CITY INTELLIGENCE

The cost of living – August 2022 update

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- 90% of Londoners say their household costs have risen over the last six months.
- 19% of Londoners are 'financially struggling', while another 30% are 'just about managing'. Just under half of Londoners have struggled or fallen behind on financial commitments, with credit commitments the most common struggle.
- 12% of Londoners said they have regularly or occasionally been unable to buy food or essential items or relied on outside support in the last six months. This proportion triples (39%) among Londoners who say they are 'financially struggling'.
- Responses on the GLA's Talk London platform give examples of Londoners saying the rising cost of living makes the capital increasingly inaccessible except for the richest.

Price trends in London

- Evidence suggests that some prices in London are rising faster than across the wider UK.
- Food is one of the largest pressures pushing the capital's inflation above the national average. This will affect the lowest-income Londoners the hardest.
- Some key inflation drivers are less of a concern for Londoners, such as energy, petrol and vehicle prices. But Londoners spend more on private rentals, where prices may soon accelerate rapidly – an area where inflation is not just a result of global trends.

Pay trends in London

- While pay in London recovered very strongly from late 2020 to early 2021, real wages have started to go into reverse as inflation picks up. And pay growth has tended to be strongest in the best-paid sectors, reinforcing income inequalities.
- Pay in Hospitality, the lowest-paid industry in the private sector, has fallen 1% since the pandemic, while median pay in IT, already 50% above the London average before the pandemic, has risen 20% up to July this year.
- Labour productivity growth has been weak in London and the UK since 2019, limiting the ability of firms to absorb higher wage costs, while the labour market is still not fully recovered from the pandemic.

Public sector pay and inflation

- During the pandemic, public sector pay growth was more stable than private sector wages. However, the recovery has seen private sector pay growth rise much faster.
- While research suggests public sector pay growth tends to affect private sector pay growth in the short term, this is not across all industry sectors, and in the long run public sector pay growth does most of the adjustment towards private sector rates.
- After a long period of pay restraint, the balance of risks lies more with public sector recruitment difficulties and skills shortages than with pushing up private sector pay.

Overall inflation trends

- CPI annual inflation hit a 40-year record high of 9.4% in June. Energy bills, fuel and food are the biggest contributors, but prices are rising on a broad basis. The average annual shop is rising in price by an estimated £533 a year.
- The war in Ukraine is likely the single largest driver of inflation now, as the fear of gas, oil and agricultural commodity shortages drive up global costs.
- Rising inflation will affect those on the lowest incomes the worst. NIESR estimate the rise in living costs will equal an income cut of 9.5% for the hardest-hit households, compared to just 0.6% for the highest-income 10% of households.

- Inflation may take until winter to peak and then fall slowly. High inflation is likely to drag on real incomes, dampening demand and slowing output growth. It is possible that cooling commodity markets and falling demand pull back inflation more quickly.

Historic periods of high inflation

- In past eras, fighting inflation has usually prompted a recession. London's downturns in the 1980s and 1990s were deeper than in the wider UK, and recovery took longer.
- Macro policy and the UK's economic structure have shifted over the last 50 years in ways that should help fight inflation.
- However, there are some signs that inflation expectations have recently come at risk of de-anchoring from low and stable rates. This could prompt the Bank of England to tighten monetary policy aggressively to bring expectations in line, raising the risk of recession.

Introduction

The cost of living crisis increasingly dominates the outlook for London, threatening to widen existing inequalities, halt the recovery from the pandemic and push many into being unable to afford necessities.

This report builds on previous work at the start of this year to set out an evidence base on the impact of the cost of living crisis on Londoners. Using opinion polling, economic data, analysis of trends and discussion of past episodes of high inflation, it presents a difficult picture for the months ahead.

Prices across the board are rising more rapidly than they have since the 1980s, and Bank of England projections point to inflation accelerating further later this year. Global energy costs are soaring due to the war in Ukraine, and the Ofgem standard tariff for consumer energy bills is set to surge again in October and January.

Meanwhile, wages are falling well behind inflation, with real household incomes set for some of the worst conditions since the Second World War. And pay growth has tended to be strongest in the best-paid sectors, reinforcing income inequalities.

Our polling research suggests that nearly one in five Londoners is financially struggling – that is, struggling to make ends meet, relying on debt to pay for basic needs or having to go without them. Another three in ten Londoners are just about managing. These proportions have risen over recent months and are much higher among groups of Londoners who already face stark inequalities.

The profile of price increases in London is also troubling. Our data research suggests that London is experiencing faster inflation in some prices than in the wider UK, with food prices a major contributor to that gap.

As the rising cost of living drags on incomes and spending, the Bank of England now projects a recession in its baseline forecasts for the UK. There are reasons to suggest that London's aggregate economy may prove more resilient to the shock of inflation than the rest of the UK. However, past recessions following high inflation have seen the opposite experience, meaning a healthy recovery for the capital cannot be taken for granted.

The evidence in this report points to an acute challenge for all Londoners, but especially those who were already in a precarious financial position.

How Londoners perceive the cost of living

- 90% of adults in London say overall their household cost of living has risen over the last six months.
- 19% of Londoners are 'financially struggling', having to go without basic needs, rely on debt or struggle to make ends meet. Another 30% are 'just about managing'.
- Just under half of Londoners have struggled or fallen behind on financial commitments. Forty-six per cent said this applied to their rent or mortgage payments, 47% to their bills and 49% to their credit commitments
- 12% of Londoners said they have regularly or occasionally been unable to buy food or essential items or relied on outside support in the last six months. This proportion almost doubles amongst deaf and/or disabled Londoners (22%), and triples (39%) among Londoners who say they are 'financially struggling'.
- The most popular actions to help manage living costs are buying cheaper products (47%) and spending less on non-essentials (46%). Over a third (35%) are using less water, energy or fuel and over a quarter (29%) are buying less food and essentials.
- Recent Talk London responses include examples of how Londoners see the rising cost of living as making the capital hard to live in except for the richest.

Londoners are increasingly experiencing cost of living increases, with a rising proportion impacted and a growing proportion saying that the increases have been large. In July, 90% of Londoners believed they had experienced increases in their cost of living over the last six months[1] compared to 79% in January. The proportion seeing large changes is also increasing with half of Londoners (52%) thinking the cost of living had increased a lot in July compared to just less than a third (29%) who thought it had increased a lot in January.

The cost of living increases are impacting Londoners differently with some demographic groups more affected than others.

In our latest poll of Londoners, **19% are 'financially struggling'**[2], that is going without their basic needs and/or relying on debt or struggling to make ends meet. This is an increase of 6 percentage points compared to January (**Figure 1**). Among **social renters, the proportion who are 'financially struggling' is now at a third (34%) up from a quarter in January (26%)**, and for private renters the proportion has increased from 16% to just over a quarter (27%), these figures contrast to homeowners where 9% are 'financially struggling', up just 3 per centage points from January**.**

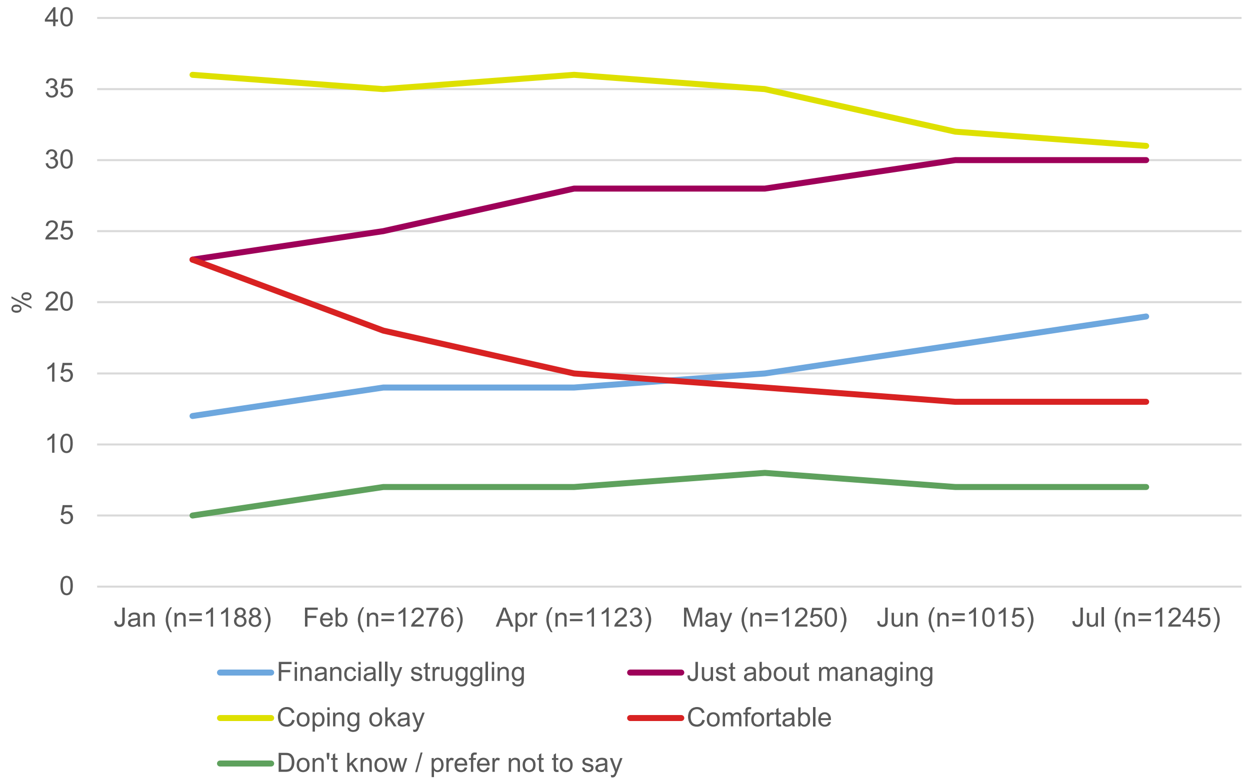
Deaf and disabled Londoners also continue to face a disproportionate impact, with a third (31%) saying they were 'financially struggling' in July, up 8 per centage points from January. We also see that whilst the proportion of households with a gross income of less than £20,000 a year that are 'financially struggling' is at 30% this is similar to the 26% who were struggling in January, whereas amongst **households with an income between £20,000 and £39,999 the proportion 'financially struggling' has increased from 14% in January to 26% in July**. Asian and Black Londoners are also more likely to be impacted. In July 31% of Black Londoners are 'financially struggling'; this is comprised of 5% who are going without their basic needs or relying on debt for them and 26% who are struggling to make ends meet.

[1] YouGov on behalf of GLA. All figures, unless otherwise stated, are from YouGov Plc. Total sample size was 1245 adults. Fieldwork was undertaken between 15th - 20th July 2022. The survey was carried out online. The figures have been weighted and are representative of all London adults (aged 18+)

[2] Those who identified as 'having to go without basic needs and / or rely on debt to pay for them' or 'were struggling to make ends meet'

Amongst Asian Londoners 24% are ‘financially struggling’[3], comprised of 9% going without their basic needs and 16% struggling.

Figure 1: Londoners’ financial situation across 2022



Source: Polling by YouGov on behalf of GLA. Total sample size for each wave shown in brackets.

This increase in the proportion of Londoners who are struggling financially or just about managing can also be seen in the proportion who are falling behind on key financial commitments such as rent, mortgage, household bills or credit payments. **Compared to January the proportion of Londoners who have struggled or fallen behind on some or all of their payments has increased,** but the extent to which Londoners are struggling differs by commitment. Those who have kept up with their rent or mortgage payments without difficulty in the last six months has dropped from 63% in January to 54% in July, with the proportion who’ve struggled to make payments increasing (30% in January versus 39% in July) rather than those who’ve fallen behind (7% in January versus 8% in July). For bills it is a similar picture, 31% were struggling to some extent in January increasing to 38% in July, with the proportion who’ve fallen behind at 8% in January and 9% in July. For credit commitments there have been increases in those who’ve struggled to keep up with payments (31% in January versus 35% in July) and those who’ve fallen behind (10% in January to 14% in July).

While previously less affected groups are now seeing an impact, the groups most affected remain the same. Those facing the worst impact were households with a gross income of less than £40,000; renters; deaf and disabled Londoners; Asian Londoners and Black Londoners, Londoners with a C2DE social grade and those not in employment. The proportion who have struggled or fallen behind on payments are shown in **Table 1**.

[3] Those who identified as ‘having to go without basic needs and / or rely on debt to pay for them’ or ‘were struggling to make ends meet’

Table 1: Proportions struggling or falling behind on payments, by demographic groups

Demographic group	Rent or Mortgage %	Bills %	Credit %
All Londoners	46	47	49
Less than £20,000 gross household income	63	66	69
£20,000 to £39,999 gross household income	60	55	58
Deaf and disabled Londoners	61	66	67
Private renters	53	55	61
Social renters	56	71	73
Asian Londoners	56	56	52
Black Londoners	59	60	68
Not in employment	56	52	55
C2DE	59	59	61

Source: Polling by YouGov on behalf of the GLA

'Financially struggling'[4] Londoners are more than three times as likely than the average Londoner to have fallen behind with payments (rent or mortgage - 19% versus 8%; bills - 37% versus 9%; credit commitments - 45% versus 14%).

