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Inflation: ticking time bomb for next year

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The last time sterling fell off a cliff we were in the midst of global financial crisis from 2007 to 2008. The currency shock sent inflation shooting up to 5.2pc, abruptly squeezing on real living standards.

On that occasion the poor were at least protected. Benefits and in-work tax credits were indexed to inflation. Social cohesion was preserved.

This time the most vulnerable families will take the brunt as the cost of imported food, clothes, and fuel suddenly jump. A parting gift of the last Government was to freeze benefits for 11.5 million households until 2020.

This is a political time bomb that will detonate next year when the inflation ‘pass-through’ from imports bites in earnest. It threatens to poison the already fractious national debate unless steps are taken to mitigate the damage.


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The Institute for Fiscal Studies estimates that the freeze was going top cut these benefits by 4pc even before the slide in sterling, but this will now be 6pc based on the deteriorating picture for inflation.

The poorest 8.3 million families will lose an average of £470 a year by 2020, and many will suffer further losses from the effects of universal credit.

“The rise in the minimum wage will help some people but beyond that the only way to compensate those on benefits is to increase those benefits in line with inflation,” said Paul Johnson, the head of the IFS.

Marmite wars have already led to a ghoulish scare over food prices, which may have been the intention of Unilever’s highly-political chief executive Paul Polman. His push for a 10pc rise across the board – regardless of whether items were produced in Britain – smacked of theatre.

In reality the exchange rate adjustment has not even begun. The Office for National Statistics says the jump in headline inflation from 0.6pc to 1pc in September had little to do with the pound. It was a legacy effect from prior causes. The Brexit shock on prices will hit next year.

How much inflation will rise – and how soon – is a hotly-debated topic. The trade-weighted devaluation in 2007-08 was 30pc from peak to trough, an earthquake for a world reserve currency.

The headline impact in that episode was aggravated by a surge in the dollar price of oil over two years following the Great Recession, from $32 to $115 a barrel. This will not be repeated.

Global crude stocks remain near record highs, and the flexibility of US shale drilling has broken the back of the OPEC cartel. The structure of the oil market has changed completely. China's industrial revolution has in any case come off the boil, and it is China that sets the marginal price of oil in the global economy.

This year's devaluation has been less extreme (so far) though you would never know it from the cacophany. Sterling has fallen 22pc. The drop is more like 15pc if you shave off the speculative jump last year driven by unwelcome inflows of hot capital.

In strict macroeconomic terms a weaker pound is necessary and unavoidable. The Bank of England describes it as a "shock absorber", the least painful way to correct a severe economic imbalance. It is a boost to tourism and manufacturing exports.

A lower exchange rate is a blunt form of stimulus, ceteris paribus – quod non ex toto est. Britain has been living beyond its means, borrowing from foreigners on a grand scale to fund consumption that could not be justified by gains in productivity, and enjoying cheap imports at artificially depressed prices. Such was our fool's paradise.

The smoking gun is the current account deficit, which has been running near 6pc of GDP, the worst in peace-time since records began in the late 18th century.

It is the sort of deficit we ran during world wars, except that this time we have been frittering the money away in shopping malls. It was corrosive. It had to stop, Brexit or no Brexit.

The International Monetary Fund says sterling was roughly 18pc overvalued earlier this year, based on its measure of the "real effective exchange rate". The pound is now trading near fair value.

Nobel-winning trade theorist Paul Krugman says Britain has a variant of the "Dutch Disease" or resources curse, except that in this case the economy has been distorted by over-reliance on the City. It has left the UK hostage to the boom-bust swings of the financial cycle, leveraged by foreign inflows into London property.

The effect of this deformed structure – and the episodic surges in the pound that characterise it – has been to hollow out manufacturing and blight the industrial hubs of the North. This has been allowed to fester for too long.

