



Not That '70's Show: Why Stagflation is Unlikely

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Not That '70's Show

Why Stagflation is Unlikely



1. What kind of world are we in today?
2. Monetary policy that anchors inflation expectations
3. Labor markets with limited bargaining power for workers over wages
4. Oil price trends not obviously accelerating upwards (yet?)
5. Productivity trend largely undiminished (yet!)
6. Avoiding historical mistakes (so far)

What sort of world are we in?



- For foreign policy , the question facing an intervention decision is whether this is Munich (deter) or Vietnam (accommodate)?
- For monetary policy, the question is similar but reversed: is this the 1930s (accommodate) or 1970s (deter)?
- The underlying dynamic today is parallel to the 1930s, but we have avoided repeating that for several reasons:
 - Structural changes (automatic stabilizers, flexible x/r , deposit insurance)
 - A smaller share of the world in synchronized contraction
 - Aggressive coordinated macroeconomic stimulus 2008-2010
- Is there a risk to go from such a state to one of overheating and inflation - or inflation and contraction (aka stagflation)?

What sort of world are we in?



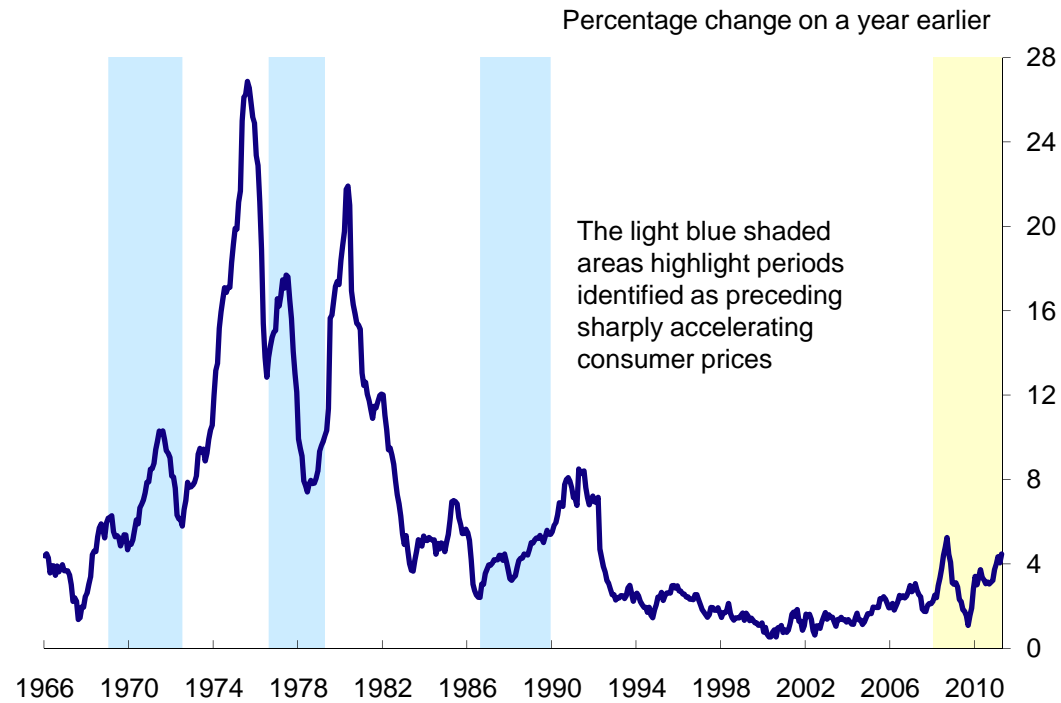
- Let's assess what it took for stagflation to occur in the 1970s
- This is a serious question, not a straw man
 - Stagflation is unusual historically, especially following a recession
 - The historical and theoretical imagery of 'pre-emptive monetary policy' stems completely from the 1970s experience
- What would be involved in repeating the wage-price spirals?
 - Unanchored inflation expectations
 - Transmission of expectations into real wage resistance
 - Economically significant energy supply shock(s)
 - An unrecognized decline in trend productivity growth
- Only the third of these (oil) seems to possibly be at work
 - Bruno and Sachs (1985), Blanchard and Gali (2007) show that all of them have to interact to (re)produce the 1970s

Monetary policy that anchors inflation expectations



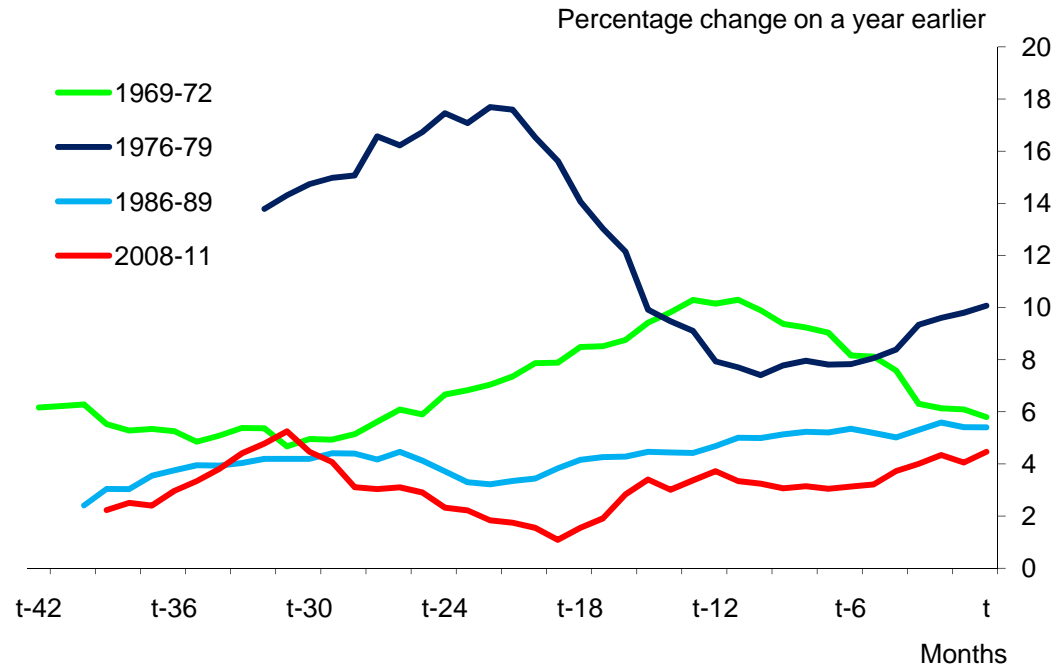
- The theoretical literature on central banking (and some press) treats monetary policymaking as under constant suspicion
- The empirical evidence has not supported this view (Blinder, McCallum, Posen on CBI; Kuttner and Posen on CB governors)
- Right now in global markets, there is understanding of explanations
 - Recent *Inflation Report* and my February speech on financial expectations
- Several factors contribute to this real-world anchoring:
 - Central bank independence from fiscal authorities
 - Better knowledge of how some (not all) of the economy works
 - Inflation targeting and transparent disclosure by central banks
- A reasonable discourse and accountability, not a ‘trigger-strategy’ game of needing to pre-empt (fighting the last war?)

