Resolution Foundation
Macroeconomic Policy Unit

The Macroeconomic Policy Outlook

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Worries about rising inflation are spreading. In this edition of our regular Macro Policy Outlook we draw a comparison between the UK and the US. Our analysis points to a sharp rise in UK inflation in the coming months, possibly to over 4 per cent. If realised, this would be more than twice the rate of inflation the Bank of England forecasted in May for the third quarter of this year (1.9 per cent), but still below US levels. The key driver for this expected rise in inflation is sharp increases in global commodity prices, which have returned to around pre-pandemic levels in recent months.

But the Bank's Monetary Policy Committee (MPC) should 'look through' this rise: history tells us that such increases in inflation normally prove temporary, and any attempt to pre-emptively reduce inflation risks entrenching a weak recovery. And beyond the near term, the outlook facing the UK is quite different from the US. The UK economy – and in particular the labour market – has much further to recover than in the US. Moreover, UK fiscal support is winding down, in contrast to the coming significant stimulus in the US from the 'Biden Plan'. Absent a tight labour market pushing up wages, or additional major stimulus, it is hard to see how significant sustained inflation could be generated in the UK.

Inflation will, however, be a concern to households. While the rise in inflation might be short lived, the reality for families is lasting increases in prices that reduce spending power. If inflation does rise above 4 per cent, that would reduce inflation-adjusted average annual household disposable income by the equivalent of nearly £700 by the start of next year compared to a situation in which inflation followed the OBR's March 2021 forecast. This reinforces the case for fiscal policy makers to provide further support and particularly for boosting incomes – for example through maintaining the £20 per week UC uplift.

The idea that we may be returning to 1970s- and 1980s-style high inflation has been the focus of much attention in recent weeks. Bank of England Chief Economist Andy Haldane has talked about a 'dangerous moment' when the 'beast of inflation is stalking the land again'. Much of the debate centres on the US where President Biden's aggressive economic stimulus measures are seen by some as risking a return to the high inflation of the past. So how worried should we be about UK inflation? In this edition of the *Macro Policy Outlook* we compare the situation here to that in the US.

IDENTIFYING THE SOURCE OF THE RISE IN INFLATION MATTERS

Economists tend to think of inflation as rising for at least one of three reasons:[2]

- First, temporary increases in the prices of some goods – for example, oil prices – which push up the price level without necessarily having a lasting impact on inflation. The pandemic has increased the volatility of some prices as demand has shifted suddenly relative to available supply (think about oil prices turning negative at the start of the pandemic);

- Second, overall demand in the economy rises above sustainable levels of output. When this happens, wages and prices will rise;
- Third, expectations of future inflation may rise. If firms, for example, expect higher future inflation they may raise prices and wages today, making such expectations self-fulfilling.

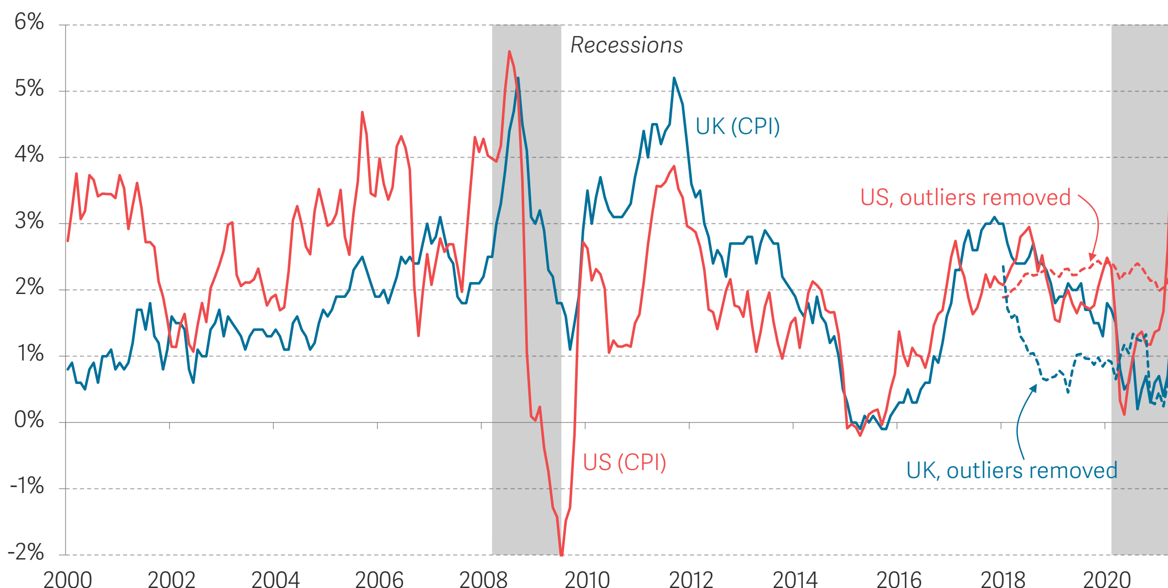
If inflation rises for the first of these three reasons it is less of a concern. In such a case, policy makers on the Bank of England's MPC (charged with keeping consumer prices index, CPI, inflation to the Government's target of 2 per cent) should simply 'look through' the blip. This is because they can have little hope of affecting such short-term inflation increases, and risk engineering an unwelcome downturn in attempting to control it. But if inflation rises because the economy starts to 'overheat' (demand outstrips supply), then the MPC should tighten policy even at the risk of weakening the economy and raising unemployment in order to stop inflation rising by more in future. If higher inflation becomes entrenched in expectations, then history tells us that such tightening will need to be more severe.

