The Inflation Crisis of 2021-2

The View from the UK

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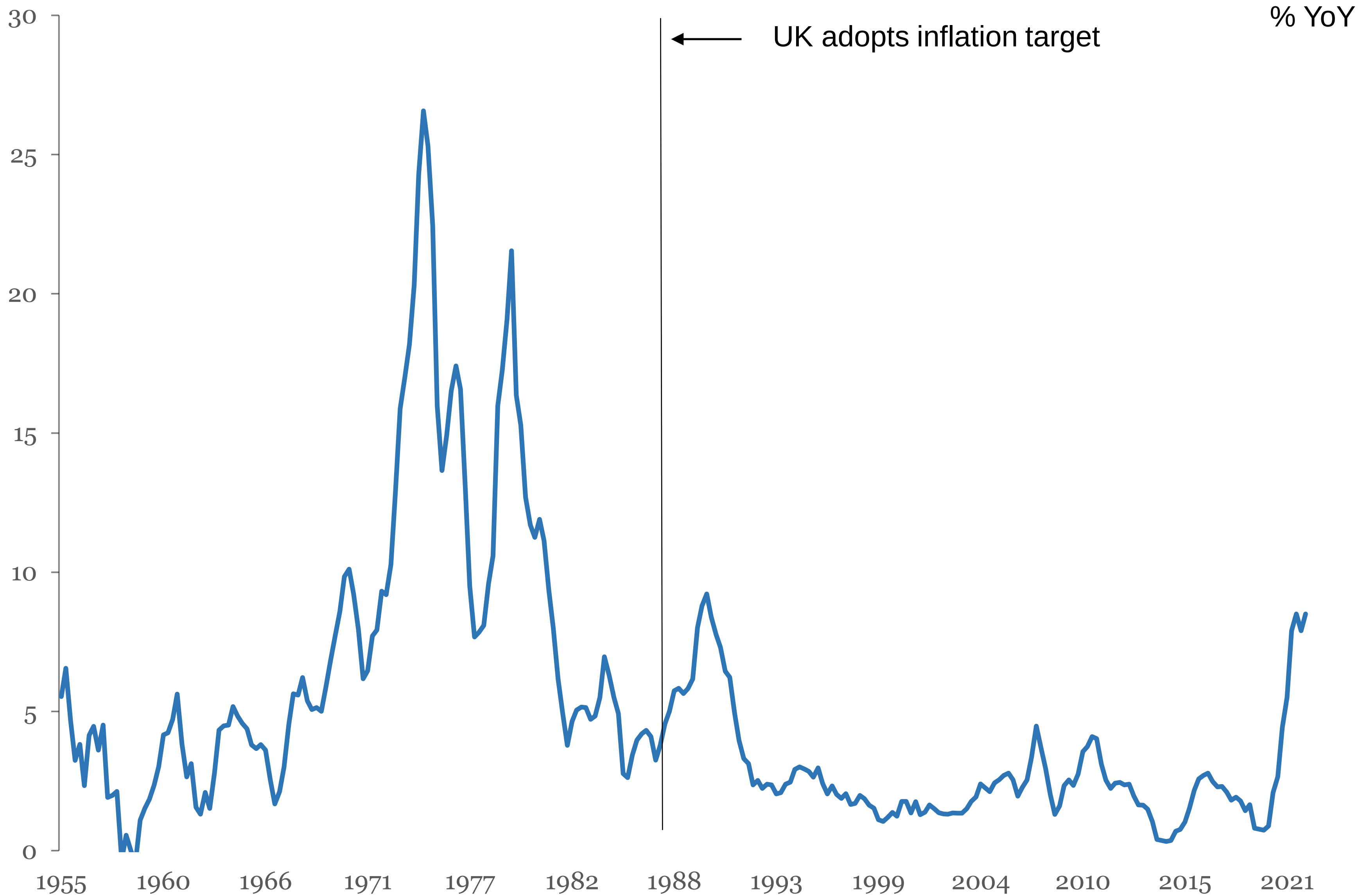
Overview

1. What has caused global inflation in 2022?
2. Why has the £ declined so much?
3. The Mini-budget crisis: an overview
4. Diagnosing the mini-budget crisis
5. Appropriate fiscal and monetary responses
6. Fallouts and remaining risks

Causes of Inflation: UK 2022

UK Inflation



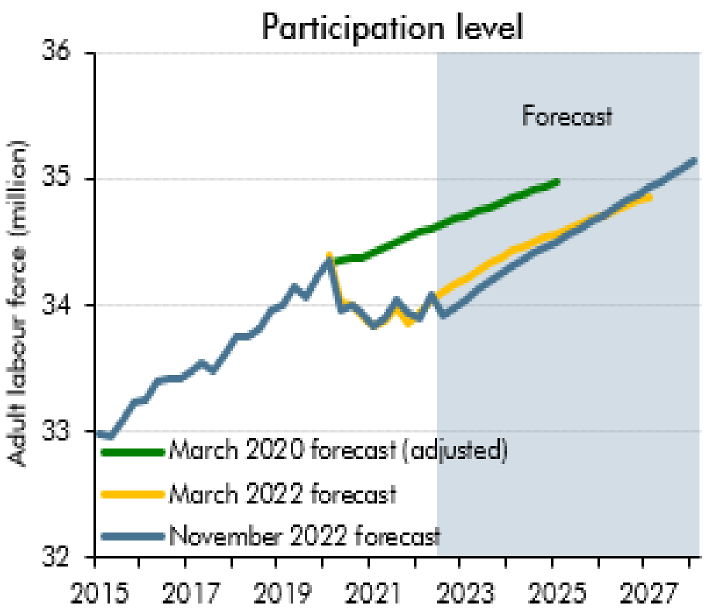
Source: ONS

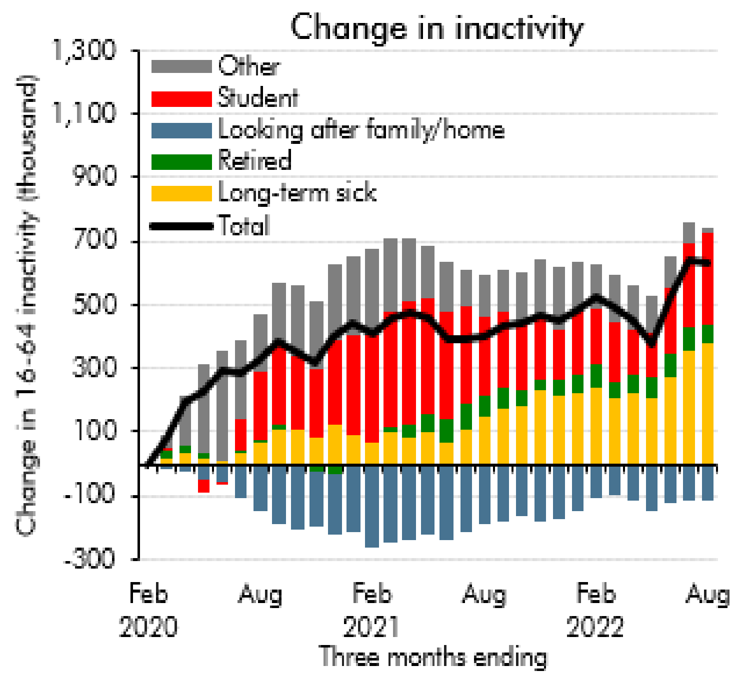
Conceptual Frameworks

In my 2022 Jackson Hole discussion I outlined several different views of the causes of inflation

- It's mostly real
  - Current context: oil shocks, Covid hangover
  - Theories: RBC, New-Keynesian
- It's mostly monetary
  - Current context: delayed/slow monetary tightening
  - RBC, Monetarist, New-Keynesian
- It's mostly fiscal
  - Current context: excessive GFC, Covid-era borrowing, **mini-budget**
  - Fiscal theory of the price level.

