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UK Inflation Prospects

By John Greenwood

Overview

- On Wednesday, March 6th the UK government released its annual budget for the fiscal year 2024-25. Since the Bank of England became independent in 1997, Budget Day has been a fiscal, not a monetary event. In other words, the decisions taken affect the size and composition of government expenditures and revenues, not the monetary policies that will accompany the measures.

- Nevertheless, the Chancellor of the Exchequer claimed some credit for bringing down inflation over the past year. Except for some minor tax changes reducing retail prices, this is to be taken as political spin, not economic reality.

- In this article I first review all major episodes of inflation in the UK since the 1970s. The evidence in Section 1 shows that all episodes of high inflation have been preceded by rapid money growth, and conversely every period of low inflation has been accompanied by low and stable money growth.

- Section 2 focuses on the transmission process of money growth, especially the relation between overall inflation and changes in the various components of the CPI. Due to currently negative M4x growth, service prices or wages cannot, in my view, create a "second round" of inflation based on cost-push. Any rise in service prices is basically catch-up inflation as price increases from the 2020-21 surge in money growth filter through the economy.

- Since June 2022, the UK has seen a sharp slowdown of producer prices (PPIs) which are now being transmitted to consumer prices (the CPI). But note that on the downswing the lags tend to be much longer than on the upswing.

- The evidence suggests that CPI inflation will continue to fall in 2024, with no "second round" resurgence of inflation. If anything, the risks are on the downside – that is, prices are likely to fall well below the 2% inflation target in 2024 and into 2025.

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Introduction

At the February meeting of the BOE's MPC, only one member of the MPC voted for Bank rate to be reduced -- Swati Dhingra. However, her vote for a rate cut was based not on monetary analysis, but on her assessment of the transmission mechanism. In a speech entitled "Money's Too Tight (To Mention)" on 21 February she argued that there is a good relation between wholesale or producer prices and subsequent movements in the CPI, and since the PPI and its various components were already falling steeply, the CPI must fall soon enough.

Given the typical lag between the implementation of monetary measures (by which she meant a cut in Bank rate) and the impact on inflation, she considered it was appropriate to lower rates in February instead of risking overly tight money and (presumably) some degree of deflation over the next two or three years.

While Dhingra's analysis of the latter stages of the transmission mechanism is largely correct, she did not consider any of the monetary antecedents of the tight money she was describing. My analysis here will explain the tightness of UK monetary policy as judged by money growth – it is as tight in quantitative terms as at any time since the 1960s – and then proceed to place the transmission effects in proper perspective. The effect of the PPI on the CPI should be seen as simply one – relatively late-stage – impact of input costs on different output or consumer price indices. In short, her analysis, while fair and correct insofar as it goes, did not delve deeply enough into the underlying drivers of inflation.

Section 1. Broad Monetary Background to Past UK Inflations

One way to present the monetary case is to examine each episode of inflation in the UK to see whether it is preceded by excess monetary growth (which, on the basis of the evidence below, we take as a growth rate above 4-7% p.a.) Since quarterly money data for M4 is available from the mid-1960s, we start with the inflation episode of 1973-75.

Table 1 below shows the average year-on-year rate of M4 growth in the year or two prior to each inflation episode. Lags of one to two years were chosen since this is typical of the "long and variable" lags in effect between money growth and inflation. Note also that until the 1990s the only general index of consumer prices was the Retail Price Index (RPI).

An important result conveyed by this table is that the two inflations of 1973-75 and 1979-83 were each preceded by prolonged double-digit money growth. However, in the popular perception both episodes of inflation are associated with the two oil crises of 1973 and 1979. Many economists also mistakenly blame the oil price hikes by OPEC, which were ***relative*** price increases, for the ***general*** price increase that occurred. (In my view economists made the same mistake with reference to the start of the Ukraine war and the associated oil price hikes in February 2022.) In the case of the 1973-75 inflation, M4 grew at an average of 19.5% p.a. for the three full years

1971-73. In the case of the 1979-83 inflation, M4 grew at an average of 16.3% for an astonishing five years, 1978-82.

Table 1. Every Episode of UK Inflation since the 1970s has been Preceded by Excess Money Growth.

