Annual report to the Treasury Committee

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A challenging year for monetary policy

We are having to navigate a set of unprecedented economic circumstances at the moment that are as challenging as anything the Monetary Policy Committee (MPC) has had to deal with before in its 25 years of existence.

Consumer price inflation rose from 7.0% in March 2022 to a peak of 11.1% in October 2022, before easing somewhat to 10.1% in the latest number for March 2023. This is much too high. The MPC has therefore raised Bank Rate by a further 3.5 percentage points since May last year, from 1.0% to 4.5% today. I can assure you that bringing inflation back to the 2% target remains our absolute priority.

Meanwhile, the UK economy has stagnated. After a swift beginning to the recovery from the sharp falls in economic activity seen earlier in the Covid Pandemic, the level of monthly gross domestic product (GDP) is yet to grow beyond its end-2019 level on a sustained basis, falling slightly below it in the latest data for March. The labour market has remained tight, however, driven in part by a significant reduction in labour supply. The primary cause of this reduction has been an increase in the proportion of the population that does not take part in the workforce either by working or looking actively for a job, in particular amongst the 50 to 64 year olds.

The need to bring inflation down has required a much tighter monetary policy stance. The best contribution monetary policy can make to the prosperity of the United Kingdom is to ensure that inflation returns to the 2% target sustainably, in line with the primary objective in the Government's Remit for the MPC. Our commitment to doing so is unwavering.

Economic developments

It is important to understand the disturbances that brought about this situation.

It has now been over three years since Covid struck and changed our lives. The virus first disrupted economic activity on a vast scale, calling for public policy interventions few of us had ever thought we would see in our lifetimes. Then in subsequent waves, even as we learnt to adapt and benefit from effective vaccines developed at record speed, it continued to add immense uncertainty to outcomes for public health and through that for the outlook for the economy. Monetary policy and fiscal policy acted independently to counter the cyclical downturn. A key aim of these policies was to support businesses and households through the crisis, limiting lasting damage to the economy at a time when inflation was well below the target.

The recovery from Covid came alongside four big supply shocks that have continued to shape economic and inflationary dynamics over the past year. After the initial recovery in 2020, the level of economic activity has only very slowly returned to a little below its pre-pandemic level in early 2022 and has remained around that level since. That sets the United Kingdom apart from other advanced economies, such as the United States and the euro area, which have more than recovered the economic ground lost in the pandemic.

The first of these supply shocks was a sharp rise in the prices of globally traded goods as global supply chains were overwhelmed by an unexpectedly persistent shift in demand from services to goods across these advanced economies. Rising prices in these traded goods may have directly contributed as much as 2 percentage points to the level of inflation in the UK consumer price index (CPI) over the past year, and that is before taking the indirect effects working through domestic supply chains into account. This shock, however, is now much reduced as global supply pressures have gradually eased. Shipping rates, for example, have stabilised at around pre-pandemic levels.

The second supply shock has been caused by Russia's appalling war on Ukraine. Russia's actions have caused untold suffering for the Ukrainian people. By driving up wholesale gas prices in European markets, this has also continued to be the largest single contributor to CPI inflation in the United Kingdom. While making up less than one twentieth of the CPI basket, electricity and gas have directly added about 3.5 percentage points to overall UK inflation throughout the year.

That number would have been even higher had it not been for the Government's Energy Price Guarantee (EPG), which capped the typical household energy bill at £2,500 a year over the winter. In the August 2022 Monetary Policy Report (MPR), prior to the EPG, the MPC projected CPI inflation to rise to just over 13% towards the end of 2022, with the risk that it would remain at very elevated levels throughout much of 2023 if wholesale gas prices remained high. This followed a near doubling in wholesale gas prices since May last year. With an expected 75% rise in Ofgem's price cap in October, the direct contribution of electricity and gas could have risen to 6 percentage points. In the November 2022 MPR, reflecting the impact of the EPG, the MPC revised down the projected peak in CPI inflation by two percentage points despite a further uptick in medium-term futures prices for wholesale gas.