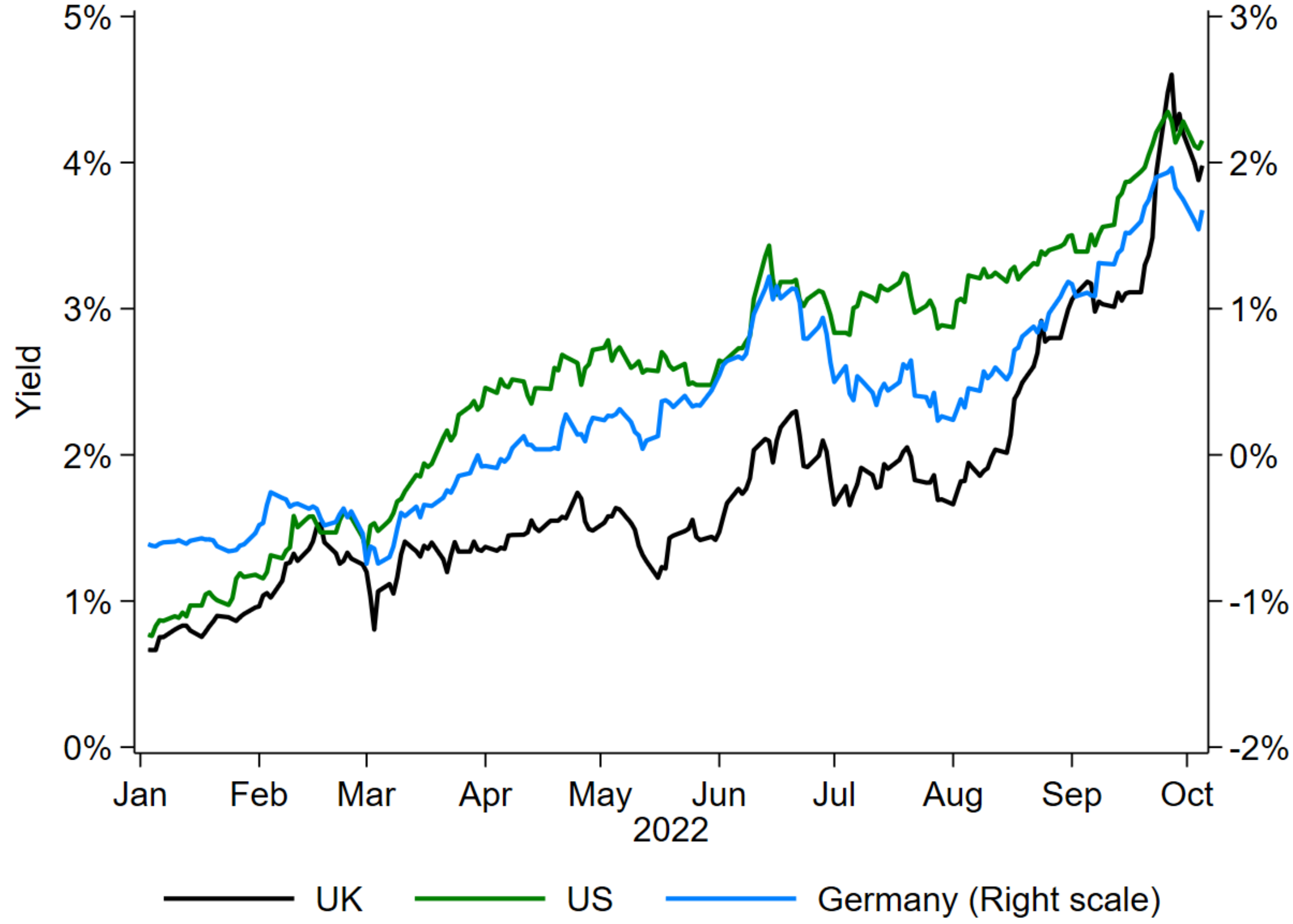
The Long Covid Economy





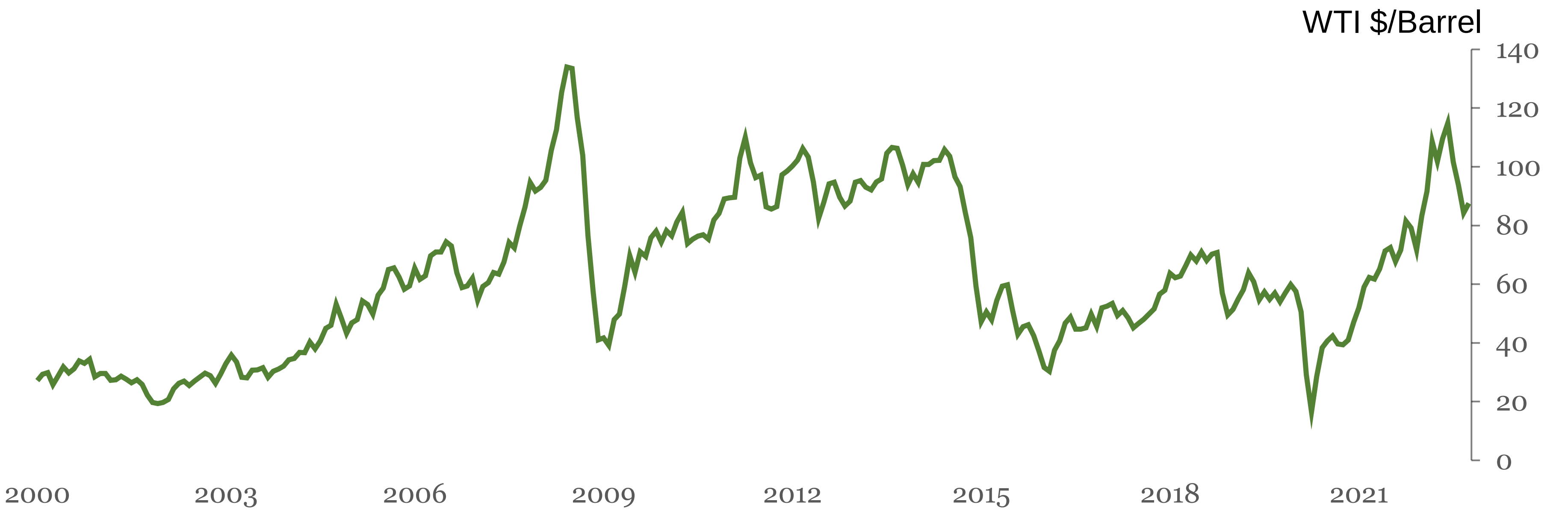
Note: We adjusted our March 2020 participation forecast up by around 0.2 per cent to take into account the unexpected strength in participation before the pandemic hit.
Source: ONS, OBR

2-Year Government Yields



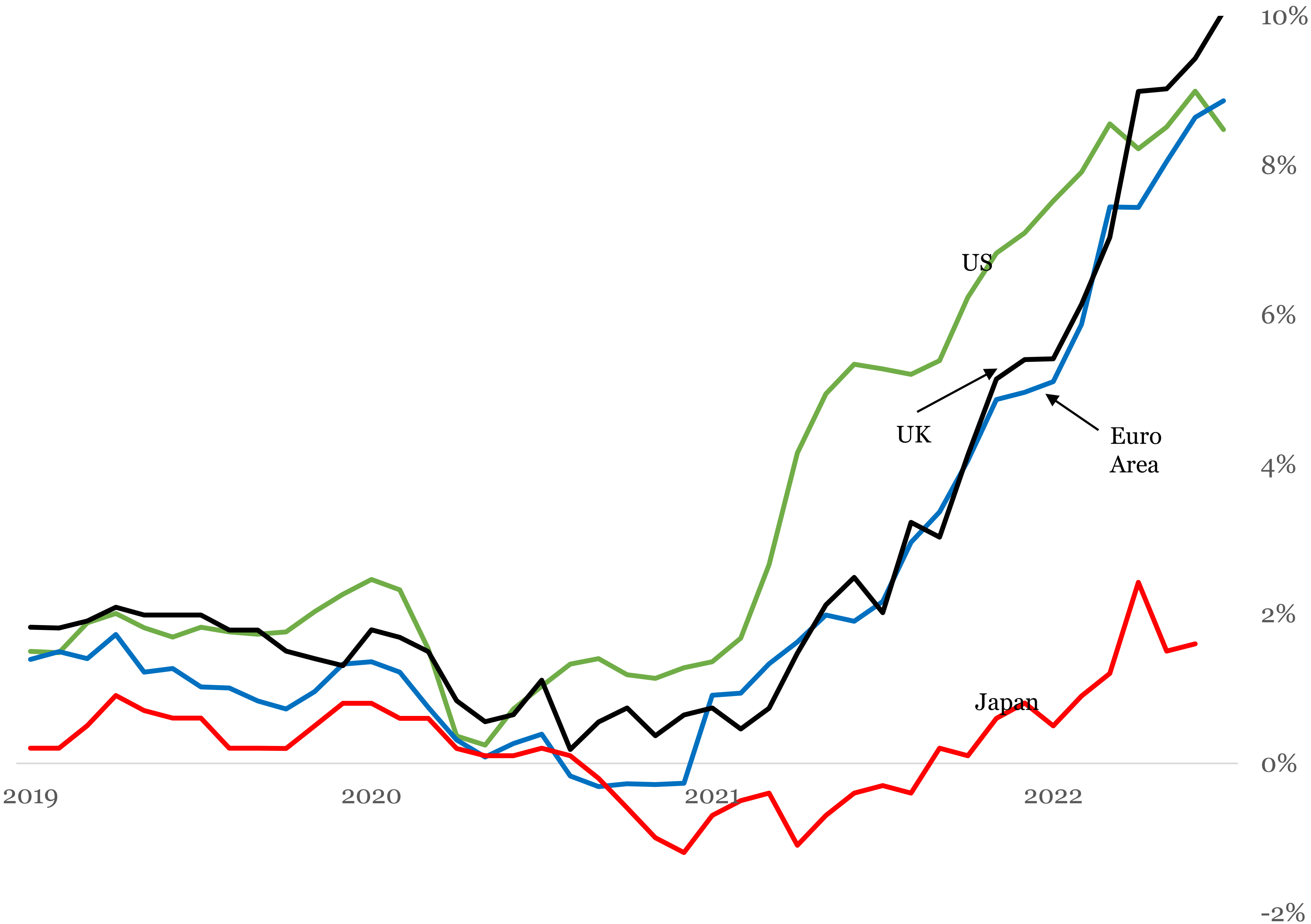
Oil Prices

WTI £/Barrel
100
90
80
70
60
50
40
30
20
10
0
2000
2003
2006
2009
2012
2015
2018
2021



