The Macroeconomic Policy Outlook

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In this edition of the MPO we consider the nature of the inflation challenge facing the Bank of England and the impact of the 'Mini Budget' on it. Here it is important to remember that the colossal scale of the energy shock – which for household incomes could be three times the size of that in the 1970s – means we shouldn't be surprised that inflation is at a 40-year high. But what matters for the Bank of England interest-rate decisions is the extent to which this high inflation risks becoming entrenched. This can happen if workers are successful in resisting falls in the real value of wages in the short term and a wage-price 'spiral' take hold. Or if firms use high inflation as cover for increasing profits. Based on the data so far, however, claims that we are heading back to the 1970s look overdone. While growth in total private-sector pay at 11.5 per cent earlier this year was much stronger than we might expect even given low unemployment, much of this reflected compositional changes in the labour force, as well as one-off bonus contributions which haven't presaged higher future pay growth in the past. The other margin of adjustment to higher inflation is firms' profits. Here businesses do not seem to have increased profits significantly – indeed, profits are falling in aggregate – nor do survey measures suggest they are planning to in the coming quarters. Overall, the adjustment to the energy shock so far looks quite different to that of the 1970s.

But that does not mean all is well from the Bank of England's perspective. At 4.7 per cent underlying private sector regular pay growth is well above the 3 to 3.5 per cent range consistent with the inflation target. Some of this is because the labour market is tight, but around 1 percentage point appears to reflect the impact of high inflation on wages. History suggests a 2-percentage-point rise in the unemployment rate has been required to squeeze such extra wage inflation out of the system. This explains why the Bank has been raising rates rapidly, and why its August forecast embodied a rise in the jobless rate to above 6 per cent. Since then, the Government's Energy Price Guarantee and measures in the 'Mini Budget' mean that while the near-term peak in inflation will be lower, there will also be more upward pressure on prices in the medium term. Worryingly, recent IMF work suggests that it is the persistence of high inflation that plays a key role in embedding high inflation. So while the risk that high inflation is here to stay has so far been contained, Government policy has increased this risk, increasing expected interest rates and pushing back the date at which the Bank may be able to cut rates to support a recovery from the cost of living crisis.

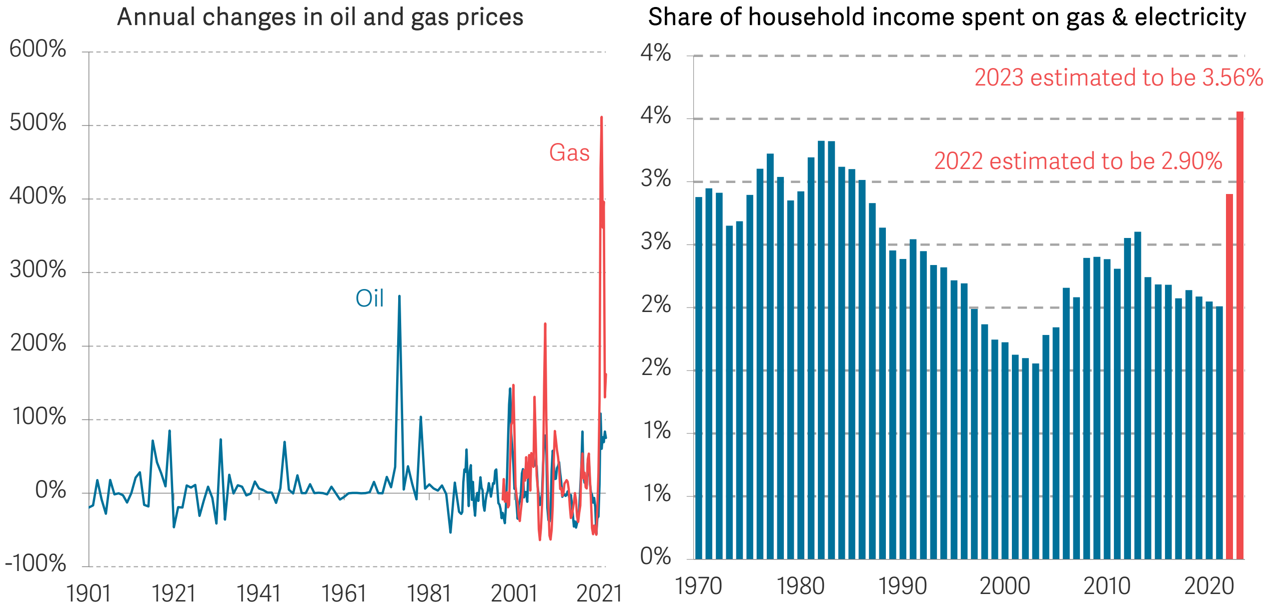
1 Conversations with staff at HM Treasury and the Bank of England are gratefully acknowledged, as are comments and contributions from others at the Resolution Foundation, including: Torsten Bell, Nye Cominetti, Hannah Slaughter and Gregory Thwaites.