	Average Money Growth (% yoy)	Av Nominal GDP Growth (% yoy)	Peak Inflation Rate (% yoy)	Average Inflation (% yoy)
Barber Boom & 1st Oil Crisis	M4 +19.5% p.a. 1971-73	17.8% p.a. 1973-75	RPI 26 .6% August 1975	RPI 16 .4% p.a. 1973-75
Callaghan Legacy Inflation & 2nd Oil Crisis	M4 +16.3% p.a. 1978-82	13.6% p.a. 1979-83	RPI 21 .6% May 1980	RPI 11.3% p.a. 1979-83
Lawson Boom	M4 +15.8% p.a. 1986-1990	9.2% p.a. 1988-91	RPI 10.4% August 1990	RPI 7.0% p.a. 1988-91
Covid-19 Pandemic	M4x +10.1% p.a. 2020-21	9.2% p.a. 2021-22	CPI 10.8% Dec 2022	CPI 6.0% p.a. 2021-2022

The surge of inflation in 1988-91 was triggered by the Lawson boom, a period when the misguided policy of "shadowing the Deutschemark" led to M4 growth averaging 15.8% for the five years 1986-90. Similarly, the latest episode of inflation during the Covid pandemic was triggered entirely by the Bank of England's policy of large-scale asset purchases (QE) between March 2020 and March 2022, which directly increased M4x by an average of 10.1% p.a. over the two-year period 2020-21.
The evidence, then, is fully consistent with the view that excess money growth causes inflation. Indeed, as the table shows, every episode of inflation in the UK since 1970 has been preceded by excess M4 or M4x growth.

Conversely, we can make the case for better monetary control by examining episodes of low inflation and observing whether such periods have been preceded by low and stable money growth.

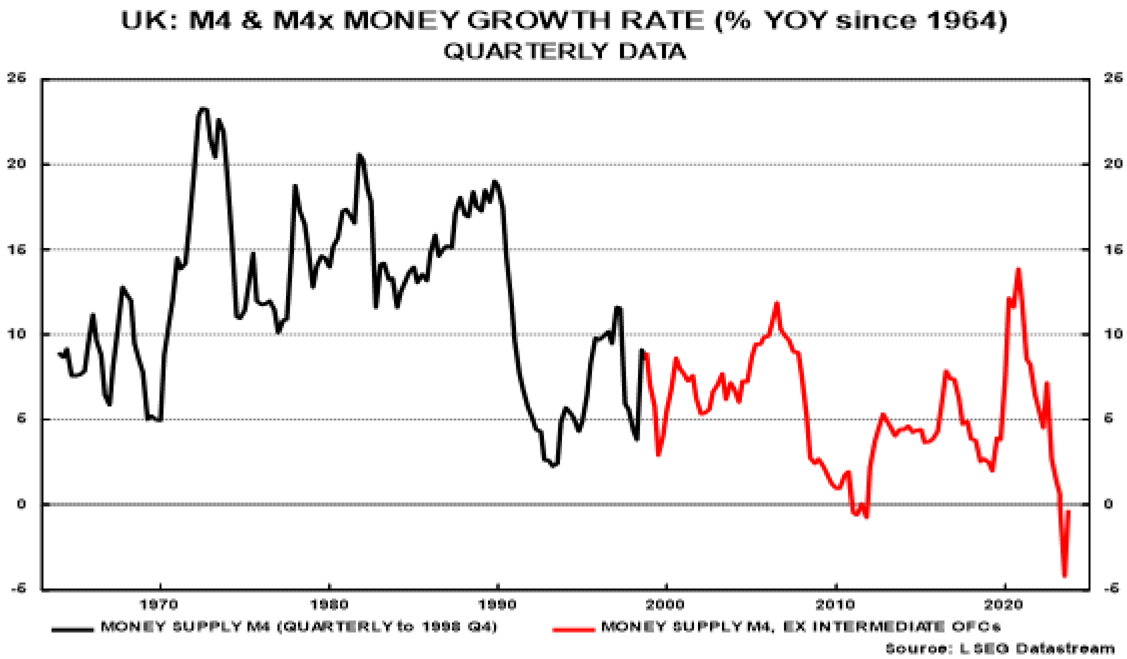
Table 2 below contains data for the "Great Moderation" (1991-2007) and the post-GFC recovery (2013-2019). In the first case, moderate M4 growth over the period 1991-2005 averaging 7.0% p.a. led to an average inflation rate of 1.9% p.a. over the period 1992-2006. In the second case, low and steady M4x growth over the period 2013-2019 averaging 4.5% p.a. led to an even lower average CPI inflation rate of 1.4% p.a. over the period 2014-2020. These two important results are consistent with the view that both periods of low and stable inflation were preceded or accompanied by low and stable M4 growth. The conclusion is clear: to ensure that the inflation target of 2% is achieved, it is necessary to ensure that UK M4x growth is within some range that, depending on the expected growth of output or real GDP and the expected change of income velocity, is roughly in the range 4.0%-7.0% p.a.