Similarly, rising living costs are impacting whether Londoners can buy food and essential household items. **Twelve per cent of Londoners said they have regularly or occasionally been unable to buy food or essential items** or relied on outside support in the last six months, this proportion triples (39%) amongst Londoners who say they are 'struggling financially'. The overall proportion of Londoners going without has increased by 3 percentage points since January. In addition, the proportion who are struggling, either constantly or from time to time, has increased from 30% to 38%.

Reducing costs through buying cheaper products (47%) and spending less on non-essentials (46%) are the top actions taken by Londoners in response to cost of living increases. **Over a third of Londoners (35%) say they are using less water, energy or fuel and more than a quarter (29%) are buying less food and essentials.** For those who are 'financially struggling' buying cheaper products and spending less on non-essentials isn't enough, they are twice as likely as the average Londoner (65% versus 29%), to be buying less food or essentials and **four times as likely to be going without essentials** (20% versus 5%). Social renters and Londoners with a gross household income of less than £20,000 are also twice as likely to be going without essentials (both 10%).

'Financially struggling'[5] Londoners are also three times more likely to be using more credit or going into debt as the average Londoner (27% versus 10%). This is despite 8% taking on additional paid work or hours, 6% saying that they are now claiming state benefits when they weren't before and 2% claiming a wider range of state benefits than they were before.

Looking to the future, Londoners remain most worried about energy bills increasing, with 83% saying that they were worried about an increase in these in the next 12 months, although only 41% said that they were most worried about being able to pay them. Other areas of worry are wages not keeping up with inflation, which concerns almost a third of Londoners (31%), affording other household bills, which concerns a quarter (26%), and rent or housing cost increases (26%).

[4] Those who identified as 'having to go without basic needs and / or rely on debt to pay for them' or 'were struggling to make ends meet'
[5] Those who identified as 'having to go without basic needs and / or rely on debt to pay for them' or 'were struggling to make ends meet'

Talk London is also tracking Londoners' experiences of the cost of living. Two recent quotes offer examples of how Londoners perceive the different pressures from the cost of living and how this crisis worsens existing precariousness and widens inequalities.

"Prices in London are skyrocketing and living here is becoming more and more struggling. London is now just a place for rich people!" [Talk London member]

"People can't retire anymore because pensions are terrible and costs are so high." [Talk London member]

Price trends in London

- Evidence suggests that some prices in London are rising faster than in the wider UK.
- Food is one of the key pressures pushing our estimate of the capital's inflation above the national average. This will affect the lowest-income Londoners the hardest.
- Some key inflation drivers are less of a concern for Londoners, such as energy, petrol and vehicle prices. But Londoners tend to spend more on other items like rental costs where other evidence suggests price growth may be building in the capital.
- These findings are based on the Office for National Statistics locally-collected prices. The main findings remain true if we include centrally-collected prices, though the disparity between London and the UK is lower.

The cost of living crisis is one that will have sharply different impacts across different groups. National figures demonstrate clearly that core staple goods such as energy, food and fuel are seeing some of the sharpest price increases. This will impact those on lower incomes who dedicate a higher share of their spending to essential items. However, the national figures do not tell us how inflation is behaving in London versus the rest of the UK.

We do know that Londoners tend to devote different shares of their consumption to various goods when compared to the national average (**Table 2**). Overall, the average Londoner tends to devote a smaller share of their consumption to food and drink, household goods, transport and recreation and culture. Meanwhile, they tend to devote a larger share of their spending to housing and energy, education and restaurants and hotels. However, there are some important differences within these categories. For example, Londoners' apparent over-spend on housing and energy is driven almost entirely by rent, while Londoners (at 3.5% of overall spending) devote a smaller share of their outlays to energy than the average Brit (at 4.4% of overall spending). Among other examples, including personal vehicle fuel, this seems to show that Londoners devote less of their spending to some of the highest-inflation items.

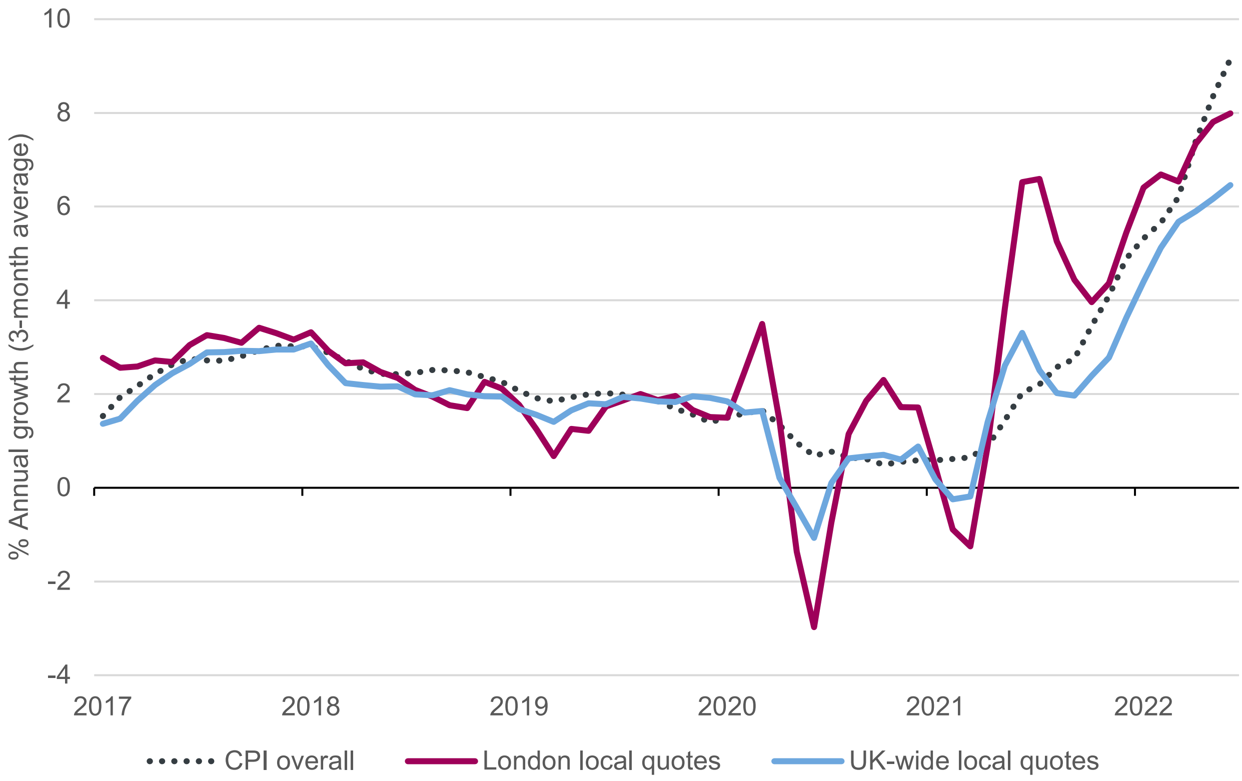
Table 2: Shares of consumption devoted to each headline category, London versus UK

Sector	London	UK	Difference
Food & non-alcoholic drinks	11	12	-1
Alcoholic drinks, tobacco & narcotics	2	2	-1
Clothing & footwear	4	4	0
Housing, fuel & power	21	15	6
Household goods & services	5	7	-1
Health	1	1	0
Transport	11	14	-2
Communication	3	4	-1
Recreation & culture	9	12	-3
Education	2	1	1
Restaurants & hotels	8	7	1
Miscellaneous goods & services	7	8	-1
Other expenditure items	15	13	1

Source: ONS Family Spending Workbook 3, Living Costs and Food Survey.

However, shifting around price weightings by average regional consumption patterns still gives an incomplete picture. We also need to understand whether prices are following different trends for the same item in London compared to the wider UK. To understand these patterns, we use the ONS' locally-collected price quotes data to build an inflation measure for London (See **Box 1** for more details). The results for the last few years are plotted in **Figure 2**. Ordinarily, London prices tend to grow at a similar pace to national prices. There is clearly some volatility in the data from the pandemic period as lockdowns and social distancing disrupted data collection. However, over the last year, the capital's underlying inflation has consistently pushed ahead of the UK average. In June 2022, London's trimmed mean annual inflation rate of 8% was around 1.5 percentage points above the average for the UK. This is in line with the average gap over the last six months.

Figure 2: Measure of inflation pressures for London and the UK

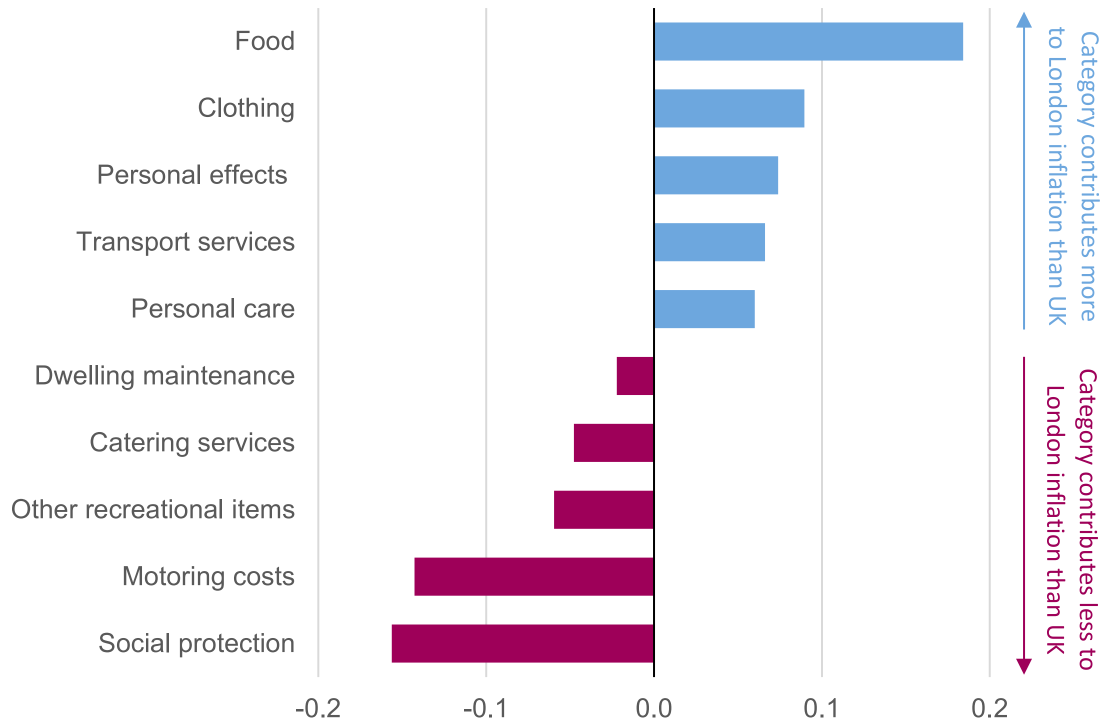


Source: GLA calculations, ONS price quotes data, as compiled in the LRPD by Prof. Richard Davies

Looking at the contributions to both the London and UK trimmed mean inflation measures, some categories stand out in explaining the gap. **Figure 3** plots the top five and bottom five categories in terms of the difference between their London and UK contributions.

Food prices are the largest contributor to the wedge between London inflation and UK inflation. Nearly 0.2 percentage points of the 1.5 percentage point gap between the capital's inflation measure and the UK average is explained by food. Meanwhile, operating transport equipment, which includes the cost of petrol for personal vehicles, and social protection (childcare, retirement homes and care in the home) both contribute between 0.1 and 0.2 percentage points less to the London measure than the UK average.

Figure 3: Highest and lowest differences between London and UK category contributions



Source: GLA calculations, ONS price quotes, as compiled in the Long-Run Price Database by Prof. Richard Davies

While the negative difference for motoring costs is in line with the fact that the average Londoner devotes less of their spending to cars and driving, the positive difference for food is different. On average, Londoners tend to devote slightly less of their spending to food than in the rest of the UK, meaning this difference must be entirely due to a more rapid rise in London's food prices compared to food prices elsewhere.

There are some mitigating pressures from differences in Londoners' spending patterns from the national average for goods whose prices are collected centrally by the ONS for the whole UK. Londoners tend to spend less on energy and vehicles than the average household across the UK, and this effect is likely to narrow the gap between UK and London inflation. If we imagine an offsetting contribution to CPI inflation based on the difference between London and UK consumption patterns, energy bills would narrow the gap by around 0.6 percentage points, with vehicle costs pulling back another 0.6 percentage points.

Summing up all the contributions to headline CPI from centrally-collected prices would probably leave London's inflation around 1 percentage point closer to the national average. However, this is still less than the overall gap from the price quotes data. And since we cannot apply the trimmed mean method to the individual item quotes for centrally-collected prices, it is unclear whether this full influence would feed through.

One remaining data gap is around rent, where the ONS collect prices centrally, but there are major differences by region. The ONS' Index of Private Housing Rental Prices[6] has London annual rent growth as the lowest in the UK at 1.7% in June. However, the Rightmove Rental Price Tracker[7] indicates asking rents for new rentals in London are growing the fastest in the UK, up as much as 15.8% annually in Q2. This suggests rent will be increasingly important for London inflation going ahead – and is a factor that policy can affect.

