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Tackling rising inflation and slowing growth

Government's big decision on how to share the pain

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Introduction

Having weathered the coronavirus pandemic, the UK economy has been hit by a wave of sharp price rises, sparking record inflation and a 'cost of living crisis' that is affecting the whole of the UK. This has been driven by global supply issues including continued Covid lockdowns in China and reductions in food and energy supplies following Russia's invasion of Ukraine in February. Inflation hit a 40-year high of 9% in April and is predicted to go above 10% later in the year. In response, the Bank of England has started to raise interest rates. Forecasts predict that growth will slow further this year and the economy could even experience a recession.

With wages not expected to keep pace with inflation, the Office for Budget Responsibility (OBR) predicts that households will face a steep fall in living standards this year – worse than anything experienced for at least half a century. The government has already announced some measures to cushion the impact on households' finances – including a council tax rebate, reduction in energy bills and an increase in the National Insurance threshold. But ministers are under mounting pressure to go further.

This presents the government with difficult choices – politically and economically. During the pandemic, the Treasury rolled out an extraordinary level of support to protect households, going far further than in any previous crisis or recession. This has perhaps raised public expectations of what the government can do for them in times of economic hardship. But while the effects of the current situation may be felt in a similar way to previous crises, with households' real incomes falling, the reasons for this are very different – not only from the pandemic but also from other recent UK recessions. This means the response from government will need to be different as well.

This paper looks at the policy choices available to the government in forming this response. It starts by briefly describing the current economic situation and how monetary policy makers – namely, the Bank of England – are likely to react. It then outlines what the possible roles for fiscal policy are and what factors should feed into the government's thinking when designing this. Its key points are:

- **The UK is experiencing high and rising inflation**, emanating from a series of global shocks to supply chains and energy supply. The Bank of England's focus on heading off the risk of permanently high inflation has led it to start raising interest rates – designed to 'cool' the economy by discouraging spending, bringing demand down in line with supply.
- **The current crisis is unlike recent recessions**. The 2008 global financial crisis and before it the early 1990s recession stemmed from a shortfall in demand. In response to both, government had a role in trying to prop up demand through spending increases and tax cuts (bringing demand *up* in line with supply). In contrast, the current economic weakness stems from the supply side.
- **The government should not seek to prop up demand**, as this might simply prompt the Bank of England to raise interest rates further – tightening its monetary policy to offset the effects of government's looser fiscal policy. As such the government should be wary of introducing broad-based tax cuts or spending giveaways that would amount to a sizeable fiscal stimulus, since these would be expensive and yet ultimately not achieve the desired effect of boosting household finances.
- **The government should not need to use fiscal policy to reduce inflation**, if it remains confident the Bank of England can fulfil its mandate. Ministers, therefore, should not be discouraged from doing things that would otherwise be sensible (or encouraged to do things that would otherwise be inadvisable) simply to affect inflation. For example, the main consideration in setting public sector pay should be an assessment of recruitment and retention pressures. Similarly, help with energy costs would likely be better done through targeted income support, rather than direct intervention to suppress the price of energy, since doing the latter would dampen incentives to adopt energy efficiency measures that are needed to meet the government's net zero target.
- **The government can, however, use fiscal policy to help allocate the pain as the economy cools**. The cost of living crisis is being felt hardest by lower income households. There is, therefore, a case for the government to focus support on lower income households. However, fiscal action will ultimately need to be guided by which groups the government wants to help.

- **There could be a role for the government in trying to reduce any long-term damage** caused by current temporary economic problems. There is so far little evidence that such intervention is needed beyond support for the most energy intensive industries. But the government should continue to monitor these risks.

This is a supply shock, not a demand shock

The 2008 recession in the UK (like those in the early 1980s and early 1990s) was caused by a demand shock – that is, demand for goods and services in the private sector suddenly falling even though the country's capacity to produce output remained largely unchanged. If left unaddressed, such a fall in demand will cause businesses to cut their production and start laying off workers.

