The Oil Drum: Europe
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

UK Inflation: the only way is up, baby

Posted by Chris Vernon on June 18, 2008 - 10:00am in The Oil Drum: Europe
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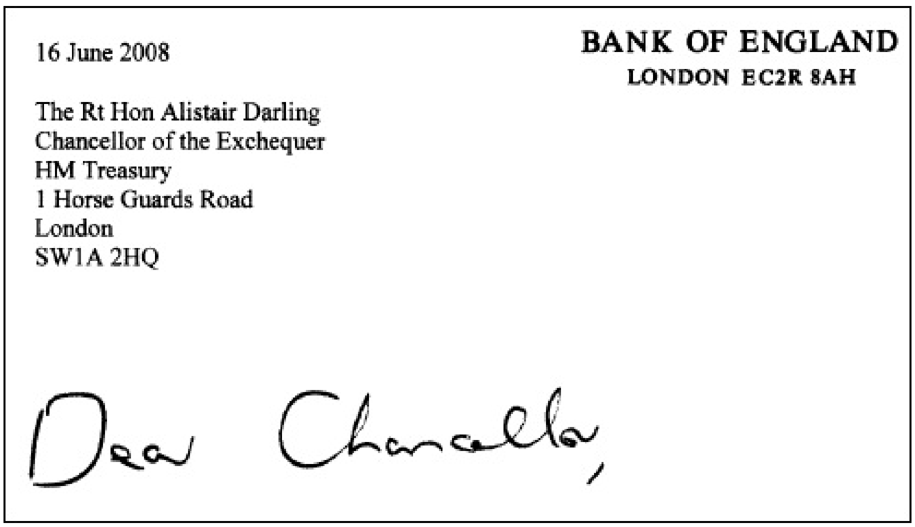
Tags: alistair darling, inflation, interest rates, mervyn king, trade deficit, united kingdom [list all tags]

With Consumer Prices Index (CPI) rising to 3.3% (year on year to May-08), the fastest rate of increase in over a decade, the Governor of the Bank of England has written to the Chancellor to explain.


16 June 2008

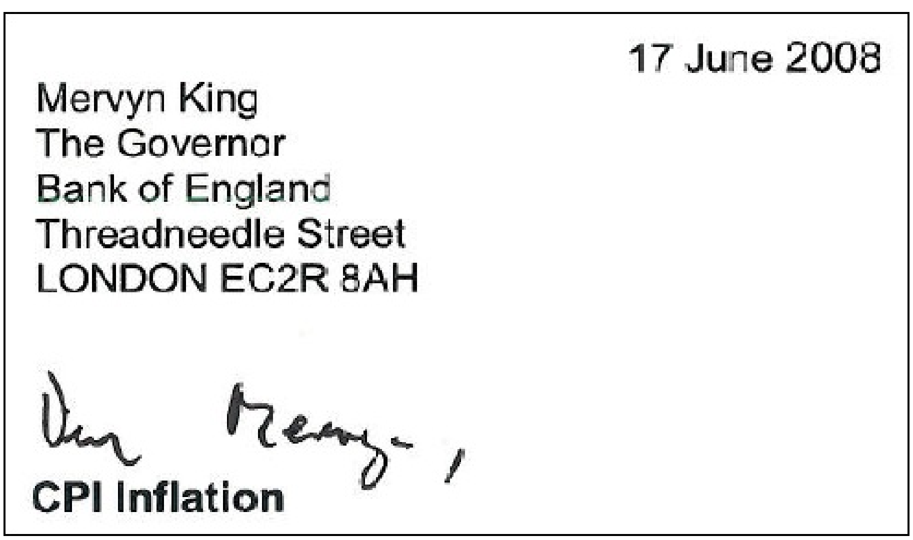
BANK OF ENGLAND
LONDON EC2R 8AH

The Rt Hon Alistair Darling
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Chancellor,

Open letter from Mervyn King governor of the Bank of England to Alistair Darling, Chancellor of the Exchequer. Click for full letter.