Table 2. Every Period of Low and Stable Inflation has Followed from a Period of Low and Stable Money Growth

	Average Money Growth (% yoy)	Av Nominal GDP Growth (% yoy)	Peak Inflation Rate (% yoy)	Average Inflation (% yoy)
The Great Moderation	M4 +7.0% p.a. 1991-2005	5.0% p.a. 1992-2006	RPI 4.8% March 2007*	CPI 1.9% p.a. 1992-2006
Post-GFC Recovery	M4x +4.5% p.a. 2013-2019	2.5% p.a. 2014-2020	CPI 3.1% RPI 4.1% Nov 2017**	CPI 1.4% p.a. RPI 2.5% p.a. 2014-2020

* Another high for the RPI during the Great Moderation was 4.2% in May 1998.
** An additional high for the CPI during the immediate post-GFC period was 5.2% in September 2011 after the pound fell from over $2.00 in the first half of 2008 to around $1.40~1.45 in 2009-10.

Figure 1. The UK is Currently Experiencing a Rare Episode of Negative Money Growth.



Turning from past episodes to the present, UK M4x money growth has been falling on a year-on-year basis since July 2023. The lowest figure was -4.2% year-on-year in September, and the latest figure for January 2024 was down by 1.6%. As I have explained elsewhere, the sudden downturn in UK money growth is a direct result of the Bank of England's steep increases in Bank rate to 5.25%, exacerbated by the adoption of an aggressive QT policy. Given the 2% CPI inflation target, these growth rates are far too low. If continued, the monetary contraction surely points to a further substantial fall in the inflation rate over the next year or two (or three).

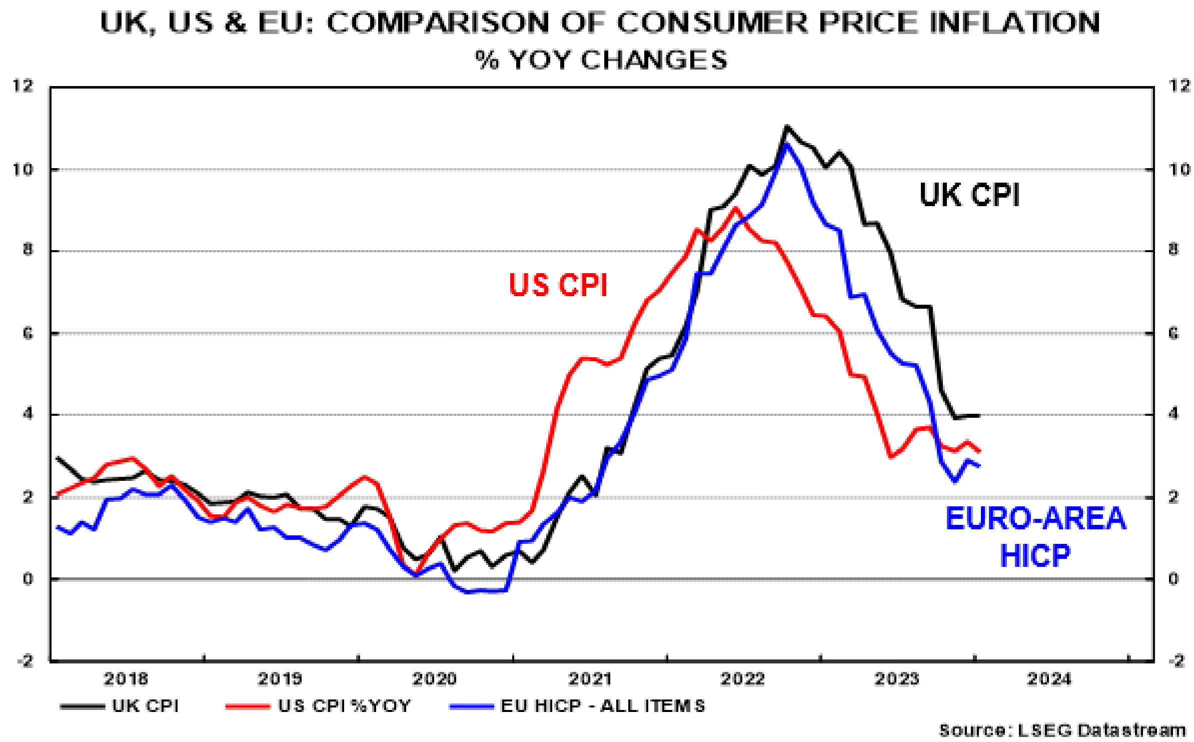
We know this because, as Figure 1 above shows, the only time in the modern era when negative money growth rates were previously recorded was for most of the year 2011, soon after the GFC and roughly coinciding with the euro-area debt crisis. Not surprisingly, on that occasion CPI inflation fell consistently on a year-on-year basis from 5.2% in September 2011 to an ***average*** of virtually zero (0.04%) in 2015. Note how long the lags were – a full three years, but nevertheless consistent with the notoriously "long and variable" lags observed by Milton Friedman and others.

