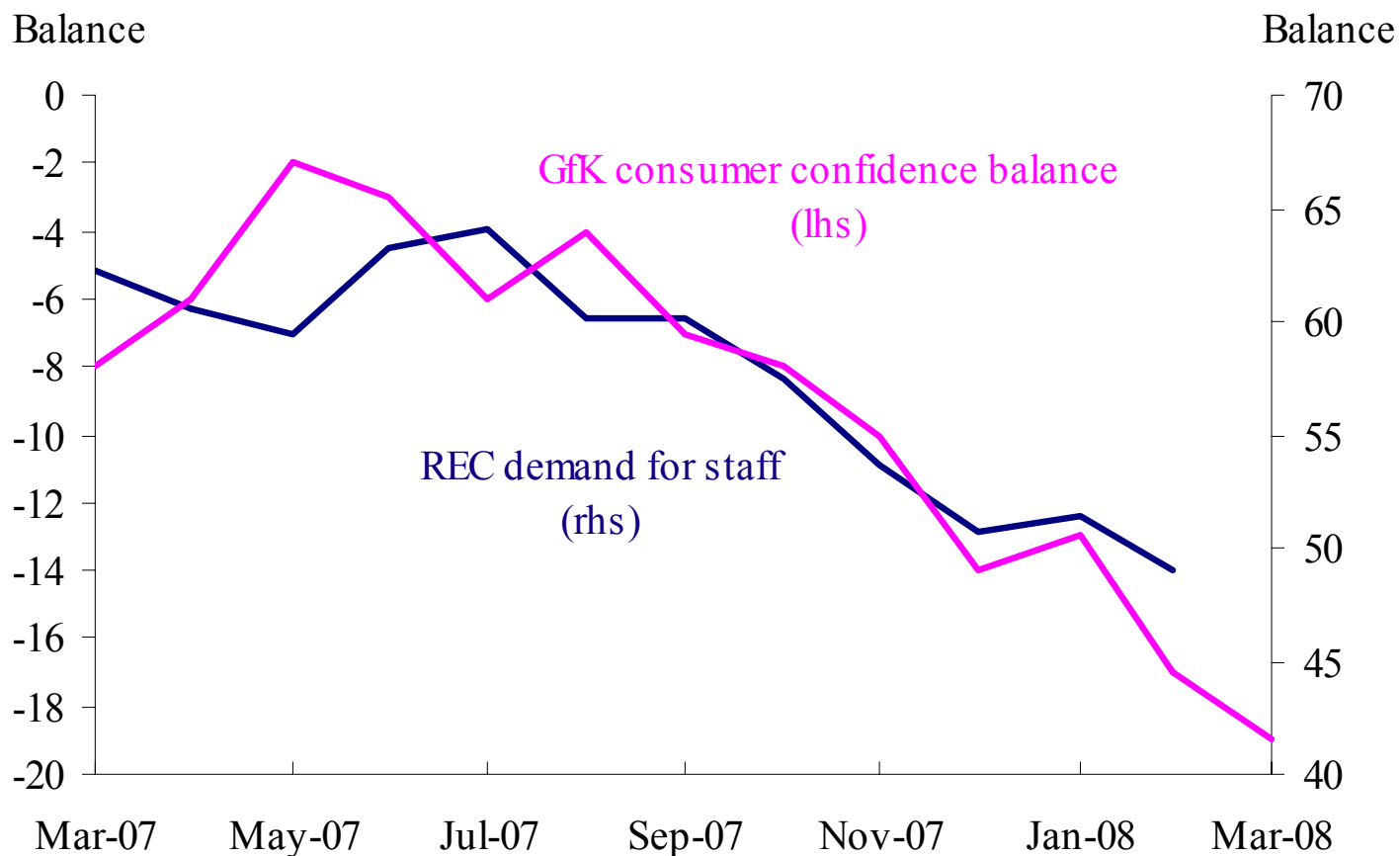
House prices start to slow in 2007 Q2 and Q3.

Housing activity measures slow from around October.