UK INFLATION LOOKS SET TO RISE SHARPLY BUT BY LESS THAN IN THE US

So what is happening to inflation in the UK right now? Figure 1 compares headline inflation measures in the UK and US. While both tend to move together, given changes in world prices and global shocks (the pandemic; financial crisis), it is clear that US inflation has diverged relative to the UK. While UK inflation picked up to 2.1 per cent in May, US inflation has risen to 5 per cent, from just 0.1 per cent a year earlier, the sharpest rise in nearly half a century. The difference appears to be a small number of erratically strong components in the US. Excluding those outliers (in the dotted lines in Figure 1) US inflation has risen by just 0.4 percentage points over the past year. These outliers reflect price moves for goods which saw very sharp falls at the start of the pandemic. For example, used car price inflation is running at over 20 per cent (contributing nearly half a percentage point to inflation on its own) after car rental fleets were sold off at the start of the pandemic and are now being rebuilt. By contrast, excluding erratic components from UK inflation makes much less difference.

FIGURE 1 **Much of the rise in US inflation so far stems from a small number of crisis base effects**

Headline consumer prices, 12-month percentage change: UK and US



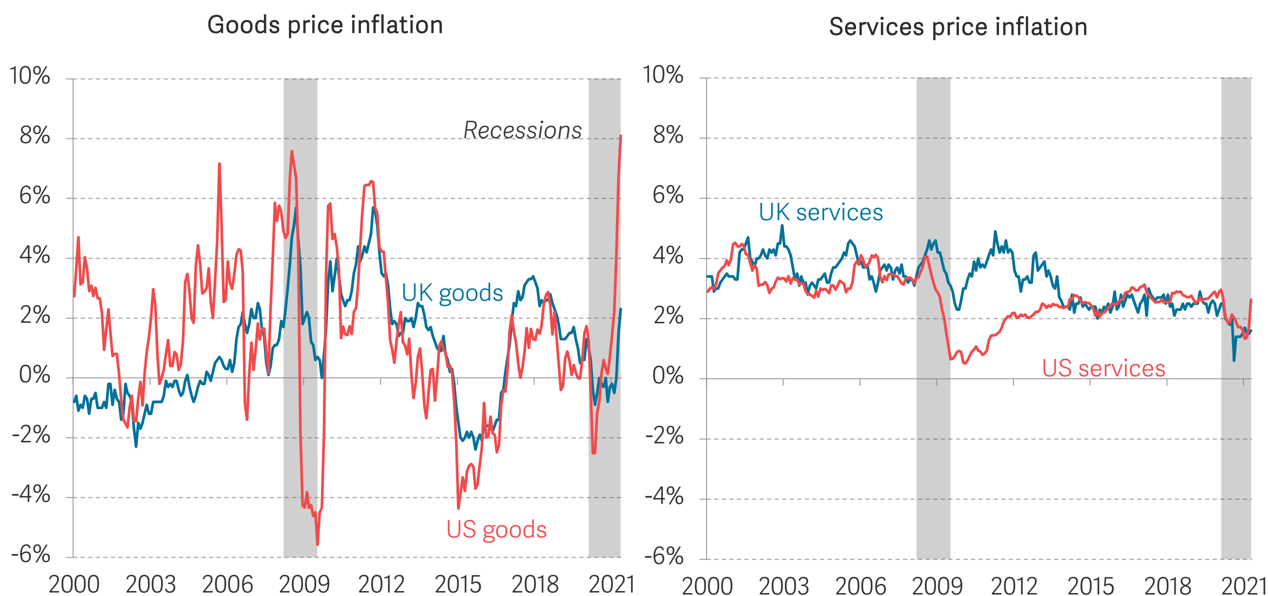
NOTES: inflation rates taken from consumer price index inflation. The 'outliers removed' series for the US comes from the Federal Reserve Bank of Cleveland's 16 percent trimmed-mean CPI (a weighted average of one-month inflation rates of components whose expenditure weights fall above the 8th percentile and below the 92nd percentile of price changes); for the UK, the series is taken from the National Institute of Economic and Social Research's CPI Tracker which excludes five per cent of the highest and lowest price changes.