The slide in sterling is no panacea. It is a necessary but not sufficient condition for a realignment of the British economy. The heavy caveat is that it also acts as a "regressive" tax and has potent implications for distributional justice.

Theresa May stood outside 10 Downing Street on July 13 and told the nation that she would bend every sinew to help those from an "ordinary working class family", with little job security, battling to pay the mortgage and bring up children in dignity.

"If you're one of those families, if you're just managing, I want to address you directly. I know you're working around the clock, I know you're doing your best, and I know that sometimes life can be a struggle," she said. "The government I lead will be driven not by the interests of the privileged few, but by you," she said. How she handles the sterling fall will be the litmus test of her sincerity.

Mark Carney, the Governor of the Bank of England, has left no doubt that he and his colleagues will let the pound find its own level, and will take an unflappable view of headline price pressures.

"We're willing to tolerate a bit of overshoot in inflation over the course of the next few years, to cushion the blow," he said.

This was the Bank's strategy in 2010 and 2011. It defiantly launched a fresh round of quantitative easing just as inflation peaked, to the consternation of those still stuck in a 1970s time-warp. This showed panache, and was vindicated by events. The shock passed. Three years later the UK was in outright deflation.

Imports are roughly 30pc of GDP, but not all the devaluation effects will be passed on. A substitution effect takes place. Centrica has locked in gas supplies from Qatar in sterling for the next five years.

Suppliers have currency hedges. Many padded their profits when the pound was strong: now they must accept a haircut to keep market share.

"Margins may partly take the strain," said David Owen from Jefferies.

Michael Saunders from the Monetary Policy Committee testified that import prices are likely to rise by an extra 12pc to 13pc, implying a boost to overall inflation of four percentage points spread over several years before the one-off adjustment fades.

The Bank has pencilled in inflation of 1.9pc in mid-2017, and 2.4pc as late as mid-2019. This suggests a long, slow, flat "pass-through" effect rather than a sudden spike. The figures are surprisingly low but this is less reassuring than it looks. They reflect a much lower forecast for economic growth, the travails of Brexit itself.

Nobody knows for sure what the pass-through will be. Research by the Bank's Kristin Forbes shows that academic models on exchange rate effects are largely useless. The outcome varies dramatically depending on the cause of the shock – and the contours that surround it – and nothing quite like Brexit has ever happened before.

What seems certain is supermarket bills will ratchet up briskly next year. "The point of maximum danger for recession is mid-2017 when real wages are squeezed and investors react to the triggering of Article 50," said Mr Owen from Jefferies.

He advises the Government to prepare for a temporary cut in VAT to smooth over the worst period. This would dampen price rises and add stimulus with surgical timing when it is most needed. It is what Alistair Darling did successfully for 13 months during the white heat of the global financial crisis.

For central bankers, inflation is not the terrible spectre it used to be. Most of the developed world is fighting secular deflation, the opposite and more dangerous enemy. The eurozone and Japan are resorting to every trick to drive down their currencies. The US is trying just as hard to stop the dollar rising further.

It is possible the UK will face rising inflation and recession at the same time

Everybody is trying to generate a few flickers of inflation as a safety buffer, and largely failing. Contract prices in the so-called TIPS inflation break-even market in the US show that investors do not expect the US Federal Reserve to reach its 2pc target over the next 30 years.

In such a world, inflation is a precious commodity. Central banks are trying to pull off a “Wicksellian shift” to escape the monetary trap of a negative natural rate of interest. Britain has inadvertently stolen a march on Japan, Europe, and America by the accident of Brexit.

Yet there is no disguising that “good inflation” and “bad inflation” in these aberrant circumstances are not the same thing. Where Britain sits on the scale is fiercely contested, but it is likely that our variant will have the sting of “stagflation”.

Is it possible the UK will face rising inflation and recession at the same time? Unfortunately it is. But remember one thing amid all the political noise: a jump in inflation to 2pc or even 3pc is hardly Götterdämmerung.