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The Bank of England's Growing Policy Dilemma

The central bank needs help countering stagflation, though it may not get it.

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Governor Mark Carney is between a rock and a hard place. *Photographer: Adrian Dennis/AFP/Getty Images*

Stagflationary winds -- declining growth and rising inflation <https://www.bloomberg.com/news/articles/2017-06-19/bank-of-england-s-forbes-warns-against-underestimating-inflation> -- are among the trickiest economic challenges that policy makers can face. They reduce the effectiveness of policy instruments and increase the risk of mistakes. And this burden should not be placed primarily on central banks, as is currently happening in the U.K.

After holding up impressively well in the immediate aftermath of the June 2016 Brexit referendum, the U.K. economy is coming under pressure. Economic growth has slowed notably, wages are stagnating and inflation has marched up toward 3 percent, the highest among the major advanced economies.

With this combination in play, it is just a matter of time until the (up-to-now solid) "soft" indicators, including business and household confidence, come under pressure. Consumers would face a further squeeze on their purchasing power caused by both sluggish incomes and rising prices for goods and services. Business investment would be undermined by Brexit uncertainty, including lingering major questions about how the U.K. will interact in the future with its major trading partner, the European Union. And exports, while they face a better outlook due to currency depreciation, would not be large enough to effectively act as a powerful locomotive of growth for the economy as a whole.

Stagflation tendencies also run the risk of triggering unpleasant feedback loops. Think of the exchange-rate channel, for example. The dimmer the growth prospects, the less attractive Britain will be for capital inflows from abroad. This places pressure on the currency, which then spills over into higher inflation, which squeezes consumers, worsening in turn the prospects for aggregate demand and growth.

This economic configuration puts the Bank of England in a particularly difficult situation. Already, inflation is above its target, and will likely deviate more in the months to come. But an interest rate hike <https://www.bloomberg.com/news/articles/2017-06-21/boe-s-haldane-sees-case-for-raising-interest-rates-this-year> to counter this could also undermine consumption, investment and growth.

This policy dilemma explains the rather close -- 5-to-3 -- vote at last week's meeting of the bank's Monetary Policy Committee. A thin majority of central bankers opted for unchanged policy due to concern about weakening growth and wage trends. In contrast, a notable minority saw reason to hike interest rates now to counter inflationary pressures. It is a situation that, as Andrew Haldane, the highly respected chief economist of the Bank of England noted in a speech <http://www.bankofengland.co.uk/publications/Pages/speeches/2017/984.aspx> this week, involves policy risks that "are genuinely two-sided," with "risks and the trade-offs that currently exit between wages and jobs, activity and inflation."

This dilemma strains not just the effectiveness of monetary policy, but also of fiscal policy. Yes, interest rate hikes and a more austere budget stance can combat inflation, including through their support for the currency; but they also add to the woes facing consumers and businesses, undermining prospects for both actual and potential growth.

The best answer to stagflation is to boost productivity and the economy's genuine growth engines. But from a political perspective, it is hard to see the current government progress until it has sorted out its Brexit action plan. And if it tries to do so preemptively, two complications may arise: first, the minority Conservative Party could expose itself to a higher risk of losing parliamentary votes, thus increasing the probability of a new election; and the supply response to the policies that do make it through Parliament would likely be muted until businesses have a better sense of the new economic and financial relationships with the EU in the post-Brexit era.

In a perfect world, the Bank of England would not -- and should not -- be front and center in combating the stagflationary winds. But it is, and finds itself facing a growing risk of lose-lose policy challenges.

Because of its history and mandate, it is only a matter of time before the central bank decides to hike interest rates, notwithstanding the weaker economic prospects. While far from a first- or second-best, this could well be the best available option at this stage. Meanwhile, the bank must use both public and private advocacy channels to argue for decisive progress on Brexit clarity and structural reform measures that bolster productivity, enhance growth potential and provide the only sustainable solution to a stagflation scare. Otherwise, it too could become part of the problem.

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