Here's Darling's reply:


17 June 2008

Mervyn King
The Governor
Bank of England
Threadneedle Street
LONDON EC2R 8AH

Dear Mervyn,

CPI Inflation

Open letter from Alistair Darling in response to King's. Click for full letter.

What can we learn from this exchange?

Starting with King. He reviews the situation noting that inflation has recently risen sharply from 2.1% in December to 3.3% in May. The increase driven almost entirely by the increased price of food, fuel, gas and electricity. In the year to May:

> - world agriculture prices increased by 60% and UK retail food prices by 8%.
> - world oil prices rose by more than 80% to average $123 a barrel and UK retail fle prices increased by 20%.
> - wholesale gas prices increased by 160% and UK household electricity and gas bills by around 10%.

This global situation is compounded by:

> The depreciation of sterling, which has fallen some 12% since its peak last July, has boosted the prices of imports and will add to the pressure on consumer prices.

The situation is only expected to deteriorate with recent increases in oil and wholesale gas futures prices.

> As things stand, inflation is likely to rise sharply in the second half of the year, to above 4%.

So far so good but now the letter becomes less clear. King suggests this period of *"above-target inflation"* is temporary (the target is 2%). This is explained by the inflation being driven by commodity prices rising relative to the prices of other goods and services yet the amount of money being spent in the economy not increasing quickly. To me this sounds like only a step away from stagflation, hardly a positive development.

From Wikipedia:

> ...stagflation can result when an economy is slowed by an unfavourable supply shock, such as an increase in the price of oil in an oil importing country, which tends to raise prices at the same time that it slows the economy by making production less profitable.

Then against all expectations King suggests:

> It is possible that commodity prices will rise further in the coming months – oil prices have now been rising for four years. But in the absence of further unexpected increases in oil and commodity prices, inflation should peak around the end of the year and begin to fall back towards the 2% target.

Further unexpected increases? Unexpected by whom? For sure, if oil and commodity prices stop rising inflation will fall but I'd hardly call further rises unexpected.

The Bank of England sets the interest rate monthly. This is seen as the main tool for controlling inflation. With inflation running significantly above target one might expect action to be taken on interest rates. However King has this to say:

> ...if the Bank Rate were set to bring inflation back to the target within the next 12 months, the result would be unnecessary volatility in output and employment. So the

> MPC is aiming to return inflation to the 2% target within its normal forecast horizon of around two years, when the present sharp rises in energy and food prices will have dropped out of the CPI inflation rate.

An admission that taking the actions required to lower inflation would damage the economy too much so all he can offer is to wait for the sharp rises to drop out of the rolling year and hope there aren't further sharp rises. Waiting and hoping doesn't fill me with confidence. And with no reason to believe current price trends will moderate, at least not before they have wrought havoc with the economy, we're left with an unchecked rise in the rate of inflation.

In chancellor Darling's response he added little but to agree with King's assessment and make some favourable comparisons with the Euro zone and United States.

Both men leave the impression that current events are unexpected, temporary in nature and won't have a long term or serious affect on the economy. On these three points they are wrong in my opinion. The trend (if not the absolute magnitude) in commodity price rises has been expected. There is nothing to suggest, as King does, that the rising trend will flatten any time soon and when compounded with the UK's declining energy production the situation can only be exacerbated.

Euan reviewed the UK energy situation in this post: UK Energy Security. It is clear that declining oil and gas production and corresponding increased imports at increasing prices will have tremendous impact on the national trade balance.

The right action to take given the situation as presented, is to find a way for the UK to operate on significantly less energy that it does today. Unfortunately this is not the course of action proposed in today's correspondence.

Euan's closing remarks last year are even more relevant today:

> The alternative may be to face real energy shortages in 2 to 8 years time when the anticipated supplies of imported natural gas and oil do not appear. Energy shortages combined with spiralling energy costs and energy import bills may paralyse our economy.