The Bank of England is data driven – it needs to be good judgement driven

Just like government explaining its line on the pandemic, the Bank tells us its decisions are driven by the data. As someone who does seek to provide sensible forecasts of inflation, growth and deficits going forward, I agree you start your task by assembling good data. You seek to understand the figure you are forecasting, so you are aware of the way it is compiled and what affects it. You need also to be aware of the imperfections in the data, and the quirks from the judgements made about how to define and compile it. As we saw in trying to compare different countries handling of the pandemic the definition of a covid death and how strenuously the authorities sought to record them mattered a lot to data outcomes. Forecasting inflation produces different results depending on whether you use CPI, RPI, core CPI or some other index.

It is however wrong to say policy decisions are data driven. If they are they will be always looking backwards. You cannot drive the car successfully by looking all the time in the rear mirror, though that will give you a perfect understanding of all the hazards you have just missed. You need mainly to observe what you can see through the windscreen ahead, but you need to judge or interpret what you see. Will the green light go amber? Will the child step off the pavement? Could there be someone dashing out from behind the parked car? Is the road ahead clear enough to accelerate safely? To drive well you need to choose the right data – data about the road ahead, not the road behind, but you also need to interpret it dynamically. So it is with the economy. Knowing inflation has been fast does not mean it will be next year. Seeing oil and gas prices surged last year does not mean they will surge again to keep the inflation rate up. You need to judge how prices will alter ahead. Putting rates up because last month's inflation was too high is not necessarily a good idea.

To make better judgements it helps to understand how prices rise. Here the Bank ignores money and credit, yet it is if there is an excess of money and credit around that you are most likely to get inflation through excess demand. The Bank does have a model of what might happen next based on a concept of capacity in the economy. They seek to judge how much capacity there is in the economy to make things and supply services and then compare that with demand. If capacity is fully used they expect inflation, if there is surplus capacity they expect inflation to subside.

There are several reasons why this is a very difficult way to judge the future. The first is it takes no account of the ability to import, yet an economy like the UK relies heavily on imports for marginal supplies of all kinds, so global capacity matters as well as domestic. The second is it is very difficult knowing what capacity is. A business may say it can only supply 200 widgets a day, but if pushed and offered more money it might be able to add a night shift to go up to 300. A restaurant might say it cannot do extra private dining, but could then discover it can hire more staff and open for more hours to serve more meals. Another manufacturer might discover that although he can put on another shift he cannot get an increase in components for the next two months to immediately boost output. To make it easier the Bank often relies on unemployment as the best indicator, assuming higher unemployment means companies could expand easily if there was extra demand by taking on more labour.

I will look in a future piece at why it is wrong to ignore credit and money and how it is difficult to find a reliable proxy for capacity utilisation which works for the future.