MONETARY POLICY REPORT PRESS CONFERENCE

Thursday 11 May 2023

Opening Remarks by Andrew Bailey, Governor

Today's monetary policy decision

The outlook for growth and unemployment has improved. Six months ago, we were expecting a shallow but long recession. Since then, energy prices have fallen substantially, and economic activity is holding up better than expected. Today, we are forecasting modest, but positive, growth, and a much smaller increase in unemployment.

We think inflation will fall quite sharply over the coming months, beginning with the April number to be released in two weeks' time. Energy prices have fallen from their peaks, and that will now start to come through as lower inflation. Food price inflation should ease too, though we can be less sure about the timing.

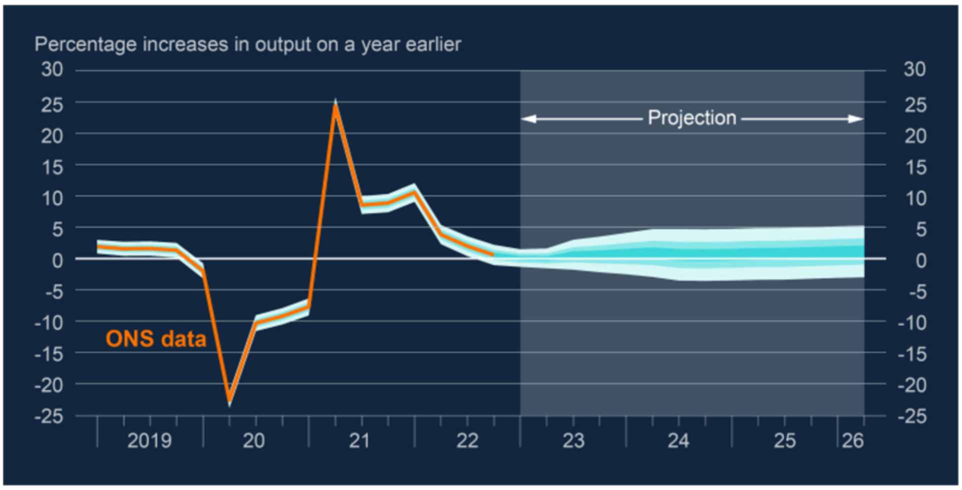
But inflation remains too high. It is our job to get it all the way down to the 2% target and have it stay there.

That is why today we have increased Bank Rate by 0.25 percentage points, to 4.5%. Low and stable inflation is the foundation of a healthy economy, and we have to stay the course to make sure inflation falls all the way back to the 2% target.

The economic outlook

In the Monetary Policy Report we present today, we have revised up our projections for growth in the UK economy. In the MPC's central projection, shown in Chart 1, the UK economy grows at a moderate pace over the next three years, with calendar-year growth expected to be ¼% this year, and ¾% in 2024 and 2025. This is still not a strong forecast, and we still expect a degree of economic slack to emerge from the end of this year, but the growth outlook is less weak than in the MPC's recent projections.

Chart 1: GDP growth projection based on market interest rate expectations



Recent survey evidence supports this upward revision. Consumer confidence, though still weak, is at its highest level for over a year. In the March edition of the Bank's NMG survey, households were more optimistic about the general economic situation than in the previous survey last September. The Bank's network of Agents has reported that activity has been stronger recently than their contacts previously expected.

Above all, the improvement in the outlook reflects a further fall in wholesale gas prices, reversing some of the terms of trade shock that has been the primary cause of falling real incomes. But there has also been greater resilience in the economy than we had expected – as seen, for example, in strong employment numbers.

Fiscal policy is also expected to boost GDP over the forecast, building to a peak impact of around ½%. Both the temporary 100% capital allowances for qualifying business investment and measures aimed at increasing labour market participation are assumed to have positive effects on potential supply.