SOURCE: ONS, Consumer price inflation; US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items; Federal Reserve Bank of Cleveland, Median CPI; National Institute of Economic and Social Research, NIESR Monthly CPI Tracker.

UK inflation is rising at its fastest rate for over a decade – increasing 1.8 percentage points over the past six months – the fastest increase since April 2010. To understand what is going on, it is helpful to look at goods and services prices (Figure 2). Goods price inflation is generally much more volatile – in the UK it accounts for roughly 60 per cent more of the variance in overall inflation than services prices. This is because goods prices tend to be more sensitive to conditions in world markets. This means they are affected by large swings in commodity prices – particularly the price of oil – as well as movements in the exchange rate. UK goods price inflation has picked up sharply to 2.3 per cent in May, but is nowhere near the outlier-driven 8.1 per cent rise in the US. By contrast, services price inflation has been much more stable in both countries.

FIGURE 2 **There has been a sharp decoupling in UK and US goods price inflation**

Consumer goods and services prices, 12-month percentage change: UK and US



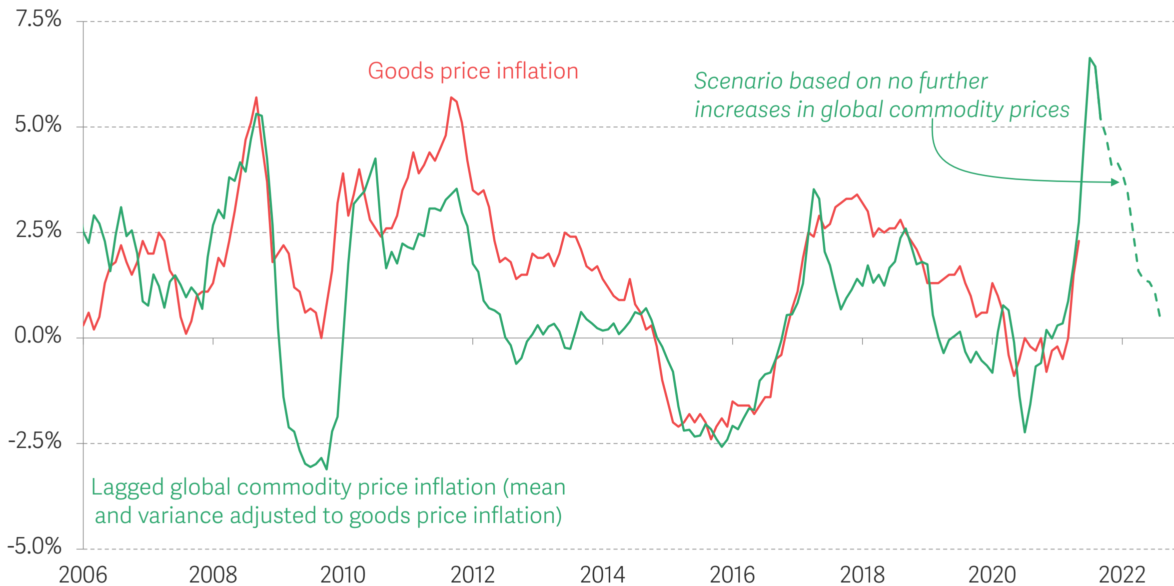
NOTES: UK and US inflation rates taken from consumer price index inflation.

