Who's buying? The outlook for consumption in a rate cutting cycle – speech by Megan Greene

Given at The North East Chambers of Commerce, Newcastle

25 September 2024

Speech

Introduction

Thank you very much for inviting me to come and speak to you this morning - I'm thrilled to be here with you in Newcastle. I'm aware that this audience represents a wide array of businesses. In light of that, I thought it would be useful to address a topic that touches many businesses, namely the weakness we are seeing in UK consumption. To put it in phrasing an audience in Newcastle might appreciate, the UK consumer doesn't seem to be "walking in fields of gold."

Over the course of my remarks, I'll highlight why this persistent weakness is somewhat unexpected, what might be underpinning it and what the implications are for our outlook and monetary policy.

The consumption puzzle

Consumption accounts for roughly two-thirds of GDP for most developed economies, including the UK, so understanding what is driving consumption is crucial to figuring out underlying trends in overall activity. Consumption also plays a key role in determining the extent to which price and wage setting behaviours feed on one another in so-called second round effects. If people are willing to spend money buying things, firms may be able to pass on higher input costs in the form of higher prices. But in the face of higher prices, workers may demand higher wages so they don't suffer a fall in living standards. This can turn into a self-reinforcing loop.

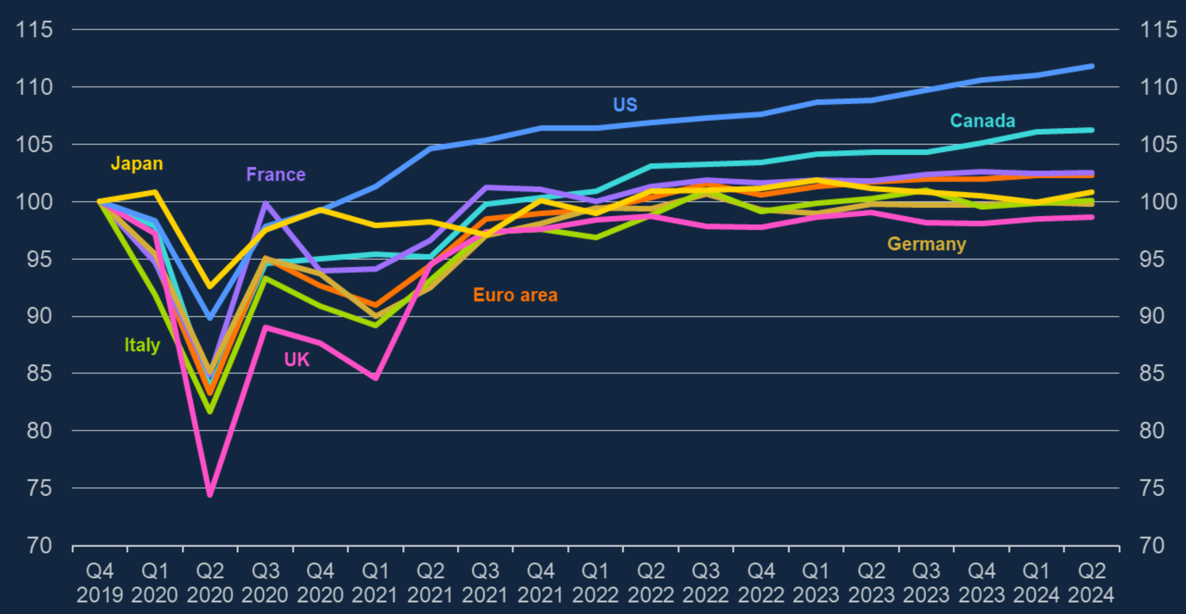
At the heart of the MPC's outlook for growth and inflation is two assumptions: firms don't feel they can pass on higher costs this year and consumption should pick up. This is a very delicate balance; if consumption picks up significantly, then firms will have more pricing power and can pass on higher costs through to higher prices. Understanding consumption dynamics can therefore inform our outlook and help us determine for how long monetary policy should remain how restrictive to squeeze second round effects out of the economy.

During the Covid-19 pandemic, we saw huge shifts in consumer spending patterns. The spread of the virus and government containment measures changed how people spent their money and led to a large contraction in overall consumption across the globe. Russia's invasion of Ukraine further exacerbated this, as global energy and food prices rose sharply. As net importers of energy, the UK and euro area were particularly hard hit by the terms of trade shock (**Dhingra, 2023**), while the impact on the US was more muted (**Greene, 2024**). The impact of these shocks has now dissipated, and we have seen a recovery in consumption in many advanced economies – as shown in **Chart 1.** But the UK is a clear laggard among advanced economy peers.

It is worth noting that many of these charts I'm showing here today are likely to change a bit next week when the ONS releases its quarterly national accounts, which will show the effects of its annual revision, the Blue Book. **Advanced estimates** suggest consumption may be revised upwards and savings downwards for 2022. But while magnitudes may shift a bit, the general trends and arguments I am presenting here should hold.

Chart 1: G7 real household consumption

Index, 2019 Q4 = 100[(a)]



Source: ONS, Statistics Canada, Trading Economics, Insee, LSEG and author's calculations. Latest data points are for 2024 Q2.

(a) Blue Book advanced estimates suggest that UK real consumption may have recovered to its 2019 Q1 level in 2022.

The overall weakness of UK consumption isn't just a stand-out from an international perspective. Developments in the wider UK economy make this weakness even more puzzling. Following the Russian invasion of Ukraine, the UK saw its import prices rise sharply relative to export prices as imported energy and food prices soared. Inflationary pressures mounted as income fell in real terms. While food prices remain high, wholesale gas prices have receded, and the terms of trade shock has now unwound - as shown in

Chart 2.