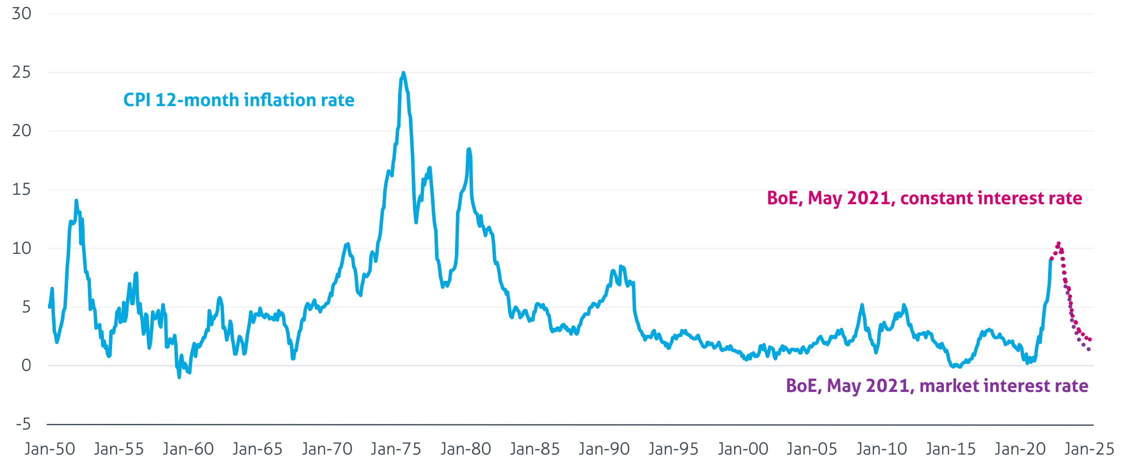
When this happens, fiscal policy – set by the government – and monetary policy – set by the Bank of England – tend to respond in the same direction, attempting to stimulate demand to minimise the fall. Monetary policy does this by cutting interest rates, which encourages people to spend money sooner rather than later as borrowing becomes cheaper and saving less beneficial. Fiscal policy does this by increasing public spending or cutting taxes, ideally in a way that gets extra money to the people who are most likely to spend it quickly, thus providing a timely boost to demand.

Traditional economic orthodoxy is that monetary policy should be the main tool used to stabilise short-term output fluctuations and that any fiscal stimulus may simply result in monetary policy makers doing less than they otherwise would have done to stimulate demand. However, many economists have increasingly advocated for more active use of fiscal policy in these circumstances if monetary policy cannot do enough. This has been the case since the global financial crisis because interest rates have been extraordinarily low – at or close to the so-called 'zero lower bound' beyond which monetary policy cannot do any more.[1]

But things are different in the event of a supply shock, as the UK faces now. The current weakness of the UK economy, so far at least, is largely driven by problems on the supply side of the economy (that are affecting how much the UK can produce, and at what price) rather than on the demand side (how much people want to buy). If anything, demand is growing too quickly.[2] This means that, while not a perfect comparison, the economic situation now has more parallels to the oil price shocks of the 1970s than it does to recessions closer in most people's memories.

The war in Ukraine has pushed up the price of oil and gas supplies to Europe and has also affected global food supplies, as Ukraine is one of the world's main producers of sunflower oil, wheat and corn. Covid lockdowns in China also continue to affect global supply chains. Both have already led to higher inflation and present the real risk of the UK economy overheating – that is, of demand for goods and services outstripping the available supply of the items needed to produce them. This could in turn fuel still higher inflation as prices are pushed up as businesses and consumers compete for increasingly scarce goods and services.

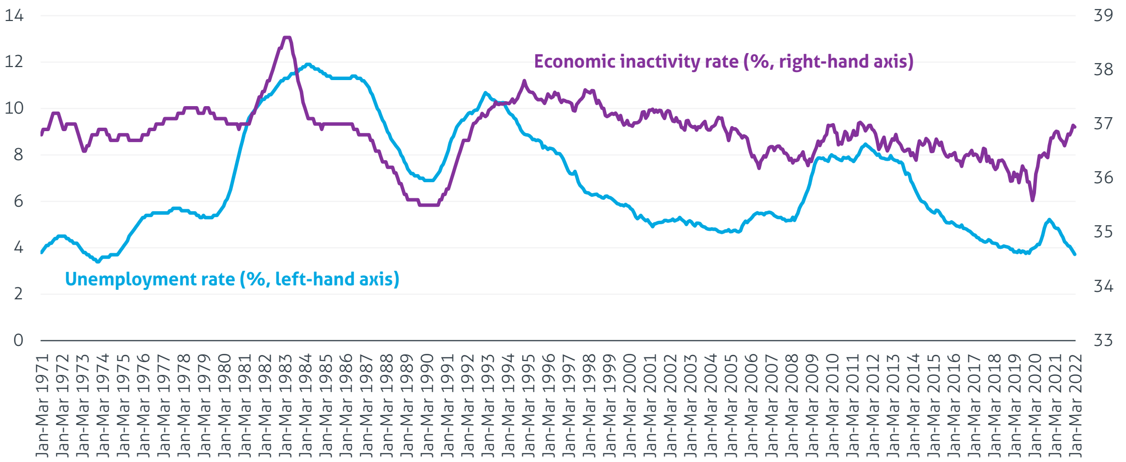
Figure 1 **Annual consumer price inflation (percentage)**



Source: Institute for Government analysis of Office for National Statistics, *Modelling a Back Series for the Consumer Price Index*, 1950–2011 and *Consumer price inflation tables*, April 2022 release, and Bank of England, *Monetary Policy Report – May 2022*.

