Bank of England

Monetary Policy Report

Monetary Policy Committee

May 2024

Monetary policy at the Bank of England

The objectives of monetary policy

The Bank's Monetary Policy Committee (MPC) sets monetary policy to keep inflation low and stable, which supports growth and jobs. Subject to maintaining price stability, the MPC is also required to support the Government's economic policy.

The Government has set the MPC a target for the 12-month increase in the Consumer Prices Index of 2%.

The 2% inflation target is symmetric and applies at all times.

The MPC's **remit** recognises, however, that the actual inflation rate will depart from its target as a result of shocks and disturbances, and that attempts to keep inflation at target in these circumstances may cause undesirable volatility in output. In exceptional circumstances, the appropriate horizon for returning inflation to target can vary. The MPC will communicate how and when it intends to return inflation to the target.

The instruments of monetary policy

The MPC currently uses two main monetary policy tools. First, we set the interest rate that banks and building societies earn on deposits, or 'reserves', placed with the Bank of England – this is Bank Rate. Second, we can buy government and corporate bonds, financed by the issuance of central bank reserves – this is asset purchases or quantitative easing.

The Monetary Policy Report

The MPC is committed to clear, transparent communication. The Monetary Policy Report (MPR) is a key part of that. It allows the MPC to share its thinking and explain the reasons for its decisions.

The Report is produced quarterly by Bank staff under the guidance of the members of the MPC.

This Report has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

The Monetary Policy Committee

- Andrew Bailey, Chair
- Sarah Breeden
- Ben Broadbent
- Swati Dhingra
- Megan Greene
- Jonathan Haskel
- Catherine L Mann
- Huw Pill
- Dave Ramsden

PowerPoint™ versions of the Monetary Policy Report charts and Excel spreadsheets of the data underlying most of them are available at **http://www.bankofengland.co.uk/monetary-policy-report/2024/may-2024**.

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Monetary Policy Summary

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 8 May 2024, the MPC voted by a majority of 7–2 to maintain Bank Rate at 5.25%. Two members preferred to reduce Bank Rate by 0.25 percentage points, to 5%.

The Committee's updated projections for activity and inflation are set out in the accompanying May Monetary Policy Report and are conditioned on a market-implied path for Bank Rate that declines from 5¼% to 3¾% by the end of the forecast period, compared with an endpoint of 3¼% in February.

Internationally, recent growth outturns have tended to be stronger in the United States than in the euro area. Underlying inflationary pressures in both regions have continued to moderate somewhat since the start of the year, though by less than expected in the United States. Forward interest rates have risen in the United States and, as a result, elsewhere.

Following modest weakness last year, UK GDP is expected to have risen by 0.4% in 2024 Q1 and to grow by 0.2% in Q2. Despite picking up during the forecast period, demand growth is expected to remain weaker than potential supply growth throughout most of that period. A margin of economic slack is projected to emerge during 2024 and 2025 and to remain thereafter, in part reflecting the continued restrictive stance of monetary policy.

With respect to indicators of inflation persistence, services consumer price inflation has declined but remains elevated, at 6.0% in March. There remains considerable uncertainty around statistics derived from the ONS Labour Force Survey. It is therefore more difficult to gauge the evolution of the labour market. Based on a broad set of indicators, the MPC judges that the labour market continues to loosen but that it remains relatively tight by historical standards. Annual private sector regular average weekly earnings growth declined to 6.0% in the three months to February, although that series tends to be volatile. Alternative indicators also suggest easing pay growth.

Twelve-month CPI inflation fell to 3.2% in March from 3.4% in February. CPI inflation is expected to return to close to the 2% target in the near term, but to increase slightly in the second half of this year, to around 2½%, owing to the unwinding of energy-related base effects. There continue to be upside risks to the near-term inflation outlook from geopolitical factors, although developments in the Middle East have had a limited impact on oil prices so far.

Conditioned on market interest rates and reflecting a margin of slack in the economy, CPI inflation is projected to be 1.9% in two years' time and 1.6% in three years in the May Report.

The MPC's remit is clear that the inflation target applies at all times, reflecting the primacy of price stability in the UK monetary policy framework. The framework recognises that there will be occasions when inflation will depart from the target as a result of shocks and disturbances. Monetary policy will ensure that CPI inflation returns to the 2% target sustainably in the medium term.

At this meeting, the Committee voted to maintain Bank Rate at 5.25%. Headline CPI inflation has continued to fall back, in part owing to base effects and external effects from goods prices. The restrictive stance of monetary policy is weighing on activity in the real economy, is leading to a looser labour market and is bearing down on inflationary pressures. Key indicators of inflation persistence are moderating broadly as expected, although they remain elevated.

Monetary policy will need to remain restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term in line with the MPC's remit. The Committee has judged since last autumn that monetary policy needs to be restrictive for an extended period of time until the risk of inflation becoming embedded above the 2% target dissipates.

The MPC remains prepared to adjust monetary policy as warranted by economic data to return inflation to the 2% target sustainably. It will therefore continue to monitor closely indications of persistent inflationary pressures and resilience in the economy as a whole, including a range of measures of the underlying tightness of labour market conditions, wage growth and services price inflation. The Committee will consider forthcoming data releases and how these inform the assessment that the risks from inflation persistence are receding. On that basis, the Committee will keep under review for how long Bank Rate should be maintained at its current level.

1: The economic outlook

Twelve-month CPI inflation remains above the MPC's 2% target, but it declined to 3½% in 2024 Q1, broadly in line with expectations in the February Report. Inflation is projected to return to close to the target throughout the second quarter of this year, before increasing slightly in Q3 and Q4, to around 2½%. This pickup is driven by energy price inflation, which is projected to become less negative during Q3 and Q4 compared with Q2 (Chart 1.1). CPI inflation excluding energy has fallen by less than headline inflation over recent quarters and is projected to be around 3% during the second half of the year, owing to the persistence of domestic inflationary pressures. Services CPI inflation is expected to continue to ease gradually from 6.0% in March, while private-sector regular pay growth is expected to slow to around 5% during the rest of this year.

The Committee expects second-round effects in domestic prices and wages to take longer to unwind than they did to emerge (Key judgement 3). The best collective judgement of the Committee is that these second-round effects are likely to fade slightly faster than assumed previously, pushing down on the latest CPI inflation projection during the third year of the forecast period. Conditioned on market interest rates and reflecting a margin of slack in the economy, CPI inflation is projected to be 1.9% in two years' time and 1.6% in three years.

There continue to be upside risks to the modal CPI inflation projection from geopolitical factors during the first half of the forecast period, but the risks overall are more evenly balanced over the second half.

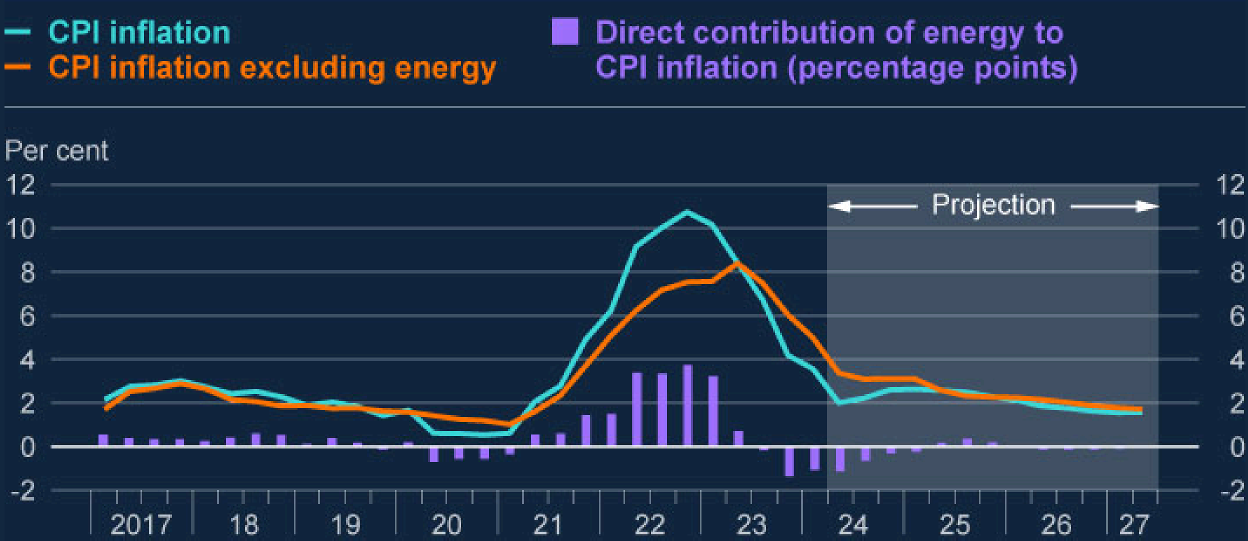
Following modest weakness last year, four-quarter GDP growth is expected to pick up during the forecast period (Key judgement 1). That reflects the fading negative impact on growth from past increases in Bank Rate and the downward-sloping market-implied path of forward interest rates, which begin to boost growth at the end of the period. Population growth is assumed to be higher throughout the forecast period. During the first half of the period, the pickup in growth also reflects fiscal policy and the boost to real incomes from the continued unwinding of the previous shocks to energy and other imported goods prices. Aggregate demand and supply are judged to be broadly in balance currently, but a margin of economic slack is projected to emerge during 2024 and 2025 and to remain thereafter, in part reflecting the continued restrictive stance of monetary policy (Key judgement 2). Unemployment is expected to rise somewhat.

Table 1.A: Forecast summary (a) (b)

	2024 Q2	2025 Q2	2026 Q2	2027 Q2
GDP (c)	0.2 (0.1)	0.9 (0.6)	1.2 (1)	1.6
CPI inflation (d)	2 (2)	2.6 (2.7)	1.9 (2.2)	1.6
Unemployment rate (e)	4.3 (4.4)	4.6 (4.8)	4.8 (5)	4.8
Excess supply/**Excess demand** (f)	-¼ (-¼)	-¾ (-¾)	-1¼ (-1)	-1
Bank Rate (g)	5.2 (5)	4.5 (3.7)	4 (3.3)	3.7

(a) Figures in parentheses show the corresponding projections in the February 2024 Monetary Policy Report.
(b) Unless otherwise stated, the numbers shown in this table are modal projections and are conditioned on the assumptions described in Section 1.1. The main assumptions are set out in **Monetary Policy Report – Download chart slides and data – May 2024**.
(c) Four-quarter growth in real GDP.
(d) Four-quarter inflation rate.
(e) ILO definition of unemployment. Although LFS unemployment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).
(f) Per cent of potential GDP. A negative figure implies output is below potential and a positive that it is above.
(g) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.

Chart 1.1: CPI inflation and CPI inflation excluding energy (a)



Sources: Bloomberg Finance L.P., ONS and Bank calculations.

(a) Energy prices include fuels and lubricants, electricity, gas and other fuels.

1.1: The conditioning assumptions underlying the MPC's projections

As set out in Table 1.B, the MPC's May projections are conditioned on:

- The higher paths for policy rates in advanced economies implied by financial markets, as captured in the 15-working day averages of forward interest rates to 29 April (Chart 2.7). The market-implied path for Bank Rate in the United Kingdom has risen by 0.7 percentage points on average over the next three years compared with the equivalent period at the time of the February Report. The path for Bank Rate underpinning the May projections declines from 5¼% to 3¾% by the end of the forecast period, compared with an endpoint of 3¼% in February.
- A path for the sterling effective exchange rate index that is broadly unchanged compared to the February Report. The exchange rate depreciates slightly over the forecast period, reflecting the role of expected interest rate differentials in the Committee's conditioning assumption.
- Wholesale energy prices that follow their respective futures curves over the forecast period. Since February, oil prices have risen somewhat and gas futures prices are broadly unchanged (Chart 2.3). Significant uncertainty remains around the outlook for wholesale energy prices, including related to recent geopolitical developments (Key judgement 3).
- UK household energy prices that move in line with Bank staff estimates of the Ofgem price cap implied by the path of wholesale gas and electricity prices (Section 2.4).
- Fiscal policy that evolves in line with announced UK government policies to date. As discussed in Section 2.3, additional measures were announced in Spring Budget 2024, including a further 2 pence cut in the main rate of employee and self-employed national insurance contributions from April 2024.
- The growth in the size and composition of the 16+ population implied by the ONS's 2021-based interim national population projections, which reflects international migration up to mid-2023. These data were published at the end of January 2024 and so were not incorporated into the MPC's February projections.

Table 1.B: Conditioning assumptions (a) (b)

	Average 1998–2007	Average 2010–19	2022	2023	2024	2025	2026
Bank Rate (c)	5.0	0.5	2.8	5.3	4.8 (4.2)	4.3 (3.4)	3.8 (3.2)
Sterling effective exchange rate (d)	100	82	78	81	82 (82)	82 (81)	81 (81)
Oil prices (e)	39	77	89	84	85 (76)	79 (73)	75 (71)
Gas prices (f)	29	52	201	101	88 (88)	91 (87)	79 (82)
Nominal government expenditure (g)	7¼	2¼	4	7.0	2½ (3)	2½ (2)	2¾ (2¾)

Sources: Bank of England, Bloomberg Finance L.P., Office for Budget Responsibility (OBR), ONS, Refinitiv Eikon from LSEG and Bank calculations.

(a) The table shows the projections for financial market prices, wholesale energy prices and government spending projections that are used as conditioning assumptions for the MPC's projections for CPI inflation, GDP growth and the unemployment rate. Figures in parentheses show the corresponding projections in the February 2024 Report.
(b) Financial market data are based on averages in the 15 working days to 29 April 2024. Figures show the average level in Q4 of each year, unless otherwise stated.
(c) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.
(d) Index. January 2005 = 100. The convention is that the sterling exchange rate follows a path that is halfway between the starting level of the sterling ERI and a path implied by interest rate differentials.
(e) Dollars per barrel. Projection based on monthly Brent futures prices.
(f) Pence per therm. Projection based on monthly natural gas futures prices.
(g) Annual average growth rate. Nominal general government consumption and investment. Projections are based on the OBR's March 2024 Economic and Fiscal Outlook. Historical data based on NMRP+D7QK.

1.2: Key judgements and risks

1.2: Key judgement 1

Following modest weakness last year, four-quarter GDP growth is expected to pick up during the forecast period.

UK GDP is expected to have risen by 0.4% in 2024 Q1 and to grow by 0.2% in Q2, stronger than expected in the February Report (Section 2.3). That follows weaker than expected GDP in the second half of last year, however, leaving activity at a similar level by the middle of this year as in the February projection. Household consumption was also weak during the second half of last year, but is expected to pick up throughout 2024, supported by a continued recovery in real incomes. That in turn partly reflects the continued unwinding of the shocks to energy and other imported goods prices experienced over recent years, and the effect of lower national insurance contributions. Real post-tax labour income is now expected to grow by over 3% in 2024 as a whole (Table 1.D).

The policies announced in the Spring Budget, including the further reduction in national insurance contributions, are expected to boost the level of GDP by over ¼% relative to the February Report projections. As these measures are also likely to boost potential supply, including through higher labour market participation, the implications for the MPC's output gap projection (Key judgement 2), and hence inflationary pressures in the economy, are projected to be smaller.

After taking account of all announced government plans, and given that the impact of past fiscal loosening measures, including those related to the pandemic and the energy price shock, continues to fade, the stance of fiscal policy tightens over the projection. This pulls down on the Committee's GDP growth projection beyond the near term.

Based on the average relationships over the past between Bank Rate and economic activity, Bank staff estimate that under current and expected financial conditions around two thirds of the peak domestic impact of higher interest rates on the level of GDP has come through. The negative impact on the level of GDP from the remaining pass-through continues to build over the first half of the forecast period. There is nevertheless a fading negative impact on the rate of GDP growth from past increases in Bank Rate and the downward-sloping market-implied path of forward interest rates, which begin to boost growth at the end of the period.

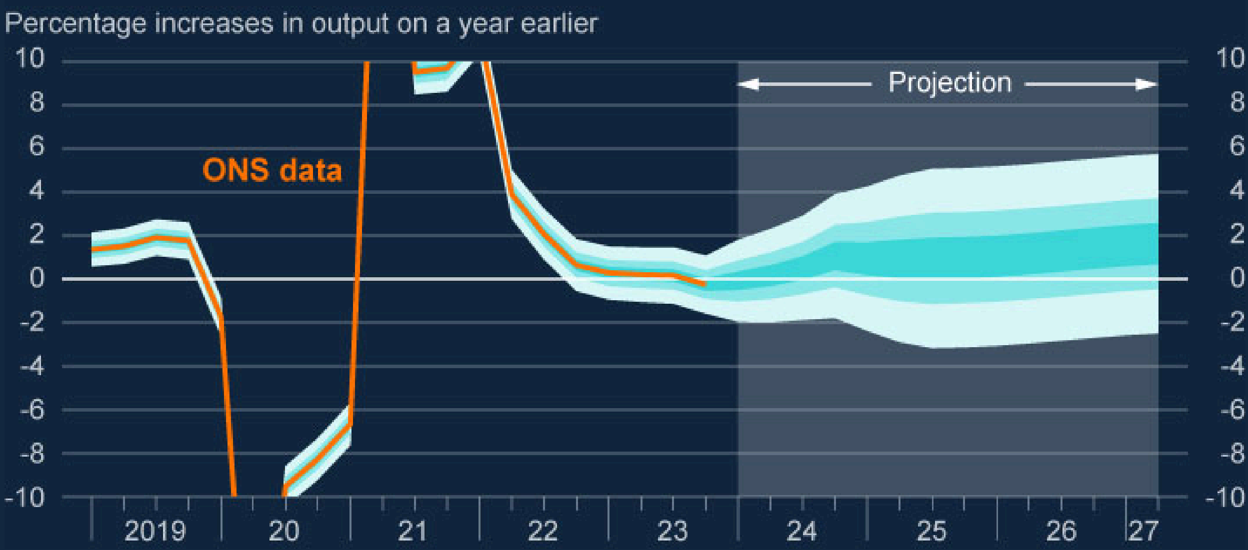
As discussed in the previous Report, the ONS's updated population projections were not available in time to be reflected in the Committee's February supply-side stocktake. The May projections are now conditioned on the most recent ONS population projections (Section 1.1), run forward after taking account of the starting point implied by the latest LFS population data (Box D). For example, the 16+ population is now assumed to rise by around 1% per year in the medium term, compared with around ¾% previously. All else equal, this raises significantly the paths of labour supply and potential output over the forecast period, relative to the February Report. In the May projection, aggregate supply growth is projected to rise to around 1¾% in the middle of the forecast period and to average 1½% over the next three years. A higher path for the population is assumed to have similar impacts on both supply and demand, and thus only a limited impact on spare capacity in the economy (Key judgement 2). Further upward revisions to the LFS population data are to be expected in the future.

There remain notable differences in patterns of international economic activity, with recent growth outturns tending to be stronger in the US and weaker in the euro area (Section 2.1). Activity in the euro area is projected to pick up in the near term, accounted for by the fading impact of tighter monetary policy and by stronger real incomes. US GDP growth is expected to slow somewhat over the forecast period, as the boost from consumer dis-saving fades and as potential supply growth, which has been strong, falls back to more normal rates. In the May Report, the path of global growth is broadly similar to February. Annual UK-weighted world GDP growth is projected to rise in the medium term, to slightly below its average rate in the decade prior to the pandemic (Table 1.D).

Overall, in the Committee's May projection, UK four-quarter GDP growth is projected to pick up during the forecast period, to just over 1½% by the end of the forecast period (Chart 1.2). That reflects the fading negative impact on growth from past increases in Bank Rate and the downward-sloping market-implied path of forward interest rates, which begin to boost growth at the end of the period. Population growth is assumed to be higher throughout the forecast period. During the first half of the period, the pickup in GDP growth also reflects fiscal policy and the boost to real incomes from the continued unwinding of the previous shocks to energy and other imported goods prices.

Relative to the February Report projection, the level of GDP has been revised up by around ½% by the end of the forecast period, accounted for by stronger assumed population growth and the fiscal loosening measures in the Spring Budget. Compared with February, the rise in the market path of interest rates over recent months pushes down on GDP, all else equal, although this is partly offset by developments in other financial conditions.

Chart 1.2: GDP growth projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on Bank Rate following a path implied by market yields, but allows the Committee's judgement on the risks around the other conditioning assumptions set out in Section 1.1, including wholesale energy prices, to affect the calibration of the fan chart skew. To the left of the shaded area, the distribution reflects uncertainty around revisions to the data over the past. To the right of the shaded area, the distribution reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter aqua areas on 30 occasions. In any particular quarter of the forecast period, GDP growth is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP growth can fall anywhere outside the aqua area of the fan chart. Over the forecast period, this has been depicted by the grey background. See the Box on page 39 of the November 2007 Inflation Report for a fuller description of the fan chart and what it represents. The y-axis of the chart has been truncated to illustrate more clearly the current uncertainty around the path of GDP growth, as otherwise this would be obscured by the volatility of GDP growth during the pandemic.

In the GDP projection conditioned on the alternative assumption of constant interest rates at 5.25% over the forecast period, growth is weaker compared with the MPC's projection conditioned on the declining path of market-implied rates.

The risks around the projection for UK GDP growth are judged to be broadly balanced.

There are risks in both directions around the central projections for domestic spending and GDP. The Committee will continue to monitor closely the impact of past increases in Bank Rate, including the channels through which house prices affect consumer spending. In the near term, there may be upside risks to GDP growth from stronger demand if some households choose to save less or run down existing stocks of savings to a greater extent. Respondents to the latest Bank/NMG survey have become more optimistic about their job security, financial prospects and expected real income growth. Set against that, the Bank's Agents have reported subdued consumer demand at the start of this year (Box E). And the household saving ratio is expected to be downward sloping in the medium term, which may not arise given the projected rising path of unemployment (Key judgement 2).

Internationally, the risk of higher commodity prices and disruption to trade flows associated with developments in the Middle East could lead to weaker economic activity as well as greater external inflationary pressures (Key judgement 3). There is also a downside risk to global growth if domestic demand in China proves to be softer than expected, for example due to weakness in the property sector.

1.2: Key judgement 2

Aggregate demand and supply are judged to be broadly in balance currently, but a margin of economic slack is projected to emerge during 2024 and 2025 and to remain thereafter, in part reflecting the continued restrictive stance of monetary policy. Unemployment is expected to rise somewhat.

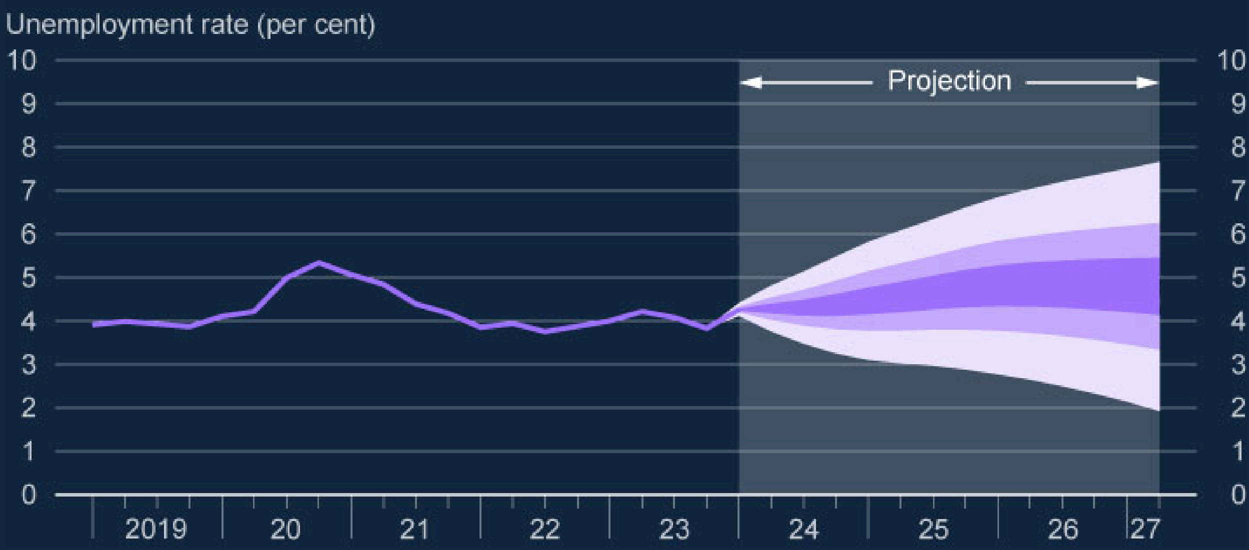
Following a period over the past couple of years in which the economy was operating with excess demand, aggregate demand and supply are judged to be broadly in balance currently. Over the past year, businesses appear to have responded to short-term weakness in demand by retaining their existing employees, while using them somewhat less intensively.

The MPC is continuing to consider the collective steer from a wide range of data to inform its view on labour market developments. As discussed in Box D, there remains considerable uncertainty around statistics derived from the ONS Labour Force Survey, making it more difficult to gauge the evolution of the labour market. Although work is underway to replace it, the LFS will remain a key source of labour market data for some time to come. The latest LFS data appear to suggest that the unemployment rate has increased slightly over the past year, but that there is no longer any sign that the inactivity rate has fallen over the same period (Chart 2.14). Underlying employment growth has slowed but remained positive in recent quarters. Overall, based on a broad set of indicators, the MPC judges that the labour market continues to loosen but that it remains relatively tight by historical standards.

Despite picking up during the forecast period, demand growth is expected to remain weaker than potential supply growth throughout most of that period, such that a margin of economic slack is projected to emerge during 2024 and 2025 and to remain thereafter. That in part reflects the continued restrictive stance of monetary policy. Aggregate excess supply is expected to reach around 1¼% of potential GDP by the start of 2026, compared with around 1% of GDP in the February Report. This slightly greater margin of excess supply relative to February reflects the impact on demand from the recent rise in the market path of interest rates.