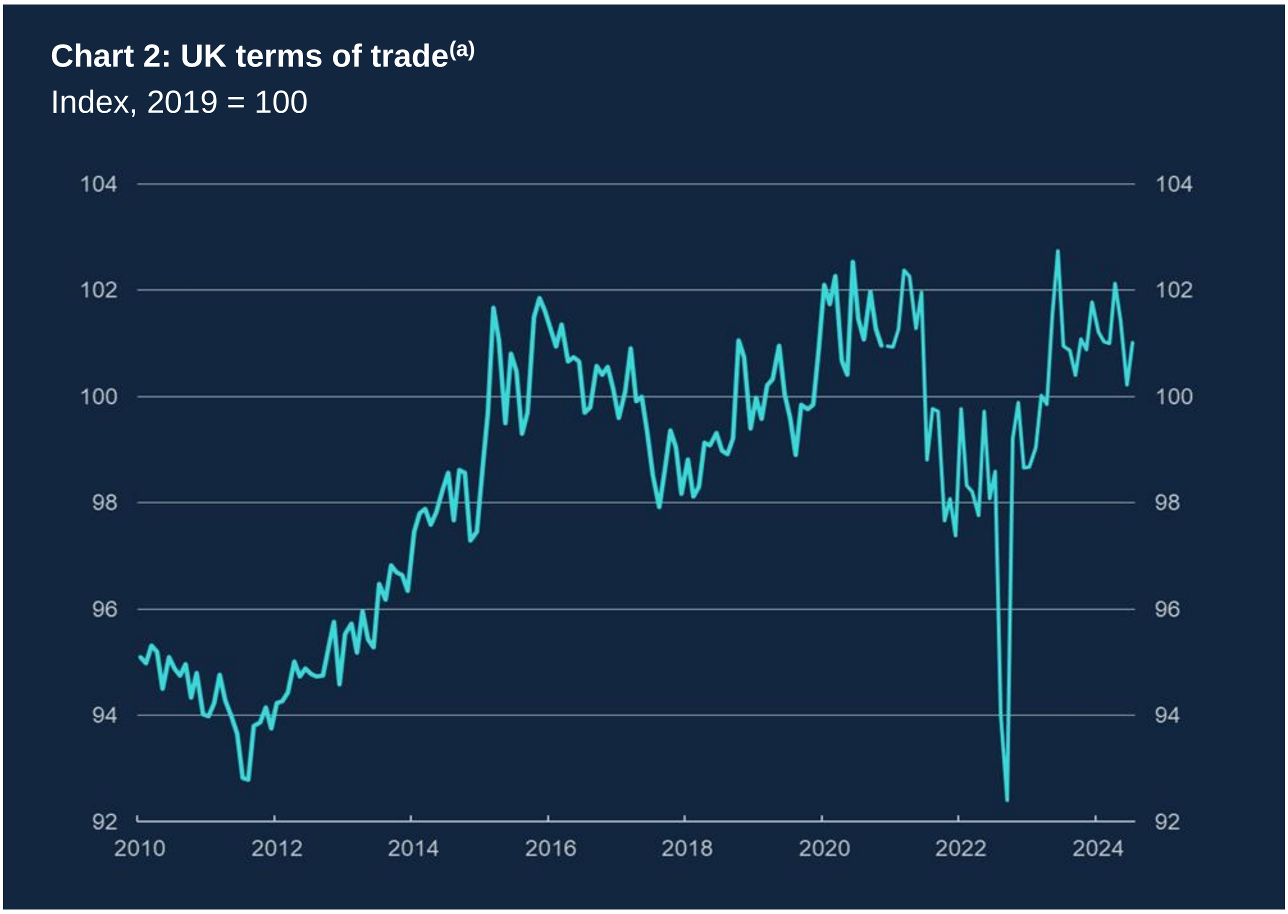


Chart 2: UK terms of trade[(a)]
Index, 2019 = 100

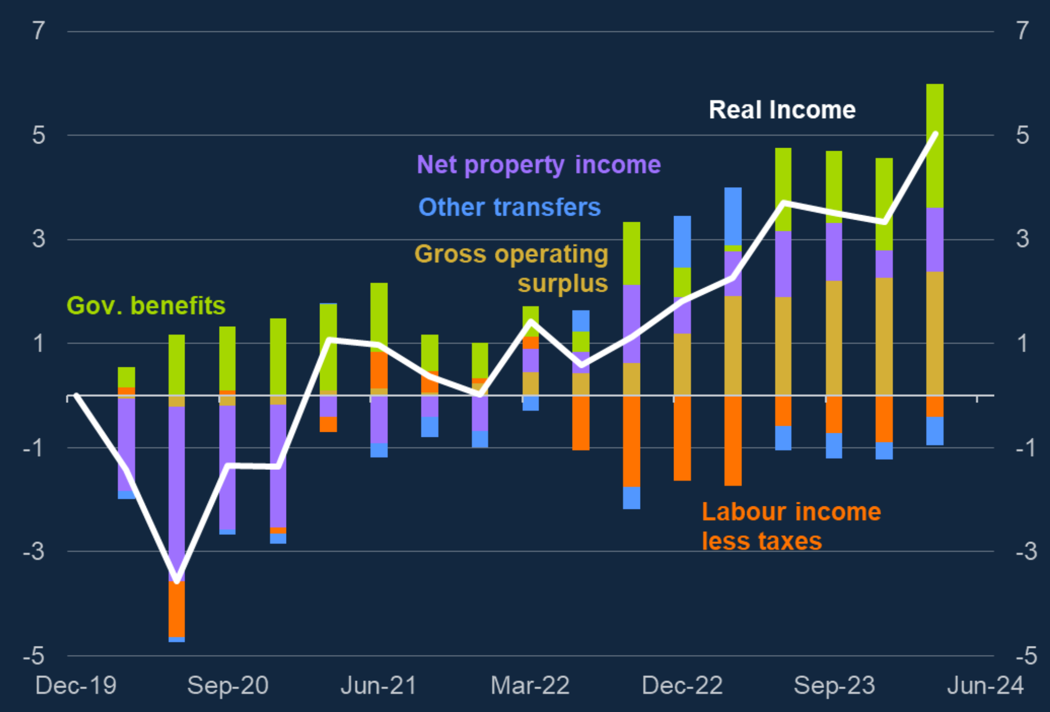
Source: ONS and author's calculations. Latest data points are for July 2024.
(a) Terms of trade is defined as the ratio of export to import prices

This has helped contribute to a sharp recovery in aggregate household real income. As shown in **Chart 3,** a combination of (1) a recovery in gross operating surplus[1]; (2) a waning drag from after-tax labour income; and (3) fiscal support provided by government has lifted the level of aggregate household real income about 5% higher than in 2019 Q4.

[1] Gross operating surplus of households includes imputed rental income from housing.

Chart 3: Aggregate household real income [(a)]

Contribution to change since 2019 Q4, per cent and percentage points

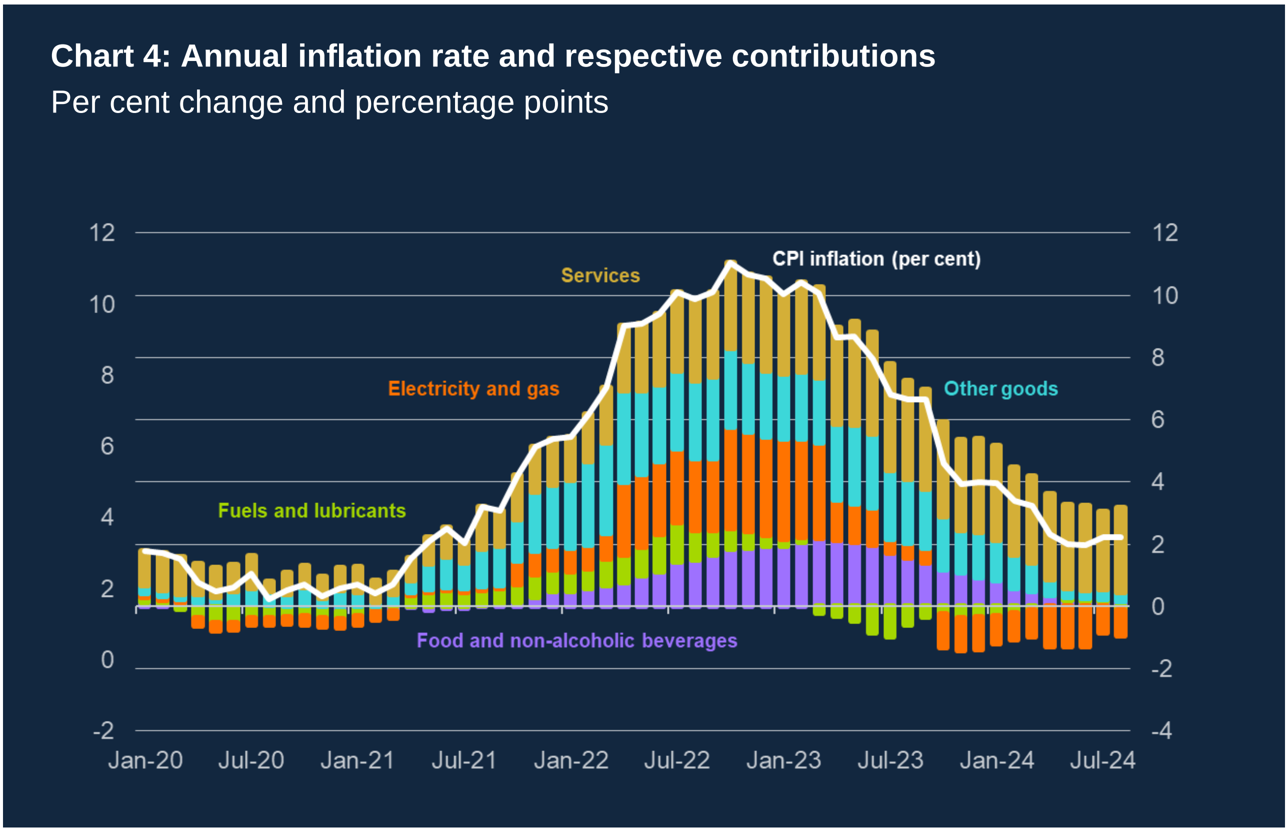


Source: ONS and author's calculations.