United Kingdom – Phase 2



November 2007 – January 2008

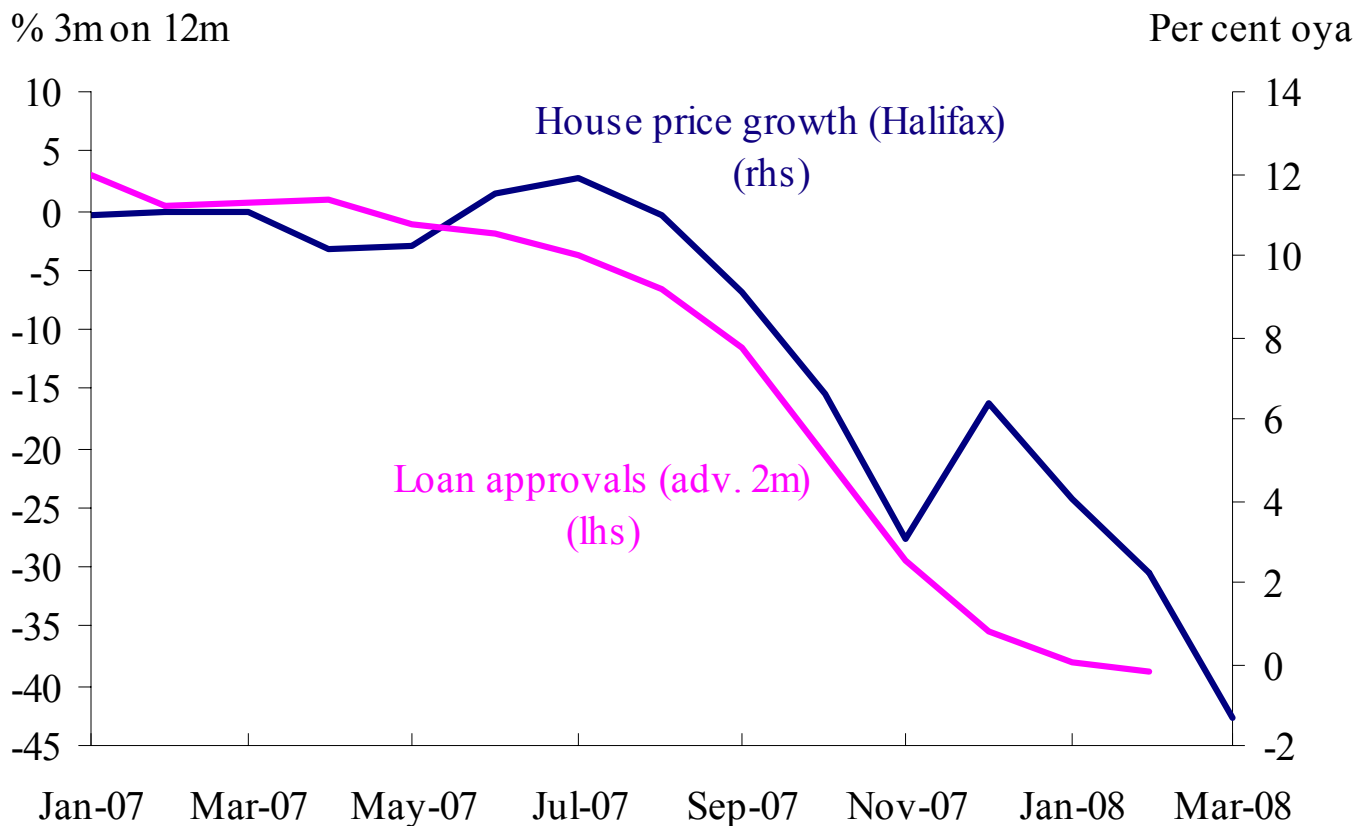


Consumer confidence measures start slowing sharply.
Qualitative labour market measures also start slowing.