Some economists have argued that the current negative M4x growth rate is justified on the basis that its growth in 2020-21 was too rapid, and therefore there needs to be a compensating decline in money growth now. However, this argument is wrong. Almost all the effects of the prior rapid money growth have already worked themselves out (in asset prices, in economic activity, and in inflation); any effects from the current exceptionally low money growth rate will show up as a separate, discrete event, likely to work its way through asset prices, economic activity, and inflation just as the decline in M4x did between 2011 and 2015.

Section 2. The Transmission Process – the Impact of PPIs on the CPI

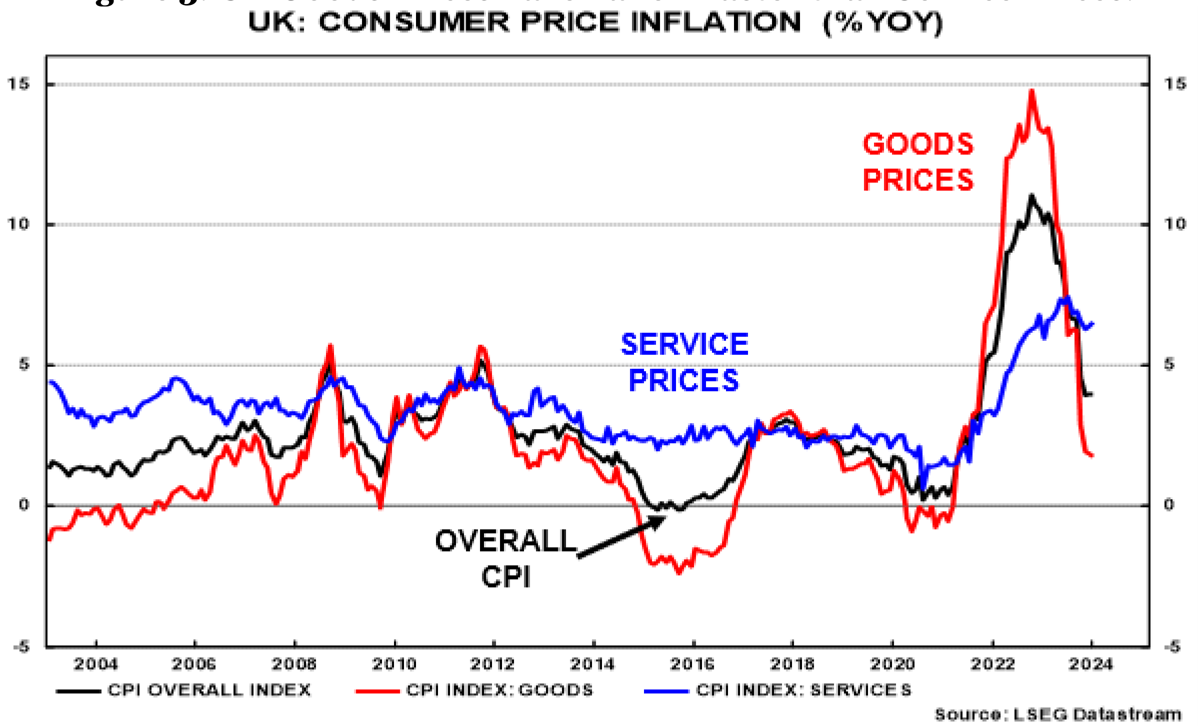
In broad profile, the inflations in the US, eurozone, and UK have been similar, with the US leading but peaking at a slightly lower rate than in the UK or eurozone (Fig.2).