(a) Labour income less taxes represents wages and salaries plus mixed income minus taxes and subsidies. Net property income represents property income resources minus property income uses. Other transfers represent other current transfers minus social benefits other than social transfers in-kind; net non-life insurance premiums; and miscellaneous transfers. Bars show percentage point contribution to the change in real income since 2019 Q4. Real income line shows percentage change since 2019 Q4. Latest data points are for 2024 Q1.

While services inflation has remained stubbornly persistent, headline CPI inflation has come in closer to target in recent months as energy prices have dragged on headline inflation, food inflation has fallen and core goods inflation has been weak. This is shown in

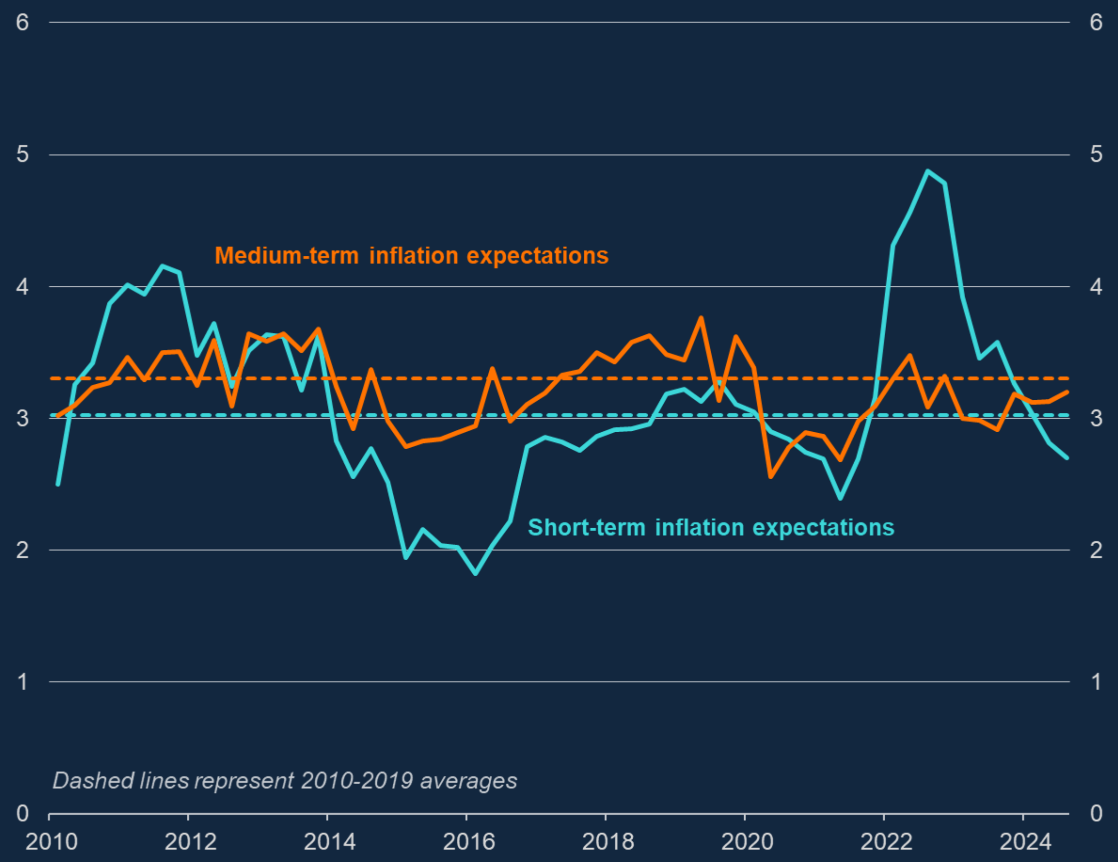
Chart 4.



Source: ONS and author's calculations. Latest data points are for August 2024.

Research by Anesti, Esady and Naylor (2024) has shown that households tend to be most sensitive to food and energy price inflation. As these components' inflation rates have fallen, so have inflation expectations – as seen in **Chart 5**. Moreover, the role of past inflation in determining household inflation expectations means falling headline CPI inflation tends to pull down expectations along with it. Indeed, both household short- and medium- term inflation expectations have fallen below their historical averages. So, it seems that households are aware inflation is coming down, and generally expect it to remain much lower than it was during the cost-of-living crisis.

Chart 5: Household medium and short-term inflation expectations
Per cent [a]



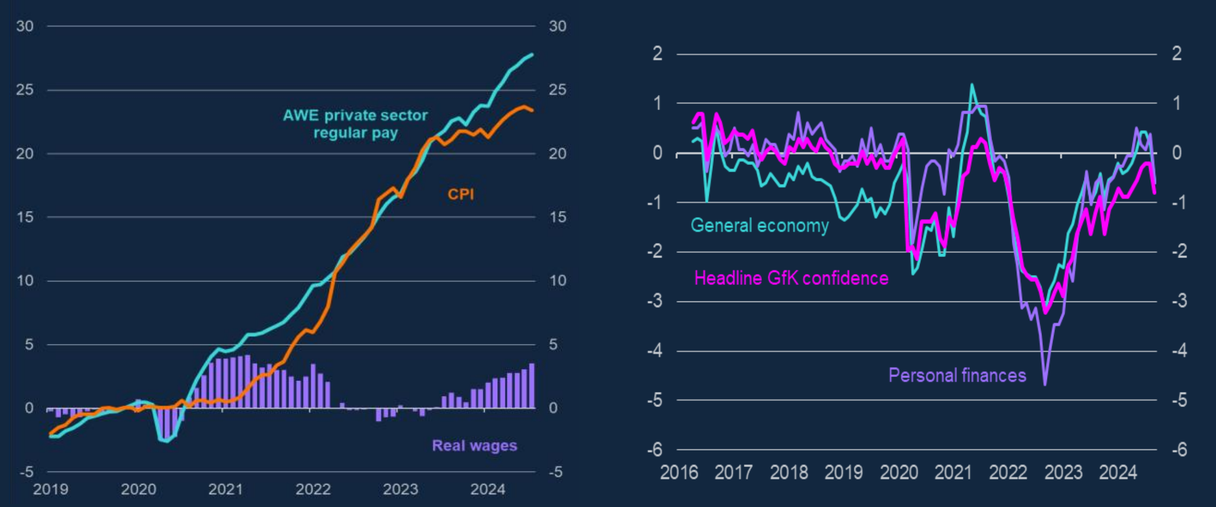
Source: Bank/Ipsos Inflation Attitudes Survey and author's calculations.
(a) Data shown are median responses from the Bank/Ipsos Inflation Attitudes Survey. 'Short-term inflation expectations' refers to inflation expectations in the next 12 months and 'Medium-term inflation expectations' refers to inflation expectations for inflation five years ahead. Dashed lines represent the series averages over 2010–19. A methodological break occurred during the Covid-19 pandemic that means a degree of caution should be taken when making long-run comparisons with these data, for more information please see the methodology notes linked in the **latest IAS release for August 2024**. Latest data points are for 2024 Q3.

At the same time, wage growth rose significantly as the labour market tightened after the pandemic. Real wages have been rising for most of the post-pandemic period, including over the last year– demonstrated in the left-side panel of **Chart 6**. Real average weekly regular wages in the private sector are now higher than their pre-pandemic (2010-2019) average and are expected to continue to rise. Yet despite this boost to people's purchasing power, consumption has flagged.

And this is in the face of growing consumer confidence, which has generally improved since the end of 2022. Sentiment fell in the most recent outturn, possibly reflecting anticipation of the upcoming budget and so may unwind once the details are available. But overall, households had broadly been reporting an improved outlook for both the general economic situation and their own finances in recent months – shown in the right-side panel of **Chart 6.**

Chart 6: Real wages and consumer confidence

Cumulative per cent change since 2019 Q4(a) Standard deviation from mean(b)



Source: ONS, GfK, LSEG and author's calculations.