United Kingdom – Phase 3



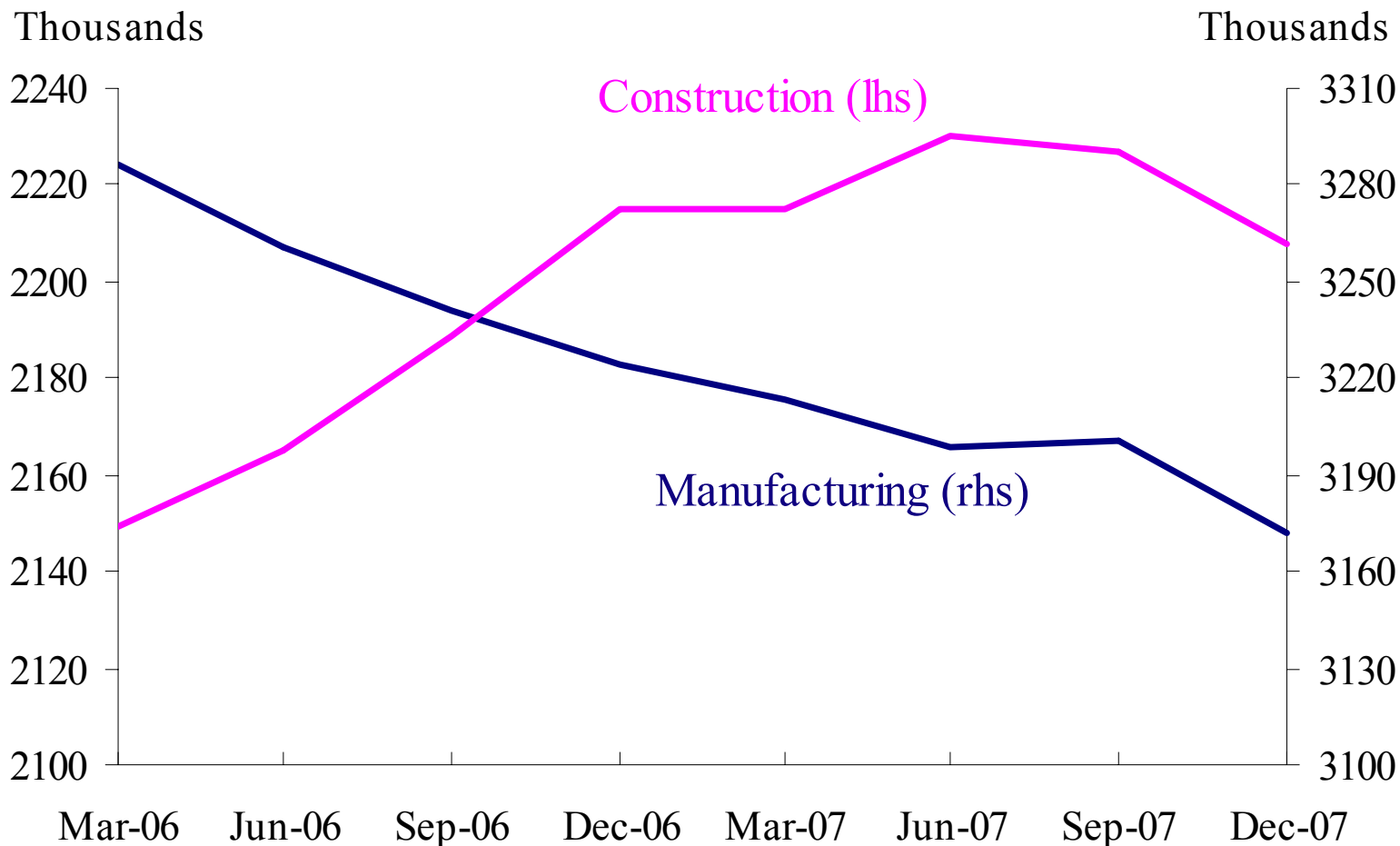
February 2008 –



House price **falls have started to accelerate.**

Measures of housing activity also **falling more rapidly.**

UK – Manufacturing and construction employment



Source: ONS Labour Force Statistics



“Some participants expressed concern that falling house prices and stresses in financial markets could lead to a more severe and protracted downturn in activity than currently anticipated.”