SOURCE: ONS, Consumer price inflation; US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers, retrieved from FRED, Federal Reserve Bank of St. Louis.

Goods price inflation is likely to pick up further in the coming months, driving overall inflation above the Bank of England's latest forecast. As shown by the green line in Figure 3, based on historical mapping between global commodity prices, the normalisation in commodity prices in the wake of the pandemic could push UK goods price inflation to over 6 per cent in the coming months if global commodity prices remain around current levels. Based on the normal time taken for commodity prices to feed through into UK prices, goods price inflation would peak around July this year at levels not seen since the aftermath of the financial crisis, pushing overall CPI inflation above 4 per cent, holding other inflation rates fixed. This would be more than twice the level of inflation expected by the Bank of England for the Q3 this year (1.9 per cent).

FIGURE 3 **UK goods price inflation looks set to rise sharply given rising commodity prices**

UK goods price inflation and lagged global commodity price inflation, 12-month percentage change



NOTES: Global commodity prices are lagged by three months. Scenario holds the commodity price index at its May 2021 value for the rest of this year.

SOURCE: RF analysis of ONS, Consumer price inflation; International Monetary Fund, Global Price Index of All Commodities, retrieved from FRED, Federal Reserve Bank of St. Louis.

THERE ARE TWO KEY REASONS FOR THINKING THERE IS LESS SCOPE FOR LASTING INFLATION IN THE UK COMPARED WITH THE US

What matters is whether the short-term rise we anticipate above is signalling a more sustained rise in inflation. As discussed above, the main source of lasting inflation is when demand is running above the sustainable capacity of the economy. There are two reasons for thinking that UK inflationary pressures will be significantly weaker on this score than those in the US.

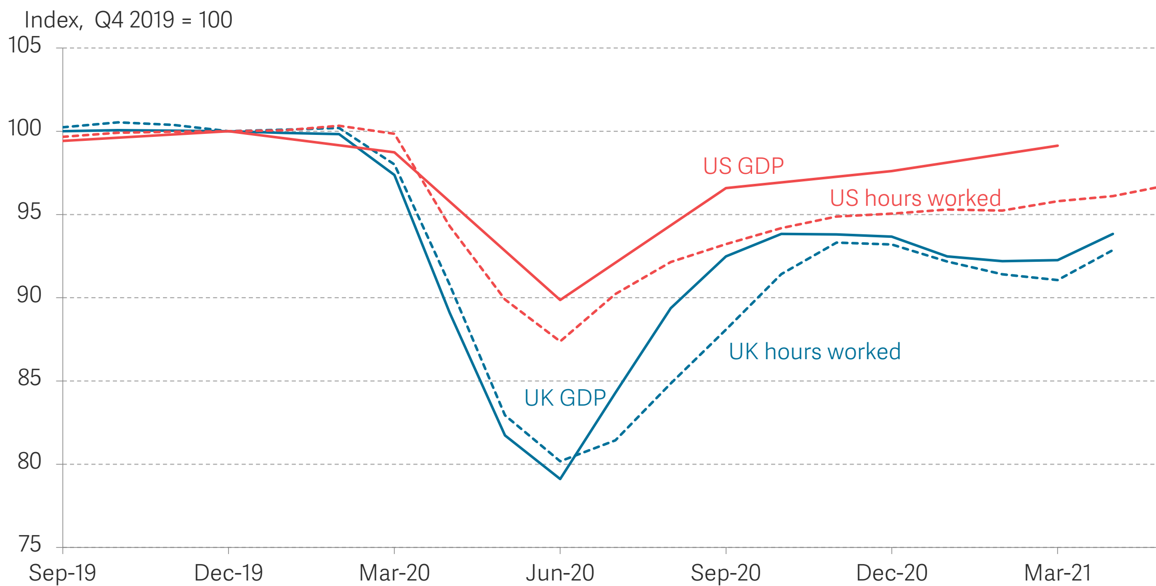
1. There has been a bigger hit to the UK economy and labour market suggesting that there is more spare capacity