UK consumer prices – the long view



Sources: Office for National Statistics since 1989 and OECD before 1989.

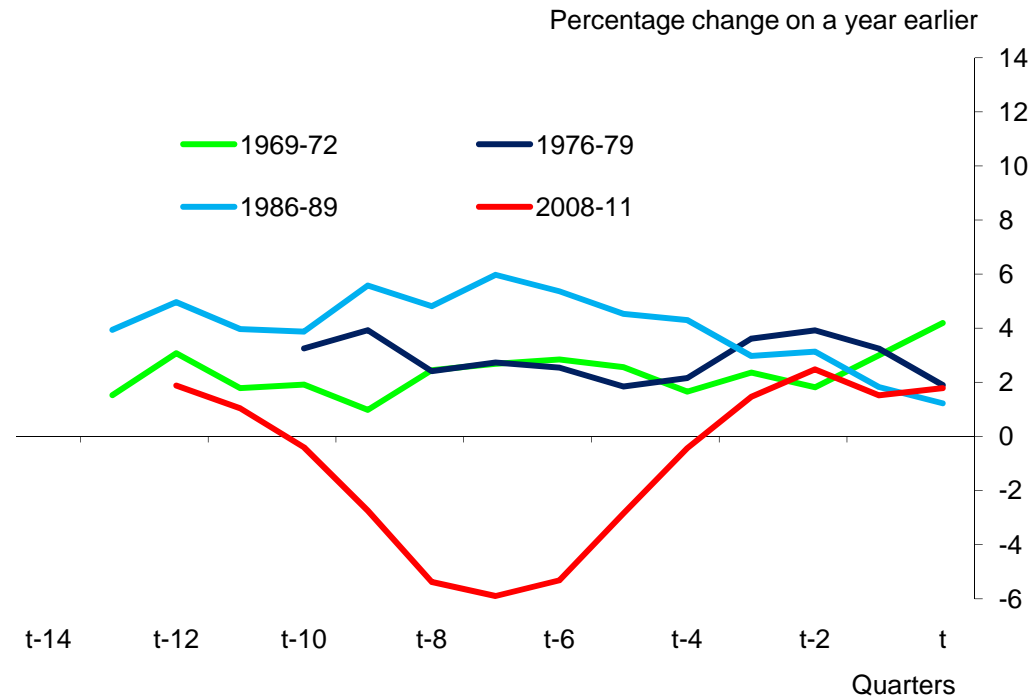
UK consumer prices – compare to previous run-ups



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Sources: Office for National Statistics since 1989 and OECD before 1989 and Bank calculations.

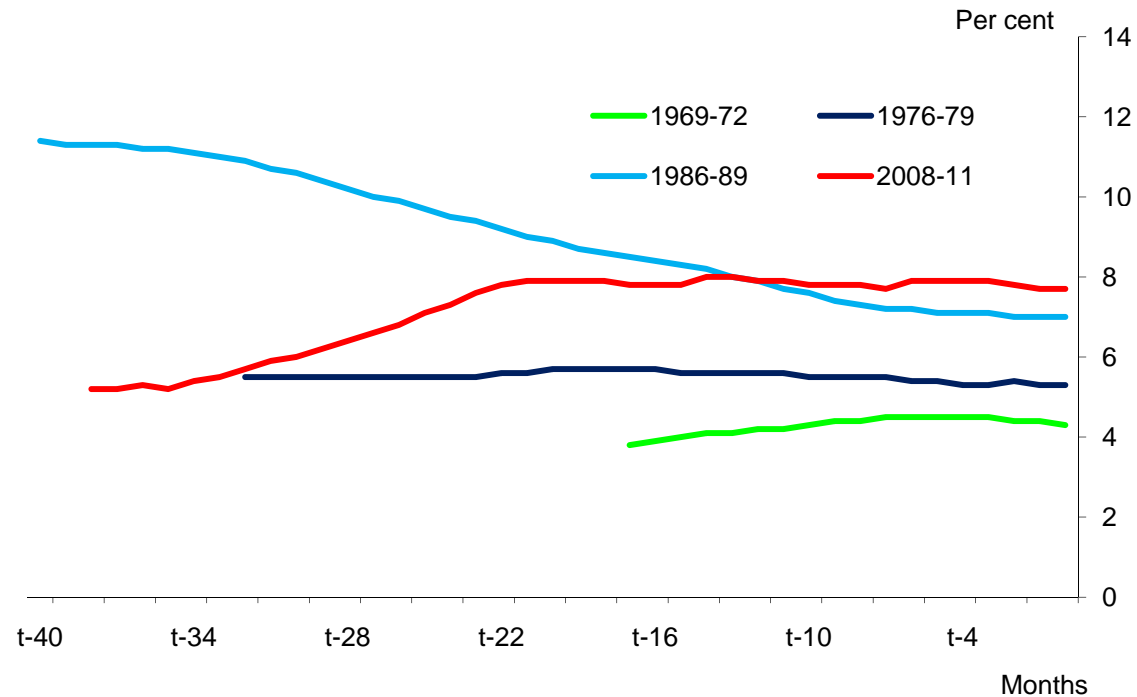
UK real GDP growth – an output gap this time



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Sources: Office for National Statistics and Bank calculations.

