UCL
POLICY LAB

# What should the government do to tackle the cost-of-living crisis?

## A UCL POLICY LAB BRIEFING

**Authors and Contact Details**
Lukasz Rachel, University College London (l.rachel@ucl.ac.uk)
Morten O. Ravn, University College London and the CEPR (m.ravn@ucl.ac.uk)

If you have questions about the paper or wish to speak directly with the authors, please contact j.baggaley@ucl.ac.uk.

## EXECUTIVE SUMMARY

Britain currently faces high inflation, which for many households means a cost-of-living crisis. Why is inflation high? What risks confront us for the future? And what policy tools are available to improve the situation?

### Causes of UK inflation

In a mechanical sense, the elevated level of inflation is due to the rising costs of energy and other commodities such as food, as well as rising import prices that relate to the depreciation of the pound. Global supply chain bottlenecks coupled with a swift recovery of global demand following the Covid crisis contributed to price pressures across the world. In addition, the UK also faces new trade barriers following its departure from the EU. Ultimately, all these forces constrain the potential capacity of the economy – make us poorer – and, without adjustment to the demand side, lead to higher prices. Yet, inflation is also broad based and in a deeper sense, the elevated inflation in the UK (and elsewhere) is a symptom of the imbalance between constrained supply on the one hand, and strong demand supported by expansionary stance of fiscal and monetary policies on the other.

### Risks that inflation becomes entrenched

While wages have not kept up with inflation, wage inflation has gone up and the risk of a wage-price spiral is real. Inflation has become a salient issue and has started to feed into expectations of future inflation. A strong response of the Bank of England should keep expectations in check; however, speculation that the government may curtail the Bank's independence or adjust its goals is detrimental to this effort. The continued tight labour market creates circumstances in which currently high inflation is more easily passed on to wages. Plans to carry out more expansionary fiscal policy would further exacerbate the imbalance between demand and supply, propelling rising prices.

### Tools for tackling inflation

The UK can achieve the goal of turning the current cost of living crisis into a temporary episode, but only if it acts in the right way.

- **Energy** is the core driver of current inflation, so the UK should aim to reduce its dependence on fossil fuels which are prone to sudden shifts in price. This means increasing investment in energy-saving technologies and renewables in both the short and long term. The Truss government has also taken steps to mitigate energy price rises for households and businesses. The approach they have taken, however, fails to suppress demand for energy in the same way as a more targeted support policy could have done presenting serious risks.

- **Fiscal policy**. The current government's policy of attempting to increase economic growth through tax cuts seriously risks embedding inflation, leading to a prolonged period of rising prices. These unfunded tax cuts further risk increasing the deficit, exacerbating the pressures on the sterling, and adding to inflation. Targeted action to improve the circumstances of those most vulnerable to cost-of-living pressures should be preferred to general fiscal expansion. Fiscal policy should be aligned with monetary policy, and not go directly against it.
- **Monetary policy**. While tightening is certainly required to bring inflation under control, the right speed of this adjustment is difficult to judge. The circumstances – current inflation rate, drifting expectations, and fiscal outlook -- require fast adjustment to the level of interest rates and appropriate monetary stance in general. On the other hand, a more gradual approach would limit the risk of overdoing the tightening in an economy that is likely to suffer zero or negative growth rates for some time. At this point, evaluating these trade-offs is very hard and empirical evidence will need to determine whether a more or less gradualist approach may be beneficial as economic circumstances evolve.

Policy tools are available which could both enable the UK to weather the worst of the storm. They would need, however, a sharply different focus to those likely to be announced on Friday. If the UK government were to act in the right way, this difficult period could be remembered as a time which redistributed the burden, acted as a showcase for social solidarity and provided a catalyst for the UK becoming a stronger, greener and more resilient economy. Making wrong choices now instead risk the economic stability of the UK. If ever, now is the time for an evidence-based approach to policy.