[6] ONS, Index of Private Housing Rental Prices, (June 2022)
[7] Rightmove, Rental Price Tracker, accessed 11 August 2022

Pay trends in London

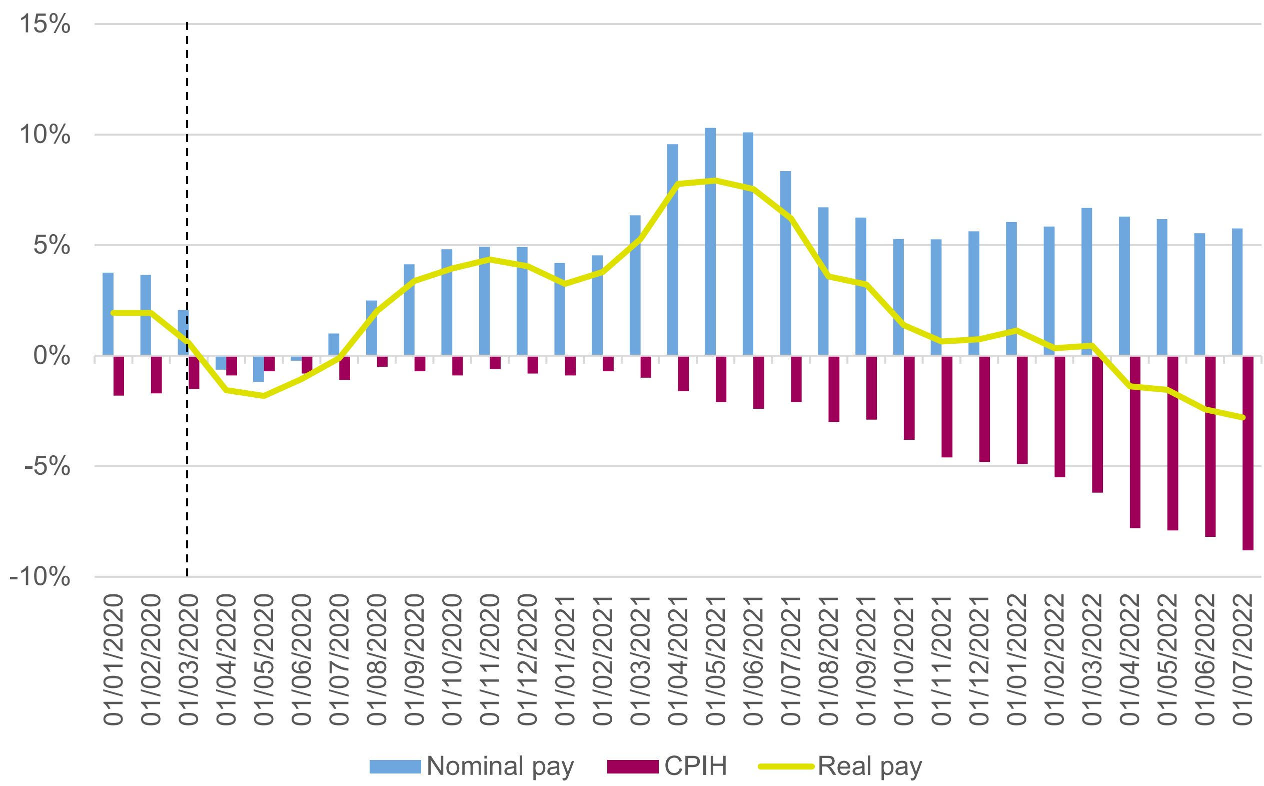
- While pay in London recovered very strongly from late 2020 to early 2021, real wages have started to go into reverse as inflation picks up.
- Across the recovery, pay growth in London has tended to be strongest in the best-paid sectors, reinforcing income inequalities. Meanwhile Hospitality, the lowest-paid industry in the private sector, has seen nominal pay fall 1% since February 2020.
- Labour productivity growth has been weak in London and the UK since 2019, limiting the ability of firms to absorb higher wage costs. But evidence of higher wage bids is limited, and the labour market is still not fully recovered.

Recent news on real wages in the UK has been ominous with the combination of accelerating inflation and slowing nominal pay growth leading to annual measures of inflation-adjusted pay growth turning negative.

Figure 4 shows how nominal pay, inflation and real pay have changed since the start of 2020 in London. The year-on-year pace of growth of nominal pay has eased (and in the latest single-month data, nominal pay in London actually fell month-on-month) while inflation has accelerated. In annual terms, we are now starting to see real pay declining.

Figure 4: Real median pay growth in London, broken down into nominal pay and inflation

Decomposition of real median pay in London, % annual change
Effect from nominal pay change and CPIH inflation, to July 2022



Source: HM Revenue and Customs - Pay As You Earn Real Time Information, ONS.
Note: March 2020 indicated by dotted line. Inflation measure does not account for region-specific housing costs. Sign of inflation rates has been reversed (higher inflation rates are associated with lower real pay growth).

While recent news has been bad, it comes against the background of very strong median pay growth for employees from mid-2020 through to early 2021 in London and the UK. As a result of that progress, real median pay remains well above its January 2019 level (**Figure 5**).

However, a further period of falling real wages is a strong possibility. The effects of first the supply chain issues associated with lockdowns and a switch in spending from services to goods, and then the energy price rise associated with the Russian invasion of Ukraine, unambiguously raised the price level. Other things being equal, real wages are set to end up lower than they were before the pandemic once those factors have rippled through the economy.

Figure 5: The level of real median pay since the beginning of 2019

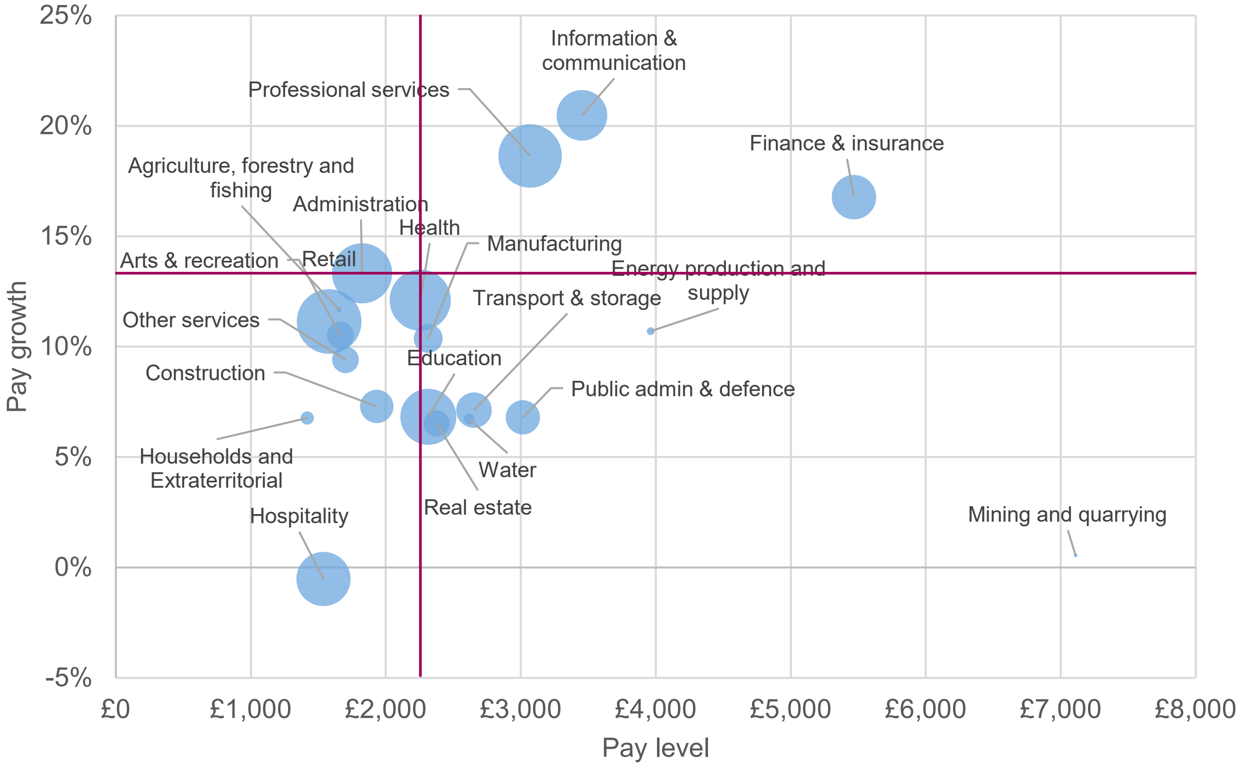
Pay indexed to Jan 2019 = 100

Source: HM Revenue and Customs - Pay As You Earn Real Time Information.
Note: Estimates are based on where employees live.
Latest data for July 2022

London also continues to see an uneven pattern of pay growth, with mostly high-paying sectors seeing the fastest wage growth, and lower-paying sectors seeing slower growth (**Figure 6**). In the top right quadrant, Finance, Media & IT and Professional Services were three of the highest-paying sectors in February 2020 and have since enjoyed median pay growth of above 15%, more than any other sector. Sectors with low median pay – notably Hospitality – have seen much smaller pay rises. Some of this pattern might be related to changes in the composition of employee jobs in the capital. For instance, more highly-paid but previously self-employed managers and contractors in finance and media may have become employees or employers may do more to retain highly qualified employees. But we do not have enough data to further understand the reasons.

Figure 6: Median pay growth by sector, compared to pay levels in each sector

Median pay level (horizontal axis) vs.median pay growth (vertical axis) to July 2022, London
Relative to February 2020, bubble size represents size of sector



Source: HM Revenue and Customs - Pay As You Earn Real Time Information.
Note: Estimates are based on where employees live. Vertical line indicates level of median pay in London in February 2020: horizontal line indicates change in London median pay February 2020-July 2022

Our data shows that employees in London working in sectors with the lowest levels of pay have seen the smallest pay rises since the start of the pandemic. Median pay in hospitality – which employs around 375,000 Londoners and has the lowest median pay in the private sector – has fallen by 1% since February 2020 even before rising prices are taken into account. This stands in stark contrast to pay trends in the information and communications sector, where median employee pay was over 50% more than the London average before the pandemic, and yet grew by 20% up to July this year.

Figure 6 above is based on median monthly pay for payrolled employees. Some of the impact of changing patterns of demand might be showing up in the average number of hours that employees work, rather than in rates of pay – and that might be particularly true in lower-paid sectors such as hospitality.

Analysis of UK level data shows that average weekly hours worked have fallen in some but not all of the sectors where median monthly pay has declined.

This is most notable in the case of hospitality – where a reduction in hours worked could be part of the reason for slow recent pay growth. However, this trend does not hold across all sectors. For example, median pay growth has been relatively robust for employees working in the Wholesale & retail sector over the February-April 2019 to February-April 2022 period, despite a drop in average hours worked at the UK level.[8]

Without more detailed data it is unclear what is causing the negative labour market outcomes for workers in these low-paid sectors. See **Box 2** for further discussion of the evidence for links between median pay, jobs and hours worked.

When energy prices surged after the Russian invasion of Ukraine, many commentators expressed concern over a wage-price spiral. While those concerns look less convincing as nominal pay growth has failed to keep pace with inflation, we can also look at changes in labour productivity – measured by real output per hour worked, a close approximation to firms' unit labour costs – to assess how much pressure rising wages may have on employers.

London saw similar labour productivity growth to the UK, of about 2% since 2019 and up to the second quarter of 2021 (**Figure 7**), according to GLA Economics calculations based on ONS data. This low level of productivity growth means firms might have to reduce other costs or profits to pay higher wages if they are not to raise prices.