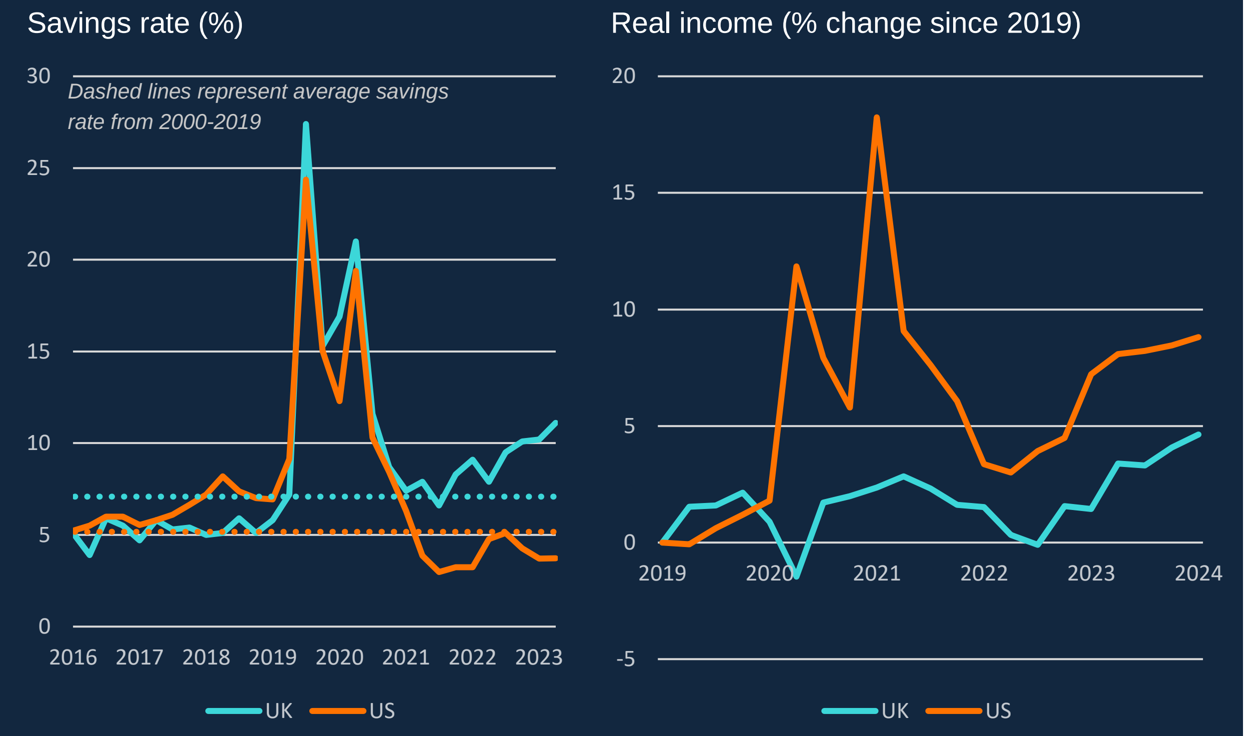
(a) Real wages represent AWE private sector regular pay deflated by CPI. Latest data points are for July 2024.

(b) The headline GfK measure is an equally weighted average of "Financial situations of households – last 12 months", "Financial situations of households – next 12 months", "General economic situation – last 12 months", "General economic situation – next 12 months" and "Major purchases at present". Lines shown for "General Economy" and "Personal Finances" refer to the next 12 months measures. Latest data points are for September 2024

Savings on the rise

Consumption and savings are two sides of the same coin; whatever doesn't get spent is saved. Savings rates (savings as a proportion of income) spiked globally during the Covid lockdowns, with households immediately slashing spending--most notably on services. I have already shown you the stark difference in the paths for consumption for the UK and the US since the pandemic. Their paths for savings look very different as well, as shown in **Chart 7**. The US savings rate has fallen below its pre-Covid average (as shown by the dotted lines), while that of the UK remains well above it and rising. This is particularly striking given real incomes have increased by much more in the US since 2019.

Chart 7: UK vs US savings rate and real income



Source: ONS, BEA and author's calculations. Dotted lines represent average savings rates from 2000-2019. Latest data to Q1 2024.

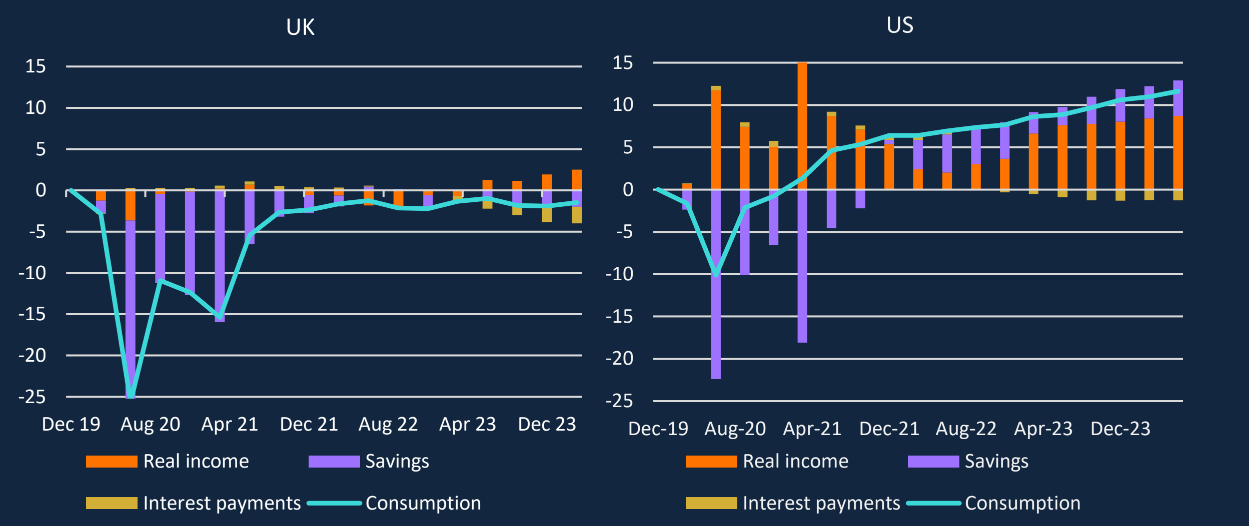
The contribution of savings and real incomes to consumption in the UK and US can be seen in **Chart 8**. Real incomes (the orange bars) have been much bigger in the US since the pandemic.[2] But while UK savings have dragged on consumption, dissaving in the US (the positive purple bars) has boosted spending. Consequently, UK real consumption has still not reached pre-Covid levels, while US consumption is around 12% higher.[3]

One reason for this could be the different government responses to the pandemic. In the UK, the furlough scheme paid 80% of employee wages, avoiding a spike in unemployment. The US took a more direct approach via large benefits increases and direct cash payments to households. It's difficult to compare the different policy approaches and there is limited research on this. But there is some evidence to suggest cash payments had a quicker and longer impact on consumption levels **(Gelman and Stephens Jr, 2022)** than an indirect policy response. People tend to spend a windfall, but save the wages they'd already expected to be getting.

[2] The US likely had higher real incomes post-pandemic because the government provided a larger fiscal stimulus –roughly 14.7% of national income compared with around 3.1%-5.9% for UK) **(Emmerson and Stockton, 2020)**.

Chart 8: UK vs US contributions to consumption[(a)]

Contribution to change in the level of consumption since Q4 2019 (per cent)



Source: ONS, BEA and author's calculations.

(a) Savings are defined here as the residual after subtracting the change in real income and interest payments from real consumption. Latest data to Q1 2024.