**INFLATION AND THE COST OF LIVING CRISIS**

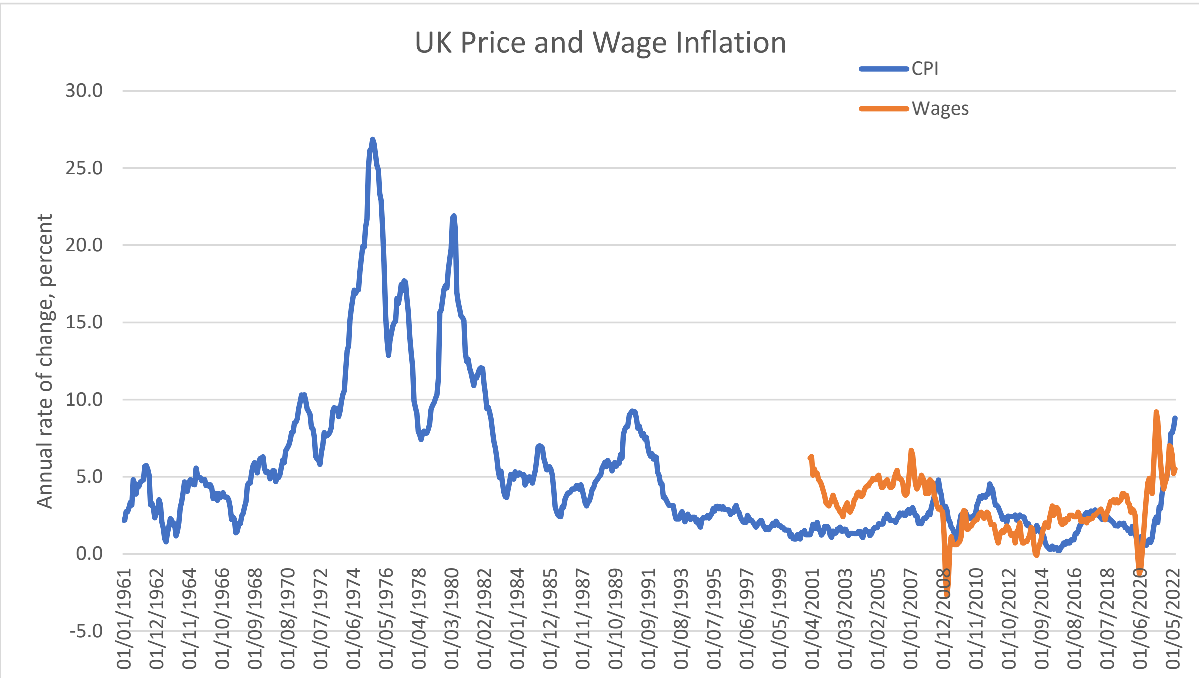
Britain finds itself in what has been referred to as a "cost of living crisis". In this briefing paper we will review the basics of inflation, analyse the underlying reasons for why we are currently seeing an elevated inflation rate, and discuss how to deal with it.

**What is inflation and how has it moved?**

The most basic measure of price inflation is the rate of change in the cost of acquiring the consumption basket of the typical household. A standard measure of this concept is the annual percentage change in the consumer price index, a cost-of-living index which weights together the prices of different goods and services according to their aggregate expenditure shares. Thus, it measures the cost of purchasing the "typical" basket of goods consumed by UK households.

Figure 1 illustrates the one-year rate of change in this price index (the CPI, all items) produced by the Office for National Statistics. By this measure, inflation is currently running at around 9 percent annually, a level that is very high relative to the last 30 years where it was 3 percent on average, yet significantly lower than what has been witnessed in the 1970s and 1980.

Figure 1: Inflation in the UK




Sources: OECD and the ONS.

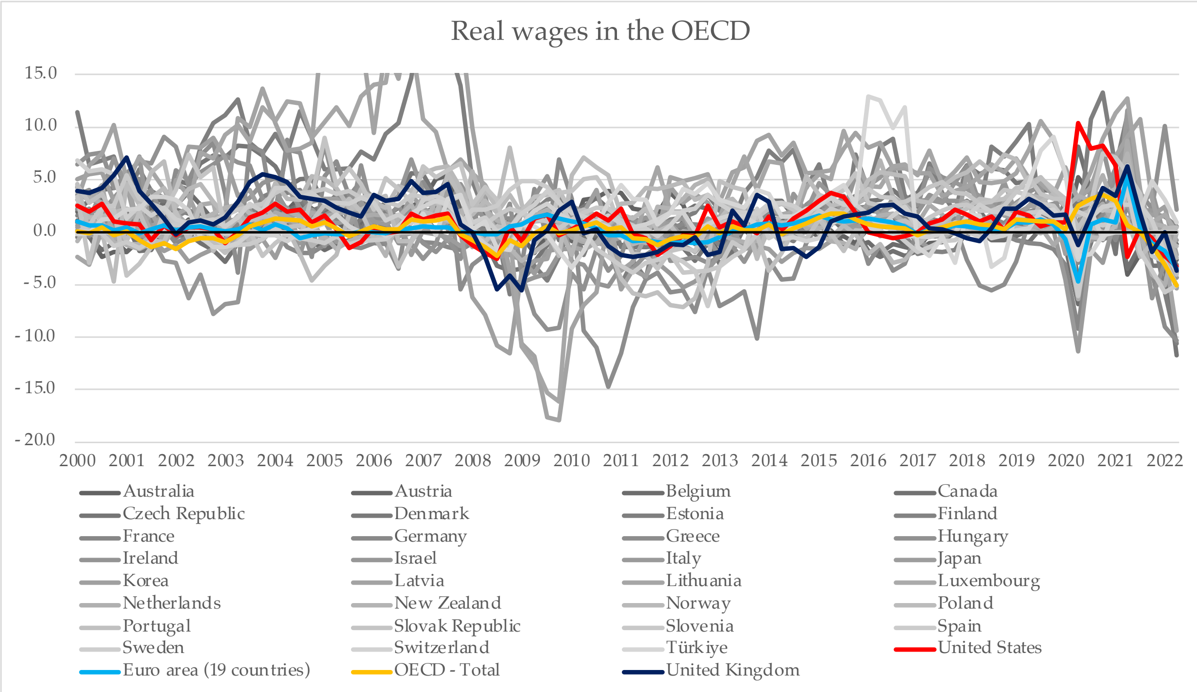
There are several ways in which high inflation is problematic at a macro level. First, a period of unexpected inflation is a source of significant redistribution (we explain why below), which can be seen as unfair, inefficient and politically destabilising. Second, when inflation is high, it tends to be more volatile, becoming an additional source of uncertainty for households and firms. Uncertainty is bad in and of itself. Furthermore, an uncertain environment can lead to bad decisions that with time are detrimental to the productive capacity of the economy and thus the standard of living. Relatedly, prices observed by households and firms become less informative when they are highly changeable, making it harder to make the right choices. Third, and perhaps most importantly, high inflation tends to feed off itself and rise over time, essentially because expectations about the future are an important driver of future inflation. Once the inflationary spiral is set in motion, breaking out of it necessitates significant adjustments to the level of activity in the economy, with a period of elevated unemployment and subdued demand. The higher inflation rate is, the costlier it is to steer it back down.

