



Impact of inflation on business

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- Why the authorities failed to forecast inflation
- Why they failed to take action
- What is likely to happen
- What does this mean for business

I'm blue in the face from trying to persuade Treasury, OBR and Bank to listen to a wider selection of views



Treasury/OBR/ BoE groupthink

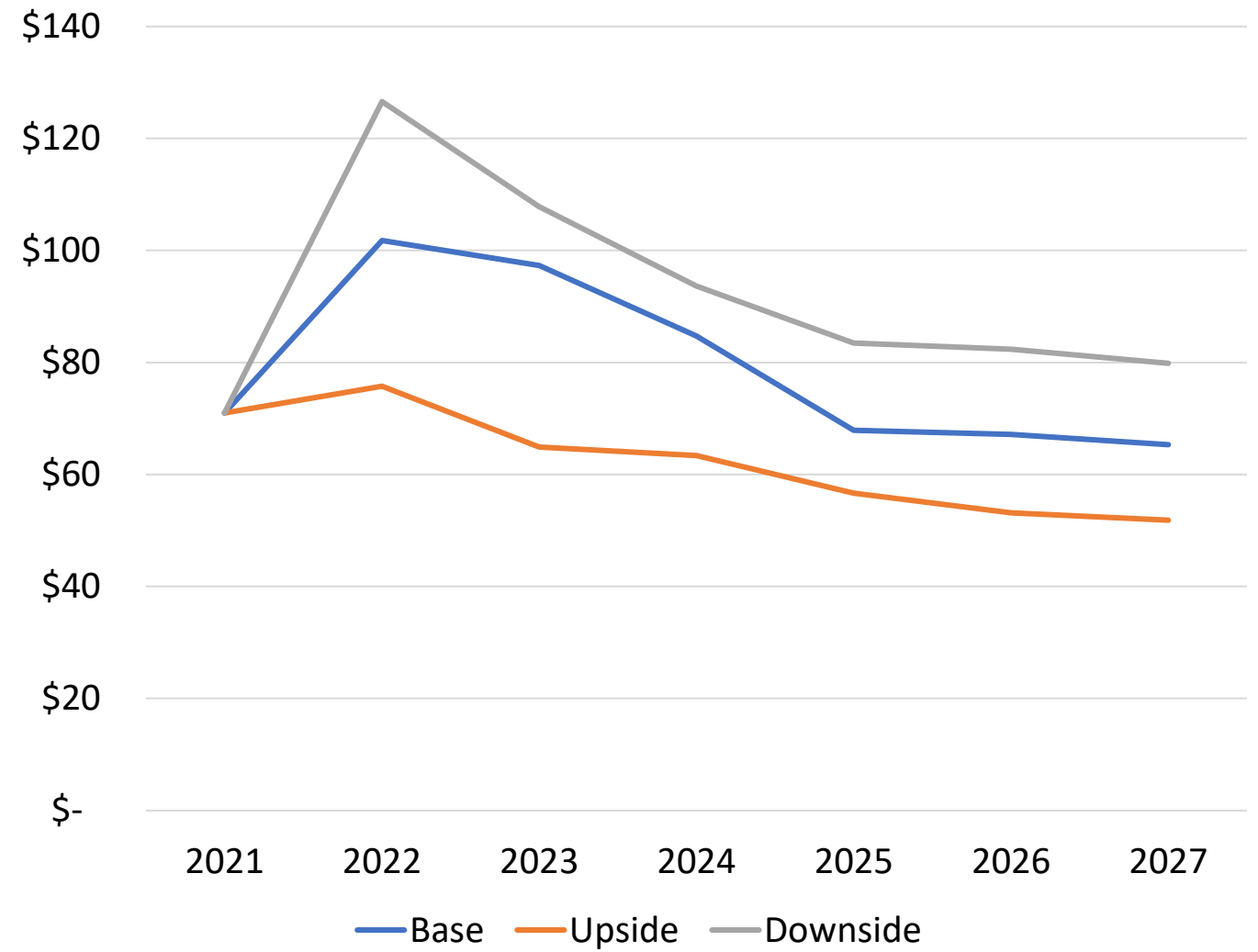
- OBR's modelling process too long winded and complex
- 'Keynesian' models need to be interpreted with a lot of common sense and detailed factual knowledge
- Too much attention to making models work 'in theory' and not enough to making them successful in practice
- Diversity of everything except views
- Unwillingness to pay attention to the consultancy sector who tend to have the practical experience and knowledge
- Consistent failure to predict impacts of major developments – eg GFC, Ukraine, inflation and arguably Brexit
- Economist criticism 'central banks got bored with maintaining price stability and decided to get involved in a variety of more exciting causes including saving the environment and promoting diversity'

Even if they had managed to forecast inflation, could they have done anything about it?