The supply potential of the UK economy has also been reduced by factors closer to home, notably a fall in the size of the labour force during the pandemic. This has happened for two main reasons: lower inward migration and a decline in labour force participation, particularly among older workers. There are signs that the UK labour market is operating at or very near to capacity. In March, the unemployment rate hit a 50-year low of 3.7%, while the number of vacancies surpassed the number of people looking for a job for the first time on record.[3] All of these factors are constraining how much the UK can produce.

Figure 2 **Rates of unemployment and economic inactivity**



Source: Institute for Government analysis of Office for National Statistics, *Employment, unemployment and economic inactivity by age group (seasonally adjusted)*, May 2022 release.

Monetary policy should bring inflation under control...

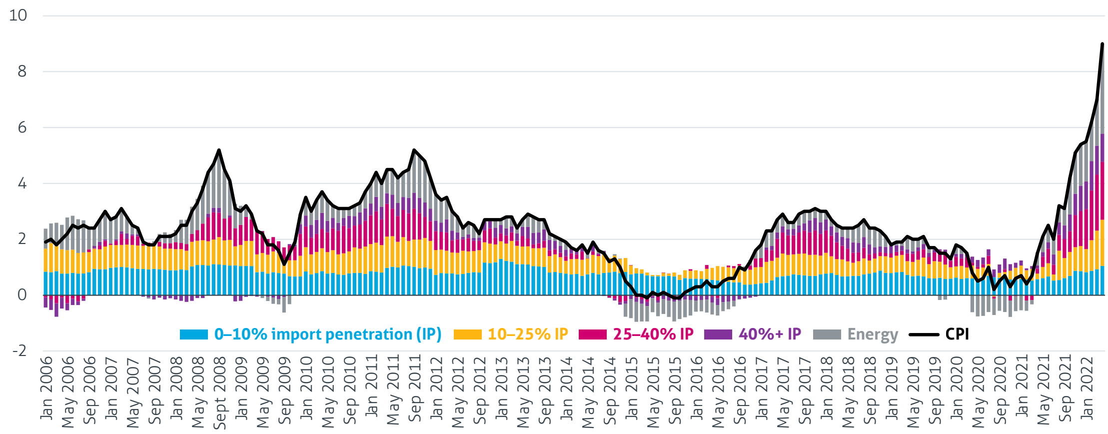
The Bank of England's remit, set by the chancellor, is to stabilise consumer price inflation at 2% in the medium term. Monetary policy makers' task, therefore, is to bring inflation under control by raising interest rates and/or reversing previous purchases of government and corporate bonds (so-called quantitative easing).

One school of thought – that many members of the Bank of England's Monetary Policy Committee (MPC) and other economists were expounding last year[4] – is that this could happen naturally without much action from the Bank because the sources of inflation are largely transitory. In particular, the global shocks that have pushed up energy and food prices are likely to have caused a one-off jump in prices: while prices may stay high, there is little reason to think that they will continue to rise ever higher. If that is the case, inflation, measured as year-on-year growth in the price level, will fall back next year – once recent high oil and gas prices have been fully passed on to households (when the energy price cap is adjusted) and once those high prices start to be included in the 'base' price level against which inflation is measured.

But the concern that has increasingly preyed on central bankers' minds this year is that inflation may be more persistent. This could happen, for example, because energy price rises start to feed through into higher prices for other goods that use energy in their production processes, and into higher wage demands from workers – both of which in turn could fuel higher consumer prices as businesses seek to protect their profit margins. Whether this happens will depend in part on how much faith the public have in the Bank's ability to return inflation to its target level of 2% and its commitment to doing so.

Inflation has so far been largely concentrated in energy and food prices but there are some signs that other goods and services are starting to catch up (see Figure 3, below). Unusually low unemployment rates also mean nominal earnings growth has surpassed the Bank's previous forecast and businesses in general are expecting to increase their prices sharply to pass on higher costs to consumers. The signals are "consistent with a continuing tightening in the labour market and with a margin of excess demand at present", according to the Bank's May 2022 Monetary Policy Report.[5] The Bank will be watching closely for any signs that those inflationary pressures are strengthening. But it will have to walk a fine line – doing enough to dampen demand to avoid high inflation becoming entrenched but not doing so much that they push demand below the country's supply potential.

Figure 3 **Composition of consumer price inflation**



Source: Institute for Government analysis of Office for National Statistics, *Contributions to the 12-month rate of CPI(H) by import intensity*, May 2022 release.

The MPC has already raised interest rates from 0.1% in December 2021 to 1% in May 2022. However, the Bank's latest forecast suggests that inflation would remain above 2% in three years' time without further interest rate rises, suggesting further rises are likely.[6] Indeed, in May the Bank hinted at this, reporting that "most members of the Committee judge that some degree of further tightening in monetary policy may still be appropriate in the coming months" (though it has also signalled that rates will probably not rise as much as financial markets expect).[*]

What is clear is that the Bank's actions and analysis suggest that members of the MPC believe that they need to dampen demand to bring inflation under control. This is a sharp turnaround from much of the period since the global financial crisis, when interest rates have been extraordinarily low and much of the debate about economic policy has focused on ways to *increase* demand.[7]

This action by the Bank will have an effect on households. This will be direct, for example as higher interest rates will increase mortgage servicing costs, and indirect, as dampening the economy tends to temper demand for the goods and services that people produce and sell, while also suppressing wage and employment growth. But this short-term pain is intended to avoid much larger long-term costs of an overheated economy and runaway inflation.

