

Novus Capital Markets Research

Two schools of thought

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A one-off shock to the price level: there are, the Governor tells us, *real differences of view* on the MPC. At the heart of them lies the interpretation of why CPI inflation is 4% and what this means for monetary policy. For the Governor, who appears to be at one end of the debate, we are experiencing a one-off shock to the price level brought about by rapid growth in import prices (due in large part to the fall in sterling), a worldwide surge in energy prices and the increase in VAT to 20%. There has been no change in the underlying rate of inflation and there is not likely to be while high unemployment keeps wages growth in check. The case for monetary tightening is not yet proven.

Four per cent CPI inflation is symptomatic of a more entrenched problem: at the other end of the spectrum Andrew Sentance believes there is no gainsaying 4% inflation and the effects this might already be having on inflationary expectations. Mainstream output gap analysis as practised by the Bank has overestimated the amount of spare capacity; its downward effect on inflation has been outweighed by strong global price pressures exacerbated by an unnecessarily large fall in sterling. The MPC should already be withdrawing some of the extreme monetary accommodation put in place to ward off the financial crisis. A modest appreciation of sterling would be no bad thing.

And another thing: UK GDP fell 0.5% in 10q4 according to the GDP statisticians. Hours worked rose 0.3% according to their counterparts on the Labour Market. The former tell us that large parts of the British economy closed down in the December snows. The latter tell us that more of us had full-time jobs and that we worked longer hours. Put the two together and the ONS tells us that we struggled into work and put in longer stints to produce less. What were we doing – talking about the weather?

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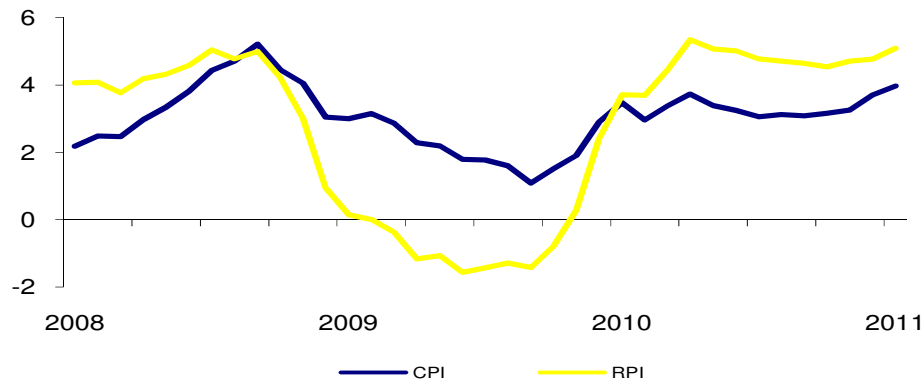
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Inflation: two schools of thought

CPI inflation hit 4% in January. From a summer low of 3.1% it has risen for four successive months to its highest level since November 2008 (Chart 1). RPI inflation, to which many pensions are linked (ho hum), rose to 5.1%.

Chart 1: CPI and RPI inflation



Source: ONS

On the MPC, where, as we have learned this week, there is a *wider than usual range of views and real differences of view*, there are two very distinct interpretations of the increase in inflation. For brevity I shall call these the Mervyn King view, since the Governor appears to be the most dovish member of the Committee, and the Andrew Sentance view, since Sentance's voting record (for a 25bp hike every month since June) and his increasingly strident speeches mark him out as the most hawkish member. In old-fashioned speak these views correspond (approximately) to a cost-push and a demand-pull view of inflation.

