MONETARY POLICY REPORT PRESS CONFERENCE

Thursday 2 February 2022

Opening Remarks by Andrew Bailey, Governor

Introduction

Welcome to the February Monetary Policy Report press conference.

Today we have increased Bank Rate by 0.5 percentage points to 4%.

Let me explain why.

The outlook for inflation

Since the November Monetary Policy Report we have seen the first signs that inflation has turned the corner. Annual consumer price inflation has come down from 11.1% in October to 10.5% in December. That is below where we thought it would be in the November Report. We think it will continue to fall this year, and more rapidly in the second half of the year.

This has a lot to do with energy prices. Last year's very large increases are now beginning to drop out of the annual calculation of the consumer price index. Moreover, wholesale gas spot prices have fallen by around 50% since November. Gas futures prices have also come down markedly.

– – – CHART 1 – – –
CPI inflation projection with direct energy contribution

This chart shows the MPC's central projection for inflation, which is conditional on a market-implied path for Bank Rate that peaks at around 4½% by the middle of this year. In the central projection, consumer price inflation falls to about 4% towards the end of the year. The purple bars illustrate that a sizeable part of this fall can be explained by direct effects from energy prices.

The expected fall in inflation is not just about energy prices, however. Global price pressures are easing as supply chain disruptions have lessened across most of the world. We therefore expect headline inflation to fall rapidly based on lower external cost pressures more broadly. This will alleviate some of the very big shock to national real income that we have had as a country.

But while external pressures are easing, other indicators of inflationary pressures have proved firmer than expected. The labour market remains tight by historical standards, and annual private sector pay growth increased to 7.2% in the three months to November, surprising on the upside.

– – – CHART 2 – – –
While core goods inflation has eased, services inflation has not

As you can see in this chart, while core goods inflation has fallen, services consumer price inflation rose to a 30-year high of 6.8% in December, above what we expected in the November Monetary Policy Report. Bank staff project that services inflation will rise further in the near term, consistent with the strength in wages and other costs facing service-sector companies.

It is price and wage setting dynamics in the UK economy that ultimately determine how long it takes to return inflation to target on a sustainable basis. So while we are confident that inflation will come down this year, developments over the coming quarters will be crucial in determining how quickly overall inflationary pressures abate.

Judging sustainability requires us to look further ahead, and that is where uncertainties increase.

In the Monetary Policy Committee's best collective judgement, the most likely outcome is that an increasing degree of economic slack, alongside reduced external pressures, leads consumer price inflation to fall below the 2% target from around spring 2024. Besides the market-implied path for Bank Rate, this is conditional on wholesale energy prices following their respective futures curves over the whole forecast period.

In other words, the forecast suggests that inflation will come down and that it will fall quite sharply.

But events may not unfold in this way. With inflation currently above 10%, we are in uncharted territory. Energy prices may not fall by as much as currently expected in financial markets – and even if they do, this period of very high inflation could play into price and wage setting in the UK economy to a greater extent than we assume in our central projection. The tightness of the labour market reinforces this risk.

– – – CHART 3 – – –
CPI inflation projection

For this reason, we think the risks around our central projection for inflation, shown in this chart, are skewed significantly to the upside, and more so than at any time in the history of the Monetary Policy Committee.

Our decision to increase Bank Rate today, despite a weak outlook in our central projection, reflects these uncertainties – uncertainties over the extent to which external and domestic inflationary pressures develop over the coming quarters, and wider uncertainties over the trajectory of the economy and inflationary dynamics further ahead.

We have done a lot already. The full effect of that is still to come through. But it is too soon to declare victory just yet. Inflationary pressures are still there. We can see that in the data, we can hear it from our Agents. And we need to be absolutely sure that we really are turning the corner on inflation. That is why we have increased Bank Rate today. And that is why we continue to monitor the data very carefully.

Key judgements

Let me say a few more things about the key judgements underlying the forecast, because these are important.

The first key judgement is about potential supply – the level of output the economy can sustain without generating too much inflation.

Over recent years, the UK economy has been hit by a series of significant economic shocks that have affected potential supply. This includes the change in the trading relationship with the European Union, the Covid pandemic, and developments in global energy prices related to Russia's brutal war on Ukraine and its people. These shocks have held back both productivity and labour supply.

We describe our assessment of these shocks in the Monetary Policy Report published today. I will just point to one important part of the story.