* An alternative forecast scenario conditioned on current market expectations for the future path of interest rates (which assumes the MPC raises the base rate to around 2.5% by mid-2023) implies that consumer price inflation would undershoot the 2% target, that there would be a shortfall of demand relative to supply and that unemployment would rise to 5.5%. Bank of England, *Monetary Policy Report – May 2022*, 2022, retrieved 24 May 2022, www.bankofengland.co.uk/monetary-policy-report/2022/may-2022

…and is likely to offset any aggregate effect of looser fiscal policy

If the Bank is right in its assessment that the economy is bumping up against its short-term supply capacity, then the government will be able to do very little to influence the overall size of economic output. Large net spending giveaways or tax cuts might appear to boost people's incomes – and are of course politically popular – but in practice they would likely just be eaten up (across the population as a whole) by higher inflation.

Therefore, were the government to roll out a large fiscal stimulus – tax cuts and/or spending increases – the Bank would try to offset the effect of this on aggregate demand by implementing even tighter monetary policy. This again makes the current situation very different from the global financial crisis, when many economists advocated for governments to rapidly roll out fiscal stimulus measures – such as temporary VAT cuts[8] – to provide an immediate boost to spending (in particular, by encouraging people to spend now rather than later), alongside cuts to interest rates.[9]

The government will need to bear in mind how its fiscal action exacerbates the difficulties facing the Bank in keeping inflation under control. But the Bank has space to tighten monetary policy further and so concerns about boosting inflation should not altogether stand in the way of the government taking fiscal action.[*]

Fiscal policy can influence who bears the pain of bringing inflation under control

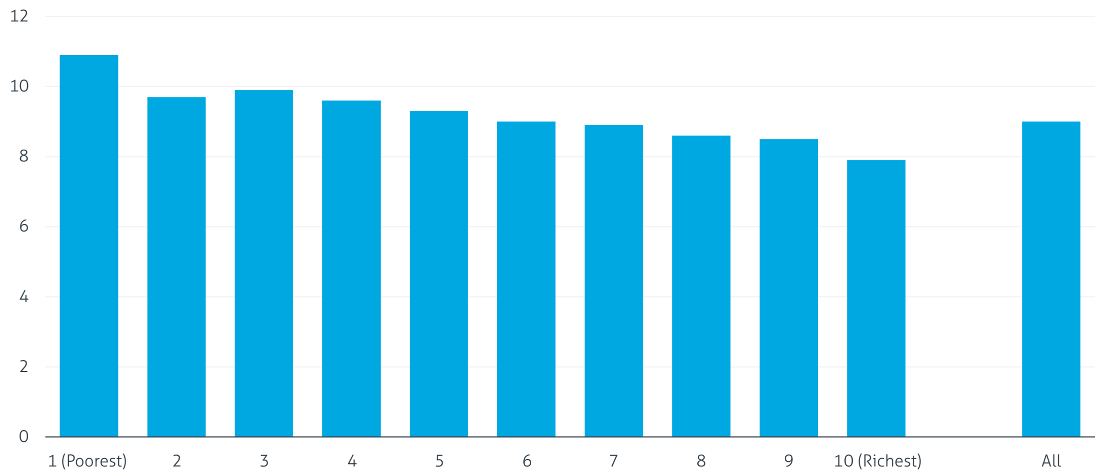
Whether or not the government provides a net fiscal stimulus, there is certainly a role for fiscal policy in achieving other objectives that monetary policy cannot fulfil. There are three possible roles for fiscal policy: redistributing the pain that will be experienced from high inflation, interest rate rises and the economic slowdown; reducing the chance there is any negative long-term effect of the short-term economic slowdown; and boosting the UK's supply capacity. In the second part of this paper we look at these, starting with redistributing the pain – under the current circumstances, by far the most pressing area for the government.

High inflation is affecting some people more than others

Energy use varies considerably across the population, even within groups with similar incomes. However, on average, lower income households tend to spend a greater share of their budgets on energy and food, which are the goods that are going up in price most quickly.[10] They also typically find it harder than richer households to consume less or substitute for cheaper alternatives, since they are usually already buying the cheapest options. The Institute for Fiscal Studies has calculated that, while the headline measure for consumer price inflation hit 9% in April, inflation for the poorest tenth of households hit 10.9%, while the rate for the richest tenth of households was just 7.9%.[11]

* The National Institute for Economic and Social Research has even suggested there could be benefits to the Bank being able to "raise interest rates more decisively". National Institute for Economic and Social Research, *UK Economic Outlook, Spring 2022.*

Figure 4 **Inflation over the year to April 2022, by decile of household income (percentage)**



Source: Adapted from Institute for Fiscal Studies, 'Inflation hits 9% with poorest households facing even higher rates', 18 May 2022.

