The Macroeconomic Policy Outlook

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2022 is shaping up to be difficult year for policy makers at the Bank of England. While the fastest recovery from a recession since the war is clearly good news, its unbalanced nature at home and abroad has led to a surprising and precipitous rise in inflation. The rise in inflation reflects a mismatch between demand and supply in the goods sector with continued strength in spending met by disruption to global supply chains and higher energy prices (a key input to producing goods). All this will be exacerbated by Russia's invasion of Ukraine which is pushing up energy prices and increasing uncertainty. All this has created significant uncertainty for the Bank of England and has plunged the UK into a cost of living crisis.

High inflation creates pressure for the Bank of England to act: with inflation at 5.5 per cent in December it is way above its 2 per cent target – and could reach 8 per cent in April. Following two rates rises in successive months, markets are expecting the Bank to raise rates at the fastest rate since its independence. But while high headline inflation creates the perception that the Bank has lost control of its target, it isn't the right metric for what it should do. Instead the key issue for the Bank is the extent to which a tightening labour market leads to lasting inflation through higher wage growth. Here, with the labour market already tighter than at the time of past interest rate rises we shouldn't be surprised that the Bank is eyeing tighter policy. The decision about how quickly to go is, however, finely balanced: tighten too slowly and higher wage demands will price many workers out of a job, raising unemployment; tighten too quickly and the Bank risks derailing the recovery. In this context, there are four reasons to proceed gradually. First, at the other end of town, the Chancellor is tightening fiscal policy rapidly – with the deficit forecast to fall at double the fastest recorded peacetime rate. Second, the rise in the cost of living will slow household spending as incomes fail to keep pace. Third, there is significant uncertainty about the extent to which labour market tightness will translate into rapid wage growth. And fourth, the situation in the Ukraine is likely to tighten financial conditions and increase uncertainty – further restraining demand. These factors suggest the Bank should resist market calls to raise rates rapidly.

[1] Useful conversations and input from Torsten Bell, Sophie Hale, Jack Leslie, Jonny Marshall, Krishan Shah and Gregory Thwaites are gratefully acknowledged (although the views in this note are the responsibility of the author).

This year is set to be a difficult one for the Bank of England. A huge rise in inflation and a tighter labour market point to the need to raise rates rapidly. Against that, headwinds on spending from the higher cost of living and the situation in Ukraine are set to slow the economy. All this creates huge uncertainty. So in this edition of the Macro Policy Outlook we look at the forces shaping this troublesome outlook and discuss what they mean for rate setters at the Bank of England.

A swift but unbalanced recovery has sparked a cost of living crisis

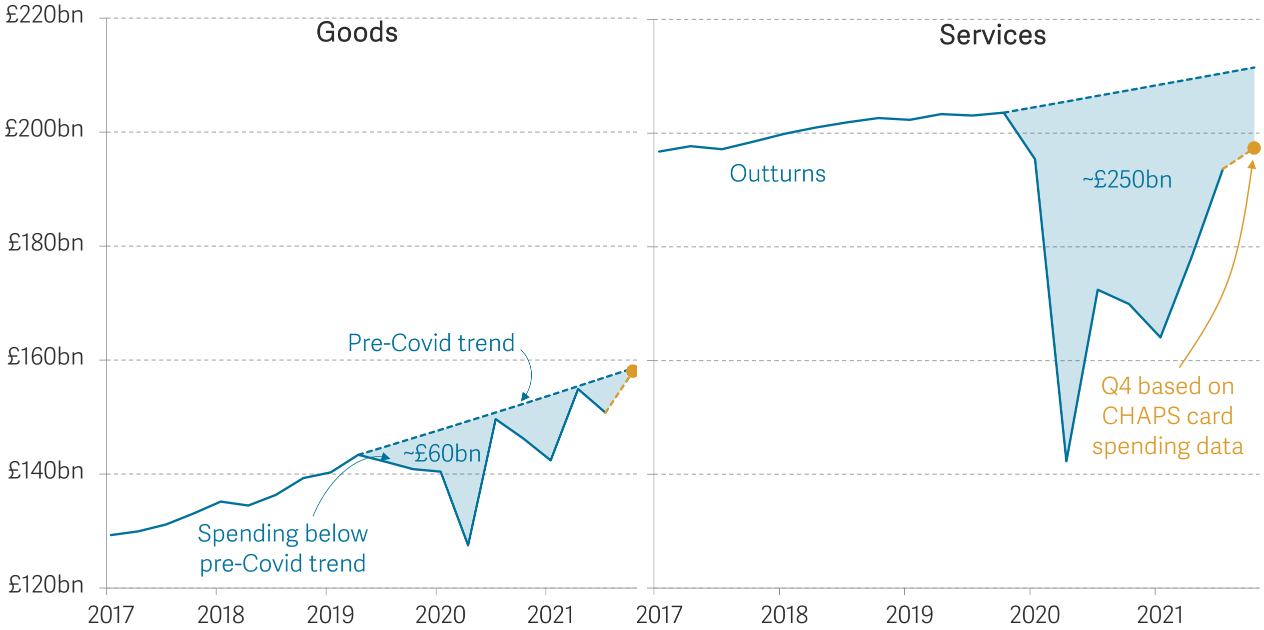
With the impact of Omicron looking like little more than a 'blip', the recovery appears strong. Despite monthly GDP contracting by 0.2 per cent in December as people pulled back from social spending, the recovery from Covid-19 has been quicker than expected. This is certainly good news, owing much to aggressive fiscal and monetary support during the pandemic. But the unbalanced nature of the recovery is creating a big dilemma for policy makers about how quickly to withdraw exceptional policy support.