High energy prices mean we're poorer, but also risk leaving us with lasting high inflation

Households are facing an unprecedented shock to the price of energy. As shown in Figure 1, wholesale gas prices in particular have risen by a factor of 10 since 2019 – equivalent to oil prices rising to £500 per barrel over the same period. And if families consumed as much gas and electricity this year and next as they did in 2019 energy-bill spending would still rise by 1.6 percentage points as a share of disposable income despite recent falls in energy prices – that would be nearly three times the size of the income hit during the 1970s oil price shock. This, combined with other increases in the prices of imported goods means that we are poorer as a country and shouldn't be surprised that headline inflation is currently is at a 40-year-high.

FIGURE 1: **There has been a colossal shock to energy prices**

Annual changes in the price of oil and gas (left-hand panel) and share of household income spent on oil and gas (right-hand panel)



SOURCE: RF analysis of Bank of England, A Millennium of Macroeconomic Data, Monetary Policy Report, August 2022 & Monthly average Spot exchange rates; Reuters, Europe Brent Spot Price; ICE, UK Natural Gas Futures; ONS, National Accounts; and BEIS, annual domestic energy price statistics.

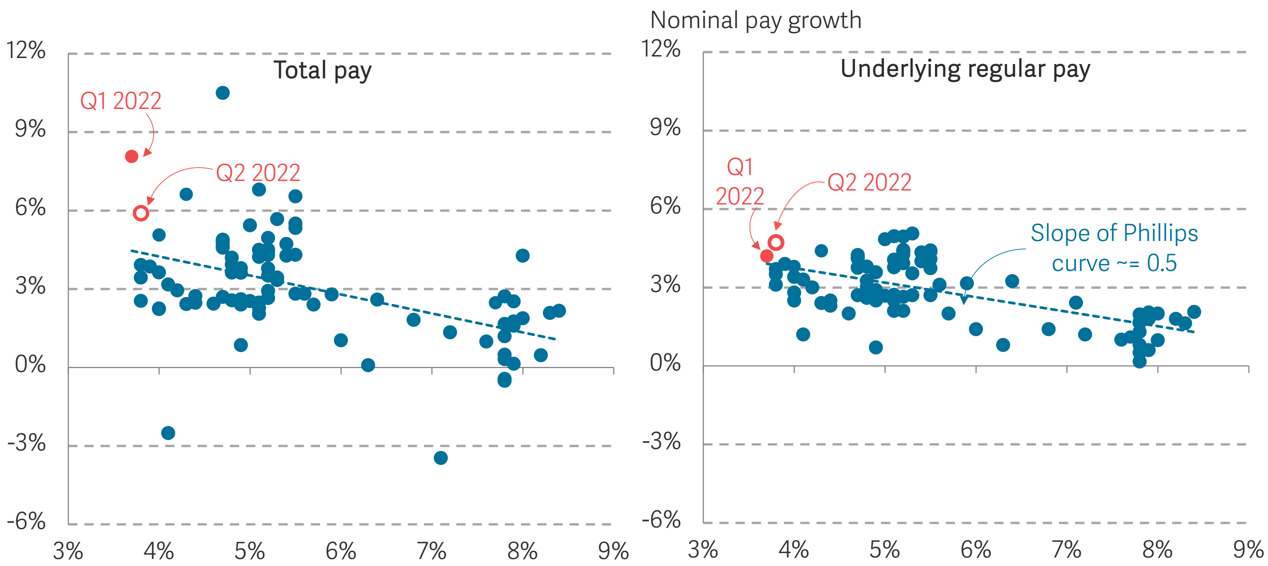
But what matters for the Bank of England's interest decisions is how the energy price shock and the fiscal statement translate into *lasting* inflation. The risk here that workers resist falls in the real value of their wages leading to a lasting period of high inflation as a wage-price 'spiral' takes hold as was the case in the 1970s, or that firms use high inflation as cover to increase profits. The key job of the Bank of England, then, is to prevent anything like this happening again by halting signs of an unsustainable inflation before they take. So how strong are these forces right now?

