The David Hume Institute at Royal Society of Edinburgh on 29 April 2008

Inflation, expectations and monetary policy

Professor David Blanchflower

An immaculate professorial CV with appointments on both sides of the Atlantic, membership of the Bank of England Monetary Policy Committee as an independent economist and thirty years of empirical labour economics under his belt mean that when Professor David "Danny" Blanchflower speaks, his listeners take note. His stark message to The David Hume Institute on 29 April 2008 was that the UK is at a tipping point when the risk of serious recession outweighs the risk of inflation and pre-emptive policy measures should be implemented.

This view was supported by the headlines the following day when it was reported that UK consumer confidence had fallen to its lowest for nearly 16 years during April as fears of a major economic slowdown continued to mount; an enlightened audience was appropriately sceptical with some challenging questions. However the weight of detailed labour, wage and consumer confidence statistics brought to bear by Professor Blanchflower demonstrated the wide but analytical range of his "economics of walking about"; such that his conviction that the indicators were clear ensured that the majority of those present left with real cause for concern.

The principal thesis was that the UK is now showing similarities to recent US experience, the US is in recession with links between labour, focused on manufacturing, construction and financial services, consumer confidence and credit availability. This situation is aggravated by the potential that "we are probably in the grip of world forces that are greater than people realize". While monetary policy is restrictive at present, it should be loosened sooner rather than later to ensure that more extreme measures are not required later to correct a major slowdown and recession.

The speaker discussed the level of inflation in the UK and with a deft hand argued very cogently that, despite perceptions informed by international commodity prices and the value of sterling, inflation is on a downward secular trend as these tendencies work their way through the supply chain. Developments in the housing market with declining prices and dramatic falls in mortgage approvals, the labour market where hourly earnings are reducing, employment intentions weakening and pay deals are modest and declining were carefully and clinically explained with serious doubts raised on some of the more orthodox indicators. These employment trends and consumer confidence as measured by an average of five balances, all of which were negative, and now at its lowest since 1992 added to the need for further moves on the credit front suggest a link with the "real economy" and a greater likelihood of downwards inflation potential with a real risk of "something horrible" happening.

Inflation expectations are primarily dependent on the setters of wages and prices which, together with their influence on consumption and investment decision-making, play an important role in inflation targeting. In his discussion Professor Blanchflower identified the relatively low level of knowledge and understanding of inflation and expectations of inflation movement by individuals and the fact that current experience tends to drive expectations. Professional forecasters have however seen a reducing rate of inflation which reinforces his belief that upwards inflation is less of a risk than the reverse. Indeed the credibility of the Monetary Policy Committee as a policy making body is dependent on both such expectations and their realization, given their target of 2% inflation in the medium term.

Professor Blanchflower was at pains to point out that he is neither obsessed with growth nor unconcerned about the inflationary implications of cutting interest rates. However he is convinced and he largely convinced his audience that the greater risk is on the downside, given the identifiable spare capacity in the economy. He clearly cares passionately about employment and believes that fear of unemployment with the consequent major personal concerns is a greater issue than inflation for most. This necessitated looking through the next two years and ensuring action that will pre-empt recession. While he believes that Bank of England should have cut rates sooner, he does not believe that it is too late to do so – but he made clear his trenchant view that the critical tipping point is now.

Professor David Bell led the discussion session with an intriguing analysis of the potential parallel Scottish experience where the housing impact would be muted. With Scottish average income at 96% of UK and average house prices at 84% of UK, his expectation was that house price reduction in Scotland would be restricted to 8% compared to 24% in UK, based on a reversion to a more normal income/price relationship. The result of this is that Scotland should ride out any slow-down rather better than UK as a whole, a view endorsed by the speaker.

The ensuing discussion ranged over the proposed cuts potentially being implemented too late, the implications of the slowing decline in non-food prices following the global reallocation of resources, the impact of sterling and trade (Professor Blanchflower welcomed a more competitive exchange rate), the difficulties of identifying the right inflation indicators, the redimensioning of the credit risk premium which had clearly been hugely underpriced and the discontinuity of consumer response to a dramatic reduction in prices (above all house prices). Nothing emerged that undermined Professor Blanchflower's unwavering clarion call which all looked forward to following in both the voting and the minutes of MPC meetings.

Nick Kuenssberg

30 April 2008