PositiveMoney

‘Inflation as an ecological phenomenon’

Briefing for UK Members of Parliament

Summary

- Volatile fossil fuels have been a major driver of UK inflation (‘fossilflation’). At the same time, fossil fuel use drives climate change, the impacts of which are increasingly inflationary (‘climateflation’).
- Interest rate hikes, which have been the primary response to inflation, are not well placed to respond to these sources of inflation, as they cannot address the drivers, impact low-income households disproportionately, and make cost-saving green investments more expensive.
- To respond to fossilflation and climateflation, the Bank of England must green its monetary policy tools to align with a just and green transition, and better coordination between the Bank and the Treasury is needed.

Climateflation and Fossilflation

Throughout 2022 and 2023, rising inflation was driven primarily by high energy prices, which were already inflated in late 2021 and were exacerbated following Russia’s invasion of Ukraine. Global energy prices impact headline inflation figures directly, as energy features substantially in inflation indices, and indirectly, as goods and services use energy for production and transportation.

“Fossilflation”, meaning fossil fuels driving inflation, is not new, as shown by the oil price shocks in the 1970s. The UK’s reliance on fossil fuels leaves it particularly vulnerable. The ONS estimated that **at the peak of the UK’s inflation, three quarters of this could be explained by the direct and indirect effects of energy prices**.[1]

The burning of fossil fuels is also the primary driver of climate change, causing rising temperatures and an increase in extreme weather events, which doubled from 1990 to 2016.[2] Climate change impacts are now subjecting economies to supply shocks, which generate inflationary pressures termed “climateflation”.

This is already manifesting in the UK. The Energy and Climate Intelligence Unit estimates that **climate change induced extreme weather is likely the biggest driver of rising grocery bills,** accounting for up to a third of UK food inflation in 2023, adding an extra 5.3 % to food inflation. Put another way, the climate change impacts are estimated to have increased the average household food bill by £361 per month in 2023 in contrast to 2001 figures.[3] **Polling conducted by Positive Money and Opinium found that 3 in 4 UK adults are concerned about the effect of climate change impacts on their bills.**[4]

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[1] ONS (2023). The energy intensity of the Consumer Prices Index 2022.
[2] IPCC. (2023). Synthesis report of the IPCC sixth assessment report.
[3] ECIU (2023). Climate, Fossil Fuels and UK Food Prices.
[4] Opinium surveyed 2000 UK Adults aged 18 and above online between 19th – 23rd January 2024, nationally representative of age, gender, and region. Full polling results can be found here.

Evidence is mounting that climate change impacts have an overall inflationary impact, which is set to worsen as climate change and environmental degradation intensifies. Importantly, climateflation exacerbates both intra-country and inter-country inequality, as low-income households and climate-vulnerable countries are most adversely affected by food prices.

Central banks' current tools cannot address the drivers of ecologically-driven inflation, and run counter to the governments' policy objectives

Most central banks, including the Bank of England, have responded to inflation using the main tool currently at their disposal: raising the rate of interest paid on central bank reserves. With its current tools, we can imagine that the Bank will similarly raise rates when faced with a future extreme weather event whose impact is persistent enough on inflation.

This approach, which targets demand, cannot address the supply-side drivers of the price rises we have seen since 2021. On the contrary, it is counterproductive to achieving price stability in response to fossilflation and climateflation, and runs counter to key government policy objectives, including reaching net zero emissions by 2050.

This is because **raising interest rates makes investment in green projects disproportionately more expensive**, because green investments tend to require more up-front capital investment. This is increasingly being recognised, with **French President Macron recently calling it "totally absurd" that the private sector benefits from the same interest rates whether it finances renewables or fossil fuels**, and advocating for the introduction of a 'dual rate' policy.[5] Polling found that a majority (55%) of UK adults would support a policy that makes it cheaper to invest in renewables rather than fossil fuels.[6]

Rate hikes also increase inequality by reducing economic activity, which is particularly damaging for lower income households who are more likely to enter unemployment and/or face income reduction.

Policy implications for the Bank of England and the Treasury

The Bank must green its monetary policy operations. Fossilflation and climateflation are increasingly relevant to price stability. Despite net zero having been a part of the Bank's mandate since March 2021, its progress has stalled. The Bank should:

- Incorporate environmental considerations into inflation forecasting and economic models
- Incorporate environmental considerations into its collateral framework
- Introduce lower interest rate schemes for lending to green activities

Better coordination between the central bank and Treasury is needed to navigate future supply constraints and shocks. The tools of the Bank should be complemented by fiscal policies like targeted price controls (such as the energy price cap) and taxation to respond to shocks, and strategic investments to drive a transition to a green and secure energy supply.

Read the full report here: Inflation as an ecological phenomenon

[5] Green Central Banking (2023). Macron endorses dual interest rates for green energy.
[6] Opinium surveyed 2000 UK Adults aged 18 and above online between 19th – 23rd January 2024, nationally representative of age, gender, and region. Full polling results can be found here.