Interest rate rises will affect some more than others

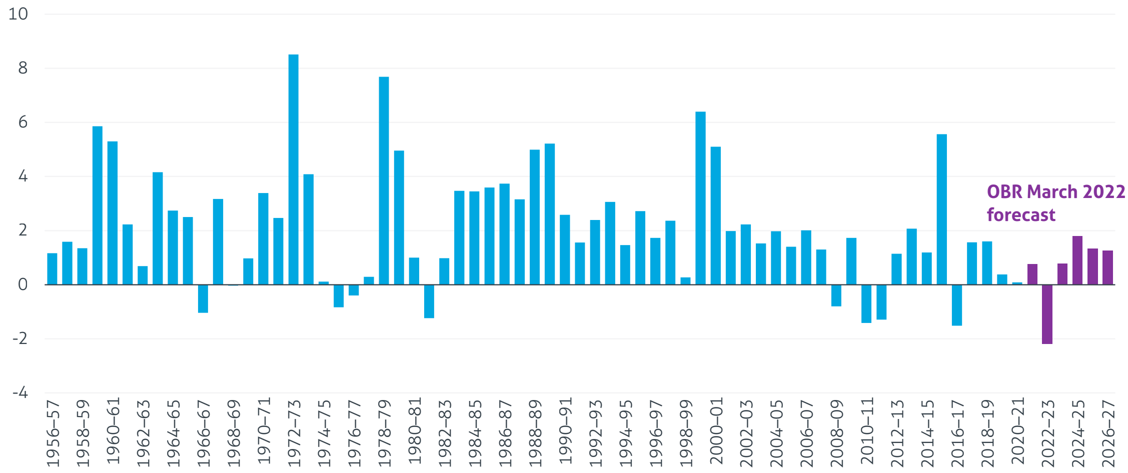
The Bank of England does not have any mandate to pursue distributional objectives. However, interest rate changes and quantitative easing affect people differently. There are direct effects from rate rises – such as higher interest payments to savers, higher costs to borrowers and lower asset prices. There are also indirect effects – such as worse labour market outcomes due to weaker economic performance.

Taking these factors together, analysis by the Bank suggests that the impact of monetary policy on households is roughly similar across the income and wealth distributions, when measured in terms of the percentage change in household income or wealth. However, the impact does vary by age. In response to a rise in interest rates, older households will tend to gain from higher income from savings but lose from asset price falls; younger households will tend to lose out from the weaker economic performance but be less exposed to asset price falls (as they are more likely to be in work but hold less wealth).[12]

Some households' incomes will keep pace with inflation – but others will not

Overall, household incomes are not expected to keep pace with inflation this year. The OBR predicted in March that real household disposable income per person would fall in 2022/23 by 2.2%, the largest fall since records began in 1955/56.[13] This takes account of the support that the government has already announced, though inflation has turned out to be even higher since March than the OBR predicted.

Figure 5 **Annual change in real household disposable income (percentage)**

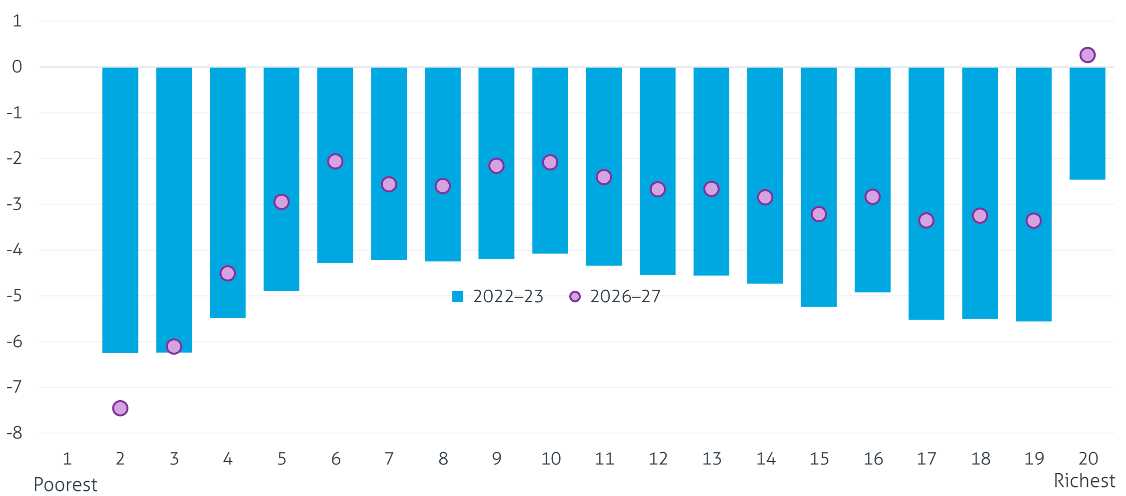


Source: Institute for Government analysis of Office for Budget Responsibility, *Economic and Fiscal Outlook – March 2022*.