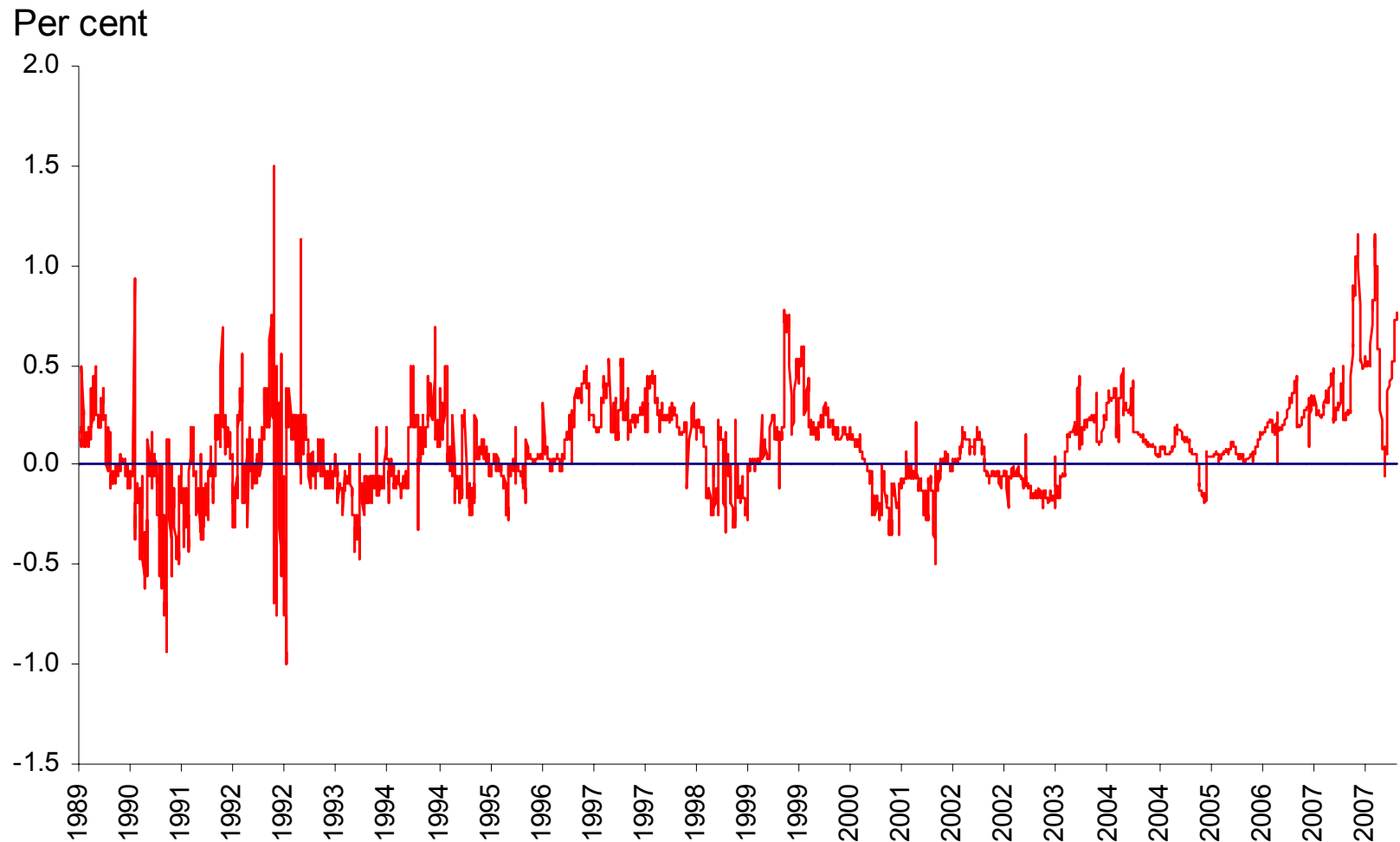
- Minutes of the **Federal Open Market Committee** (FOMC) meeting held on 18th March 2008



‘It is one thing for central banks to hold price increases generated in their own countries or regions to 2 per cent. It is quite another to compress them to offset potentially large price increases emanating from outside their area. For the time being, all that is required is some emphasis on the domestic versus external elements in inflation in, for instance, the monthly press conference of the ECB or the letters the governor of the Bank of England is required to write to the chancellor when inflation strays by more than one percentage point from target’