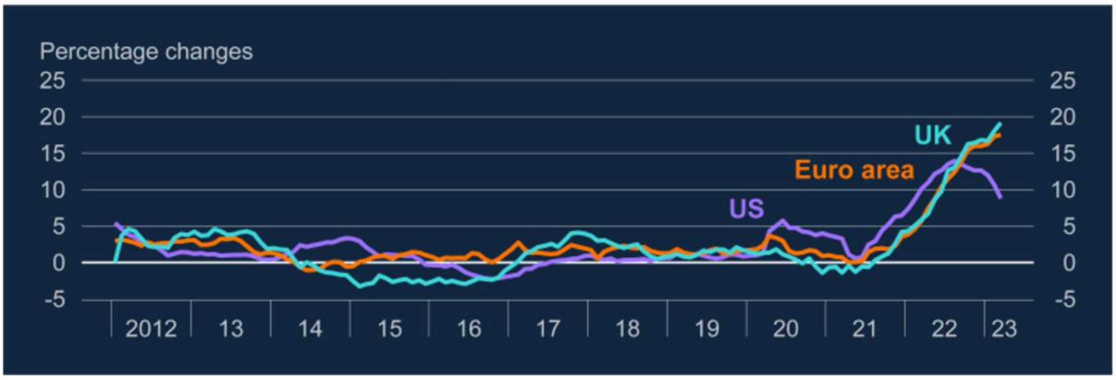
The outlook for inflation

Annual consumer price inflation has come down from a peak of 11.1% in October last year. But it remains very high. The latest figure of 10.1% for March was 0.8 percentage point higher than we expected at the time of the February Report.

Higher food and clothing prices account for most of the upside surprise. Food inflation has been particularly high, reaching 19.1%. As you can see in Chart 2, this is not just happening here in the UK. Food inflation rates are similar across Europe.

Chart 2: Food price inflation rates are similar in the UK, euro area and US

Annual food and non -alcohol beverages price inflation



Sources: ONS and Refinitiv Datastream .

We are acutely aware of how difficult this rise in food prices is for people, especially for those on lower incomes.

We do see signs that food price inflation will start to slow. Global prices of wholesale agricultural commodities have come down since the Spring of last year, and food producer price indices have eased in recent months. Evidence collected by the Bank's Agents suggests that food producers expect food production costs to moderate. While this may take longer than we previously thought, we should expect this to feed through to consumer food inflation over the coming year. That is what I hear when I visit and meet with both food producers and retailers.

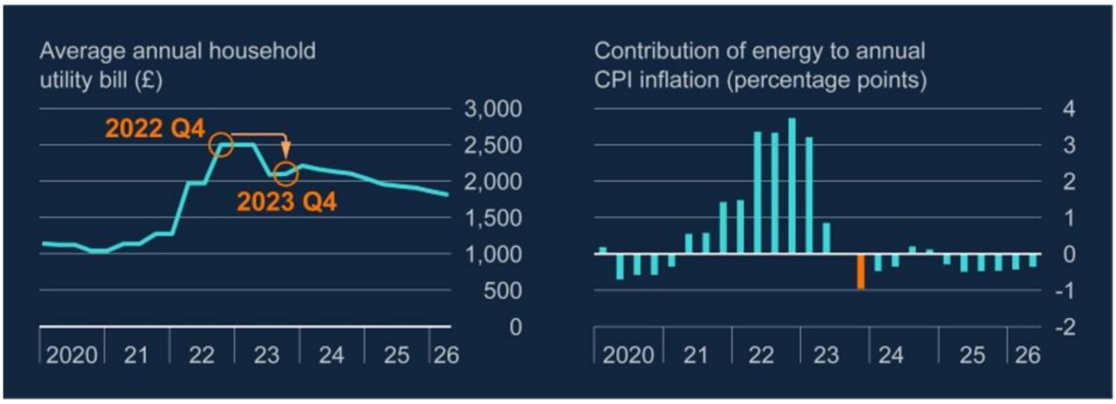
And we have good reasons to expect headline inflation to fall sharply from April as last year's large energy price rises now start to drop out of the annual calculations.

In the March release, the prices of electricity, gas and other fuels were more than 85% higher than a year ago, contributing more than 3 percentage points to headline inflation. That contribution is likely to drop significantly to about 1 percentage point in April's data as large increases in energy prices from a year ago drop out of the annual calculations.

Looking ahead to the end of the year, the contribution from energy will fall further. This is illustrated in Chart 3, which has the level of the typical household energy bill on the left and the direct contribution of energy to inflation on the right. In the fourth quarter of this year, if energy prices evolve as financial market prices now suggest, we can expect the typical household energy bill to fall to around £2,100. That is still a high number. But it is about 16% lower than the level a year before that when the Government's Energy Price Guarantee was put in place. Since energy makes up around 5% of the consumer price index, that fall in the prices of electricity and gas, along with other fuels, translates into a contribution to overall inflation from energy of minus 1 percentage point towards the end of the year (as indicated on the right-hand chart).

Chart 3: Contributions of energy to inflation to will turn negative

Typical household utility bill and contributions of energy to CPI inflation



Sources: ONS and Bank calculations

It is not least for this reason that consumer price inflation is on course to halve by the end of this year – though to be very clear, our target is a sustainable return of inflation to 2%. That is what we focus on.