But this squeeze on incomes – like the impact of inflation – will not be evenly felt across the population. Lower income households are likely to find their incomes rising less quickly than higher income households.

So far, pay growth is holding up better at the top of the distribution than at the bottom. Figures for the first three months of 2022 show that the 10th percentile of the pay distribution rose by 0.9% compared to a year earlier, while the 95th percentile rose by 6.2% and the 99th percentile rose by 11.1%. Benefit income (including state pensions) has also risen far less quickly than inflation this year. Benefits were uprated by just 3.1% in April, the figure for inflation back in September 2021 to which rises are pegged, but is well below current figures for inflation and also lags earnings growth over the same period. This mismatch will be reversed next April but in the short term it will result in a fall in spending power for households reliant on state benefits.

Figure 6 **Change in real household disposable income, by income vingtile (percentage)**

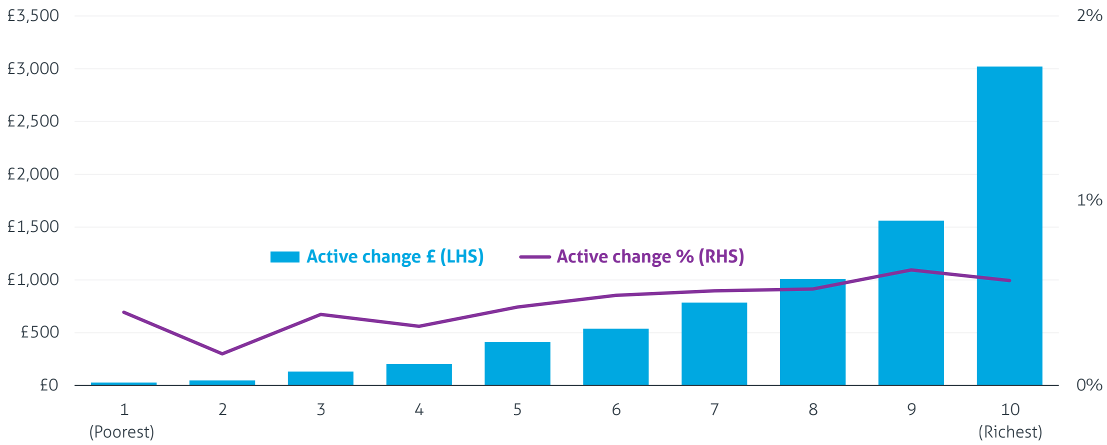


Source: Adapted from Resolution Foundation, *Inflation Nation*, 24 March 2022. Note: Forecasts for annual real growth in average equivalised household disposable income for non-pensioners after housing costs by income vingtile. The first income vingtile is excluded due to concerns about the reliability of data for this group.

The Resolution Foundation has estimated (based on forecasts from the OBR published in March) that in 2022/23 the poorest 10th of households will experience the sharpest fall in real disposable income after housing costs. This could result in a million more people falling below the absolute poverty line.[14] This pattern of larger income decline for the poorest will be reinforced over the following four years, as Figure 6 shows.

Middle and higher income households' financial positions are also helped somewhat by the fact that many of them accumulated substantial savings during the pandemic, which was much less true for lower income households.[15] Households that did accumulate financial assets during the pandemic may be able to use these to help cushion the blow from high inflation and higher interest rates. Meanwhile, lower income households are less likely to have savings to draw on or easy access to credit to fund temporarily high living costs.

Figure 7 **Accumulation of savings during the pandemic, by household wealth decile**



Source: Institute for Government analysis of Resolution Foundation estimates of median change in family wealth per adult as a result of active saving and debt changes since the onset of the pandemic, by income decile: GB, February 2020 to May 2021, Wealth (gap) year, 12 July 2021.

The government could try to distribute the pain more evenly

The government has already announced around £22 billion of tax cuts and spending increases for this financial year (2022/23) to help households with the cost of living crisis.* However, these policies have offered fairly broad-based support across households, and the cash gains will actually be largest for those in the middle and top of the income distribution, with those at the bottom gaining comparatively little from the announced increase in the National Insurance threshold and cut to fuel duty.[16]

Given the uneven impact of recent economic conditions on different households, there is a case for the government to use any further fiscal action to focus help on lower income households. A further reason to favour targeting support on this group is the greater risk that they could end up making decisions with long-term negative consequences if their budgets are squeezed too tightly – for example, becoming ill or children not being able to learn properly at school (or adults underperforming at work) as a result of inadequate heating or nutrition.

* This includes: £150 council tax rebates to those in band A–D properties; £200 (repayable) energy bill rebates; 5p per litre fuel duty cut; increase in National Insurance threshold; freeze in alcohol duties; discretionary household support fund to be distributed through local authorities.