WTI $/Barrel
140
120
100
80
60
40
20
0
2000
2003
2006
2009
2012
2015
2018
2021

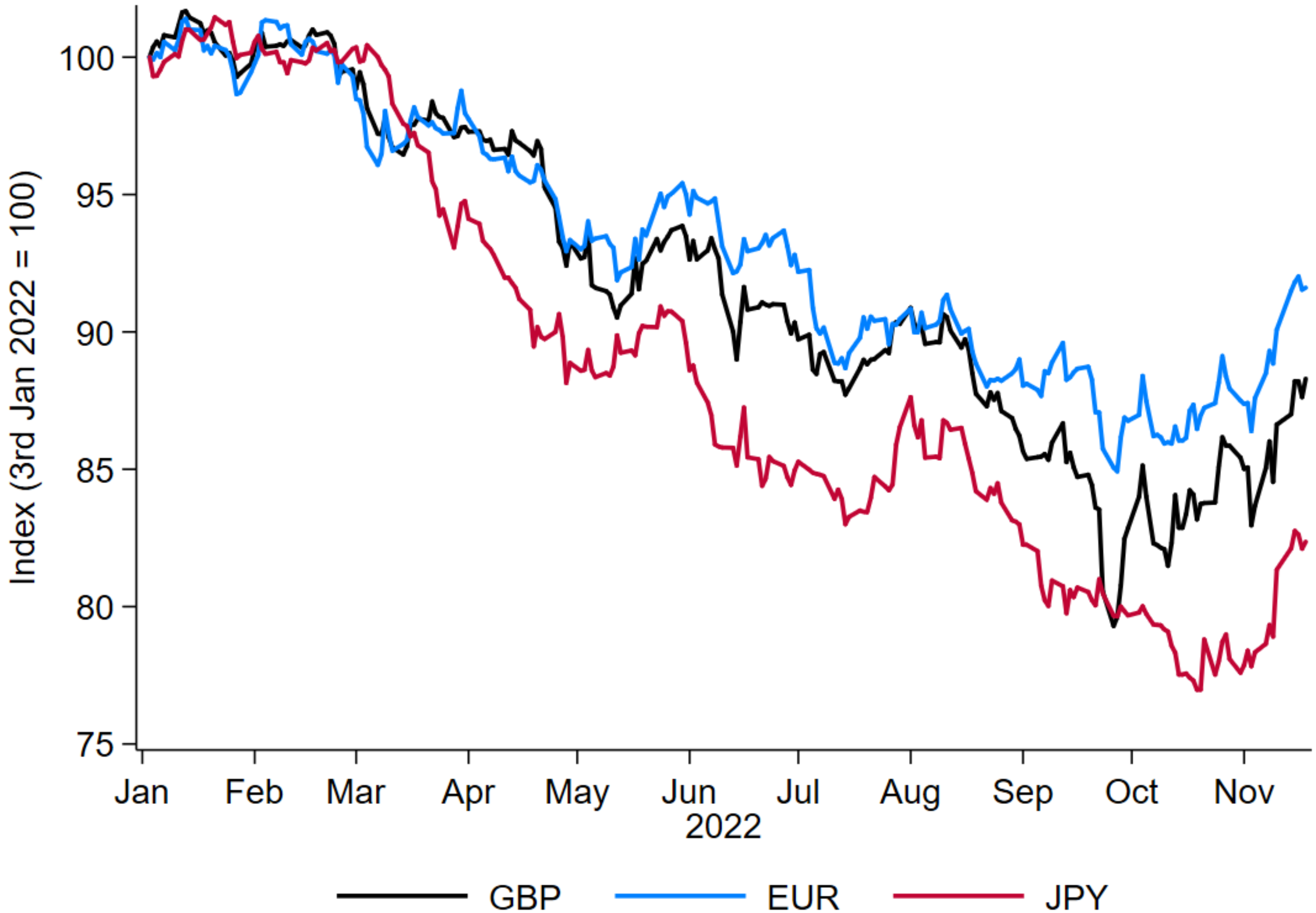
Recent Inflation



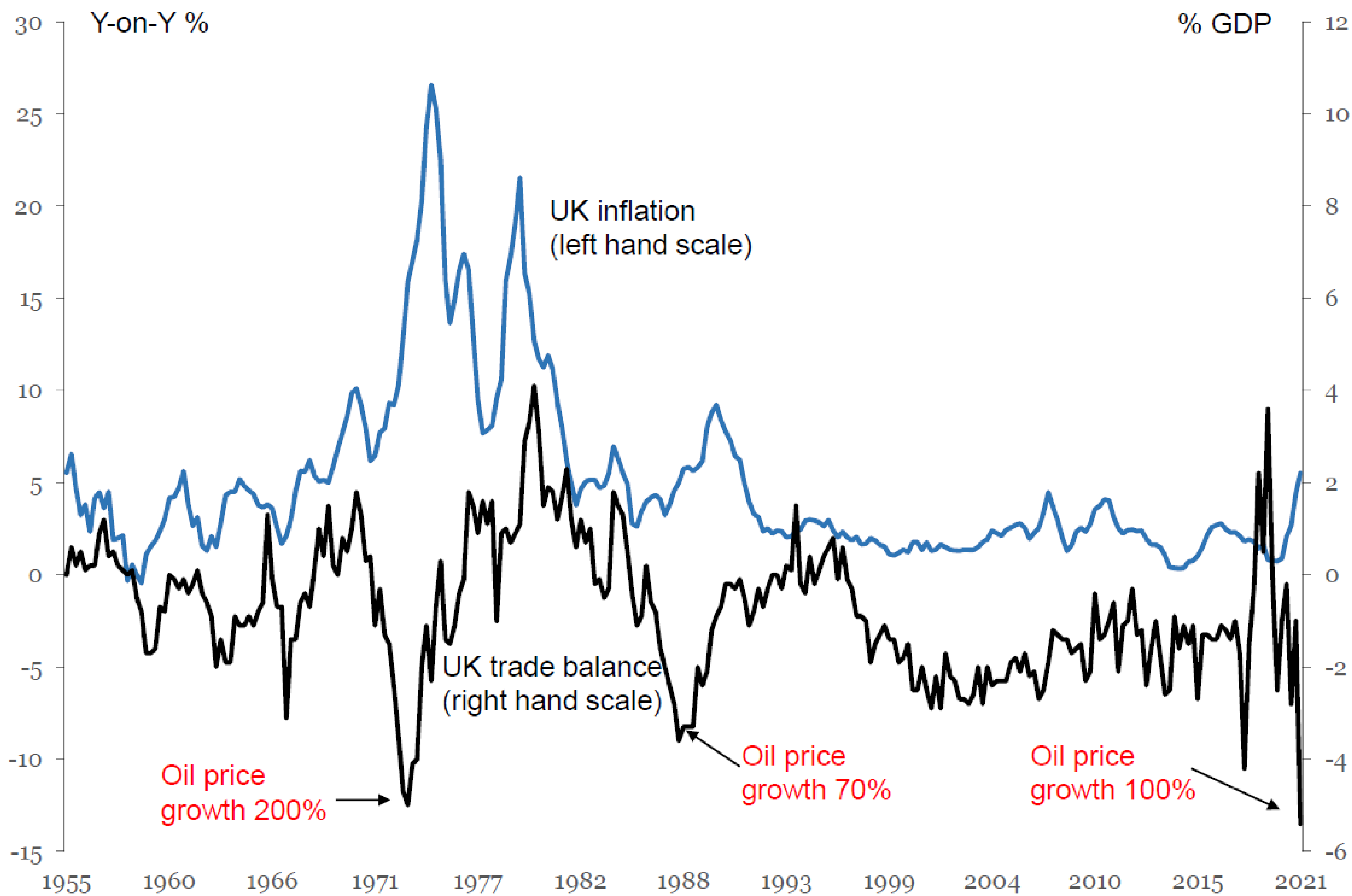
Inflation in the 1970s

The Strong Dollar of 2022

Exchange Rate Movements are Healthy



UK Trade Deficit



Exchange Rate Volatility is Low

EUR-USD Abs Monthly Change

Source: Ilzetzki, Reinhart and Rogoff (2020, Euro Punching)

Exchange Rate Volatility is Low

JPY-USD Abs Monthly Change

Source: Ilzetzki, Reinhart and Rogoff (2020, Euro Punching)

Revenge of Dornbusch

In IRR (2020) we coined the phrase "revenge of Dornbusch": *

- Monetary policy only factor that explains (daily and) monthly ER volatility

What did we learn in 2022?