So we also have to look carefully at other components of the consumer price index. So-called core inflation, which excludes energy and food prices, is driven by items that can have more persistent inflationary dynamics. The upside news in inflation since February has predominantly been to headline inflation rather than core, but we still need to watch out for an effect on persistence.

As you can see in Chart 4, core inflation is also elevated.

Chart 4: Headline and core CPI inflation have risen rapidly and remain elevated

Headline and core annual CPI inflation

The latest data points are for March 2023. Core CPI is CPI excluding energy, food, beverages and tobacco.

Some of this strength in core inflation reflects the indirect effects of higher energy prices. But it also reflects 'second-round effects' as the external shocks we have seen interact with the state of the domestic economy. And as headline inflation falls, these second-round effects are unlikely to go away as quickly as they appeared. The MPC judges that there is an important asymmetry in inflationary dynamics in this respect.

This is why, even as headline inflation is coming down, the MPC is paying particular attention to indicators of inflation persistence, including labour market tightness and wage growth, and services inflation.

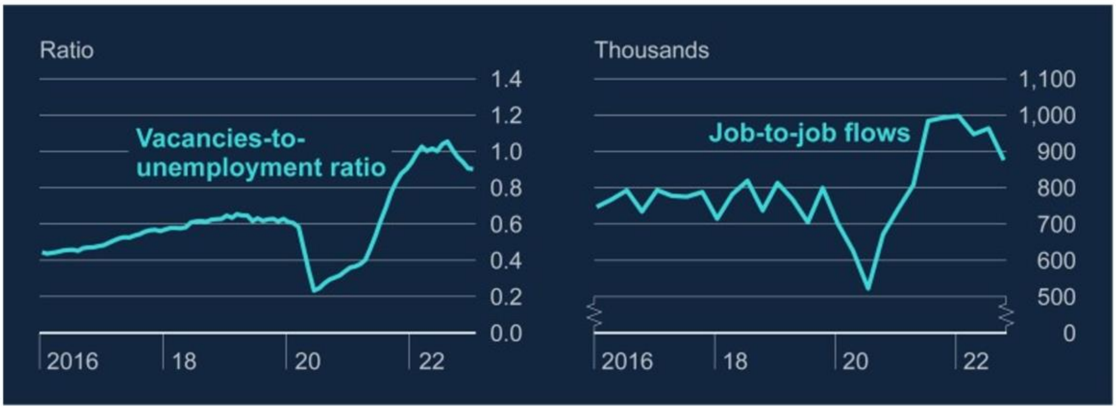
Since the February Report, the news on these indicators has been mixed.

There are some signs that the labour market is loosening a little, though at a slower pace than we expected in February, and it nevertheless remains tight.

Employment growth has been partially met by an increase in labour market participation, especially by younger people. The number of vacancies has come down from very high levels as well. As Chart 5 shows, the ratio of vacancies to unemployment – a key measure of labour market tightness – has fallen as a result. Similarly, job-to-job flows have declined a little in the most recent data.

Chart 5: The labour market remains tight with some signs of loosening

Ratio of the number of vacancies to people unemployed and job -to-job flows



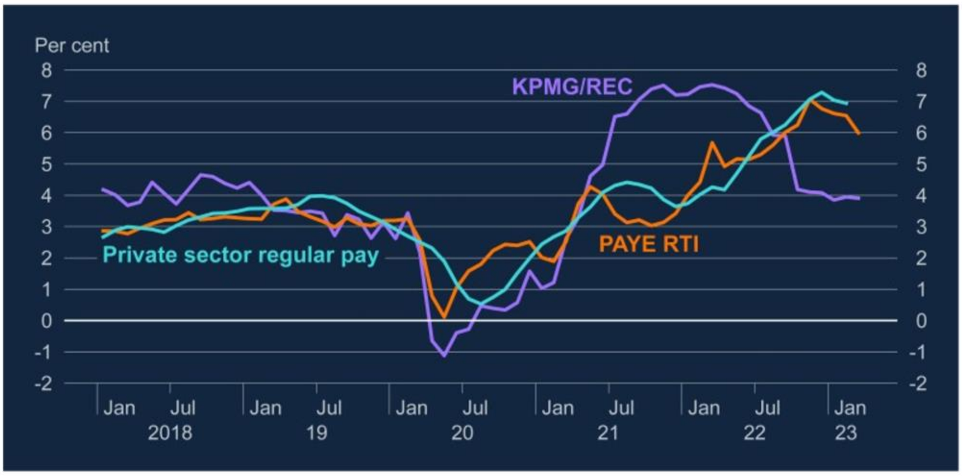
V/U ratio data are monthly with latest data point for the three months to February 2023.
Job-to-job flows are quarterly with the latest data point for 2022 Q4.