- International causes of inflation (not directly Brexit!)
- Swiss and German experience of the 1970s suggests quite considerable output losses if countries try even partly to insulate themselves from an international inflationary trend
- In the 1970s both Switzerland and Germany were able to cushion the domestic blow by sending ‘Gastarbeiter’ back home. Not a feasible policy today
- **But what policy can do is preserve confidence in the currency – UK failed to do this in the 1970s and faced both high inflation and calling in the IMF – recent fall in £ this year ‘worrying’**

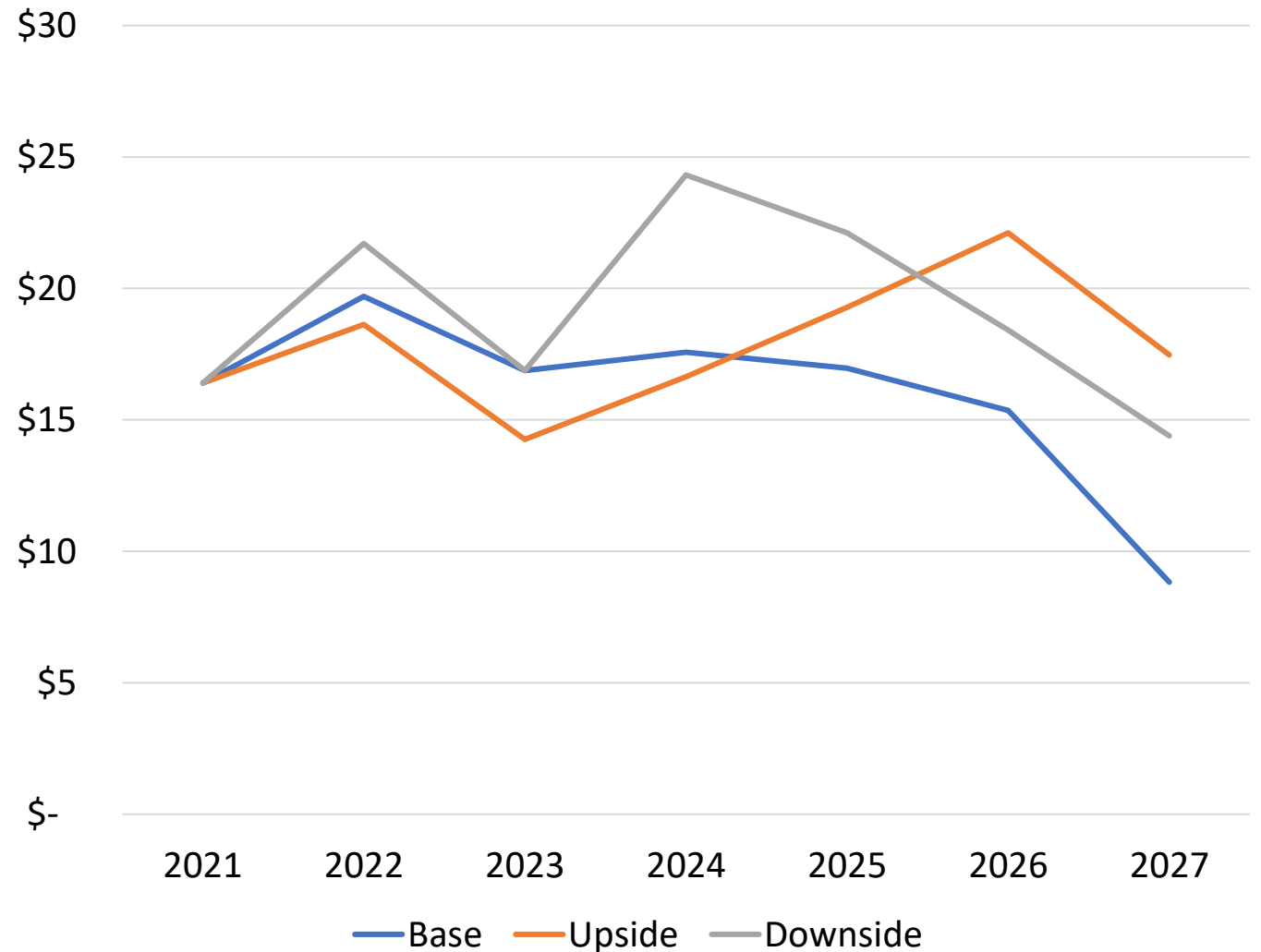
On all scenarios the price of oil is likely to fall as demand diminishes due to the high price and alternative sources from Saudi etc become available