From the perspective of an average household in the economy, price inflation is a problem if it is higher than the growth rate of its nominal income. Figure 1 shows also one indicator of this, the rate of change in nominal wages as measured by the ONS measure of *total pay excluding arrears*. By this measure, wages are currently growing at around 5.5 percent, a slower pace than prices so that the real wage, the nominal wage adjusted for inflation, is declining. Therefore, the increase in the rate of change of prices correspond to a cost-of-living crisis for the average worker in the economy.

To illustrate this more directly and to put this in a cross-country perspective, Figure 2 shows the rate of change of real wages – nominal labour compensation adjusted for inflation – across the OECD economies through the second quarter of 2022. In the current episode real wages are declining sharply across the developed economies – in the year to June, they declined by nearly 4% in the UK and 5% in the OECD as a whole.

UCL
POLICY LAB

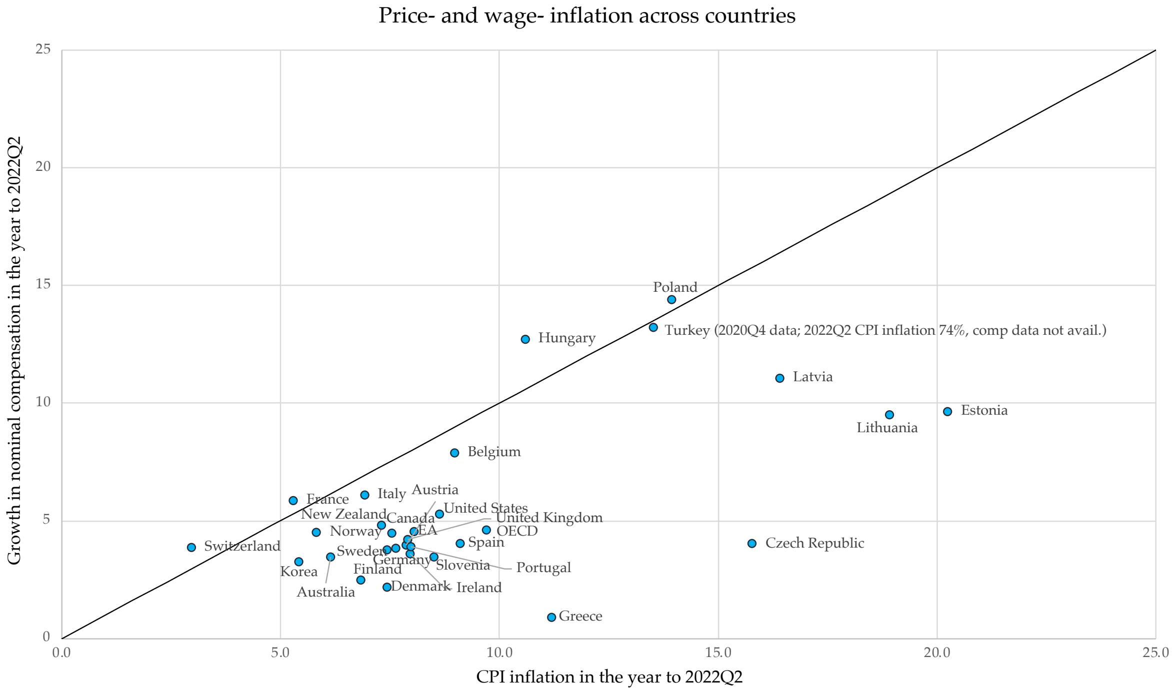
Figure 2: Real Wages




Source: OECD. Labour compensation per employed person adjusted for the 4-quarter change in the CPI.

Figure 3 looks at more detail at the two components of real wages. It plots the most recent readings of the consumer price inflation on the x-axis against wage inflation on the y-axis. Countries below the 45-degree line are currently experiencing a decline in average real wages in the economy. The Figure shows that thus far, UK has been in the middle of the pack, in terms of both consumer price inflation and wage inflation. Over the past year, hardly any country has gained in terms of standard of living – only Switzerland, France, Hungary and Poland have seen stability in real wages, although in the latter two this is happening at very high rates of inflation, suggesting problems ahead.