Uncertainty around LFS data notwithstanding, the unemployment rate is projected to rise somewhat over the first half of the forecast period, such that it exceeds the assumed medium-term equilibrium rate of just over 4½% by the middle of next year. The unemployment rate reaches around 4¾% by the end of 2025 (Chart 1.3), a slightly lower path for unemployment than in the February Report. Some of the slack in the labour market that is expected to emerge over the forecast period also reflects weakness in the participation rate. Employment growth is stronger than in the February Report throughout the forecast period, reflecting the updated population growth assumption.

Chart 1.3: Unemployment rate projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various future outcomes for the ILO definition of unemployment and begins in 2024 Q1. Although LFS unemployment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D). The fan chart has been conditioned on Bank Rate following a path implied by market yields, but allows the Committee's judgement on the risks around the other conditioning assumptions set out in Section 1.1, including wholesale energy prices, to affect the calibration of the fan chart skew. The coloured bands have the same interpretation as in Chart 1.2 and portray 90% of the probability distribution. A significant proportion of this distribution lies below Bank staff's current estimate of the long-term equilibrium unemployment rate. There is therefore uncertainty about the precise calibration of this fan chart.

In projections conditioned on the alternative assumption of constant interest rates at 5.25% over the forecast period, the unemployment rate rises to a greater extent compared with the MPC's projection conditioned on market rates.

The risks around the unemployment rate projection are judged to be broadly balanced.

Reflecting the continuing uncertainties around interpreting estimates from the LFS, there are risks in both directions around the recent path of the unemployment rate, and hence the outlook for unemployment and labour market tightness. The labour market could remain tighter or looser than assumed for a number of economic reasons, including the risks around the outlook for demand (Key judgement 1). There is also continuing significant uncertainty around the Committee's assumptions for the path of the equilibrium rate of unemployment, news in which would, holding demand fixed, have implications for labour market tightness and inflationary pressures.

Based on the data available at the time of its supply stocktake published in the February Report, the MPC judged that the Covid-related drag on potential participation might be unwinding faster than anticipated. This now stands in contrast to the latest indications from the aggregate LFS participation series. There are considerable uncertainties around these data, however, and an alternative approach suggests that the participation rate could be significantly higher than currently estimated (Section 2.3).

1.2: Key judgement 3

CPI inflation is expected to return to close to the 2% target in the near term, but to increase slightly in the second half of this year owing to the unwinding of energy-related base effects, which reveals the persistence of domestic inflationary pressures. The Committee expects second-round effects in domestic prices and wages to take longer to unwind than they did to emerge. The best collective judgement of the Committee is that these second-round effects are likely to fade slightly faster than assumed previously, pushing down on the latest CPI inflation projection during the third year of the forecast period.

Twelve-month CPI inflation remains above the MPC's 2% target, but it declined to 3½% in 2024 Q1 and to 3.2% in March, broadly in line with expectations in the February Report. Inflation is projected to return to close to the 2% target throughout the second quarter of this year, before increasing slightly in Q3 and in Q4, to around 2½%. This profile of CPI inflation over the second half of the year is more than accounted for by developments in the direct energy price contribution to 12-month inflation, which is projected to become less negative during Q3 and Q4 compared with Q2 (Chart 1.1). CPI inflation excluding energy is projected to be around 3% during the second half of the year, owing to the persistence of domestic inflationary pressures.

As part of the May forecast round, Bank staff have reviewed the degree to which past increases in import prices are yet to pass through to consumer prices. Based on recent developments in producer and consumer goods prices, the MPC now judges that a greater proportion of that pass-through has occurred already, relative to the assumptions incorporated into previous inflation projections. A shorter than usual lag between changes in import and consumer prices may have reflected the nature of the external shock, including that it was associated with acute shortages of products. This was a large external cost shock facing almost all companies in some form. This behaviour may have reflected domestic economic conditions to some extent as well, as companies were likely to have had greater than usual pricing power to pass on cost increases. As a result of this change in judgement, external inflationary pressures on the CPI are likely to be somewhat weaker than previously assumed, particularly during the first half of the forecast period.

The MPC is continuing to monitor closely indications of persistent inflationary pressures and resilience in the UK economy as a whole, including a range of measures of the underlying tightness of labour market conditions (Key judgement 2), wage growth and services price inflation.

Services CPI inflation fell to 6.0% in March, slightly higher than expected in the February Report. Higher-frequency measures of services price inflation show a somewhat greater slowdown than annual rates but still indicate elevated domestic inflationary pressures (Section 3.3). Services inflation is expected to continue to ease gradually over the course of this year, as wage growth and indirect effects from energy and other goods prices weaken further.

Annual private sector regular AWE growth declined to 6.0% in the three months to February, slightly higher than expected in the February Report, and broadly in line with alternative indicators of wage growth. Recent outturns in wage growth have continued to be stronger than standard models would have predicted (Chart 3.10). Private sector regular AWE growth is nevertheless expected to slow further in the near term, to around 5% during the rest of this year, compared with 4¾% in the February Report.

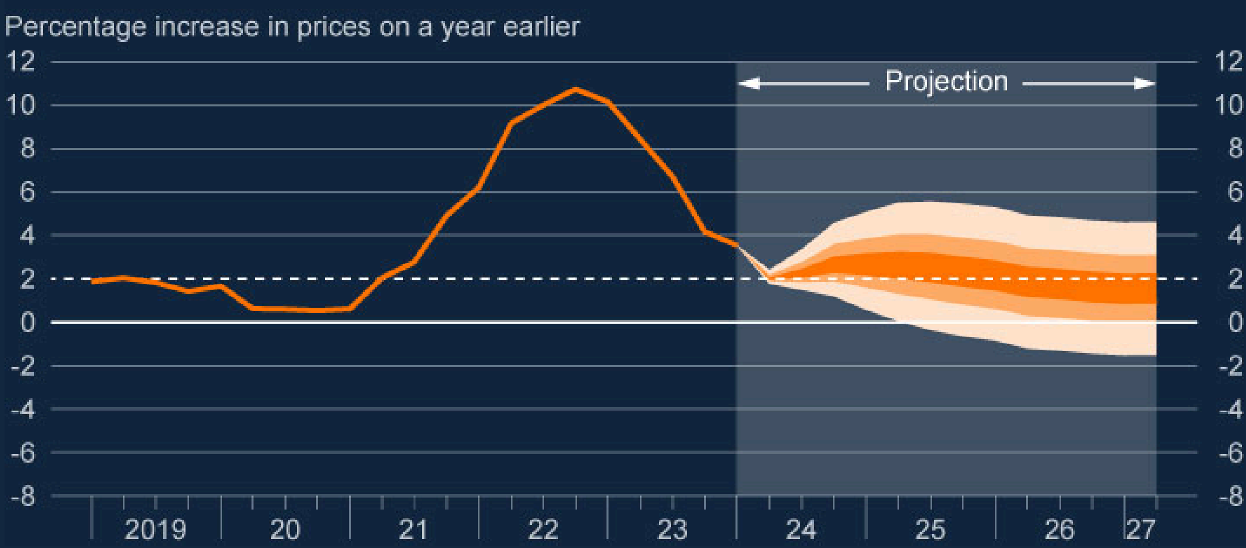
As part of this forecast round, the Committee has reviewed its judgement that second-round effects in wages and domestic prices will take longer to unwind than they did to emerge. Specifically, the February CPI inflation projection assumed that this metric of the degree of excess persistence would build marginally further in the near term before tapering off over coming years but remaining present at the end of the forecast period. Based on the latest evidence and modelling presented by Bank staff (Section 3), the best collective judgement of the Committee is that these second-round effects on domestic prices and wages are likely to fade slightly faster than assumed previously, pushing down on the latest CPI inflation projection during the third year of the forecast period. There remains considerable uncertainty around the calibration of this judgement and a range of views among MPC members (as set out in the subsequent risks sub-section).

In the MPC's modal, or most likely, projection conditioned on the higher market-implied path of interest rates as captured in the 15-working day average to 29 April, CPI inflation increases from close to the 2% target in 2024 Q2 to around 2½% at the turn of the year. Reflecting the continued restrictive stance of monetary policy and a margin of slack in the economy (Key judgement 2), CPI inflation then falls back again, to 1.9% in two years' time and to 1.6% in three years (Table 1.C and Chart 1.4).

The May CPI inflation projection has a broadly similar trajectory to the February projection, but it is slightly lower next year and, to a somewhat greater extent, in the medium term, reaching the 2% target two quarters earlier than in February. This lower profile in part reflects weaker external inflationary pressures following the Committee's revised judgement on the pace of previous import price pass-through. In the medium term, it also reflects the building impact on inflation of a slightly greater margin of excess supply in this forecast conditioned on the latest market interest rate path, and the Committee's judgement to unwind slightly earlier in this forecast its judgement on the degree of medium-term persistence in domestic prices.

In the MPC's May projection, private sector regular AWE growth falls further during 2025 and reaches just under 3% by the end of the forecast period, as short-term inflation expectations are assumed to fall back further and a margin of spare capacity is expected to open up in the labour market in the medium term (Key judgement 2). This is a similar medium-term profile for AWE growth as in the February Report.

Chart 1.4: CPI inflation projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various future outcomes for CPI inflation and begins in 2024 Q2. It has been conditioned on Bank Rate following a path implied by market yields, but allows the Committee's judgement on the risks around the other conditioning assumptions set out in Section 1.1, including wholesale energy prices, to affect the calibration of the fan chart skew. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter orange areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the orange area of the fan chart. Over the forecast period, this has been depicted by the grey background. See the Box on pages 48–49 of the May 2002 Inflation Report for a fuller description of the fan chart and what it represents.

Table 1.C: The quarterly modal projection for CPI inflation based on market rate expectations (a)

	2024 Q2	2024 Q3	2024 Q4	2025 Q1	2025 Q2
CPI inflation	2.0	2.2	2.6	2.6	2.6
	2025 Q3	**2025 Q4**	**2026 Q1**	**2026 Q2**	
CPI inflation	2.5	2.3	2.1	1.9	
	2026 Q3	**2026 Q4**	**2027 Q1**	**2027 Q2**	
CPI inflation	1.8	1.6	1.5	1.6	

(a) Four-quarter inflation rate.

In the modal projection conditioned on the alternative assumption of constant interest rates at 5.25% over the forecast period, CPI inflation is expected to fall below 2% from 2025 Q4 onwards. This path is lower than the Committee's modal projection conditioned on market rates.

> **There continue to be upside risks to the modal CPI inflation projection from geopolitical factors during the first half of the forecast period, but the risks overall are more evenly balanced over the second half.**

There are near-term risks in both directions around the path of CPI inflation from domestic factors, including related to developments later this year in pay settlements and in companies' price-setting behaviour. The Bank's Agents continue to report that settlements will average around 5½% this year, with higher outturns expected in consumer-facing sectors owing to the impact of the increase in the National Living Wage. The latest Agency intelligence also suggests, however, that companies' relatively downbeat view of recent consumer demand could limit the extent to which they are able to pass on increases in costs to their prices.

In the medium term, there are also risks around the judgement that second-round effects in domestic prices and wages take longer to unwind than they did to emerge.

To the downside, the recent accumulation of evidence could support an earlier tapering of the Committee's persistence judgement than has been incorporated into the May projection during the third year of the forecast period. As headline inflation and short-term inflation expectations fall further (Section 2.5), inflationary dynamics could adjust as rapidly on the downside as they did on the upside. Less persistence could also reflect the continued unwind of the previous shocks to energy and other imported goods prices, which may be limiting the extent to which employees and domestic firms are seeking higher nominal pay and domestic selling prices to recover the reductions in real incomes that they experienced in the past.

To the upside, in the absence of clear evidence from recent developments that domestic inflationary pressures have moderated significantly, there could be a case for maintaining the previous persistence judgement from the February Report across the full forecast period. The possibility of some upside risks to demand or downside risks to supply could, via a smaller margin of spare capacity in the economy and given a relatively tight starting point for the labour market, also motivate a higher medium-term profile for domestically generated inflation.

Overall, the risks around the Committee's latest best collective judgement on the persistence of domestic price pressures are evenly balanced, following an extended period in 2022–23 during which they were skewed to the upside.

There remain upside risks around the modal projection for UK CPI inflation from international factors. Geopolitical risks have intensified following events in the Middle East, although there has so far been a relatively limited impact on trade and oil prices. The impact of a further intensification on oil prices could, over a number of quarters, be mitigated to some extent by flexibility in other sources of oil production. Nevertheless, in an adverse scenario, oil prices could still increase significantly in the short run, alongside greater disruption to all types of trade flowing through the Red Sea. If this were to be amplified by other financial market and economic channels including additional second-round effects on domestic wages and prices, it could lead to a material upward impact on UK CPI inflation over the first half of the forecast period relative to the modal projection. Set against that, recent weakness in Chinese export prices could pose a modest downside risk to UK inflation if it were to intensify, for example alongside softer Chinese activity.

Table 1.D: Indicative projections consistent with the MPC's modal forecast (a) (b)

	Average 1998–2007	Average 2010–19	2022	2023	2024	2025	2026
World GDP (UK-weighted) (c)	**3**	**2½**	**3**	**1¾**	**2 (1¾)**	**2 (2¼)**	**2¼ (2¼)**
World GDP (PPP-weighted) (d)	4	3¾	3½	3	3¼ (3)	3 (3)	3 (3)
Euro-area GDP (e)	2¼	1½	3½	½	½ (¾)	1½ (1¾)	1¾ (1¾)
US GDP (f)	3	2½	2	2½	2¾ (2)	1½ (1½)	2 (1¾)
Emerging market GDP (PPP-weighted) (g)	5½	5	4	4¼	4¼ (3¾)	4 (4)	3¾ (4)
of which, China GDP (h)	10	7¾	3	3	5¼ (4½)	4¼ (4¼)	4 (4¼)

UK GDP (i)	**2¾**	**2**	**4¼**	**0**	**½ (¼)**	**1 (¾)**	**1¼ (1)**
Household consumption (j)	3¼	2	5	¼	¼ (-¼)	1¼ (¾)	1¾ (1¾)
Business investment (k)	3	4¼	9½	5½	0 (-2½)	1¼ (¾)	3½ (3¾)
Housing investment (l)	3¼	4	9½	-7½	-4 (-5)	-¼ (½)	-1 (½)
Exports (m)	4½	3½	9	-½	2 (-¼)	1¼ (1)	1 (1)
Imports (n)	6	4	14¾	-1½	½ (-½)	2½ (1¾)	2¼ (2¾)
Contribution of net trade to GDP (o)	-¼	-¼	-1¾	¼	½ (0)	-½ (-¼)	-½ (-½)
Real post-tax labour income (p)	3¼	1½	-2½	¾	3¼ (2)	1¼ (½)	¼ (-¼)
Real post-tax household income (q)	3	1½	¼	1¾	1¾ (½)	1 (¼)	½ (0)
Household saving ratio (r)	7¼	7¾	8¼	9¾	11 (10¼)	11 (9¾)	9¾ (8½)
Credit spreads (s)	¾	2½	1	¾	1 (1¼)	1¼ (1½)	1½ (1½)
Excess supply/**Excess demand** (t)	0	-1¾	**1½**	½	-¼ (-¼)	-1 (-¾)	-1¼ (-1)
Hourly labour productivity (u)	2¼	½	¼	-¼	-¼ (½)	1¼ (1¼)	¾ (1)
Employment (v)	1	1¼	1¼	¼	0 (-½)	½ (-¼)	¾ (¼)
Average weekly hours worked (w)	32¼	32	31¾	31½	31¾ (31¾)	31¾ (31¾)	31¾ (31¾)
LFS unemployment rate (x)	5¼	6	4	3¾	4¼ (4½)	4¾ (5)	4¾ (5)

Participation rate (y)	63	63½	63	62¾	62¾ (63¼)	62½ (62¾)	62½ (62¾)
CPI inflation (z)	**1½**	**2¼**	**10¾**	**4¼**	**2½ (2¾)**	**2¼ (2½)**	**1½ (2)**
UK import prices (aa)	-¼	1¼	12½	½	-1¾ (-1¾)	-¼ (¾)	-¼ (0)
Energy prices – direct contribution to CPI inflation (ab)	¼	¼	3¾	-1¼	-¼ (-¼)	¼ (¼)	0 (0)
Average weekly earnings (AWE) (ac)	4¼	2	6¼	5¾	5¼ (4)	2¼ (2¾)	1½ (1¾)
Unit labour costs (ad)	3	1¼	7¼	6¾	3½ (2¾)	1¾ (1¾)	¾ (¾)
Private sector regular pay-based unit wage costs (ae)	2	1½	6¾	7¼	3¾ (3¼)	2¾ (2)	1¾ (1½)

Sources: Bank of England, Bloomberg Finance L.P., Department for Energy Security and Net Zero, Eurostat, IMF World Economic Outlook (WEO), National Bureau of Statistics of China, ONS, US Bureau of Economic Analysis and Bank calculations.

(a) The profiles in this table should be viewed as broadly consistent with the MPC's projections for GDP growth, CPI inflation and unemployment (as presented in the fan charts).
(b) Figures show annual average growth rates unless otherwise stated. Figures in parentheses show the corresponding projections in the February 2024 Monetary Policy Report. Calculations for back data based on ONS data are shown using ONS series identifiers.
(c) Chained-volume measure. Constructed using real GDP growth rates of 188 countries weighted according to their shares in UK exports.
(d) Chained-volume measure. Constructed using real GDP growth rates of 189 countries weighted according to their shares in world GDP using the IMF's purchasing power parity (PPP) weights.
(e) Chained-volume measure. The forecast was finalised before the release of the preliminary flash estimate of euro-area GDP for Q1, so that has not been incorporated.
(f) Chained-volume measure. The forecast was finalised before the release of the advance estimate of US GDP for Q1, so that has not been incorporated.
(g) Chained-volume measure. Constructed using real GDP growth rates of 155 emerging market economies, weighted according to their relative shares in world GDP using the IMF's PPP weights.
(h) Chained-volume measure.
(i) Excludes the backcast for GDP.
(j) Chained-volume measure. Includes non-profit institutions serving households. Based on ABJR+HAYO.
(k) Chained-volume measure. Based on GAN8.
(l) Chained-volume measure. Whole-economy measure. Includes new dwellings, improvements and spending on services associated with the sale and purchase of property. Based on DFEG+L635+L637.
(m) Chained-volume measure. The historical data exclude the impact of missing trader intra-community (MTIC) fraud. Since 1998 based on IKBK-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBK.

(n) Chained-volume measure. The historical data exclude the impact of MTIC fraud. Since 1998 based on IKBL-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBL.
(o) Chained-volume measure. Exports less imports.
(p) Wages and salaries plus mixed income and general government benefits less income taxes and employees' National Insurance contributions, deflated by the consumer expenditure deflator. Based on [ROYJ+ROYH-(RPHS+AIIV-CUCT)+GZVX]/[(ABJQ+HAYE)/(ABJR+HAYO)]. The backdata for this series are available at **Monetary Policy Report – Download chart slides and data – May 2024**.
(q) Total available household resources, deflated by the consumer expenditure deflator. Based on [RPQK/((ABJQ+HAYE)/(ABJR+HAYO))].
(r) Annual average. Percentage of total available household resources. Based on NRJS.
(s) Level in Q4. Percentage point spread over reference rates. Based on a weighted average of household and corporate loan and deposit spreads over appropriate risk-free rates. Indexed to equal zero in 2007 Q3.
(t) Annual average. Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.
(u) GDP per hour worked. Hours worked based on YBUS.
(v) Four-quarter growth in the ILO definition of employment in Q4 (MGRZ). Although LFS employment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).
(w) Level in Q4. Average weekly hours worked, in main job and second job. Based on YBUS/MGRZ.
(x) ILO definition of unemployment rate in Q4 (MGSX). Although LFS unemployment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).
(y) ILO definition of labour force participation in Q4 as a percentage of the 16+ population (MGWG). Although LFS participation data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).
(z) Four-quarter inflation rate in Q4.
(aa) Four-quarter inflation rate in Q4 excluding fuel and the impact of MTIC fraud.
(ab) Contribution of fuels and lubricants and gas and electricity prices to four-quarter CPI inflation in Q4.
(ac) Four-quarter growth in whole-economy total pay in Q4. Growth rate since 2001 based on KAB9. Prior to 2001, growth rates are based on historical estimates of AWE, with ONS series identifier MD9M.
(ad) Four-quarter growth in unit labour costs in Q4. Whole-economy total labour costs divided by GDP at constant prices. Total labour costs comprise compensation of employees and the labour share multiplied by mixed income.
(ae) Four-quarter growth in private sector regular pay-based unit wage costs in Q4. Private sector wage costs divided by private sector output at constant prices. Private sector wage costs are average weekly earnings (excluding bonuses) multiplied by private sector employment.

Box A: Monetary policy since the February 2024 Report

At its meeting ending on 20 March 2024, the MPC voted by a majority of 8–1 to maintain Bank Rate at 5.25%. One member preferred to reduce Bank Rate by 0.25 percentage points, to 5%.

Since the MPC's previous meeting, market-implied paths for advanced economy policy rates had shifted up. In the United States and the euro area, inflationary pressures had continued to abate, though by slightly less than expected. Material risks remained, notably from developments in the Middle East including disruption to shipping through the Red Sea.

Having declined through the second half of last year, UK GDP and market-sector output were expected to start growing again during the first half of this year. Business surveys remained consistent with an improving outlook for activity.

The fiscal measures in the Spring Budget 2024 were likely to increase the level of GDP by around ¼% over coming years. As the measures would probably also boost potential supply to some extent, the implications for the output gap, and hence inflationary pressures in the economy, were likely to be smaller.

Reflecting uncertainties around the ONS's Labour Force Survey, the Committee continued to consider a wide range of indicators of labour market activity. The labour market had continued to loosen but remained relatively tight by historical standards. Although still elevated, nominal wage growth had moderated across a number of measures. Contacts of the Bank's Agents continued to expect some decline in pay settlements this year and to report greater difficulty in passing on cost increases to prices.

Twelve-month CPI inflation had fallen to 3.4% in February from 4.0% in January and December, a little below the expectation in the February Monetary Policy Report. Services consumer price inflation had declined but remained elevated, at 6.1% in February. Most indicators of short-term inflation expectations had continued to ease.

CPI inflation was projected to fall to slightly below the 2% target in 2024 Q2, marginally weaker than previously expected owing to the freeze in fuel duty announced in the Budget. In the February Report projection, CPI inflation had been expected to increase slightly again in Q3 and Q4, accounted for by the direct energy price contribution to 12-month inflation. Services price inflation was expected to fall back gradually.

Headline CPI inflation had continued to fall back relatively sharply in part owing to base effects and external effects from energy and goods prices. The restrictive stance of monetary policy was weighing on activity in the real economy, leading to a looser labour market and bearing down on inflationary pressures. Nonetheless, key indicators of inflation persistence remained elevated.

Monetary policy would need to remain restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term in line with the MPC's remit. The Committee had judged since last autumn that monetary policy needed to be restrictive for an extended period of time until the risk of inflation becoming embedded above the 2% target dissipated.

The MPC remained prepared to adjust monetary policy as warranted by economic data to return inflation to the 2% target sustainably. It would therefore continue to monitor closely indications of persistent inflationary pressures and resilience in the economy as a whole, including a range of measures of the underlying tightness of labour market conditions, wage growth and services price inflation. On that basis, the Committee would keep under review for how long Bank Rate should be maintained at its current level.

2: Current economic conditions

Global activity is expected to grow by around 2% over 2024, but geopolitical developments still present a key source of uncertainty for trade and energy prices. Oil prices have risen since the previous Report, albeit only to around their levels six months ago, while gas prices are little changed. Advanced economy labour markets continue to show some signs of loosening and wage pressures have been easing from elevated levels. Headline consumer price inflation has been on a downward trend across advanced economies over the past year or so, although there have been some upside surprises to inflation in the US recently, where indicators of activity have tended to be firmer than elsewhere. Services price inflation remains high across advanced economies. The paths implied by financial markets suggest that policy rates are likely to be reduced across advanced economies in coming quarters.

UK GDP contracted in the second half of last year. But growth is now expected to be firmer in the first half of 2024, supported by rising real incomes, leaving activity at a similar level by the middle of the year to that in the February projection.

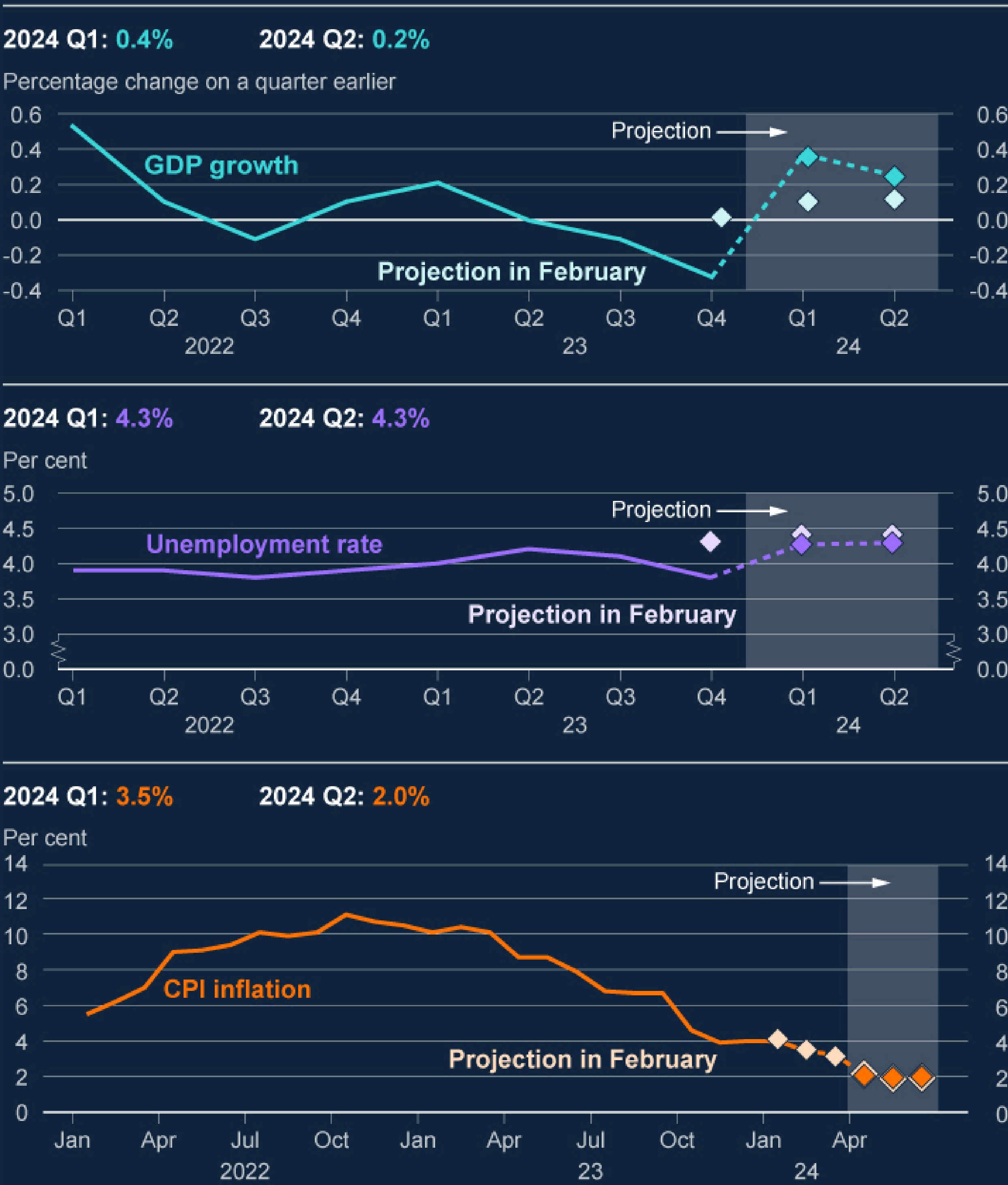
While there is much greater than usual uncertainty around the evolution of the labour market, underlying employment growth appears to have slowed. Nonetheless, it has been positive in recent quarters and the labour market remains relatively tight by historical standards. Looking forward, despite some acceleration in output, the labour market is expected to continue to loosen over coming quarters and unemployment drifts higher.