Price of oil (average of WTI and Brent) on different scenarios



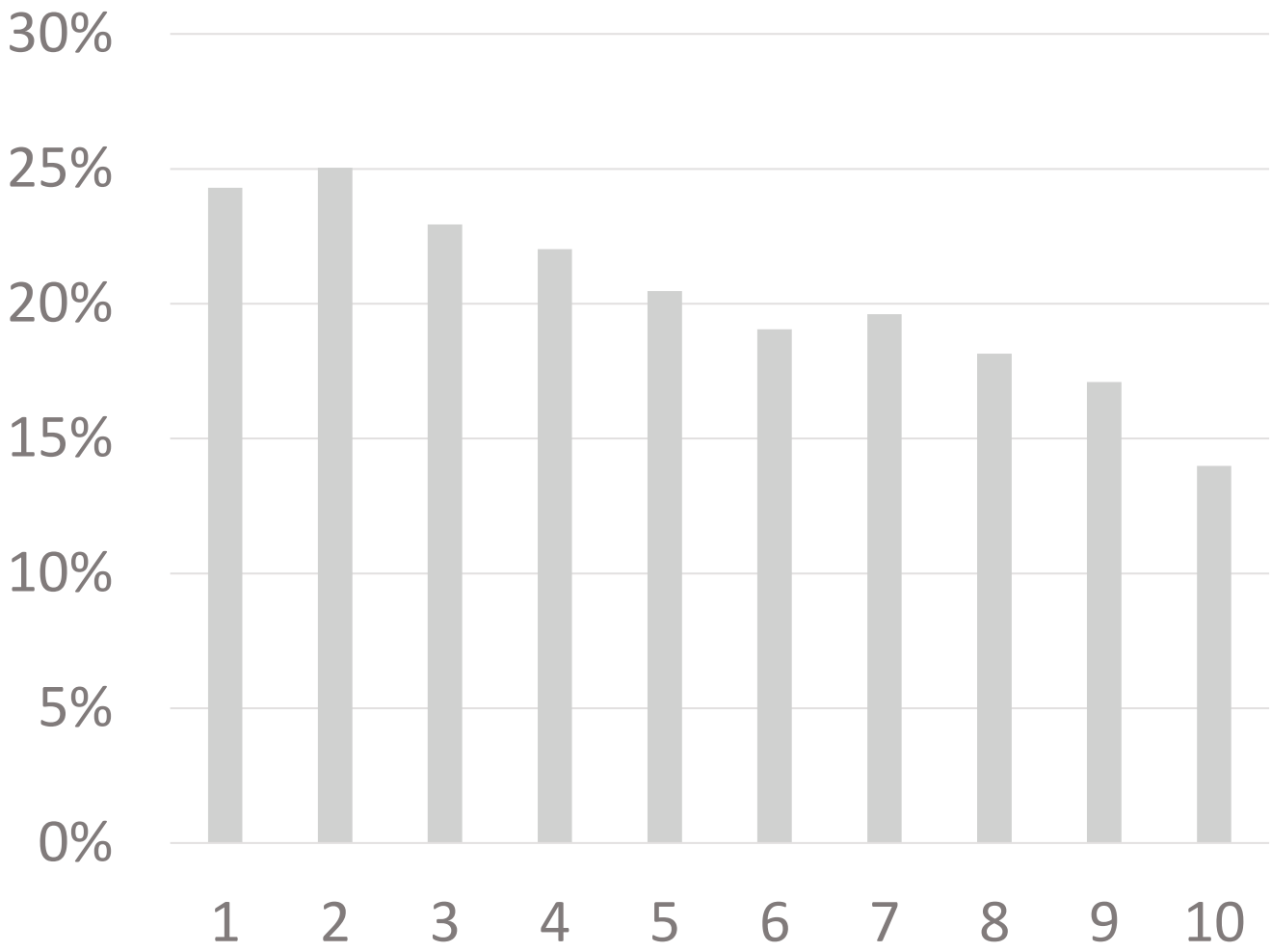
Eventually the price of gas will fall from its current exceptionally high level as demand diminishes and new sources of supply emerge