Figure 7: Output per hour growth since 2019

Index of productivity in London and the UK
Output per hour, 2019 = 100

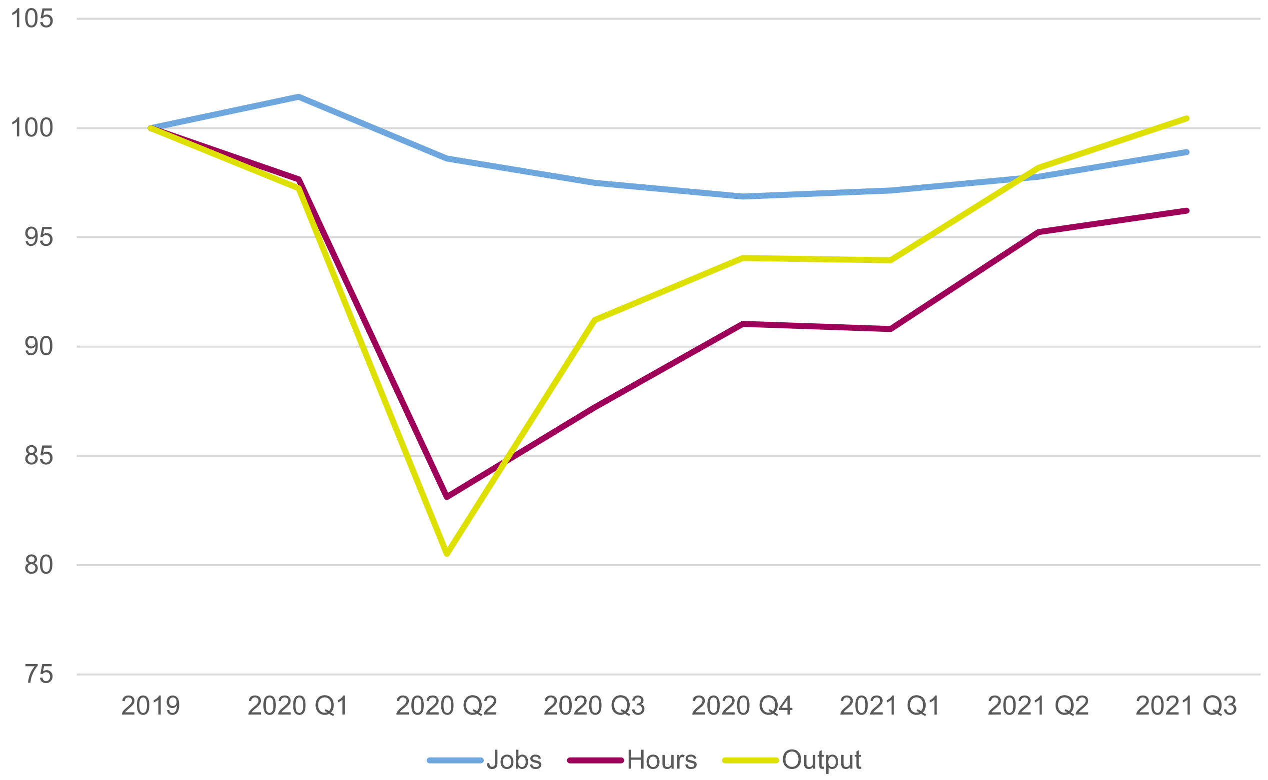
Source: GLAE estimates of UK real GDP and London real GVA (LET July 2022) and ONS quarterly regional productivity hours and jobs (June 2022)

[8] We do not have a measure of hours worked by industry for London. We also use the Feb-Mar 2019 to 2022 period rather than the February 2020 to April 2022 in the figure above as the LFS data is not seasonally adjusted and we require a same quarter comparison that does not overlap with the start of the pandemic.

It is also the case that London's labour market recovery has stalled. While output, measured by real gross value added (GVA) was just above its 2019 level at the end of the third quarter of 2021 (see **Figure 8**) the number of jobs in the capital still lagged. Hours worked lagged further behind last autumn, at almost 5% below the pre-pandemic level.

Figure 8: The jobs recovery lags output, with total hours worked even further behind

Index of hours worked, jobs and real GVA in London
2019 = 100



Source: GLAE estimates of London real GVA, ONS Regional Labour Productivity, May 2022

Public sector pay and inflation

- During the pandemic, public sector pay growth was relatively stable, while private sector wages fell sharply. Private sector pay growth has since recovered much faster.
- Research suggests that in the short term a 1% increase in average public sector wage growth on average was associated with an increase of 0.1%-0.4% in average private sector pay. But this varies widely across industry sectors.
- In the long run, public sector pay growth adjusts towards private sector rates.
- After a long period of pay restraint, the balance of risks lies more with public sector recruitment difficulties and skills shortages than with pushing up private sector pay.

The rising cost of living relative to wages in 2022 has been more acute for some groups than others, as discussed above. With the Government publishing its pay review recommendations for many public sector workers in July[9], the policy implications of changes in relative public sector to private sector awards have been widely debated. In this section we review the available evidence.

Reviewing the level of pay in **Figure 9**, nominal average earnings in the public sector[10] grew consistently at 3%-4% throughout the first year of the pandemic, up until the 2021-22 pay freeze. Since then, nominal pay has grown at around 2% year-on-year. The pay review bodies suggested awards for 2022-23 (which cover around 45% of public sector workers) are expected to be around 4%-5% when they are implemented in the autumn, with some groups getting more and others less.

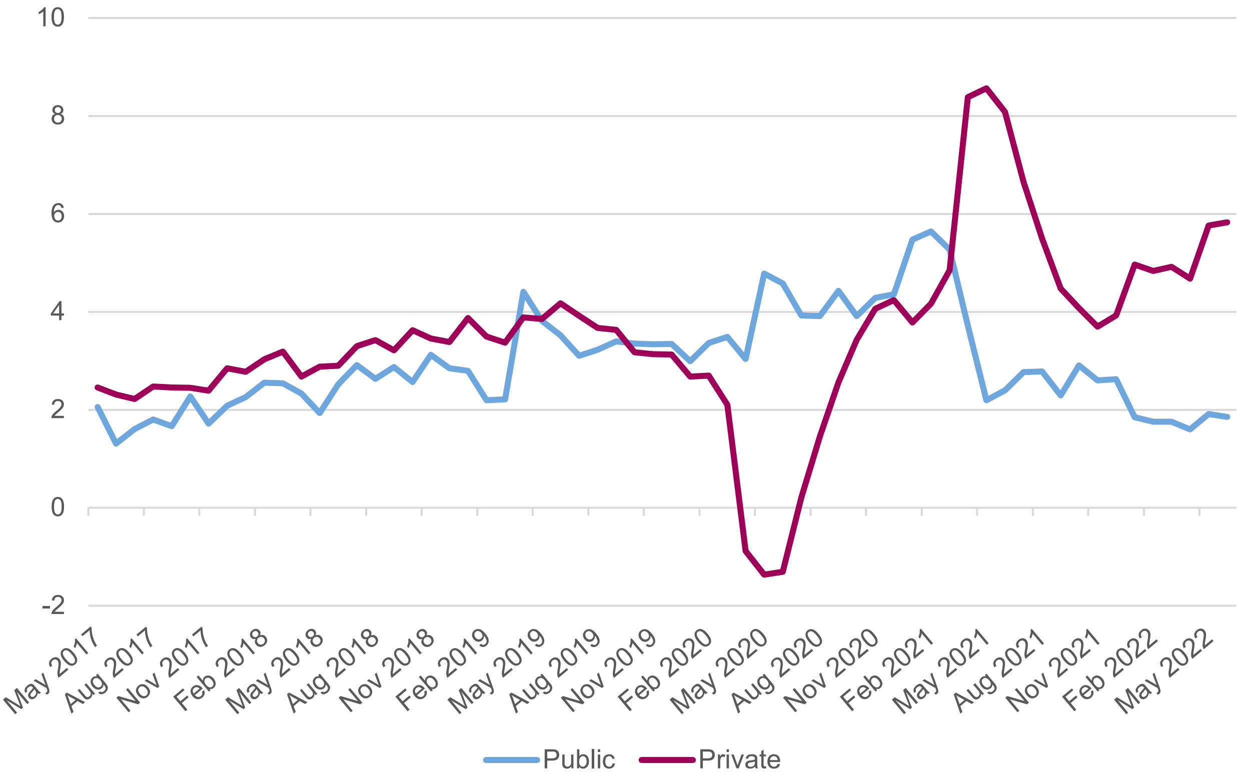
Private sector pay fell sharply during the pandemic but then recovered strongly and was growing at 4%-6% a year in the first part of 2022.

The prospect of higher public sector pay has led some commentators to worry about the effects on inflation and the wider cost-of-living crisis.[11] Some suggest that generous pay awards could act to embed higher inflation expectations, leading to the type of 'wage-price spiral' associated with the 1970s.

[9] See the front page of the Office of Manpower Economics website.
[10] For the purposes of this report, public sector refers to the ONS series 'Public sector excluding finance' which removes employees of Royal Bank of Scotland from the series.
[11] For example, in its evidence to the Pay Review Bodies, HM Treasury warned of the risks 'if public sector pay increases were to exacerbate temporary inflationary pressure'.

Figure 9: Public sector falling behind private sector pay again

UK public and private sector average weekly earnings
Change on year earlier, %



Source: ONS AWE regular pay (August 2022), seasonally adjusted

There has been relatively little academic research to understand the linkages between public sector and private sector pay in the UK, or any modelling of how public sector pay awards might push up inflation in the wider economy. [12]

However, the government's Office for Manpower Economics – which acts as the secretariat for the Pay Review Bodies – commissioned a study from the National Institute for Economic and Social Research (NIESR) in 2020[13] to assess the direction and determinants of spillovers between public and private sectors. These spillovers involve workers moving between sectors based on pay differentials, and pay in the public sector affecting pay and pricing decisions made in the private sector.

The main findings from the NIESR paper are that there is a strong long-run relationship between public and private sector pay, and that it is public sector pay that adjusts over time to maintain this relationship.

There is also evidence of short-run spillovers from the public sector to the private sector: in the analysis of pay over the 1990-2017 period in the UK, a 1% increase in average public sector wage growth on average was associated with an increase of 0.1%-0.4% in average private sector pay. These spillover effects on pay

[12] Note, rising public sector pay itself will generally not raise consumer price inflation directly, owing to the lack of prices in the public sector. But if pay spillovers are large then private sector firms facing higher wage costs might raise prices.
[13] https://www.niesr.ac.uk/publications/dynamics-public-and-private-sector-wages-pay-settlements-and-employment?type=report

levels in the private sector are stronger for domestically-facing private sector jobs like hospitality, wholesale & retail and other services.[14]

However, the authors also warned that a widening pay differential could lead to skills shortages in certain areas of the public sector as workers seek employment in higher paid private sector jobs.[15] This creates potential for negative impacts on public sector performance.

The report used data up to December 2018. At that point, the long period of public sector pay constraint following the financial crisis left public sector pay around 4% lower than the authors' estimated equilibrium relative to the private sector (after controlling for a number of factors). Since then, average public sector pay has fallen another 3 percentage points behind private sector pay. This would suggest that the balance of risks lies more with public sector recruitment difficulties and skills shortages than with pushing up private sector pay and prices.

[14] We note that these sectors are the same as those that we highlighted above as seeing below-average growth in median weekly pay in London in 2021-22. It is possible that the public sector wage freeze affected workers in these sectors via these spillovers, or the lack of them.
[15] For a further discussion, see: Institute of Fiscal Studies (2022) What should public sector pay policy be trying to achieve?

Overall inflation trends

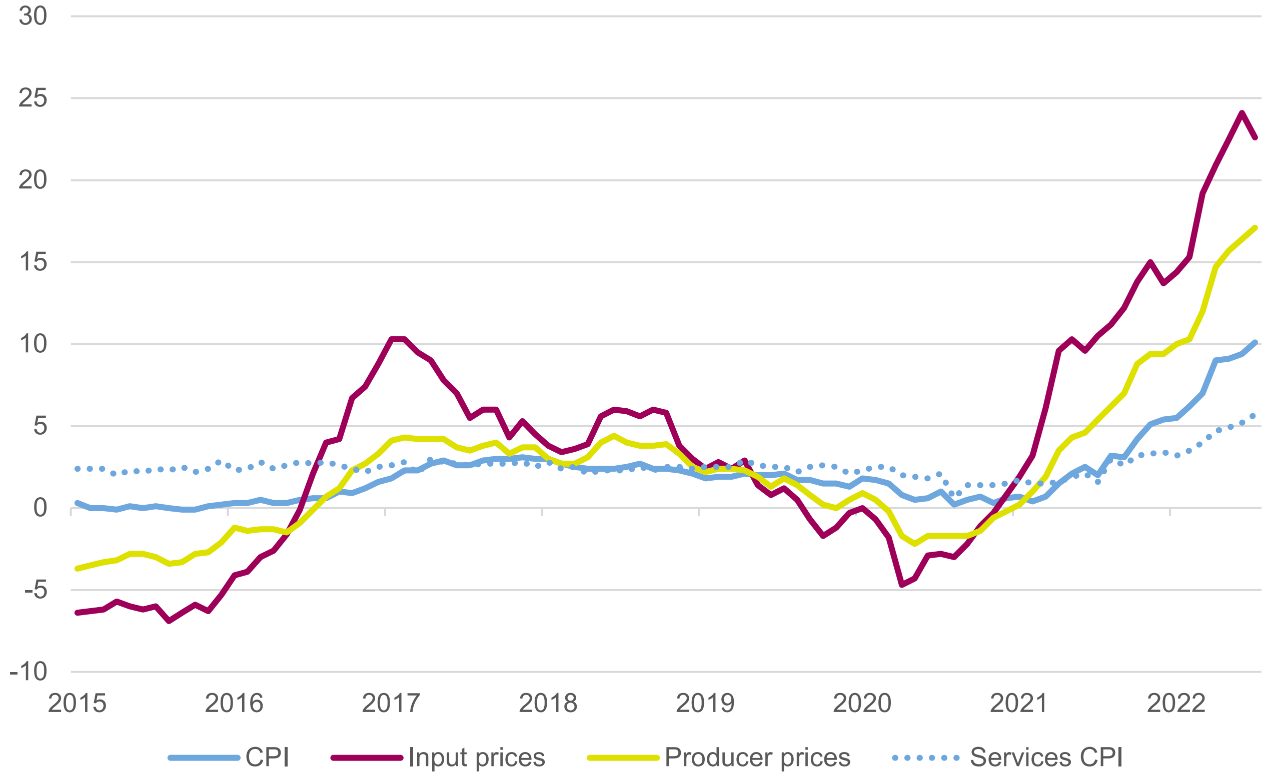
- Annual CPI inflation has hit a 40-year record high at 10.1 per cent in July. Energy bills, fuel and food are the biggest contributors, but prices are rising on a broad basis.
- Kantar estimate that grocery price inflation is even higher at 11.6% year-on-year. This implies the average annual shop is rising £533 a year, or over £10 a week.
- The war in Ukraine is likely the single largest driver of inflation now, as the fear of gas, oil and agricultural commodity shortages drive up global costs. However, supply chain challenges also persist, due to factors including COVID-19 lockdowns in China.
- With futures contracts and supply chain tightness pointing to elevated costs for some months, the Bank of England project inflation may take until the winter to peak at as much as 13% and then fall only slowly, still at 5.5% by the end of 2023.
- Rising inflation will affect those on the lowest incomes the worst. NIESR estimate that the rise in living costs will total 9.5% of disposable income for those hardest-hit households who face food and energy bills greater than their disposable income.
- High inflation is likely to drag on real incomes, dampening demand and slowing output growth in the capital. Retail and entertainment sectors face the greatest risk.