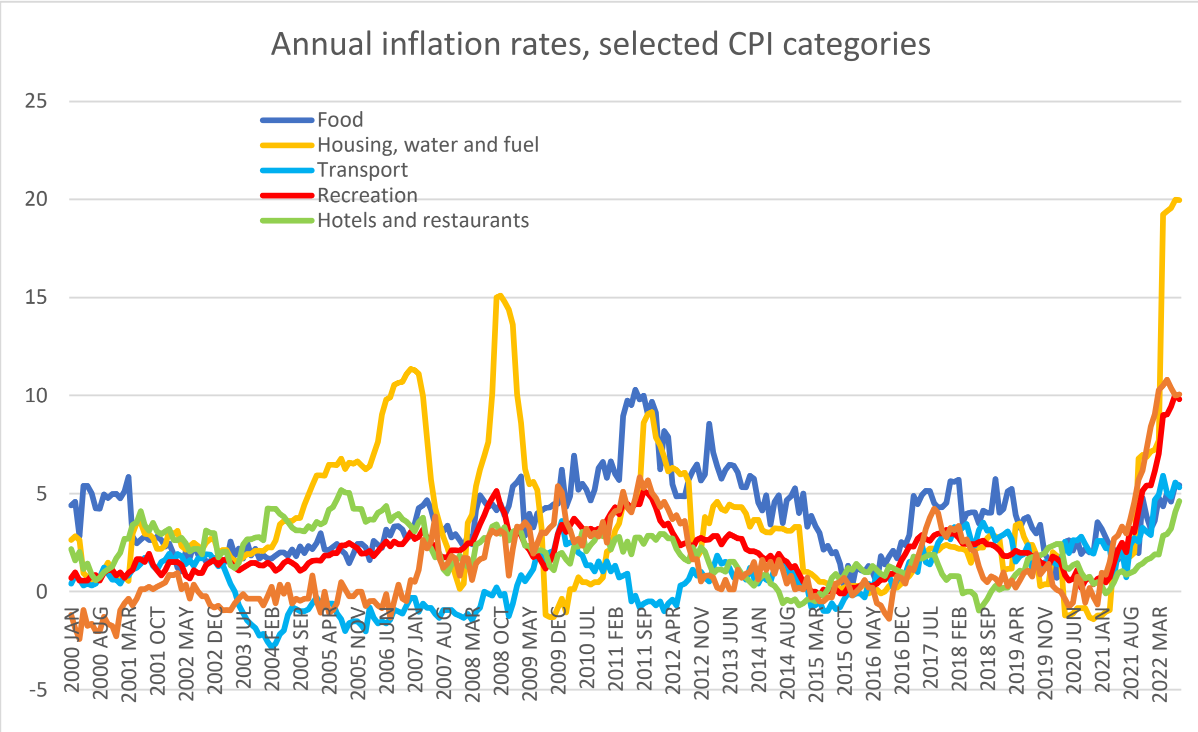
Figure 3: Prices and Wages




Source: OECD

As with any country, the headline numbers hide many differences across goods and households. Take heterogeneity across goods first. At any point in time, different items in the CPI basket experience different rates of price growth. In Figure 2 we illustrate some of the main items of the CPI in the UK and show how inflation of these items have developed since 2001. Most recently, the largest increase in prices has occurred for “housing, water and fuels” where the annual inflation rate from August 2021 to August 2022 was close to 20 percent and with little outlook for a reversal in the short run. The spike in inflation was more moderate for other items such as the cost of eating out which experienced an increase of 5 percent. In general, commodities (food and energy) display the most volatile inflation rates over time and are often excluded from so-called “core price inflation” measures. Nonetheless, the Figure also reveals that current bout of inflation is broad based: we are seeing an increase in prices across a range of categories.

Figure 4: Inflation rates for components of the CPI




Source: ONS.

Different households are also affected by inflation in different ways. There are three main dimensions in which this is true. First, households' consumption patterns differ: some eat out more, others spend more money on services such as childcare, etc. These patterns to some extent reflect the position of households in the wealth distribution: for instance, poorer households spend a larger fraction of their budget on essentials such as food and energy. This means that commodity driven inflation is likely to affect poorer households more. By some estimates, these differences in consumption baskets across the wealth distribution implies that the poorest 10 percent households currently are experiencing up to 50 percent higher inflation rates than richest 10 percent of households. Moreover, poorer households are in a more difficult position to deal with the crisis because they have less resources available that they can tap into. These differences are likely to disappear as the economy adjusts to the commodity price shock but may still be a concern in the short to medium term. An equally important issue is that households differ in terms of how their nominal income keeps pace with inflation. Those on fixed nominal salaries renegotiated only sporadically will be worse off; others whose pay is aligned with inflation may be better protected. The third important dimension of heterogeneity is the asset position: some households are net debtors, perhaps with an outstanding mortgage on the home they live in; others are creditors, e.g., with substantial bank deposits. Since such assets / liabilities are nominal contracts, a period of high inflation erodes their real value. This redistributes from creditors – who tend to be older and wealthier – to debtors, who are younger and tend to be in the middle of the income and wealth distribution.