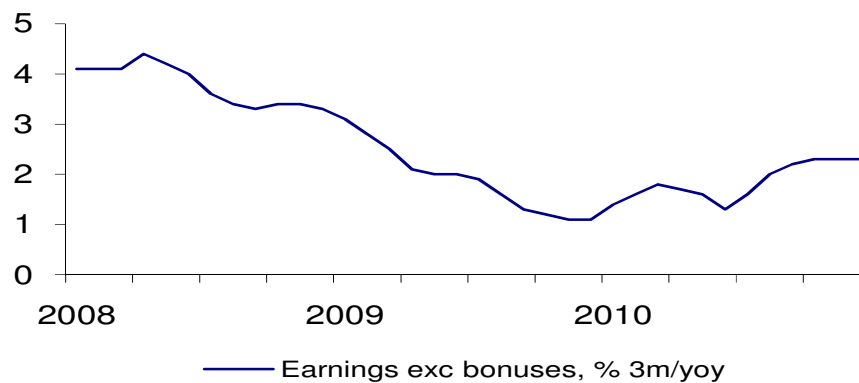
The Mervyn King interpretation, as spelled out in his speech last month in Newcastle¹, is that there has been a one-off shift in the price level. This has been brought about by higher import prices (in large part the product of the fall in the exchange rate), a worldwide rise in energy prices and the increase in VAT to 20%. In support of this view the Governor repeated words he had written in 1997 (*changes in indirect taxes or commodity prices often affect the domestic price level but do not in themselves change the underlying rate of inflation*).

As such there has been no change in the underlying rate of inflation and there is no need for the MPC to react to this increase in inflation in the absence of second-round effects (a wage response). In fact the Governor went further than this, warning that the cut in living standards brought about by higher inflation was the inevitable consequence of the financial crisis and that any attempt on the part of wage-bargainers to recoup the loss via higher wages would be doomed to failure, that is it would be offset by

¹ <http://www.bankofengland.co.uk/publications/speeches/2011/speech471.pdf>

higher interest rates. But, while earnings are rising at a rate close to the 2% inflation target (Chart 2), there is no pressing need for the MPC to respond.

Chart 2: Whole economy underlying earnings growth



Source: ONS (KAI9)

For Sentance, this is intellectual pussy-footing. Inflation is 4%, double the target and heading higher. Much of this, he agrees with King, comes from the global economy (energy and also record high food prices) but this is no reason not to react. Absent an interest rate response, higher current inflation will get embodied in price and wage expectations. Monetary policy is extraordinarily accommodative, as all MPC members would agree. Now is the time to start returning policy settings to normal; later and the risk is that rates end up higher than they otherwise would.

In today's speech at the IEA conference, Sentance went further. He argued that *inflation has run persistently above target because the upward impetus of global price pressures and the fall in the pound have been much stronger than any downward pressure we have seen from spare capacity in the aftermath of the recession*. For Sentance more capacity was lost in the recession, and the output gap is smaller, than the Bank estimates. On top of that the fall in sterling was very large, significantly more than we have experienced in previous recessions. A modest appreciation in the pound, brought about by higher interest rates, would be no bad thing.

Which view is correct? Unfortunately – and in economics this is often the case – they both might be. Gradually removing the excess monetary accommodation, as Sentance advocates, would in all likelihood keep a lid on rates in the medium term but it might also tip the economy into a second downturn. If that were to happen, which is the Governor's fear, then Sentance would argue that any rate hikes could be

swiftly reversed. For the Governor the balance of risks argues against an early hike; for Sentance the balance is exactly the other way round.

Trying to explain why any two individuals reach such polar opposite views on the balance of risks is not easy. For the Governor, it might be the case that, having presided over the biggest financial crisis and the deepest recession since the 1930s, he is keen in the extreme not to preside over a double-dip recession. He would prefer to wait to see how big an effect the fiscal consolidation has on demand and output. For Sentance, the chances of a double-dip are remote and can be tackled if need be.

While sounding marginally less dovish, the Governor's Letter to the Chancellor developed his view that, absent the three shocks to the price level that he had previously identified, inflation would have been much lower (*although one cannot be sure, prices excluding the effects of these factors would probably have increased at a rate well below the 2% inflation target*). Andrew Sentance might well respond, that, yes, if you omit everything that is rising at an above-2% rate, inflation will indeed be below the target.