Claims that we are heading back to a 1970s inflation regime look overdone

Looking at total pay, there are clear signs of worry. Indeed, annual total pay growth reached 11.5 per cent in March. Figure 2 shows the link between labour market tightness and different measures of wage growth – the wage Phillips curve – since 2001. In Q1 2022 as a whole, total pay growth was significantly higher than suggested by the relationship over the past 20 years at 8.1 per cent (right-hand panel of Figure 2). But headline total pay overstates the problem because it is affected by compositional effects related to the pandemic, including from the furlough scheme which added around 1 percentage point to wage growth in Q1 2022. Total pay growth also includes bonuses which are backward looking and so don't always reflect the current tightness of the labour market directly. The contribution of such bonuses was particularly large in Q1 at 3.2 percentage points largely reflecting the contribution of bonuses paid in the financial and construction sectors.

FIGURE 2: **Total pay growth is worryingly high but regular pay growth is not out of line with tightness of labour market**

Private-sector wage growth and unemployment correlation: UK, 2001 to 2022

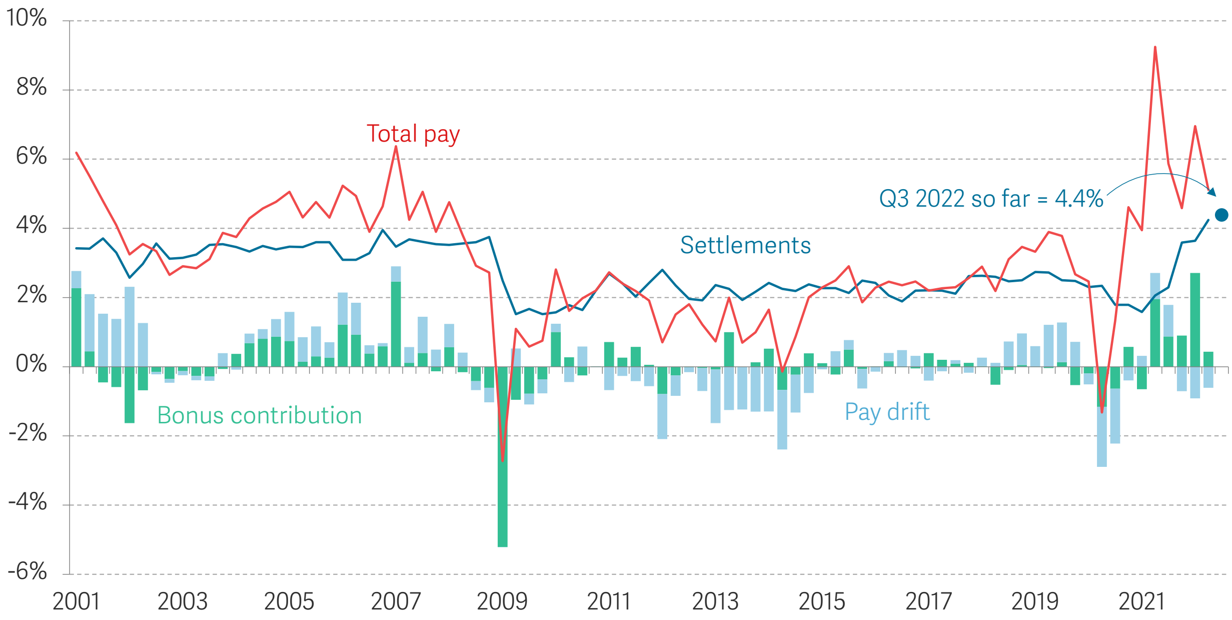


NOTES: Regular pay is Bank of England's underlying private sector regular pay growth from 2012 to 2022.
SOURCE: RF Analysis of ONS, Labour Market Statistics; and Bank of England, Monetary Policy Report, August 2022.