- Monetary policy remained major factor in high frequency
- Monetary policy became *more* volatile, but still very *correlated*
- Real factors (oil) were important in the lower frequency movements

Healthy Exchange Rate Responses

Seen through this lens, exchange rate declines in oil importing countries are a healthy response.

Exchange Rates are doing exactly what they're supposed to do

- Boost exports and limit imports of trade deficit countries

Exchange rate volatility is mostly a risk in countries with currency mismatch: dollarized economies

Good news: exchange rate declines have so far been small in emerging markets

Mini-Budget: What Happened

The Events

Sep 6: Liz Truss becomes UK prime minister

Proposes new budget with

- 2-year guarantee of energy price subsidies with expected 4% of GDP cost
- 1.5% of GDP tax cuts, primarily for corporations and high-income earners
- This on top of 95% debt to GDP
  - France: 112%
  - US: 124%
  - Japan: 260%

The Events (II)

Sep 22: budget announced

- Following a 50bp tightening 2 days earlier
- Only new component was scrapping the 45% tax band

UK gilt yields jumped by >100 basis points in next 5 days

- From a *very* low -0.5% real on 5-year gilts

£ collapsed by 5% in one day

Bank of England indicated that it would have to raise interest rates in face of the budget

The Events (III)

Fire sale of 30-year gilts by pension funds spiralled

This was because of margin calls on

Bank of England intervened in gilt markets for 2 weeks to stabilize collapsing long-term gilts (£65 billion)

- Finding itself in a strange "twist" of tightening short term rates and conducting a quasi-QE to lower long run yields

After several "U-turns," a sacked Chancellor, Liz Truss resigns.

The Autumn statement of the new government was a 180-degree turn of tax increases and public spending cuts

Diagnosis

False Comparisons with £ Crisis 1992

1) Exchange rate volatility has been very small

Mini-budget: 5%, nearly no change on the month

ERM crisis: 15% in a month

Argentina 2002: 55% in 2 months

2) UK doesn't have an exchange rate objective.

1992: UK committed to a peg to the DM

Had finite FX reserves to meet the challenge

2022: No exchange rate target, no reserves

End of analogy

The Fiscal Theory of the Price Level

The fiscal theory of the price level starts from 2 observations:

1) The price level is the relative price of good and services to *all* government liabilities.

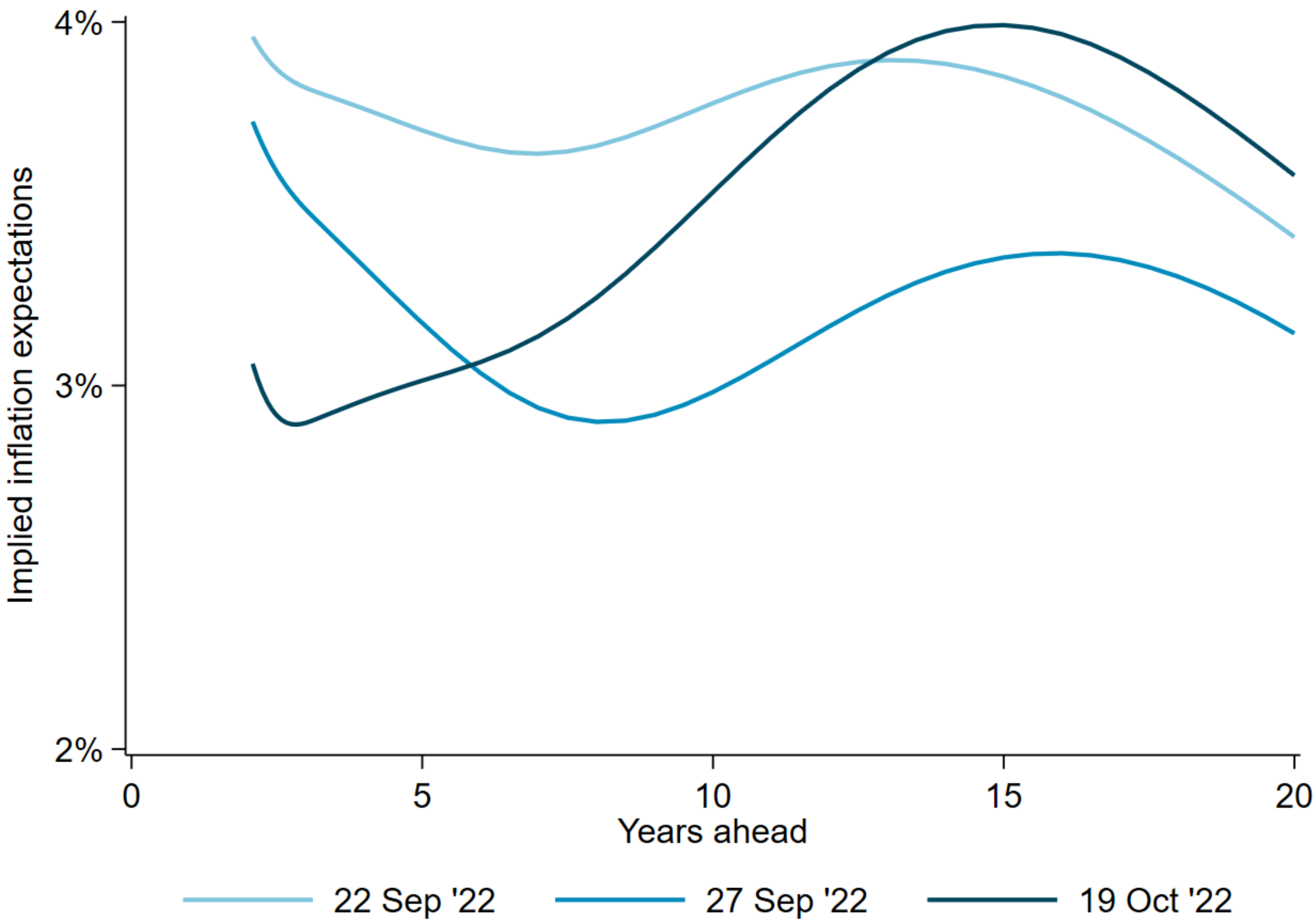
2) Budget accounting identity (absent government default):

Government Debt = NPV(future government surpluses)

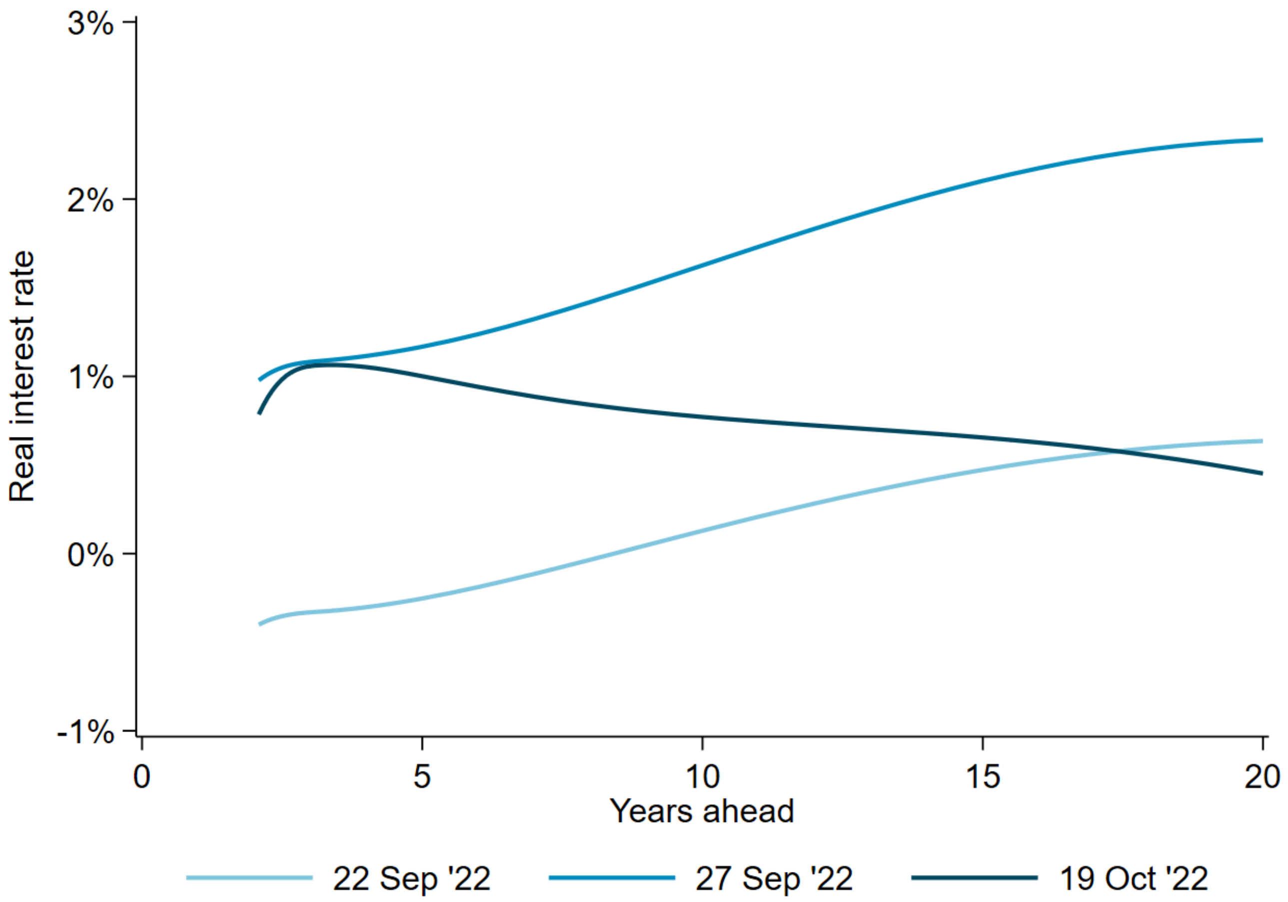
Premise of FTPL: If Debt> expected NPV of surpluses →