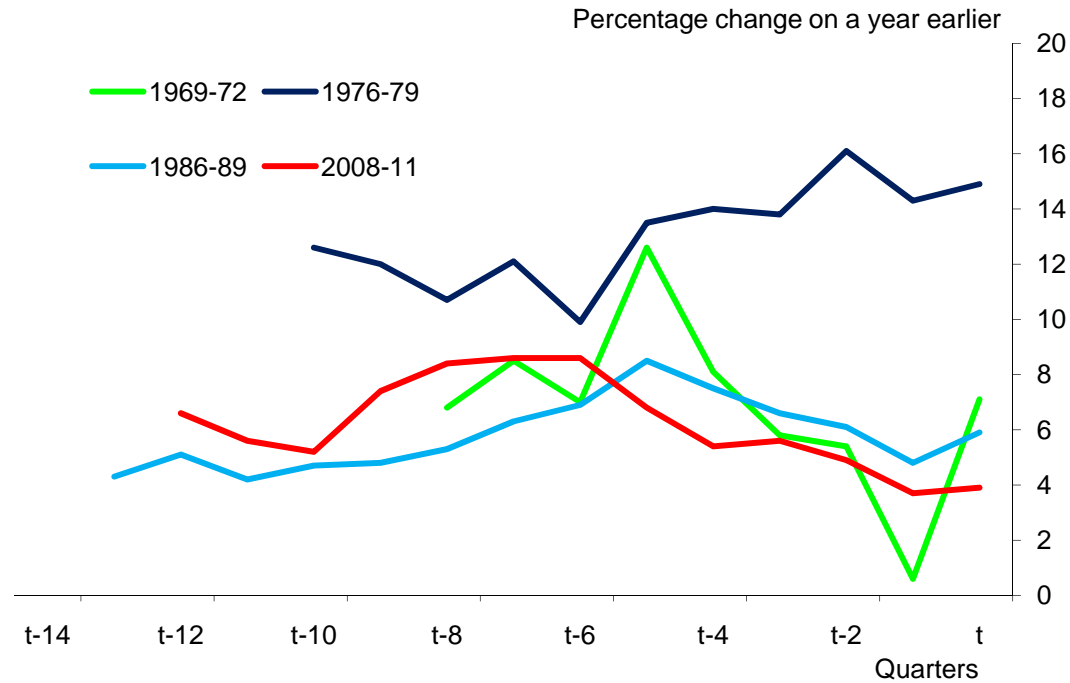
UK unemployment rate – Rising this time



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Source: Office for National Statistics and Bank calculations.

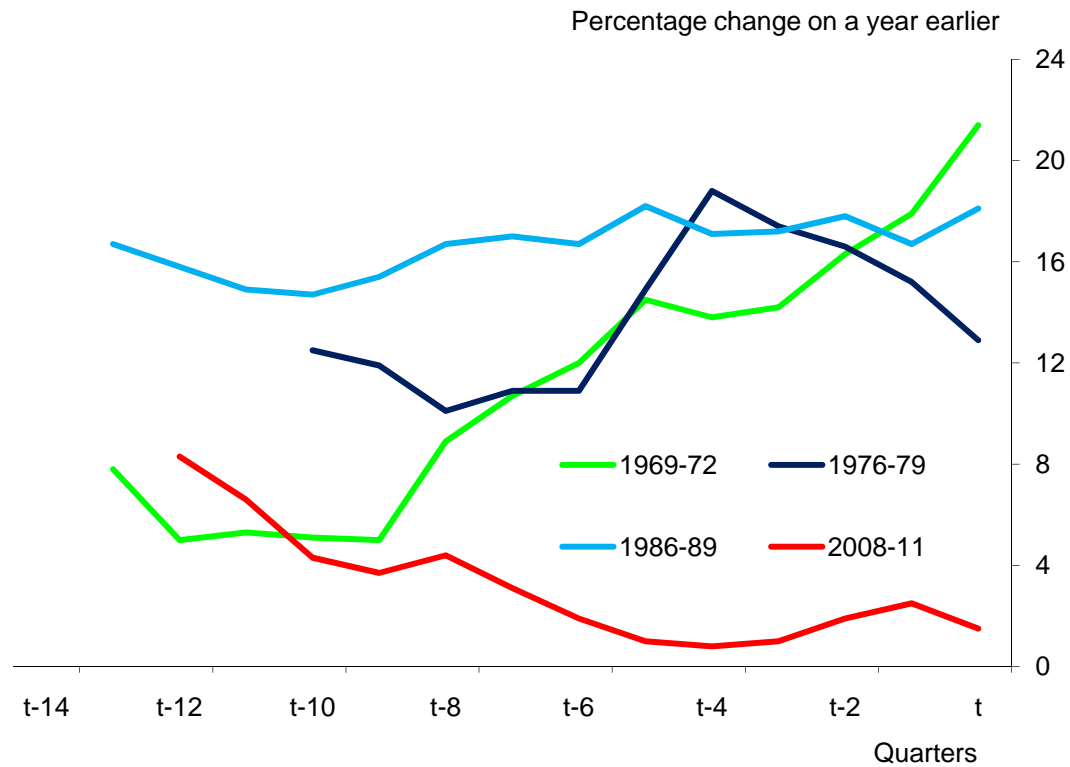
UK narrow money – compare to previous run-ups



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Source: Bank of England, including Bank calculations.