The third supply shock has been a domestic one. As Covid hit, UK labour supply growth came to an abrupt halt. The size of the workforce declined by more than 130,000 people, or nearly ½%, from the three months to December 2019 to the three months to January this year. That stands in stark contrast to a steady growth rate of around ¾% per year during the preceding decades. The primary cause of this reduction in labour supply is an increase in economic inactivity, not just reflecting the ageing of the population, but also driven by a fall in the share of working-age people taking part in the labour market. Between December 2019 and July 2022, the

number of people not taking part in the labour market rose by more than 800,000. While there are signs in the more recent data that this trend may be reversing, the shrinkage of labour supply has contributed to continued tightness in the labour market throughout the past year.

Finally, a fourth supply shock has gained momentum since my last annual report in May 2022. This is the sharp rise in food prices. When I appeared before the Treasury Committee in May last year, I pointed to the risk that disruptions to Ukraine's supply of agricultural products to the global market could drive up food prices to worrisome levels. Since then, the annual CPI inflation for food and non-alcoholic beverages in the United Kingdom has risen from 5.9% in March 2022 to 19.1% in the latest March 2023 numbers. This is not just happening here in the United Kingdom. Other European countries have similar food price inflation rates. Increases in energy prices and poor harvests, in addition to Russia's invasion of Ukraine, have played a role throughout the continent. With a 12% weight in the UK CPI, food prices alone are now contributing more than 2 percentage points to inflation.

In sum, these big external shocks continue to account for a large part of the inflation overshoot above target. In turn, by worsening the terms on which we trade with the outside world, the rise in external prices has reduced our real national income. This is being felt by households across the United Kingdom, most acutely by those on lower incomes. Many people face difficult choices and have had to cut back even on essentials.

Through the Bank's outreach programmes, we hear first-hand from people about the economic hardship they face, and from charities about how challenging it can be to muster resources to help people through these difficult times. These experiences weigh heavily on my mind.

Monetary policy

August MPC meeting

Throughout this past year, monetary policy has had to navigate these conflicting developments of rising inflation and a weakening outlook for spending and the real economy, both for the most part driven by higher external prices. While the MPC has been expecting external inflationary pressures to dissipate over time, the Committee has had to pay close attention to the extent to which inflation could become embedded in domestic inflationary dynamics.

The labour market has remained very tight, with the unemployment rate falling to 3.5% in the three months to August 2022, the number of vacancies rising to around 1.3 million in the first half of 2022, and private sector regular wage growth rising to 7.6% in November, well above levels that are consistent with the inflation target. Services price inflation, which is more influenced by domestic cost and price setting

dynamics than goods price inflation, rose to 6.8% in December. The MPC has been particularly alert to any indication of persistence in domestic inflationary pressures and has acted with force as evidence of persistence has emerged.

These dynamics became very apparent in the time leading up to the MPC's August 2022 meeting. The sharp rise in wholesale energy prices, owing to Russia's restriction of gas supplies to Europe and the risk of further curbs, was on course to feed through to retail energy prices both driving up CPI inflation further in the near term and exacerbating the fall in real incomes for UK households. The expected rise in inflation therefore came with another significant deterioration in the outlook for economic activity.

In the August MPR, the MPC projected that the United Kingdom would enter a recession from the fourth quarter of 2022. At the same time, domestic inflationary pressures were projected to remain strong over the first half of the MPC's forecast period as the labour market remained tight, before an increasing degree of economic slack would ease domestic inflationary pressures in the second half of the forecast.

It was very clear to the Committee, however, that the risks around its projections were exceptionally large. Reflecting the range of plausible paths the economy might take, the MPC put less weight on the implications of any single set of conditioning assumptions and projections than it normally would. In addition to its baseline projection, conditioned on a path for wholesale gas prices following the market futures curve for six months and then remaining constant, the August 2022 MPR contained an alternative projection in which energy prices were assumed to follow their downwards-sloping futures curves throughout the forecast. In this alternative, GDP would be materially higher, while CPI inflation would be materially lower towards the end of the forecast. The MPR also presented a scenario exploring the implications of greater persistence in domestic price setting than in the baseline based on evidence from the Bank's survey of its Decision Maker Panel.

