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# News release

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## Sticky inflation - speech by Spencer Dale

Spencer Dale – Chief Economist at the Bank of England – tackles two important issues in monetary policy: the persistence of above target inflation, and coupon transfers to HM Treasury.

### The persistence of above target inflation

Spencer asks why inflation is so "sticky" at above target rates despite the presence of slack in the economy. Some of the reasons have been highlighted before: "past increases in import prices... university tuition fees... and increases in food prices in the wake of poor global harvests." But this is not the full story. Spencer asks "why aren't domestic costs pressures growing more slowly?"

The answer, he concludes, can in large part be found by considering the massive real adjustments that our economy has had to undertake.

Spencer explains that "we are still adjusting to the new realities" associated with the global financial crisis, in particular "the unprecedented weakness of productivity" and "large changes in relative prices triggered by the depreciation of sterling, repeated rises in commodity prices and the increase in VAT". "The harsh but inescapable reality of these developments – and the real adjustments they necessitate – is that households and families in our economy are worse off. Much worse off." "The less we produce" and the less "we can purchase using the proceeds from our domestically produced output", "the less we can ultimately consume".

Spencer notes the "extraordinary flexibility" shown in the labour market. Real wages, measured in terms of consumer prices, have fallen by over 15% compared with the pre-crisis trend. So "no wonder that people are finding life tough". "The majority of that adjustment has been achieved by weak nominal wage growth", which Spencer points out is not consistent with "the suggestion by some commentators that the (wage) Phillips curve has suddenly become far flatter". "But the sheer size of the required adjustment has meant that it could not be delivered by wage restraint alone. Some of it has come about via higher inflation." And this is a large part of the explanation for why inflation has proved to be so sticky. "One important lesson we should draw from this episode...is that there is no simple mechanical mapping from the output gap...to inflationary pressures."

Turning to the policy implications, Spencer notes that “Monetary policy has only a limited role to play as an economy adjusts to these types of real shocks. The final destination cannot be altered. Like a London cabbie picking up a new fare, all that monetary policy can do is decide the route by which that destination is reached.” Did the MPC pick the wrong route? The MPC could have tried to bring even more of the real adjustment about through weaker pay growth. But that “..would have required the MPC to run a tighter stance of monetary policy, thereby presiding over an even deeper recession.” So Spencer suggests that “there are no easy fixes to these type of real adjustments”.

Spencer concludes that the “adjustment process is not yet complete”. “To the extent that the weakness in productivity persists, domestic cost pressures are not likely to ease materially unless private sector wage growth slows from its already muted rates”, “... and so the stickiness in inflation may persist for a while yet.”

**Coupon Transfers**

Spencer also discusses coupon transfers to HM Treasury from the Bank’s Asset Purchase Facility (APF) and addresses some concerns that have been sparked by the decision. He explains why the transfer does not constitute “monetary financing”, since the Government already effectively owns the APF.

Spencer accepts that the transfer will change monetary conditions. But that is also true of, for example, movements in the sterling exchange rate, changes in bond yields, and decisions by the FSA on banks’ capital and liquidity requirements. “The MPC does not have a monopoly over factors affecting monetary conditions. But what it does have is the power – each and every month – to respond to those developments.” “The MPC remains firmly in control of the stance of monetary policy.”

Spencer claims that “in all likelihood [he] wouldn’t have voted for more QE even in the absence of the Government’s decision”. But he feels that voting to offset the monetary implications of the APF cash transfer would have been to overstate “our ability to fine tune policy... to offset exactly the impact of the myriad of factors affecting monetary conditions.” He states that he “will take the Government’s actions into account, both in terms of any decision to increase further the size of the asset purchase programme and, potentially, in terms of the timing at which we begin to tighten monetary policy”.

Spencer notes that “much of the transfer will eventually need to be reversed” “at a time when the MPC is tightening monetary policy, raising Bank Rate and selling back gilts”. “We should have our eyes open that large financial flows between the fiscal and monetary authorities ...may raise understandable concerns.” But “none of this is a deep economic problem. The MPC’s decisions about the pace at which to tighten monetary policy will, as always, be determined by the outlook for inflation.”

**Key Resources**

Sticky inflation

Full speech by Spencer Dale