While rising inflation was already a defining feature of roughly the last year, recent months have marked a major escalation of the problem. The Ofgem price cap for standard energy bills rose over 50% in April, while supply chain challenges are still pushing up producer prices for goods. As a result, Consumer Price Index (CPI) inflation hit 10.1% year-on-year in July. This is the highest reading since formal records began, and estimated back data suggest inflation has not been this rapid since the early 1980s. The UK's inflation has also pushed above the pace seen in any other G7 economy after months of lagging US figures[16].

While rapidly rising inflation was initially a goods-focused phenomenon, with most strain on producer prices, rising prices have spread to all sectors. Headline CPI inflation is clearly very high, but an upward trend is now evident in usually more stable service prices (**Figure 10**).

[16] See for example data collected in The Guardian, Why does the UK have the highest inflation in the G7?, (May 2022)

Figure 10: Cost pressures have spread from production inputs to wider consumer inflation



Source: Office for National Statistics

The main drivers of the current surge in inflation are the war in Ukraine pushing up commodity prices and supply chain issues increasing input costs. Russia is the second-largest global producer of both crude oil[17] and natural gas[18], while Ukraine and Russia are both globally significant grain producers, together supplying around a quarter of global wheat exports[19]. Actual and expected disruptions in these markets has pushed up prices across global commodity markets. Following Russia's invasion of Ukraine, oil prices pushed above $100 per barrel for the first time since 2014, though they have now fallen back below that level. Meanwhile natural gas prices more than doubled over the first week of March 2022. They then eased to below pre-invasion prices, but have once again surged, pushing well above those initial post-invasion peaks as Russia increasingly squeezes gas supplies to Europe. Finally, global wheat prices surged by nearly 70% between early February and early March, though they have since unwound most of that increase.

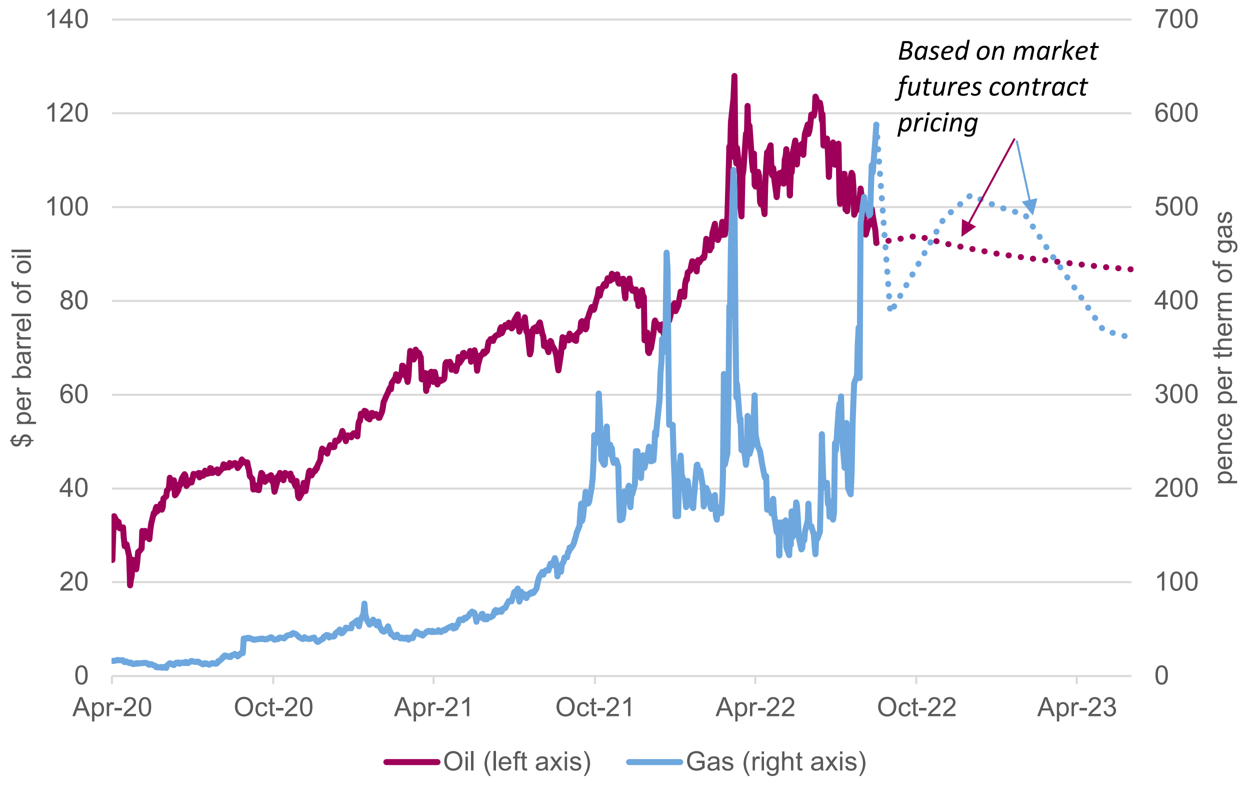
All these global commodity price movements have had an impact on UK consumer prices. The single biggest contribution to annual CPI inflation in July was energy (accounting for 2.5 percentage points of the total 9% growth). This comes after April saw the Ofgem price cap for standard energy bills increase by more than 50%, finally accounting for the prior six months of soaring wholesale prices. The next largest contribution to CPI inflation was vehicle fuel (contributing 1.5 percentage points) as elevated global oil prices fed into the domestic market. Finally, food (1.3 percentage points) and catering services (0.7 percentage points) were the next largest contributors as global agricultural prices have fed through into UK food prices.

[17] EIA. Accessed March 3, 2022.
[18] IEA. Accessed March 3, 2022.
[19] News sources including NY Times, The Conversation. Data can be found on ITC Trade Map.

In the context of everyday shopping, data research firm Kantar found that grocery price inflation hit 11.6% year-on-year, the fastest since they began to measure these costs in 2008[20]. Butter, milk and poultry are key drivers of grocery price inflation across the UK. Overall, if a household were to buy the same goods across the year, they would have seen the cost of an average annual shop increase by £533. This averages a striking increase of £10.25 per week. Likely as a result of increased costs, own-brand products are accounting for 51.6% of the market compared to branded products, the highest share Kantar have seen.

The bad news for households is that market signals point to high commodity prices for some time (**Figure 11**). As well as trading the goods themselves right now at a 'spot' price, global market traders can make deals to buy commodities in the future at a pre-agreed price. These 'futures contracts' tell us what traders think will happen to the price at a particular point in the future. For natural gas, futures pricing anticipates further volatility in gas prices, with a drop followed by another rebound to current levels late this year. The market only sees gas prices falling on a more sustained basis in Spring 2023. There is little let-up in oil markets either, as while futures prices suggest oil should get cheaper, traders anticipate a very gradual path. On the agricultural commodities side there is some relief, as Russia and Ukraine have come to an agreement on allowing grain exports to leave major Ukrainian ports. Combined with lower global growth expectations, this has eased agricultural commodity prices and wheat futures point to limited further pressure through 2023.

Figure 11: Energy commodity prices, including market projections of future prices



Source: MarketWatch

Supply chain challenges, the other main driver of higher inflation, also remain a lingering threat. As the global economy recovered from the pandemic, demand recovered faster than supply was ready to resume. Economies reopened from lockdown, at the same time as fiscal stimulus was supporting developed

[20] Kantar, "Grocery price inflation hits new peak as Brits navigate £533 annual increase", (August 2022)

economies, while demand for services was restrained by COVID contagion concerns. Rising demand then hit still-recovering supply networks, and COVID-19 outbreaks disrupted major ports. One example of how this affects UK costs is second-hand car prices, where inflation peaked in March at 31% year-on-year in the CPI measure, contributing 0.8 percentage points to total inflation. This is due to a semiconductor shortage higher up the supply chain slowing new car production and heating up the second-hand market.

While some indicators suggest supply chain challenges peaked in late 2021, there are still widespread issues and major uncertainty around the future. The London PMI outstanding business index, a measure of companies' backlogs in the capital, has rebounded upwards in the last two months, suggesting businesses are still struggling to fill orders. At the global level, while global PMI Commodity Supply Indicators showed supply shortages softened in July, they are still over four times higher than long-run averages[21]. Shipping costs briefly spiked in mid-May, though they have since eased to levels in line with Spring 2021[22]. And recent lockdown disruptions to China's production and distribution centres are a key factor, as outbreaks of the highly transmissible Omicron variant of COVID-19 clash with the country's zero-COVID policy. Summarising all these factors, The New York Fed's index of Global Supply Chain Pressures has eased from a peak in late 2021[23]. Yet the index remains high, as China delivery times have worsened[24], even as broader pressures are easing.

With war in Ukraine continuing to disrupt gas markets, the Ofgem price cap is likely to rise sharply again in October, possibly by as much as 75%, meaning inflation may yet push higher later this year. Between the current cap in summer 2022 and the new quarterly cap in January 2023, the Ofgem standard price tariff may more than double to over £4,000 per year[25]. Beyond this year, it may take some time for all the pressures currently pushing up prices to ease. The Bank of England expect inflation to spike to as high as 13% in the winter before only gradually easing next year[26].

In the Bank's baseline scenario, they assume that energy prices follow market futures signals for 6 months then remain flat. In an alternative scenario where commodity prices continue to follow market futures pricing and ease across next year, this still leaves inflation at over 8% by this time next year. There is a risk that commodity prices fall more rapidly and that weakening global and domestic demand drag on inflation, making it slow down more rapidly. However, this currently looks like an outside risk.

As elevated inflation is likely to be the norm for this year and into next year, this will have consequences for London's macroeconomy. With wage growth failing to keep in line with inflation[27], sagging real incomes will drag on aggregate demand. This will then slow activity growth in the key reconstruction phase after the pandemic. Consumer-facing sectors involved in retail and entertainment are likely to face a tough period as households tighten their purse strings in response to rising costs. The scale of the challenge is stark. The Bank also predicted that despite Government support for energy bills, high inflation and tax changes would generate a fall in real household disposable incomes of nearly 4% across 2022 and 2023. The 2.2% drop in 2022 alone would be the worst annual figure for income growth since records began in the 1950s[28].

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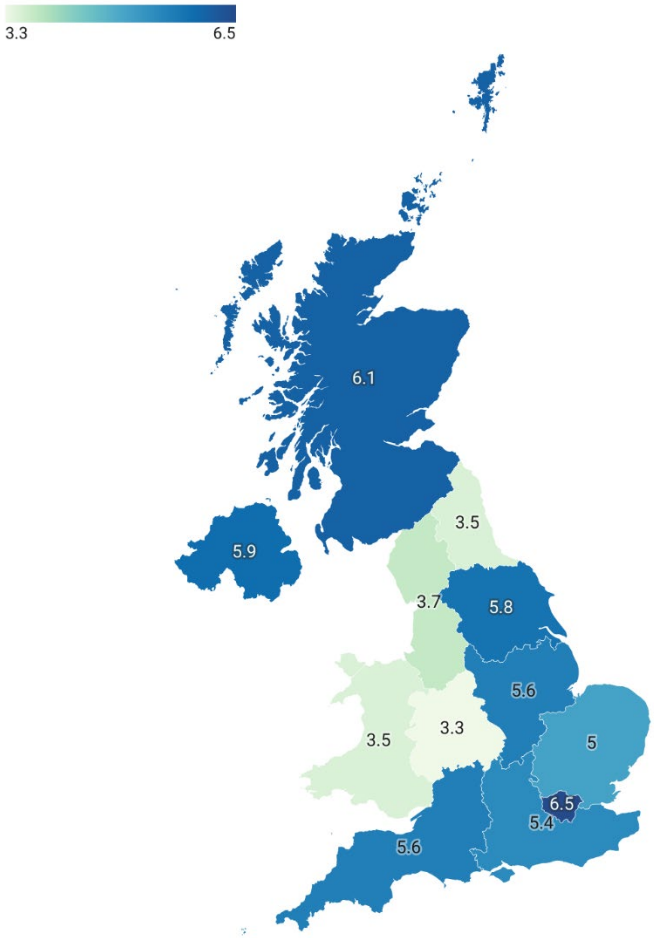
[21] S&P Global Commodity Price & Supply Indicators (August 2022)
[22] Baltic Dry Freight Index, as reported by CNBC
[23] FRBNY Liberty Street Economics, Global Supply Chain Pressure Index. Accessed 17 August, 2022.
[24] S&P Global/Caixin China General Manufacturing PMI (August 2022)
[25] Cornwall Insight, "Price cap forecasts for January rise to over £4,200 as wholesale prices surge again and Ofgem revises cap methodology", (August 2022)
[26] Bank of England, Monetary Policy Report, August 2022
[27] Regular pay in the three months to April 2022 fell 2.8x% year-on-year in real (inflation-adjusted) terms. ONS, Average weekly earnings: June 2022
[28] Based on Real Household disposable income (RHDI) growth rate, series CSC9 in the ONS UK Economic Accounts

Some households will certainly be harder hit than others in the capital. NIESR have conducted research on how much of households' disposable income will be used up by food and energy bills over the next two years. They found that 6.5% of households in London will see their food and energy bills exceed their total disposable income in 2022 and 2023 (**Figure 12**). This was the highest share of any region. The £15 billion cost of living package announced by the Government should help mitigate this figure. However, NIESR have since calculated that even after the new assistance, 1.2 million households across the UK will have to choose between heating and eating, down from an original estimate of 1.5 million.

