THE TIMES

Brexit can't be blamed for Britain's high inflation

Ryan Bourne

June 22, 2023

Yesterday's inflation numbers were a shocker. Annual consumer prices index inflation remained anchored at 8.7 per cent, even as it's falling in other countries. The Bank of England is left needing a more convincing scapegoat.

Workers' wage demands, corporate greed and various countries' weather patterns have been blamed at times, alongside President Putin and the pandemic, for inflation's high level and persistence, whitewashing the Bank's own monetary mismanagement. Now we face the question: why here?

Mark Carney, the former Bank governor, offers a convenient culprit: Brexit. Referencing his damning 2016 Brexit assessment, last week Carney claimed that leaving the European Union inevitably reduced our economy's capacity to produce goods and services, resulting in the "weaker pound, higher inflation and weaker growth" we're experiencing. While other shocks have exacerbated inflation since 2016, Brexit, he said, was a "unique adjustment", implying that it explained why inflation was higher and more enduring here than in the eurozone.

There's a grain of truth here. When the UK left the EU single market in December 2020, new tariffs and regulations on EU goods trade were erected and related uncertainties reduced business investment. The UK liberalised non-EU migration, but ending free movement from the EU eliminated a flexible source of migrant workers, limiting our ability to fill specific job vacancies quickly. So when spending soared after the economy reopened in the pandemic, productive capacity was less responsive, facilitating inflationary pressure.

Carney is correct that the mechanical impact of Brexit on trade and migration reduces real output. If the amount of money growth in our economy stays the same but real growth falls by 1 per cent because of Brexit, we'd expect inflation to rise by one percentage point. This prompts some to look at inflation excluding food and energy being higher here (7.1 per cent) than in the eurozone (5.3 per cent) and scream that it's all Vote Leave's fault.

Yet that hypothesis explains too much. For starters, the Bank is supposed to take these supply conditions as a given when aiming monetary conditions at its 2 per cent inflation target. If Brexit's impact were as obvious as Carney suggests, then the Bank has had seven years after the vote and two and a half years since leaving the single market to tighten policy to offset this pressure on prices.

Unless the effects have been unexpectedly worse than predicted these past two years, high inflation stemming from Brexit today would come primarily from monetary policy having been too expansive. In other words, only too much money driving higher spending can really test the limits of these supply constraints.

In any case, the timing doesn't suggest Brexit is a significant inflation driver today. The Bank thinks long-run productivity will be about 3.25 per cent lower because of Brexit, but much of this impact was baked-in immediately after the Brexit vote, after the departure from the single market or will occur in the longer term. The pound took a battering against the euro in 2016, for example, heightening import prices. None of this affected inflation this past year.

John Springford, at the Centre for European Reform, has produced a model that compares us today with a hypothetical Britain outside the EU. There have been substantive criticisms of his approach, which has been very pessimistic on Brexit. As of last spring, he suggested that the economy was 5.5 per cent smaller than if we'd remained. Crucially, however, all of this underperformance was baked-in by the spring of 2021. Under his model, Brexit's supply side impacts don't explain inflation being higher than in other countries in early 2022.

This is the key point. In focusing on Brexit as an inflation source, we risk trivialising the bigger story. Prices (as measured by the CPI) are now 13 per cent higher than if inflation had stuck at the target from December 2019 onwards. At most, unexpected Brexit effects might have contributed one to two percentage points to this. Blaming Brexit for inflation therefore distracts from the monetary policy committee's own, far more significant errors.

Unfortunately, it's enticing for politicians and central bankers to exploit confusion about inflation's causes to push their own agendas. It was useful for Rishi Sunak's government, for example, to claim that wage-price spirals were a cause, rather than a consequence, of inflation during debates around public sector pay and union militancy.

Progressives have pushed the "greedflation" narrative that corporations are exploiting customers by raising mark-ups even when their business costs haven't risen. This ignores why customers' demand was so strong to begin with (hint: too loose macroeconomic policy), but creates the drumbeat for the anti-business policies and higher taxes that certain people demand at all times.

President Biden made use of uncertainty over whether economic stimulus or international energy prices were driving the initial inflation spike in the United States to push through the wildly misnamed Inflation Reduction Act. This hosed around green energy subsidies to reduce reliance on fossil fuels. He capitalised on inflation's salience to push through policies he had always sought to implement anyway.

The tendency of figures like Carney and MPC member Catherine Mann to invoke Brexit as inflation's cause should be viewed as similarly self-serving. Yes, Brexit harmed the supply side of the economy and made the central bank's job more difficult by introducing new uncertainty. Yet it's a marginal issue for inflation compared with the pandemic, Ukraine war shocks and monetary errors seen since 2020. Who stands to gain from elevating Brexit as some almighty juggernaut driving today's prices? None other than those central bankers who, despite their responsibility to adjust monetary policy to Brexit's realities, have failed to keep inflation in check.

Ryan Bourne occupies the R. Evan Scharf Chair for the Public Understanding of Economics at Cato and is the author of the recent book Economics In One Virus.