Figure 2. Inflations in the US, UK & Eurozone have been Similar.



As Figure 2 (above) shows, US CPI inflation peaked at 9.4% in June 2022, while the UK and euro-area peaked at 11.1% and 10.6% respectively in October 2022. In January 2024 the inflation rates had fallen to 2.8% (euro-area), 3.1% (US), and 4.0% (UK).

Figure 3. UK Goods Prices have Fallen Faster than Service Prices.



Against a background of tight money since March 2022, goods prices within the CPI have fallen steeply from their peak of 14.8% year-on-year in October 2022 to 1.8% in January 2024. I expect goods prices to overshoot – i.e., to fall below zero in 2024. Service prices, which lagged considerably on the upswing, appear now to have also peaked at 7.4% in July 2023 and are headed slowly downwards. As the service sector has been slower to adjust its prices upwards, and because service prices typically rise more than goods prices (about 3% p.a. versus about 1% p.a. for goods prices), we cannot expect the downturn in service prices to be as steep as the fall in goods prices. In addition, the service price component of the CPI will probably finish up this episode still in positive territory as opposed to falling like goods prices.

By far the largest contributions to UK inflation have come from utilities (housing, water, and fuels) as shown by the blue line in Figure 4, with the second largest contribution coming from food and beverages as shown by the red line.

One of the most controversial of the government's policies during the pandemic concerned their interventions in the energy market. Before commenting we will examine the year-to-year changes in the free market prices of the two key fuel commodities – crude oil and natural gas – which are shown in Figure 5. Prices in both markets were already rising by mid-2021 when the authorities began to become aware that there might be an inflation problem brewing.

Figure 4. The Biggest Moves in the CPI have been in Energy and Food.