Overall, NIESR calculate that excess inflation will cost these hardest hit households higher bills at a cost equivalent to 9.5% of their disposable income in 2022-23[29]. This is the worst relative cost increase across the income distribution in the UK. More generally across the distribution, high inflation is hitting those at the bottom of the distribution much harder than at the top. The lowest-income 10% of households see higher bills cost 8.3% of their income, while the highest-income 10% of households only see costs rise by the equivalent of 0.6% of their income. As a result, it is still likely that, in line with our polling results, the lowest-income Londoners may still have to turn to unsustainable borrowing and support from food banks and other charities.

Figure 12: Share of households whose food and energy bills NIESR projected would exceed their disposable income over 2022 and 2023.



Source: NIESR modelling (using LINDA, NiReMS), Created in Datawrapper

[29] NIESR, UK Economic Outlook – Summer 2022, (August 2022)

Despite the challenges facing low-income Londoners, the macroeconomic effect of high inflation should be less pronounced in the capital than in other regions of the UK. Average incomes are higher[30], the capital's housing stock is typically less costly to heat[31] and Londoners rely less on personal vehicles[32]. Recent consumer confidence data support this idea. National consumer confidence held at minus 41 in July 2022, which is its lowest ever level since records began in 1974[33]. Meanwhile, although London's figure also held at very low levels in July, the reading of minus 23 shows consumers in the capital are much less pessimistic than the average UK household.

Yet even if the aggregate impact of high inflation will not be as severe for London, some of the capital's sectors face a sharper challenge. Even some of the less drastic responses in the recent YouGov polling commissioned by the GLA demonstrate the consequences of high inflation for the capital's recovery. Forty-six per cent of respondents said that to handle rising costs, they are spending less on non-essentials. While this is a less serious step for households than the share cutting back on essentials, it demonstrates the risks to consumer-facing sectors. A drop in discretionary spending is likely to have a particularly sharp impact on the Wholesale and retail, Accommodation and food services and Arts and entertainment sectors. So while London on aggregate may not be as hard-hit by the cost of living crisis, some London households and certain sectors may face a very difficult situation this year and next.

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[30] The ONS Regional gross disposable household income figures for 2019 showed London's average income at £30,256, higher than in any other region.

[31] Based on the Family Spending dataset, Workbook 3 (ONS, figures for 2020, published 2021), the average Londoner devotes 3.3% of their weekly outlays to electricity, gas and other fuels, compared to a UK average of 4.1%. London had the lowest share of Energy Performance Certificates lodged in the low energy efficiency bands (E, F and G) for any region in the five years from 2016 to 2021 at 13%. A key reason for this difference is that a larger share of London's housing stock is in apartments, which are more compact and easier to heat.

[32] The average Londoner devotes 3.6% of outlays to operating personal transport, versus a UK average of 5.8%.

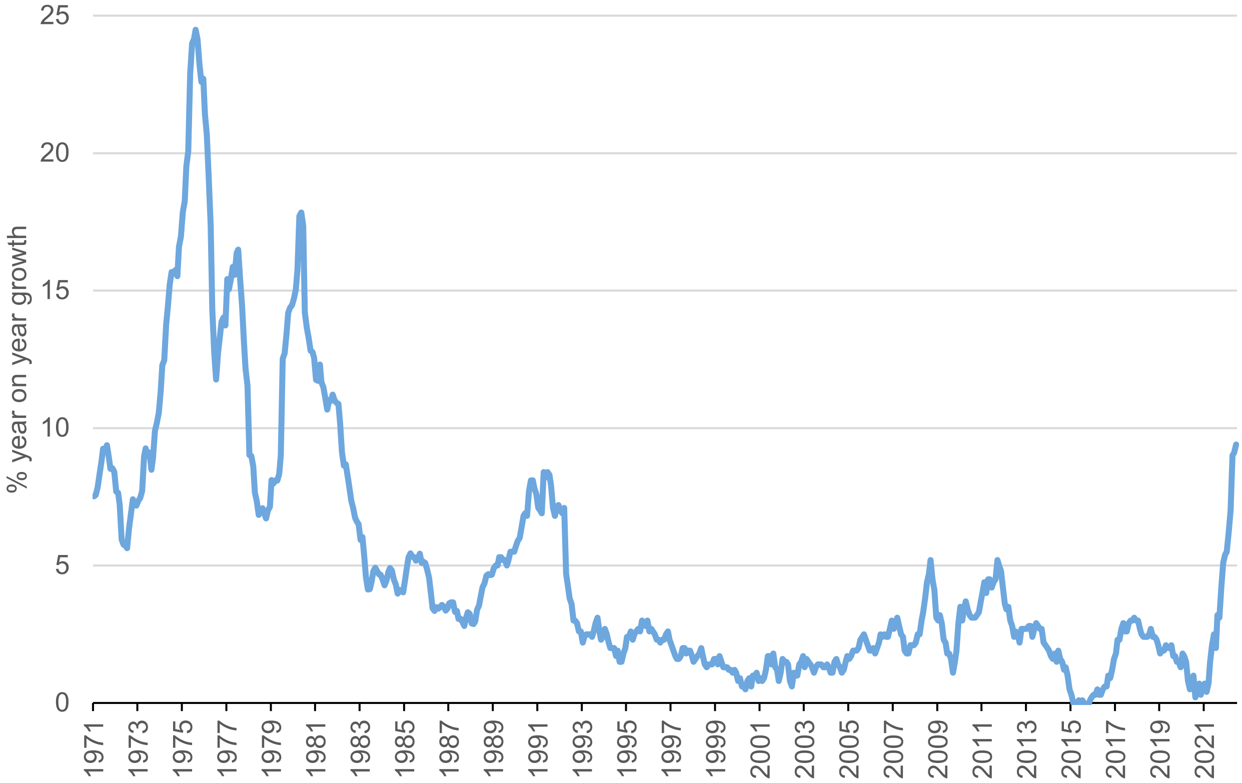
[33] GfK Consumer Confidence Barometer (June 2022)

Historic episodes of high inflation

- The background for previous episodes of high inflation in the UK has varied widely, but fighting inflation has usually prompted a recession. In the 1980s and 1990s, London's downturns were deeper and took longer to recover than the wider UK.
- The last time inflation outpaced wage growth significantly was in the early 2010s, and during this period London outperformed the wider UK.
- Macro policy and the UK's economic structure have shifted over the last 50 years in ways that should help fight inflation. However, there are some signs that inflation expectations have recently come at risk of de-anchoring from low and stable rates.

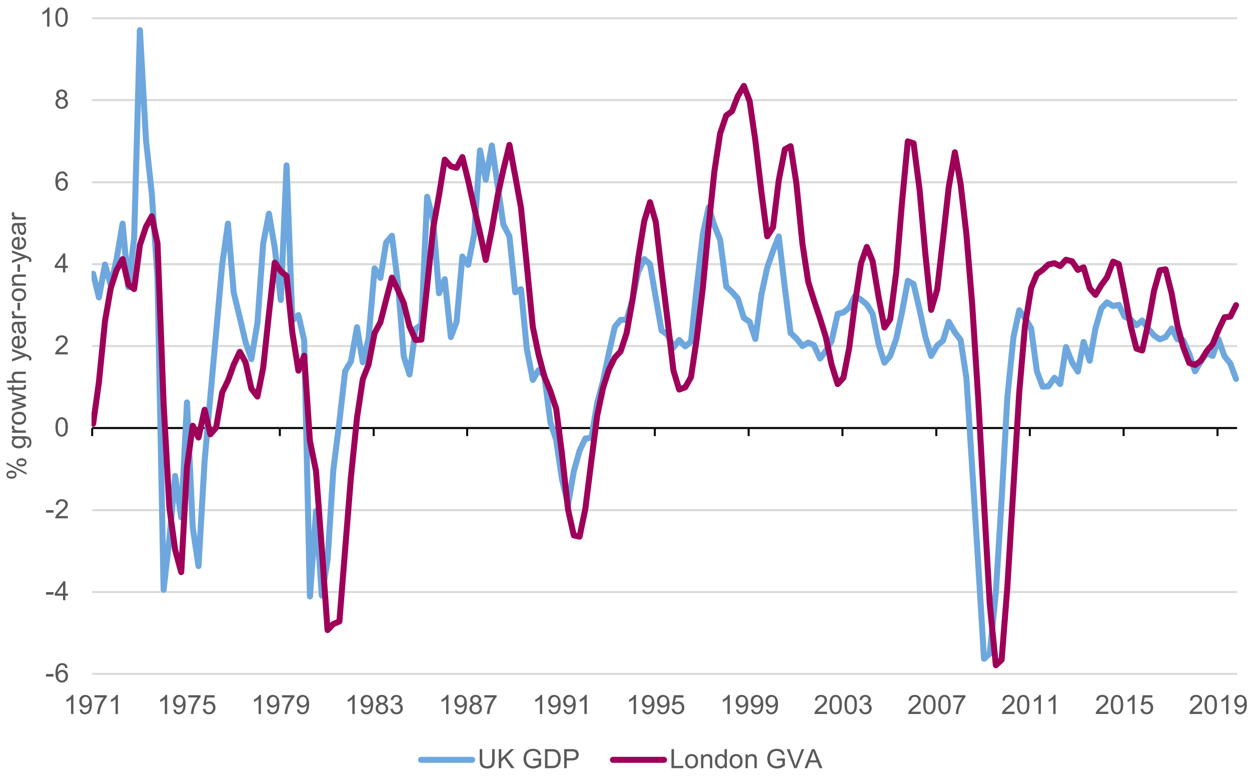
As CPI inflation reaches levels not seen since the early 1980s, it is worth examining previous spells of rapid price increases in the UK. The most recent key periods when inflation held at a high pace for an extended period came in the mid-1970s and in the late 1980s to early 1990s (**Figure 13**). There was also a period in the early 2010s when inflation temporarily accelerated above target and wages failed to keep pace with prices for some time. In general across this period, London's output growth has been more volatile than the wider UK, but in particular its recovery seems to have lagged behind following the recessions in the early 1980s and early 1990s (**Figure 14**)

Figure 13: The path of UK CPI inflation from the 1970s to the present



Source: ONS Consumer Price Index, ONS historical CPI estimates

Figure 14: The path of UK and London output growth from the 1970s to 2019



Source: ONS, ESCoE

The experience of the 1970s and 1980s

How inflation evolved

The middle of the 1970s is perhaps the period in recent history most closely associated with high inflation. Around the world, prices began to rise very rapidly and the challenge this presented prompted a sharp shift in both macroeconomic policy and theory. Historic estimates of CPI inflation[34] show that price growth in the 1970s started fluctuating between 5% and 10% year-on-year. This was already high compared to much of the period from 1955 to 1969, but the inflation that came after was far higher still. After accelerating across 1972 and 1973, estimated CPI inflation pushed above 15% year-on-year by July 1974, and then reached 20% year-on-year in May 1975. A peak of over 24% came in September 1975, before inflation began to ease again.

Causes

LSE economist Ricardo Reis summarises three classic characterisations of why the inflation of the 1970s took place[35]. One trigger of the high inflation that kicked off from late 1973 was a series of global commodity price shocks. Following the Yom Kippur War in 1973, global oil supplies faced disruption, leading to a surge in energy costs. Global crude oil prices more than tripled, in the fastest acceleration on record[36]. Later in the decade, the Iranian Revolution in 1978-79 triggered another tightening of global oil markets and prices for crude oil roughly doubled between 1978 and 1980. However, this does not seem to be a sufficient explanation, as when oil prices stabilised in 1974-75, inflation continued to rise, only peaking in

[34] ONS, Consumer price inflation, historical data, UK 1950 to 1988, (2022)
[35] Reis, 'Losing the Inflation Anchor', Brookings Papers on Economic Activity, (Fall 2021)
[36] US Energy Information Administration, Short-Term Energy Outlook, (July 2022)

August 1975. While inflation came down after that point, it accelerated again between summer 1976 and 1977 and remained above 10% year-on-year until 1978.