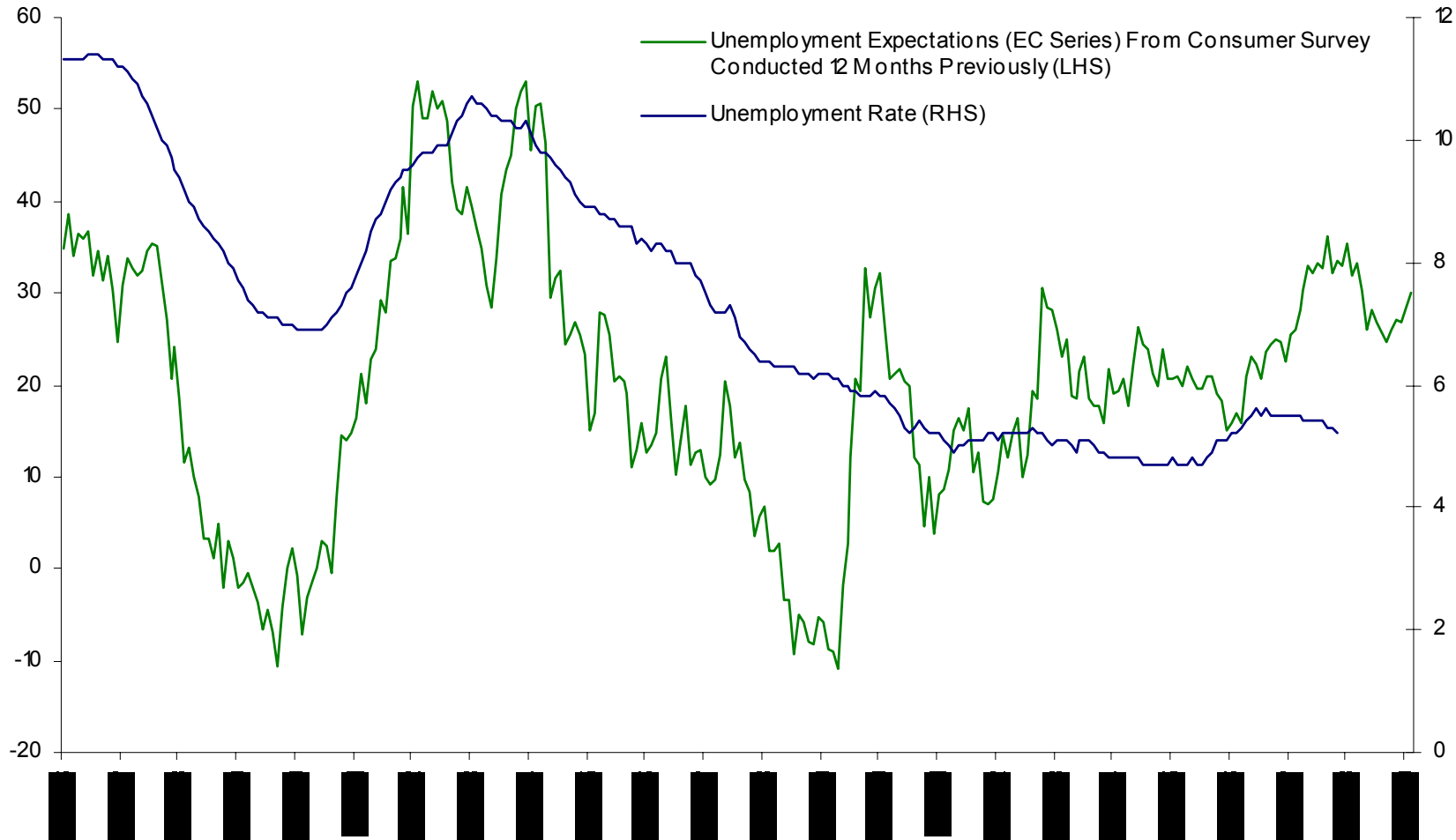
- **Sam Brittan**, *Financial Times*, March 27th 2008