On the demand side, the services sector is in a depression while the goods sector is booming

To understand why, we need to look at the big change in spending brought about by Covid-19 which has lasted into the recovery. Figure 1 shows that spending on services has fallen dramatically during the pandemic and timely data on credit card spending suggests it was around 7 per cent below its pre-Covid path in Q4 2021. This is not surprising given evidence that older people have continued to be cautious in returning to social mixing. Instead, households have upped their spending on goods (Figure 1, left panel). This is particularly true for durable goods (not shown) which was 2.6 per cent above its pre-pandemic trend in Q3 2021. This big shift in the composition of demand has proved more long lasting than expected, despite the economy recovering to its pre-pandemic size in November. It is also a global phenomenon with goods demand rising internationally but particularly in the US.

FIGURE 1: **Household spending has shifted away from services and towards goods**

Quarterly household consumption spending on goods and services, current prices: UK



NOTES: 'Pre-Covid trend' is defined as the average post financial crisis, pre-pandemic (2012 to 2019) growth rate. Q4 2021 estimate is based on the growth rate of CHAPS spending data for staple and social spending for goods and services consumption spending for services.

SOURCE: RF analysis of ONS, National Accounts & Economic activity and social change in the UK, real-time indicators

But on the supply side, the hit to the goods sector is larger

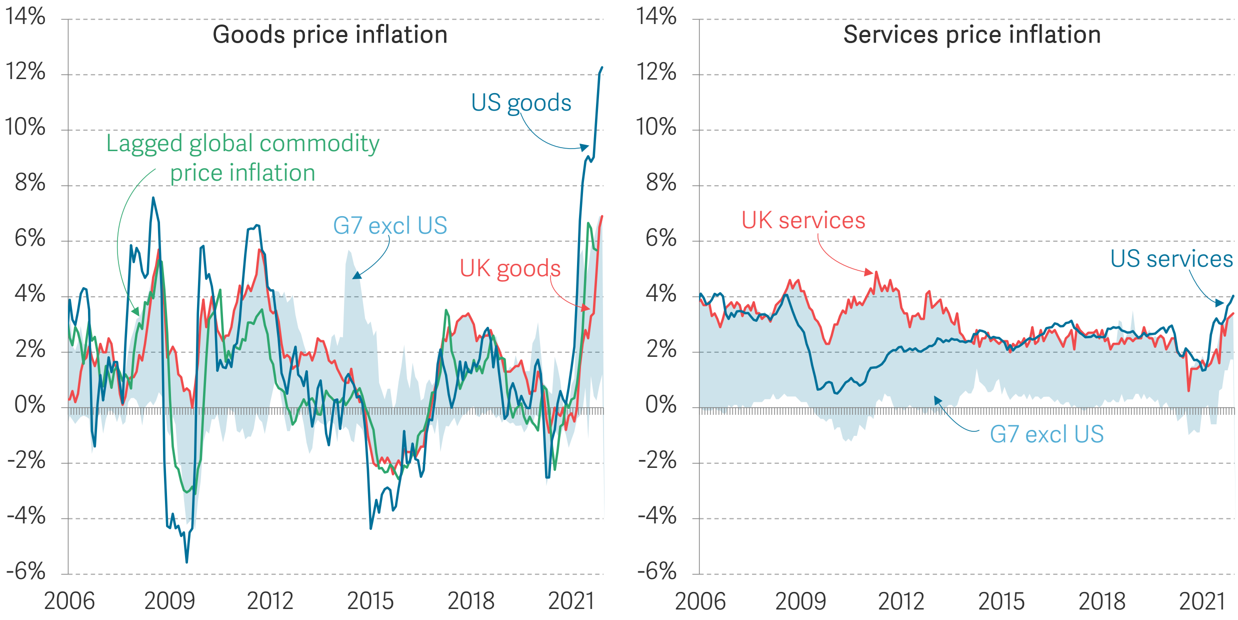
The pandemic has hit the supply of goods hard. Part of this comes domestically from the labour market where self-isolation absences and lower participation among the older workers has hit the goods sector to a similar extent to the services sector. But the goods sector is inherently global in nature. And global production has been disrupted by factory shutdowns and other disruptions to global supply chains. The Federal Reserve Bank of New York produces summary measures of these disruptions for different countries. For the UK, the measure of disruptions has more than tripled in the two years to December 2021 (although it has fallen by about a half since then). These disruptions affect global markets for tradable goods – exactly the place where demand has been strongest (durable goods are particularly tradable). On top of this, the huge rise in commodity prices – oil price inflation was around 70 per cent in Q4 2021, and has increased since – will also affect the supply of goods (think of this as a key part of the production process suddenly demanding a huge pay rise).