Annual private sector regular average weekly earnings (AWE) growth fell to 6% in the three months to February, with the latest rate broadly consistent with the steer from other pay indicators. While that was a little higher than expected in the February Report, growth is still expected to continue to moderate over 2024.

UK CPI inflation has evolved broadly in line with expectations. Twelve-month consumer price inflation fell to 3.2% in March, driven by base effects and some moderation in the strength of price increases more recently. CPI inflation is projected to fall to around the 2% target in 2024 Q2 before picking back up slightly during the second half of this year. Core goods and food price inflation are expected to continue to ease. While services inflation is expected to remain elevated, it is projected to fall below 5% in September.

Chart 2.1: In the MPC's latest projections, GDP recovers in 2024 H1 following weakness in 2023, the unemployment rate rises in 2024 Q1 and CPI inflation falls to around the 2% target from April

Near-term projections (a)



Sources: ONS and Bank calculations.

(a) The lighter diamonds show Bank staff's projections at the time of the February 2024 Monetary Policy Report. The darker diamonds show Bank staff's current projections. Projections for GDP growth and the unemployment rate are quarterly and show 2024 Q1 and Q2 (February projections show 2023 Q4 to 2024 Q2). Projections for CPI inflation are monthly and show April to June 2024 (February projections show January to June 2024). The GDP growth and unemployment rate projections for 2024 Q1 are based on official data to February, while the CPI inflation figure is an outturn. Although LFS unemployment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).

2.1: Global economy and financial markets

Global activity is expected to grow modestly in the near term.

Demand conditions in other countries are an important determinant of UK trading prospects. UK-weighted world GDP, which weights countries according to their shares in UK exports, grew by 1.8% in the four quarters to 2023 Q4. There were notable differences in growth across regions during 2023, with growth stronger in the US and weaker in the euro area (Chart 2.2). World GDP is projected to have grown by 0.5% on the quarter in 2024 Q1, and is projected to grow at a similar rate over the remainder of this year.

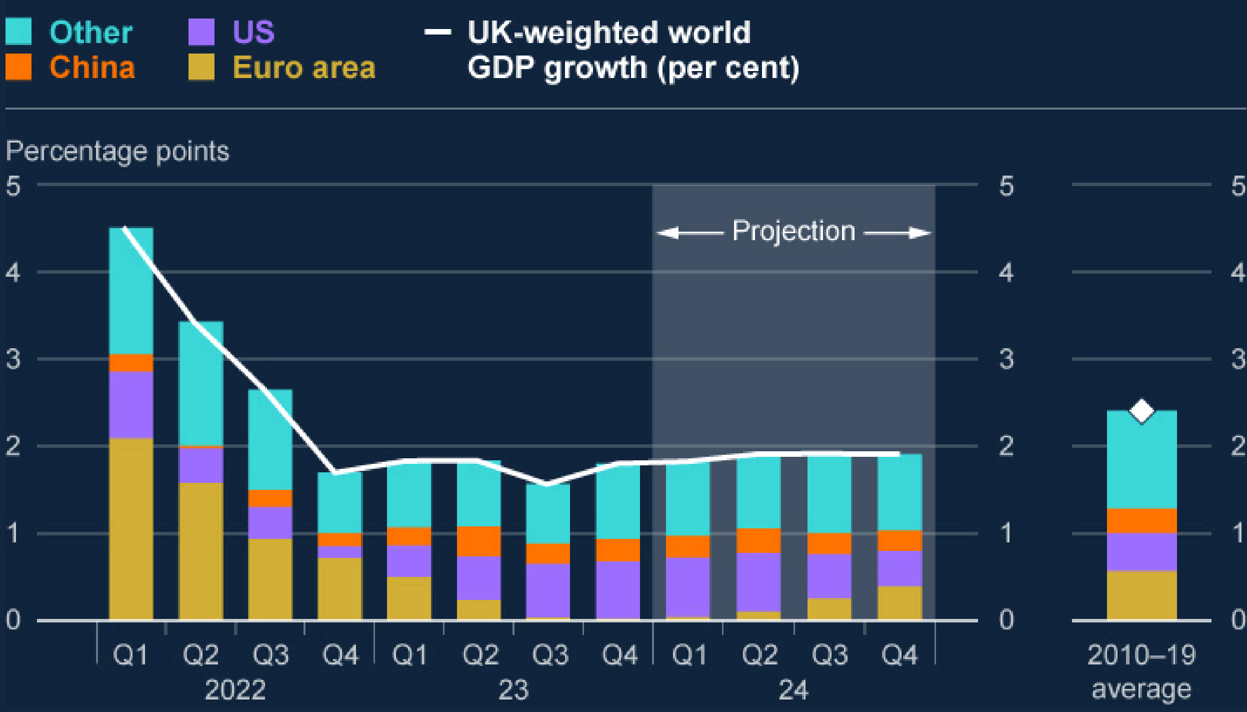
US GDP grew by 0.8% in the final quarter of 2023, higher than anticipated in the February Report. Faster supply growth appears to have contributed to the recent strength in US GDP growth, with upside news in net migration, labour force participation and productivity over the past year. Advance estimates suggest US GDP growth moderated to 0.4% in 2024 Q1. Quarterly US GDP growth is projected to average a similar pace throughout the remainder of 2024.

According to the preliminary flash release, euro-area GDP grew by 0.3% in 2024 Q1 following a contraction of 0.1% in 2023 Q4. Euro-area growth over the course of this year is expected to be supported by a recovery in real incomes as the effects of the energy shock continue to fade and as the impact of tighter monetary policy wanes.

Although China accounts for only a small share of UK exports, its prominent role in the global manufacturing sector means that China has an important influence in commodities and globally traded goods markets. Chinese GDP is estimated to have grown by 1.6% in 2024 Q1, with quarterly growth expected to fall back to 1.1% in 2024 Q2. Growth over the rest of the year is expected to be supported by looser fiscal policy. Chinese export values fell in the year to March, but surveys of export orders have been recovering in recent months.

Chart 2.2: Global GDP growth is expected to pick up slightly this year

Four-quarter UK-weighted world GDP growth with contributions by region (a)



Sources: Refinitiv Eikon from LSEG and Bank calculations.

(a) See footnote (c) of Table 1.D for definition. Figures for 2024 Q1 to 2024 Q4 are Bank staff projections. These projections do not include the advance estimate of US GDP in 2024 Q1 or the preliminary flash estimate of euro-area GDP for the same quarter, as the data were not received in time to incorporate fully into the forecast.

Global export price inflation is expected to remain weak in the near term…

Global supply and demand conditions determine the degree of inflationary pressures in globally traded goods and services markets. Global export price inflation has a direct effect on UK CPI inflation – through its impact on the prices of goods and services imported by consumers – and an indirect effect – through its implications for the price of imported inputs into domestically produced goods and services. Four-quarter UK-weighted world export price inflation, excluding the direct effect of oil prices, eased markedly over 2023, reflecting the indirect effects of lower energy prices, the continued clearing of supply chain bottlenecks and weak global producer price inflation. Global export price inflation is expected to remain weak in the near term but to a lesser extent as these factors move further into the past.

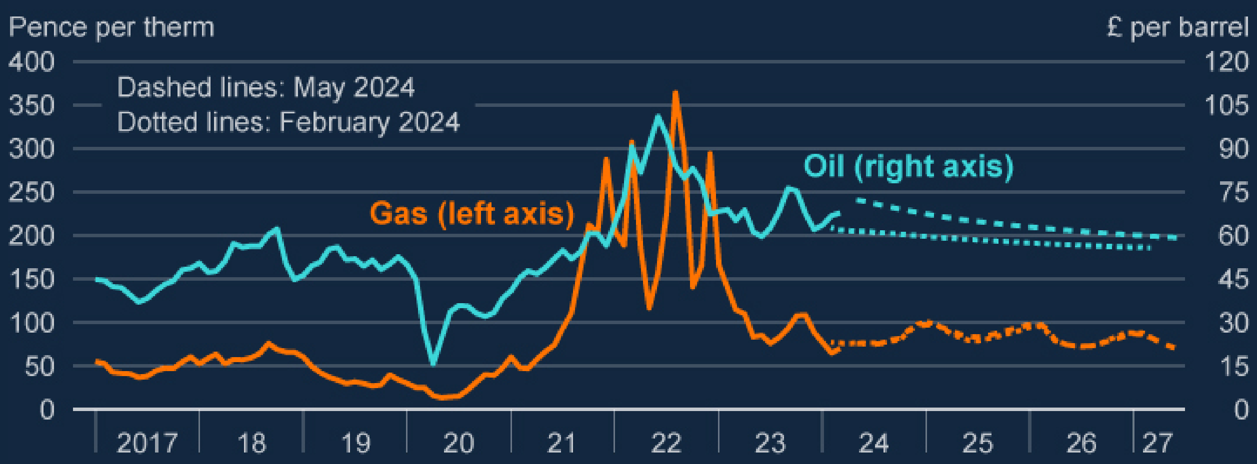
…though oil prices have risen in recent months…

The Brent spot oil price has increased by around 13% since the February Report, to $90 per barrel. The price remains much lower than its peak in mid-2022, however, and closer to its level around six months ago (Chart 2.3). Recent oil price rises have in part reflected geopolitical developments in the Middle East as well as the extension of production cuts by OPEC and other aligned oil producers, although increases in US crude oil production over the past decade have reduced slightly the exposure of global oil markets to these factors. In addition, prices are likely to have been boosted by indicators of strengthening global demand, in particular those from China.

European wholesale natural gas spot and near-term futures prices are little changed compared with the February Report. European gas storage is high for the time of year, and demand has remained subdued.

Chart 2.3: Oil prices have risen since the February Report, while gas prices are little changed

UK wholesale gas and oil prices (a)



Sources: Bloomberg Finance L.P. and Bank calculations.

(a) Oil prices are Brent crude, converted to sterling. Gas prices are Bloomberg UK NBP Natural Gas Forward Day price. Dashed lines refer to respective futures curves using one-month forward prices based on the 15-day average to 29 April 2024, while dotted lines are based on the 15-day average to 23 January 2024. The final data points shown are forward prices for June 2027.

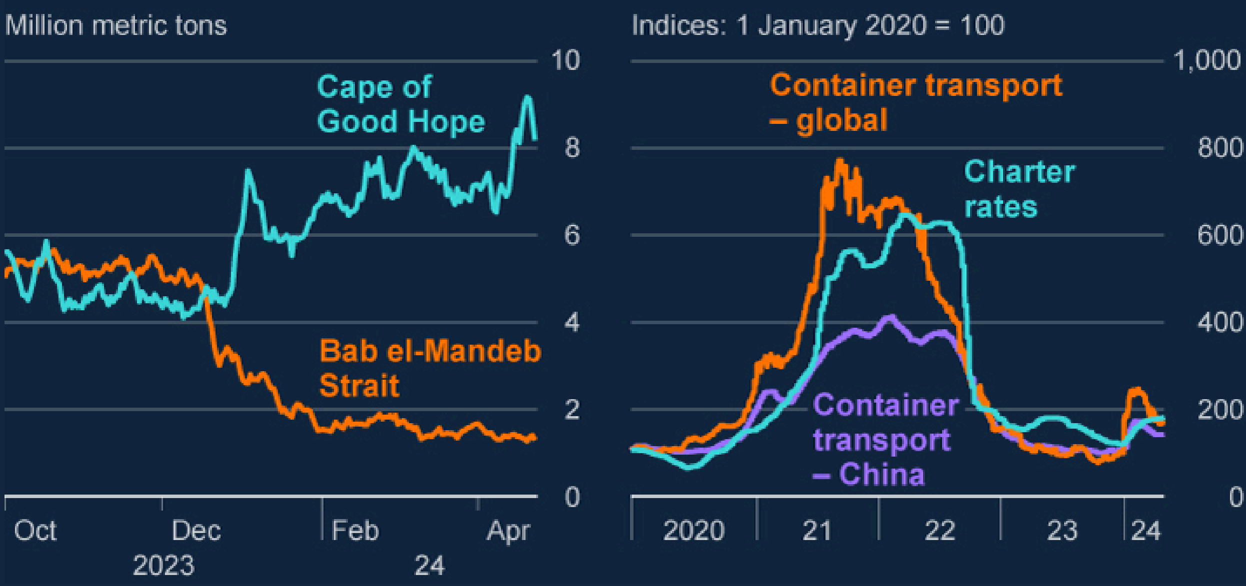
…and geopolitical developments still present a key source of uncertainty for both trade and energy prices.

Developments in the Middle East, including disruption to shipping through the Red Sea, pose upside risks to the outlook for global export prices. Since the start of 2024 there has been a reduction in the volume of goods being shipped via the Bab el-Mandeb Strait – one of the key trading routes affected by the Red Sea disruption – with some trade being redirected to alternative shipping routes that avoid the affected areas, such as via the Cape of Good Hope (left panel of Chart 2.4). These alternative shipping routes take longer to transport goods and so are typically more costly. A range of global shipping price indices, which track the cost of shipping items on container ships, picked up somewhat around the turn of this year, though they have since begun to fall back and remain well below their peaks in the immediate post-pandemic period (right panel of Chart 2.4).

A further escalation of recent geopolitical tensions, were it to arise, could lead to further disruption with larger and more prolonged effects, including on energy prices. The MPC will continue to monitor closely these developments, and their implications for the UK economy (Section 1.2).

Chart 2.4: Red Sea disruption has resulted in a rerouting of some trade, with some knock-on effect for shipping costs

Shipping volumes and global shipping price indices (a)



Sources: Freightos Baltic Index, Harper Petersen, IMF, Refinitiv from LSEG, Shanghai Shipping Exchange and Bank calculations.

(a) The final data points for shipping volumes and price indices refer to 23 April and 29 April 2024 respectively. 'Container transport – global' represents the Freightos Baltic Container Index, a global measure of the cost of container transport. 'Charter rates' represents the Harpex Charter Rates Index, a measure of the cost of chartering container ships. 'Container transport – China' represents the China Containerised Freight Index, a measure of the cost of container transport from China.

Advanced economy labour markets continue to loosen but remain historically tight.

Inflation in advanced economies is being shaped by developments in domestic labour markets, alongside other input costs. Labour market tightness also plays a key role in determining the persistence of inflationary pressures.

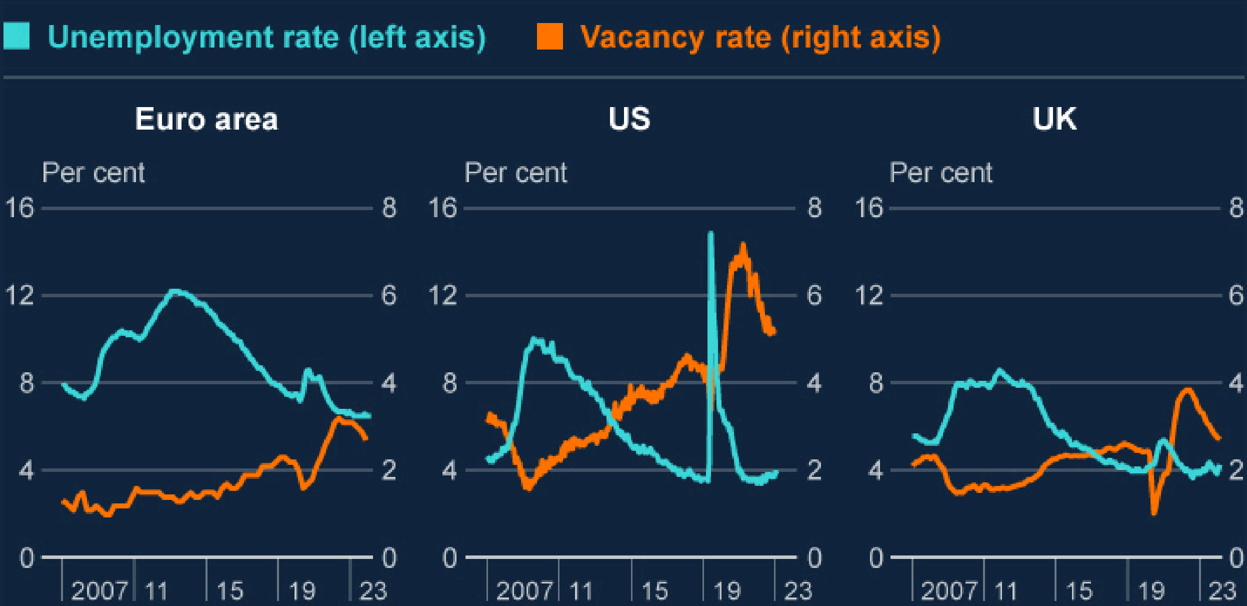
One of the key metrics of labour market tightness, the vacancies to unemployment ratio, has been falling back across advanced economies. These declines can largely be attributed to fewer vacancies, though vacancy rates remain historically elevated (Chart 2.5).

Unemployment rates have remained relatively low across advanced economies, indicative of some tightness remaining in labour markets (Chart 2.5). In the latest data, the US unemployment rate rose a little to 3.9% in April, while non-farm payrolls grew by 175,000 in the same month. The unemployment rate in the euro area was unchanged at 6.5% in March.

Consistent with the labour market having loosened somewhat, the latest estimates suggest that wage growth has fallen from its peaks in the euro area and the US. Annual growth in the wages and salaries component of the US employment cost index was 4.4% in 2024 Q1, while euro-area compensation per employee growth fell to 4.7% in 2023 Q4. Analysis by Bank staff, which attempts to decompose wage growth into its possible determinants, suggests that labour market tightness is playing a notable role in recent US wage growth, while inflation expectations can account for more of the remaining strength in wage growth in the euro area.

Chart 2.5: Labour markets continue to loosen across advanced economies, but remain tight overall

Vacancy and unemployment rates across regions (a)



Sources: Eurostat, ONS, US Bureau of Labor Statistics and Bank calculations.

(a) Unemployment rate is 16+ for all regions. Vacancy rates are calculated as the number of vacancies divided by the sum of vacancies and people in employment. Unemployment and vacancy rates are three-month rolling averages in the UK and monthly data for the US and euro area (with the exception of the euro-area vacancy rate which is interpolated from the quarterly average and is non-seasonally adjusted). The final data points shown are for February 2024, except for the US unemployment rate, which is to March 2024 and the euro-area vacancy rate which is to November 2023 (interpolated from 2023 Q4 data). These charts do not therefore capture data from the March US Job Openings and Labor Turnover Summary and euro-area unemployment releases or the April US unemployment situation release, which were all released after the data cut-off.

Consumer price inflation has declined across many advanced economies over the past year or so, though services inflation is still particularly elevated.

Headline and core consumer price inflation have fallen back from their peaks in many advanced economies over the past year or so (Chart 2.6). Recent US inflation releases have, however, surprised to the upside. Headline PCE inflation ticked up to 2.7% and core PCE inflation was unchanged at 2.8% in March. In the euro area, headline HICP inflation was unchanged at 2.4% in

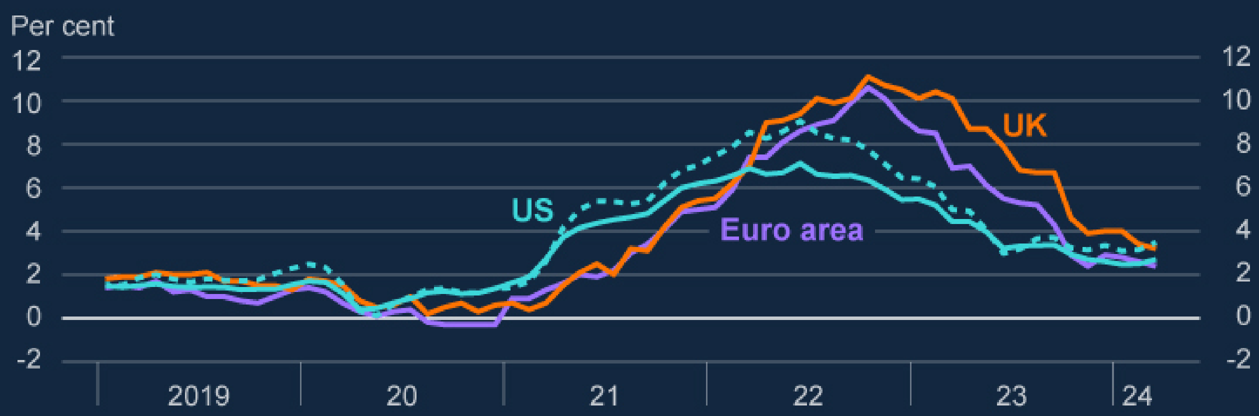
April, and core inflation eased to 2.7%. Falls in core inflation over recent quarters have been accounted for by core goods prices, on account of easing global supply conditions and the indirect effects of lower energy prices.

Services price inflation has remained elevated in the US and the euro area, at 4.1% and 3.7% respectively in the latest available data – where the US measure excludes energy services to improve comparability. In part, this probably reflects developments in pay growth, with wage pressures elevated, albeit moderating, across economies. In the US, continued strength in housing services inflation is also playing a role.

Bank staff now expect US headline PCE inflation to level off around its current rate over 2024. That in part reflects the profile for services price inflation, which is expected to remain elevated at above pre-pandemic rates. Euro-area headline inflation is projected to moderate to around 2% by mid-2025. That is in large part driven by the continued fading of external cost shocks, with a further moderation in core inflation expected as the indirect effects from past rises in energy prices and pressures from supply bottlenecks continue to fade.

Chart 2.6: Headline inflation has trended down across advanced economies over the past year or so

Annual consumer price inflation across regions (a)



Sources: Eurostat, ONS, Refinitiv Eikon from LSEG, US Bureau of Economic Analysis, US Bureau of Labor Statistics and Bank calculations.

(a) For United States, the solid line represents PCE inflation, and the dashed line represents CPI inflation. The latest data points shown are for March 2024. The flash estimate for euro-area HICP inflation in April was released after the data cut-off.

Market expectations of policy rates have risen since February…

Over recent years, central banks in the UK, US and euro area have increased their respective policy rates (Chart 2.7). Since 2023 Q3, the FOMC and the ECB Governing Council have kept their main policy rates unchanged, at 5.25%–5.5% and 4% respectively. The latest market-implied paths suggest that policy rates are likely to be reduced in coming quarters across advanced economies, though the expected timings of cuts differ.

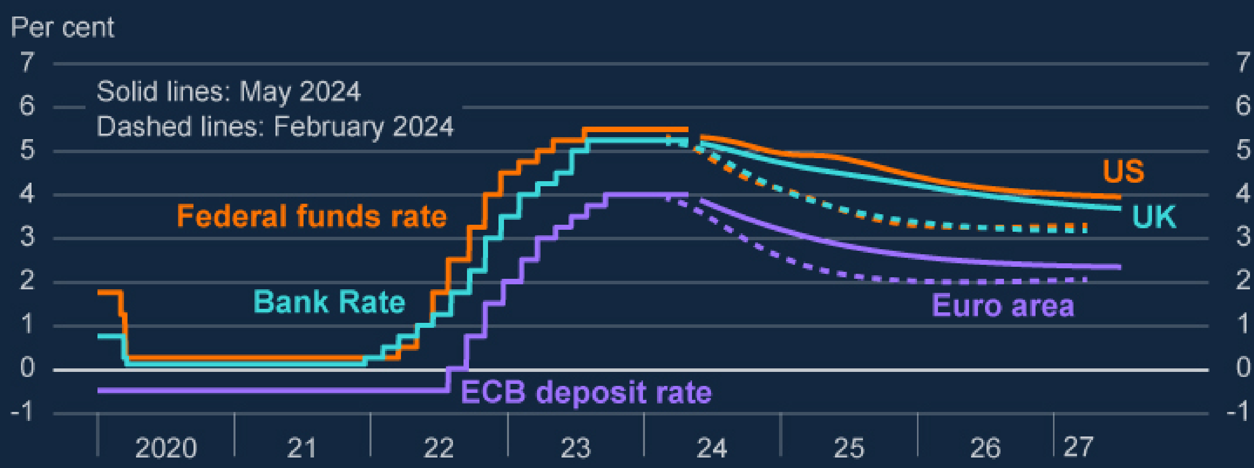
Since the February Report, stronger than expected economic data, particularly inflation releases in the United States, and central bank communications have pushed out the expected timing of future reductions in policy rates across major advanced economies (Chart 2.7). Market contacts have begun to judge that the increasing divergence of the US economic outlook from that of other major advanced economies could be reflected in their monetary policies in the near term. But they also expect that, beyond 2024, the influence of global factors could result in greater macroeconomic and monetary policy convergence across advanced economies.