Why has consumption been so weak?

UK consumption has been weak relative to that in most advanced economies and to what other domestic macroeconomic indicators would suggest. I'd like to explore why this might be the case, highlighting three potential explanations. These three explanations are by no means exhaustive, but I think they may be the biggest drivers.

Reason 1. A cost-of-living crisis has led to precautionary savings

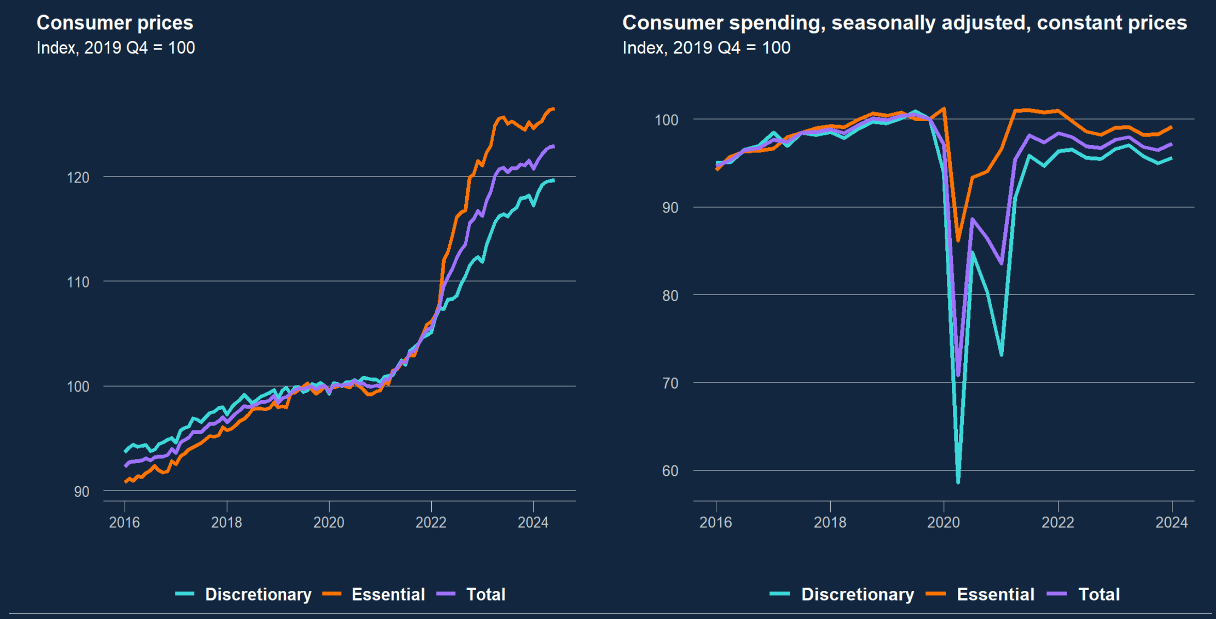
The first explanation is that the two massive and successive shocks of the pandemic and war in Ukraine sparked a cost-of-living crisis that caused people to worry about the outlook for the economy and prompted a rise in precautionary savings. Although inflation has recently fallen back close to our target, the cumulative increase in prices over the past 5 years has been enormous and has weighed substantially on household consumption. High interest rates and a loosening labour market have kept household perceptions about the general economy below the 2015-19 average.[4] While real wages have risen over the past year, much of this may have been ploughed into a rainy day piggy bank rather than spent.

This explanation is supported by the mix of goods and services that consumers have been buying and forgoing. We can split UK domestic household expenditure into essential

[4] According to the NMG survey, household perceptions of the general macroeconomy have improved since 2023, but from very low levels such that they remain below their pre-pandemic averages.

versus discretionary spending. Essential goods and services are generally more price insensitive because they are things like food, energy and healthcare, which consumers need to buy and can't cut back on significantly. **Chart 9** shows that since the Russian invasion of Ukraine in 2022, the prices of essential goods and services have risen much more quickly than prices of discretionary goods and services. This is clearly because the war caused imported energy and food prices to spike. On the consumption side, as we might expect, spending volumes (in real terms) on essential items, as shown by the orange line, have flattened off at around pre-pandemic levels, while they're still well below pre-pandemic levels for discretionary items.

Chart 9: Essential vs discretionary prices and real consumption[a]

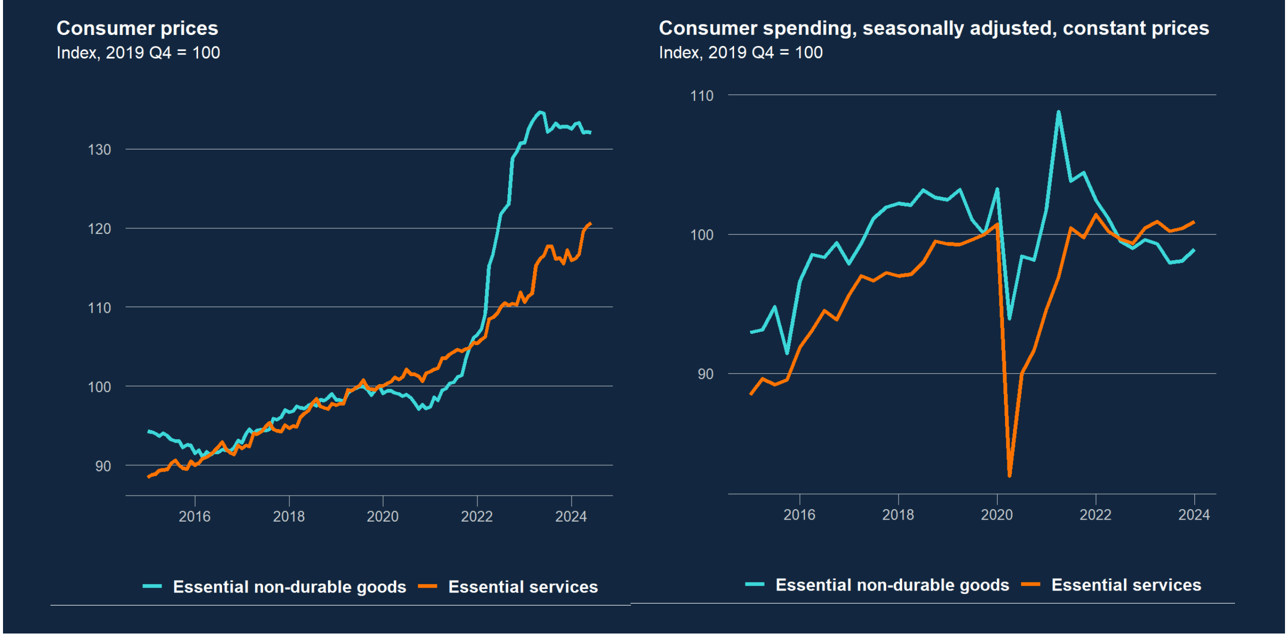


Source: ONS and author's calculations

(a) Expenditure categories (COICOP) are classified as essential or discretionary spending according to ONS **classifications** which builds on work done by the Australian Bureau of Statistics (ABS). Latest data to Q1 2024.

Digging deeper, we can further split consumption into durable goods (such as furniture and cars) and non-durable goods (such as clothing, beer, food and energy). In **Chart 10** we can really see the extent of the cost-of-living crisis as essential non-durable goods prices, largely consisting of food and energy, spiked immediately following the Russian invasion of Ukraine. By 2023 non-durable goods prices were more than 30% higher than before the pandemic. Given this jump in prices, real spending in this category has broadly flattened out over the past year.

