Bank of England needs to guard against a wage price spiral

T
he recent burst of industrial action, such as last week's train strikes, highlights how the cost of living crisis is causing pain across large segments of society. The Bank of England holds the medicine and needs to administer it to ensure the cost of living crisis is short rather than sustained.

Contrary to the common perception, the cost of living crisis doesn't really have anything to do with wage growth being low. Annual pay growth in April was running just shy of 7.0%, which is more than double the 3.0% average over the past 20 years. And if we ignore the distorted rates during the pandemic, the 4.2% rise in earnings excluding bonus payments is the biggest in 14 years.

Instead, it is a result of inflation being too high. CPI inflation of 9.1% in May is four-and-a-half times the Bank of England's 2.0% target. As a result, in real terms, wages have fallen by 2.2% over the past year. That's the largest decline since March 2012. It means that the rapid rise in prices is absorbing all of the rise in wages and forcing households to buy fewer items. The solution, therefore, is not to raise wage growth but to lower inflation.

Unfortunately, households can't influence inflation. But they can influence their own wage growth. And with the possible pool of replacement workers running dry (April's unemployment rate of 3.8% is close to a 47-year low), workers have a lot of bargaining power. That's why railway workers, postal workers, teachers and lawyers have all recently been on strike or are considering strikes.

This appears to be working too. According to XpertHR, the annual pay settlement of 4.0% across the economy in May was the biggest since September 1992. And some employees, such as railway workers in Liverpool, have recently secured a pay settlement as big as 7.1%.

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For the economy as a whole, however, the risk is that bigger increases in wages add to businesses' costs, which forces them to raise their prices even more, which then prompts workers to demand even bigger increases in pay. That would be similar in style to the wage-price spiral of the 1970s when wages and prices raced each other upwards.

I'm not suggesting people shouldn't seek higher pay or turn down pay rises. That wouldn't be rational. Instead, it is up to the Bank of England to generate a set of conditions that results in inflation falling back below wage growth. Only then will the cost of living crisis end and households can once again enjoy real gains in their wages. Higher interest rates can achieve this in two ways.

First, by weakening the outlook for economic activity, higher interest rates make businesses think twice about raising their selling prices and make households think twice about asking for higher pay. Second, higher interest rates demonstrate that inflation will be 2.0% in the future, which prevents businesses from embedding higher inflation into their budgets.

Of course, higher interest rates won’t solve the cost of living crisis immediately. In fact, in the near-term they will add to the pain by forcing households to pay more to service their debts. But the other option of letting inflation rip is less appealing as that would mean the cost of living crisis lasts longer. Higher interest rates are the lesser of two evils.

If the Bank of England were to raise interest rates from 1.25% now to 3.00% pretty swiftly, then there’s a chance that inflation will be back below wage growth in the second half of 2023. By that point, real wages will have declined for two years, which would be shorter than the six-year long decline after the Global Financial Crisis.

The risk is that the Bank doesn’t raise interest rates far enough, soon enough. That would increase the chances of higher inflation feeding into higher wage growth and back into higher inflation. Not only would that mean the cost of living crisis lasts longer, but it would also mean that the Bank would have to engineer a bigger weakening in activity to reduce inflation. The Bank needs to work hard now to guard against the risk of a wage-price spiral.

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