Price level rises to inflate away debt.

UK Inflation Breakeven Curve



UK Real Yield Curve



The “Textbook” Model

Three equations in three unknowns: GDP, inflation, interest rates.

Three ingredients:

- Supply side where inflation increases in GDP (Philips curve)
- Demand that declines with the interest rate (Euler equation)
- A central bank that raises interest rates to combat inflation (Taylor rule)

The Mini-budget in the Textbook Model

- Mini-budget: is massive stimulus of 5.5% of GDP → Expected to increase demand.
- Demand is riding on an upward sloping (and currently steep) supply curve → ***potential*** for high inflation.
- Central bank with strict inflation target expected to fully quash inflation → high nominal and real interest rates, ***no high inflation***

A Health Response to Bad Policy

I view the market response to the mini budget crisis as a healthy response to bad policy.

- The market response reflected strong faith in UK monetary institutions and rejected fiscal dominance.
- Once the mini-budget policies were reversed, so did the market reaction

The alternative could have been far worse:

- A loss of faith in UK monetary policy
- Increases in nominal yields *and* inflation expectations
- Experience shows that U-turns are too little, too late, when there is a full-fledged panic.

Fallouts and Remaining Risks

What to Look Out For

With higher interest rates

- More cracks in the financial system may be exposed
- And Bank of England risks ***financial dominance***

- UK mortgagors will face a mortgage affordability crisis
- Bank of England risks ***mortgage dominance***
- UK lacks long-term (>5 year) fixed rate mortgages

So far the markets have rejected the ***fiscal dominance*** possibility

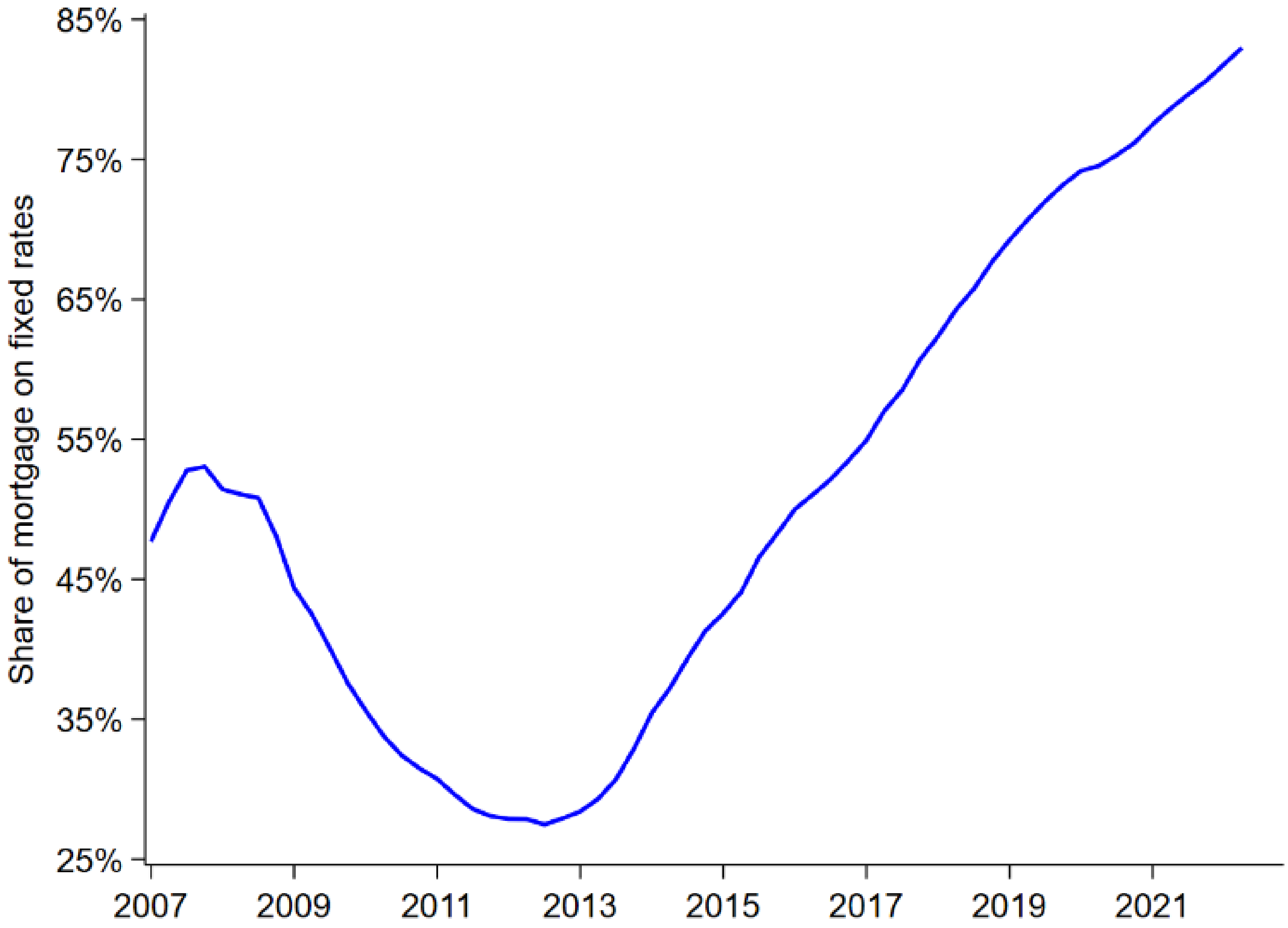
Financial Dominance

Bank of England was right (had no choice) but to “bail out” pension funds.