Beyond these three channels, there are other, less direct influences that exist “in general equilibrium”: higher inflation causes other macroeconomic variables to adjust, affecting people differently. The most obvious is that, faced with high inflation, central banks began to raise policy rates (the Bank Rate in the UK has increased from 0.1% to 1.75% and there is little doubt it will rise further – see below). Monetary tightening translates into higher mortgage payments for borrowers on variable rate contracts or those coming up to the end of their mortgage deal term. Those with consumer debt may be particularly exposed as interest rates on such unsecured debt are likely to increase significantly. Asset prices tend to decline as monetary policy tightens, which again has differential effects on households who already own these assets versus those who plan to buy them in the future.

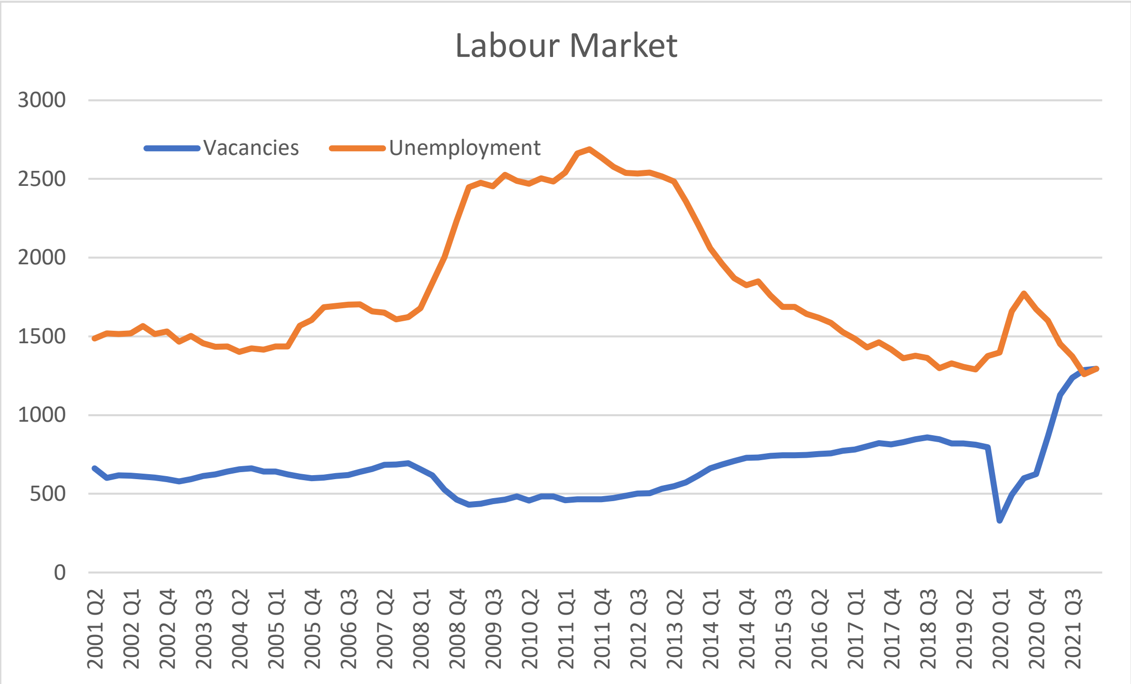
**Why is inflation so high?**

While there are several underlying sources of the current spike of inflation, the main factor is the rise in energy prices, driven in part by the deliberate and strategic reduction in supply from Russia in the year preceding the invasion of Ukraine. In the final months of 2021, gas flows from Russia along the Yamal Europe route dropped sharply to less than a third of normal levels, causing wholesale prices to jump by 400%. The subsequent invasion in February 2022 further raised the tensions in the market, and the recent decision by Putin to halt the deliveries through Nord Stream 2 have resulted in prices that are 10 times higher than a year ago (the most recent increases have not yet fed through to the CPI). Another part of the story has been the rapid and uneven recovery from the pandemic shock across sectors. As a result, Brent crude oil prices went from \$25 a barrel in March 2020 to more than \$125 in the summer of 2022 but have since stabilised and fallen back below \$100. Increases in energy prices have a direct impact on the CPI through prices of petrol, heating and electricity, and they impact on the prices of goods because energy is an input into the production of many goods and services.

An important proximate cause of the increase in inflation is the depreciation of sterling. Since the beginning of 2022, the sterling’s value relative to the dollar has dropped almost 15 percent (from 1.35 US dollars per sterling to 1.14 dollars per sterling). This drop in the value of the sterling means that UK imports of foreign goods (often priced in dollars) have become much more expensive and contributed to driving up inflation. Fundamentally, the drop in the value of the sterling is due to a combination of factors including forecast of high future inflation and low growth in the UK, repercussions of Brexit, and the fiscal stance of the UK (see below).

As we showed above, the rate of price increases has so far exceeded the rate of wage increases. However, it is also clear from Figure 1 that wage inflation is rising. Labour costs are a big share of firms' costs of production and a key worry is that a period of high inflation will ignite a wage-price spiral where expectations of high inflation motivate high wage inflation which in turn produces high price inflation. The strength of such a wage-price spiral depends crucially on two factors. First, the extent to which policy makers can stabilise mid- to long term inflation expectations. We will get into this more below. The second factor is the demand and supply conditions in the labour market: when workers are scarce and difficult to replace, their wage demands are more likely to be met. This factor is hard to evaluate in a situation that is certainly fast-moving, but one can gain valuable insight by looking at unemployment (the number of workers looking for a job) relative to vacancies (the number of jobs firms are looking to fill). We show the time series of these two indicators in Figure 3. These data show signs of an overheating job market with unemployment low and declining while vacancies having increased sharply over the last 12-18 months.