The market-implied paths for policy rates in both the US and the euro area have shifted up by about 90 and 50 basis points respectively, on average, over the next three years, with policy rates now expected to stand at around 4% and 2¼% respectively at the end of 2026.

Market expectations of UK policy rates have also risen since the previous Report, by about 70 basis points over the next three years, on average, following a decline of around 90 basis points across the curve between the November 2023 and February 2024 Reports.

Chart 2.7: Policy rate expectations have risen across many advanced economies since the February Report

Policy rates and forward curves for the US, euro area and UK (a)



Sources: Bloomberg Finance L.P. and Bank calculations.

(a) All data as of 29 April 2024. The February curves are estimated based on the 15 UK working days to 23 January 2024. The May curves are estimated using the 15 working days to 29 April 2024. Federal funds rate is the upper bound of the announced target range. ECB deposit rate is based on the date from which changes in policy rates are effective. The final data points shown are forward rates for June 2027.

…though corporate bond spreads have narrowed and equity prices have risen.

Although market-implied paths for policy rates across major advanced economies have risen since the February Report, corporate bond spreads have narrowed and equity prices have increased. Corporate credit spreads have declined by over 10 basis points across most advanced economies, and equity prices have picked up by 6% in the US and by 9% in the euro area. UK equity prices have increased by 5%.

Over the latter half of 2023, market contacts attributed the improvements in risky asset markets to expectations of lower policy rates. This mainly reflected perceptions of a more rapid fading of global inflationary pressures rather than concerns about future activity. Market intelligence suggests that the continued improvements in risky asset markets since the beginning of this year have reflected growing confidence that global growth and corporate earnings will improve going forward.

Elsewhere, the sterling effective exchange rate has been broadly stable since the February Report. Within that, sterling has depreciated by around 2% against the dollar.

2.2: Domestic credit conditions

Household deposit rates are little changed since February.

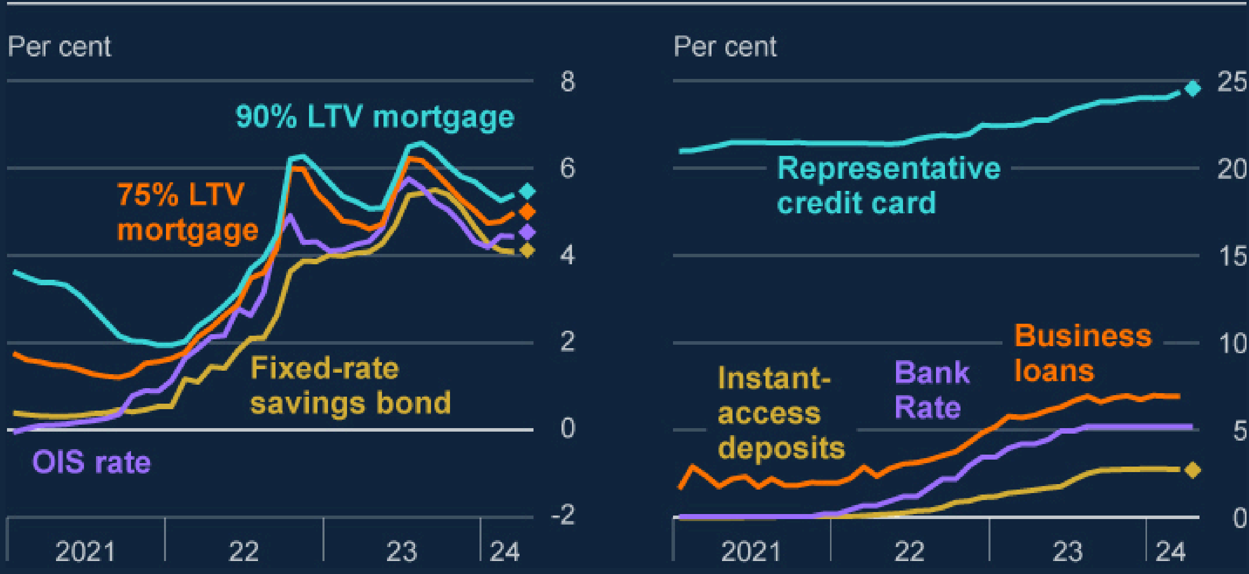
Instant-access savings accounts make up around two thirds of household deposits and tend to be priced relative to the current level of Bank Rate. Pass-through from previous increases in Bank Rate has been partial and slow overall but accelerated somewhat between June and October last year (right panel of Chart 2.8). Instant-access savings rates have since levelled off and remain around 2½ percentage points below Bank Rate in aggregate, with the gap close to its pre-financial crisis average. Interest rates on new fixed-rate savings bonds have been little changed since February (left panel of Chart 2.8).

UK mortgage rates have increased but remain well below their peaks last summer…

Since February, quoted mortgage rates have retraced some of their previous declines, largely reflecting pass-through of increases in risk-free reference rates (left panel of Chart 2.8). They remain substantially below the levels reached last summer, however. According to the latest Moneyfacts data, the number of advertised owner-occupied mortgage products is now back at the levels recorded before the start of the interest rate tightening cycle.

Chart 2.8: Rises in reference rates have fed through to rates on secured and unsecured lending to households and businesses

Average interest rates on selected household and business products, and their respective reference rates (a)



Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

(a) Rates shown are average quoted rates, with the exception of the lending to businesses series – which shows effective rates. The Bank's quoted rates series are weighted monthly average rates advertised by all UK banks and building societies with products meeting the specific criteria. For more information, see **Introduction of new Quoted Rates data**. The reference rate for two-year fixed-rate mortgage products and fixed-rate savings bonds is the two-year overnight index swap (OIS) rate. Diamonds represent averages of daily quoted rates using data to 29 April 2024 and were provisional. OIS rate and Bank Rate show monthly averages and the OIS diamond shows the average of daily rates to 29 April 2024.

…while rates on corporate and credit card lending are at or close to cycle highs.

Quoted interest rates on credit card lending to households and effective rates on new bank lending to businesses, most of which are extended on a floating-rate basis, are at or around their peaks since the MPC began increasing Bank Rate (right panel of Chart 2.8). For credit cards, quoted rates have continued to drift upwards in recent months consistent with the previous experience of pass-through from changes in Bank Rate being very slow. Quoted rates on personal loans are also close to cycle highs, though rates have ticked down for some loan terms in recent months.

Lenders have reported improvements in credit availability for households and SMEs.

According to the **latest Credit Conditions Survey (CCS)**, which was conducted between 26 February and 15 March 2024, lenders reported an improvement in the availability of secured lending to households for the second consecutive quarter, with an increased number of lenders expecting availability to improve over the next three months. Lenders mostly attributed this to wholesale funding conditions, with improvements in the economic outlook also expected to play a role in the coming quarter. Elsewhere, lenders reported little change in the availability of unsecured lending to consumers over the previous three months.

The reported availability of credit for corporates overall was unchanged in 2024 Q1 in the CCS but was reported to have increased for small businesses. Intelligence collected by the Bank's Agents from businesses themselves, however, continues to suggest little change and that SMEs judge overall credit availability to remain quite tight. Consistent with that, the latest Federation of Small Businesses Index suggests that SME's perceptions of credit availability and affordability are little changed and remain low by historical standards.

Lending volumes growth is historically weak, though there are some signs of a pickup in credit demand.

The annual growth rate of sterling net lending to private sector companies and households, or M4Lex, rose to 0.9% in March but remained historically weak. Credit volumes have been subdued for both households and businesses. Aggregate lending volumes have also been impacted by sizeable swings in net lending to non-intermediate other financial corporations, which includes firms such as pension funds and insurance companies.

Lending growth to households remains weak, with the annual growth rate at 0.3% in March. Within this, mortgage lending fell by 0.1%. Lenders reported an increase in demand for secured lending in the latest CCS, however, with additional increases expected in the coming quarter. Consistent with this, the housing market has shown further signs of recovery and, though still weaker than their pre-pandemic averages, mortgage approvals for house purchase increased for the sixth consecutive month in March. Annual growth in consumer credit was strong in March, at 8.8%. According to CCS respondents, demand for unsecured lending to households is expected to strengthen over 2024 Q2.

Net lending to non-financial businesses (including overdrafts) was 1.4% lower in March than a year earlier. Within that, the annual growth rate of lending to SMEs was particularly weak, at around -5%, largely reflecting the continued repayment of borrowing under Covid loan schemes. Lenders in the CCS expected little change in corporate demand for bank lending in the coming quarter.

As bank lending growth is one of the key drivers of broad money growth (**McLeay et al (2014)**), weakness in aggregate lending volumes has been mirrored in the aggregate broad money data. Box B considers the role that developments in the broad money data play in informing the MPC's understanding of trends in activity and inflation, as well as some of the determinants of the recent movements.

2.3: Domestic activity and the labour market

Economic growth was weak in 2023, with output contracting in the second half of the year…

GDP growth slowed in the first half of last year and then turned negative in the second half (Chart 2.9), leaving the level of output in 2023 Q4 around ¼% lower than a year earlier. Within that, GDP contracted by 0.3% in the final quarter, in contrast to an expected flattening in the February Report.

The contraction reflected weakness in market sector output, although government sector activity also fell towards the end of the year (Box C).

Several factors, including the past squeeze on real incomes coming from higher energy, food and tradeable goods prices as well as past increases in Bank Rate, have been weighing on demand. Housing investment fell in each quarter of 2023 and household consumption also declined in the second half of the year, while business investment was volatile (Chart 2.9). Government spending continued to expand, offsetting some of this weakness in private demand.

Chart 2.9: Economic activity is expected to return to growth in the first half of 2024

Contributions to quarterly GDP growth (a)

Sources: ONS and Bank calculations.

(a) Diamonds show quarterly headline GDP growth. Figures for 2024 Q1 and Q2 are Bank staff projections.

…but GDP is likely to grow in the first half of 2024.

Economic activity appears to have begun to recover towards the end of last year moving into this one. Monthly GDP data rose by 0.2% in the three months to February, consistent with the improvement in business surveys. The S&P Global/CIPS UK composite output PMI, for example, has risen to around its historical average. GDP is now projected to increase by 0.4% in 2024 Q1 and by 0.2% in Q2, returning GDP to the level anticipated in the February Report from the middle of this year.

Survey indicators of future growth have remained more positive, although reports from the Bank's Agents signal some ongoing near-term weakness. The output expectations PMI is currently above its long-term average, as is the one year ahead expectations measure from the Lloyds Business

Barometer. Despite this positivity in business surveys, contacts of the Bank’s Agents reported weakness in consumer services and manufacturing in early 2024, while business services activity was more buoyant. Nonetheless, most contacts expect activity to strengthen as the year progresses (Box E).

Fiscal measures announced in the Spring Budget should increase the level of GDP over coming years.

The Government presented its Spring Budget 2024 in March, which included a number of measures expected to affect GDP over the forecast period. These included a further 2p reduction in the main rate of employee and self-employed National Insurance contributions and increases to the High Income Child Benefit Charge thresholds from April. Bank staff estimate that these measures will, relative to previous plans, increase the level of GDP by over ¼% over coming years. In addition to boosting demand, these measures are also expected to boost supply, including through higher labour market participation.

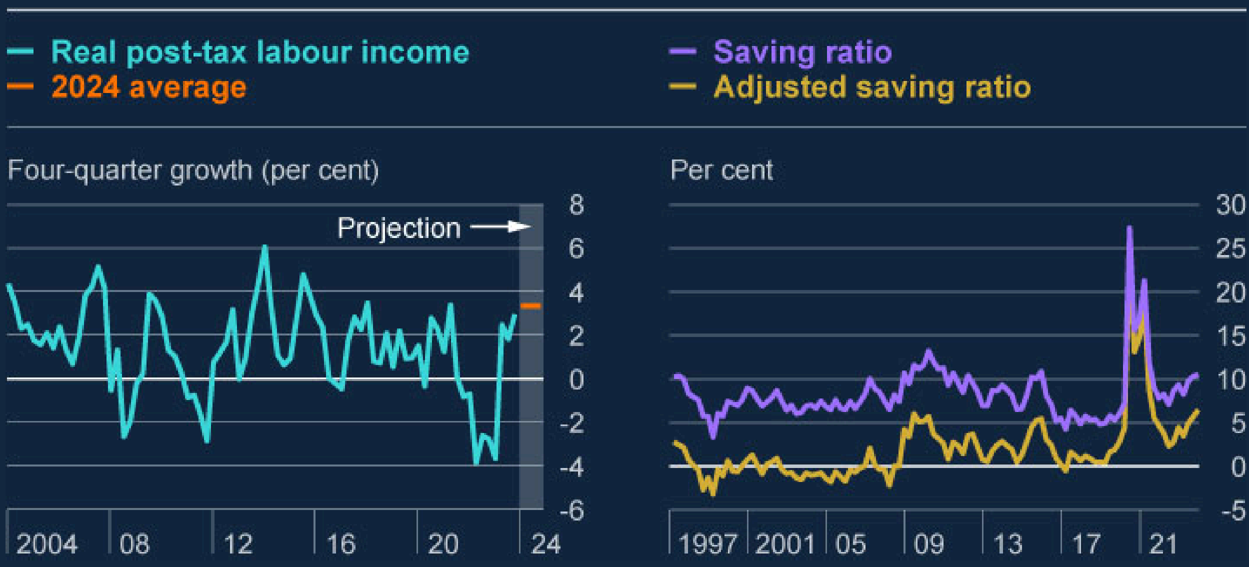
Following weakness at the end of last year, consumption growth is projected to pick up in coming quarters…

Household consumption growth weakened throughout 2023 and the latest data point to a more pronounced fall across the second half of the year. Although the decline in 2023 Q4 was broadly in line with expectations, downward revisions earlier in the year meant that the level of consumption in the final quarter was 0.3% below the February forecast.

This period of weak consumption has coincided with a recovery in households’ real incomes as the effects of past shocks to energy and other imported goods prices waned. Real post-tax household incomes rose by 1.6% in the four quarters to 2023 Q4, and within that, real post-tax labour incomes rose by closer to 3% (left panel of 2.10). Consistent with rising real incomes and lower consumption in aggregate, the household saving ratio increased over the course of the year to 10.5% in 2023 Q4 (right panel of Chart 2.10). After adjusting for pension entitlements, the saving ratio increased to 6.5%, its highest level since 1997, excluding the pandemic period.

Chart 2.10: In aggregate, households' real incomes have picked up and savings have increased

Real post-tax labour income growth and household saving ratios (a) (b)



Sources: ONS and Bank calculations.

(a) See footnote (p) of Table 1.D for a definition of real post-tax labour income. Data to 2023 Q4. The orange line represents Bank staff's projection for calendar year average growth in 2024.
(b) Saving as a percentage of household and non-profit institutions serving households (NPISH) post-tax income. The adjusted saving ratio excludes the adjustment for the change in pension entitlements from income. The final data points shown are for 2023 Q4.

The increase in the saving ratio will in part have reflected tighter monetary policy, which incentivises a higher degree of saving. The latest Bank/NMG survey suggests that increases in reported savings have been driven by households in the highest income quintile, where the dissaving effects of higher costs of living and mortgage payments are being partially offset by more attractive interest rates on savings products. Higher saving rates may also reflect greater precautionary saving against the risk of future unemployment, or some households rebuilding the savings that they used as a buffer when their incomes were squeezed.

Consumer confidence has been on an upward trend during most of the past year. In April, the GfK consumer confidence balance for households' expectations of their financial situation in the coming 12 months rose back towards its historical average (Chart 2.11). This chimes with the findings from the latest Bank/NMG survey, in which respondents were more optimistic about their financial prospects and expected real income growth, with the improvement led by mortgagors and higher-income households.

Chart 2.11: Confidence in households' own financial situation continues to improve

Indicators of consumer confidence (a)

Sources: GfK, Refinitiv Eikon from LSEG and Bank calculations.

(a) GfK Consumer Confidence Index is based on the net balances of respondents reporting how their personal financial situation and the general economic situation have improved over the past 12 months or how their situations are expected to change in the next 12 months. The aqua line shows one of the five sub-indices that make up the overall measure. Averages calculated over 1996 to 2023. Data are not seasonally adjusted. The final data points refer to April 2024.

There are increasing signs of the continuing recovery in real incomes and improving consumer confidence feeding into higher spending. Retail sales volumes grew by 1.9% in 2024 Q1, more than reversing the 1.0% decline seen in 2023 Q4 and taking sales back to the levels seen last summer. Similarly, output among consumer-facing services has grown by 0.5% since December.

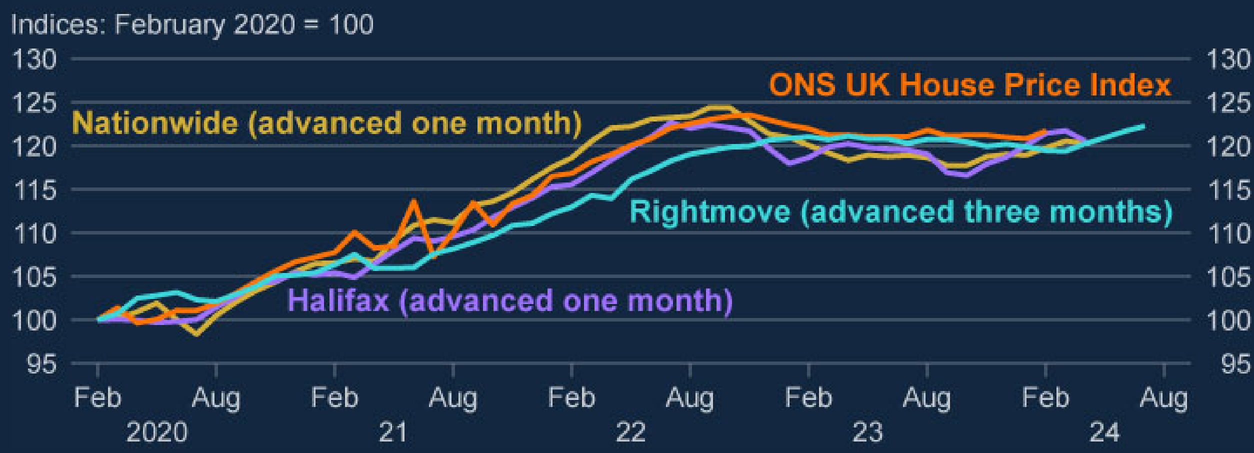
Overall, household consumption is now expected to rise by around ¼% in both Q1 and Q2. This would be consistent with the rate of saving remaining high, but with a boost to real incomes from the continued unwinding of the previous external cost shocks as well as the recent loosening in fiscal policy, principally through lower National Insurance contributions. Real post-tax labour income is now expected to grow by over 3% in 2024 as a whole (left panel of Chart 2.10).

…and housing market activity is beginning to pick up…

Higher incomes and improved sentiment among households are also likely to be supportive of the housing market. The official ONS house price series suggests prices have been broadly flat over the past year (Chart 2.12). However, timelier indicators point to some pick up in the months ahead.

Chart 2.12: House prices have been flat for the past year but show signs of a return to growth

House price indices (a)



Sources: Nationwide, ONS, Refinitiv Eikon from LSEG, Rightmove.co.uk, S&P Global/Halifax and Bank calculations.

(a) The latest data point for the ONS House Price Index is February 2024. Halifax and Nationwide data to March 2024 and Rightmove data to April 2024 are advanced to reflect the respective timing of each data source in the house-buying process. The Nationwide and Halifax figures for April were released after the data cut-off.

Housing investment has been limited by the effects of tighter monetary policy, although the transactions-related component is expected to recover in coming months. The declines recorded last year were led by falls in the larger dwellings investment component of housing investment, although transfer costs associated with property transactions also fell. Continuing weakness in construction indicators suggests that dwellings investment will remain subdued, with the Agents' contacts only expecting to see modest growth returning later in the year. The more recent pickup in mortgage approvals (Section 2.2) should, however, translate to higher housing transactions. The monthly RICS balances for new buyer enquiries and instructions to sell have also recently returned to positive territory, indicative of increased activity within the housing market.

…although prospects for business investment remain subdued.

Business investment increased by 1.4% in 2023 Q4, partially reversing a sharp decline in the previous quarter. Overall, business investment grew by 5½% in 2023, with growth being predominantly accounted for by the transport equipment sub-component. Respondents to the DMP Survey have indicated that investment was 7% lower than it would otherwise have been owing to the effects of higher interest rates, with weakness likely stemming from a mix of higher direct financing costs and wider reductions in demand leading to lower required investment. Respondents expected only small additional effects from interest rates on investment this year. Surveys and intelligence from the Bank's Agents point to modest expectations for business investment growth over the coming year. Contacts report that financial pressures, subdued demand and uncertainty continue to weigh on investment.

There are concerns surrounding the latest LFS labour market statistics.

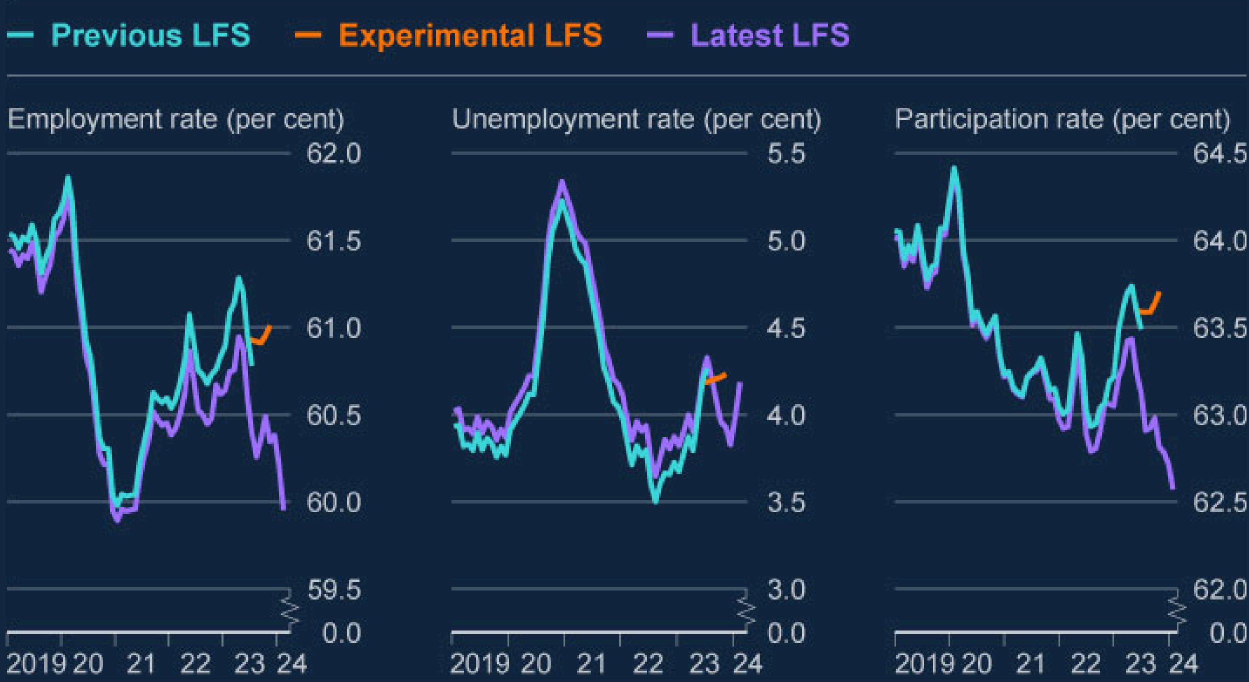
Given concerns about lower achieved sample sizes leading to greater volatility, the ONS recommends caution when interpreting the latest LFS data (Box D). The ONS suspended the publication of the LFS data last summer (aqua lines in Chart 2.13) and began to publish experimental estimates (orange lines) until the LFS was reinstated in February 2024 (purple lines). In addition to overwriting the previous experimental estimates for the recent past, the LFS data have been reweighted to reflect more up to date population estimates.

The latest LFS statistics appear to suggest that the unemployment rate has increased over the past year, but that there is no longer much sign that the inactivity rate has improved over the same period (Chart 2.13). The counterpart to these movements has been a downward drift in the LFS employment rate, consistent with only modest increases in employment growth owing to increases in the population.

Not least given the considerable uncertainties around the LFS data, however, the MPC continue to monitor a broader set of indicators of labour market developments. Overall, the MPC judges that the labour market continues to loosen but remains relatively tight by historical standards (Section 3).

Chart 2.13: The recent LFS updates have caused some sizeable revisions to key labour market series

LFS employment, unemployment and participation rates (a) (b)



Sources: ONS data and Bank calculations.

(a) The final data points for the previous LFS data, experimental LFS data and latest LFS data are the three months to July 2023, three months to November 2023 and three months to February 2024, respectively.
(b) Although LFS data have recently been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).

Employment growth has slowed…

A broad range of indicators corroborate the view that employment growth has slowed over recent quarters (left panel of Chart 2.14). Other official estimates have, however, tended to grow at a higher rate than in the LFS. Whereas the LFS implies that employment has only grown by 0.6% since 2019 Q4, the Workforce Jobs and HMRC payrolls data point to growth having been closer to 4% over that period (right panel of Chart 2.14).

Continued positive employment growth would be consistent with some businesses having smoothed through the weakness in activity last year by maintaining headcounts in the expectation of a subsequent pickup. In that case, the more recent rise in business activity need not be matched by a concurrent improvement in employment, as firms first utilise their existing workforce more intensively. Indeed, taken together, the latest data suggest that underlying employment growth will remain subdued in the near term.

Chart 2.14: A broad range of indicators corroborate a recent slowing in employment growth, but also show firmer growth in recent years than in the LFS

Measures of quarterly employment growth and cumulative growth since 2019 Q4 (a) (b)

Sources: Bank of England Agents, HMRC, KPMG/REC/S&P Global UK Report on Jobs, Lloyds Business Barometer, ONS, S&P Global/CIPS and Bank calculations.