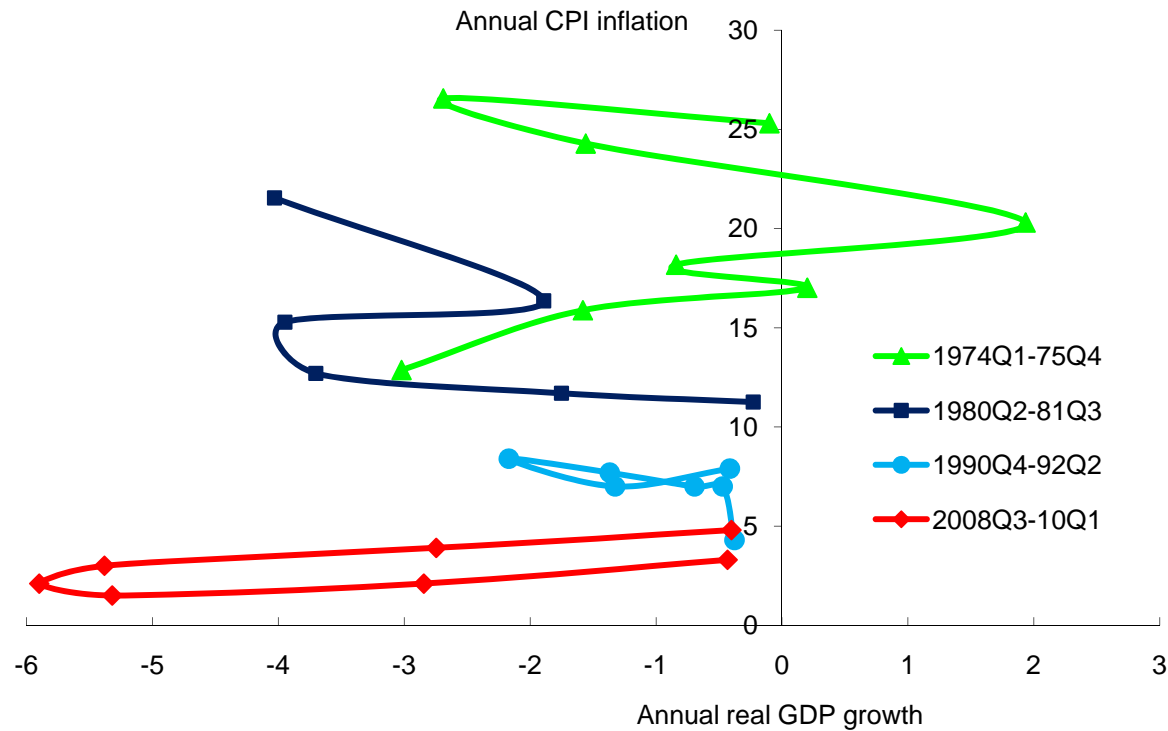
UK broad money – No credit expansion this time



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.
M4 prior to 1998 Q4; M4 excluding intermediate OFCs after 1998 Q4.

Source: Bank of England.

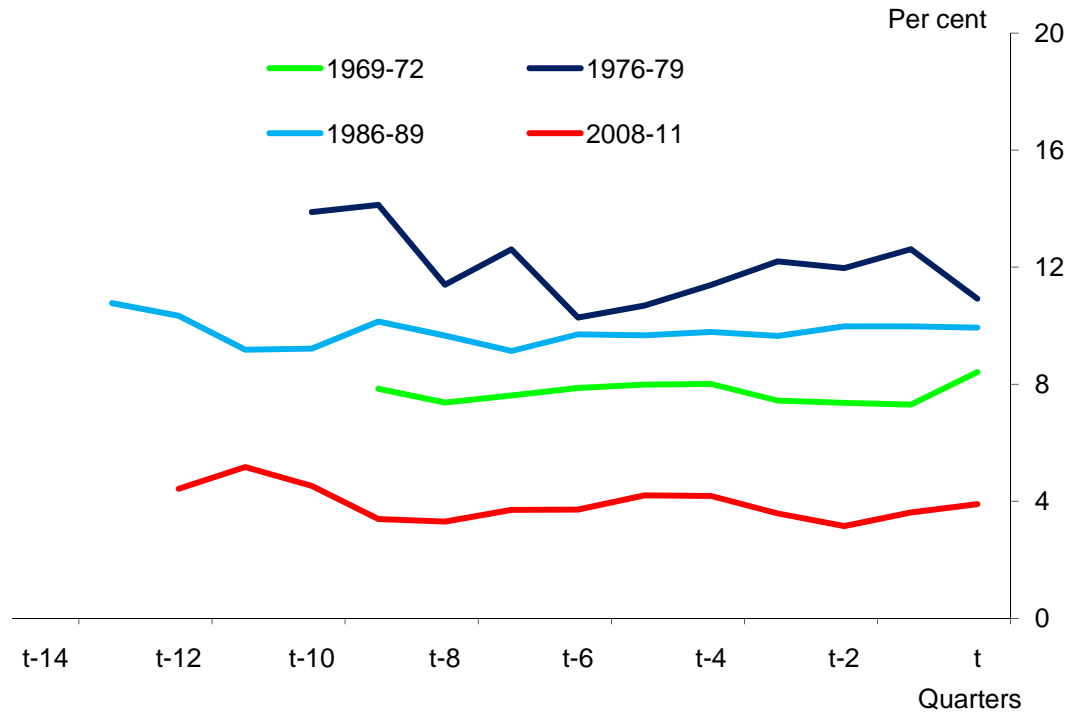
UK CPI inflation and GDP growth – a comparison of anchoring through time



No
upward
drift

Source: Office for National Statistics, except for consumer price data before 1989, which are from the OECD.
Bank of England calculations.