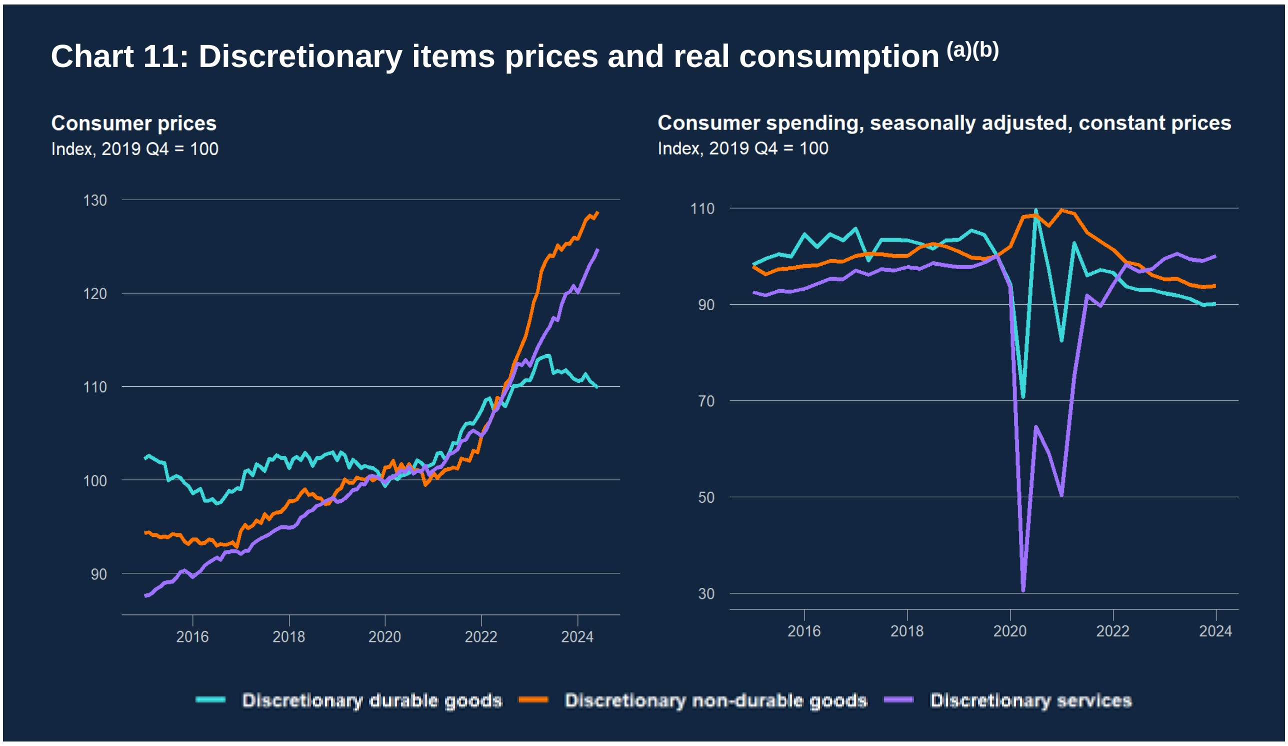
Chart 10: Essential items prices and real consumption [(a)(b)]



Source: ONS and author's calculations

(a) Expenditure categories (COICOP) are classified as essential or discretionary spending according to ONS classifications which builds on work done by the Australian Bureau of Statistics (ABS)
(b) Goods are further classified as durable or non-durable according to ONS classification. Durable goods are goods that can be repeatedly or continuously used over a period of more than a year. Non-durable goods and services can only be consumed or used once. Latest data to Q1 2024.

Consumers have cut back instead on the discretionary side, particularly in discretionary durable goods as shown on the right in **Chart 11**. Discretionary durable goods include big-ticket items such as large household appliances, furniture and vehicles—the latter account for roughly half of this category. This is consistent with what our Agents have been telling us for some time now. Spending in this category has been subdued even though it has seen the smallest price increase of all discretionary and essential categories since the pandemic.



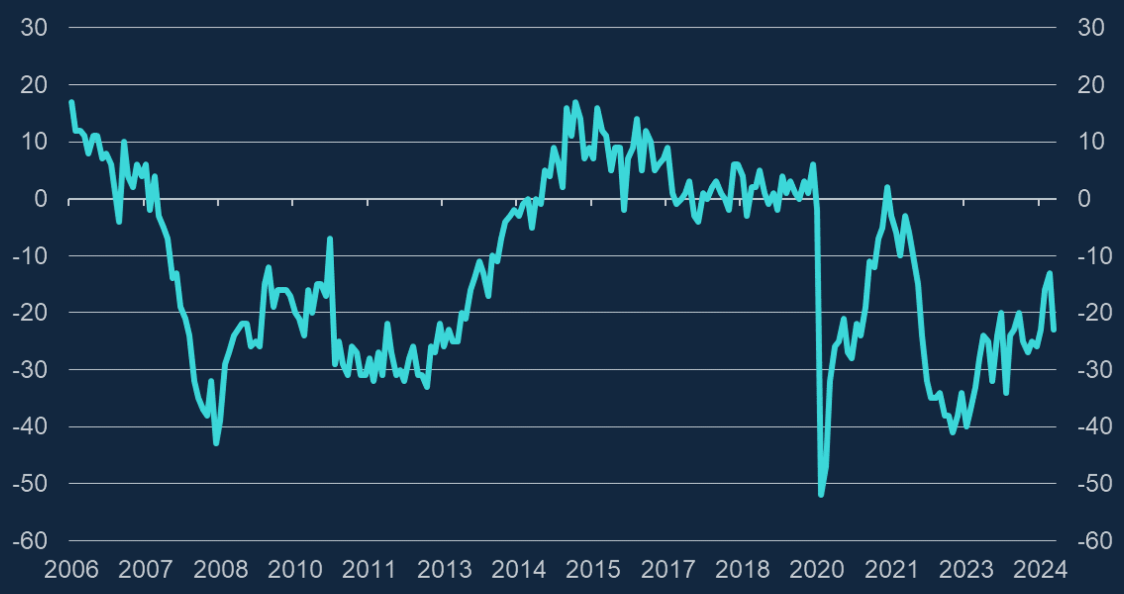
Source: ONS and author's calculations

(a) Expenditure categories (COICOP) are classified as essential or discretionary spending according to ONS **classifications** which builds on work done by the Australian Bureau of Statistics (ABS).
(b) Goods are further classified as durable or non-durable according to ONS classification. Durable goods are goods that can be repeatedly or continuously used over a period of more than a year. Non-durable goods and services can only be consumed or used once. Latest data to Q1 2024.

In contrast discretionary services spending is slightly above its pre-pandemic level despite considerable price rises. It's not surprising that discretionary services spending recovered sharply after lockdown restrictions were lifted, but it is notable that it has remained high while other discretionary spending categories have fallen. People are holding back on buying new washing machines in part to continue paying their essential energy bills and going out.

A pullback on buying big ticket items is also reflected in the GfK consumer survey, as major purchase intentions fell to a near historic low during the cost-of-living crisis. Although we have seen some recovery, it remains well below pre-pandemic levels (**Chart 12**).