Reis also identifies other explanations. They include institutional factors such as high unionisation (which can bake in inflation into wage demands), central bank dependence on political authorities (which can restrain monetary policy from fighting inflation) and fiscal policy focused heavily on preventing unemployment (which may shy away from tightening policy to cut inflation if this also cuts jobs).

In addition, Reis highlights intellectual factors, including a focus in macroeconomic theory at the time on the idea of a trade-off between employment and inflation (which tends to break down when inflation expectations shift), under-estimation of equilibrium unemployment rates (which may lead macro policy to run the economy hot) and a lack of ideas on how to replace the Bretton Woods exchange rate system with another form of macro stabilisation.

Across all these explanations, a key mechanism keeping inflation high for extended periods was the role of inflation expectations. Unionised wage demands are only likely to remain high if workers expect inflation to remain high in the medium term. A tentative approach to inflation from macro policy may convince the public that policy will never cut inflation, raising long-term inflation expectations. And the flaw in the inflation-employment trade-off approach is that this relationship is only stable when there is an anchor on long-run inflation expectations. This points to the central role of expectations in understanding the danger of an extended period of high inflation.

Policy response

In response to the high inflation of the 1970s, there was a global shift in macro policy in the early 1980s towards tight monetary policy. In the UK, Chancellor Geoffrey Howe targeted sharply slower growth in the money supply. While the goal of slowing broad money growth saw mixed results, annual growth in narrow money fell from over 14% in late 1979 to 4% in late 1981 and near to zero by the summer of 1982[37].

Tight monetary policy is widely credited with bringing down the high inflation of the 1970s, but that this also triggered recessions in the early 1980s in a number of countries. Both Mervyn King[38] and Charles Bean[39], then Bank of England officials, pointed to the late 1970s as the period that saw monetary policy take up a central role in fighting inflation and stabilising macroeconomic demand. The Bank of England's recent round of interest rate hikes should therefore help prevent the current spell of high inflation becoming entrenched beyond after commodity markets stabilise and supply chains resume.

Christopher Sims, an empirical macroeconomist, also points to the role of unpredictable fiscal policy in the inflation of the 1970s[40]. This means that any further targeted government support should be signalled in advance and its deficit contribution should reflect established fiscal policy rules.

Impact on UK and London

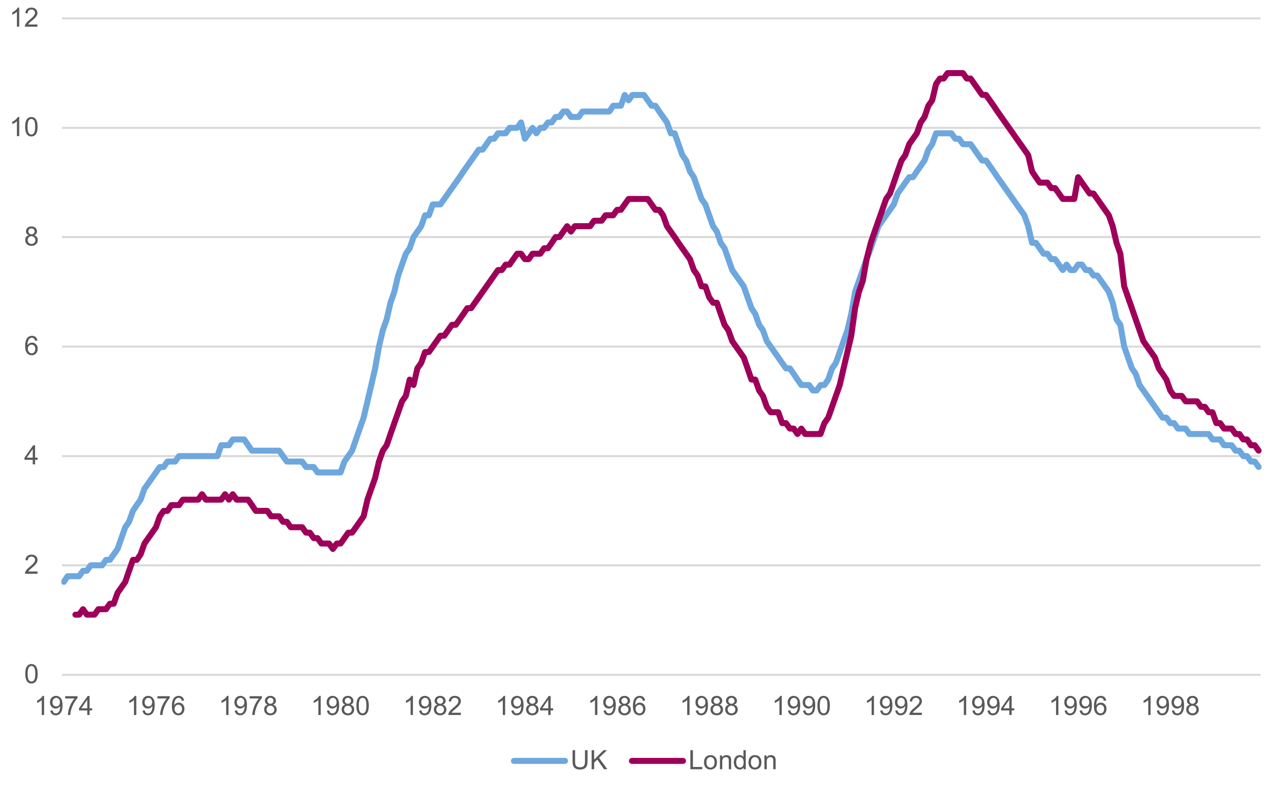
These inflation-fighting actions helped bring CPI growth down from a May 1980 high of 17.8% to below 6% by January 1983. However, this came at the cost of a sharp recession, with UK GDP falling over 4% between Q4 1979 and Q1 1981[41] and the unemployment rate soaring from a little over 5% in mid-1979 to over 10% by autumn 1981[42]. Joblessness was persistent, peaking at just under 12% in spring 1984 and remaining

[37] Bank of England, Total sterling M0 data, series LPMVQMX (discontinued)
[38] King, Monetary Policy: Practice Ahead of Theory, Mais Lecture, (May 2005)
[39] Bean, Inflation Targeting: The UK Experience, (October 2003)
[40] Sims, Stepping on a Rake: The Role of Fiscal Policy in The Inflation Of The 1970's, (2010)
[41] ONS, Gross Domestic Product: chained volume measures: Seasonally adjusted £m
[42] ONS, Unemployment rate (aged 16 and over, seasonally adjusted)

above 10% until autumn 1987. However, over the course of the following years, inflation did return to low and stable levels, falling below 10% by mid-1982 and below 5% within the following year.

While specific data is limited, the impact on London may have been even more severe. Historic GVA estimates by EScOE[43] indicate that London saw a peak to trough decline in output of over 6% during the early-1980s recession. While UK GDP recovered to pre-pandemic levels by Q1 1983, London's output took until Q3 1984. The labour market data are more ambiguous. Employee jobs in London fell roughly in line with the national average from September 1981 (when the data begins) to a trough in Q1 1983[44]. Yet London payrolls then stagnated for roughly the next four years, while UK payrolls picked up, and London took nearly a year longer to return to 1981 levels of employee jobs. On the other hand, London's benefit claimant count as a share of the labour force remained lower than the national average in the late 1970s and 1980s[45]. The capital's claimant count unemployment also rose more slowly than the national average in the early 1980s (**Figure 15**).

Figure 15: Claimant count unemployment rates for London and the UK, 1974-1999



Source: ONS Claimant count unemployment, accessed via NOMIS

The experience of the early 1990s

How inflation evolved

With inflation having stabilised below 5% by early 1983, the remainder of the decade saw a much more contained pace of inflation than in the 1970s. However, after maintaining a pace of around 3% for much of

[43] Back series for London GDP calculated by seasonally adjusting levels of GDP implied by the historic growth series derived from "Regional Output Growth in the United Kingdom: More Timely and Higher Frequency Estimates, 1970-2017", Journal of Applied Econometrics, Vol. 35, 2, pp. 176-197, data published February 2021

[44] ONS workforce jobs by industry, accessed via NOMIS

[45] ONS claimant count, seasonally adjusted, accessed via NOMIS

1986 and 1987, inflation began to creep up in the second half of 1988. By spring 1989, inflation pushed above 5% again, reaching over 6% a year later and then pushing to over 8% by September 1990. Inflation then hovered between around 7% and 9% through to March 1992, after which it fell sharply.

Causes

This period of rising inflation, while not even close to the highs seen in the 1970s, may be attributable to a mis-estimate of the UK's potential growth and a de facto exchange rate target with the German Mark. Economic theory suggests that if economic activity growth pushes persistently above its supply-side 'potential' rate, this will accelerate inflation. If demand is constantly ahead of supply, this will create shortages, driving up prices. As a result, mis-estimating potential output may give policy-makers an over-optimistic or over-pessimistic view of whether current activity growth is sustainable without creating inflation. Nelson and Nikolov[46] estimate that under-measurement of the UK's 'output gap' between actual and potential activity accounts for a large amount of the higher inflation rate by the early 1990s compared to the mid-1980s. Contributing to both sides of this issue was the set of tax cuts introduced in the 1980s. Policymakers believed these tax cuts had permanently increased the UK's potential growth rate, prompting looser policy, while the tax cuts themselves stimulated economic demand.

In addition, Charles Bean observed that the informal exchange rate target against the German Mark allowed the government of the time to believe they could control inflation by keeping the pound strong, without having to raise interest rates. Indeed, the Bank of England Bank Rate had been cut from around 12% for much of 1985-1986 to below 8% by the middle of 1988[47]. This likely resulted in over-stimulated domestic demand, and the Bank of England then had to hike interest rates sharply back to above 12% by early 1989. By early 1990, the Bank Rate reached a peak of around 15%. Rising inflation, low productivity and growing 'twin deficits' in both the government account and the balance of the UK's imports and exports were prompting market traders to re-assess Britain's economic fundamentals versus other European countries. As a result, depreciation pressure grew on the pound.

Policy response

Ultimately, raising interest rates to combat inflation helped prompt a recession – as in the 1980s. However, the government was forced to maintain interest rates at a relatively high level partly to back up the pound by making financial returns look more attractive in the UK. Eventually the tension between high interest rates and a recessionary environment prompted the European Rates Mechanism crisis in September 1992 and the pound was forced to de-peg from the German Mark in what has become known as 'Black Wednesday'. With monetary targets proving difficult to maintain in the early 1980s and an exchange rate peg no longer a viable means to contain inflation, 1992 saw the UK codify an explicit inflation target for the Bank of England, with the Bank using interest rates to control demand and achieve low and stable inflation. Inflation fell from 7.1% in March 1992 to a steady pace of around 2.5% by a year later. Between 1993 and 2019, inflation only pushed above 5% twice, both times briefly and coinciding with an oil price surge.

Impact on UK and London

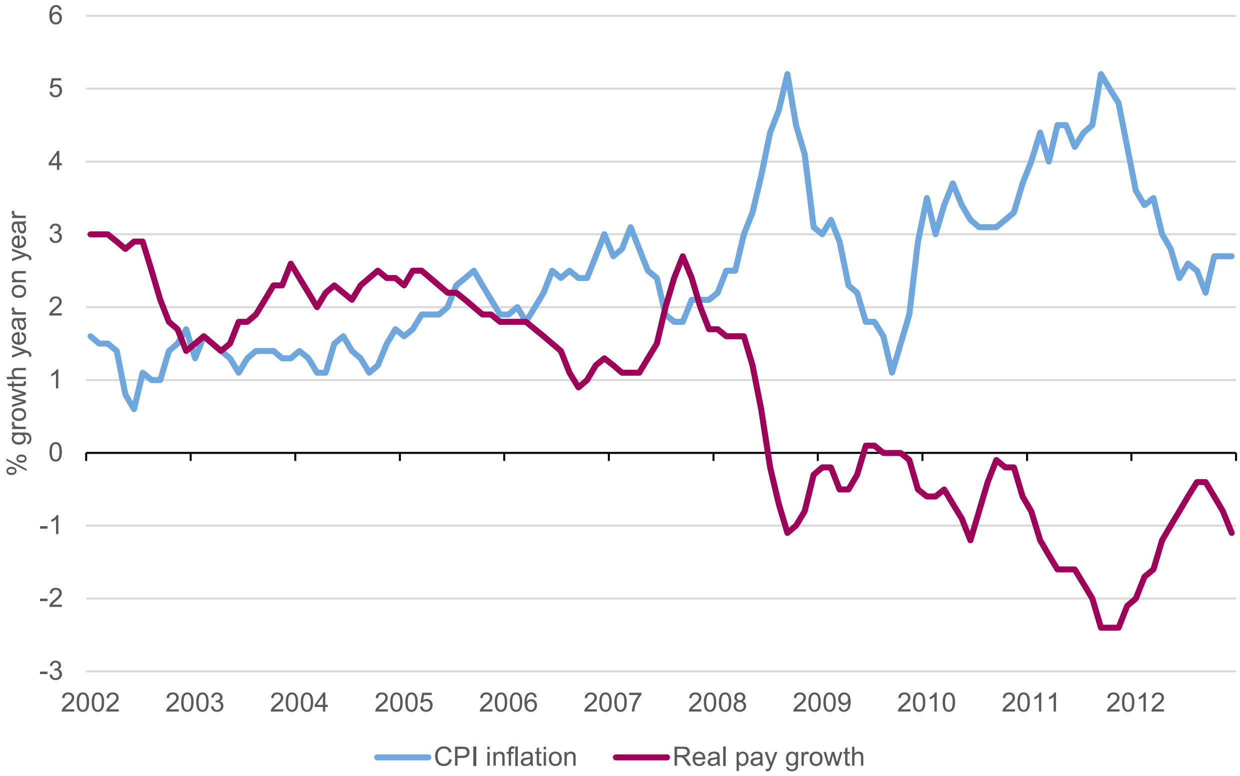
The recession of the early 1990s saw UK GDP slow to a crawl in 1990, before contracting 1.2% in 1991 and barely growing in 1992. Unemployment rose sharply from below 7% in spring 1990 up to a peak of 10.5% in autumn 1992. The experience for London was even worse, as while the capital's output took longer to turn downward, it troughed around 3% below levels in late 1990 – deeper than the roughly 2% drop experienced nationally. London's output also took around 9 months longer to recover to pre-recession levels than the national average. London's labour market fared even worse, with the capital's claimant count unemployment rate climbing above the national rate in July 1991 for the first time since records began in the 1970s. The

[46] Nelson & Nikolov, "UK Inflation in The 1970s and 1980s: The Role of Output Gap Mismeasurement", CEPR Discussion Paper No. 2999, (October 2021)
[47] Bank of England, Official Bank Rate history Data from 1694, available at page "Interest rates and Bank Rate"

claimant count unemployment rate for London then peaked at its highest level on record in spring 1993 at more than a percentage point higher than the national average. London's unemployment by this measure then held above the UK average for the rest of the 1990s and for most of the period up to the financial crisis.