– – – CHART 4 – – –
Rising inactivity has been driven by people aged 50+

As this chart shows, since the start of the Covid pandemic we have seen a large increase in the number of people who do not take an active part in the labour market. Some of this rise in economic inactivity is caused by the population ageing. But as the chart shows, those aged 65 and above account for only around a third of the increase (shown in blue bars).

There has also been a marked increase in inactivity amongst 50 to 65 year olds (shown in orange). Many say they have retired early, making a choice about the life they would like to live. At the same time, however, many people report that they are affected by long-term illness. A number of these people say they are unlikely to come back into the labour market.

This significant and lingering fall in the labour supply weighs on the UK economy's potential.

– – – CHART 5 – – –
The fall in participation will take time to unwind

You can see this directly in this chart. The white line is the participation rate – the share of people over 16 who take part in the labour market. It fell sharply with the onset of Covid, which is not unusual by international standards. But it has not reversed, which is unusual. We think this fall will take some time to unwind. So we have revised down our estimates of the trend in participation with persistent effects from Covid adding to population ageing.

– – – CHART 6 – – –
The level of supply is only expected to recover gradually

As this next chart shows, as a result of the rise in inactivity – combined with the effects of the other shocks I briefly mentioned – the level of potential supply has not yet regained its pre-pandemic level. Supply growth is weak by historical standards, hence we assume that the level only recovers gradually. This is the first key judgement underlying our February forecast.

The second key judgement is that the squeeze on real incomes from high energy prices and the path of market interest rates continue to weigh on demand. Economic output is therefore expected to fall slightly throughout 2023 and into 2024.

– – – CHART 7 – – –
Changes in GDP since pre-recession peaks

This is nevertheless a much shallower decline than expected in the November Monetary Policy Report. This chart shows that the projected downturn in the economy, while still technically a recession by a common definition, is now significantly milder than past recessions. The peak-to-trough fall of gross domestic output (in the purple line) is less than 1%, compared with 3% or more in the 1980, 1990 and 2008 recessions (shown in blue, red and yellow, respectively).

In part, the smaller decline in output reflects the fall in energy prices as well as the fall in the market-implied path for Bank Rate since the November Monetary Policy Report – and related to that the moderation of rates on new mortgages from the elevated levels we saw in the autumn.

In part, however, the shallower downturn in the forecast reflects a reassessment of the outlook for consumption in light of the strength in the labour market and upside surprises to earnings. The Committee now expects a weakening in labour demand to be met to a larger extent by a reduction in vacancies and in hours worked, and to a lesser extent by an increase in redundancies and unemployment. In turn, as firms hold on to workers, households may worry less about the risk of job losses, which is likely to result in lower precautionary saving and higher consumption than previously assumed.

This takes me to the third key judgement that, over the forecast period, what starts as excess demand becomes excess supply.

– – – CHART 8 – – –
Headwinds to demand lead to increasing economic slack

You can see that in this chart, where we have added the projected level of output to the estimated path for potential supply. Notwithstanding the MPC's reassessment of the outlook for demand, continued headwinds lead to an increasing degree of economic slack emerging from the second quarter of 2023 – despite the weak outlook for supply.

Finally, our fourth key judgement on inflation. In the central projection, as I have described, the increasing degree of economic slack, alongside reduced external pressures, leads consumer price inflation to fall below the 2% target in the second half of the forecast.

The Committee has retained a judgement from previous forecasts that – given pressures from wage growth – inflation will be somewhat more persistent than the balance of supply and demand alone would suggest. This pushes up inflation a little in the central projection.

While this still leaves inflation well below target in the second half of the forecast, there continue to be significant upside risks around this central projection. If wholesale energy prices remain at current levels, for example, consumer price inflation could be nearly one percentage point higher towards the end of the forecast. And domestic wage and price dynamics could prove more persistent than the central projection implies. The course of the economy over the coming quarters will be a key determinant of whether these risks crystallise.

The monetary policy decision

This takes me back to the monetary policy decision.

Headline consumer price inflation has begun to edge back and is likely to fall sharply over the rest of the year. This is very welcome. However, the labour market remains tight and domestic price and wage pressures have been stronger than expected, suggesting risks of greater persistence in underlying inflation.

The extent to which inflationary pressures ease will depend on the evolution of the economy, including the impact of the significant increases in Bank Rate so far. There are considerable uncertainties around the outlook. The Monetary Policy Committee will continue to monitor closely indications of persistent inflationary pressures, including the tightness of labour market conditions and the behaviour of wage growth and services inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.

Looking further ahead, the Committee will adjust Bank Rate as necessary to return inflation to the 2% target sustainably.

With that, Ben, Dave and I will be happy to take your questions.