Price of gas \$ per mmbtu on different scenarios



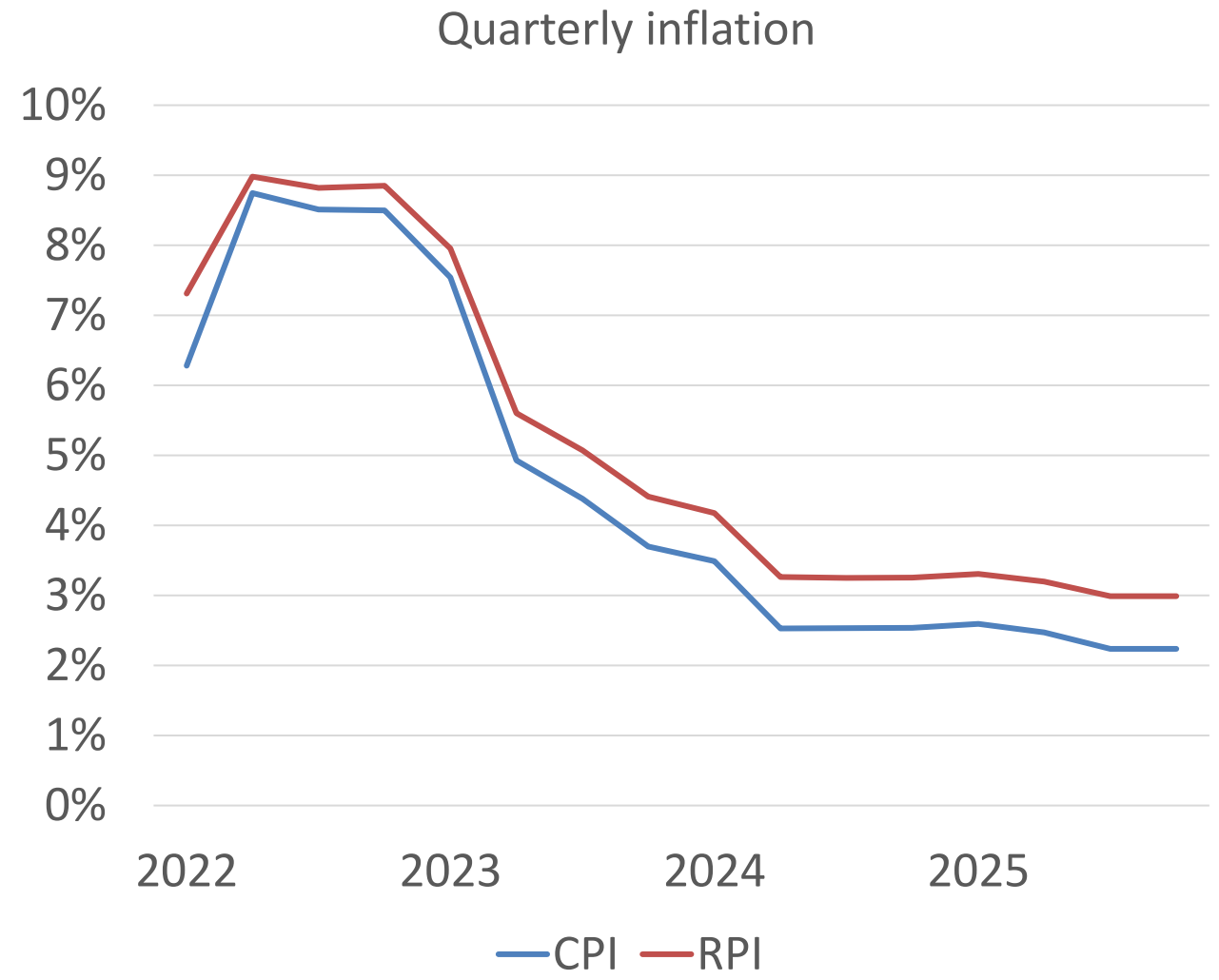
Obviously some of the pain from high prices has to be faced. But Cebr remains amazed that not more had been done to compensate the worst off

Share of total expenditure on energy, fuel and food by income decile (FY 2019/20)



