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When, why, and what's next for low inflation?: No magic slippers needed

In a speech at the London School of Economics this evening, External MPC member Kristin Forbes explained why she is confident that inflation is currently "on track to rebound toward target" by early 2016. And unlike the solution to deflation proposed in the Wizard of Oz, the UK's rebound will not require "assistance from wizards or magic slippers".

Kristin opens by noting the "remarkable shift" in most developed countries; from inflation "too high" in the 1970s, to "just right" in the 1990s to mid-2000s, to falling to levels that raise concerns about being "too low" over the last few months.

Kristin then considers several concerns that have been raised about current low inflation and finds some "overhyped" and others worthy of close attention. The first of these is the claims that consumers and businesses could delay purchases and investment if they expect items to be cheaper in the future. Kristin finds this argument "unconvincing for the UK today". Instead the evidence suggests that "consumers tend to spend more – not less – on items whose prices fall".

Likewise the claim that low inflation will make it harder for individuals, businesses and governments to repay debt "have some merit" but are not applicable today; "interest rates are near historically low levels, credit is readily available for most credit-worthy borrowers, debt-servicing ratios are relatively low, and low inflation is expected to be short lived."

A more significant concern is that the current low level of inflation will have persistent second-round effects by lowering inflation expectations which could in turn supress wage growth. This is something for the MPC to watch closely but "there is not yet any evidence that low inflation has significantly held back wage growth. Instead, wage growth has picked up over the period that inflation has fallen." In fact, "the rapid normalization of the labour market should continue to support wage increases – even in an environment with low headline inflation".

Kristin dedicates most of her analysis to the final concern; that "low rates of global inflation, or just low inflation in individual countries with strong links to the UK, could create additional spillover effects that drag on UK prices”. An unusually large number of countries are currently experiencing deflation or low inflation, and there is a risk that the UK could be exposed to weak prices abroad through its significant export and import markets or even “latent competitive effects”.

The recent downward movement in core inflation, however, seems to be driven more by sterling’s 18% appreciation than by any spillover effects from low inflation in other countries. Kristin confirms this by introducing an expanded set of measures of domestically-generated inflation, which show remarkable stability in domestic inflation over the last year, after removing the effects of exchange rate movements – and even upward movement in wages and unit labour costs. A detailed analysis of the effects of inflation in other countries finds that “inflation in some of the UK’s more important trading partners (such as Germany) may have some small additional effects on UK inflation rates. But inflation in many economies with strong ties to the UK – whether through location, colonial linkages, language, or other variables – does not exert any significant effect on UK inflation. Even key trading partners’ inflation rates do not seem to generate any consistent and significant spill-overs to UK core inflation rates.” Therefore, low inflation elsewhere seems unlikely to cause low-inflation to persist for longer than currently expected.

All of which leads Kristin to conclude that “inflation is currently on track to rebound toward target without any need for assistance from wizards or magic slippers.”

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