This unbalanced recovery has led to ballooning goods prices

Because the supply hit is larger in the goods sector where demand has been strong, the result is a jump in prices in that sector. As shown in Figure 2, goods price inflation has jumped across countries and is correlated with commodity price-developments. The higher price level means it will cost more for UK families to buy goods, making us poorer. The other point that stands out here is that the US experience has been much more extreme – reflecting even stronger demand for goods as a result of fiscal stimulus measures. And although inflation has broadened to the service sector – including in the US – it remains much more contained here than in the goods sector.

FIGURE 2: **Goods price inflation has risen internationally**

Goods and services price inflation rates: G7 countries



SOURCE: RF analysis of 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; OECD, Consumer Price Inflation; and IMF, Global Price Index of All Commodities, retrieved from FRED, Federal Reserve Bank of St. Louis.

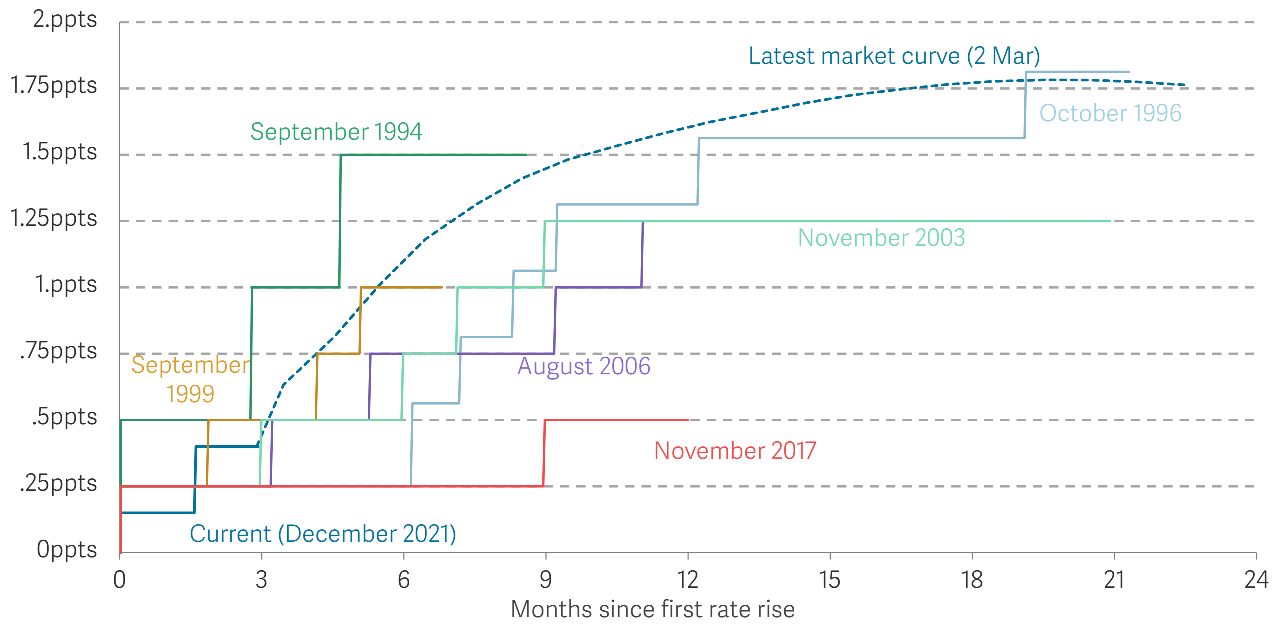
This will all be exacerbated by the Russian invasion of the Ukraine. Since the invasion started, oil prices have risen to over $100 per barrel (above $110 per barrel at the time of writing) for the first time since 2014. Gas prices have spiked further, leading some to speculate that the energy price cap could rise to around £3,000 when it is next reviewed in October (having previously risen by 54 per cent in April to reach £1,971). If this were to happen – some estimates suggest that inflation could rise to 8 per cent or higher, and remain above 6 per cent into next year – well above the Bank of England's forecast made just a few weeks ago.

