ESSENTIAL READING FOR KEY ISSUES

Follow-up questions from the Benchmark meeting

(CAPD)

This note provides answers to two follow-up questions from the Benchmark forecast meeting.

1. How much weaker would domestic or world demand have to be to return inflation to where it was in August?

Inflation in the Benchmark forecast reaches 2.4% by year 3. At the Benchmark meeting, some MPC members asked how much weaker domestic or world demand would need to be to return the inflation forecast to 2.1% at year 3, where it was in the August *IR*.

To return inflation to 2.1%:

- Consumption would need to be 2½% lower or investment would need to be 14% lower at year 3. In each case, the level of GDP would be around 1% lower at year 3.
- UK-weighted world GDP would need to be around 1.2% lower, with world trade around 3½% lower.[1]

At Key Issues 1 and 2 we will discuss the risks to domestic and world demand and ask whether you would like to make any judgements to aim off the Benchmark profiles for either of these.

2. What would our suite model imply would be the effects of the actual changes in asset prices since August?

The suite model that we use to estimate the effects of changes in the yield curve works by estimating the marginal effect on other asset prices of movements in the curve and then using the estimated relationship between asset prices and spending from MASD's sectoral model. The suite model implies that, all else equal, the 50bps fall in the yield curve should have raised net financial wealth by around 1¼% and lowered the real cost of capital by around 30bps per year. These channels contribute around half the 0.6% increase in GDP that we have assumed from the fall in the yield curve sinced August, with the remaining half coming from cashflow effects.

In reality, though, while the yield curve has fallen, its effect on wealth and the cost of capital has been outweighed by other factors as risky asset prices have fallen and spreads have risen since August. Using actual changes in asset prices since then implies a fall in net financial wealth of around 2½% and a rise in the real cost of capital of around 30bps. Some MPC members asked what the suite model would give for the GDP and inflation effects of these falls. The answer is that it would imply a combined -0.4% impact on GDP via wealth and the cost of capital. Maintaining our estimate that cashflow effects from the lower yield curve push up on GDP by 0.3%, that would give a net effect from the changes in these observed asset prices since August of -0.2% on the level of GDP. That is 0.8pp lower than the +0.6% (see previous paragraph) that we have assumed from the moves in asset prices in the Benchmark forecast. And the net impact on inflation would be -0.1pp rather than +0.3pp.

Whether you think this poses a downside risk to the forecast – and, if so, how big a risk – will depend on a couple of things:

- First, it will depend on the extent to which you think the falls in risky asset prices reflects other things that are captured elsewhere in the forecast. The falls largely appear to reflect increasing concerns in markets about global growth[2]; consistent with that, we have already made the largest downward revision to our world forecast since the euro area crisis. We think this argument holds even if you think there should be a direct wealth effect from the falls in asset prices – while our models treat the impact of the world downgrade

[1] The emerging market risk scenario set out in the International Forecast Overview note would generate a weaker world GDP outlook of this magnitude.

[2] For more details see the recent note on) .

as coming through trade, it is quite possible that their estimation will also pick up any effects via wealth and other channels.

- Second, it will depend on the extent to which you think this is a plausible estimate of the effect of changes in wealth on activity. The impacts from the sectoral model are somewhat larger than our consumption and investment suite models would imply: combining estimates of the effects from those models of the change in wealth and the real cost of capital that we have observed since August would leave the level of GDP around 0.1% lower by the end of the forecast, giving a net effect of +0.1% with cashflow effects included – compared with the assumed +0.6% in the Benchmark forecast. Also, the suite model does not structurally identify the source of the shock to asset prices, so it is possible that the estimation is just picking up the fact that asset prices will tend to rise when GDP is expected to rise.

Of course these arguments might also lead you to question the size of our assumed effects of moves in the yield curve. However, the evidence presented at Benchmark suggests our monetary policy multipliers are within the range of other empirical estimates, so it may be that the effects of individual channels within the overall multiplier may be misallocated.