The most effective tools for doing this would be targeted transfers to these households – for example, through Universal Credit and other regular benefit payments, or through one-off payments such as the Warm Homes Discount, Winter Fuel Payments (for pensioner households) or Cold Weather Payments. Tax cuts would be much less well-targeted, since much of the support provided by those would go to higher income households. In the case of some tax cuts – such as an income tax or National Insurance cut – little or no support would go to the lowest income households, since they already are not liable to pay these taxes.[17]

If the government was worried about the impact of spending increases or tax cuts in fuelling inflationary pressures, it could pair giveaways to some groups with takeaways from others. In devising such a package it would need to think carefully about what the overall effect would be on demand. This would depend on how much of any giveaway was likely to be spent immediately (as opposed to saved) and how much any takeaway would be funded by cutbacks to spending (rather than lower saving).

There has been a lot of debate about the possibility of levying a windfall tax on oil and gas producers to recoup some of the gains they have made as a result of unexpectedly high energy prices. This tax would probably not have much immediate impact on aggregate demand, given that some oil producers have already indicated the tax would not affect their investment decisions and dividend payments (which could be reduced by the tax) tend to go to people with a high propensity to save, rather than spend.[18] However, there may be other reasons to favour imposing such a tax.

These are ultimately political choices about how to distribute the pain, which are rightly in the gift of a democratically elected government.

Fiscal policy could help ease supply constraints…

Since one of the reasons that inflation is high and could remain so is supply constraints, the government could try to ease these. This could take some pressure off prices. The main problems relate to energy and labour supply. It will, however, be difficult for the government to do much in either of these areas in the short term.

In our response to the government's *British Energy Supply Strategy*, we discussed the scope to extend the lives of existing coal-fired power stations, increase North Sea oil and gas production and expand renewables generation, although we also note that these would have only a marginal impact on overall energy supply before next winter. The government could also encourage – and, in the extreme, mandate – lower energy consumption by encouraging faster take-up by businesses and households of energy efficiency measures (such as loft insulation) and through public information campaigns to encourage householders and businesses to turn down their thermostats.

On labour supply, the government could seek to reverse the two main factors that have contributed to the recent drop in size of the UK's labour force: lower inward migration and a decline in participation among older workers. However, there are no easy answers to either. Achieving a notable, quick increase in migration would likely require changes to immigration rules, which would be politically as well as administratively difficult. The rise in inactivity among older people mainly reflects a greater number retiring early or (an even greater number) due to long-term sickness; the barriers to this latter group returning to work may be particularly great.

...and reduce the risk of scarring

The other factor the government should be focused on is ensuring that nothing happens in the next few months that causes lasting harm to the UK's production potential. Economists describe this sort of long-term negative impact of a short-term economic downturn as 'scarring'. There are normally two channels through which this can occur. The first is through the labour market: periods of unemployment can damage workers' longer-term productivity and prospects – for example, if workplace skills are forgotten, past experience becomes less relevant or the individuals themselves become discouraged from looking for work. The second is through the impact on businesses. One possibility here is that a temporary negative economic shock could cause an otherwise viable business to go to the wall and it can take a long time for another to replace it. Another is that uncertainty about the economic outlook may cause businesses to hold off on making investments, which would reduce the capital stock that the country has to work with.

At the moment, there is little sign of such scarring developing, as unemployment is at a record low. The government should monitor what is happening in the labour market but there seems to be little risk of high unemployment leading to widespread scarring.

Business groups are often vocal when calling for support in response to rising prices,[19] but government intervention is not always justified. This might apply here: there are few signs at the moment of longer-term problems for businesses. Business investment has been weak, but despite this – and high energy prices and disruption to global supply chains – business confidence has remained strong and firms have been reporting strong investment intentions to the Bank of England's agents.[20]

One subset of businesses that is likely to be more heavily affected than others is those that are very energy intensive. For these businesses, energy makes up a large proportion of their input costs, meaning their activities could easily have become unprofitable because of the energy price rise – which is expected, at least in part, to be temporary. As we set out in another recent paper, the grounds for government intervention to support energy intensive industries (EIIs) are strongest where there are competitiveness concerns – in other words, where the government believes that UK firms risk losing competitive advantage relative to firms in other countries. This could happen either because of a temporary UK-specific shock to input costs or because of a wider global shock that other countries respond to by offering support. A second justification for support for EIIs affected by energy price rises is the negative spillover effects that this could have on other firms further down the supply chain.

The government has already announced measures to support these businesses.[21] It will need to continue monitoring whether this package is appropriately calibrated.