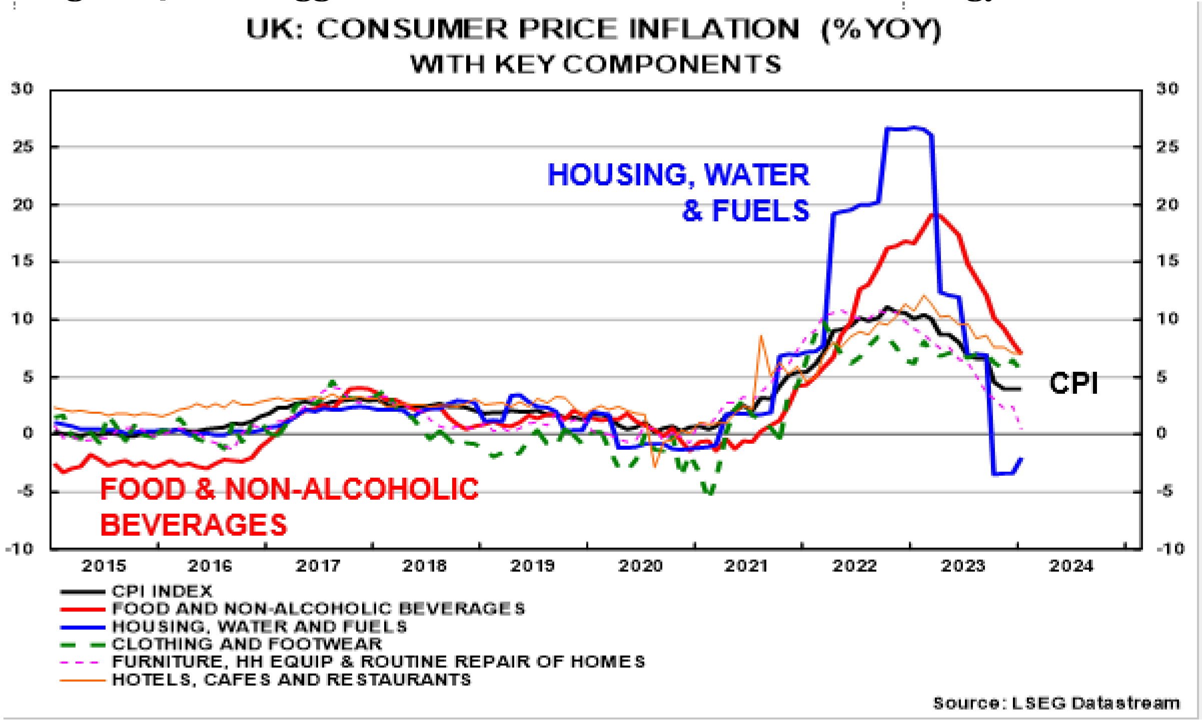
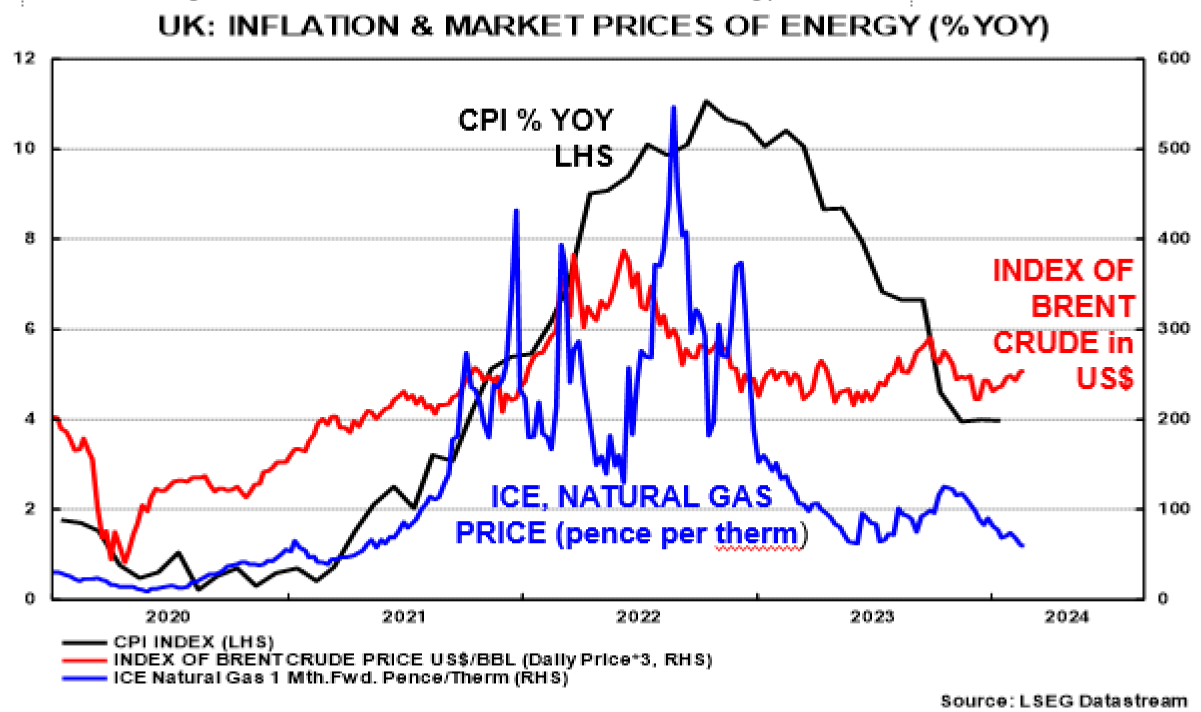