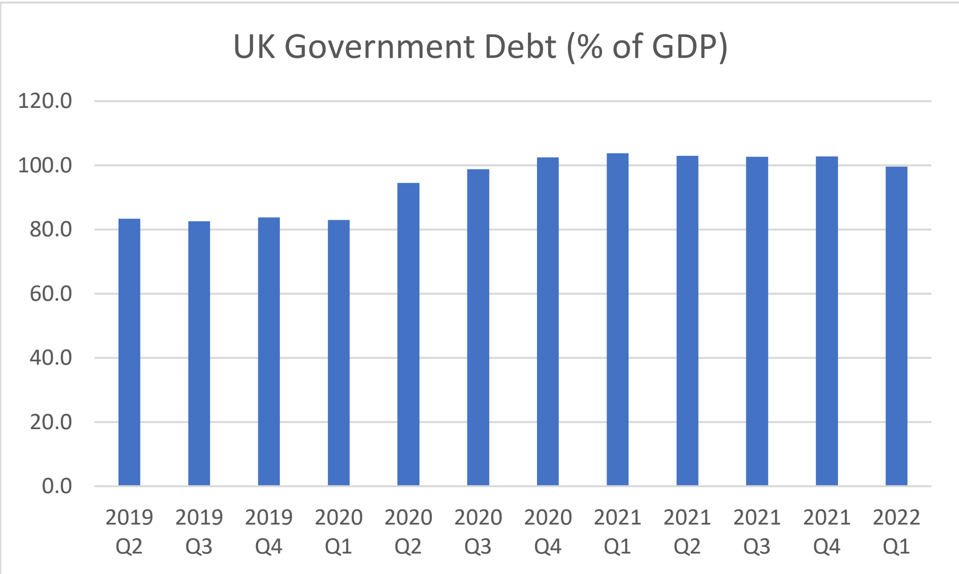
Figure 5: Labour market trends




Source: ONS

Other factors that impact on inflation relate to fiscal and monetary policy in the UK and abroad. The central UK government budget deficit rose significantly during the Covid-19 pandemic reaching 27 percent of GDP in the second quarter of 2020 and returned to single digit numbers only by the end of 2021. This increase in the deficit generated a large increase in the ratio of central government debt to GDP from 83 percent pre-pandemic to close to 100 percent by early 2022. Some other countries have had a similarly large increase in public sector balance sheets; the post-pandemic stimulus was particularly significant in the US. The links from fiscal policy to inflation are complex and depend on the circumstances, e.g., on households' willingness to spend out of transferred wealth and on their expectations about the extent to which an inflation tax may be used to ultimately lower the government debt burden. Globally, a coordinated fiscal effort in the pandemic resulted in a rapid demand recovery and strained supply chains that struggled to keep up. All in all, the large increase in central government balance sheet over the past two years, in the UK but also in other countries, especially in the US, have most likely contributed to robust demand recovery from the pandemic, with the unintended consequence of higher inflation.

