Box B: A serious monetary policy failure – how policy-makers let the inflation cat out of the bag

By Andrew Sentance CBE

Since the late 1970s and early 1980s, it has been widely recognised that monetary policy needs to play the key role in controlling inflation. High interest rates were used to subdue UK inflation in the early 1980s and again in the late 1980s/early 1990s. On both occasions, the official Bank of England rate was raised to 15 per cent or higher. Inflation was brought under control, but a severe cost to the real economy. The early 1980s recession was the worst post-war economic downturn in terms of its broader economic and social impact. The unemployment rate rose to double digit levels in 1981 and stayed over 10 per cent until 1987. The UK economy bounced back more strongly in the 1990s, partly because of labour market reforms - introduced in the 1980s and 1990s - and partly as a result of a more pragmatic approach to economic policy under John Major's government when compared with Margaret Thatcher's administration in the early 1980s.

We now face the biggest inflation surge that the UK has experienced for over 40 years, with consumer price index (CPI) inflation widely expected to reach over 10 per cent later this year. This wave of inflation is not confined to the UK, however: North America and Europe are experiencing something very similar. But the response of central banks has been slow and ineffective. In the UK, official interest rates have risen from 0.1 per cent to 1.25 per cent so far. They have risen slightly faster in the United States but by much less in the euro area. There appears little urgency in raising interest rates across the industrialised world, but these interest rate levels are totally out of kilter with the actual and expected levels of inflation in the UK and other countries in the western world.

This now looks like a major policy failure. In the UK, the Bank of England Monetary Policy Committee (MPC) was established in 1997 to keep inflation under control – at or close to the official inflation target. The target was initially set as a benchmark of 2.5 per cent inflation for the Retail Price Index excluding mortgage interest payments (RPIX) and, since 2004, 2 per cent inflation for the CPI. Before the current inflation surge, there were a few short-term inflation spikes, most notably in 2008/9 and 2011/12. CPI inflation briefly exceeded 5 per cent in each of these but quickly fell back. In general, inflation was kept close to the official target.

The expectation of central banks when inflation started rising last year was for something similar. In the UK, CPI inflation rose above 2 per cent in May last year and was already over 5 per cent in November 2021. But instead of reaching a peak, inflation kept rising and hit 9 per cent in April this year. The projected peak for inflation has now been pushed back to the end of this year, when the latest Bank of England projection (Bank of England, 2022) suggests CPI inflation will reach around 11 per cent. After that, inflation is projected to drop back to the 2 per cent target quite rapidly, over the following 12-18 months.

Though the response of the MPC so far has been to raise interest rates very gradually, its policy response has been very slow and reluctant. After resisting calls for rate rises in the second half of 2021, the first increase came in December of that year. That followed a bizarre situation in November 2021 when the Bank's forecasts pointed to the need for a rate rise, but the majority of the MPC voted against. At the same time, the MPC continued to pump new money into the UK economy through its policy of Quantitative Easing until December, sending a clear signal to financial markets that the MPC was not taking the inflation threat seriously, even though projections for price rises were rising sharply.

One reason for this reluctance to act was that a large part of the inflation surge was being driven by global energy and food prices. As we moved through the year ahead, the MPC argued, the impact on inflation of these upward global price pressures was likely to subside. There was therefore a danger of overkill if interest rates were raised too far or too fast.

The MPC's second argument was that economic growth would slow sharply as the "cost of living crisis" hit the spending power of households. According to the Bank's forecast, this effect was likely to produce very slow growth in the next couple of years with a heightened risk of recession.

However, setting monetary policy is about judging a balance of risks. There are some powerful counter-arguments to the MPC's thinking. These now point to the need for a stronger interest rate response.

First, the current inflation surge is affecting a wide range of prices in the consumer basket, not just food and energy. Of the 12 sub-categories which make up the CPI, all are rising at above 2 per cent per annum and 9 are increasing at over 4 per cent. For clothing and footwear, as well as in pubs, restaurants and hotels, prices are up by around 7-8 per cent or more on a year ago. Manufacturers are also seeing large price increases coming through the pipeline which are likely to affect consumers and business costs later this year. Factory gate price inflation is 15.7 per cent and the cost of manufacturing materials and components is rising by over 22 per cent a year. This evidence points to a much longer and more sustained rise in inflation.

Second, the UK labour market is very tight and this is leading to upward pressures on wages – potentially fuelling future inflation via a wage-price spiral. The unemployment rate – at 3.8 per cent – is very close to the lowest recorded since the 1970s and there are now more vacancies (1.3 million) than unemployed people for the first time since current records began. This is contributing to upward pressure on wages. In the private sector, total pay in the first quarter of 2022 was up 8 per cent on a year ago and regular pay (excluding bonuses) increased by nearly 5 per cent. In addition, demands for pay rises are likely to intensify as employees seek compensation for high headline inflation this year and next.

The expectations of the general public about future price rises are already shifting upward. The latest Citi/YouGov survey shows that inflation expectations for the next 12 months are over 6 per cent and for the next 5-10 years are at 4 per cent. These high expectations are not consistent with the Bank's 2 per cent inflation target and could well rise further as we move through this year.

Another factor pointing to the need for tighter UK monetary policy is the evidence from the housing market, where property prices have been rising at around 10 per cent or more for some time. Extremely low interest rates, coupled with a low level of housebuilding, have fuelled a house price boom over many years. This has been preventing potential new homeowners from getting on the first rung of the housing ladder. Higher interest rates would generate a more affordable level of house prices for new homeowners, bringing social as well as economic benefits.

It is often argued that higher interest rates would not help the economy when a large part of inflation is being generated by high energy and food prices – driven by global factors. But, as the German Bundesbank demonstrated in the 1970s, a robust monetary policy response can also help counter imported inflation by supporting the value of the currency in difficult circumstances. Imported inflation in the UK has been boosted recently by a significant decline of the pound against the dollar – from around $1.40 last summer to less than $1.20 over the past year. A stronger monetary policy response from the MPC could have helped resist this currency-driven rise in import prices.

As I argued in a recent blog (Sentence, 2022), more robust monetary policy last year could have headed off the recent surge in inflation in other ways. The pandemic crisis has created a significant negative hit to the supply capacity of the economy. Restricting the growth of demand to bring it more closely into line with supply would have helped to keep price increases in check. A stronger signal from the MPC via monetary policy would also have helped curb the rise in inflation expectations.

Unfortunately, inflation is now "out of the bag" in the UK and many other countries. We face a sustained inflation surge, which can only be brought in check by more robust monetary policy. How high interest rates need to rise to bring inflation in check remains to be seen, but, if the MPC continues its slow and ponderous course, the negative impact on the real economy will be much harsher. Timely monetary policy action is the best response to a significant inflation surge, whatever its cause. The Bank of England and other central banks are now behind the curve and need to catch up quickly before more damage is done.

References

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