Where do these *real differences of view* leave us on interest rates? The market is unsure. Having brought its expectation of the first hike forward from August to May over the last few weeks, it is having second thoughts. Tuesday's Letter to the Chancellor appeared to endorse a 25bp hike in May and two more before the end of the year (*the MPC's-central judgement, under the assumption that Bank Rate increases in line with market expectations, remains that, as the temporary effects of the factors listed above wane, inflation will fall back so that it is about as likely to be above the target as below it two to three years ahead*). But after yesterday's press conference, in which the Governor (predictably) denied endorsing the market view of rates, the market was backtracking on May.

My own view is unchanged. The MPC should wait for the Q1 GDP data before doing anything. If the bounce in output that January will almost automatically produce is sustained in February-March, it will be safe to raise rates. If the economy starts going backwards in Feb-Mar, policy can be left on hold. At this stage, I would put the odds in favour of the former outturn and a May hike, but I am ready to be persuaded otherwise. Overall my views are nearer to that of the Governor than to Andrew Sentance (but then we Villa supporters should stick together).

And another thing

The preliminary estimate for GDP released on 25 January showed GDP falling 0.5% in 10q4. The ONS reported that most of the Q4 decline took place in December when the weather disrupted output. The effects were particularly marked in construction, where output fell 3.3% in the quarter but there were also significant effects in the service sector (down 0.5%), particularly road transport and distribution. Industrial production (IP) by contrast rose 0.9% as the weather boosted the demand for energy.

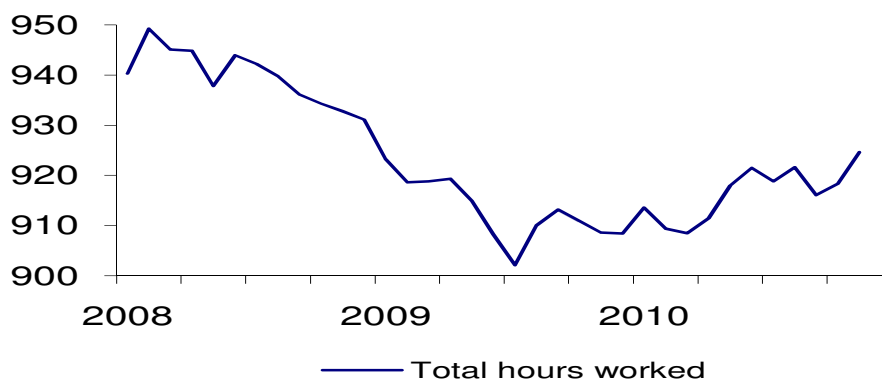
Subsequently, the ONS has revised IP growth down to 0.7%. This reflects changes to October and November. In December alone IP rose 0.5% boosted by a 6.1% increase in the output of the utilities. It has also revised the data for construction (Great Britain) where output is now estimated to have fallen

2.5% in the quarter, rather less than the 3.3% originally reported (for the UK). Between them, the revisions to IP (down) and construction (up) would have a negligible effect on GDP.

On these data the picture is clear. December's severe weather disrupted activity in many parts of the economy. We struggled to get to work and to go shopping. Construction sites closed down. HGVs were forced off the road. Activity in many regions ground to a halt.

So how do we explain this week's data which show that total hours worked in the economy rose 0.3% in Q4 to their highest level since 2008 (Chart 3)? The labour market statistics provide a partial answer. Although total employment (which includes the self-employed and those on government training schemes) fell 0.2% in Q4, employment (the number of employees) was fractionally higher and, within employment, the number of full-time workers rose 0.4% at the expense of a drop in the number of part-timers. The switch from part-time to full-time working would have boosted hours worked for any given level of employment.

Chart 3: Total hours worked



Source: ONS (YBUS)

But then, if we were able to get to work and put in a longer stint, why was output down so much? It seems that, against all the odds, we managed to haul ourselves through the snow and into work. Having made the effort, we worked the longest hours in two years. But to little avail since overall we produced less. What were we doing at work – talking about the weather? Why did we bother? Or might it just be the case that the ONS national accounts and labour market statisticians simply don't talk to one another?

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