Chart 12: GfK Consumer Confidence – Major Purchase Index
Diffusion Index

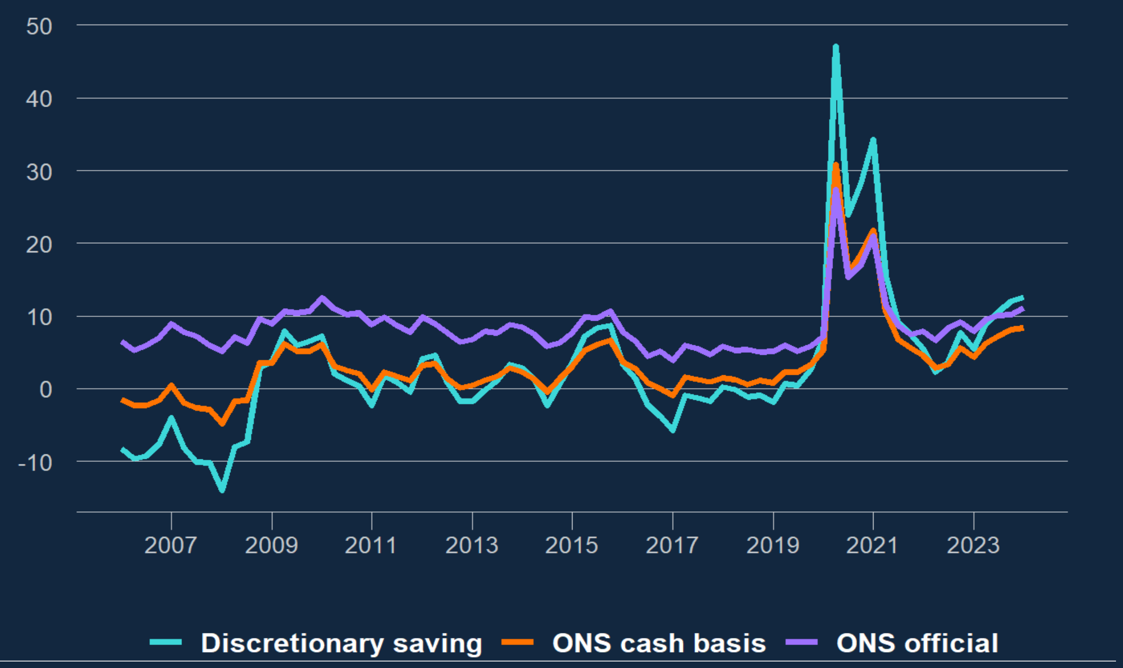


Source: GfK, LSEG. Latest data points are for September 2024.

Customers are also forgoing big ticket items to put some money in the bank. This is reflected in different savings rates we can calculate for the UK, shown in **Chart 13.** The official ONS savings rate includes imputed transactions and pension contributions that households do not actually directly observe. The ONS publishes an alternative cash-basis savings rate that strips these factors out, providing a truer representation of total cash savings as a proportion of net income. This is shown in the orange line. We can go one step further by removing spending on essential items from disposable income, leaving us with income available for discretionary goods and services. Taking savings as a percentage of this discretionary spending gives us the aqua line.

Chart 13: UK savings rate measures

Saving as a percentage of income (%) [(a)]



Source: ONS and author's calculations

(a) The discretionary savings rate uses the same measure of savings (income less expenditure), but as a fraction of a more narrowly-defined measure of disposable income. We define disposable income for this purpose as total cash income less taxes and social contributions paid, interest payments, and essential expenditure. Essential expenditure is calculated from detailed consumption data, based on a **classification** used by the ONS. The **cash-basis** measure is an alternative ONS saving rate intended to provide a more accurate measure of cash saving by removing unobserved transactions. Latest data to Q1 2024.

The sharper increase in the aqua line relative to the orange line since 2022 suggests that after accounting for essential spending, consumers have increasingly chosen to save their disposable income rather than spend it on discretionary goods and services.

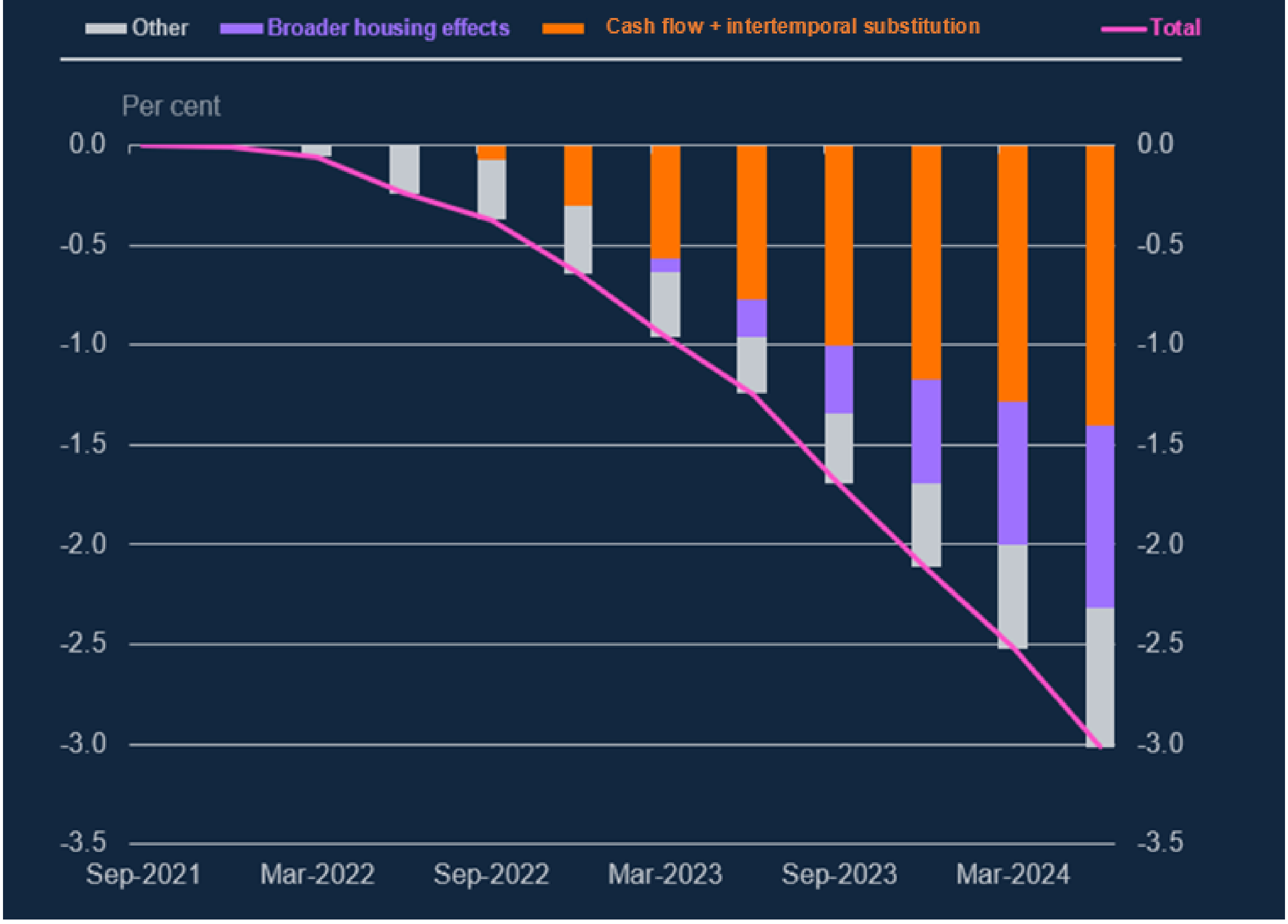
It makes sense that consumers increasingly put their money away in a rainy day fund rather than buying big ticket items as the UK economy was hit by successive shocks that increased uncertainty about the outlook for growth. If precautionary savings is a significant driver of weak consumption and a higher savings rate, then we could expect a rate cutting cycle to mitigate this. All else equal, as interest rates fall, the drag on activity from monetary policy wanes, the labour market strengthens, and consumers are likely to feel less worried about their future income. This should result in a lower savings rate and a rebound in consumption.

Monetary Transmission Mechanism

Greater precautionary savings have caused savings to rise and consumption to remain weak, but of course restrictive monetary policy has contributed as well. This is a feature, not a bug; it is partly how monetary policy transmits to the real economy. Higher interest rates have fed through to consumption via various channels, shown in **Chart 14** (and explained in our **August Monetary Policy Report)**.

According to our calculations, tighter monetary policy since August 2021 has dragged on cumulative consumption growth by about 3 percentage points. There is, as always, a lot of uncertainty around these kinds of calculations. Nevertheless, this is a significant drag given real consumption has only risen 0.8% since the beginning of this rate hiking cycle.

Chart 14: Estimated impact of changes in OIS yield curve since August 2021 on the level of consumption[(a)]



Source: Bloomberg Finance L.P.