First, the overall Covid-19 hit to the economy and the labour market is significantly larger in the UK than it has been in the US. As shown in Figure 4, GDP fell by around 21 per cent in the UK in Q2 2020 compared with the final quarter of 2019, whereas the fall in GDP in the US was less than half that. The impact on the labour market – which is crucial for inflation prospects – is more complex. Headline unemployment has risen much more sharply in the US – to nearly 15 per cent – compared with a peak of just 5.1 per cent in the UK. This difference, however, is largely about measurement and reflects the approaches taken in the UK and US to supporting workers. In the US, many workers were put on 'temporary layoff' and became officially unemployed despite a large number returning to their original job, whereas the UK's Coronavirus Job Retention Scheme (JRS) saw workers remain officially employed. A measure of the size of the hit to the labour market that abstracts from these differences is to look at falls in total hours worked. As shown in Figure 4, as with the shortfall in GDP, it is clear that

the hit to the labour market is much larger in the UK. This suggests that spare capacity is larger for the UK than the US.

FIGURE 4 **The UK has had a considerably bigger hit to the economy and labour market than the US so is likely to have more spare capacity**

Level of GDP and total hours worked, three-month moving averages, Q4 2019 = 100: UK and US



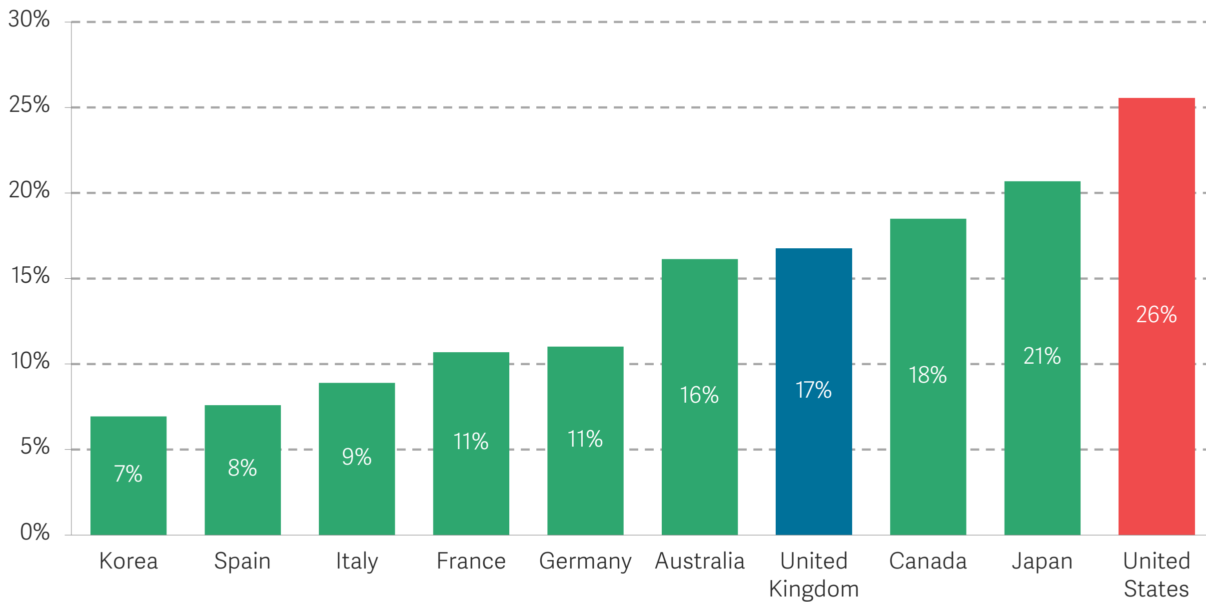
NOTES: US GDP is quarterly; all other series are monthly. US hours series is for the private sector, UK is whole economy.
SOURCE: RF analysis of ONS, GDP monthly estimate; ONS, Labour Market Statistics; US Bureau of Economic Analysis, Real Gross Domestic Product, retrieved from FRED, Federal Reserve Bank of St. Louis; US Bureau of Labor Statistics, Indexes of Aggregate Weekly Hours of All Employees, Total Private, retrieved from FRED, Federal Reserve Bank of St. Louis.