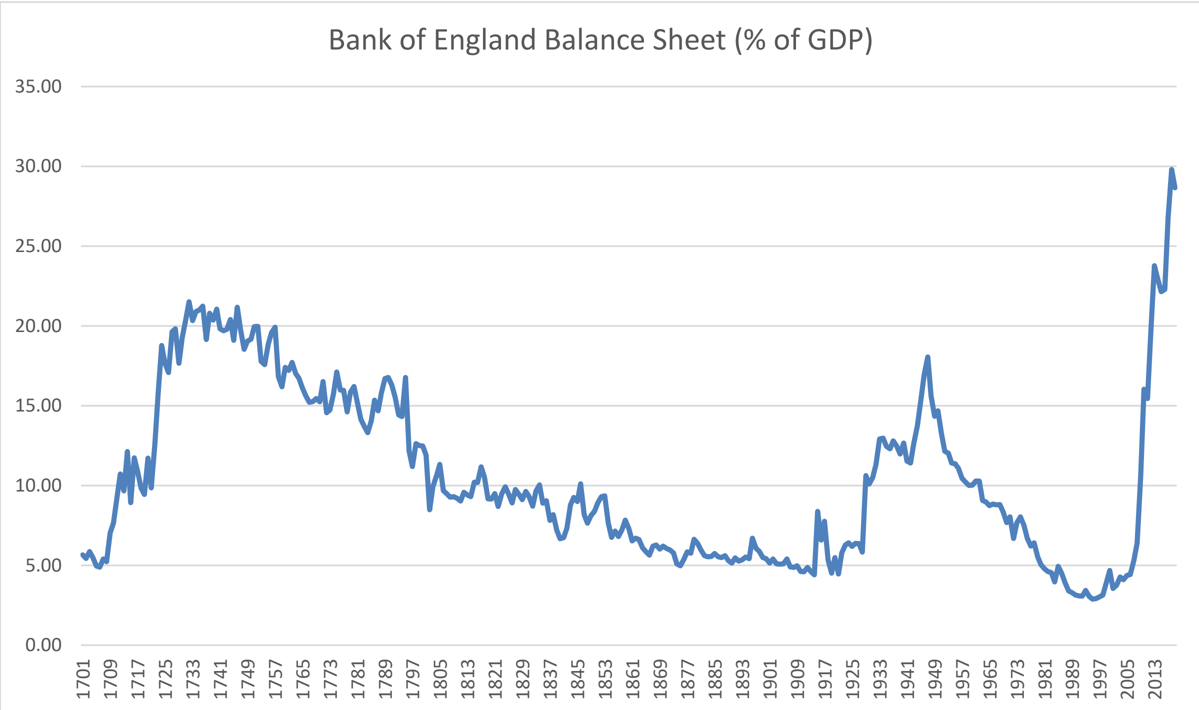
Figure 6: UK Government Debt




Source: ONS

Monetary policy plays a key role. In the longer run, inflation is largely determined by monetary policy, and, as we will return to shortly, monetary policy will be key for the extent to which UK can bring inflation back down. However, there are also some underlying monetary factors in the current episode. Following the Global Financial Crisis, the Bank of England and many other central banks tried to stabilise the economy by cutting short term nominal interest rates. This quickly led to policy rates close to zero and unwillingness to experiment with negative interest rates led central banks to search for so-called unconventional instruments. An important component of these were asset purchases through which central banks essentially exchanged fewer liquid assets of various sorts with liquid assets (often central bank reserves). This induced a large increase in central bank balance sheets, see Figure 5, and in the amount of liquid assets in the economy. In the economy post global financial crisis, with low-risk appetite and subdued credit creation, this expanded balance sheet did not result in inflation. But perhaps the circumstances have changed and what we are seeing now is some pass-through of the expansionary monetary stance on inflation.

Figure 7: Bank of England Balance Sheet




Source: Bank of England

**What should be done?**

How should UK policy makers respond to inflation? This question is ultimately value-ridden, and we will here abstain from making any normative judgements apart from commenting on what we see as "obvious" policy recommendations.

A key aspect of the current increase in inflation are energy prices. Higher energy prices make the UK poorer because it is a net importer of energy and rising prices are driving up inflation. Tackling the core of this problem is outside the set of feasible options in the very short term, but one might consider building some capacity to withstand very short-term supply issues by improving storage facilities. Yet, it is important not to create a conflict between short to medium term considerations and longer-term trends. In the longer term, UK will need to put in place policies that are consistent with the Green Transition, i.e., invest in energy saving technologies and in renewables, as well as possibly try to lower its exposure to highly volatile sources of energy such as gas and oil. Thus, the government ought to be mindful not to embark on policies that do little in the near term (e.g., because of long implementation periods) but stand in opposition to the desired longer-term direction.

It is likely that energy prices will stabilise and may even decline sharply, so that the direct contribution of energy to price inflation falls over time. In and of itself this would not necessarily guarantee the return of inflation to target (which stands at 2% per annum in the UK). The reason is the potential of wage-price spiral: inflation can become more entrenched as expectations adjust. To tackle this, macroeconomic adjustments will necessarily need to be made.

The primary tool for controlling inflation is monetary policy. In the UK, monetary policy is delegated to the Bank of England which was granted independence to set interest rates in 1997. The Bank of England has responsibility for monetary and financial stability. Monetary stability here means implementing policies aimed at achieving a 2 percent inflation target. The Bank of England aims for this so through conventional instruments (the short-term interest rate), unconventional instruments (asset purchases), and through its communication strategy including “forward guidance,” i.e., by signalling its future policy intentions. In practice, it is hard, if at all possible, to control inflation in the short run so the instruments are adjusted to target an *inflation forecast*. Moreover, while the Bank of England’s inflation target is the CPI, it has little control over commodity prices which are determined in international markets and, as we showed earlier, display high volatility. Thus, much of the attention relates to the so-called core-CPI which excludes the most volatile (but important) components of food and energy. The ideas behind granting the Bank of England independence and imposing an inflation target are that the former gives credibility to pursuing a policy of low and stable inflation regardless of other issues (such as government solvency) while the latter, a simple rule, minimises issues related to discretionary policies.

Given the current inflation situation, the Bank of England therefore has little choice but to tighten monetary policy. This will be implemented through increasing interest rates and by reverting asset purchases. Higher interest rates impact the economy both through a signalling effect and through making it costlier for households to consume beyond their means and for firms to contribute to aggregate demand through investment spending. Higher interest rates will therefore induce a cooling effect on the economy. The signalling effect is that the increase in interest rates, as well as communications about the future interest rate path, will lend credibility to its inflation target and help anchoring inflation expectations. In combination, monetary policy is therefore aiming at dampening aggregate demand in the economy and preventing price and wage setters from building in elevated inflation expectations to their current decisions thereby minimising the risk of wage-price spirals. This stance of monetary policy will necessarily have short term costs as it will cool off the labour market and income growth, but the costs of doing nothing would be much higher and risk a return of in-built inflation through the loss of the anchoring of inflation expectations.