In line with the data, businesses across the United Kingdom tell our network of Agents that recruitment difficulties have eased in recent months. Employees are moving jobs less frequently and employers are getting more applications for job vacancies.

Nominal pay growth, shown in Chart 6, has also fallen back slightly, in line with our February projections. Near-term indicators, such as HMRC payroll data and the KMPG/REC salaries index, suggest that pay growth could ease further later this year. We hear the same from our network of Agents.

Chart 6: Pay growth has eased, and some indicators point to a further decline

Indicators of annual pay growth

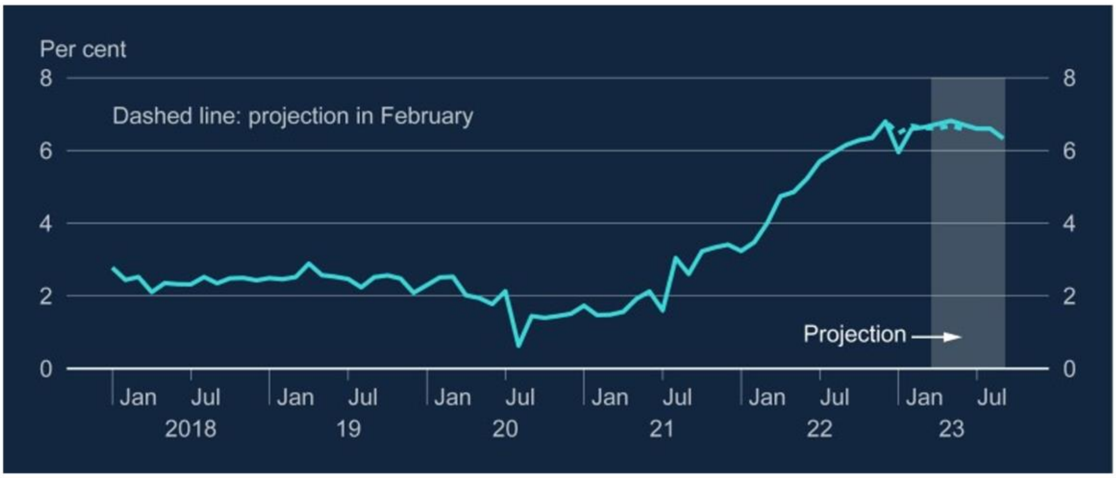


Sources: HMRC, KMPG/REC UK Report on Jobs, ONS, S&P Global and Bank calculations

Meanwhile, services price inflation, in Chart 7, remains elevated, broadly as expected in the February Report. This is likely to reflect some rebuilding of margins as well as wage growth and the indirect effects of higher energy and other input costs. The extent to which firms have already passed through higher costs will influence the pace at which services inflation declines.

Chart 7: Services price inflation remains strong

Services price inflation



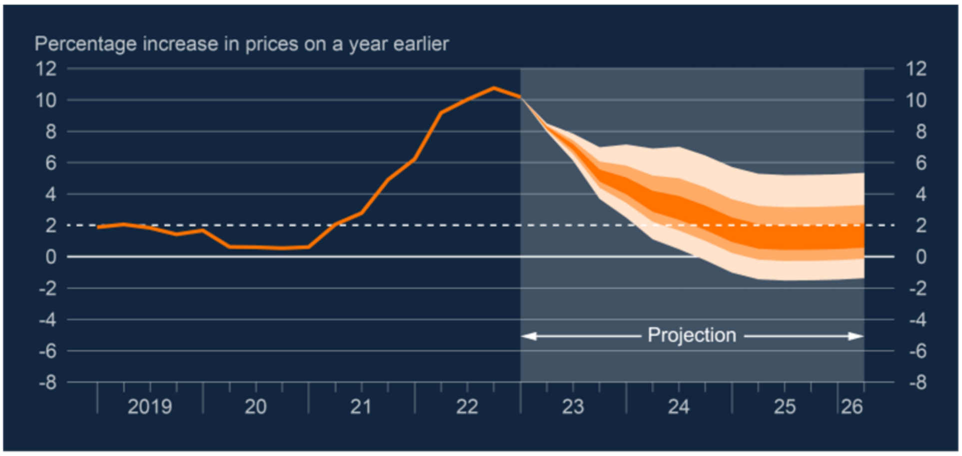
Sources: ONS and Bank calculations

So while CPI inflation is expected to fall quite sharply as energy costs begin to ease, albeit at a somewhat slower pace than projected in February given the near-term outlook for food prices, the outlook for inflation further out is more uncertain and depends on the extent of persistence in wage and price setting.