UK ten-year nominal gilt yield – proxy measure for inflation risk premia

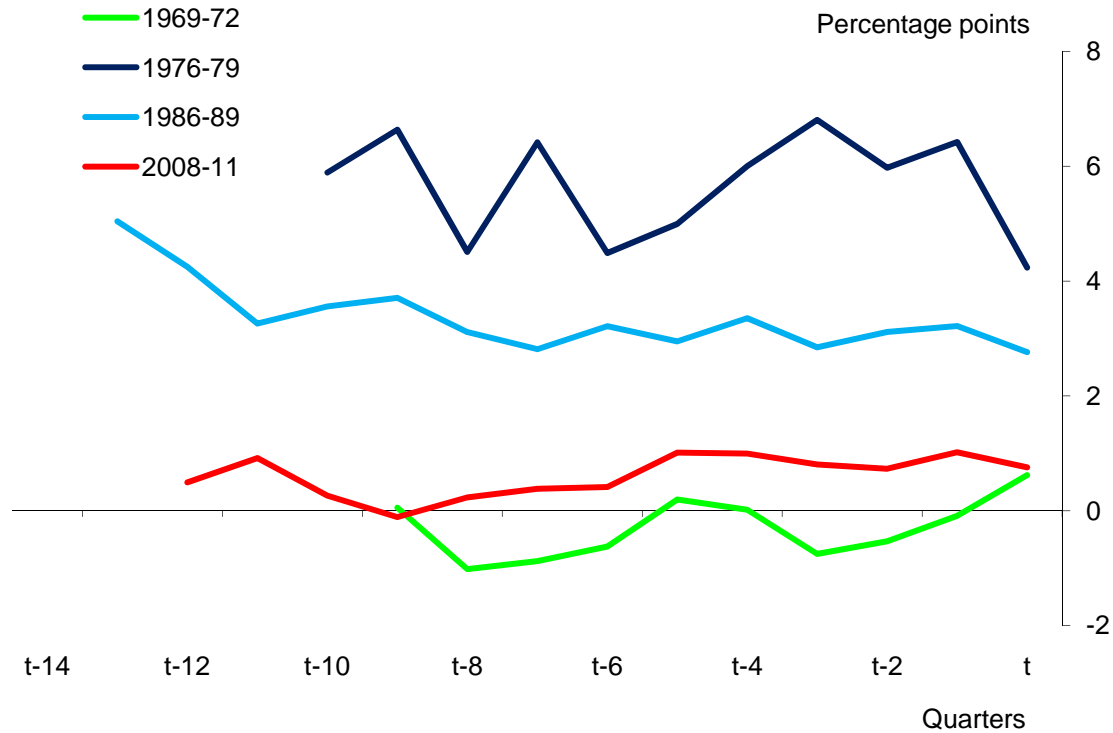


Low
and
stable

Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Source: Bloomberg and Bank of England calculations.

UK-German long-term government bond yield spread



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.
The spread is calculated as the difference between UK ten-year gilt yields and average yields on German government bonds with a maturity greater than three years.

Source: Bloomberg, IMF International Financial Statistics and Bank of England calculations.

Labor markets with limited bargaining power for workers over wages



Everyone in the UK should remember (or know) about the 1970s, the Winter of Discontent, *Britain Against Itself* (Beer (1982))...

- That was in part the result of 30 years of rising union power
- But that was then, this is now
 - Today, we are seeing the result of 30 years of declining union power

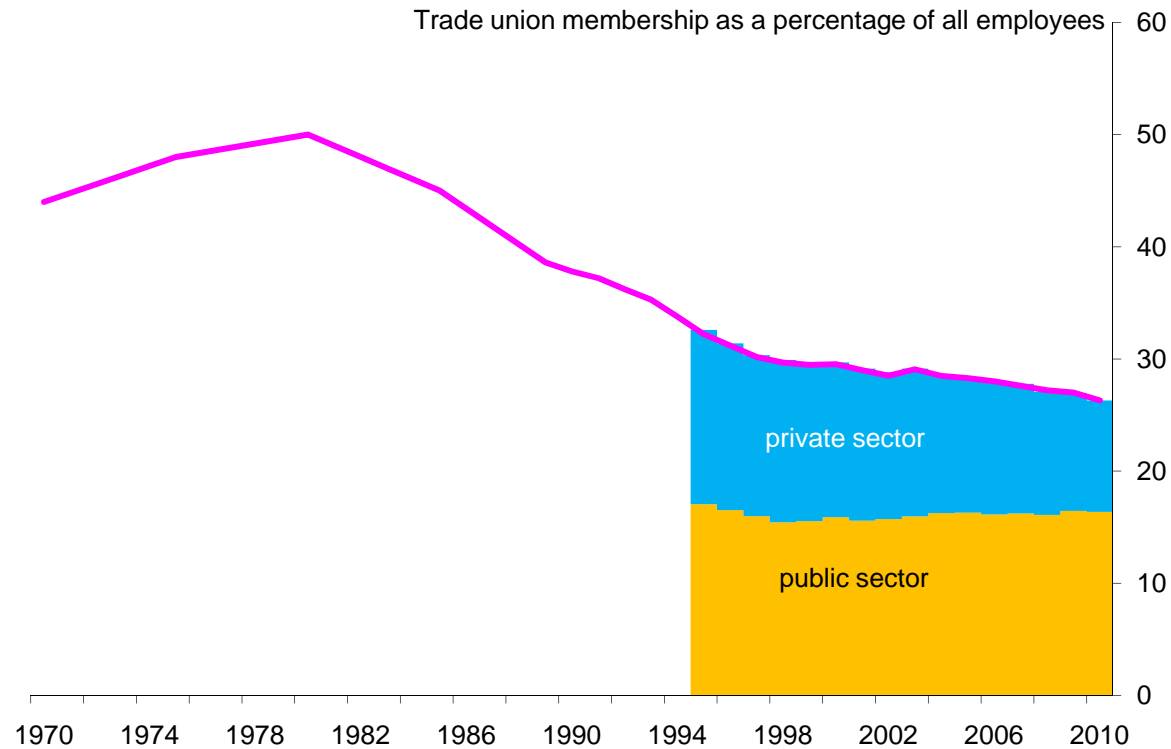
Labour market structures have changed in the UK and globally

- Liberalization and other policies from Thatcher and Blair
- Pressures from globalization of production and global labour force
- Changes in the technology and specialization of work