2. There is much more stimulus to come in the US than in the UK

Even if there is more spare capacity in the UK than in the US, a rapid recovery in demand could lead to that gap closing quickly and inflationary pressure emerging. In the US context, the $1.9 trillion stimulus embodied in the 'Biden Plan' suggests that demand may grow very rapidly. For the US some top economists have argued that this will close the output gap rapidly and generate a sharp rise in inflation. Figure 5 suggest this is much less of a concern for the UK, however. This is partly because the overall size of fiscal measures is smaller, and markedly smaller when put in the context of the hit to GDP (17 per cent for the UK compared to 26 per cent for the US). But it is also because while the stimulus under the Biden plan should start to boost the US economy over the next year or so, UK measures are winding down sharply with the tapering of the JRS starting in July.

FIGURE 5 **The US fiscal policy response has been substantially larger than elsewhere, including the UK, with much of that spending still to come**

Covid-19 policy response, as a proportion of GDP: selected countries since January 2020



NOTES: Only reflects 'Above the line measures' including additional spending or foregone revenues, but excluding loans, or contingent liabilities incurred as part of the policy response. Estimates as of March 2021.
SOURCE: IMF, Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic, April 2021.

SOME HAVE ARGUED THAT MONETARY POLICY SHOULD TIGHTEN TO HEAD OFF THE RISK OF HIGHER INFLATION – SUCH AN APPROACH RISKS MAKING US ALL POORER

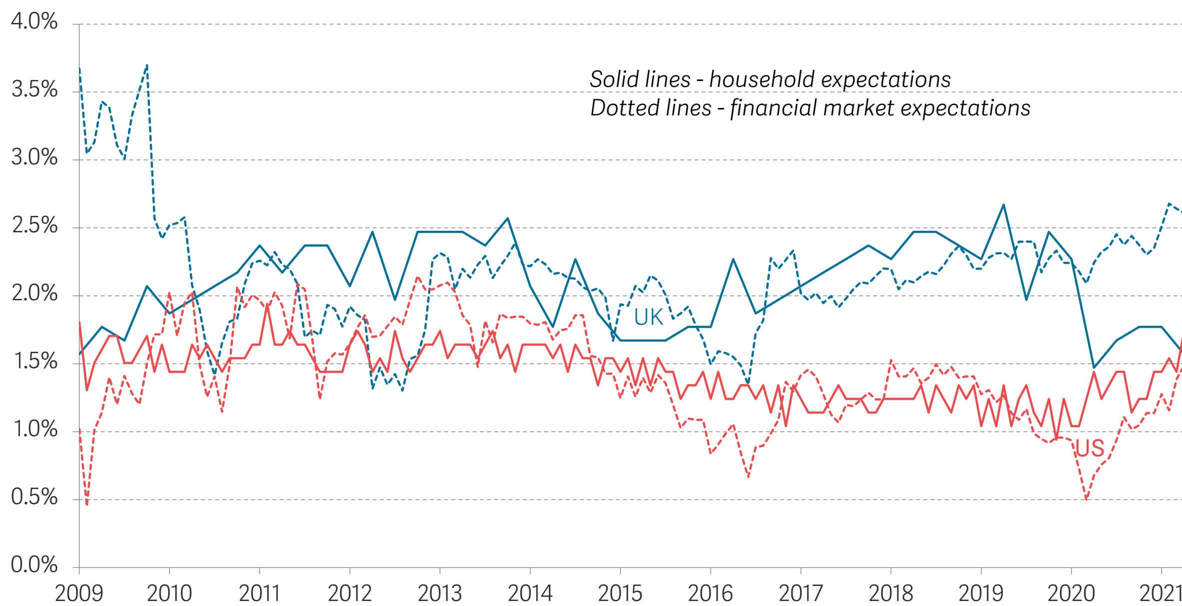
Overall, then, our view is that the recent rise in inflation reflects temporary factors. And, looking ahead, there is much less reason to think that fiscal stimulus will lead to capacity pressures – and a sustained rise in inflation – in the UK compared with the US. But the outlook is unusually uncertain given the impact of the pandemic so how should macro policy makers respond to all this? Because changes in interest rates take time to have their full effect on the economy, some have argued that policy makers should tighten policy in the near future in order to head off the possibility of longer-term higher inflation. Such an argument has its roots in the experience of the 1970s and 1980s when monetary policy was slow to respond to rising prices. This lead to entrenched higher inflation expectations requiring long, painful periods of high unemployment in order to put an end to disruptively high prices.