As shown in Chart 8, in the MPC’s baseline modal projection, which is conditional on a market-implied path for Bank Rate that peaks at 4¾% in the fourth quarter of this year, an increasing degree of economic slack, combined with declining external pressures, lead inflation to fall materially below the 2% target in the medium term.

Chart 8: CPI inflation projection

Based on market interest rate expectations



But the Committee continues to judge that the risks to inflation are skewed significantly to the upside, primarily reflecting the possibility of more persistence in domestic wage and price setting. We think the unwinding of second-round effects may take longer than it did for them to emerge. The current circumstances are so unusual, however, that it is hard to be precise about the extent of this asymmetry. So we have not made it part of our baseline modal projection. Nevertheless, the MPC judges that, relative to the baseline projection of significant declines in inflation to levels below target, there remains material upside risks over the medium term.

Reflecting those risks, conditional on the market-implied path for Bank Rate, the MPC's mean forecast path for inflation is at or just below to the 2% target at years 2 and 3.

I want to emphasise the point that having this large upside risk on inflation does not call into question meeting the inflation target in our projection using market rates.

Upside risks may not materialise, and so the MPC's baseline modal forecast, remains for inflation to fall below the target in the medium-term, conditional on the market-implied path for Bank Rate.

The transmission of monetary policy

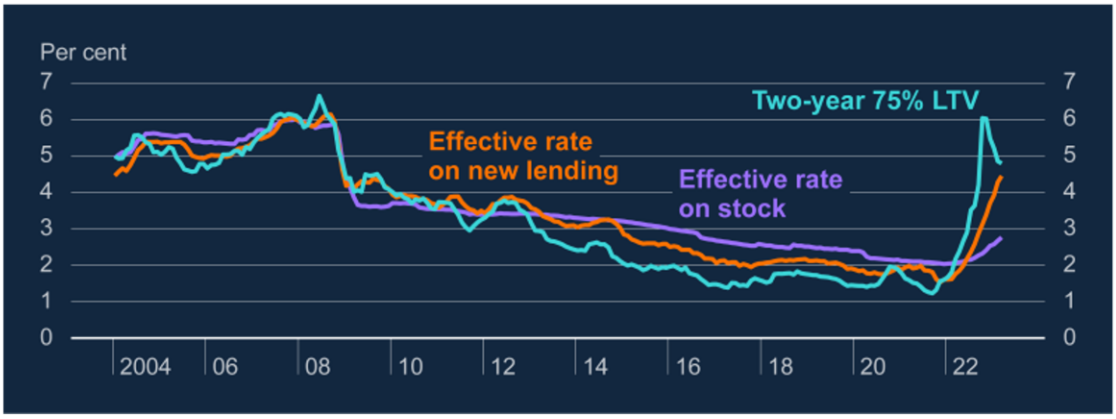
Monetary policy is now working to bring inflation down.

Changes in Bank Rate seem to have passed through as would be expected into new mortgage and corporate borrowing rates. Overseas bank failures have resulted in asset price volatility since the February Report, and spreads on UK banks' wholesale funding rose. But this was short-lived, implying little impact on the interest rates facing households and companies. While pass-through into household sight deposit rates has been muted, rates on term deposits and fixed-rate bonds have risen more in line with changes in reference rates.

These changes are still working their way through the economy. For example, while we have seen higher rates being quoted on new mortgages, illustrated in Chart 9 by rates on new two-year 75% loan-to-value mortgages (in blue) as well as the effective rates on new mortgage more generally (in red), the effective rates on the whole existing stock of mortgages (in purple) are still catching-up. Given such lags in the transmission of monetary policy, the rise in Bank Rate since December 2021 will weigh more on the economy in the coming quarters. The MPC factors this into its policy decisions.

Chart 9: Rates on stock of mortgages have risen by less than quoted rates

Quoted rates on new two-year 75% LTV mortgages, and effective rates on new lending and existing stock of mortgages



The monetary policy decision

Let me conclude with today's decision.

At this meeting, the Committee has voted to increase Bank Rate by 0.25 percentage points, to 4.5%. In doing so the MPC is continuing to address the risk of more persistent strength in domestic price and wage setting, as represented by the upward skew in the projected distribution for CPI inflation.

The pace at which inflationary pressures ease will depend on the evolution of the economy, including the impact of the significant increases in Bank Rate so far. Uncertainties around the global financial and economic outlook remain elevated.

The MPC 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 price inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.

The MPC will adjust Bank Rate as necessary to return inflation to target sustainably in the medium term, in line with its remit.

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