While there were significant differences between these alternative projections in the latter half of the forecast period, conditional on a market-implied path for Bank Rate reaching 3.0% in the second quarter of 2023, all three alternatives showed very high near-term inflation, a fall in GDP over the year ahead and a marked decline in inflation thereafter. In view of the tight labour market and elevated domestic price pressures, the MPC put weight on the risk that a longer period of externally generated price inflation could lead to more enduring domestic price and wage pressures. Accordingly, the Committee voted to increase Bank Rate by 0.5 percentage points at the August meeting.

September MPC meeting

Following the sad news of the death of Her Majesty Queen Elizabeth II, the September MPC meeting, which had originally been scheduled to end on 14 September, was postponed by one week in light of the period of national mourning.

Wholesale gas prices continued to be highly volatile in the period leading up to the meeting. Uncertainty around the outlook for UK retail energy prices had nevertheless fallen, following the Government's announcements of the EPG. It was evident that the Guarantee would limit further increases in CPI inflation driven by energy prices. Nevertheless, there were further signs of continuing strength in domestically generated inflation, and the EPG also meant that household spending would be less weak than projected in the August MPR. Moreover, the Government had scheduled the announcement of a Growth Plan that was likely to contain material news for the economic outlook. In light of these factors, a 5-4 majority of MPC members voted to increase Bank Rate by a further 0.5 percentage points, to 2.25%, at the MPC meeting ending on 21 September. This was a finely balanced decision, and three Committee members would have preferred a 0.75 percentage point increase at this meeting.

November and December MPC meetings

In the period following the MPC's September meeting, the UK Government made a number of fiscal announcements. UK financial markets experienced violent moves, particularly at the long-end of the Government debt market. This put the spotlight on flaws in the strategy and structure of some pension funds, and the Bank intervened in the market to deal with the resulting financial stability threat. These interventions – described in detail in letters from my colleague Jon Cunliffe to the Treasury Committee in October – were made in pursuit of the Bank's statutory financial stability objective. Designed to be strictly temporary and targeted, ending after two weeks of operation, they worked to ensure that yields were not distorted by severe liquidity strains in financial markets. They were not monetary policy interventions affecting the monetary policy stance.

At its subsequent meeting in November, the MPC had to contend with large moves in UK asset prices. When turmoil in the market was most intense in September, the market-implied path for Bank Rate had reached a peak of nearly 6½%. At the market close on the day of the MPC's final meeting in November, it stood at about 4¾%. Given those moves, the MPC's November forecast was conditioned on an average of the market-implied paths over the final 7 days of our usual 15-day window. This meant that the November forecast was based on a path for Bank Rate that rose to a peak of 5¼% in the second quarter of 2023. Given the EPG, the Committee also moved to condition its baseline forecast on the full downward-sloping futures curve for wholesale energy prices to avoid an implausible mechanical jump in the projection for consumer prices when the scheme was due to close. Using these assumptions, the baseline projection had inflation fall far below target in the second half of the forecast.

In part for this reason, based on where we were in November, it seemed unlikely that Bank Rate would have to go up by as much as was priced into financial markets at the time. This also meant that that the sharp increases in rates on new fixed-term

mortgages at the time seemed excessive. Indeed, while Bank Rate has increased further since November, these rates have fallen from their autumn peaks.

Regardless of the path for Bank Rate, the MPC judged that the risks to its inflation projections were skewed to the upside, reflecting the possibility of more persistence in domestic wage and price setting. It was not least for this reason that the MPC voted to increase Bank Rate by 0.75 percentage points at this meeting, while noting that further increases in Bank Rate might be required should the economy evolve broadly in line with the forecast presented in the November MPR, followed by a further 0.5 percentage point increase to 3.5% in December.

