Worlds apart? UK inflation and monetary policy in an international context

Transcript of Megan Greene Q&A with Brian Coulton, Chief Economist at Fitch Ratings.

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Brian Coulton: A lot of you charter are disaggregating CPI into the various components. I suppose the question is, are we being a bit too clever trying to be a bit too clever here in the sense that the CPI basket is what the ONS tells us that's what the typical British family spend their money on. Energy prices matter, everything matters. But the target is for the headline CPI. I'm reminded of Paul Krugman who got in a bit of hot water on social media a few months ago when he said if you look at CPI, excluding food, energy and rents, there's nothing to worry about. He got lambasted by just about everybody! So why don't just focus on headline inflation, if headline inflation gets back to the target, just take that as a win. Why do we need to unpick things like this?

Megan Greene: Why disaggregate and run all of these decompositions? We do expect headline inflation to come down to target in the second quarter of this year, which I think was widely expected. That was in our latest forecasts. So if inflation was coming to target, why don't we just start cutting. The answer to that is, well, first of all, we only expect inflation to come down to 2% briefly before it actually rises again, and then it's not due to hit the target until the end of the forecast period. So as a policymaker, given the lags in which monetary policy actually hits the real economy, we have to look at where we think things will be in the medium term. So unfortunately, I don't think we can declare victory just because headline inflation hit our target very briefly before changing again. That's part of the answer.

The other part is that not all inflation is created equal. Services inflation tends to be much more labour intensive than goods inflation, and so consequently, wages are a bigger piece of that and wages tend to be sticky. Also, services inflation tends to be less energy intensive, then a lot of goods inflation, and so as energy prices have come down, we're seeing goods pricing come down pretty significantly, but it's not doing quite as much work on the services side. And then services inflation tends to be more ore domestically driven. So as a UK policymaker, I can't do much about what's going on in the rest of the world. But I am interested in what's happening with the UK. So services inflation is a useful thing to look at from that perspective as well.

Brian Coulton: Just follow up on my last point, because that was something I read in the literature before the shock was that there was this consensus that with goods there's lots of global factors and that's not where monetary policy has an impact. It's on the services side [where monetary policy has an impact], which is consistent. So services are where you can make a difference. You can't affect the price of a barrel of oil, or food prices.

Megan Greene: Yes, I think that's right. I mean there are parts and services that are more internationally affected. So things like travel and tourism, package holidays, air fares. That's why one of the metrics that I showed you for core services inflation strips some of those out. But on the whole services inflation tends to be more representative of what's happening.

Brian Coulton: One thing I was really struck by in your presentation was that you started with the supply side. And that's quite unusual, most macro economist C +I + G. That's what you go through and then at the end, you get to the supply side. We used to think about the supply side as this very kind of slow moving kind of quantum and most macro models, including those that the central banks use to analyse the economy, you've got some five year average of productivity and then along comes a pandemic, and everything shuts down, and there's this massive supply shocks, but they're not very long lasting. And so the volatility on the supply side has gone up hugely, I think, compared to how we used to view the world before the pandemic. And obviously, a lot of your assessment is about the weakness on supply. So what are the big uncertainties there? And how is the Bank of England thinking about the supply side? Is it thinking about the supply side differently to how it how it used to before the pandemic and these massive shocks?

Megan Greene: so you’re right, it shouldn't shift around that much. It's more of a tanker than a Ferrari. That said, I do think we are seeing more volatility now. So you know, we had a lot of discussions about NAIRU, with the natural rate of unemployment, which we judged to be a bit higher than we had previously expected, you know, in the middle of the year, so I do think we're having more of those discussions. You can't measure or observe the supply side of an economy. So that also makes it rife with uncertainties. To my mind in terms of the labour supply piece, we haven't seen older workers come back into the workforce. There's an upside risk on that front and that if there is more remote working after COVID, and that's here to stay that actually might allow women or older workers to come back into the workforce because they can work from home. So that's an upside potential There have also been huge amounts of investments in AI and also in the green transition. And so it's possible those could feed through in a greater productivity growth. We haven't seen it come through in realised productivity growth numbers, yet. But that's often the case often it comes through with a lag. You know, when we invented the personal computer, I took 10 years to show up in productivity data. So we can expect it to come through at some point, pinning exactly when that will come through and boost productivity growth and therefore boost the supply side? That's really difficult. We've judged that to be longer term, but that's an upside risk.