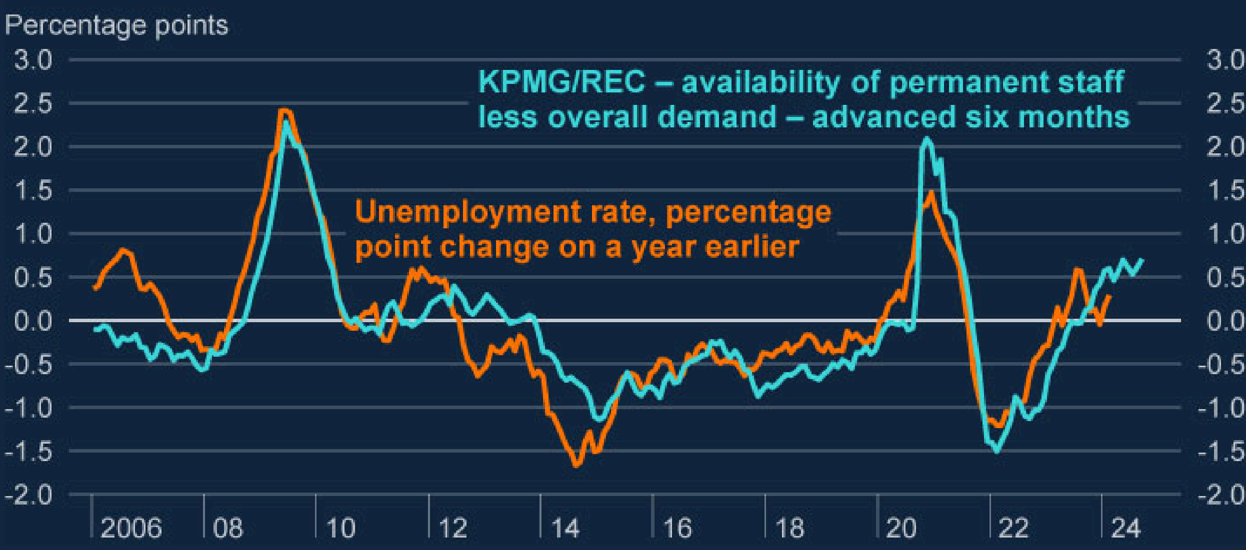
(a) The left panel shows the quarterly change in employment for people aged 16+ from LFS data. The right panel contains the cumulative growth in total employment since 2019 Q4 derived from the respective data sets. Although LFS employment data have recently been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D). Latest data points shown are for 2023 Q4.
(b) Bank staff's indicator-based model of near-term employment growth uses mixed-data sampling (MIDAS) techniques (**Daniell and Moreira (2023)**). A range of indicators inform the model, including series from the Bank of England Agents, Lloyds Business Barometer, HMRC/ONS PAYE payrolls, S&P Global/CIPS purchasing managers' index and the KPMG/REC UK Report on Jobs. Indicators are weighted together according to their relative forecast performance in the recent past. Diamonds represent projections for 2024 Q1 and Q2.

…and there are indications that unemployment is rising, although developments in participation are less clear.

There are fewer indicators beyond the LFS to keep track of unemployment (**Broadbent (2023)**). Nevertheless, the indicators that are available, such as the claimant count and Agents' scores for recruitment difficulties, also point to the unemployment rate having been flat or rising slightly over the past year. One such survey measure based on the KPMG/REC survey, which has tended to lead the cycle, implies further increases in unemployment to come (Chart 2.15). Consistent with that broad trajectory, the unemployment rate is projected to increase from its latest estimated rate of 4.2% in the three months to February to around 4½% over the next year.

Chart 2.15: Abstracting from volatility, unemployment seems to be rising

Change in the unemployment rate on a year earlier and REC survey measure of staff availability less demand for staff (a) (b)



Sources: KPMG/REC, ONS and Bank calculations.

(a) The final data point shown for the unemployment rate is for the three months to February 2024. The final data point for the KPMG/REC series is for March, which is then advanced six months. The comparable figure for April was released after the data cut-off. The KPMG/REC measure has been mean and variance adjusted to match the 12-month change in the unemployment rate over the period since 2000.

(b) Although LFS unemployment data have recently been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).

The drop in participation apparent in the latest LFS estimates is very different to the path that was estimated previously (right panel of Chart 2.13). The LFS participation rate has declined precipitously since last May, to its lowest level since 1998, in contrast to signs of a recovery in the previous data vintage. As participation is an individual choice rather than an administrative category, monitoring it usually relies on asking people their preferences directly through surveys, with the LFS by far the most prominent such survey. Broad estimates can be derived indirectly, however, by taking a view on other labour market quantities and inferring participation as a residual to reconcile these. If employment growth has been as firm as implied by some other indicators including the PAYE RTI or Workforce Jobs data (right panel Chart 2.14), while the unemployment rate has been flat or rising a little, then the participation rate may well be significantly higher than currently estimated. That ambiguity speaks to the degree of uncertainty around the LFS data at present (Box D).

2.4: Wage growth and inflation

Wage growth has fallen to around 6% and is expected to ease further.

The ONS measure of annual private sector regular AWE growth declined from 6.6% in the three months to November to 6.0% in the three months to February. This was close to, albeit a little above, expectations at the time of the February Report. The general steer from other indicators also points to a continued easing in pay growth, to around 5%–6% more recently. Those indicators imply a more gradual decline than seen in the AWE data, from a lower implied peak last summer (Section 3).

In the MPC's latest projection, pay growth is expected to slow further this year, informed by the latest steer from surveys and the Bank's Agents. The latest Agents' intelligence suggests that pay settlements will average 5½% this year, broadly consistent with the Agents' recent annual pay survey **(Box D of the February 2024 Report)**. Firms continue to report stronger pay expectations in consumer-facing sectors than elsewhere, in part owing to a higher National Living Wage (NLW). The direct impact of the NLW on aggregate pay growth is expected to be reasonably modest, but there are uncertainties around the extent to which employers may seek to retain pay differentials for employees further up the pay distribution. Pay settlements are otherwise expected to moderate further during the year, reflecting a less tight labour market and the continued easing in CPI inflation.

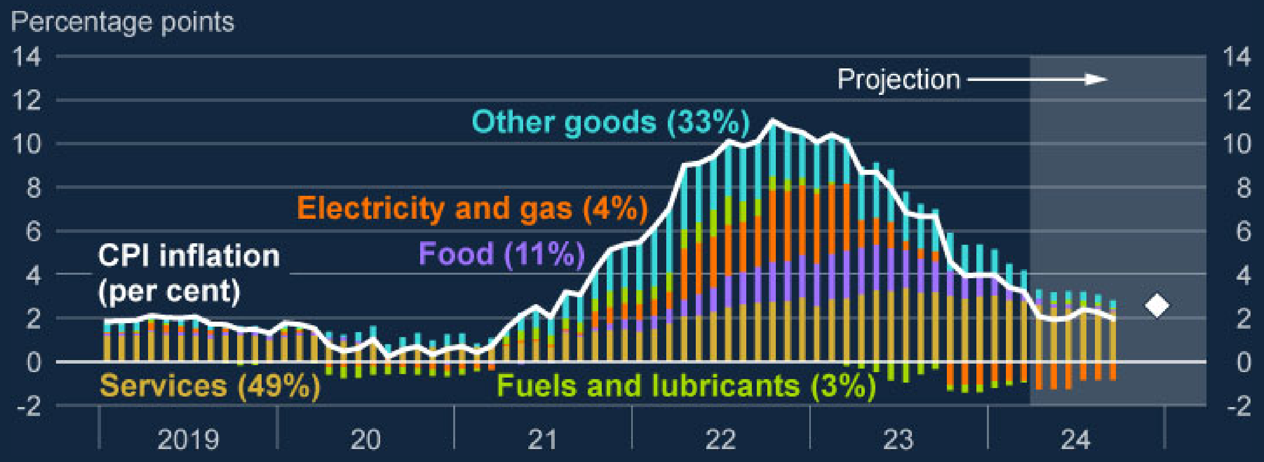
Consumer price inflation has continued to fall…

Twelve-month consumer price inflation fell to 3.2% in March from 4.0% in December, its lowest rate since September 2021 (Chart 2.16). Contributions to the decline in inflation were spread across food, core goods and services components, which more than offset a reduced drag from energy inflation.

Core CPI inflation, which excludes energy, food, beverages and tobacco, fell by a similar margin, from 5.1% in December to 4.2% in March. That was in line with the February Report forecast, although core goods inflation was a little lower than expected, and services inflation a little firmer.

Chart 2.16: Consumer price inflation is expected to fall to around the 2% target in 2024 Q2 before rising somewhat in H2

Contributions to CPI inflation (a)



Sources: Bloomberg Finance L.P., Department for Energy Security and Net Zero, ONS and Bank calculations.

(a) Figures in parentheses are CPI basket weights in 2024. Data to March 2024. Component-level Bank staff projections from April 2024 to September 2024. Diamond indicates projection for headline inflation in 2024 Q4. The food component is defined as food and non-alcoholic beverages (FNAB). Fuels and lubricants estimates use Department for Energy Security and Net Zero petrol price data for April 2024 and are then based on the sterling oil futures curve.

…and is projected to fall to around 2% in 2024 Q2 before picking back up slightly during the second half of the year.

CPI inflation is expected to fall towards 2% in April and to remain close to that rate in May and June (Chart 2.16), broadly as expected at the time of the February Report. The anticipated decline in April largely reflects base effects dropping out of the annual calculation for non-energy components and a fall in the Ofgem energy price cap from £1,928 to £1,690. In the Spring Budget, the Government extended the 5p per litre cut in fuel duty that was due to end in April and cancelled the planned inflation-linked increase, which also push down on the projection for inflation relative to the February Report forecast.

Inflation is then projected to rise back above 2% in 2024 Q3 and to 2.6% in Q4. The profile over the second half of the year is accounted for largely by energy price base effects, reflected in the orange bars in Chart 2.16 becoming less negative, and remains close to the February Report forecast. CPI inflation excluding energy is expected to be more stable, at around 3%, reflecting still elevated services inflation.

Core goods and food price inflation are expected to continue to ease in the near term.

Inflationary pressures from external cost shocks have dissipated over the past 18 months or so, with their effects particularly evident in goods prices (Section 3). The MPC now judges that a greater proportion of the pass-through of higher import prices into consumer prices has occurred already, relative to the assumptions incorporated into previous inflation projections (Section 1.2). Goods price inflation has fallen from a peak of close to 15% in late 2022 to around ¾% in March and is expected to be negative in coming months. Energy price inflation has been negative since mid-2023, and food and core goods price inflation have also slowed to 4% and 1.5%, respectively, in the latest data for March, considerably below their recent peaks. Both core goods and food price inflation are expected to continue to weaken over the forecast, with food inflation around 1% and core goods inflation hovering at just above zero by September. Additional border checks being introduced this year on food, animal and plant products imported from the EU are expected to have only a small impact on food price inflation.

Services inflation is expected to ease more gradually, and to remain elevated.

Services inflation has slowed more gradually than for goods, in part reflecting relatively more dependence on labour as an input (Section 3). Another factor that continues to push up services inflation is strong rental price inflation. A recovery in rental demand following the pandemic and reduced supply have contributed to rents inflation on the stock of private rented properties rising above 9%. A **recent change** in the ONS measurement of private rents has also pushed up the latest estimates and is expected to continue doing so over coming months. While leading measures of rents suggest that the factors that have driven rents higher over the last couple of years have started to wane, this will take time to affect the stock of rented housing and therefore the CPI.

Overall, services inflation was 6.0% in March following a peak of 7.4% last year. The monthly rate of price increases has moderated in the recent data, which appears to be attributable largely to a declining contribution from non-labour input costs. This should allow the annual rate to continue to decline in the coming months, and it is expected to fall below 5% in September.

2.5: Inflation expectations

Indicators of inflation expectations for both households and firms continue to moderate.

Households' one year ahead inflation expectations continued to ease in the latest YouGov/Citigroup survey for April, to 3.3%, dipping slightly below the longer-term measure, which remained close to its historical average (Chart 2.17). The proportion of respondents expecting inflation to be as high as 6% or more on average over the medium term has fallen significantly from its peak in 2022 but remains above its pre-pandemic share. The latest quarterly Bank/Ipsos Inflation Attitudes Survey for February showed a similar picture of lower expectations for the year ahead and a more stable view in the medium term. Households' median inflation expectations eased to 3.0% one year ahead, and were 3.1% at the five-year horizon, with both figures close to their past averages.

In the DMP Survey, business expectations for CPI inflation one year ahead continued to ease from just under 4% in the three months to January to 3.1% in the three months to April (Chart 2.17). Over the same window, firms expected their own prices to rise by 4.0%, down from 4.3% in January, and for CPI inflation to increase by 2.7% over a longer horizon of three years.

A measure of markets' medium term, five year ahead inflation compensation based on swap prices has increased a little since the February Report to just under 4%, albeit remaining around ½ percentage point below its 2022 peak. Meanwhile, the median respondent in the latest Market Participants Survey expected CPI inflation to be 2.2% one year ahead, unchanged from March (Chart 2.17). Median five year ahead expectations remained stable at 2%, although with the distribution skewed to the upside.

Chart 2.17: Year ahead inflation expectations have generally edged down, with medium-term expectations more stable

Survey-based measures of inflation expectations (a)

Sources: Bank of England, Bloomberg Finance L.P., Citigroup, DMP Survey, YouGov and Bank calculations.

(a) Short-term inflation expectations are shown in solid lines, medium-term expectations in dashed lines. Household expectations are taken from the YouGov/Citigroup survey for the next 12 months (short term) and five to 10 years ahead (medium term). Businesses' expectations are three-month averages from the DMP Survey. Short-term expectations show firms' own-price growth expectations for one year ahead, while medium-term expectations are firms' CPI inflation expectations three years ahead. Short-term financial market expectations are median one year ahead CPI expectations from the Bank's Market Participants Survey (MaPS). Medium-term financial market expectations are five year ahead CPI inflation expectations from the MaPS. The latest data are for April 2024 (DMP and YouGov/Citigroup survey) and May 2024 (MaPS).

Box B: Assessing developments in broad money

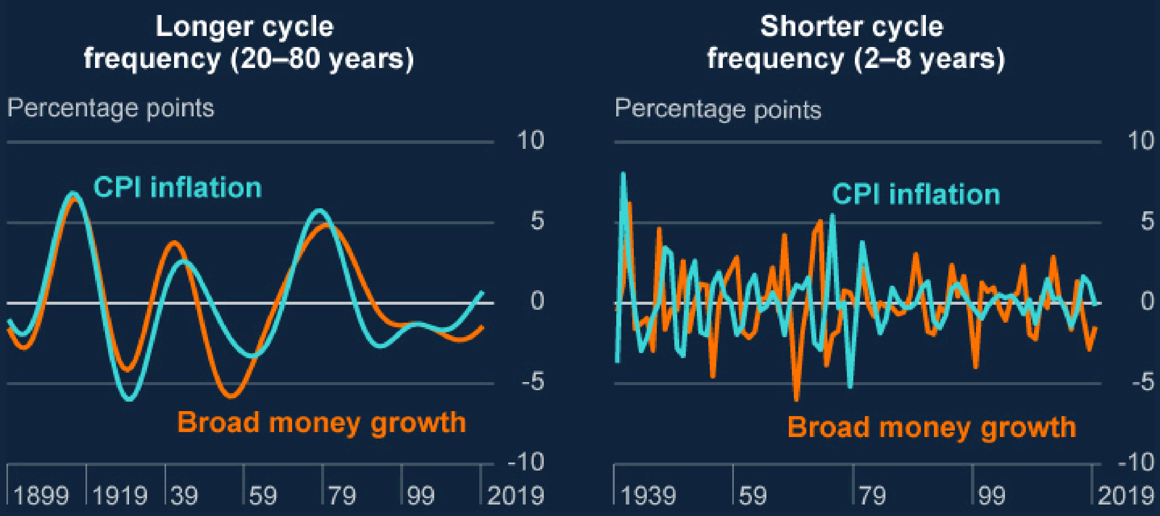
Developments in aggregate money growth can provide a signal about longer-run trends in activity and inflation, though the relationship is less stable over shorter horizons.

Broad money – the amount of money held in cash or as deposits in banks – is the key medium of exchange used to pay for goods and services. Because of its essential role for payments, standard economic theory suggests that changes in the growth rate of broad money contain information about developments in nominal spending over time. Recognising that inflation is ultimately a monetary phenomenon (**Friedman (1963)**), developments in money growth can also present an alternative lens through which to monitor inflationary dynamics by exploiting the relationship between the two in the past (**Pill (2022)**). Viewing the inflation outlook through this lens offers a potential cross-check for the assessment embodied in the MPC's regular macroeconomic projections.

A range of studies across advanced economies have demonstrated that the relationship between money growth and CPI inflation tends to be tighter over longer windows of time than shorter ones. One approach, following **Benati (2009)**, illustrates how broad money growth and inflation appear to have moved together over long cycles of 20–80 years in the UK (left panel of Chart A). This suggests that the persistent component of money growth can be informative about the persistent component of inflation. Over shorter cycles of 2–8 years, however, despite some periods in which changes in money growth appear to lead changes in inflation, that relationship is found to be less stable (right panel of Chart A).

Chart A: Long-run cycles in broad money growth and inflation tend to move together, but the relationship is less stable over shorter periods

Variation in broad money and CPI inflation – contributions to growth relative to series averages (a)



Sources: A millennium of macroeconomic data, ONS and Bank calculations.

(a) Broad money captures M4 excluding the deposits of intermediate other financial corporations. For more information on these data, see **Further details about M4 excluding intermediate other financial corporations (OFCs) data**. Prior to 1998 the data uses the growth rate of M4 using the **historical data in Thomas and Dimsdale (2017)** and break-adjusts for the exclusion of southern Irish banks in 1922. Charts use the band-pass filtering technique of **Christiano and Fitzgerald (2003)** and adopted by **Benati (2009)** to extract the cyclical time series components for inflation and broad money growth. 'Longer cycle frequency' sets the band-pass filter to capture cycles of 20–80 years. 'Shorter cycle frequency' sets the band-pass filter to capture cycles at the typical business cycle frequency of 2–8 years. Series are demeaned prior to applying the filter. To avoid end-point problems over the pandemic period the estimates cover the sample 1871 up to the end of 2019. Contributions to growth rates are approximated using log changes in levels.

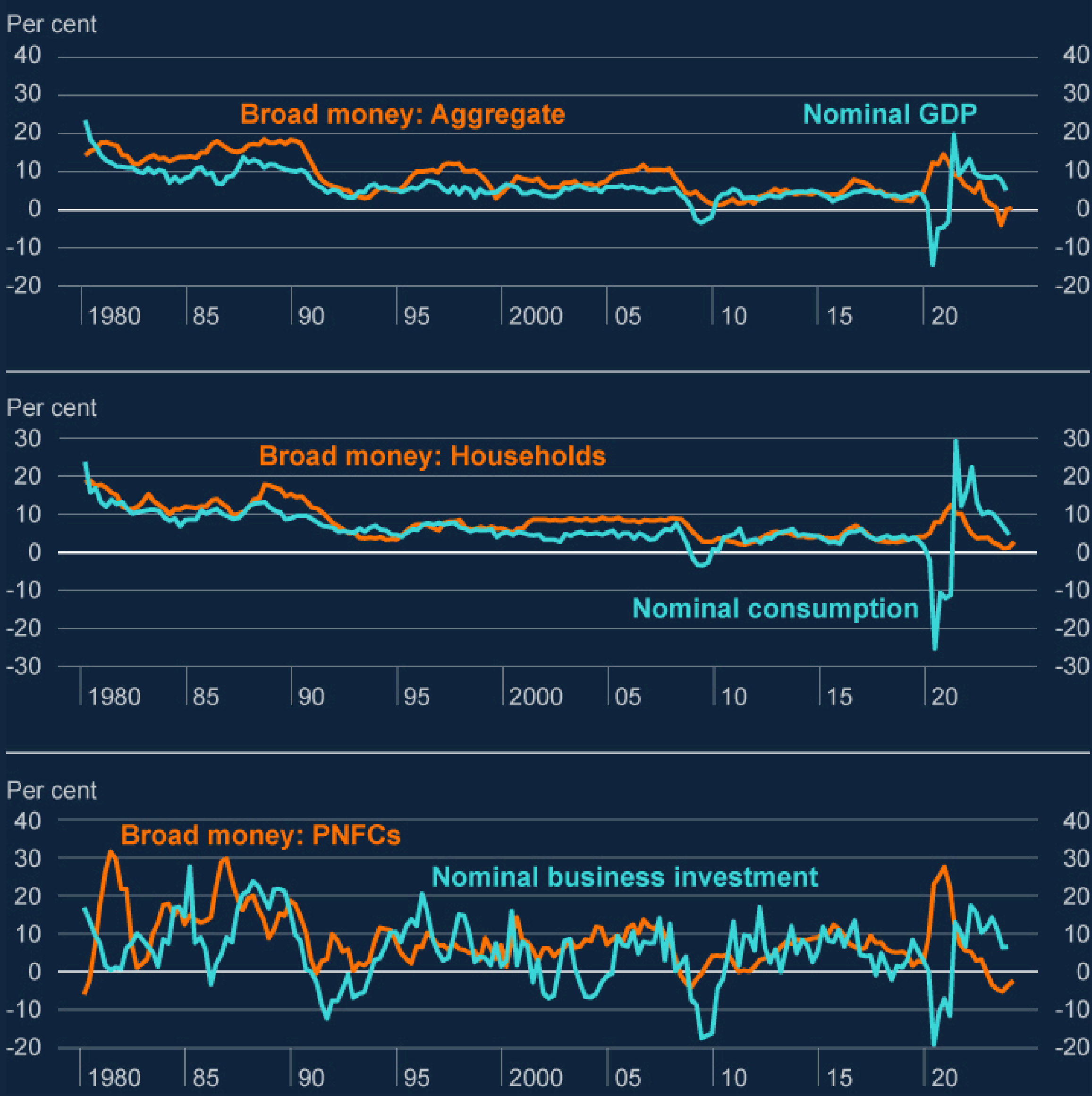
This finding implies it is harder to take an unambiguous signal about inflationary pressures from growth in the aggregate money data in isolation over shorter, policy-relevant, horizons. That is in part because both demand and supply factors can influence the amount of money in circulation, which complicates its relationship with activity and prices (**Broadbent (2023)**). For example, movements in the money supply that match movements in the underlying demand for money would, in themselves, imply little change in inflationary pressure. But shifts in the money supply may also lead to a build-up in money holdings that cannot be accounted for by shifts in underlying money demand – known as a 'money overhang'. Such overhangs, when they emerge, may contain information about the future evolution of nominal spending. The MPC therefore pays close attention to the evolution of the monetary data, and the possible implications for activity and inflation, during these periods.

Changes in sectoral money holdings may contain signals about shorter-run trends in specific sectors.

Looking within the aggregate data, developments in money holdings across different sectors of the economy may also help to highlight economic trends. Household money and nominal consumption growth, for example, are reasonably well correlated (Chart B). Similarly, some studies have shown that changes in the money holdings of private non-financial businesses are a leading indicator of nominal business investment (**Brigden and Mizen (2004)**). Growth in money holdings of non-intermediate financial companies also appears to be correlated with growth in equity prices.

Chart B: Money growth is currently weak relative to growth in nominal spending

Four-quarter growth in aggregate and sectoral broad money and nominal spending (a)



Sources: Bank of England, ONS and Bank calculations.

(a) Aggregate broad money captures M4 excluding the deposits of intermediate other financial corporations. For more detail on what is captured within the private non-financial corporation (PNFC) and household sectors, see **Further details about sectoral analysis of M4 and M4 lending data**. Broad money series are shown up to 2024 Q1. Nominal GDP, consumption and business investment are at current market prices, and the final data points shown are for 2023 Q4.

As with the aggregate money data, however, not all sectoral movements will have material implications for nominal spending. For example, given money is the most liquid asset, households may choose to increase their money holdings if either the economic outlook or their ability to access credit is unusually uncertain. In addition, it is worth noting that previous

Bank analysis has found that other consumer indicators have statistically been better predictors of spending than household money growth (Box 3 of the **August 2018 Inflation Report**).

With these factors in mind, the Committee monitors developments in aggregate and sectoral broad money data alongside a range of other indicators to inform its views on spending and inflationary trends.

In the latest data, money growth has been historically weak…

The annual growth rate of aggregate broad money was 0.3% in March, up from a low of -4.2% in September. Within the sectoral breakdowns, PNFCs' money holdings have been notably weak, falling 2.4% in the 12 months to March (Chart B). Swings in broad money holdings of non-intermediate financial companies have also been a driver of recent weakness. Elsewhere, households' money holdings have increased on a 12-month basis, albeit at a historically slow pace.

…although that appears to be in most part the reversal of the past, pandemic-related, strength in money growth.

At face value, the historical relationships between money growth and nominal spending suggest that the recent weakness in money growth could potentially result in weakness in nominal spending and inflation. Overall, however, it seems more likely to be consistent with the unwinding of unusual pandemic-era strength in money balances, which had previously resulted in a sizeable money overhang (Chart C).