I am NOT saying one state is better or worse normatively

I am saying that as a policymaker, one has to recognize reality

Union density in Great Britain – a different world

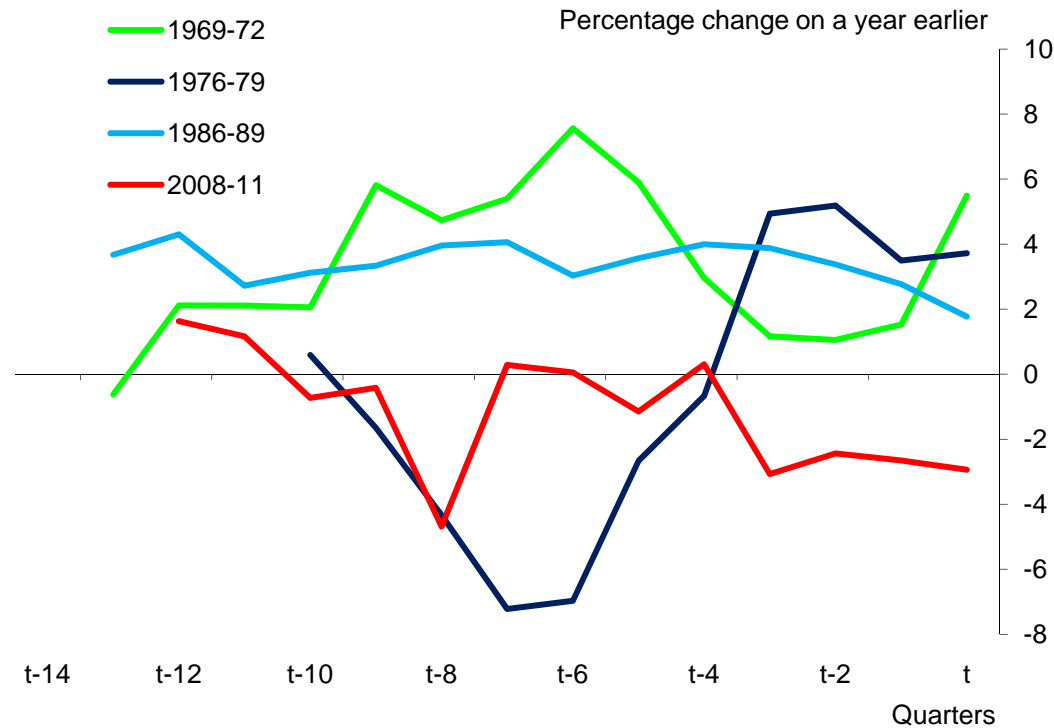


Mostly
public
sector

Note: Data since 1989 are from Table 1.2 of [Trade Union Membership 2010](#) and data before 1989 are interpolated using annual data from Table 2 of [“The Recent Performance of the UK Labour Market”](#) by Nickell and Quintini, Bank of England, August 2001.

Source: Department for Business Innovation and Skills and Bank of England calculations.

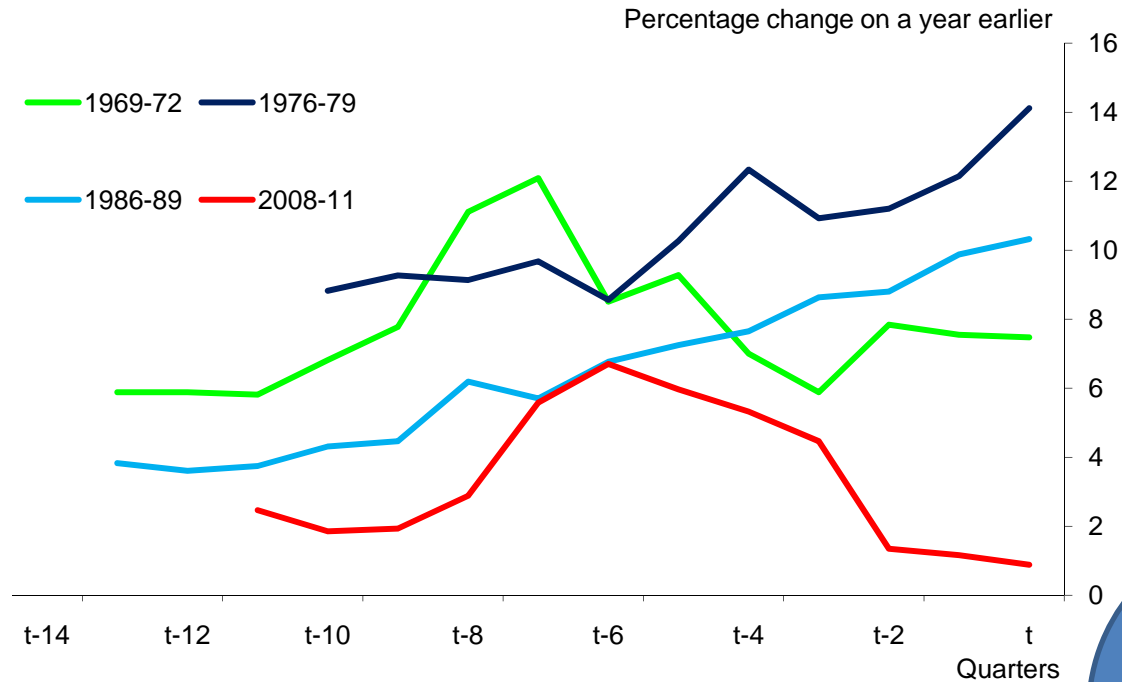
UK real consumption wage – No run-up this time



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Source: <http://www.bankofengland.co.uk/publications/quarterlybulletin/threecenturiesofdata.xls> for the average earnings index before 2000; Office for National Statistics for whole-economy AWE since 2000 and for the household consumption deflator. Bank of England calculations.