On the downside, during COVID, a lot of micro firms sprang up, which on average tend to be less productive. And so in line with a higher borrowing costs, we expect some of those micro firms to fall out. And so just from a compositional effect, that should increase productivity growth. If that happens at a faster rate than we expect, then that could provide an upside. If that happens at a slower rate than we expect then you end up with zombie firms. That presents a real downside risk for our forecasts on UK potential growth.

Brian Coulton: You'll also frame your views on inflation, contrasting the supply side in the UK much weaker than what we're seeing in the US. But then also the demand side is much weaker than the US. So those two things kind of balance out a little bit. So is this something that you're looking at very closely, measures of the output gap and what's the analysis there?

Megan Greene: so yes, you'll note I didn't mention them partly because output gaps are also unobservable. And so they're really difficult to measure. When comparing jurisdictions, the ways that we're calculating the supply side and output gaps is pretty different. So the Congressional Budget Office is doing it differently than we are. The Bank of England's expecting the UK output gap actually to close in the first half of this year. So there's currently excess demand. But slack should open up that should take upward pressure off of inflation. The Congressional Budget Office for what it's worth, expects the output gap to be mildly positive this year in the US and then mildly negative next year. So there's a similar picture, I guess, and that there should be less inflationary pressure. But you can't just look at output gaps. You also have to look at how slack feeds through into inflation. And so you have to look at the slope of the Phillips curve, which is different in different economies, certainly different in the US and the UK. And estimating that is rife with its own uncertainties particularly off the back of all these shocks, we have all these nonlinearities. And so that is a kind of a Phillips Curve, adjusted output gap, is just a highly uncertain number, which is why we didn’t focus on output gaps.

Brian Coulton: when you think about the sort of the macroeconomics macro policy literature, before the pandemic and how useful it's been. It feels as if maybe we've learned that we don't know as much about the inflation process as we thought, you know, we had all these models that didn't seem to have worked very, very well. We’ve talked a lot about persistence. The BIS has published some very interesting research talking about low inflation regimes and high inflation regimes. And once inflation gets above a certain level, it stays there for a certain time. It kind of becomes self-reinforcing. There was, I can't remember which member of the ECB, called inflation a “greedy beast”. Once inflation starts, you know, firms realised everyone else is putting their prices up. And it's easy for them to do it themselves. And in a zero to 2%, inflation world, prices just don't move at all. That seems to be evidence, but that all changed in 2021. And so I guess that persistence element is really not something that's very well captured in the standard approach.

Megan Greene: that’s right, models aren't great as incorporating successive shocks and nonlinearities and that's what we faced over the past couple of years. To your point, I think the persistence of persistence is important as well. And that often works through inflation expectations, channels, if you've been above target for a certain period of time, that has a bigger impact on how things will go, going forward, than if you’ve only been above target for a little bit. There's a risk of inflation expectations becoming de- anchored, though, to be clear, we haven't actually seen any signs of that.

Brian Coulton: This reminds me a bit about the European unemployment debate in the 80s. There were of all these theories of what the driver of unemployment was. And the answer was, unemployment is driving unemployment.

Megan Greene: So that's the concern, that you get second round effects that end up being more persistent. And I think there's a real argument for us seeing more of that in UK than other jurisdictions.

Brian Coulton: I got a follow up on this as well, because, again, the concept called real wage resistance that we all used when we were studying inflation in the 70s and 80s. The price level goes up and people don't want to be poor, even though it's the terms of trade shock. If that adjustment doesn't happen, if wages keep pace with prices, then you're not going to get that adjustment in the economy and inflation is going to last longer. There was some interesting analysis by Chris Giles in the FT about how nominal wages in the UK, according to his charts have grown in the last three years by as much as prices. Which is very different to what we've seen in the Euro zone. So is that something that you're concerned about? That this is just the wage growth now was creeping through to the price growth and maybe it's not a wage price, spiral wage price spiral the whole thing will be accelerating, but certainly wage-price persistency.

Megan Greene: So wage catch-up has been a factor in the US, as I mentioned, it's also been a factor in the UK. I would say we should look at the data and I showed you the charts, various different metrics for wage growth. And what we're seeing is that actually wage growth is coming off from very high levels and remains at above target consistent levels, but it's heading in the right direction.