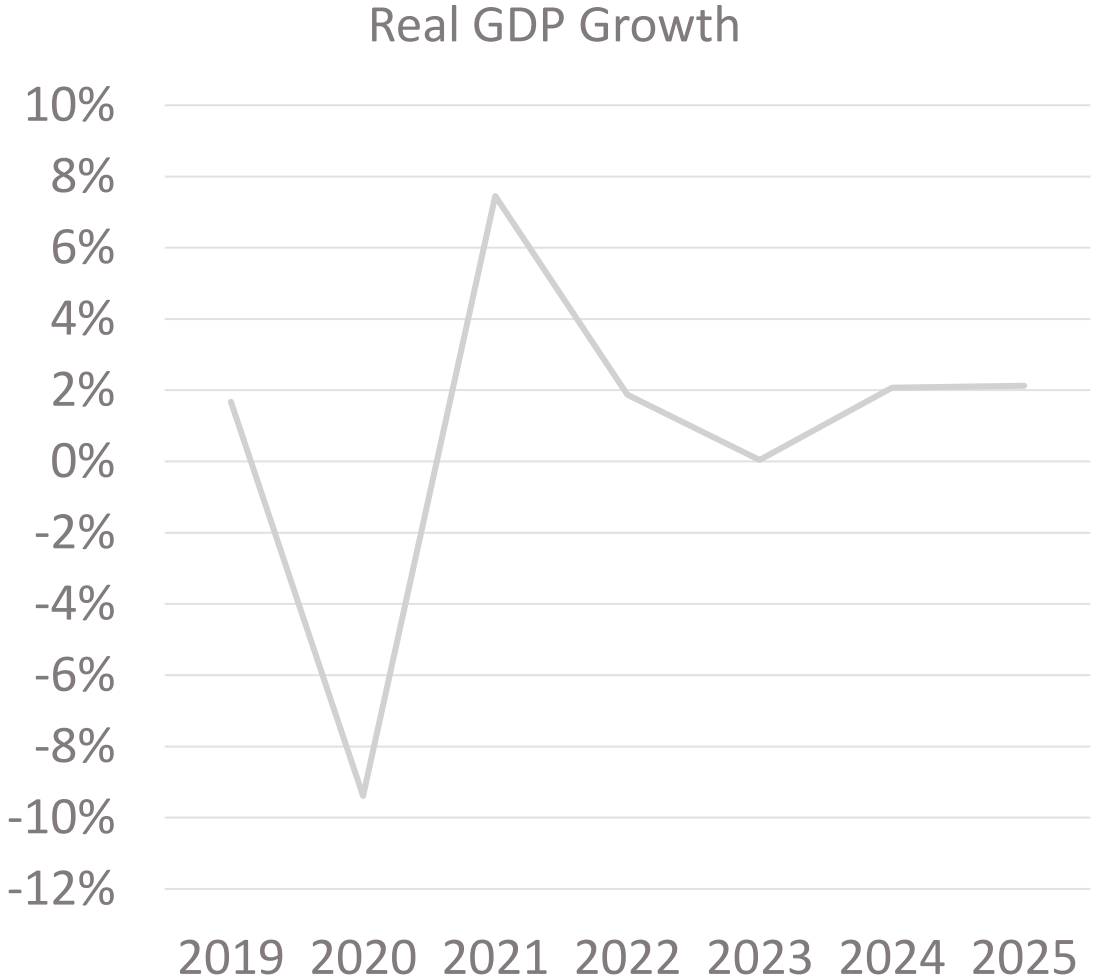
Like the Bank we expect inflation to fall (though more slowly). But it is expected only to get within target late 2024

How long will inflation stay high?



It was always unlikely that we could get through the after effects of the crisis and the associated inflation without recession. The impact of the Ukraine war has made this more or less certain

UK real GDP growth



Impact of inflation on business

- The current bout of inflation pushes up costs
- At present companies have pricing power but they are unlikely to have this over the next two years
- We expect to see a major profits squeeze resulting from inflation
- Moreover the higher costs will require a boost to working capital at a time when monetary policy is being tightened
- And the current tax system means that inflationary profits that are not real also get taxed

SO INFLATION IS NOT GOOD FOR THE CORPORATE SECTOR

Conclusions

- We are unlikely to escape from the current bout of inflation without a recession
- Inflation will probably diminish after a really tough year, but the cause of that diminution will be the recession
- Although higher pay would make the short term living standards problem less bad, it would make getting inflation down very much more difficult
- The bottom 40% of the income distribution will be hit by higher inflation disproportionately
- Policy making – and especially forecasting – can be improved substantially
- But even had OBR/Bank got their forecasts right, they would still have faced an unenviable tradeoff
- BUT need to protect the currency....
- The corporate sector faces a triple whammy from squeezed profits, squeezed cashflow and a higher real tax burden