The experience of the early 2010s

Figure 16: UK CPI inflation and real regular wages 2002-2012



Source: ONS CPI and Average Weekly Earnings figures

How inflation evolved
While the early 2010s did not see inflation reach the levels of the 1990s, let alone the 1970s, price growth accelerated from around 1.1% in September 2009 to over 5% by September 2011. While the firm pace of inflation did not last, falling back towards the 2% target in 2012, it was enough to push real pay growth firmly into negative territory between autumn 2010 and autumn 2011, when real regular pay saw an annual decline of around 2.4%[48] (**Figure 16**). This was the post-2000 record low until the pay data came in for May 2022.

Causes
As the global economy began to recover from the shock of the financial crisis, crude oil and other commodity prices also picked up with growing demand[49]. This helped create a period of some of the fastest price growth since inflation targeting began in 1992.

[48] ONS, Average Weekly Earnings, real regular pay series
[49] IMF Global Price of All Commodities index shows these trends, accessible at Federal Reserve Economic Data

Policy response
In this case, the Bank of England held interest rates at their then record low of 0.5% and continued its programme of Quantitative Easing. With the recovery from the financial crisis still in its early stages, the Bank focused on the transitory nature of the shock from a VAT hike and commodity prices[50]. Long-run inflation expectations at the time crept up a little, but held close to levels from late 2009, when inflation was last running below 2%[51].

Impact on UK and London
The economic performance of this period is shaped by the impact of the recovery from the financial crisis, but the quarterly pace of growth did noticeably slow. In the year to autumn 2010, quarterly growth averaged a pace consistent with nearly 3% annual growth. In the following year as inflation rose and real wages fell, that average fell to a pace consistent with 1% annual growth. Yet London's pace of growth decelerated much less during this period. London's output had been largely in line with the pace of the national recovery up to late 2010, but after this stage the capital pulled ahead and eventually reached pre-2008 levels of output almost two years earlier than the wider UK.

How the UK economy has evolved to be more resilient to inflation

While media commentary has increasingly drawn parallels between the experience of the 1970s and the recent acceleration in inflation[52], there are a number of key differences that are likely to be economically important.

First, the institutional setup of the macroeconomy is significantly different today, with an inflation-targeting, politically independent central bank already hiking interest rates to stave off further price increases. In the 1970s, the default approach to inflation was to impose price controls across the economy, which tended to be costly for the government and only sustainable for limited periods of time[53]. As Huw Pill on the Monetary Policy Committee (MPC) puts it, "unlike in the 1970s, we now have a strong institutional framework that protects against such self-sustaining cost/price dynamics. The Bank and MPC have been given independent powers to pursue that target, and, through parliament, are accountable to the public for our performance in this regard."[54]

Second, the labour market is structured very differently. The OECD rates the UK as one of the most flexible labour markets in the developed world[55], which should help quickly ease recent reports of worker shortages. The UK has also lost less than 2 million working days a year to industrial action since 1990, with the latest figures in 2018 at less than 0.3 million[56]. This compares to figures of 23.9 million days lost in 1972 and 29.5 million in 1979. Collective bargaining agreements now cover a little over a quarter of the workforce, from over 80% in the 1970s[57]. Taken together, these factors mean workers and businesses are unlikely to engage in a spiral of unsustainable nominal wage demands and sale price increases.

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[50] November 2011 Monetary Policy Committee minutes: "Energy price rises had contributed significantly to the recent elevated rate of inflation, alongside sizable contributions from VAT and import prices. As these effects began to drop out of the twelve-month comparison, inflation was likely to fall back sharply."
[51] Bank of England/Ipsos Inflation Attitudes Survey, Long-run summary results data
[52] Sources could include City AM (3 August 2022), Daily Mail (20 July 2022), or Financial Times (8 July 2022),
[53] King (2005) quotes Nicholas Kaldor, an adviser to Harold Wilson, as saying in 1971 that "It is also far more generally acknowledged – even by Conservative Prime Ministers – that the process of inflation is 'cost-induced' and not demand-induced', with the evident implication that it can be tackled only by an incomes policy"
[54] Huw Pill, Bank of England, 'Crossing the river by feeling the stones' (Nov. 2021)
[55] Table 3.3 of the OECD Employment Outlook 2020 ranks the UK as 6th lightest out of its membership on Strictness of regulation of individual dismissals of regular workers
[56] ONS, Labour disputes in the UK: 2018
[57] OECD data on Collective bargaining coverage

Third, while energy cost increases are hitting households and businesses hard, UK economic output is overall less energy-intensive. In 1970, the UK used energy equivalent to just under 300 tonnes of oil per million pounds of GDP. By 2020, that figure was just under 86 tonnes of oil equivalent per million pounds of GDP[58]. This should mean that, despite the need to cushion the blow from high energy costs to the lowest-income households, the wider economy should be less sensitive to commodity price increases than it was in the 1970s.

Against these cautious reasons to expect a more inflation-resilient economy, there is some indication that household inflation expectations are becoming less well-anchored than in recent years. The Bank of England surveys individuals on what they expect inflation to average in five years' time, and the distribution of responses shows some signs of growing worry about high long-term inflation[59]. While there are always a chunk of respondents expecting inflation to be 10% or more in the long run, the share of responses in this category has increased between last spring and this May. Meanwhile, the dispersion of responses has also risen, suggesting respondents are overall less certain about the long-term path of inflation. A growing share of high responses and more uncertainty overall are both indicators that Reis points towards as evidence of inflation expectations becoming less well anchored. Monetary policy is likely taking these signs into account as it hikes interest rates despite a slowing pace of GDP growth. Yet if Bank of England policymakers conclude that inflation expectations are clearly de-anchoring, they may be forced into a more aggressive pace of policy tightening. This would likely increase the risk of a recession, and past episodes suggest that London might take longer to recover than the wider UK.

[58] BEIS Energy consumption in the UK 2021; Energy intensity data tables

[59] Bank of England/Ipsos Inflation Attitudes Survey, Individual survey responses

Box 1: Method for the London-specific inflation measure

Our measure of London-specific inflation uses the Office for National Statistics' (ONS) locally-collected price quotes data. Every month, while compiling the Consumer Price Index (CPI), ONS-contracted price collectors record about 100,000 prices for around 520 items. For other goods and services it is more efficient to collect prices centrally (that is, at ONS). This is the case for another roughly 90,000 prices for 150 items. The ONS publicly releases all of the individual item price quotes (without identifying individual retailers), including a geographical indicator to show where the quote was collected[60].

The ONS only release the quotes in one file per month of data, making it hard to collect the data into a coherent panel over time. However, we use a version of this dataset compiled in Professor Richard Davies's Long-Run Price Database (LRPD)[61]. This version allows us to build a measure of inflation for all the locally-collected prices over time from the 1990s.

To build comparable measures of national and London-specific inflation, we take inspiration from the National Institute of Economic and Social Research (NIESR). They deploy the price quotes data for their measure of "underlying inflation"[62]. This uses a trimmed mean of monthly inflation rates, excluding a "fraction of the highest and lowest price changes each month, [and] calculating the arithmetic mean across the remaining observations". NIESR build up a measure of annual inflation from this series of truncated mean monthly price shifts, with the top and bottom 5% excluded. The mean is also unweighted. We build a slightly different trimmed mean figure. We average directly across annual growth rates rather than building up a series from monthly changes. We exclude the top and bottom 10% of annual inflation figures and average the rest using COICOP[63] item weights in the LRPD.

This data offers us an idea of how London's underlying price pressures measure up against the wider UK, but it has limitations. The LRPD does not contain prices collected by the ONS at the national level. The list of centrally-collected prices contains some of the key drivers of national inflation, including energy bills and second-hand cars. To mitigate this limitation, we have tried to explore how much less or more of a contribution some of these categories would make to total inflation if weighted in line with London consumption patterns.

For the London-specific measure, we also adjust these weights for Londoners' spending patterns. Specifically, we take the most detailed level of spending data published in Table A35 ('Detailed household expenditure by countries and regions') from the Family Spending Workbook 3, which is derived from the Living Costs and Food Survey. We then calculate the difference in spending shares between the London average and the UK average. To achieve item-specific weights, we divide each item's standard LRPD weight by the total weight for that item's higher-level COICOP category. We then adjust the higher-level category's total weight in line with London-specific consumption patterns and multiply out by the item's share of that category's total weight to achieve a London-specific item weight.

[60] ONS, Price quote data and item indices dataset
[61] The latest version of the LRPD is accessible on Richard Davies' website. The database was originally publicised in a working paper: Davies (2021), Prices and inflation in the UK - A new dataset, Centre for Economic Performance Occasional Paper, No. 55
[62] NIESR set out the method in 'The price of everything', a box for the National Institute Economic Review, no. 245, August 2018
[63] This is a UN typology of consumption categories, the 'Classification of Individual Consumption According to Purpose (COICOP)' standard.

Box 2: Understanding sectoral pay, jobs and hours worked

While we do not have timely data on hours worked at the London level, we do have self-reported estimates of average hours worked by industry at the UK level. For instance, from February-April 2019 to February-April 2022, average hours increased the most in Finance (0.9%). Median pay in Finance also grew the most of any sector over the same period (24.7%). Workers in the Hospitality sector have suffered similarly low pay rises in London as they have in the UK (4.5% versus 5.8% nationally) at the same time as hours have also fallen steeply (-4.9%).

However, despite some correlations between pay performance and changes in hours, it is also clear that adjusting changes in median pay by the changes in average hours worked does little to shift the overall picture of low-paying sectors seeing the weakest wage growth.

When we also look at the final two columns in Table 3, which show changes in employee jobs over the period, we see different patterns emerging in London and the UK. On average, employers in the UK have continued to add jobs in Hospitality, even while average worker hours have fallen. In London, the number of employees in the sector has instead fallen (and we do not yet know what has happened to hours). In other low-paid sectors such as Wholesale and retail, we also see a large drop in hours in the UK (-3.2%) but stronger median pay growth in both London and the UK alongside declining employee jobs.

These patterns are likely the result of many different factors affecting industries in different ways – but without more detailed data it is unclear what is causing the negative labour market outcomes for workers in these low-paid sectors.

Table 3: Changes in median pay, employee jobs and hours worked, Feb-Apr 2019 to Feb-Apr 2022

Sector	Median pay UK	Median pay London	Average hours UK	Jobs UK	Jobs London
Finance and insurance	24.7%	17.6%	0.9%	-3.4%	1.1%
Information and communication	21.3%	24.6%	-0.3%	5.7%	6.8%
Professional, scientific and technical	20.2%	20.5%	-0.3%	7.3%	7.73%
Administrative and support services	17.3%	15.4%	0.7%	3.1%	1.9%
Health and social work	15.4%	12.8%	0.1%	7.5%	9.6%
Wholesale and retail; vehicle repair	13.4%	12.6%	-3.2%	-1.9%	-3.8%
Arts, entertainment and recreation	13.3%	9.0%		-3.9%	-3.5%
Education	13.1%	12.1%	0.9%	2.9%	1.5%
Manufacturing	10.2%	10.7%	-2.6%	-3.7%	-2.3%
Transportation and storage	10.1%	6.0%	-2.5%	-0.7%	-5.7%
Public administration and defence	8.6%	7.9%	0.0%	7.2%	10.3%
Construction	8.1%	2.8%	-2.8%	3.2%	1.9%
Accommodation and food services	5.8%	4.5%	-4.9%	1.1%	-5.6%

Source: HMRC PAYE Real Time Information, ONS Labour Force Survey

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