One reason to focus on high total pay is if bonuses are forewarning us of future pay pressures. Figure 3 shows different components of total private sector pay. Total pay can be thought of as being comprised of three components: basic settlements, that are the focus of bargaining between workers and firms; regular pay 'drift', the extent to which actual regular pay growth deviates from those basic settlements, for example because of overtime payments; and bonuses, which are one-off payments given to reward past performance. Even though bonuses are backward looking, firms paying higher bonuses could be a sign of firms competing for scarce labour and so be forewarning of stronger regular pay growth and settlements in future. Here statistical tests (Granger causality tests) suggest that overall private-sector bonuses do not help predict future changes in settlements or regular pay. Overall, then, we view timely and comprehensive data on settlements and regular pay as the key measures of pay growth with which to compare the tightness of the labour market. In practice, timely official AWE data on regular pay means that this is the measure we focus on.

FIGURE 3: **High bonuses do not seem to presage higher settlements or regular pay**

12-month growth in total pay and settlements with contributions from bonuses and pay drift: UK



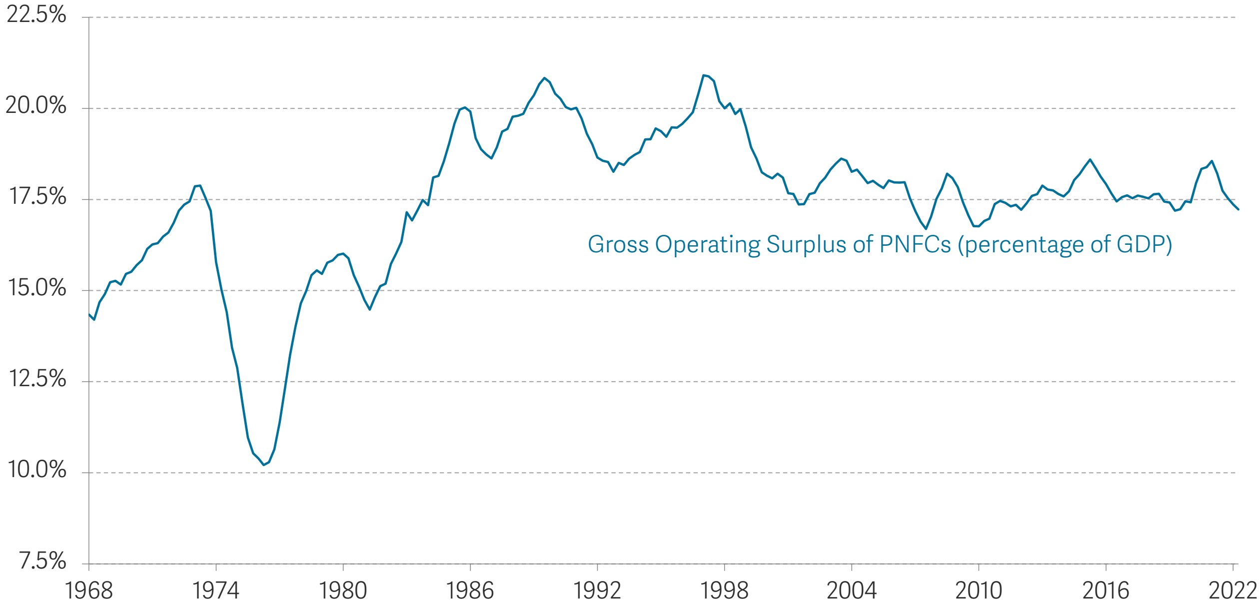
NOTES: Settlements shows the mean of whole-economy pay settlements as recorded in Incomes Data Research, Pay Benchmarker.
SOURCE: RF analysis of ONS, Labour Market Statistics; Incomes Data Research, Pay Benchmarker.