UK unit labour costs – no run-up this time

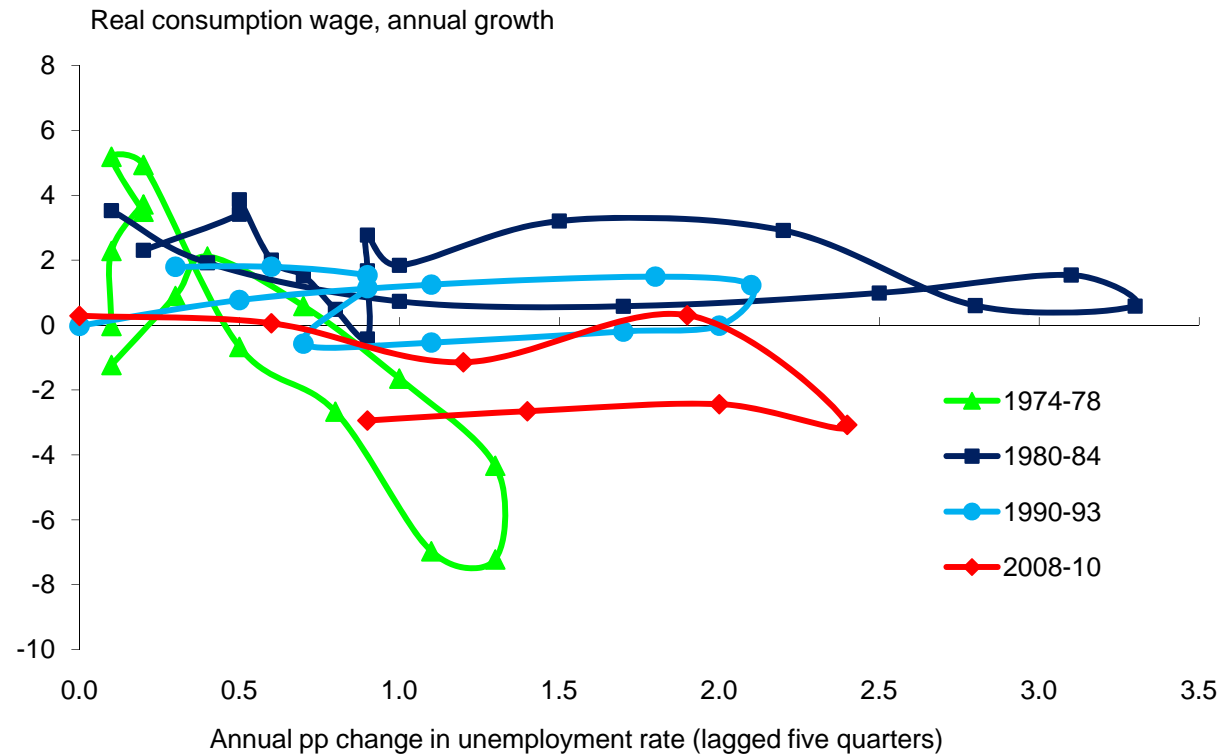


Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Source: Office for National Statistics and Bank of England calculations.

Very low
despite
productivity
numbers

UK real wage and unemployment trade-off – wages did decline as unemployment rose over time



Source: <http://www.bankofengland.co.uk/publications/quarterlybulletin/threecenturiesofdata.xls> for the average earnings index before 2000; Office for National Statistics for whole-economy AWE since 2000 and the household consumption deflator. Office for National Statistics for the unemployment rate. Bank of England calculations.

Oil price trends not obviously accelerating upwards (yet?)



Oil matters for modern economies, but less than it did 30 years ago

- Is there a major supply shock, or an exaggerated response to one given high demand?
- What is the elasticity of demand by consumers and businesses?
- How fast would/could there be a supply response to demand?

Deciding the importance of the trend in energy prices depends on:

- The size of the trend and the good's importance in the basket
- The size of the underlying trend versus the fluctuations around trend

IF the trend is big enough and reversals short-enough, we will respond to keep inflation in line with the target (Bean (2011))

But, a majority of the MPC (and I agree) says not yet there

Oil price trends not obviously accelerating upwards (yet?)



Could we (I) be making the wrong call on energy prices? Yes.

There is a plausible story to be told regarding both supply and demand that we are all going to cope with ongoing price rises in energy

- But we rely on futures markets for our oil price forecast, and those are only flat to slightly upward
- And no one seems to be stockpiling oil in the face of such pressures
- And the price reversals seem to be pretty big and sustained
- So we are watching carefully, and will change assumptions as warranted – but no change of assumption is warranted yet (especially if a global slowdown diminishes energy demand)

Productivity trend largely undiminished (yet!)



The other big 1970s mistake was trying to keep growth up at an unsustainable level – arguably because a productivity growth slowdown went unrecognized (Orphanides (1994) and others)

When there is an economic downturn, how much is a shock to trend?

- Lots of talk about output gap, but trend both matters more and is more measurable (Kuttner and Posen (2001, 2004))

An apparent puzzle in the UK right now:

- The numbers on UK productivity of late are pretty bad looking
- Firms are hiring workers and in surveys citing capacity constraints
- Should this lead us to revise down our estimate of trend growth?

Productivity trend largely undiminished (yet!)