But the situation facing policy makers today is quite different. Most obviously, interest rates are now set by an independent Bank of England and so there is less reason to think that the mistakes of the past will be repeated. There is little to suggest the Bank will make the repeated policy errors needed to lead to a rise in longer-term inflation expectations. In fact, as shown in Figure 6, recent history tells us that inflation expectations have remained well anchored even when UK inflation spiked up to over 5 per cent in 2011. And while there has been some rise in market-based measures of inflation expectations back to around pre-pandemic levels (which appears to be linked to changes in how the Fed targets inflation – for more see our previous work), overall longer-term inflation expectations have

remained remarkably well anchored over the past decade – an assessment shared by the Bank of England in its recent Monetary Policy Report – despite large swings in inflation.

FIGURE 6 **Longer-term inflation expectations have remained well anchored**

Measures of household and financial market longer-term (five-year) annual price inflation expectations: UK and US



NOTES: Inflation expectations are calculated using a survey-based measure and have been mean adjusted to match the observed inflation (CPI for the UK, PCE for the US) from 2009 to 2020. For the UK, financial market expectations are 5-year instantaneous breakeven inflation rates, for the US they are 5-year spot rates, 5 years forward.
SOURCE: RF analysis of Bank of England/Kantar, Inflation Attitudes Survey; Bank of England, Yield curve data; University of Michigan, Surveys of consumers; Federal Reserve Bank of St. Louis, 5-Year, 5-Year Forward Inflation Expectation Rate, retrieved from FRED, Federal Reserve Bank of St. Louis.

Instead, policy makers should learn the lessons from the financial crisis and respond to the risk that a weak recovery could lead to greater lasting damage to the economy. Even prior to the pandemic, UK GDP was more than 15 per cent below a continuation of its pre-financial-crisis trend, with the premature withdrawal of policy support in the aftermath of the financial crisis widely accepted as a key part of this story. The big risk is that we make the same mistake again, withdrawing policy support too early, ending up with another disappointing recovery that leads to further lasting damage to living standards.

HIGHER INFLATION SHOULD BE A CONCERN FOR THE TREASURY RATHER THAN THE BANK OF ENGLAND

This Macro Policy Outlook takes a sanguine view on UK inflation: the forces pushing up on inflation in the near-term appear largely temporary and policy makers at the Bank of England should 'look through' their initial impact. Nonetheless, fiscal policy makers should not simply ignore the rise in inflation. An unexpected rise in inflation will be an unwelcome headwind to households' real incomes in the near term. A simple estimate illustrates the rough size of this effect: if inflation were to rise to rise to over 4 per cent in the coming months, as suggested by the scenario above, that would be equivalent to reducing inflation-adjusted average annual disposable incomes by around £700 in the

year to the first quarter of 2022 compared to a situation in which inflation followed the OBR's March 2021 forecast. This would act as an unwelcome headwind to the recovery and reinforces the argument for more support for the economy, and particularly for boosting household incomes – for example through maintaining the £20 per week UC uplift.

1 Input from Torsten Bell, Mike Brewer, Lindsay Judge, Gregory Thwaites and Jack Leslie is gratefully acknowledged.

2 The way that macroeconomists think about inflation is summarised in the New Keynesian Phillips Curve. That relationship (written as, $\pi_t = \beta E_t \pi_{t+1} - \kappa[u_t - u^*_t] + u_t$) is one where inflation, π_t, is determined by three factors: short-term, cost-push shocks, u_t, including those in international goods markets; how 'hot' the economy is running – often measured as the difference between unemployment the natural rate, $(u_t - u^*_t)$; and expectations of future inflation, $E_t \pi_{t+1}$.

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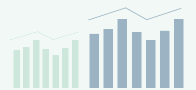

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