Firms do not seem to be using high inflation to increase profits

Another way high inflation could become embedded is if firms resist falls in profit margins. If profits were not part of the adjustment to higher import prices, this would mean that wages needed to fall even further. There is, however, little sign – in aggregate at least – that this is happening. As shown in Figure 4, non-financial firms' gross operating surplus has fallen as a share of GDP over the past year (from 18.2 per cent in Q2 2021 to 17.2 per cent in Q2 2022) with the level slightly below the pre-pandemic long-run average (of 17.4 per cent). So while there is some evidence of profits rising, particularly in energy-producing sectors, the aggregate picture is one in which firms reducing profits in response to the rise in imported inflation.

FIGURE 4: **Profits do not seem to be rising more quickly in industries with higher inflation**

Gross Operating Surplus of PNFCs (percentage of GDP)



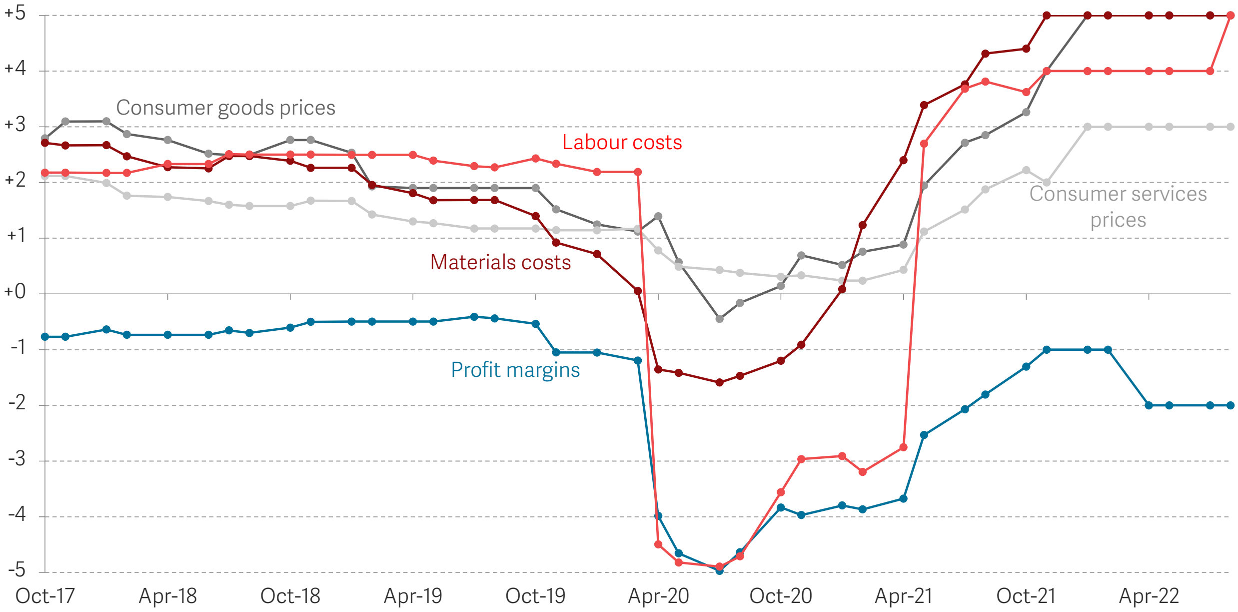
SOURCE: RF Analysis of ONS, National Accounts.

And looking ahead, survey evidence does not suggest firms are raising profit margins. The Bank of England's network of Regional Agents produce a set of judgement-based scores of the economic conditions faced by firms across the country. Figure 5 shows the recent trajectory of these scores for prices, costs and margins. It shows that while prices, particularly those of consumer goods, have been rising rapidly over the past year, these have been matched by a sharp increase in the labour costs and material costs over the same period. The net effect of this is that firms are reporting that their margins are under pressure relative to 'normal' conditions suggesting that recent increases in prices are still consistent with firms decreasing profits as part of the adjustment to higher energy prices.

So it does not look like firms are using high inflation as excuse to increase profits. Indeed, on bptj profits and wages we see real falls that are consistent with this not being a rerun of 1970s where people were better able to protect their positions at least temporarily.