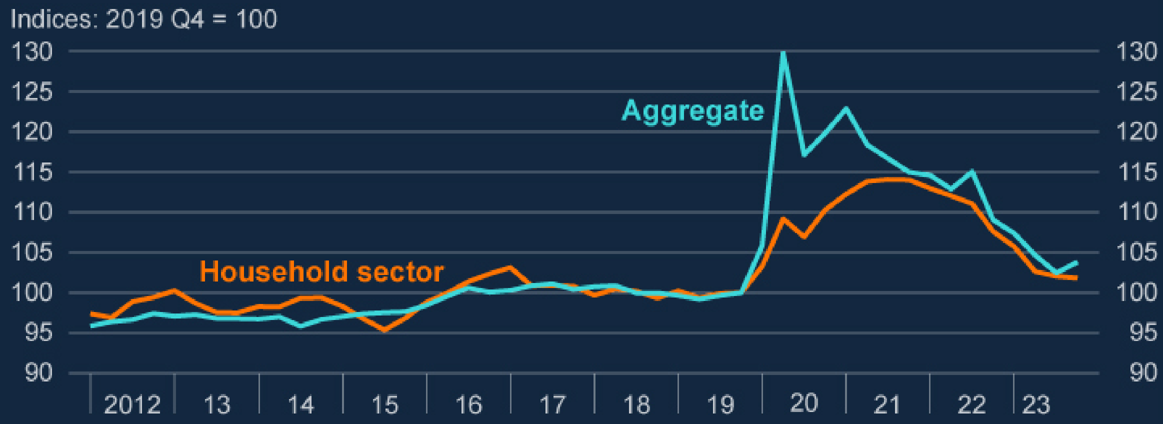
The increase in aggregate broad money holdings during the pandemic period reflected a combination of resilient bank lending growth as well as the effects of quantitative easing, which the MPC undertook to support activity during the pandemic. Purchases by the Bank's Asset Purchase Facility tend to increase the overall level of bank deposits, although at times this can be offset by other factors (**Butt et al (2012)** and **Broadbent (2023)**). Within the total, growth in PNFCs' money holdings was particularly high, on account of the large scale of borrowing under the Government's Covid business loan schemes. By amount, however, households accumulated the largest increase in money holdings during the pandemic period. Households built up sizeable liquid savings (Chart C), as spending was restricted due to lockdowns while incomes were supported by the Government's furlough scheme. The MPC monitored closely the significant household money overhang, and what the speed of run-down of those accumulated savings might imply for the demand and inflation outlook (**Saunders (2020)**, Section 1 of the **February 2021 Report** and **Broadbent (2023)**).

Recent aggregate money growth has been weak, owing mostly to a reduction in banks' net lending alongside the effects of quantitative tightening, which the Bank commenced in February 2022. Net lending has been particularly weak, partly on account of businesses repaying their Covid-era loans. In addition, repayments from non-intermediate other financial corporations have contributed to weakness over the past 12 months. As Chart C shows, the recent weakness in household money growth relative to incomes suggests the build-up that emerged during the pandemic has now mostly been reversed. This reversal, alongside other indicators, gives the Committee reassurance that inflationary pressures are abating.

As the recent weakness in money growth appears to be in large part consistent with a normalisation of the pandemic-related strength, it is less likely to be an incremental signal of weaker trends in inflation and activity. There are some tentative signs of a pickup in the recent data, with aggregate and household money growing by 3.1% and 5.1% respectively in March on a three-month on three-month annualised basis. That said, if money growth were to remain weak such that a money underhang emerged, this could present a downside risk to nominal spending and inflation in the future.

Chart C: The money overhang that emerged during the pandemic has mostly been reversed

Ratio of aggregate broad money to nominal GDP and household broad money to annualised gross disposable income (a)



Sources: Bank of England, ONS and Bank calculations.

(a) Aggregate broad money captures M4 excluding the deposits of intermediate other financial corporations. For more detail on what is captured within the household sector, see **Further details about sectoral analysis of M4 and M4 lending data**. Final data points shown are for 2023 Q4.

Box C: Recent developments in the market sector

The market sector covers all activity that is subject to a market-determined price. The CPI basket almost exclusively measures prices determined in the market sector, and so the rate of CPI inflation will largely reflect the balance of market sector demand and supply pressures. For this reason, developments within the sector are particularly worthy of attention.

While households or the public sector may also produce output, these are not typically exchanged at market prices, either because they are consumed directly or provided free at the point of delivery, and so are not included in the CPI basket. In practice, the lack of a price also means that much of government output needs to be measured indirectly, presenting its own challenges. Nevertheless, the public sector can affect the overall balance of demand and supply in the economy in two important ways. The first is through its purchases of goods and services directly from the private sector, and the second is via its use of resources in production, most notably labour.

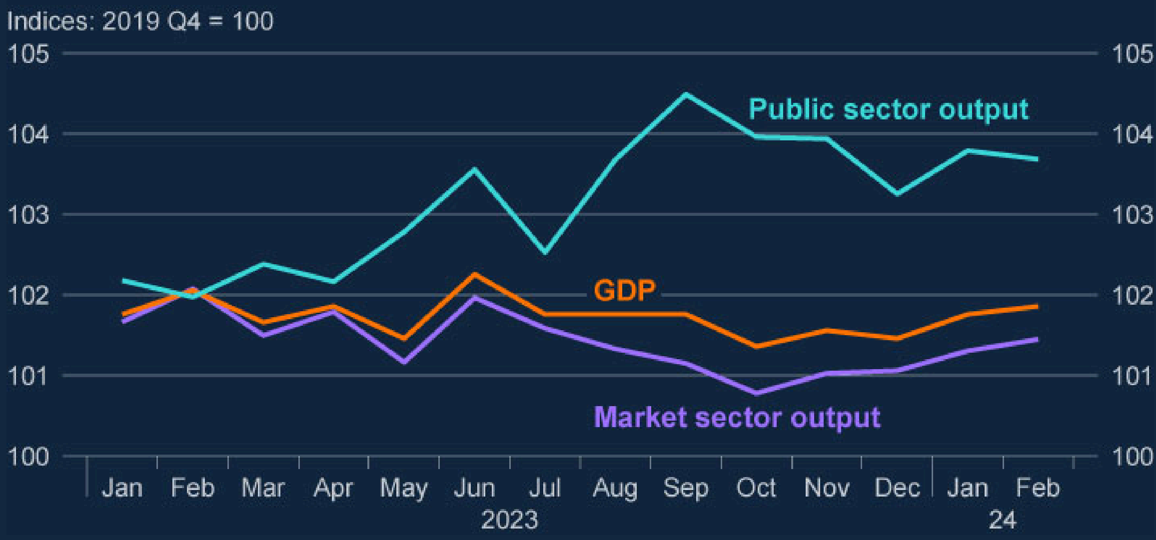
Market sector output weakened by more than overall GDP last year…

Over the course of 2023, market sector output grew broadly in line with headline GDP until the middle of the year, after which it declined by more (Chart A). Within its subsectors, performance was mixed in the first half of the year, with growth in business services and weakness in retail and transport-related categories. However, this weakness became more widespread later in the year such that, by the final quarter, most components of market sector output were in decline.

Headline GDP fared better across 2023 as higher public sector output partially offset weakness in the market sector. Public sector output rose in the first three quarters of the year before falling across the final few months due to declines in the health and education sectors. Overall, GDP fell by ½% in the six months to October, whereas market sector output declined by 1% over the same period.

Chart A: Market sector output has weakened by more than GDP over the past year

Monthly output by sector (a)



Sources: ONS and Bank calculations.

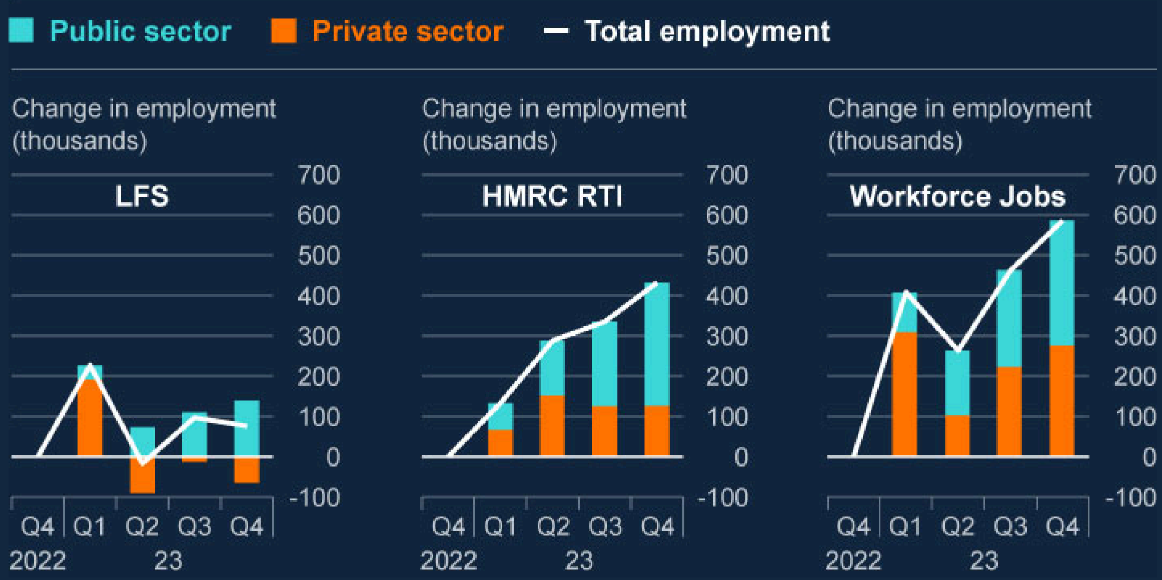
(a) Public sector output is approximated by Bank staff as the appropriately weighted average of the public administration and defence, education and health sectors. Market sector output is proxied by removing these sectors from total monthly GVA. This is a proxy measure since the sectors which are removed are predominantly outside the market sector, but not exclusively so. Nonetheless this closely tracks the official ONS measure of market sector GVA, which is published at a quarterly frequency. Final data points shown are for February 2024.

…and private sector employment also lagged behind.

Aggregate employment increased through the course of 2023, led by higher public sector employment. Official estimates of public sector employment, based on a survey of local authorities, the civil service and other public bodies, point to modest growth during the year (left panel of Chart B). Subtracting these estimates from LFS employment implies that private sector employment fell at the same time. Given the low achieved sample sizes for the LFS at the moment though (Box D), it is useful to look at other sources of employment data. Estimates derived from the HMRC RTI payrolls and Workforce Jobs data sets (middle and right panels of Chart B, respectively) suggest that private sector employment continued to grow, but also that public sector employment increased to a greater extent.

Chart B: Employment growth was softer in the private sector than in the public sector over 2023

Changes in employment by sector since 2022 Q4 (a) (b)



Sources: ONS and Bank calculations.

(a) The LFS public sector estimates are based on returns from public sector organisations and exclude the effects of major reclassifications. The HMRC RTI and Workforce Jobs public sector estimates are proxies and include the public administration and defence, education and health sectors. Private sector measures exclude these public sector estimates from the total. The Workforce Jobs data have also been adjusted to place all self-employed jobs in the private sector. Final data points are for 2023 Q4.

(b) Although LFS employment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).

Whereas the market sector fared less well than the wider economy over 2023, the two are expected to move more closely together going forward.

Both market sector output and GDP have recovered by similar degrees since the autumn, while public sector output has weakened (Chart A). Business surveys suggest that the recent momentum in market sector activity will be sustained in the near term, though restrictive monetary policy continues to weigh on demand.

Box D: Uncertainties around Labour Force Survey data

The Labour Force Survey (LFS), which is used to compile the UK's headline labour market data, has resumed publication. However, pending further review and progress being made on improving sample sizes, LFS statistics are being badged as official statistics in development. The ONS currently recommends caution in interpreting the LFS data due to lower achieved sample sizes, which are leading to greater data volatility. Several measures have been taken to address these problems, although these will take time to be fully reflected in the data. The data have also been reweighted to reflect updated, albeit not the latest, population data, which has led to some revisions.

There remains considerable uncertainty over statistics derived from the LFS, making it more difficult to gauge the underlying state of the labour market. The MPC has for some time utilised a wide range of data to inform its judgements on the labour market, including other official data, business surveys and intelligence from the Bank's Agents. The continuing uncertainties surrounding the LFS data underscore the importance of this approach.

The LFS has resumed publication, but response rates remain a significant issue.

Following a period of suspension, the LFS was reinstated with the February release, but the survey's response rate remains very low (Chart A). The response rate has declined significantly over time which eventually led the ONS to suspend its publication last year (Box B of the **November 2023 Report**). Low response rates are problematic for surveys since they can introduce volatility, a higher margin of error, and potentially non-response bias too if the remaining respondents are not representative of the population.

Insufficient achieved sample sizes as a result of low response rates mean that more granular data, relating to a smaller share of the overall sample, have a higher potential to be inaccurate. As a result, the ONS has continued to suspend the publication of important data on labour market flows, which were last published in August 2023. Labour market flows data provide estimates of the transition rates between various labour market states, for example, moving from employment to unemployment. These data can be used to generate timely indicators of the state of the labour market, including estimating movements in the natural rate of unemployment.

The ONS has taken several measures to address the issue of low response rates and achieved sample sizes. These include reintroducing face-to-face interviews in October 2023 and increasing the number of households it asks to complete the survey by around 50% from January 2024. Such changes are expected to improve the number of responses received, however this will take time to feed through. The changes have so far resulted in only a modest increase to the response rate and achieved sample sizes (Chart A).

Chart A: Response rates to the LFS remain extremely low

LFS response rate and number of responses (a)

Sources: ONS and Bank calculations.

(a) The response rate is the proportion of participants who were approached that then filled in the survey. The response rate is estimated using data for Great Britain only, while the total number of responses refers to the United Kingdom. Final data points shown are for the three months to December 2023.

The LFS has now been reweighted to account for some of the most recent population figures.

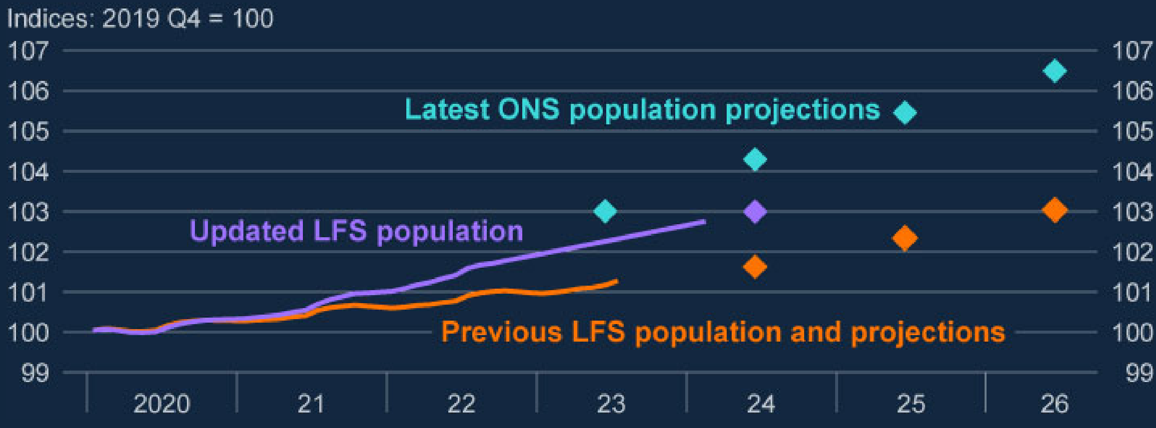
The population data used to scale and weight the LFS have now been updated to include more recent estimates. The figures used previously effectively assumed that there had been no change to the structure of the population since June 2021, meaning emerging trends in ageing and migration flows were not reflected. The LFS now uses population figures based on mid-2022 population estimates, which are projected forward using the 2020-based population projections. This means the LFS figures now capture higher net migration in previous years but not the latest increases.

This population update has resulted in revisions to the LFS data over recent years. Changes in the makeup of the population affect labour market variables since the rates of employment, unemployment and economic activity typically vary by demographic characteristic. Groups which typically have above average rates of unemployment and inactivity have generally seen their share of the overall population increase, while those with below average rates of unemployment and inactivity are now estimated to make up less of the population. Both these changes in the age structure have exerted upward pressure on the overall unemployment and inactivity rates.

Overall, the size of the population underpinning the LFS data is around 1¼% larger than in the previous set of assumptions (Chart B). That increase has more than offset revisions to activity and unemployment rates, such that the level of employment estimated in the LFS was also revised up by 0.6% in mid-2023.

Chart B: The population figures underpinning the LFS have been revised up, but are still below the latest interim population projections

Population estimates and projections (a)



Sources: ONS and Bank calculations.

(a) Updated LFS population figures are consistent with the latest LFS release, with the data points going up to the three months to February 2024. The purple diamond shows a consistent projection for mid-2024. The orange diamonds show staff estimates of the LFS population consistent with the population projections prior to the reweighting for mid-2024, mid-2025, and mid-2026. The aqua diamonds representing the latest population projections are constructed by growing the LFS population in 2022 Q2 with the growth rates implied by the latest set of interim national population projections.

Although the LFS is using more recent population data, it does not yet take into account the latest set of interim national population projections which were published on 30 January 2024. This means the population figures being used in the LFS are growing at a slower rate than they would be if they were following the very latest set of projections (aqua diamonds in Chart B). As a result, we may expect to see further upward revisions to the LFS population data in future. All else equal, that may in turn give rise to further upward revisions to estimates for the level of employment.

The MPC's latest projections take into account the starting point implied by the updated LFS population data, with population growth converging towards and then moving in line with the ONS's latest interim population projections. As a result, the 16+ population is now assumed to rise by around 1% per year in the medium term, compared with around ¾% previously (Section 1).

The remaining issues with the LFS data are substantial and will take time to resolve.

The LFS will remain a key source for labour market data for some time to come, and therefore it is critical that the survey is fit for purpose. The roll out of the transformed Labour Force Survey (TLFS), the survey intended to eventually replace the current LFS, has been pushed back from March of this year to at least September 2024. The TLFS data will need to be evaluated over time, to assess the robustness and completeness of estimates, and the treatment of associated discontinuities with the LFS will also need to be considered.

The ONS has taken steps to improve the response rate of the LFS and recently published an **update** on the actions to date and future plans, but these will take time to have a meaningful impact. In addition to reducing volatility, improvements in sample sizes should allow the publication of granular data such as the labour market flows data set to resume, and for meaningful inferences to be drawn from them. The ONS is also currently reviewing how and when it might be able to take on updated population figures into the LFS.

Box E: Agents' update on business conditions

The key information from Agents' contacts considered by the MPC at its May meeting is presented in this box, which summarises intelligence gathered in the six weeks to mid-April.

Contacts are a little more downbeat on consumption and investment than in the previous reporting period, but otherwise many of the themes in the **Agents' Summary of Business Conditions** for March continued into this round. Contacts are still cautiously optimistic of a return to growth over the course of the year. The labour market story remains much the same. Employment intentions suggest flat to low employment growth over the next 12 months. And recent intelligence continues to suggest average pay settlements of 5.5% in 2024, a little down on 2023, as the impact of a looser labour market is being partly offset by the upward effect of the NLW. This NLW effect is occurring mainly via the direct impact on the lowest paid workers, but also indirectly where firms are preserving differentials for those paid more. Inflationary pressures continue to ease, as some non-labour input costs are falling, labour costs are moderating gradually, and contacts report that they are less able to pass on cost increases than last year, owing to weaker demand. Services inflation continues to ease more slowly than goods inflation.

Contacts have been surprised by the weakness in consumer spending on goods and services in 2024 Q1 and are revising down their expectations of growth for 2024. However, they are still cautiously optimistic that quarterly sales volumes will grow this year owing to rising real incomes, in part reflecting falling energy prices and a potential reduction in Bank Rate.

Subdued consumer demand is widespread across the retail and service sectors. While some of the weakness in spending in 2024 Q1 owed to poor weather, there is also a sense that underlying demand has weakened, although contacts are unsure as to the reason.

Supermarkets continue to see growing volumes supported by promotions and discounts, and customers increasingly eating at home. This is a trend that is also seen in the falling trade reported by pubs, restaurants, and fast food outlets.

Airports report growing passenger numbers, with holiday travel now above pre-pandemic levels. Passenger numbers across rail and bus services continue to grow, supported by the gradual decline in working from home.

Investment intentions have fallen back a little compared to the March update. Contacts cite challenging balance sheet positions, higher costs of investment and soft demand as prominent headwinds.

While improvements in the economic outlook motivated more positive investment sentiment in March, this is now being mentioned less frequently. Instead, financial pressures, associated with squeezed margins, a desire to pay down debt, and weaker demand have become more prevalent, leading to reduced current or planned capital expenditure.

Spending on digital infrastructure is falling and is increasingly switching from capital to operational spending, as companies switch to subscription models. For many professional services firms, the fall is a reversion to regular levels of digital investment following recent major IT overhauls. Distribution, logistics, and retail firms continue to invest in automation, incentivised by the higher cost of labour and improvements in robotics. Software development is aiding automation in financial and legal services.

> **Goods export volumes continue to fall, but contacts expect to see modest positive growth during 2024 H2. The value of export services grew steadily compared to the same period last year and contacts expect this to continue.**

Both the EU and Chinese goods export markets continue to weaken. Demand from the US and Middle East remains robust despite some reports of increased protectionism – both existing and expected – affecting exports to the former. Red Sea disruption is reported to be having a relatively small impact with importers mainly affected. Contacts report that delays so far (2–3 weeks) have had a limited price impact to date and, being more predictable, they have been much more manageable than the delays that occurred during the pandemic. The falling costs of Asian goods, resulting from their oversupply and favourable exchange rate, has helped offset increases in the cost of freight.

Growth in exports of professional services such as architecture, civil and design engineering and legal is strong, as is demand for IT and software. Insurance sales are increasing globally due to heightened geopolitical uncertainty. Inbound tourism continues to pick up, particularly from the US.

> **Business services revenue growth remains positive, with volumes still broadly flat. Confidence is building, aided by lower Bank Rate expectations, and contacts expect revenue growth to strengthen modestly during 2024 owing to price increases and, for some, higher volumes.**

Professional services remains the strongest area of growth. Insolvency and restructuring activity is increasing further, though mainly for small and medium enterprises. IT services remain busy with digitisation, managing cyber risk and some AI work.

Distributors' revenue is growing although volumes remain subdued. Weaker volumes for logistics and haulage continues, with some linked to domestic destocking. Clients' cost cutting has led to tougher trading for those in recruitment, advertising, marketing, and consultancy services.

> **Manufacturing volumes are down slightly compared to the same period last year. Contacts increasingly report that output is stabilising and more now expect a modest recovery in orders and growing volumes in the second half of the year. Construction activity continues to decline, although the rate of decline is easing.**

Output of food and drink manufacturers is broadly stable, as is that of motor vehicle producers. Strong growth in the aerospace and defence sectors continues. In contrast, construction-facing manufacturing output remains lower compared with this time last year. Output is mostly unaffected by Red Sea disruptions, as contacts increase stock or use alternative logistics. Any impact on costs is limited for the reasons set out above.

The construction sector is still seeing a widespread fall in output compared to a year ago, although the rate of decline is easing. Private house building remains markedly weak but with signs of bottoming out. Budget constraints continue to slow new public sector, social housing and infrastructure work. And commercial development continues to fall modestly, constrained by difficulty in accessing funding at a viable rate.

Contacts are more optimistic that growth in demand for construction will return around the autumn, as stabilising material and labour costs lead to more certain returns on investment and in anticipation of lower funding rates.

Confidence is returning very gradually to the housing market, although many potential buyers are waiting for a reduction in Bank Rate.

Estate agents report higher levels of interest in the housing market, although this is not yet translating to a substantial uplift in sales. They expect that lower mortgage rates linked to a reduction in Bank Rate will be the catalyst for increased transactions. A larger proportion of new lending is on standard variable rates as borrowers are reluctant to fix at higher interest rates. Poor weather may have contributed to lower activity recently, especially for house builders.

Supply into the rental market remains tight, but contacts in some regions expect rents to flatten off later in the year, owing mostly to increased constraints on affordability.

There is little change in corporate credit conditions.

Debt markets remain open, private debt funds are active and high street banks, wanting to grow business loan books, continue to compete for the large, most creditworthy borrowers. Smaller firms and the less creditworthy continue to report tight access to bank finance.

Contacts continue to pay down debt in response to higher interest rates. Demand for working capital remains stronger than for capital expenditure as cash remains tight. Banks are still reporting limited borrower distress.

There is little labour market news. Employment intentions suggest flat to low employment growth over the next 12 months.

While around half of firms plan to maintain their current employment level over the next 12 months, the net balance of future employment intentions is marginally positive. Most firms who are increasing employment sell business to business. Of those expecting headcount to fall, only a few expect to make redundancies, instead favouring natural attrition.

Recruitment difficulties continued to ease to pre-pandemic levels, although, as they did then, contacts characterise the labour market as being tight. In some cases, firms are sourcing labour from abroad, directly or through offshoring. Skill shortages and elevated pay settlements are incentivising firms to use labour more efficiently. While some companies are holding on to workers in anticipation of improved activity, high wage costs, including the NLW, are leading others to reduce headcount or hours.

Agency intelligence continues to suggest pay settlements for 2024 will average 5.5%, similar to the recent annual pay survey, and down from 6% in 2023.

Lower inflation, weaker inflation expectations and a looser labour market are feeding into lower pay settlements for 2024 than 2023, although this is partly being offset by the upward impact of the NLW. As a result, pay settlements, in aggregate, are expected to be a little lower in 2024 than 2023. However, pay settlements in consumer-facing sectors are expected to be higher than last year, above 7% for 2024, with contacts overwhelmingly citing the NLW as the reason. This is mainly through its direct effect on the lowest paid workers but also through firms raising the pay of those higher up the wage distribution to maintain differentials. In contrast, settlements in non-consumer facing sectors are expected to average closer to 4.5% in 2024. Firms settling later in the year, and who generally have less exposure to the NLW, intend to give materially lower pay rises than those settling in April.

Inflationary pressures continue to ease, as some non-labour input costs are falling, labour costs moderate gradually, and contacts report they are less able to pass on cost increases than last year owing to weaker demand. Services inflation continues to ease more slowly than goods inflation.

Imported finished goods prices are expected to remain flat. Moderate increases in shipping costs from Red Sea disruptions are being offset by lower underlying wholesale costs of goods as Asian markets have oversupplied relative to global demand. Manufacturers' domestic price inflation continues to ease. Lower raw materials and imported components prices are partially offsetting higher labour and other costs.

Food price inflation is easing a bit faster than expected previously. Some contacts expect food price inflation could be as low as 2–3% in 2024 H2 owing to weaker energy and agricultural commodities prices and continued fierce retail competition. The oversupply of many other consumer goods in East Asia is driving wholesale prices down. This is partially offset domestically by higher labour costs and business rates.

