Funding the Future

Inflation data suggests that the Bank of England should...

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A new article on Bank Underground, which publishes staff papers written by personnel working at the Bank of England, is interesting. Written by Galina Potjagailo, Boromeus Wanengkirtyo and Jenny Lam, it focuses on the underlying causes of inflation. Its opening premise is this:

The recent rise in UK inflation was initially fuelled by two large external shocks: supply bottlenecks along global value chains due to the Covid-19 (Covid) pandemic (for instance, with microchips and used cars) and soaring energy and food prices related to Russia's invasion of Ukraine.

Having then noted that the prices in question are set externally to the U.K. the authors suggest:

However, broader domestic price increases via 'second-round effects' can follow because energy prices affect the costs of many other goods and services through their role as indispensable input in production and transport.

So far, so good, and I agree. The second claim can't be disputed in some cases, although its significance can be.

What they do next is interesting. What they argue is that there are four causes of inflation right now:

* The Ukraine war

* Covid reopening (which they assume is now taken over by a war effect, but may be continuing)

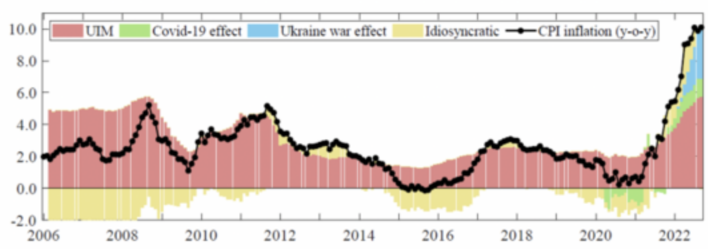
* Idiosyncratic inflation e.g. that in second-hand car prices because of shortages of chips to make new cars

* Remaining inflation (underlying inflation, or UIM as they call it). This can include secondary effects from the above.

The split makes some sense, although it is unsophisticated on secondary impacts without cause being established.

Their first iteration of this is as follows:

Chart 2: Underlying inflation, 2006–22



As they note:

In September, the historic underlying inflation measure (red bars) has reached 5.8%, the highest level observed over the sample period, having increased by 3.6 percentage points in cumulated terms since early 2021.

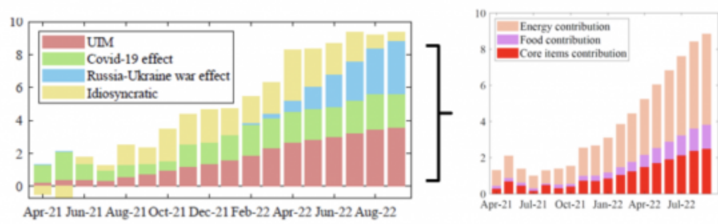
They add:

It is … comparable to the Federal Reserve's estimates of [US underlying inflation] (6.0% for September).

But they do not then accept this as the final answer on underlying inflation. As they note:

The bulk of the increase in underlying inflation is due to broad-based energy price increases, suggesting that energy prices have increasingly comoved with other prices. **Chart 3** decomposes the cumulated increase in UIM, the Covid and Russia-Ukraine war effects since March 2021 (overall 8.8 percentage points). Almost two thirds of this increase came from broad-based increases in energy items' prices (5 percentage points), and a much smaller contribution of 1.3 percentage points came from broad-based increases in food prices.

Chart 3: Cumulative change in inflation since March 2021



They argue:

These broad-based increases in energy and food items contributed not only to the more erratic Covid and Russia-Ukraine war effects, but also to the UIM. The effects on underlying inflation should, in principle, decay once the external shocks behind energy and food price spikes subside.

They are quite clear that they expect this to happen:

The effects of these components should fade out relatively quickly as the two shocks subside – we therefore view them as another type of erratic component rather than as part of underlying inflation.

In other words, they are quite sure that as the first part of Chart 3 shows, core inflation is at present under 4%, and as the second part shows, once the impact of conflict (in particular) is limited in the calculation of inflation (which it will be by mid-2023, because by then inflation calculation will compare post-Putin war prices with post-Putin war prices) then inflation might be under 3%.

The authors then reveal their Bank of England colours, saying:

However, the fact that these items have moved jointly with many other UK price items indicates that the external shocks might begin to propagate to domestic price pressures.

I suggest 'might' is doing a lot of heavy lifting in that sentence. It should actually say 'should', because people will need to recover their purchasing power. But the reality is that the inflationary impact of this is going to deliver inflation only a little over the 2% arbitrary target set for it.

The authors conclude:

Our finding of a rise in underlying inflation among core items suggests that the inflation in the UK is partially driven by broad-based increases in prices that are typically rather stable. Over the past, shifts in this component have been quite persistent, so it could plausibly remain elevated. The precise link between the breadth of price increases and inflation persistence in a high inflation environment remains an open question relevant for central banks.

My suggestion is that the data strongly implies three other things.

First, inflation will decline significantly next year. There is no reason to increase interest rates to make that happen: it will anyway.

Second, Bank of England monetary policy is fundamentally flawed as a result: this analysis shows that.

Third, the right question to ask now is whether a 2% inflation target is reasonable for the next two or three years as spending power is restored. Wouldn't a year at 4% and two more at 3% make sense in that case? And then decide if 2% might ever make sense again, I suggest. Underlying economic factors might suggest it does not. But right now, using this logic, inflation is essentially under control and policy should focus on restoring monetary purchasing power in the economy - which is all down to fiscal policy. In that case, the Bank of England should be doing precisely nothing at this moment.