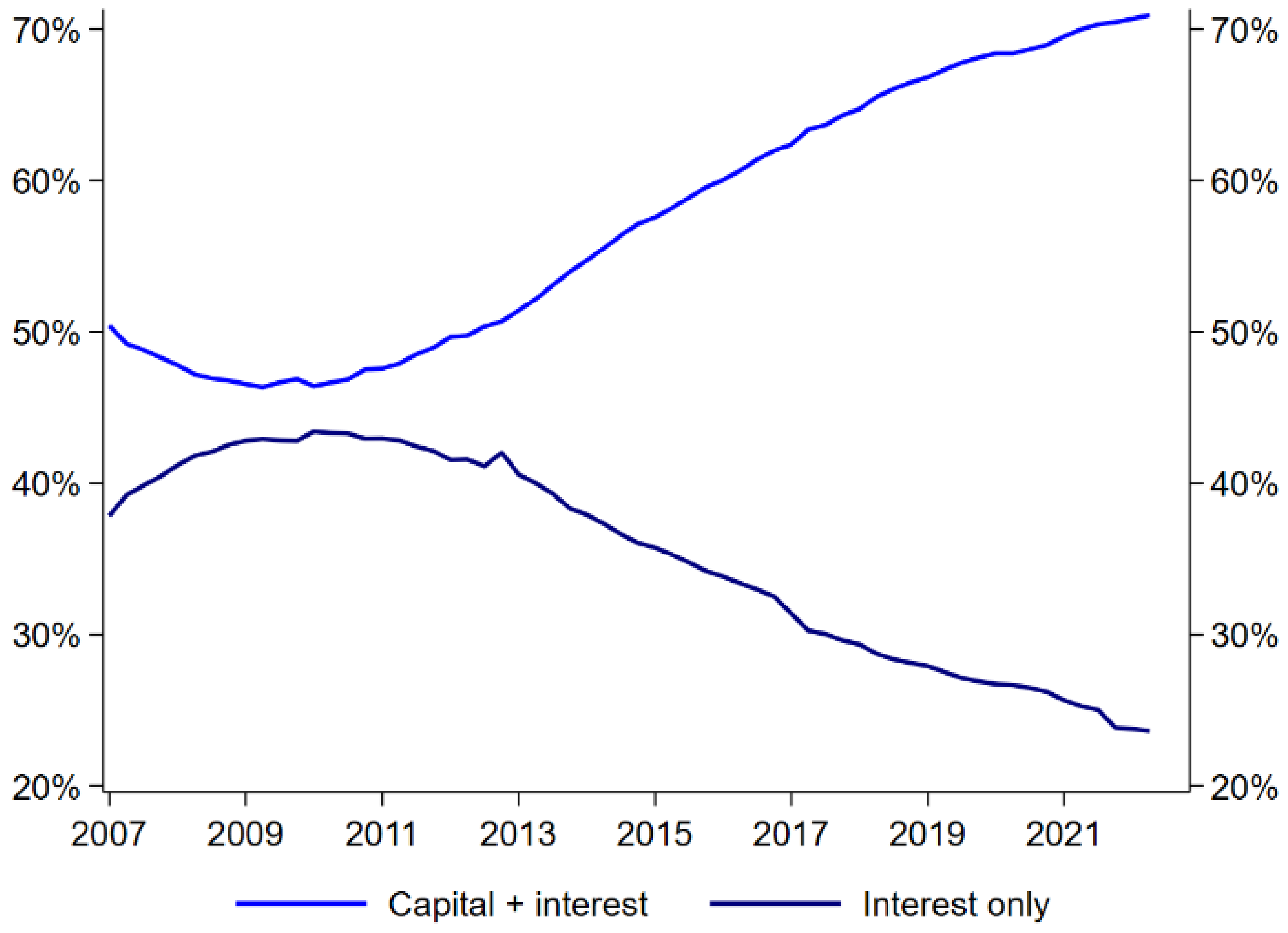
- But this put us in an unexpected situation of monetary tightening and quantitative *easing*
- We don’t have off-the-shelf frameworks to set policy optimally in these circumstances

Known unknown risks in financial system may yet emerge

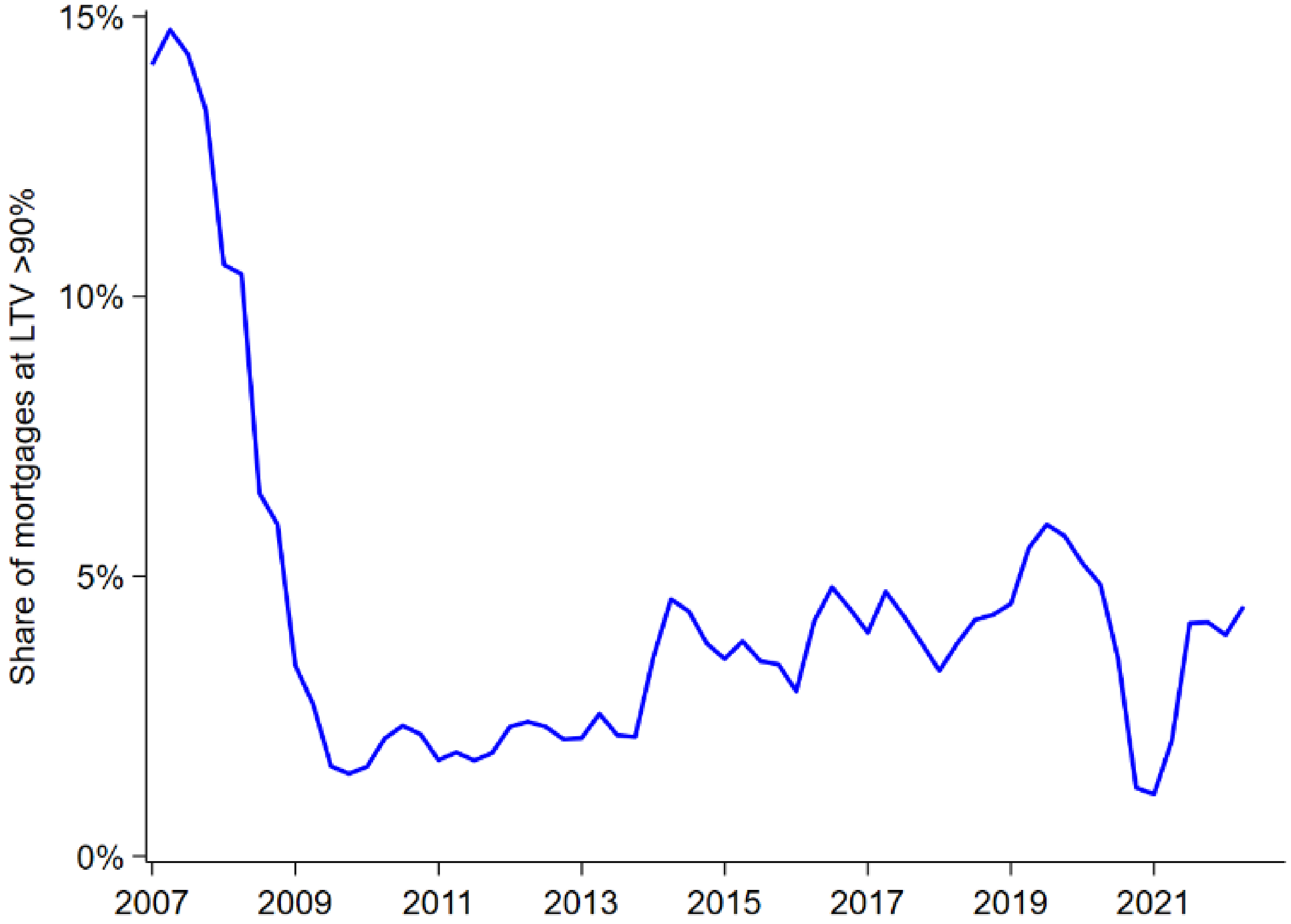
Share of Mortgages with Fixed Rate



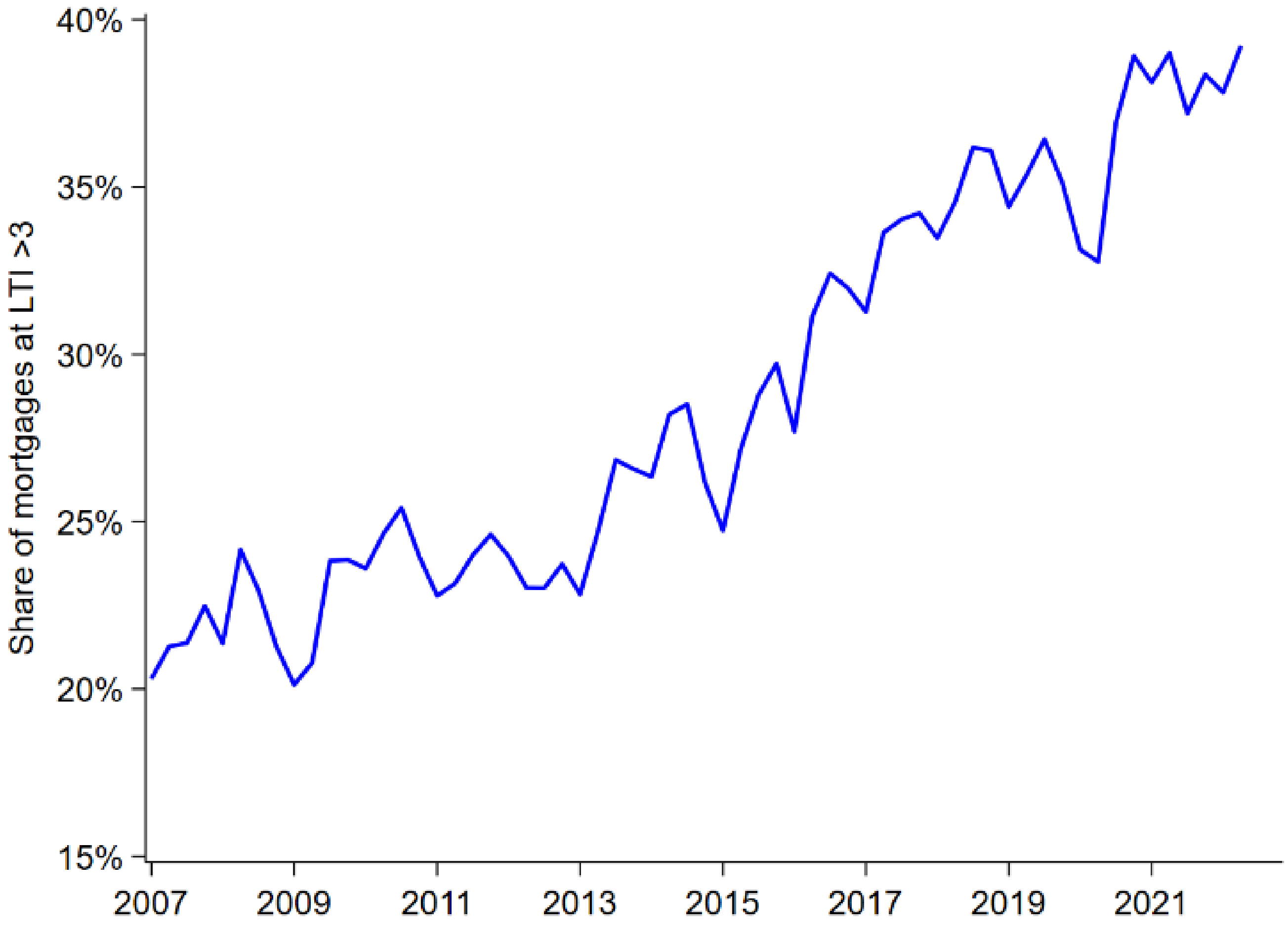
Share of Interest Only and Amortizing Mortgages