February MPC meeting

As we moved into the MPC's February meeting, we were beginning to see the first signs that inflation had turned the corner. CPI inflation had come down from 11.1% in October to 10.5% in December, below where we thought it would be in the November MPR. With marked falls in wholesale gas prices and, with prospects of the previous year's very large increases in the prices of electricity and gas beginning to drop out of the annual calculation of the CPI, we expected inflation to continue to fall, especially in the second half of this year. Global price pressures had also been easing as supply chain disruptions had lessened across most of the world.

But while external pressures were easing, domestic indicators of inflationary pressures had proved firmer than expected. While we were confident that inflation would come down this year, lingering domestic inflationary pressures could prolong the time it would take to return inflation to target on a sustainable basis without further monetary tightening. The risks to the inflation outlook remained skewed to the upside. So even though the full effect of the previous increases in Bank Rate were still to work its way through the economy, the MPC judged that a further 0.5 percentage point increase in Bank Rate was warranted.

March MPC meeting

Given stronger than expected employment growth and an unexpected uptick in CPI inflation in February, this was followed by a vote to increase Bank Rate by a further 0.25 percentage points, to 4.25%, in March.

Leading up to the March meeting, there had been large and volatile moves in global financial markets with market concerns about possible broader implications from the failure of the US Silicon Valley Bank and purchase by UBS of Credit Suisse. The Bank's Financial Policy Committee (FPC) had briefed the MPC about these global banking sector developments, and judged that the UK banking system remained resilient and well-placed to continue to support the economy in a wide range of economic scenarios.

This positive assessment is important for monetary policy. The MPC should be able to respond to the macro implications of any dislocation to credit markets to the extent

that they influence the outlook for inflation, just as the MPC conditions its policy decisions on asset prices at every meeting. But what monetary policy should not do, and has not had to do, is to aim off the preferred setting of monetary policy because of financial stability concerns. The strong macroprudential policy framework in the United Kingdom, overseen by the FPC, works powerfully to this effect.

Unwinding the stock of assets purchased for monetary policy purposes

At its August 2022 meeting, the MPC noted that it was provisionally minded to commence sales of UK government bonds held for monetary policy purposes in the Bank's Asset Purchase Facility shortly after its September meeting, subject to economic and market conditions being judged appropriate and to a confirmatory vote at that meeting. This followed the decision in February 2022 to cease gilt reinvestments and to initiate sales of the purchased sterling non-financial investment grade corporate bonds.

In the run-up to the August meeting, Bank staff set out a framework for assessing whether conditions were appropriate for the gilt sales to commence. The MPC agreed that, over the first twelve months of a sales programme starting in September, a reduction in the stock of purchased gilts of around £80 billion to a total of £758 billion was likely to be appropriate. These decisions reflected the MPC's decision to reduce the size of its asset holdings in a gradual and predictable manner so as to maintain Bank Rate as its active monetary policy tool and avoid disrupting the functioning of financial markets.

Consistent with the guidance set out in August, the MPC agreed at its September meeting that the Bank should reduce the stock of gilt purchases by £80 billion over the following 12 months. While the Bank Executive postponed the start of these gilt sale operations in light of the dysfunctional market conditions that emerged shortly after the September's fiscal events, the first gilt sale operation took place on 1 November and auctions have been proceeding smoothly since.

As of 19 April 2023, the combination of maturities and gilt sales had reduced the stock of gilt purchases by £59.7 billion. As of the same date, the stock of corporate bond holding in the APF had reduced by £14.0 billion, or over 70%, through a combination of maturities, sales by auction and buybacks by bond issuers. This has allowed for a reduction in the maximum size of the APF under HM Treasury's indemnity to a total of £821.3 billion as confirmed in my exchange of letters with the Chancellor on 28 April 2023.

The outlook for inflation

As the MPC convened for its recent May meeting, the outlook for growth and unemployment had improved. While six months earlier we had been a expecting a shallow but long recession in the UK economy, we were now, based on the evidence

as it presented itself, forecasting modest, but positive growth, and a much smaller increase in unemployment.