For consumer services, where demand growth is expected to ease or remain muted, companies are looking to limit pass-through of increases in their costs, like the recent NLW rise, by reducing labour inputs, compressing differentials, or pursuing efficiency gains or automation. Even where contacts think volumes growth could support their profitability, for example in recreational services, companies are generally not planning to pass on their costs. They are keen not to stifle the fragile recovery in discretionary spending by putting up prices too much.

3: In focus – Developments in the persistence of UK inflation

Twelve-month CPI inflation remains above the 2% target but has fallen back materially over recent months as the impact of past shocks wanes. In particular, there is greater evidence suggesting that past increases in import prices will not push up domestic prices much further. Goods price inflation, which peaked at almost 15%, is now just under 1%, although the decline partially masks the slower easing of domestic inflationary pressures. Services price inflation, which is less affected by global factors, has fallen back to 6% and is projected to remain elevated in the near term.

Other indicators of underlying inflationary pressures have also shown signs of improvement. Labour market tightness continues to ease, wage growth is slowing, and household inflation expectations appear to be normalising. But the labour market remains relatively tight by historical standards and wage growth remains elevated, with second-round effects from past high inflation continuing to push up on current inflation rates.

3.1: Why is inflation persistence important?

As monetary policy affects inflation with a lag, policy needs to be forward-looking and focus on the more persistent implications of a shock.

The transmission of monetary policy to consumer price inflation is generally thought to operate with long and variable lags **(Friedman (1961)** and **Havranek and Rusnak (2013))**. The available empirical work suggests that the peak effect on inflation of a change in interest rates occurs at a horizon somewhere between 12 and 24 months.

The lags in monetary policy transmission, and the uncertainties surrounding them, make controlling inflation at a shorter horizon difficult and even undesirable. As the effects of policy take time to build, substantial measures would be needed to affect inflation in the short term meaningfully. But such actions would have a larger impact on inflation further ahead, which may be unwarranted and require future countermeasures. In effect, attempts to return inflation to target too quickly risk becoming a source of additional volatility, rather than a contribution to containing inflation and returning it to target sustainably.

Monetary policy, therefore, needs to be forward looking and focus on the inflationary impact of a shock in the medium term. That is, monetary policy should focus on the more persistent implications of a shock that may cause lasting deviations from the CPI inflation target and be calibrated to steer inflation towards the 2% target sustainably in the medium term.

Extended deviations of inflation from target, even if stemming from what are fundamentally a series of transitory inflation shocks, may prompt changes in behaviour that generate more long-lasting inflationary dynamics **(Pill (2023))**. For example, there may be a shift in inflation expectations or the emergence of second-round effects in price-setting behaviour that lead to further momentum in inflation, even after the initial effects from an original shock have faded. The existence of such intrinsic channels determines the extent to which a shock risks becoming embedded in the domestic inflation generating process, and therefore the extent to which monetary policy needs to respond.

3.2: The effects of external supply shocks on inflation

Inflation has been pushed up by a succession of external shocks in recent years...

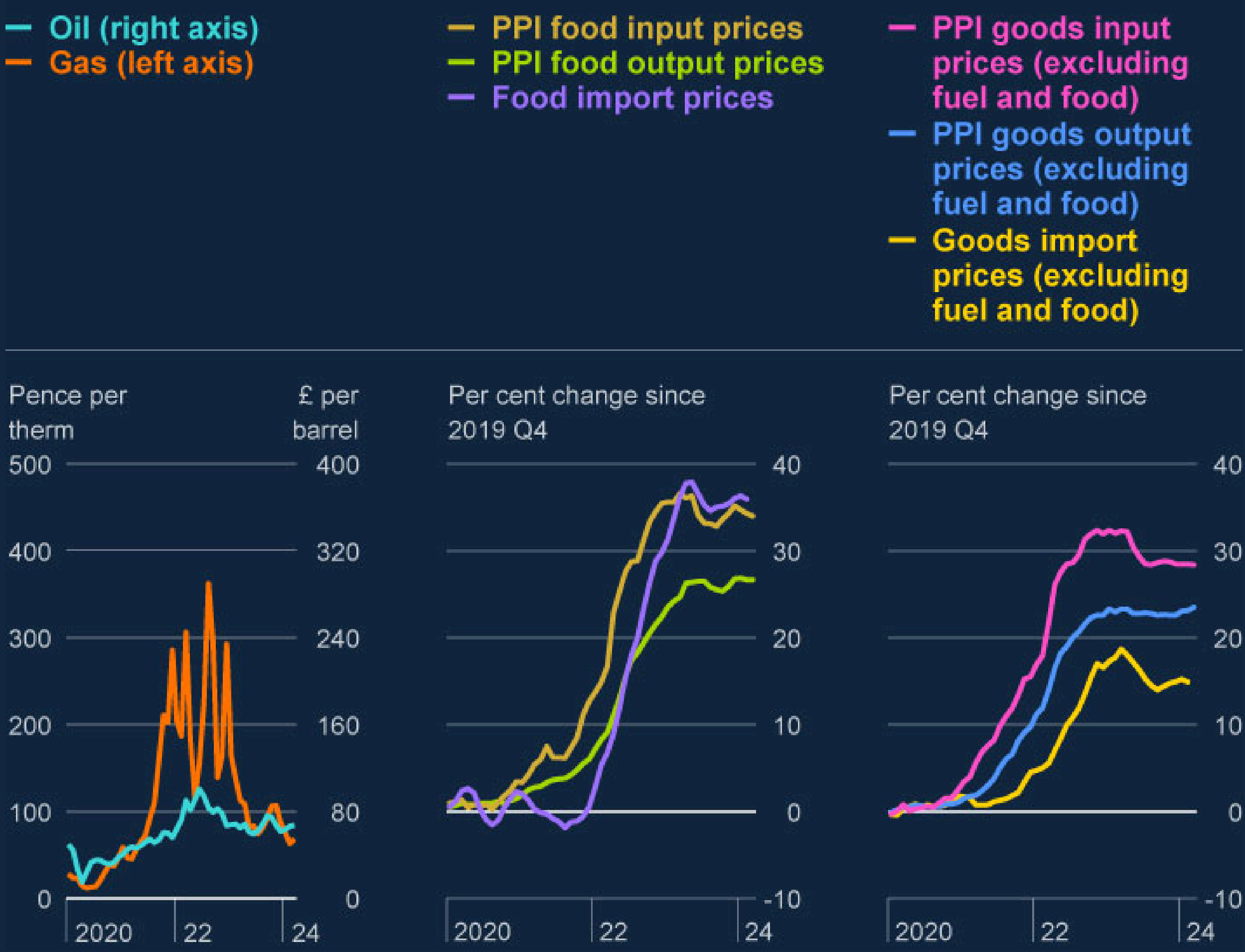
Since 2020, the UK economy has faced a series of external shocks that have added to inflationary pressures. CPI inflation rose on account of bottlenecks in international goods markets that emerged from the interaction of disruption to global supply chains and changes in the pattern of consumer demand, both triggered by the onset of the Covid pandemic (**Haskel (2023)**). UK energy prices rose considerably following the Russian invasion of Ukraine. Owing to higher prices of energy and other goods, UK consumers had to pay more for their imports relative to the prices of the UK's exports. That resulted in a decline in domestic real incomes. This is also likely to have contributed to some of the strength of inflation over recent quarters, as firms and workers have sought to preserve their own real spending power.

…although these external cost pressures have waned more recently.

Energy prices have fallen materially from their highs in 2022, particularly for wholesale gas prices which considerably pushed up on inflation (left panel of Chart 3.1). Supply chain pressures, more generally, have eased driven by softer global demand and a normalisation from the past supply chain problems resolving. Producer input prices have been broadly flat over the past 18 months for food products (middle panel of Chart 3.1) and have fallen for other non-energy goods (right panel of Chart 3.1). Agents' contacts expect some continued modest deflation in raw material inputs over the next 12 months. Nevertheless, they remain materially higher than a counterfactual based on a continuation of their pre-pandemic trends.

Chart 3.1: Indicators of supply chain pressures shot up post-pandemic and have since flattened off

UK wholesale gas and oil prices, input and output producer prices and import prices (a) (b)



Sources: Bloomberg Finance L.P., ONS and Bank calculations.

(a) Oil prices are Brent crude, converted to sterling. Gas prices are Bloomberg UK NBP Natural Gas Forward Day price. Both are calculated on a monthly basis, and the final data points shown are for March 2024.
(b) The food input and output PPI series are the ONS measures for food, beverages and tobacco products, and the goods input and output PPI series are the measures for core manufactured products, which exclude fuel, food, beverages and tobacco products. Food import prices are constructed using the ONS measure for trade volumes in food, beverages and tobacco goods, divided by their value. Goods import prices are constructed using the ONS measure for trade volumes in goods excluding fuel, food, beverages and tobacco, and other unspecified goods, divided by their value. The import price series are calculated on a three-month average and seasonally adjusted basis. The latest data points shown are for March 2024 for the PPI series, and February 2024 for the import price series.

Declining external cost pressures have been more evident in goods than in services price inflation.

Given their nature, the effects of the external shocks have been particularly significant for goods prices. Goods CPI inflation was close to 15% at its peak in 2022. Within that, core goods inflation peaked at around 8% (left panel of Chart 3.2). In recent months there has been some flattening off in seasonally adjusted food and core goods prices, mirroring developments in producer input prices with a lag (Chart 3.1). Indeed, the three-month on three-month annualised seasonally adjusted measure for core goods inflation dipped into negative territory in October 2023 and has remained very weak since (right panel of Chart 3.2). Based on these recent developments in producer and consumer goods prices, the MPC now judges that the estimated pass-through of past increases in import prices has been faster than anticipated in previous inflation projections. As a result of this change in judgement, external inflationary pressures on headline inflation are likely to be somewhat weaker than previously assumed going forward, particularly during the first half of the forecast period (Section 1.2).

The contribution to headline CPI inflation from services took longer to build following the initial shocks and is also proving to take longer to unwind. Services inflation fell to 6.0% in March from a peak of 7.4% last summer (left panel of Chart 3.2). The three-month on three-month annualised seasonally adjusted services inflation rate has also continued to decline to around 4% in March (right panel of Chart 3.2), suggesting that the annual rate could continue to recede. However, this rate remains above past averages, which could point to some degree of intrinsic persistence being embedded in services inflation (Section 3.3).

Chart 3.2: Higher-frequency measures of inflation suggest little evidence that external cost shocks are pushing up on prices

Inflation rates for components of CPI (a)

Sources: ONS and Bank calculations.

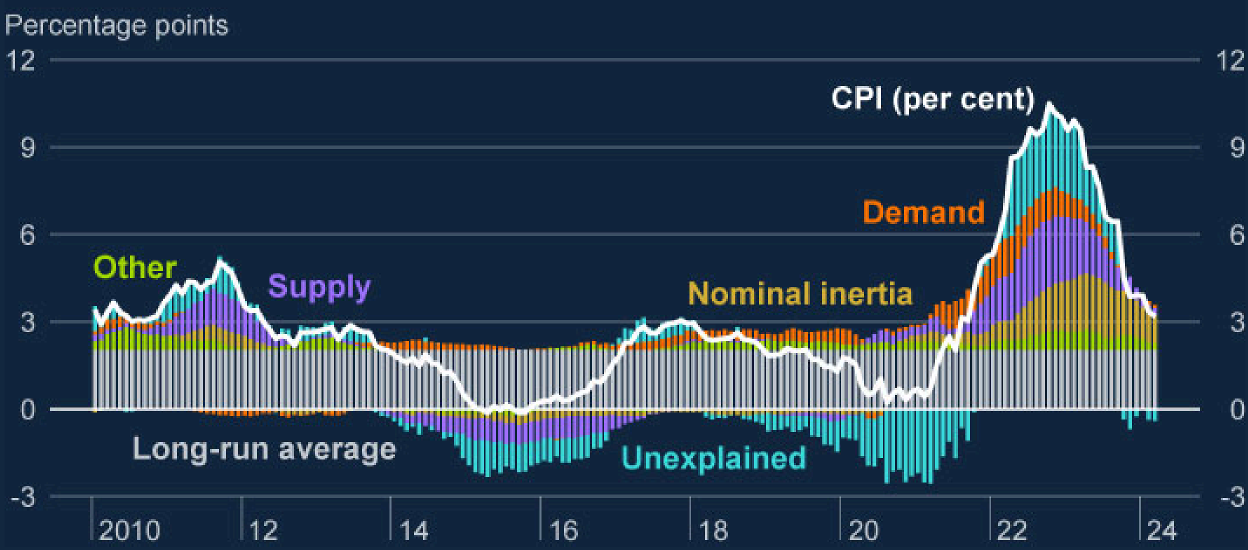
(a) Core goods inflation is defined as goods excluding energy, food, beverages and tobacco. The higher-frequency series are seasonally adjusted. The latest data points shown are for March 2024, followed by the forecast up to September 2024 for the left panel.

Underlying inflationary dynamics are yet to return to pre-pandemic norms, with evidence of non-linear relationships between inflation and broader economic conditions.

Machine learning techniques provide one way to quantify the relative role of external and domestic shocks on inflation. Chart 3.3 shows the results from a machine learning model designed by Bank staff to estimate the relative contributions of various factors to inflation. This builds on previous Bank staff work on services price inflation **(Section 3 of the May 2023 Report)**. In this model, factors are grouped into inflation subcategories covering supply (for example energy prices), demand (for example measures of economic output and consumer sentiment), nominal inertia (reflecting wage growth, past inflation values and inflation expectations), and other factors such as financial conditions.

Chart 3.3: Evidence suggests previous high inflation continues to push up on current inflation rates

Contributions to consumer price inflation (a)



Sources: **Baumeister and Hamilton (2019)**, Bloomberg Finance L.P., **Braun et al (2023)**, **Känzig (2021)**, OECD, ONS, World Bank and Bank calculations.

(a) This builds on the services price inflation analysis in the **May 2023 Report**, see notes in Chart 3.9 of that Report. This new version separates out demand and supply contributions to inflation by restricting the association between CPI inflation and indicators of activity and slack via sign restrictions. The supply component is also fed with a range of measures of costs, commodity prices, global supply pressures, and identified supplied shocks. The non-linear associations between indicators and inflation within each block are captured via training many decision trees. The 'other' category includes monetary policy and other financial conditions. Results are estimated relative to average historical inflation levels, calculated between 1993 and 2019, captured in the grey bar. Monthly price inflation is calculated using log changes and the chart shows the 12-month moving average. The latest data points shown are for March 2024.

This analysis shows that the direct contribution from external factors, broadly captured by the supply subcategory, is now small, having been elevated throughout 2022 and 2023.

In contrast, the model suggests that past high inflation is continuing to boost current inflation rates. The magnitude of this contribution, shown in the gold bars covering 'nominal inertia', is currently higher than at any point during the 2010s, albeit lower than in 2023. As headline inflation continues to drop, the contribution from nominal inertia should decline but this currently represents a source of continued inflation persistence.

The underlying results from the model also highlight the importance of non-linear relationships between economic conditions and developments in prices. For example, the evidence suggests that the effects of lower unemployment in wage and price pressures build disproportionately as unemployment moves further below its equilibrium. Similarly, the sharp spikes in input costs post-pandemic are likely to have had out-sized effects on consumer prices. These non-linear effects are less evident when the economy is operating closer to historical norms but help explain the magnitude of inflation in 2022 and 2023.

The importance of non-linear relationships is supported by alternative analysis based on individual firms' price-setting behaviour. For example, drawing on the DMP Survey and firm-level Bureau van Dijk data, Bank staff estimate that the average pass-through of unit cost increases to firms' own price inflation is a little over 20%. In contrast, when experiencing cost falls, firms tend to pass through relatively little to their prices. That could limit the pace at which consumer price inflation falls as input cost pressures abate.

3.3: The persistence of domestic inflationary pressure

Domestic inflationary pressures can be monitored in a number of ways.

An absence of continuing external shocks affecting UK prices is not by itself sufficient to ensure that inflation returns to the 2% target sustainably in the medium term: domestically generated inflationary pressures also need to continue to fade.

There are no direct measures of domestic inflationary persistence, but the extent of persistence can be inferred from indirect measures. The MPC has previously set out, for example in recent MPC minutes and in the **May 2023 Report**, the key indicators for the inflation outlook at present: labour market tightness, wage growth and services price inflation.

These indicators are pertinent for several reasons. First, all three reflect to a large extent the evolution of domestic economic factors and can therefore provide an insight into the economy which is less dependent on potentially still volatile external factors. Second, the indicators all capture crucial parts of the price-wage setting mechanisms in the economy which have been impacted by second-round effects from high inflation. For example, if the labour market is tight, firms face greater competition when hiring workers and are more likely to raise nominal wages as workers seek to protect their real incomes, which may in turn lead to firms raising prices to maintain margins. And third, as noted by **Broadbent (2023)**, when economic conditions are more volatile and inflationary pressures are more supply driven, it is harder to assess the inflationary implications of movements in traditional measures such as GDP growth.

These indicators can all be measured in multiple ways. The MPC considers a variety of measures to ensure it uses the broadest range of data possible to inform its judgement on developments in inflationary pressures in the economy.

Labour market tightness

The labour market has loosened since 2022 but remains relatively tight by historical standards.

One measure of tightness in the labour market is the relationship between the number of job vacancies and the unemployment rate. When there are few unemployed people and a large number of vacancies, businesses will find it harder to recruit staff. Equally, higher than normal vacancies will encourage more people to leave their jobs as it should be easier to move to a better position. This results in businesses needing to raise wages to attract and retain staff. All else equal, higher wage growth can lead to firms raising prices in order to maintain margins and thus lead to greater inflationary pressure.

The vacancies to unemployment ratio has declined since vacancies reached a peak in 2022 (Chart 3.4). There has been relatively less movement in the unemployment rate, which was estimated to be 4.2% in the three months to February (Section 2.3). That remains below the MPC's estimate of the medium-term equilibrium rate. Abstracting from the uncertainties around the latest unemployment figures (see Box D), the vacancies to unemployment ratio suggests that the labour market remains somewhat tighter than prior to the pandemic, and 2019 was itself a period where the ratio was higher than in preceding years (right panel of Chart 3.4). Importantly, other indicators of labour market tightness provide a similar message, such as indicators of recruitment difficulties.

Chart 3.4: The labour market has loosened since 2022, largely reflecting a fall in job vacancies

Contributions to changes in the vacancies to unemployment ratio since 2019 Q4 and its level since 2007 (a)

Sources: ONS and Bank calculations.

(a) Latest data points shown are for the three months to February 2024. Contributions to the change in the vacancies to unemployment ratio since 2019 Q4 are approximations calculated as changes in the individual series and so do not exactly sum to the total. Although LFS unemployment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).

Movements in vacancy and unemployment rates can be compared over time using an economic relationship known as the Beveridge curve (Chart 3.5). This tends to show a natural comovement where higher levels of the unemployment rate are associated with lower levels of the vacancy rate, illustrated in the downward sloping purple line in the chart representing the labour market between 2002 and 2019.

This relationship broke down during the pandemic, but is showing some signs of normalising. Although the job vacancy rate remains high, it is now close to where we might expect given the current level of unemployment. As such, any further loosening in the labour market may reveal itself more through higher unemployment as opposed to fewer vacancies. In the MPC's latest projection, the unemployment rate increases gradually to around 4¾% by the middle of 2025 (Section 1.2).

Chart 3.5: The relationship between unemployment and the job market vacancy rate has continued to normalise since 2022

Beveridge curve (a)

Sources: ONS and Bank calculations.

(a) The latest data point shown is for the three months to February 2024. The job market vacancy rate shows the number of job vacancies divided by the sum of job vacancies and employment. Although LFS unemployment data have recently been re-instated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from very low response rates, which can introduce volatility and potentially non-response bias (Box D).

Wage growth and inflation expectations

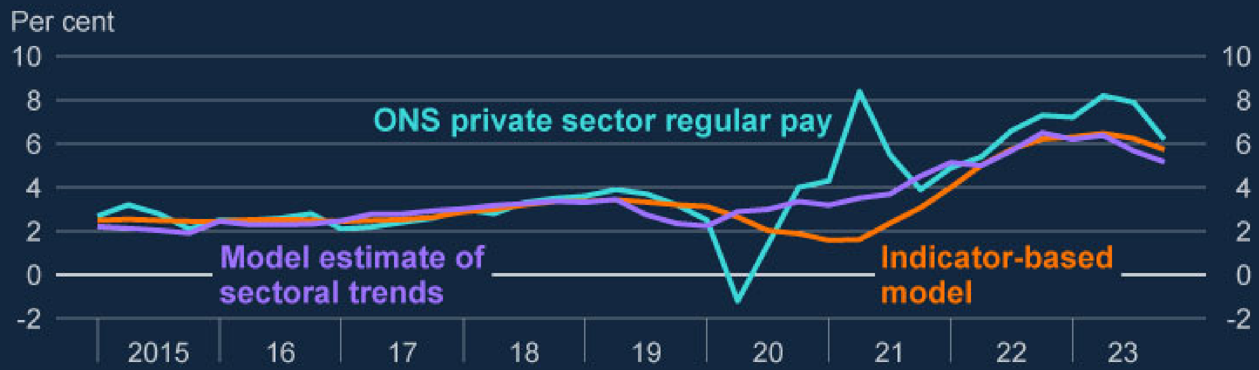
> **Falling inflation expectations and the loosening in the labour market have contributed to lower wage growth.**

Annual private sector regular average weekly earnings (AWE) growth slowed to 6.0% in the three months to February, down from a peak of 8.2% in mid-2023.

The official AWE measure of pay growth has been volatile over recent quarters but estimates of underlying pay growth also show that wage growth has been slowing. The AWE measure is derived from the ONS's Monthly Wages and Salaries Survey. This is a survey of businesses and has not been affected by the fall in response rates in the LFS (Box D). Nevertheless, this series tends to be volatile with recent movements being larger than normal. That makes drawing strong conclusions from single data points difficult. Chart 3.6 compares AWE growth to two alternative measures of underlying pay growth: one based on trends within and across different sectors of the economy (the purple line) and one based on a statistical combination of alternative measures of pay growth (the orange line). Both measures of underlying pay growth suggest that pay growth has slowed since the peak but remains elevated at 5%–6%.

Chart 3.6: Pay growth measures have slowed but remain elevated compared to the pre-pandemic period

Measures of four-quarter pay growth (a) (b)



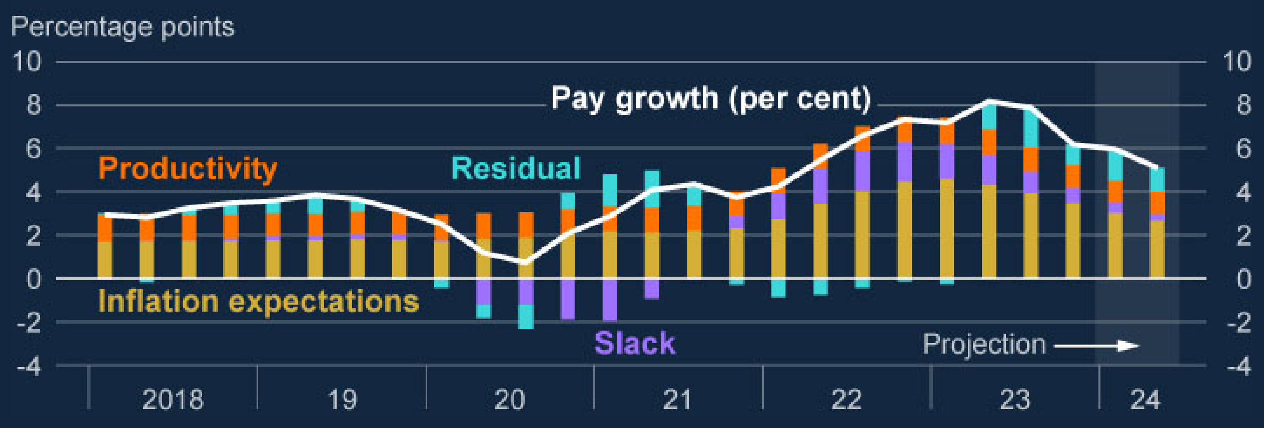
Sources: Bank of England Agents, HMRC, Indeed, KPMG/REC UK Report on Jobs, Lloyds Business Barometer, ONS and Bank calculations.

(a) The latest data points shown are for 2023 Q4. The model of trend growth is based on the approach of **Stock and Watson (2016)**, estimated using quarterly AWE data for 24 industrial sectors. Pay growth in each sector is decomposed into a common trend, a sector-specific trend, a common transitory shock and a sector-specific transitory shock using a dynamic factor model. The common and sector-specific trends are then weighted using employment shares to produce an estimate of the trend in aggregate AWE growth.
(b) Bank staff's indicator-based model of near-term private sector regular pay growth uses mixed-data sampling (or MIDAS) techniques. A range of indicators inform the model, including series from the Bank of England Agents, the Lloyds Business Barometer, Indeed, ONS/HMRC PAYE payrolls and the KPMG/REC UK Report on Jobs. Indicators are weighted together according to their relative forecast performance in the recent past.

Models estimated by Bank staff suggest that falling inflation expectations and the loosening in the labour market have contributed to that slowdown in wage growth (Chart 3.7). Based on these models, high short-term household inflation expectations were estimated to be adding close to 5 percentage points to private sector wage growth at their peak. Similarly, the tightness in the labour market was adding around 2 percentage points to wage growth in late 2022. The contribution from these factors to current wage growth is projected to fall to around 3 percentage points in 2024 Q2. This remains above the typical contributions during 2018–19 of around 2 percentage points from inflation expectations and little impact from slack.