High headline inflation puts pressure on the Bank of England

The failure of the Bank of England to meet its primary objective (of 2 per cent inflation) puts it in an uncomfortable position. With inflation already at 5.5 per cent in December, and set to rise much higher in the coming months, there is a pressure for action. That pressure is exacerbated by the extra inflation arising from the situation in the Ukraine. The Bank has already raised rates in two successive months (by 0.4 percentage points in total, to 0.5 per cent) with more expected. Indeed, as shown in Figure 3, based on current market prices, rates are expected to rise by around 1.6 percentage points by the end of the year, which would be the fastest rate tightening cycle since the Bank was granted independence in 1997.

FIGURE 3: **Markets expect rates rises to come more quickly than in past tightening cycles**

Bank Rate during past tightening cycles (percentage points): UK



SOURCE: RF analysis of Bank of England, Yield Curves; and Bank of England, Bank Rate.

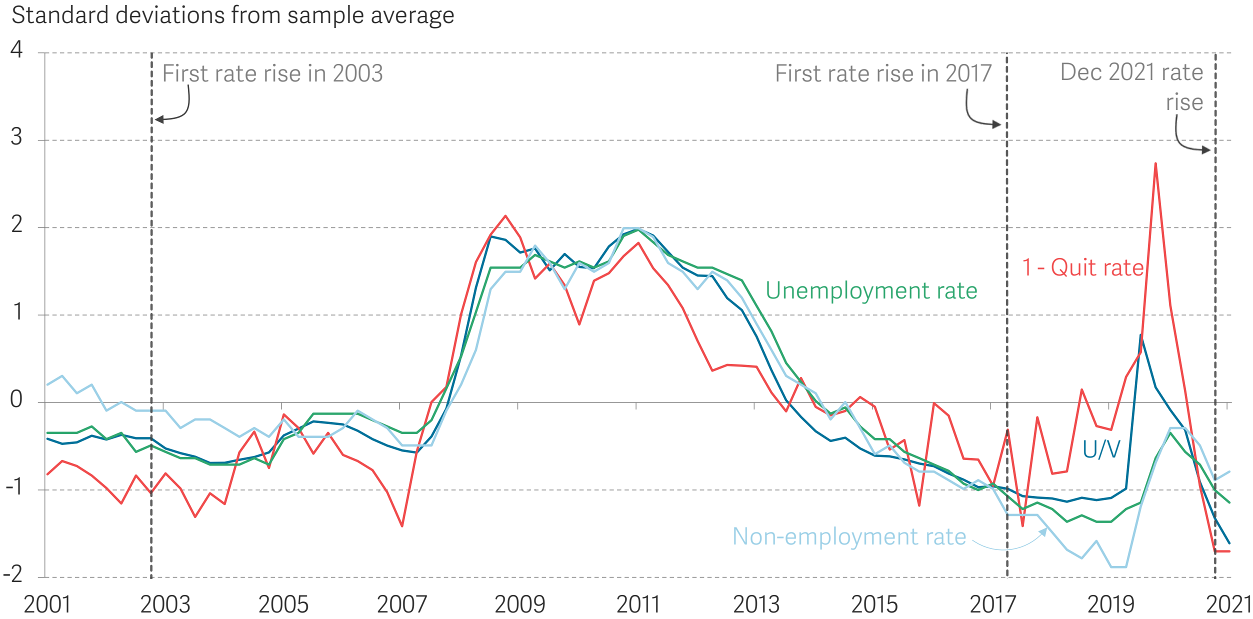
Many commentators have leapt on high headline inflation as the key driver for this decision – but this is not the right metric for what the Bank should be doing. Rather than a sign of generalised inflationary pressure, the rise in the relative price of the goods we buy is telling us we are going to be poorer. The Bank can't do anything about this – interest rate policy is not targeted towards specific sectors and works with a delay so, as set out in a recent speech by Silvana Tenreyro, rates would have had to rise considerably during the pandemic to have stopped the current rise inflation – derailing the recovery and pushing unemployment above 10 per cent. Instead it is the labour market which decides who pays the price: if workers bargain to maintain the real value of their wages, the impact will be a concentrated rise in unemployment; if wage rises are more contained, real incomes will take the hit with a smaller rise in unemployment. (This is what lies behind Governor Bailey's well-publicised call for wage restraint.) The Bank's contribution to the response to inflation is stop the current spike in inflation becoming a longer-lasting phenomenon.