Above all, the improvement in the outlook reflected a further fall in wholesale gas prices, reversing some of the terms of trade shock that has been the primary cause of falling real incomes. But there has also been greater resilience in the economy than we had expected, evidenced for instance in the employment and unemployment data. Fiscal policy could also be expected to boost GDP over the forecast period. Both the temporary 100% capital allowances for qualifying business investment and measures aimed at increasing labour market participation could be assumed to have positive effects on potential supply.

Inflation had surprised on the upside. The latest figure of 10.1% for March was 0.8 percentage points higher than we expected at the time of the February Report. Higher food and clothing prices accounted for most of the surprise. Food prices, in particular, had been particularly high.

We do, however, have good reasons to expect inflation to fall sharply over the coming months, beginning with the April number to be released on 24 May.

Energy prices have fallen from their peaks, and that will now start to come through as lower inflation. In the March release, the prices of electricity, gas and other fuels were more than 85% higher than a year ago, contributing more than 3 percentage points to headline inflation. That contribution is likely to drop significantly to about 1 percentage point in April's data as large increases in energy prices from a year ago drop out of the annual calculations. Looking ahead to the end of the year, if energy prices evolve as financial market prices now suggest, the contribution from energy will fall further. Towards the end of the year, energy prices should begin to pull overall inflation down rather than push it up as it has done over the past two years.

While we can be less sure about the timing, food price inflation should start to ease too. Global prices of wholesale agricultural commodities have come down since Spring of last year, and food producer price indices have eased in recent months. Evidence collected by the Bank's Agents suggests that food producers expect food production costs to moderate. While this may take longer than we previously thought, we should expect this to feed through to consumer food inflation over the coming year. That is the message I hear when I visit and meet with both food producers and retailers across the country.

However, we need to continue to keep a watchful eye on other components of the consumer index too. Core inflation, which excludes energy and food prices, is driven by items that can have more persistent inflationary dynamics. At 6.2% in March, core inflation also remains elevated.

Some of the strength in core inflation reflects the indirect effects of higher energy prices. But it also reflects so-called second-round effects as the external shocks we

have seen interact with the state of the domestic economy. And as headline inflation falls, these second-round effects are unlikely to go away as quickly as they appeared. The MPC has considered this issue carefully and judges that there is an important asymmetry in inflationary dynamics in this respect. So even as headline inflation is coming down, the MPC pays particular attention to indicators of inflation persistence, including labour market tightness and wage growth, and services inflation.

The news on these indicators has been mixed recently. There are some signs that the labour market is loosening a little. There has been some recovery in labour market participation, especially amongst younger workers, and the number of vacancies has come down from very high levels. The ratio of the number of vacancies to the number of unemployed, a key measure of labour market tightness, has fallen as a result. Our Agents report that businesses face fewer recruitment difficulties and that employees are moving jobs less frequently. But the easing of labour market tightness is happening at a slower pace than we expected in February, and the labour market remains very tight. The vacancy to unemployment ratio remains significantly higher than before the pandemic, and employment figures have been strong.

Meanwhile, nominal wage growth and services price inflation have evolved much as we have been expecting. Nominal pay growth has also fallen back slightly, and near-term indicators suggest that pay growth could ease further later this year. This is also backed up by what our Agents hear about expectations for pay settlements for the coming year. Services inflation is still elevated, and the extent to which firms have already passed through higher costs will influence the pace at which it will decline.

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

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

Importantly, however, the Committee continues to judge that the risks to inflation are skewed significantly to the upside, primarily reflecting the possibility of more persistence in domestic wage and price setting. We think the unwinding of second-round effects may take longer than it did for them to emerge. But since the current circumstances are so unusual, it is hard to be precise about the extent of this asymmetry, and we have not made it part of our baseline modal projection for this reason. Instead, relative to the baseline projection of significant declines in inflation

to levels below target, we think of this as a material upside risk to the inflation outlook over the medium term.