Brian Coulton: You had some charts on market expectations. That moved around a lot. So do you think these moves in the yield, the financial markets were just desperate to call an end to rate hikes. These shifts in the markets expectation. Do you think they're warranted by the data and do they matter for policy?

Megan Greene: So they teach you at central bankers school never to say that the market curve is wrong! And I'm particularly reticent to talk about other countries' curves. But as I mentioned, there is typically co-movement. So in the US, given how huge the bond market is there, often times tend to spill over in to other bond markets. Interestingly, as of the most recent non-farm payrolls data, 10 year government bond yields in the US were up 17 basis points. They were also up 17 basis points in the UK by the end of business that day. Which doesn't necessarily make sense. It's not clear how non-farm payrolls in the US actually affect the UK economy. So there is that co- movement. I showed you 1 chart, I could have shown you 4, showing that co-movement. So you know, the UK curve is much more affected by what's happening in the rest of the world. And in particularly, in the US. That's always the case. It's a bit more of the case now than usual, but as I tried to explain, I think there are some real idiosyncrasies about the UK economy, and about the persistence of inflation in the UK, that I've tried to tease out here, that suggests that we need to be a little bit more worried about persistence in the UK than in the rest of the world.

Given these curves are all pricing in the rate path. They're all pricing in rate cuts, for the US, Euro zone and UK and so I guess I'll just take the opportunity to highlight that there are rate cuts priced in for the UK. In time it's possible that there could be rate cuts, but that the policy stance is still restrictive. But I need to see more signs that persistence isn't as embedded as we previously thought. They're nice encouraging signs. I would need to see more of that before I vote to cut.

Brian Coulton: About uncertainties, what's the biggest? What’s the biggest puzzle if you like, about the UK economy?

Megan Greene: I would say the labour market is actually a pretty big puzzle, and the UK isn’t unique in this perspective. I think this is a developed economy phenomenon. Demand has been pretty weak in the UK and yet the labour market has held up remarkably well. So normally, if you had stagnating growth or even a small dip, you might expect to see unemployment tick up. We actually saw unemployment tick down in December in the UK, so the labour market is still pretty tight. It’s hard to work out exactly what's going on there. One possible explanation is labour hoarding. We hear that anecdotally from our Agents, whereby companies were so scarred by having to hire backup, when economies reopen, that they're just hanging on to workers in the hopes that we can all weather this soft patch and then they won't have to rehire and retrain people. We don't know how to measure labour hoarding. We don't know where the capitulation point might come in. We do know if companies were hoarding labour, that would probably not be great for productivity, if you're more headcount, and we are seeing pretty weak productivity out turns in the UK. So that's consistent.

We also know that labour matching - the matching efficiency in the UK - has fallen since before the pandemic, and so that only exacerbate labour recording. If it's harder to find the right workers, you might just hang on to the ones you have. But it could also be that all the work is being done by vacancies. So the vacancies numbers hit record highs during the pandemic in the UK and they've been coming down since the peak pretty consistently and so it's possible that unemployment need not tick up. We'll see all the work done on the vacancies side. There was a big debate in the US about this between Waller on the one hand and Blanchard and Larry Summers on the other hand. So you know, this time might be different. It's dangerous to say that as an economist, but, you know, the economy's been through a bunch of successive shocks that are unprecedented. So it's possible.

Brian Coulton: Let's not get into nonlinearities in the beverage curve! Final question from me, risks from the situation in the Middle East. How do you see them?

Megan Greene: Yeah, so I'll start by not pretending to be a Middle East expert, but to my mind the risk’s only on the upside for inflation, and only on the downside for output. And that puts central banks in a difficult place because then you’re in trade off territory. We've seen that shipping costs are not nearly as high as they were during the pandemic. But they have gone up. That hasn't fed through into the higher prices, in part because of how contracts are priced. And ships are going the long way around the Cape of Good Hope. So that represents a bit of a supply shock. If this is temporary, and sort of a continuation of the tensions we've seen, we expect the impact on inflation to be temporary and fairly moderate. If it lasts longer and extends to things like energy, then the shock would be bigger. I guess it's worth pointing out that global container capacity is increasing significantly over the next couple of years. So that take some of the edge off that supply shocks. So overall, you know, actually energy costs have fallen since November. And so we're not seeing the risk priced in the energy markets. Overall, if we saw a continuation of these tensions, there might be a moderate impact on inflation, but the risk is that it's bigger, so the risk is on the upside on inflation.