The spread between Bank rate and LIBOR



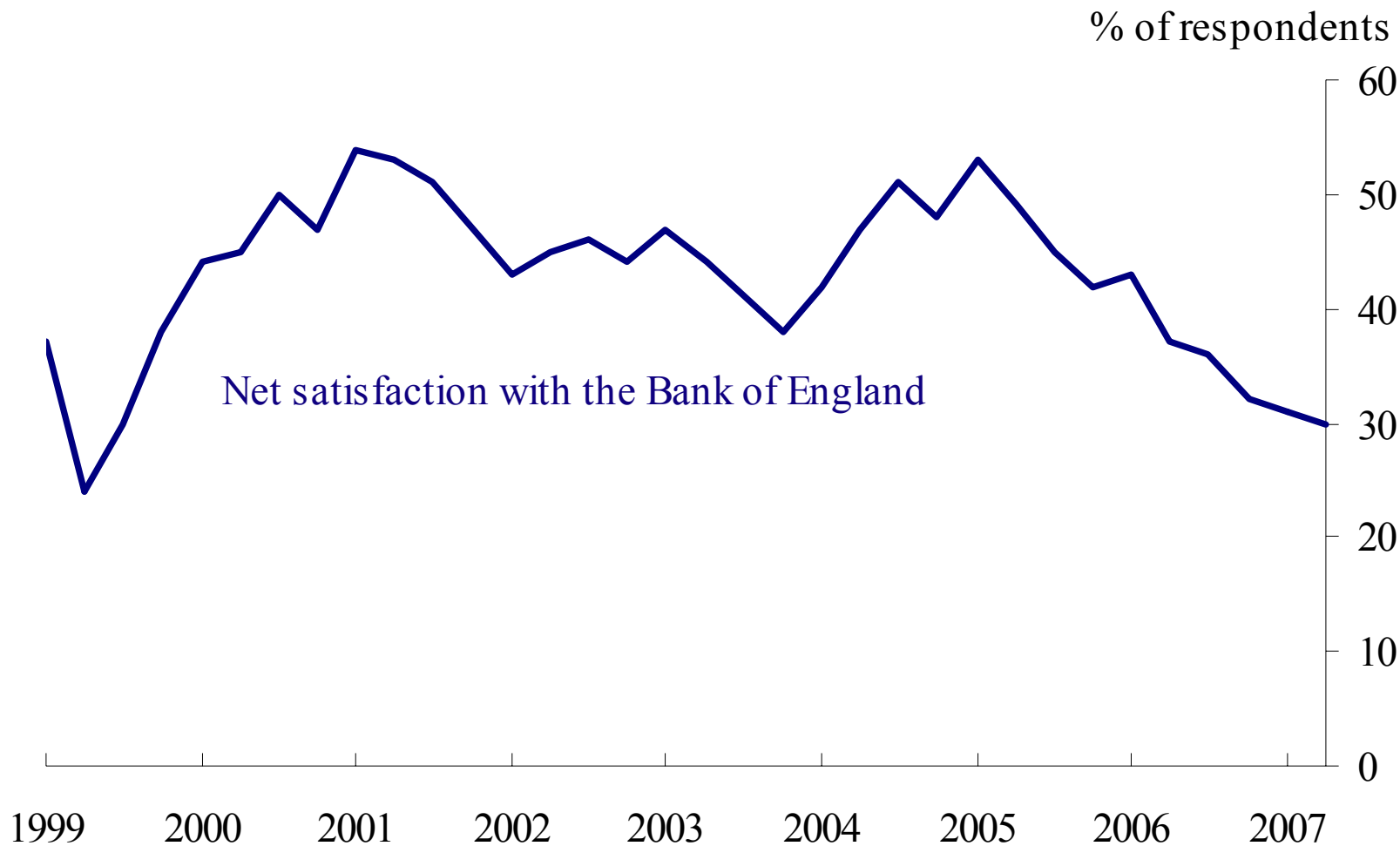
Source: British Bankers' Association

Unemployment expectations



Source: EC, LFS

Public views of the Bank of England



Source: BoE / GfK NOP survey of public attitudes to inflation