Reflecting those risks, conditional on the market-implied path for Bank Rate, the MPC's mean forecast path for inflation is at or just below the 2% target at years 2 and 3. Hence, having this large upside risk on inflation does not call into question meeting the inflation target in our projection using market rates.

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

These changes are still working their way through the economy. While we have seen higher rates quoted on new mortgages, and while the effective rates on new mortgage lending have been increasing, the effective rate on the whole stock of mortgages is still in a process of adjustment towards higher reference rates. This is a reflection of the increasing share of fixed-rate mortgages in the UK mortgage markets. As this process plays out, the rises in Bank Rate we have put in place since December 2021, will weigh more on the economy in the coming quarters. The MPC factors these lags in the transmission of monetary policy into its policy decisions.

At the May meeting, the MPC judged that a further 0.25 increase in Bank Rate, to 4.5%, was appropriate. The MPC is continuing to address the risk of more persistent strength in domestic price and wage setting, as represented by the upward skew in the projected distribution for CPI inflation, and the Committee will continue to monitor closely the indicators of persistence in inflationary pressures.

I can assure you that the MPC will adjust Bank Rate as necessary to return inflation to target sustainably in the medium term, in line with its remit. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.

External engagement

The Bank's network of Agents, who travel to all corners of the country to talk to businesses and organisations, continue to provide invaluable information ahead of, and in addition to, the information reflected in the official data. The intelligence this work provides has been of particular importance in the MPC's assessment of domestic inflationary pressures as well as of demand adjustments to higher prices. I regularly join them in this work, and I have visited each of the twelve regions and nations of the United Kingdom in the past year.

I have set out below my speeches and regional visits.

Speeches on Monetary Policy

"Opening remarks at OeNB monetary policy panel" given at Oesterreichische Nationalbank, Annual Economic Conference, Vienna, 23 May 2022

https://www.bankofengland.co.uk/speech/2022/may/andrew-bailey-panellist-at-the-oesterreichische-national-bank-annual-economic-conference

"The economic landscape: structural change, global R* and the missing-investment puzzle" given at the Official Monetary and Financial Institutions Forum, London, 12 July 2022

https://www.bankofengland.co.uk/speech/2022/july/andrew-bailey-speech-at-omfif-the-economic-landscape

"Bringing inflation back to 2% target, no ifs no buts" given at the Mansion House Financial and Professional Services Dinner, London, 19 July 2022

https://www.bankofengland.co.uk/speech/2022/july/andrew-bailey-speech-at-mansion-house-financial-and-professional-services-dinner

"Monetary policy and financial stability interventions" given at G30 37th Annual International Banking Seminar, Washington, D.C., 15 October 2022

https://www.bankofengland.co.uk/speech/2022/october/andrew-bailey-opening-remarks-and-panellist-37th-annual-international-banking-seminar

"The cost of living" given at Brunswick Group's Cost of Living Conference, London, 1 March 2023

https://www.bankofengland.co.uk/speech/2023/march/andrew-bailey-speech-at-cost-of-living-crisis-conference-brunswick-group

"Supply matters" given at the London School of Economics, London, 27 March 2023

https://www.bankofengland.co.uk/speech/2023/march/andrew-bailey-speech-at-london-school-of-economics

"Monetary and financial stability: lessons from recent times" given at the Institute of International Finance, Washington, D.C., 12 April 2023

https://www.bankofengland.co.uk/speech/2023/april/andrew-bailey-remarks-at-the-institute-of-international-finance

Regional Visits

Scotland – 17 June 2022

West Midlands – 22 July 2022

East Midlands (virtual) – 27 September 2022

Central Southern – 21 October 2022

North West – 9 November 2022

North East – 10 November 2022

Wales – 18 January 2023

Yorkshire and the Humber – 10 February 2023

East Midlands – 29 March 2023

Greater London – 3 April 2023

North West – 19 April 2023

South West, including a Bank Community Forum – 16 May 2023