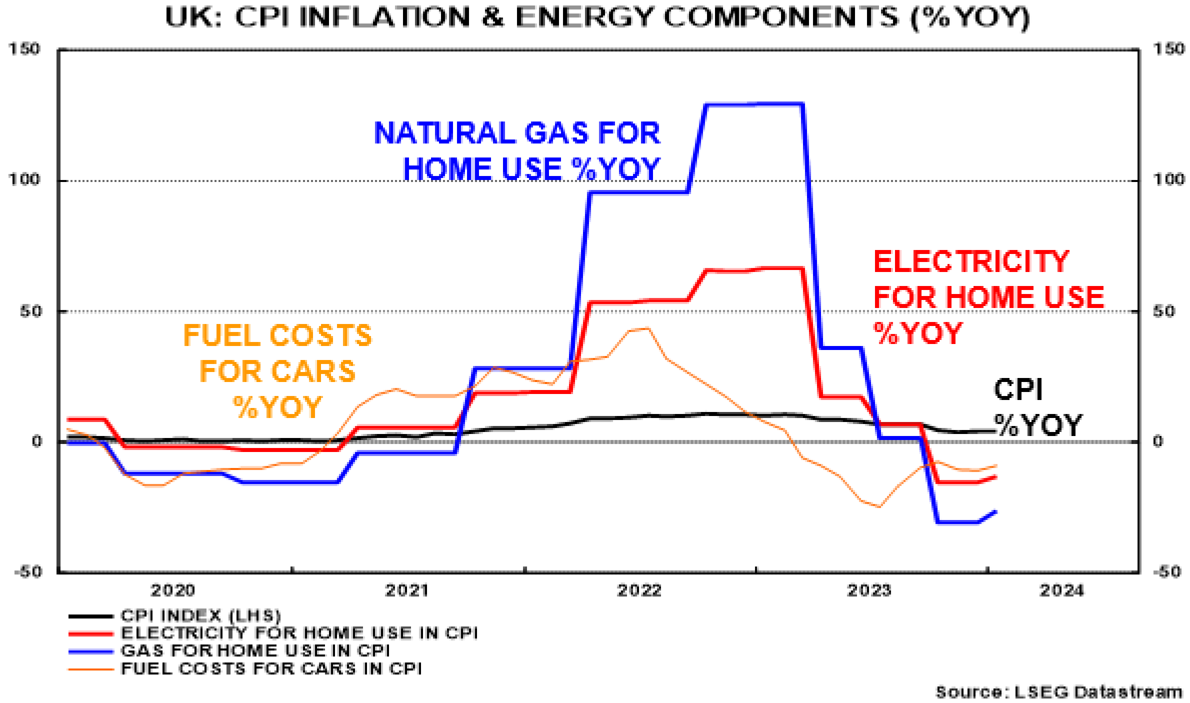
Figure 5. Free Market Prices of Energy Peaked in 2022.



Natural gas prices spiked upwards first in October and December 2021, followed by another peak in early March 2022 immediately following the Russian invasion of Ukraine. Crude oil prices also spiked upwards as the Ukraine war started, with their first peak in late March 2022. These spikes were followed by further peaks in June

2022 (crude oil) and August and December 2022 (natural gas). Since these price peaks in 2022, high prices have reduced demand and fuel prices have been mainly on a downward path, although both sets of prices moved upwards modestly in September/October 2023. Looking ahead, my view is that with inflation on the wane and the eurozone, the UK, and Japan already in recession, the trend of crude oil and gas prices will be downward.

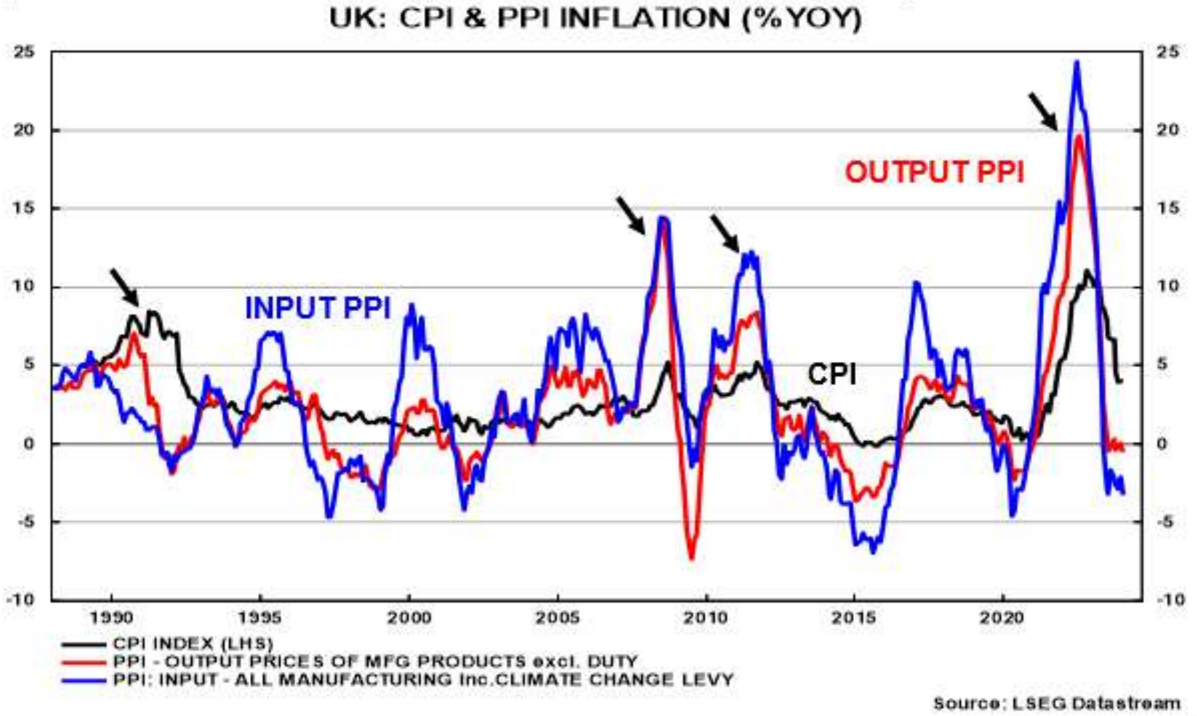
Figure 7. Government-Controlled Prices of Energy Peaked in 2023.