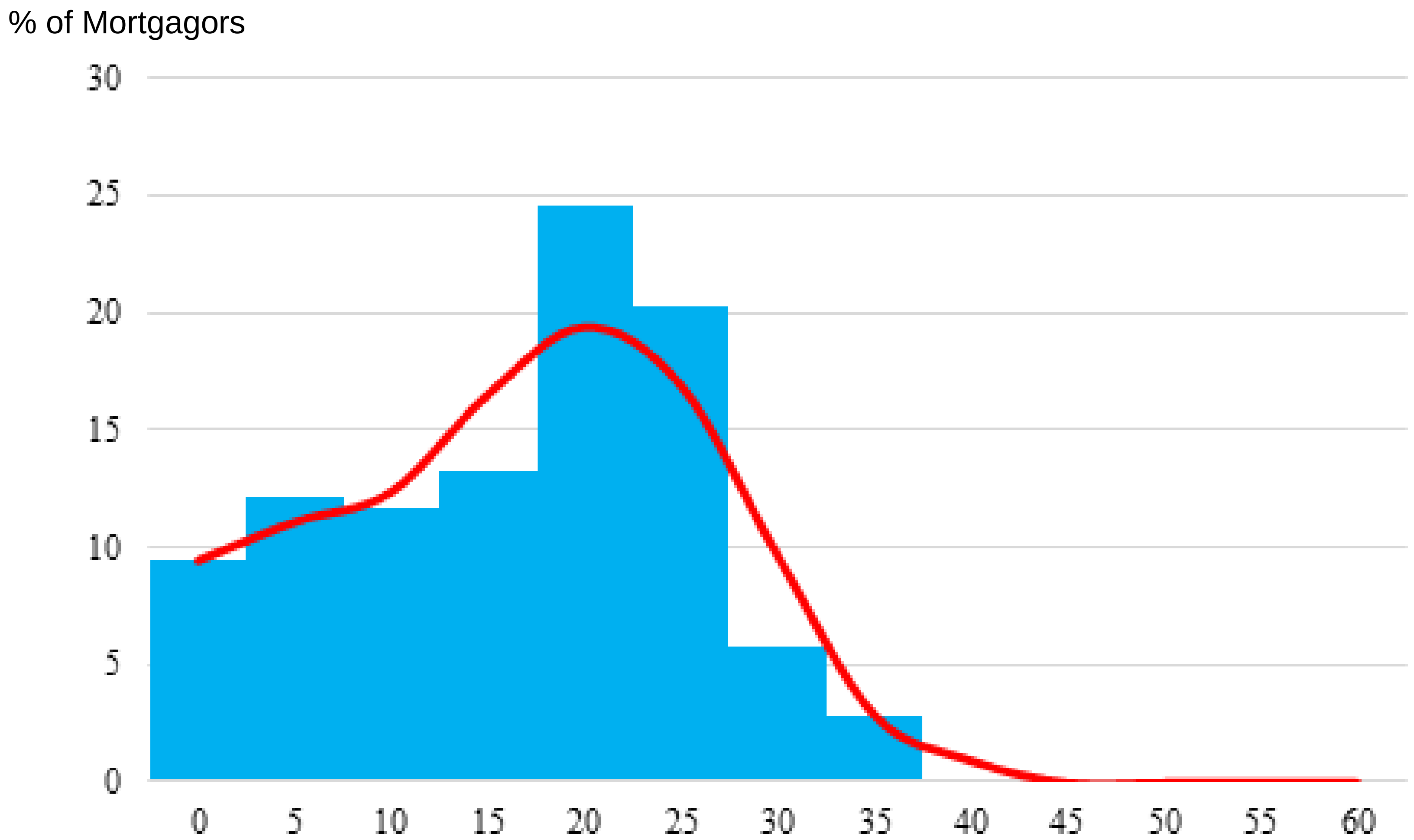
Share of Mortgages with LTV>90%



Share of Mortgages with LTI>3

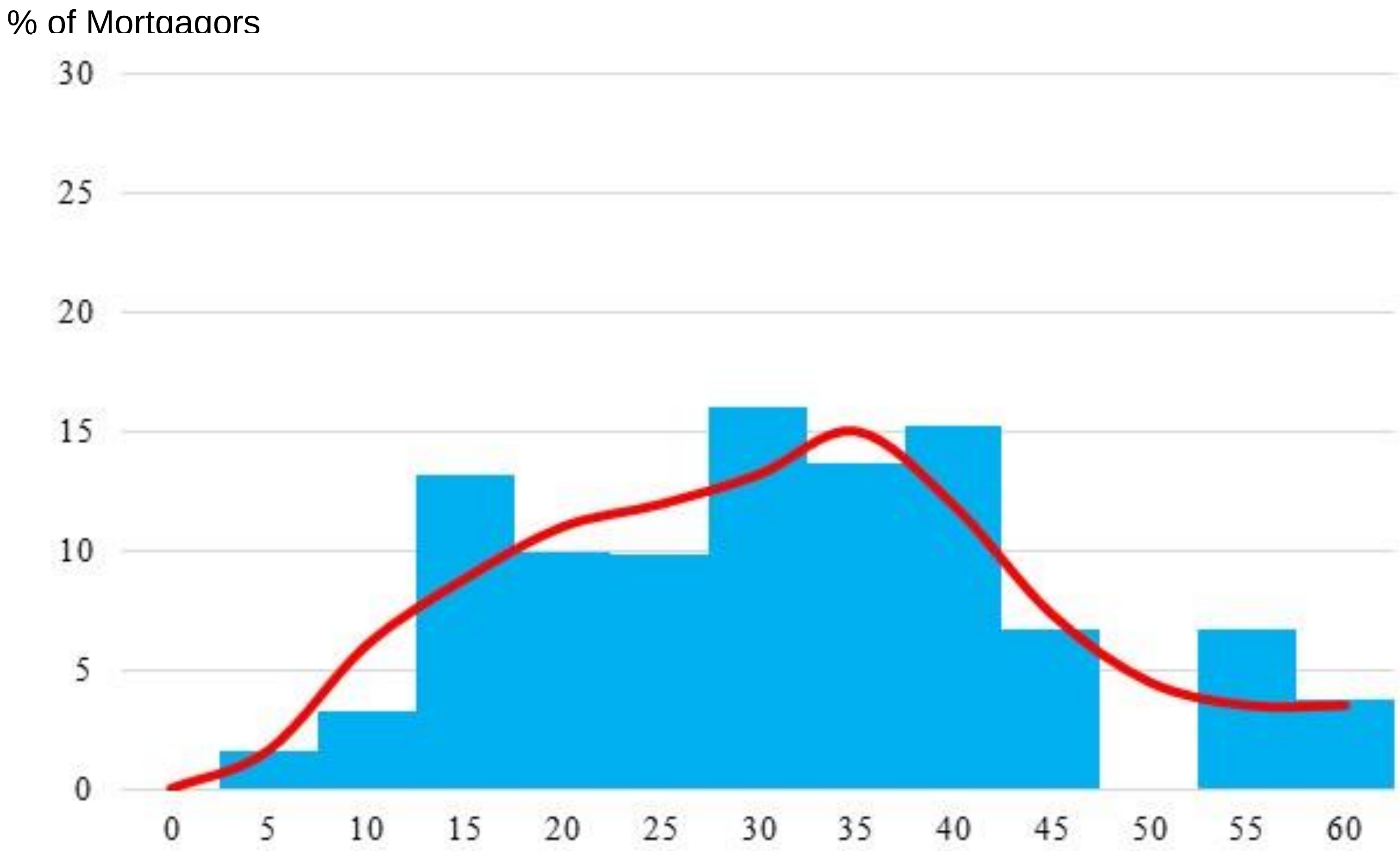


Predicted Monthly Payments to Income January 2022

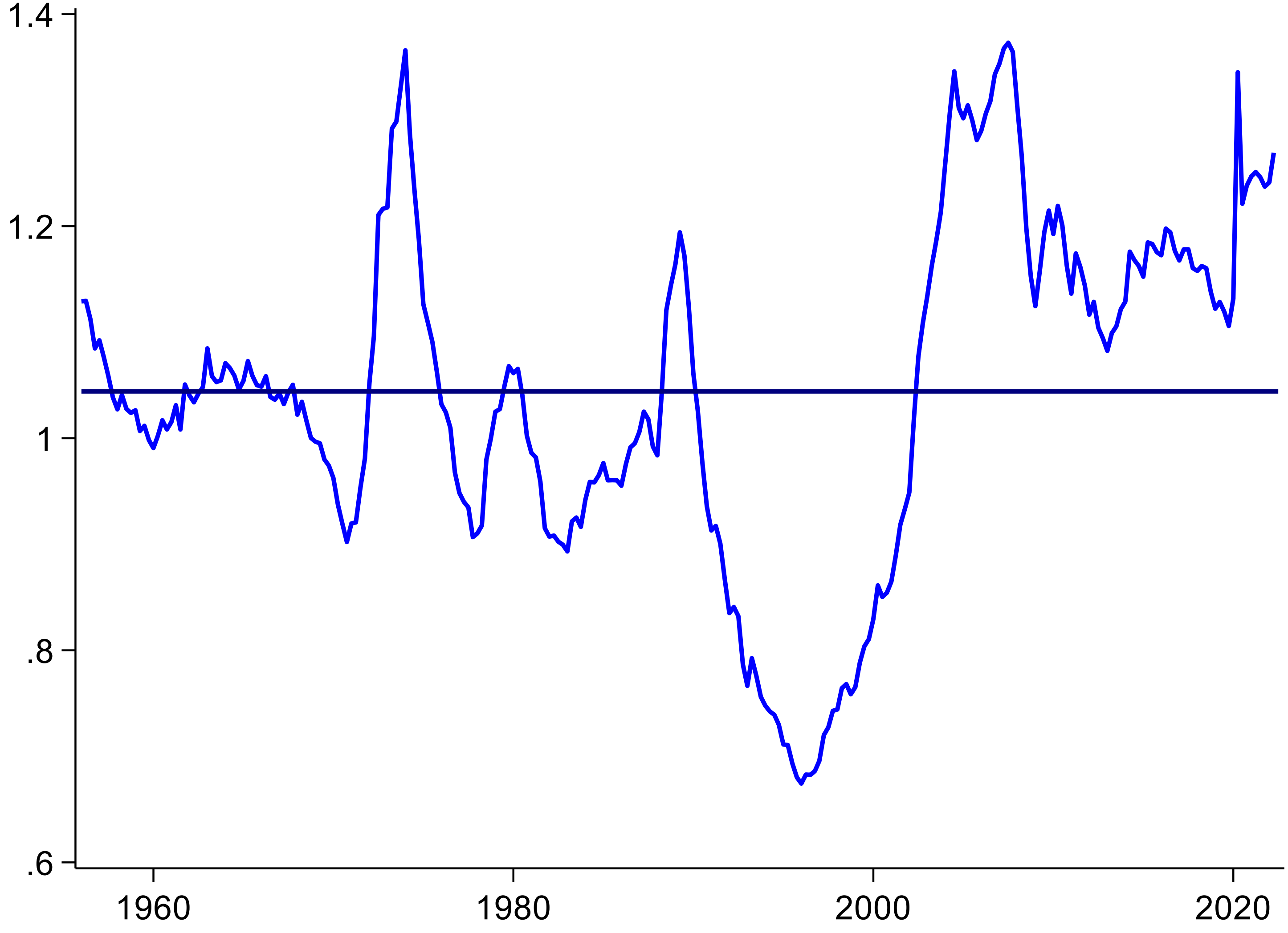


Predicted Monthly Payments to Income January 2022

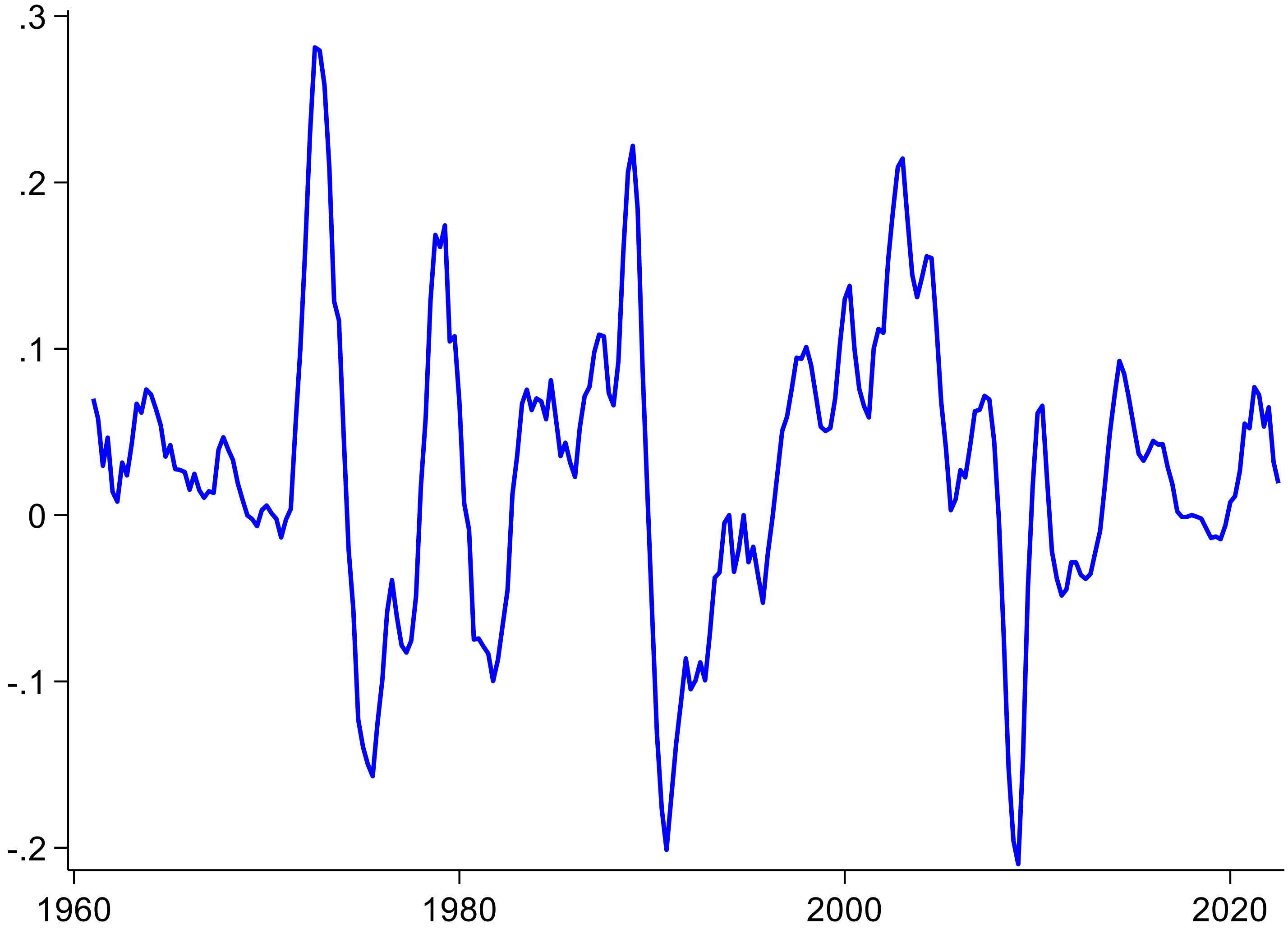
Predicted Monthly Payments to Income January 2022 with 10% House Price Drop



House Prices to GDP Index



Real House Price Growth



Policy Recommendations

Contingency plans for mortgage restructuring

- Higher rates will lead to unaffordable mortgages
- Restructuring may beneficial to both households and banks
- Study the forbearance plans in Ireland and Australia

Introduce long-term mortgages

Free Bank of England to do its job and avoid mortgage dominance

Pro-growth, revenue neutral tax reform is possible

(Resolve Brexit uncertainty)