The key for the Bank, then, is to focus on the labour market where indicators of tightness suggest the Bank should be on a gradually tightening path but there is massive uncertainty about the extent to which this will translate into wage rises. As shown in Figure 4, the labour market is tightening across all key metrics. In a tight labour market, higher inflation is more likely to lead to increased wage demands and lasting inflation. In this context it is striking that all four of the measures of labour market tightness signal more inflationary pressure than at the time of the first rate rise in 2003; and all but the non-employment rate signal that the market is tighter than the first rate rise in 2017. Based on past decisions, then, rates should be on the rise.

But there is massive uncertainty about the extent to which rate rises will be needed to stop the tight labour market from leading wages to increase to the point where higher inflation will become entrenched. Information from the Bank of England's regional agents points to a sharp rise in wage settlement – to around 5 per cent. So far, settlements are coming in much weaker but there is a risk they could rise sharply.

FIGURE 4: **Measures of labour-market tightness are giving an unusually divergent view at the moment**

Measures of labour market tightness: UK



NOTES: Measures are scaled such that the more negative the number, the tighter the labour market is on that measure. Quits are seasonally adjusted using X-11 method. All series are normalised to standard deviations relative to the sample mean for the period shown in the chart.

SOURCE: RF analysis of ONS, Labour Market Statistics.

Policy makers must decide how quickly to withdraw stimulus

The rise in the cost of living implied by this bout of inflation will reduce family spending power, hobbling growth. But the extent of that slowing is also uncertain. At the moment, notwithstanding the Omicron blip, we are in an economic 'sweet spot' in which better off households are returning to spending on services, but are also continuing their goods splurge. Demand is likely to slow as prices rise but also because the scope for services spending 'catch-up' growth is limited (for reasons explained here – the key idea is that you might go out for a more expensive meal, or have a pricier haircut – but it's unlikely that all that spending will match the spending lost in nearly two years of the pandemic). Against that, families have built up almost £200 billion of 'excess' deposits in the bank that they can use to keep spending in the face of the cost of living rise (although such savings are skewed towards the top of the distribution among those with lower propensities to spend). The invasion of

Ukraine will probably provide a further headwind to spending – increasing uncertainty leading to a tightening in financial conditions.

Fiscal policy is tightening rapidly and adds to the case for raising rates only gradually