Chart 3.7: Falling inflation expectations and a looser labour market have contributed to lower wage growth

Contributions to annual private sector regular pay growth (a)



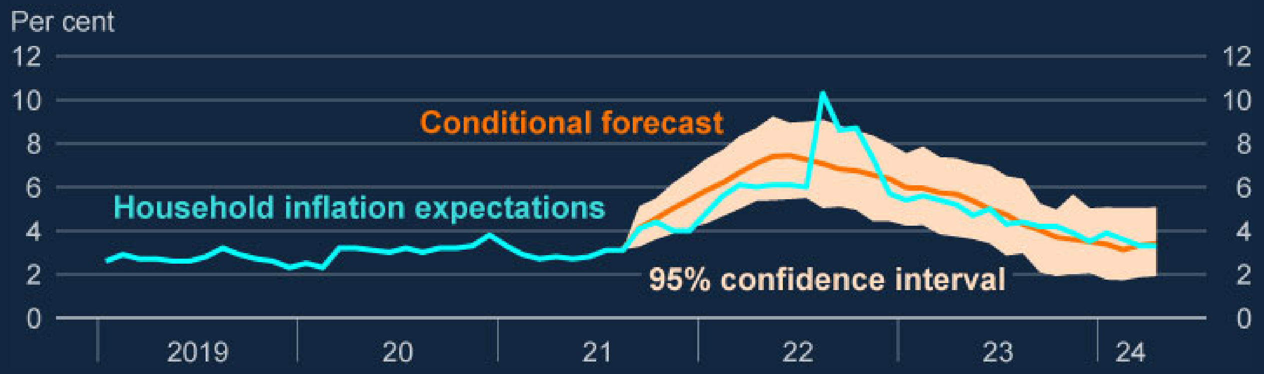
Sources: Barclays, ONS, YouGov/Citigroup and Bank calculations.

(a) Wage equation based on **Yellen (2017)**. Private sector regular pay growth is Bank staff's estimate of underlying pay growth between January 2020 and March 2022 and ONS private sector regular pay growth otherwise. Short-term inflation expectations are based on the Barclays Basix Index and the YouGov/Citigroup one year ahead measure of household inflation expectations and projected forward based on a Bayesian VAR estimation. Slack is based on the MPC's estimates, informed by the vacancies to unemployment ratio. Productivity growth is based on long-run market sector productivity growth per head. The unexplained component is the residual. Data are to 2023 Q4, with projections for 2024 Q1 and Q2.

Median household inflation expectations are now close to their historical averages (Section 2.5). Research shows that household inflation expectations tend to move in line with recent experiences of actual inflation (**Rowe (2016)**). Chart 3.8 shows a comparison between households' average reported expectation for inflation one year ahead (in aqua) to a model-based estimate of how inflation expectations would have been expected to evolve given changes in the economy over the high-inflation period (in orange). This suggests that the normalisation of inflation expectations has largely run its course.

Chart 3.8: Household inflation expectations have largely evolved in line with economic drivers

One year ahead household inflation expectations (a)



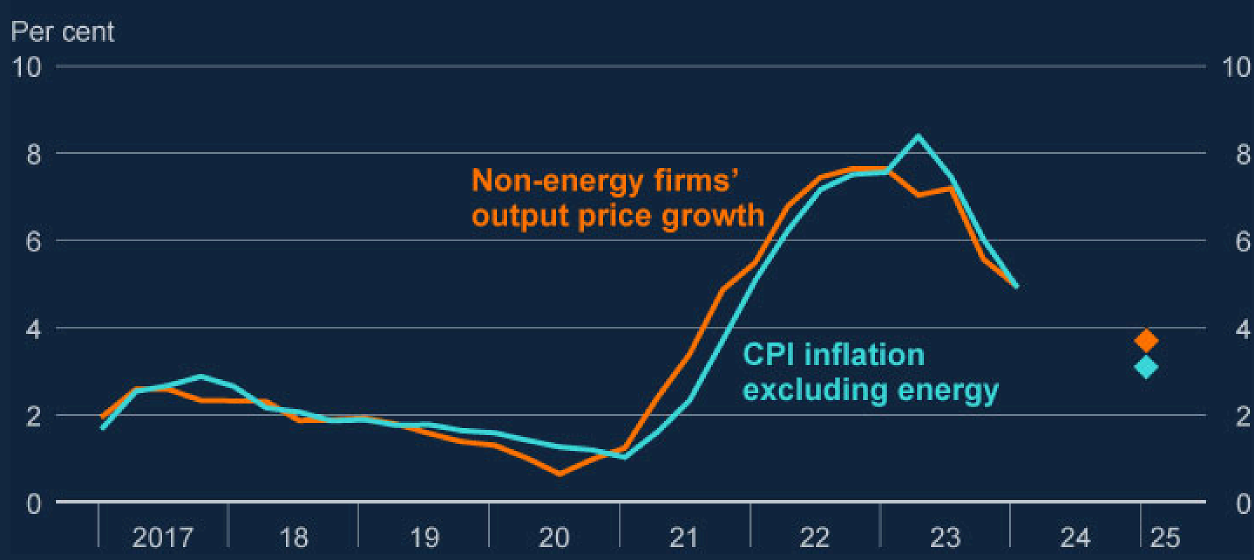
Sources: ONS, YouGov/Citigroup and Bank calculations.

(a) The orange line shows a forecast for one year ahead household inflation expectations from August 2021 conditional on observed economic outturns since then. The conditional forecast is estimated using a Bayesian vector autoregression. The latest data points shown are for April 2024.

Average expectations for businesses' own price inflation from the DMP Survey have fallen back but remain elevated, in contrast to household inflation expectations. These expectations have tended to be a reasonable guide to firms' subsequently reported realised price changes over the relatively short history of the DMP Survey. In turn, businesses' reported own output price inflation has broadly matched CPI inflation outturns over the past few years when excluding the direct effects of energy (Chart 3.9). The latest survey results show that, on average, businesses expect their own prices to rise by around 4% over the coming year. Within that, there is evidence that businesses more exposed to the effects of higher interest rates are expecting to raise prices by less than the average, consistent with monetary policy helping to anchor expectations and reduce inflationary pressures more generally.

Chart 3.9: Businesses expect their own output price inflation to continue to come down, but to remain elevated

Measures of four-quarter inflation (a)



Sources: DMP Survey, ONS and Bank calculations.

(a) Firms' realised output price growth (orange line) is based on responses to the question: 'Looking back, from 12 months ago to now, what was the approximate % change in the average price you charge, considering all products and services?'. Expected price growth (orange diamond) is based on average responses to the question: 'Looking ahead, from now to 12 months from now, what approximate % change in your average price would you expect in each of the following scenarios: lowest, low, middle, high and highest?', and respondents are asked to assign a probability to each scenario which is used to create a weighted average expectation of price growth. DMP data show annual inflation for firms excluding those in the energy sector. The series is mean and variance adjusted to CPI inflation excluding direct energy prices on a quarterly basis between 2017 and 2024 Q1. The CPI energy prices excluded are fuels and lubricants, electricity, gas and other fuels. The latest data points shown are for 2024 Q1, with the diamonds representing the Bank staff projection and firms' expectations for 2025 Q1.

Second-round effects from past inflation are expected to take longer to unwind than they did to emerge, contributing to more persistently high wage growth.

Inflation expectations can affect future developments in price-setting through a number of channels. For example, some firms change their prices periodically, such as at a one-year interval, rather than in response to changes in economic conditions (Chart 3.10 in **May 2023 Report**). If these firms have high expectations for future price increases, they are likely to raise their own prices by more when they are repricing in order to account for future cost growth, which leads to more persistent aggregate price inflation.

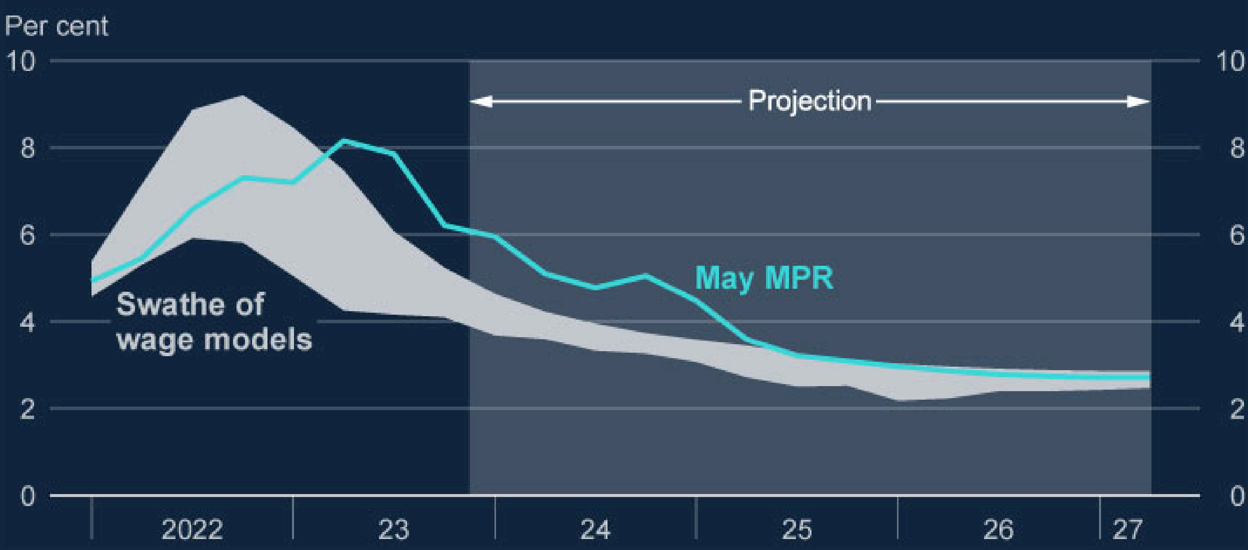
It might also be the case that there is additional intrinsic wage growth persistence that subsequently affects pricing. Past high inflation rates may continue to skew pay settlements upwards even as expectations for future inflation come down. Households may have become more backward-looking

(**Mann (2023)**) and aim to make up for the reductions in real incomes that they experienced previously. The impetus to do so should recede over time, however, as the previous shocks to energy and other imported goods prices unwind and real incomes continue to recover (Section 2.3).

In the MPC's latest projections, wage growth is expected to remain elevated throughout 2024. Chart 3.10 compares the MPC's projection (in aqua) to the range of estimates from three alternative models which incorporate inflation expectations and labour market tightness. The observed strength in wage growth during 2023 and 2024 Q1 outpaced what would be expected given historical average relationships between pay growth and inflation expectations, labour market tightness and productivity – as reflected in the aqua bars in Chart 3.7 showing the unexplained residuals from one of the models. The MPC's latest wage projection is consistent with some of this unexplained strength in current wage growth continuing.

Chart 3.10: Wage growth is expected to remain elevated compared to typical levels until 2025

Projections for private sector regular average weekly earnings four-quarter growth (a)



Sources: Bloomberg Finance L.P., Citigroup, ONS, YouGov and Bank calculations.

(a) The shaded swathe represents a range of projections from three statistical models of nominal private sector regular average weekly earnings growth, including a wage equation based on **Yellen (2017)** as shown in Chart 3.7, a wage equation based on **Haldane (2018)** and a simple error-correction model based on productivity, inflation expectations and slack in the labour market as embodied in the difference between the actual unemployment rate and the Committee's estimate of the medium-term equilibrium rate. The projections are dynamic, multi-step ahead forecasts beginning at a point within the models' estimation periods and are sensitive to data revisions, which can lead to changes in the range over the past as well as over the forecast period. The May MPR series is consistent with the latest published data for the three months to February 2024.

Services price inflation

Underlying measures of services price inflation have moderated but remain substantially higher than historical norms.

Twelve-month services price inflation was 6.0% in March 2024, down from a peak of 7.4% in July 2023 (Chart 3.11).

Headline services price inflation can be affected by volatile or idiosyncratic components which are less reflective of domestic inflationary pressure, for example airfares. No single measure provides a perfect signal for underlying inflationary pressures at all times and so the MPC takes account of a range of measures when assessing developments in services price inflation. One such measures of inflation is the median inflation rate among services subcomponents of the CPI inflation. This shows that services price inflation remains elevated and has only fallen back a little (Chart 3.11).

Higher-frequency measures of services price inflation, which help to remove the influence of base effects on current inflation rates, are running at a lower rate than headline inflation. However, these measures still indicate elevated domestic inflationary pressures. For example, the three-month on three-month inflation rate remains above 4% on an annualised basis (Chart 3.11).

Chart 3.11: Services price inflation remains elevated

Measures of services price inflation (a)

Sources: ONS and Bank calculations.

(a) The median services inflation is based on the median price change across over 180 services price CPI indices. The higher-frequency series is seasonally adjusted. The latest data points shown are for March 2024.

An alternative indicator of price pressures is the share of prices which are changed in any given month. Prior to the pandemic, a broadly stable share of services prices increased and decreased each month (Chart 3.12). Following the pandemic and energy price shocks, the share of services prices, excluding catering and accommodation, which increased each month close to doubled, while price cuts remained less frequent. More recently, the share of prices which are increased has stabilised but at a level far above pre-pandemic norms.

Chart 3.12: The share of individual CPI services price quotes that are increased each month remains elevated

Share of monthly CPI services price quotes which show price increases or decreases, excluding catering and accommodation (a)

Sources: ONS and Bank calculations.

(a) Chart shows a rolling 12-month average. Catering and accommodation services are excluded as these have been more affected by external cost shocks – for example being affected by the elevated food price inflation – than other types of services. The latest data points shown are for March 2024.

Elevated pay growth has contributed to high services price inflation, and given lags in pass-through to prices, that is set to continue in the near term.

To understand the potential future path of services price inflation, it is important to understand what has driven its current high rate. Chart 3.13 provides a breakdown from Bank staff analysis, based on a simple model utilising the correlation between current and past levels of services price inflation, pay growth and other input costs, represented by producer prices. Pay growth tends to be associated with services price inflation with a lag. Therefore, despite the recent moderation in pay growth, the model estimates suggest pay will continue to be the biggest upward contributor to services price inflation in the near term.

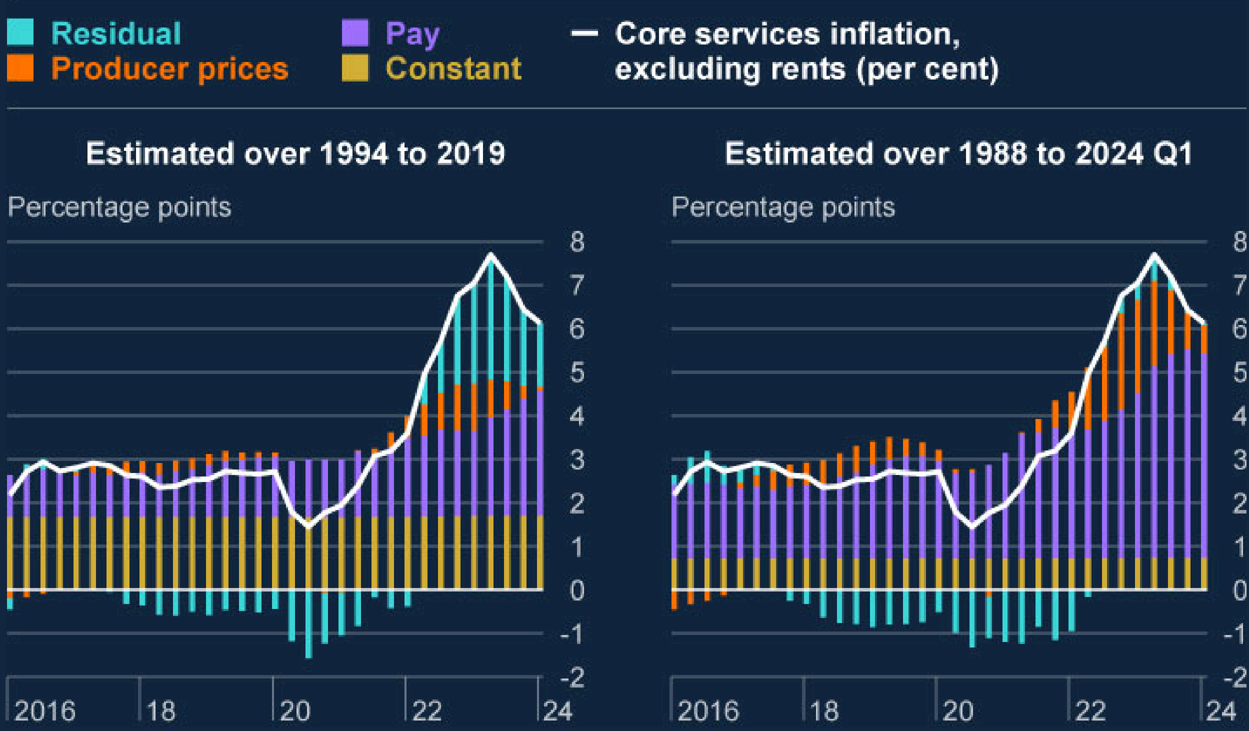
There is significant uncertainty around these estimates, particularly as there is no direct historical precedent for the sequence of international and domestic shocks that have affected the economy over the past few years. Chart 3.13 provides two alternative estimates of the contributions to services price inflation – one estimated on data between 1994 and 2019 (left panel) and one estimated on data from 1988 until 2024 Q1 (right panel). As noted in previous research, for example **Dhingra (2023)**, energy and other non-labour input costs have an important role in driving services price inflation. But the estimated scale of the contribution can be sensitive to the period considered. The recent peak in services price inflation has coincided with rapid increases in non-labour costs, for example energy prices. So, naturally, a model estimated over a period including the most recent period will tend to find that input costs can explain more of the rise in services price inflation.

One way of reconciling these estimates is if there is a non-linear relationship between non-labour input costs and firms' pricing decisions. If firms tend to absorb changes in input costs in their profit margins when input cost volatility is low but more actively change prices when costs increase materially, then we would expect to see the divergence in model estimates as shown in Chart 3.13. In either case, however, the contribution from non-labour costs to services inflation appears to have faded, suggesting that labour costs are now the key upside pressure for services inflation.

The speed and extent to which labour costs are passed through to prices will in part be determined by the strength of demand. Agents' contacts generally expect lower pass-through of higher labour costs to prices than last year, owing to demand remaining subdued. Perhaps consistent with this, the S&P Global/CIPS UK composite input price PMI increased sharply in April, at a time when many pay settlements were implemented and the NLW was increased, but the equivalent output price PMI edged down on the month. But as demand recovers over time, firms might choose to pass through higher wages into services prices more fully.

Chart 3.13: Pay growth is pushing up on services price inflation, and other costs by less so than in the recent past, although estimates are uncertain

Contributions to core services inflation, excluding rent (a)



Sources: ONS and Bank calculations.

(a) The results show the estimated contribution of factors to core services excluding rents price inflation (measured as CPI services excluding airfares, package holidays, rents and education) using an autoregressive distributed lag model. The model is estimated using quarterly seasonally adjusted CPI indices, in log differences and excluding an estimate of the impact of VAT.

3.4: The MPC's forecast for inflation

In the MPC's latest modal projection, CPI inflation is expected to return to around the 2% target throughout 2024 Q2 before rising slightly in the second half of the year (Section 2). This pickup is driven by energy price inflation, which is projected to become less negative during Q3 and Q4 compared with Q2. CPI inflation excluding energy is projected to be around 3% during the second half of the year, owing to the persistence of domestic inflationary pressures. Assuming interest rates evolve in line with market expectations, CPI inflation is projected to fall back to 1.9% in two years' time and to 1.6% in three years (Section 1).

There remain considerable uncertainties around the medium-term outlook for CPI inflation. The Committee has considered a range of analysis by Bank staff concerning the persistence of inflation in wages and domestic prices, some of which is set out in this section. The Committee continues to judge that second-round effects in domestic prices and wages will take longer to unwind than they did to emerge (Key judgement 3 in Section 1.2). However, the best collective judgement of the Committee is that these second-round effects are likely to fade slightly faster than assumed previously, pushing down on the latest CPI inflation projection during the third year of the forecast period.

Annex: Other forecasters' expectations

This annex reports the results of the Bank's most recent survey of external forecasters. Responses were submitted in the two weeks to 26 April and are summarised in Chart A. These are compared with the MPC's modal projections, which are conditioned on a range of assumptions (Section 1.1) that may differ from those made by external forecasters.

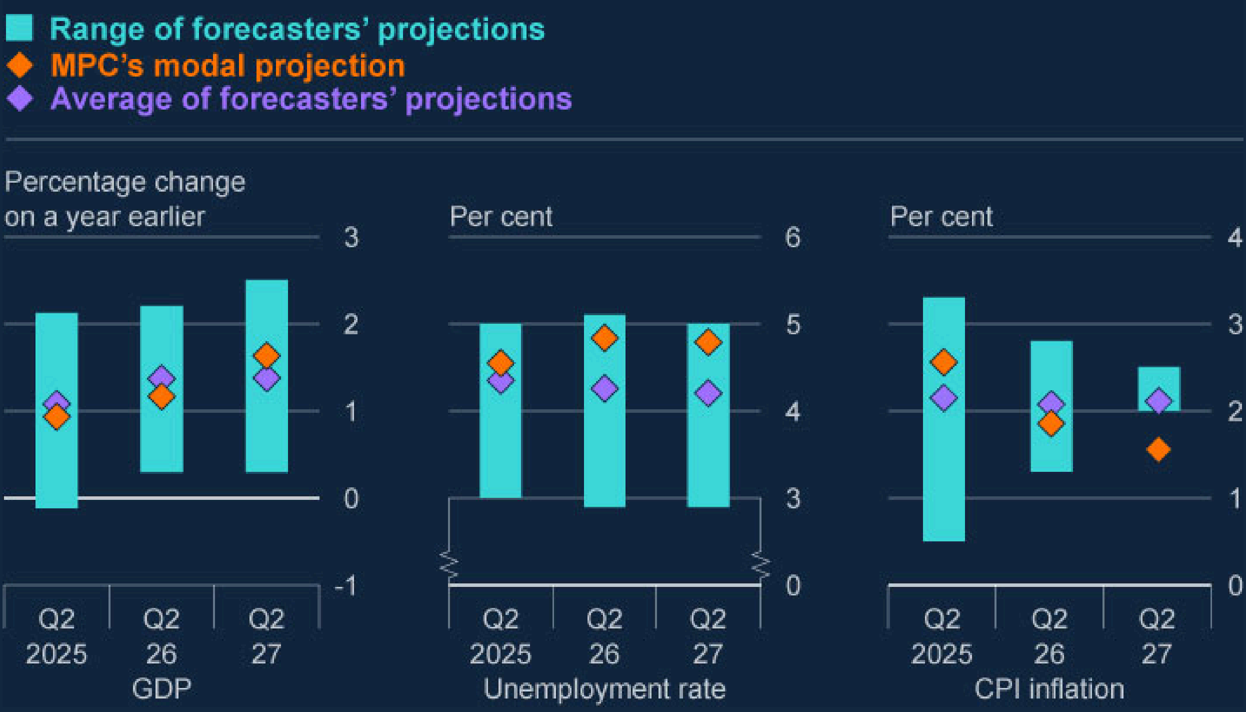
GDP over the four quarters to 2025 Q2 was expected to rise by 1.1%, with four-quarter growth increasing to 1.4% in 2026 Q2 and remaining at that rate in 2027 Q2, on average (left panel of Chart A). The average external forecast is above the MPC's modal projections for 2025 Q2 and 2026 Q2, of 0.9% and 1.2% respectively, and below the MPC's projection for 2027 Q2, of 1.6%.

The unemployment rate was, on average, expected to be 4.4% in 2025 Q2, below the MPC's projection of 4.6% (middle panel of Chart A). External forecasters then expected the unemployment rate to fall to 4.3% and 4.2% in 2026 Q2 and 2027 Q2 respectively. By comparison, the MPC's projection increases to 4.8% in 2026 Q2 and remains around that rate in 2027 Q2.

CPI inflation was expected to fall to 2.2% in 2025 Q2, below the MPC's projection of 2.6% (right panel of Chart A). The average forecasts for 2026 Q2 and 2027 Q2 were broadly in line with the 2% target at 2.1% for both periods. By contrast, the MPC's modal projections are 1.9% and 1.6% in 2026 Q2 and 2027 Q2 respectively.

Chart A: At the three-year horizon, external forecasters expected four-quarter GDP growth to be 1.4%, the unemployment rate to be 4.2%, and CPI inflation to be 2.1%

Projections for GDP, the unemployment rate and CPI inflation



Glossary and other information

Glossary of selected data and instruments

AWE – average weekly earnings.

CPI – consumer prices index.

CPI inflation – inflation measured by the consumer prices index.

DMP – Decision Maker Panel.

ERI – exchange rate index.

GDP – gross domestic product.

HICP – harmonised index of consumer prices.

LFS – Labour Force Survey.

M4 – UK non-bank, non-building society private sector's holdings of sterling notes and coin, and their sterling deposits (including certificates of deposit, holdings of commercial paper and other short-term instruments and claims arising from repos) held at UK banks and building societies.

OIS – overnight index swap.

PCE – personal consumption expenditure.

PMI – purchasing managers' index.

PPI – producer price index.

REC – Recruitment and Employment Confederation.

Abbreviations

CCS – Credit Conditions Survey.

CIPS – Chartered Institute of Purchasing and Supply.

ECB – European Central Bank.

EU – European Union.

FNAB – food and non-alcoholic beverages.

FOMC – Federal Open Market Committee.

GfK – Gesellschaft für Konsumforschung, Great Britain Ltd.

GVA – gross value added.

HMRC – His Majesty's Revenue and Customs.

ILO – International Labour Organization.

IMF – International Monetary Fund.

LTV – loan to value.

MaPS – Market Participants Survey.

MIDAS – mixed-data sampling.

MPC – Monetary Policy Committee.

MTIC – missing trader intra-community.

NLW – National Living Wage.

NPISH – non-profit institutions serving households.

OBR – Office for Budget Responsibility.

OECD – Organisation for Economic Co-operation and Development.

OFC – other financial corporation.

ONS – Office for National Statistics.

OPEC – Organization of the Petroleum Exporting Countries.

PAYE – Pay As You Earn.

PNFCs – private non-financial corporations.

PPP – purchasing power parity.

REC – Recruitment and Employment Confederation.

RICS – Royal Institution of Chartered Surveyors.

RTI – Real Time Information.

S&P – Standard & Poor's.

SME – small and medium-sized enterprise.

TLFS – transformed Labour Force Survey.

VAT – Value Added Tax.

WEO – IMF World Economic Outlook.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Bank of England or the Office for National Statistics (ONS) and all data, apart from financial markets data and results from the Decision Maker Panel (DMP) Survey, are seasonally adjusted.

n.a. = not available.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.