Other policy decisions should not be dictated by concern over inflation

There has been some debate among politicians and in the media about whether other aspects of government policy should be used directly to try to reduce inflation. In particular, this has been discussed in relation to setting public sector pay and in relation to proposals for a VAT cut or measures to directly reduce the price of energy. Controlling inflation is the job of the Bank of England. If the government has confidence in the Bank's ability to do that, ministers should not be overly concerned about using government policy to try to pursue the same goal. Certainly the government should not be discouraged from doing something that would otherwise be beneficial – or encouraged to do something that would otherwise be inadvisable – simply to try to get inflation down.

When deciding on public sector pay increases, the government should make decisions based on a thorough assessment of recruitment and retention pressures. Addressing these will be important for ensuring that the public sector has the quality and quantity of staff needed and any reasonable assessment is unlikely to result in pay being set so high as to induce an uncontrollable wage-price spiral across the economy.

Direct government intervention to alter market prices – such as through a temporary cut to the main rate of VAT, reductions in taxes specifically on energy and fuel, or regulating the retail price of energy – has been advocated as a way of cutting the headline measure of inflation as well as reducing the cost of living (although any subsequent reversal of a tax cut would increase inflation later on). If a reduction in headline inflation of this sort affected people's expectations about future inflation, it would make the Bank of England's job of bringing inflation under control easier.[22] But the Bank should have other tools to do that. In the absence of evidence that the Bank is struggling to fulfil its mandate to control inflation, government policy should not be dictated simply by a concern to reduce inflation. There may be other policies that are better designed to achieve other government objectives (such as easing cost of living pressures and encouraging energy efficiency) and should not be overlooked simply because they do not also reduce measured inflation, for example:

- Any measures to cut the retail price of energy would reduce living costs and inflation but would dampen incentives for people to adopt energy efficiency improvements. It may, therefore, be better for the government to provide direct transfers to households to help them meet high energy costs, while retaining the signal that they receive from high prices about the benefits of reducing energy use and adopting energy efficiency improvements.

- A cut to the main rate of VAT (which is charged on roughly half of all goods and services) would reduce headline inflation. But to achieve a noticeable reduction in living costs, it would be expensive. The aggregate effect of this stimulus would be offset by tighter monetary policy, while the benefits would not be well-targeted at those who have experienced the sharpest increase in living costs and sharpest fall in real incomes (if that was the government's objective).

Conclusion

The UK is experiencing high and rising inflation, emanating from a series of global shocks to energy supply and other supply chains. The Bank of England has started to raise interest rates to head off permanently high inflation. The government is under growing pressure to do more to support households and the economy through this, presenting it with many difficult political and economic choices.

However, the current crisis is unlike the economic problems that faced the UK in the early 1990s and then 2008. Both of those recessions stemmed from a shortfall in demand. In response to that, government had a role in trying to prop up demand through spending increases and tax cuts to cushion the economic hit. In contrast, current economic weakness has arisen from the supply side. There are already signs that, if anything, demand is outstripping supply.

There is therefore likely to be no role for government in further stoking demand overall. Any attempts to do so would likely simply prompt the Bank of England to offset looser fiscal policy with tighter monetary policy. The government may, therefore, want to consider making any interventions fiscally neutral (that is, with giveaways for one group offset by takeaways for another). The Bank will be able to tighten monetary policy more if needed and so fears about stoking inflation should not be a total impediment to fiscal action. Nonetheless, the government should be wary of introducing broad-based tax cuts or spending giveaways that would amount to a sizeable fiscal stimulus, since these would be expensive and yet ultimately would probably not achieve the desired effect of boosting household finances.

Provided the government remains confident that the Bank of England can fulfil its mandate to control inflation, ministers should also not focus too much on trying to use fiscal policy deliberately to lower inflation. Certainly the government should not be discouraged from doing things that would otherwise be sensible (or encouraged to do things that would otherwise be inadvisable) simply to cut inflation. For example, the main consideration in setting public sector pay should be an assessment of recruitment and retention pressures. Similarly, help with energy costs would likely be better done through targeted income support, rather than direct intervention to suppress the price of energy, since doing the latter would dampen incentives to adopt energy efficiency measures that are needed to meet the government's net zero target.

There is, however, an important a role for government in helping to reallocate who bears the pain of the economic slowdown that is needed to head off permanently high inflation and ensure demand remains in line with supply. Bank of England analysis suggests that monetary policy tightening affects people across the income and wealth distribution roughly evenly, in terms of the percentage change in their income and wealth. Other economic factors, however, are not having an even impact. High inflation is negatively affecting lower income households more than higher income households, as is the pattern of wage rises and slow growth in benefit rates. Middle and higher income households are also more likely than poorer ones to have built up their savings during the pandemic which could be drawn down to support living standards now.

There is, therefore, a case for the government to focus support on lower income households – with this potentially being offset by takeaways from other groups to reduce any stimulative effect on the economy, which could push inflation higher. However, fiscal action will ultimately need to be guided by which groups the government wants to help.

There could in theory be a role for the government in trying to reduce long-term scarring. There is, however, so far little evidence that such intervention is needed beyond support for the most energy intensive industries. But the government should continue to monitor these risks.

References

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