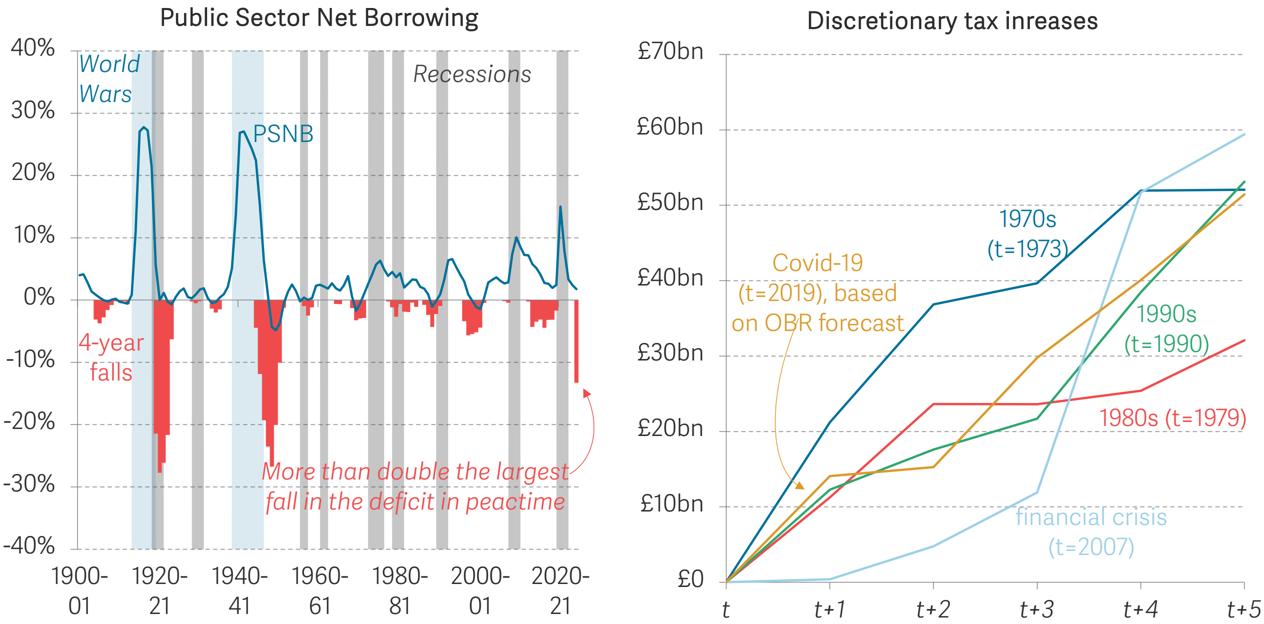
Meanwhile on the other side of town the Chancellor is also tightening fiscal policy. Government debt has risen from around a third of national income to being roughly equal to it over the past 15 years. This is awkward for a Chancellor clearly bent on building a reputation for sound money management, and who has been open that he intends to cut taxes and shrink the size of the state. Reflecting this, a new fiscal framework was announced at last year's Autumn Budget – in which the Chancellor pledged to have debt falling within three years.

Following that, fiscal policy is now tightening very rapidly – with public sector net borrowing (PSNB) forecast to fall by 13.3 percentage points in the four years to 2024-25 – more than double the fastest recorded rate over such a period (of 5.7 percentage points) in the four years to 1997-98. The Chancellor is now in the mode of reducing discretionary spending wherever possible – a key reason why support for families in the face of a cost of living catastrophe was designed to minimise the impact on the public purse. That suggests fiscal policy is set to become a drag on the economy.

One counter to this is that the fall in the deficit includes the withdrawal of emergency measures only appropriate during lockdown (for example the end of the furlough scheme). But, as the right-hand panel of Figure 5 shows, it is not just that the deficit is falling as exceptional measures end – discretionary tax rises are being applied at their fastest rate since the 1970s (when tax rises sparked a 'double-dip' recession). This matters far more than the tightening in monetary policy (a small rate rise will do "diddly-squat" to the growth outlook according to one former policy maker).

FIGURE 5: **UK fiscal policy is tightening very rapidly**

Changes in PSNB and discretionary taxes rises after recessions: UK



NOTES: For discretionary tax rises chart, t = year of pre-recession GDP peak. This chart uses financial years. Covid-19 shows OBR forecast made in October 2021. Based on forecasts from the time meaning actual impacts on tax revenue may have differed. Converted into 2019-20 prices using the GDP deflator.

SOURCE: Analysis of OBR, PSF Databank and Economic and Fiscal Outlook, October 2021.

Overall, then, there is a strong case for the Bank of England to respond to this difficult outlook by raising rates only gradually. With inflation spiking and energy prices rising sharply, the Bank's forecast is for real incomes to be squeezed by around £1,000 on average this year, providing a significant headwind to spending. The Russian invasion will act as a further brake both by pushing up inflation higher as mentioned above, but also by increasing uncertainty about the economic outlook and tightening financial conditions. The Bank cannot provide targeted support in the face of these headwinds – so it is down to the Chancellor to provide support to poorer households (richer households have tended to build up savings during the pandemic). Instead, these headwinds, combined with uncertainty about the extent to which labour market tightness will feed into wage increases and strength of underlying demand, imply a strong case for caution on the part of the Bank in terms of raising rates. Indeed, policy makers must be ready to respond if growth turns out weaker than expected.

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