An important question in the current juncture is just how fast monetary conditions should tighten. Should the Bank of England increase interest rates in a gradual manner and signal its intention to do so in advance? Gradualism has the potential benefit of reducing the cost of monetary policy tightening, as households and firms have more time to prepare. Also, a gradual approach minimises the potential of overcooling, in an environment where high current rate of inflation is driven by temporary factors: monetary policy affects inflation with long and uncertain lags, so that actions taken today will show up in inflation rate in over a year's time. Moreover, to the extent that communicating the intention of future rate rises influences current inflation expectations, it may imply less need to raise rates ex post, a sort of double dividend. However, there are also risks. Most importantly, if expectations fail to adjust to gradual changes in interest rates and signalling about the future path of interest rates, it might become much harder to bring inflation under control as wage and price setters start to factor in future inflation. With too much gradualism, the central bank can quickly find itself "behind the curve". We think the jury is out on the question of speed; it is a difficult balancing act in which careful monitoring of the activity and inflation expectations data are crucial.

What about fiscal policy? Two aspects are important. First, it is risky, and most likely a mistake, to enact fiscal stimulus in an economy suffering from high inflation. Expansionary fiscal policies would stimulate demand and inflation thereby making the Bank of England's job much harder, with resulting much higher increases in Bank Rate. This is one of the key lessons that was learned during the 1970s and 1980s as policy makers argued that the temporary nature of inflation (which back then also initiated in energy prices) should be compensated through a demand stimulus. Moreover, energy price hikes make the UK poorer as it is a net-energy importing nation. A fiscal expansion cannot change this fact. Secondly, as we discussed earlier, there are distributional aspects of the current inflation episode. Poorer households are more sensitive to commodity price increases and less able to use savings to limit the loss of their living standards. Thus, targeted policies that redistribute towards lower income households would help alleviate much of the cost-of-living crisis and would preserve what is left of the social fabric in the UK. It is important to note that such interventions can and should be budget neutral. Our opposition to fiscal stimulus is decisively not an excuse for the government to do nothing. By distributing the costs of this episode fairly, the government can make this shock bearable to all, and help the country emerge stronger and more united once the crisis abates.

What about energy price caps? We believe such policies to be imperfect and possibly harmful. There are many problems. First, and independently of their implementation, price caps will sustain demand for energy products and therefore increase the chances of energy demand exceeding energy supply. Should such a situation arise, energy will have to be rationed. This would obviously be a very difficult situation where extremely hard choices must be made. We see no signs that the government is prepared to carry out rationing in a way that would not be disruptive. Secondly, unless provisions are made, price caps will be regressive in the sense of providing the largest implicit transfers to households and firms with the biggest energy needs, i.e., households in large and not well-insulated houses, and firms using less energy efficient production techniques. Since the policy will eventually need to be paid for through taxation, this implies that poor households in small dwellings and energy efficient producers will effectively pick up the bill. This is unfair and has adverse incentive effects on firms and households. Third, depending on the implementation of the policy, a price cap means a redistribution from the taxpayer and towards energy suppliers because their demand is sustained. This might be addressed through taxation of energy suppliers, but policy makers appear so far to have been reluctant to use this instrument. Fourth, and again depending on implementation, a problem with price caps is that it discourages the economy from adopting technologies associated with efficiency gains. Households and firms will have little/less reason to engage in energy saving behaviour and adopting energy saving technologies. If energy suppliers are compensated with the difference between the price of energy that they sell at and the cost of energy, they will also have less reason to avoid supply shortages thus increasing the risk of rationing.

A smarter policy choice would be to let the price mechanism operate as much as possible, keeping the incentives to reduce energy usage, while at the same time providing ample social support to struggling households (and possibly to industries that are intensive in energy use and critical for the functioning of the economy). There is plenty of evidence that incentives provided by prices work (demand curves really are downward sloping). Reductions in demand will help alleviate the short-term pressures and will take us some way towards our long-term climate goals. The social insurance policies can be financed by taxes on activities that became much more profitable due to energy price spike.

The new Truss government has signalled a dedication to the pursuit of a 2.5 percent annual growth rate of the UK, and to stimulate growth through tax cuts. While tax reforms can be good if implemented the right way, this is probably not be the right moment for such a policy, and details will need to be made public about the exact nature of the tax cuts and how to finance them. Tax cuts are likely to stimulate demand and therefore contribute to inflationary pressures (although they may also reduce the pressure for wage inflation as lower tax rates increase the net of tax real wage). It is often claimed that tax cuts are self-financing (through a so-called Laffer-curve effect), but we think this is unlikely. And even if tax cuts may stimulate growth, there will be a need to finance them either through reduced spending or through issuing government debt. Government debt issuance may further weaken the sterling and is only a short run solution; in the medium term the deficit will need to be financed either through increasing government revenues from other sources or through spending reductions. Thus, rather than rushing through tax cuts, it would be wiser to support the Bank of England's commitment to monetary stability through a responsible fiscal stance that concentrates on targeted policies aimed at helping those struggling must with coping with the cost-of-living crisis.

We firmly believe that with the right set of policies we can achieve the goal of turning the current cost of living crisis into a temporary episode remembered as a time of honest and fair redistribution of burden, as a showcase for social solidarity, and a catalyst for the UK becoming a greener and more resilient economy.