FIGURE 5: **Bank of England's Regional Agents' survey does not suggest firms are increasing their profits**

Bank of England Regional Agents' scores on pre-tax profitability, consumer goods prices, consumer services prices, labour costs and material costs: UK



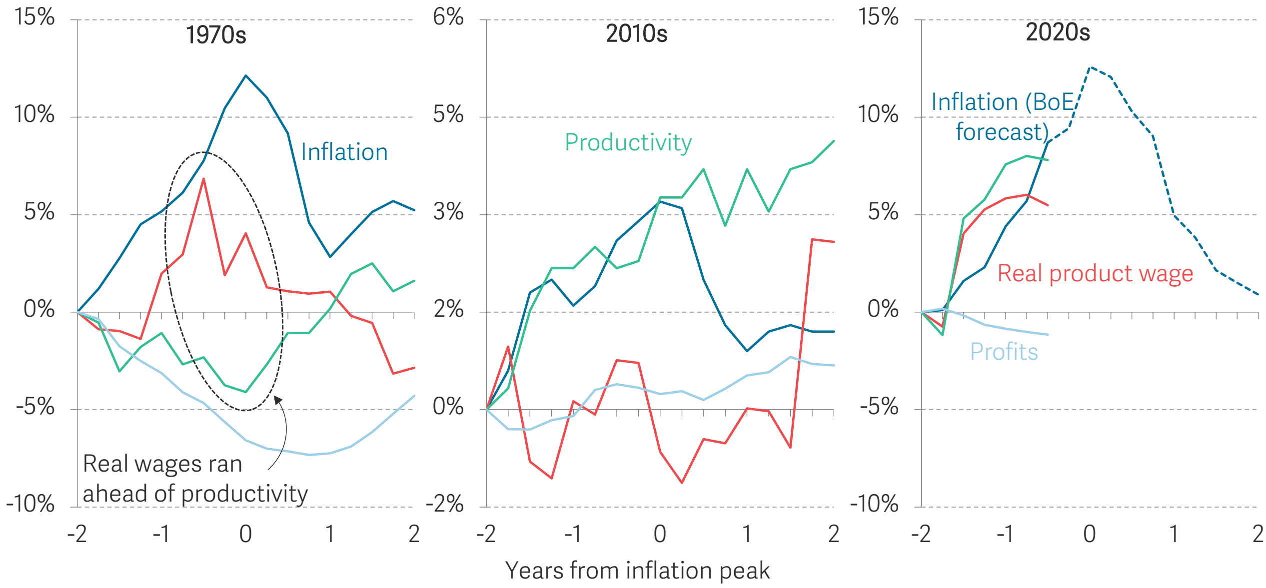
NOTES: Agents' scores vary between +5 and -5 referring to whether agents see the variable increasing or falling. Value for profit margins reflects conditions relative to normal where 0 indicates 'normal' conditions.
SOURCE: RF analysis of Bank of England, Agents' Scores Spreadsheet.

The adjustment to the energy price shock so far looks quite different to that of the 1970s

As shown in Figure 6, the dynamics of wages, profits and productivity have been very different during the 1970s oil price shock, the 2010s rise in oil prices and the current episode (using the Bank of England's forecast to date the peak in inflation). In the 1970s, real wages grew more quickly than productivity, and profits fell significantly. Workers effectively priced themselves out of jobs – with unemployment rising by more than 600,000 to around 1.5 million. Inflation remained stubbornly high as a pronounced wage-price spiral took hold. The result was that unemployment increased in the aftermath of the rise in energy prices and remained elevated for more than a decade – only falling back after unemployment had risen to over 3 million. This illustrates the costs of trying to bring down embedded high inflation. By contrast, during the 2010s real wages remained stable despite a sharp increase in inflation, with profits increasing slightly. During that episode inflation fell back sharply, to below 2 per cent within two and half years, and unemployment fell.