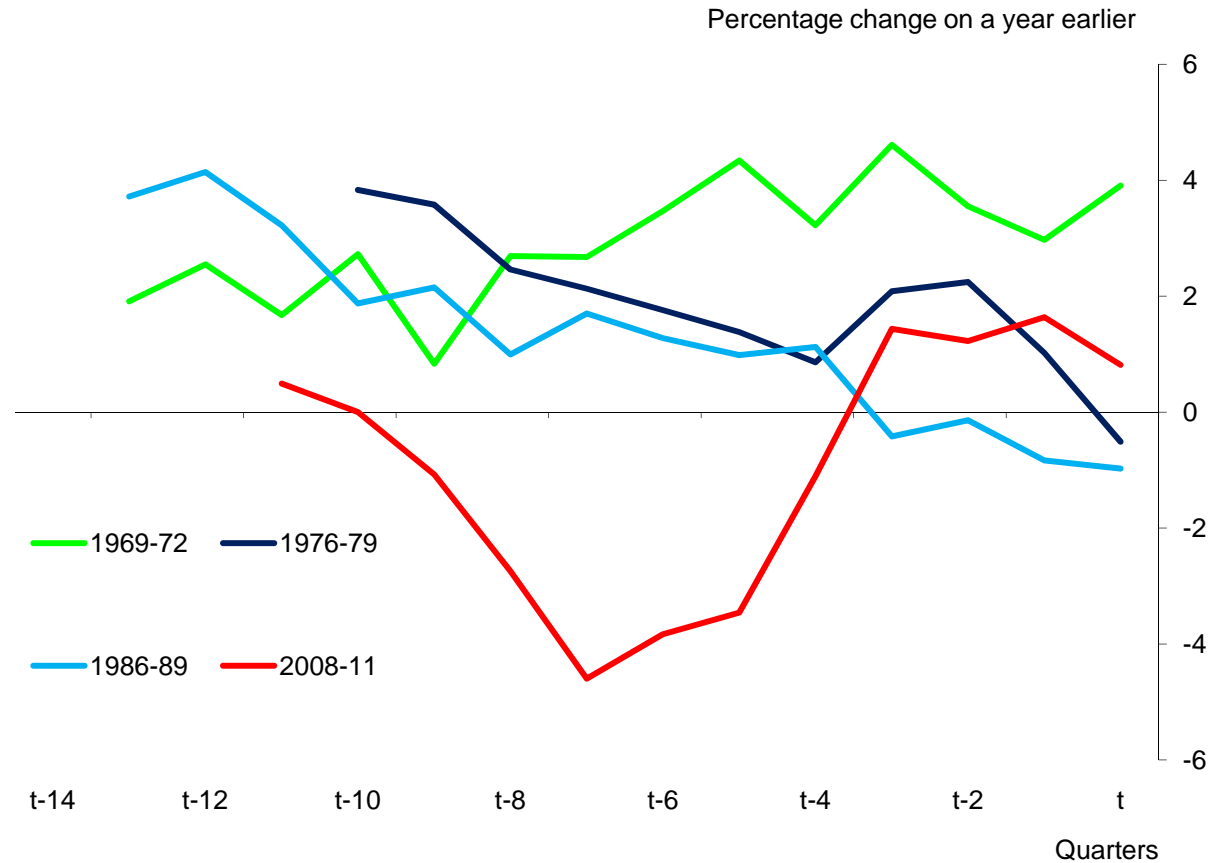


NO, we should continue to treat UK trend growth as largely unchanged

There are good reasons to doubt the observed productivity data:

- Companies with low margins are hiring labour and increasing hours – counted data that we can believe in, and that cannot be easily reconciled with belief in declining labour productivity
- The UK economy has shown great adaptability and limited evidence of sectoral or labour market mismatch to date
- Direct measures of the way that supply shocks are usually felt – corporate liquidations, investment shortfall, long-term unemployment – have not yet accumulated to very much impact
- There is no comparable international ‘technology shock’
- GDP data tends to get revised up after recessions (particularly in UK) and there is an obvious candidate in Net Export measures
- If there remain overemployed sectors, then productivity will rise

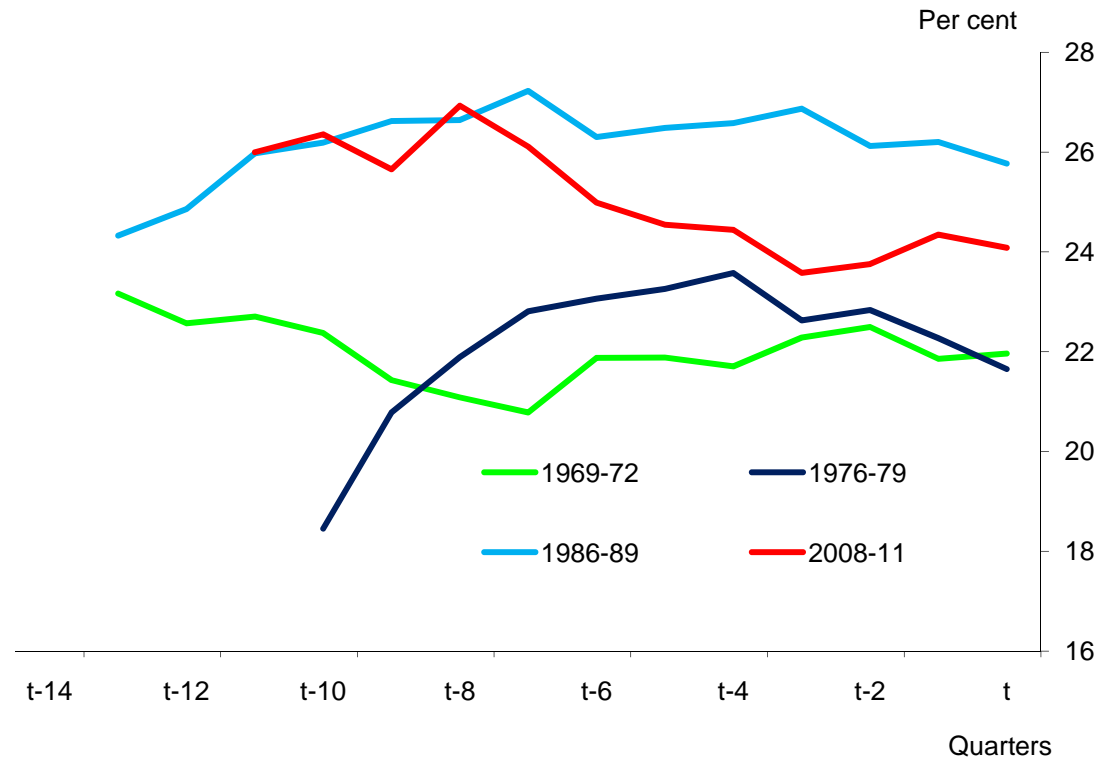
UK labour productivity – even as measured, rebounding not declining



Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Source: Office for National Statistics and Bank of England calculations.

UK corporate profit share



Would support investment *if* financial system allows

Note: t denotes the start of the sharp acceleration of consumer prices until 1989.

Source: Office for National Statistics and Bank of England calculations.

Avoiding historical mistakes (so far)



Independent central banks have a tendency to err on the pre-emptive deterrent side, not to be too soft

BIS just said all central banks should raise rates, and pointed to the UK's above target past inflation - NONSENSE

Some central banks, particularly in EMs pegged to the US dollar, should raise rates as their conditions demand

In the UK and the west more broadly, there is little or no credit growth, little wage growth beyond productivity, little evidence of rising inflation expectations, and oil prices are not (yet) a one way bet

Every MPC meeting, I sit opposite the huge portrait of Montagu Norman, and ask myself "What Would Montagu Do?" and do the opposite. So should other central bankers.

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We are in an economic situation in the UK today where:

- Monetary policy anchors inflation expectations
- Workers have limited bargaining power over wages
- Oil prices are not obviously accelerating one way
- Trend productivity growth is largely undiminished

Therefore little risk of inflation let alone stagflation

- But we still risk echoing that 30's show writ small