However, when it comes to the prices paid by British consumers, government intervention in the various energy markets has been so extensive as to delay and then extend the high prices for energy, hurting consumer budgets and preventing market forces from providing the solutions that might otherwise have occurred. Ofgem (the Office of Gas and Electricity Markets), the UK regulator, was tasked with setting prices for UK households from January 2019. As Figure 7 shows, since then the price of natural gas for home use (in blue) has moved in large, discrete steps based on decisions by Ofgem. For a period from September 2022 (under PM Liz Truss) until September 2023 the price cap was replaced with an Energy Price Guarantee (EPG).

The idea of these schemes was to soften the blow of rising prices for households, subsidising the cost to some households and spreading the cost to government over five years from 2023. Despite these measures, the UK's dependence on external energy sources has meant that the country has basically had to follow international prices, but domestic prices have stayed higher for longer. For example, the peak of international natural gas prices was in August 2022, but UK households continued to pay peak prices under the Ofgem price cap until March 2023. By this time free market prices had fallen from 546 pence per therm to around 100 pence per therm. Fortunately domestic prices have continued to slide and are now below their levels a year previously. For the overall CPI this means that the upward momentum from energy prices has now dissipated, and their contribution is now negative (Figure 5).

Figure 8. PPIs, which lead the CPI, have been Falling for 9 Months.



A further indication that consumer prices are now headed downwards from their peaks is that producer prices – both input prices and output prices – are firmly on downward trajectories. The significance of PPIs may be judged from Figure 8 which shows UK manufacturing input and output prices compared with the CPI since 1988. Of course, there are times when PPIs rise and fall without having any impact on the CPI (for example because producers absorb the increase in costs and do not pass them on to customers), but in all cases where the CPI has risen by 5% or more (the four arrowed cases) producer price peaks and troughs have led the CPI.

Typically, the lag at the peak is 3-5 months, though longer at the troughs due to the large service element in the CPI. For example, the recent peak of the PPIs was in June 2022 and the peak CPI was in October 2022. It is probably too soon to judge whether the PPIs have troughed , but on a year-to-year basis they have been falling at a steady rate for nearly nine months (since July 2023).

3. Conclusion

M4x, the broadest definition of money in the UK, has been falling on a year-on-year basis since July 2023 and continues to contract. Based on the experience of money growth rates and inflation in the UK over the past five decades, this portends an inflation rate well below the targeted 2%, and possibly even deflation. Precisely when the UK will start to experience sub-2% inflation or deflation is hard to pin down, but it is safe to say that inflation will fall below 2% in the first half of 2024, and deflation could follow in 2025. One thing is for sure, the profile of inflation will have very little to do with fiscal policy, whether it be under the present Conservative government or under a future Labour government.

Summary and Investment Conclusions

- On Wednesday, March 6th the UK government released its annual budget for the fiscal year 2024-25. Since the Bank of England became independent in 1997, Budget Day has been a fiscal, not a monetary event. In other words, the decisions taken affect the size and composition of government expenditures and revenues, not the monetary policies that will accompany the measures.

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- The evidence suggests that CPI inflation will continue to fall in 2024, with no "second round" resurgence of inflation. If anything, the risks are on the downside – that is, prices are likely to fall well below the 2% inflation target in 2024 and into 2025.

- The investment conclusion from this overview of the UK monetary policy is that a strong equity recovery is unlikely to come from any easing of interest rates unless money growth picks up substantially. A more modest recovery could come from the interaction of falling prices with a recovering economy, but a safer bet is that long-term yields will fall further and faster than current market projections expect. Sterling will be vulnerable under any scenario of interest rate easing.

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