FIGURE 6: **The 1970s period of high inflation illustrates the costs of trying to bring down embedded high inflation**

Change in productivity, real wages and profits around the peak of inflation during episodes of energy-driven inflation: UK



NOTES: In all cases inflation is CPI, productivity is output per worker, the profits measure is gross operating surplus (excluding the alignment adjustment) as a share of GDP, and the real product wage is 'wages and salaries' deflated by the GDP deflator. 1970s inflation peak = Q2 1975; 2010s = Q3 2011; and 2020s = Q4 2022.
SOURCE: RF analysis of ONS, Quarterly National Accounts, Consumer Price Inflation and Labour Market Statistics.

During the current episode real wages have been clearly falling, particularly relative to productivity growth (Figure 6, far right panel). Indeed, while wage growth has picked up, they have not kept pace with increases in the GDP deflator (let alone consumer price inflation which is higher because of the larger weight of imported goods in the CPI basket). This means that profits have been broadly flat so far. Taken together, then, looking across the labour market, the signs that high inflation might become embedded are so far confined to the labour market. And, even there, the dynamics look very different to the those of the 1970s. This difference with the 1970s should not come as a surprise given big differences in labour market institutions (for example, much lower levels of unionisation) and the framework for setting monetary policy (we now have an independent Bank of England)

But those who claim there is no problem here are being too sanguine

There clear signs that high inflation is affecting wage bargaining, underpinning the Bank of England's current policy trajectory of raising rates. Underlying private sector regular pay growth of 4.7 is still well above the 3 to 3.5 per cent range consistent with the 2 per cent inflation target. That range is both consistent with wage growth during periods in which inflation has been ±1 percentage point of the inflation target, and consistent with 1 to 1.5 per cent productivity growth plus the 2 per cent target. Some of this difference reflects the tightness of the labour market: the unemployment rate was just 3.6 per cent in the three months to July – the lowest since 1974. But it is mostly because higher inflation seems to be bleeding into faster wage growth: as shown in the right-hand panel of Figure 2, underlying private sector regular pay growth is around 1 percentage point above what you would be expected based on the historical correlation with the unemployment rate at its lowest level in almost 50 years.

For the Bank of England, the scale of rate rises will depend on the extent to which workers are resisting falls in their real wages. Here, the Bank would need to be more aggressive if workers were pushing for very large pay rises in an attempt to keep pace with high headline inflation. The Bank's August forecast embodied a recession for five quarters and a rise in the unemployment rate to 6.3 per cent (our analysis is here). This is a bleak assessment, suggesting unemployment needs to increase by nearly 900,000 in order to squeeze workers' real wage resistance out of the system. But this is, however, broadly consistent with our assessment above. With inflation appearing to add around 1 percentage point to regular pay growth (this interpretation is consistent with Bank of England modelling – see Chart 2.17 in its August Monetary Policy Report), and with the slope of the wage Phillips curve of around 0.5 (Figure 2), this suggests a 'sacrifice ratio' – the amount of unemployment needed to reduce wage growth by 1 percentage point – is around 2. In turn, this implies that the unemployment rate would need to rise by around 2 percentage points to bring regular pay growth back down, similar to the rise incorporated in the Bank's forecast.

Measures announced by Liz Truss's Government have increased the risk that high inflation becomes embedded

Since the Bank of England August forecasts, the Government have announced measures that will add to inflation pressure in the medium term. While the Energy Price Guarantee will lower the peak for inflation this winter, it will raise it over the medium term. This is because while energy bills will be lower in the near term, the temporary nature of the policy means that energy prices will not be lower in the medium term, implying that inflationary pressure will be higher beyond the impact in the near term. That, combined with £43 billion in unfunded tax cuts which will boost demand in the coming years will put lasting upward pressure on inflation. In this context, it is worrying that recent work by the International Monetary Fund suggests that it is the persistence of inflation that matters more for the risk that high inflation will become embedded than the short-term peak in inflation. This is because lasting inflation has a bigger impact on expectations of future inflation. So while the risk that high inflation is here to stay has so far been relatively contained, the net effect of the EPG and 'Mini Budget' is to increase the risk of higher inflation becoming embedded. In turn, this has had the effect of markedly increasing market expectations of Bank Rate which is now expected to peak at 5.8 per cent – an increase of around 2.9 percentage points since the August.

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