(a) OIS rates are the overnight index swap rates and represent market expectations for Bank Rate. Data from the 15 working days up to 22 July 2024 are included. Estimates show the output from the standard treatment of the impact of changes in Bank Rate and Bank Rate expectations in the Bank's forecasting models. The consumption effects of the estimated impact of changes in the OIS curve on sterling exchange rates have been excluded. Both the overall total impact and the individual channel estimates are uncertain and could be higher or lower than presented here. The 'cash flow' bars include some effect from intertemporal substitution where higher interest rates shift incentives to consume later than otherwise would be the case. The 'Other' bars show the net effect of changes in Bank Rate excluding the direct cash-flow channel, intertemporal substitution and broader housing effects.

One of the channels through which restrictive monetary policy has dragged on consumption is the housing channel (the purple bars). Higher interest rates tend to reduce house prices, which diminishes homeowners' net wealth and drags on their consumption. While house prices and consumption are highly correlated, there is a great deal of uncertainty around the strength of the relationship and the precise mechanisms through which it operates.

I think it is more important to focus on the biggest channel for our monetary policy through to consumption, the cash flow and intertemporal substitution channel (orange bars). I'll split this channel into its two components, because they have different potential policy implications.

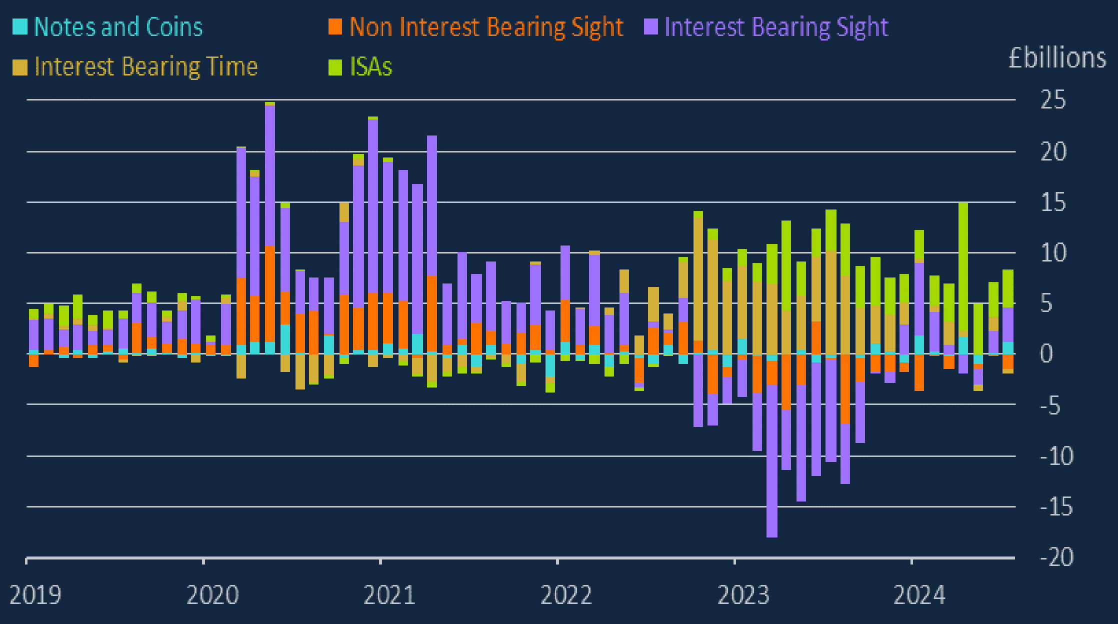
Reason 2. Intertemporal substitution channel

The first component is intertemporal substitution. Higher interest rates incentivise households to save more, borrow less and delay consumption. These effects can't be directly observed, and so are very difficult to estimate. However, we can find some indication that the intertemporal channel has been working in the face of restrictive monetary policy by looking at the flow of household deposits, shown in **Chart 15**.

During the rate hiking cycle from 2021 through 2023, there was a considerably greater flow of funds into interest bearing time deposits. These are deposit accounts from which funds can't be withdrawn within a particular time frame without a penalty and usually offer higher levels of interest. This is in contrast to sight deposits, which allow instant access to funds without penalty but offer lower interest rates. Flows into the former and out of the latter indicate a preference for locking away savings at higher rates over keeping cash available for spending. That these flows have slowed this year suggests this channel has probably passed its peak.

Chart 15: Household deposit flows[(a)]

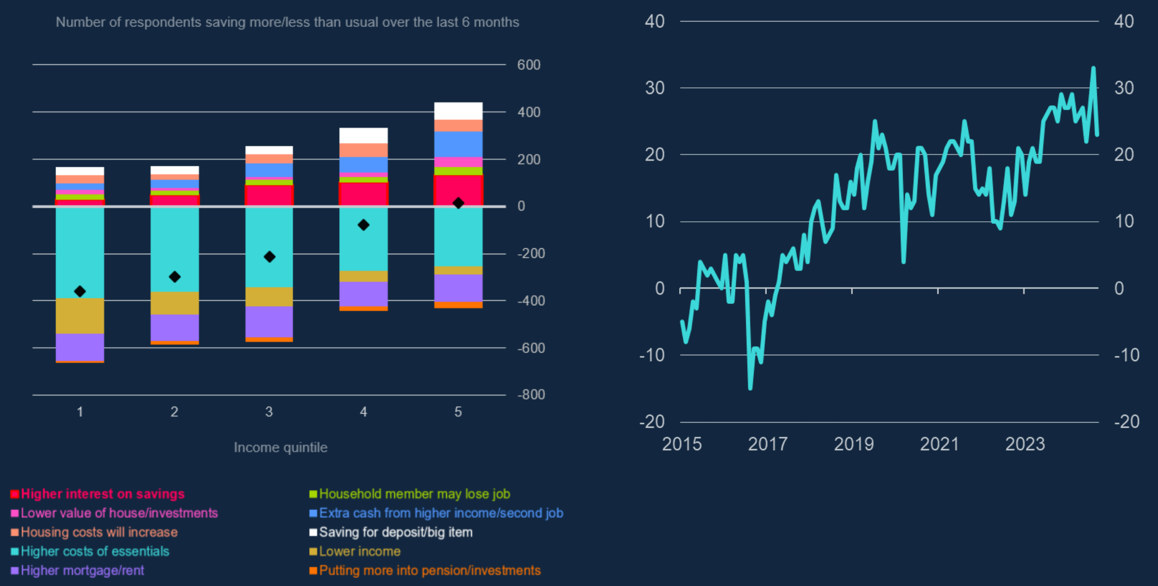
Household deposit product breakdown flows, SA



Source: Bank of England. Latest data to June 2024.

We can also use surveys to see evidence of intertemporal substitution. According to the latest NMG household survey from March 2024 - shown in the left-side panel of **Chart 16** - respondents across all but the lowest income quintile cited higher interest on savings as their biggest reason for saving more than usual.[5]

Chart 16: NMG survey – reasons for saving and GfK - climate for saving[(a)(b)]



[5] In the six months prior to the survey being conducted in March 2024.

Source: Bank of England/NMG Consulting survey and Bank calculations, GfK, LSEG. Right-hand side panel latest data points are to September 2024.

The GfK climate for saving index - shown in the right-side panel of **Chart 16** - was also at its highest level for several years prior to the latest data release, with the index still remaining elevated, showing that people think it is historically a very good time to save.[6]

As higher interest rates have encouraged people to save more, borrow less and delay consumption, we can expect a rate cutting cycle to have the opposite effect. It is clearly too early to see the impact of our 25 basis point cut in August in any of this data, though it arguably comes through anecdotally in the reports we get from our Agents. Firms have consistently told them that consumer demand remains weak, but that it is expected to rebound going forward as interest rates come down.

Reason 3: Cash flow channel

The cash flow channel is also dragging on consumption given restrictive monetary policy. As Bank Rate has risen, so have mortgage and savings rates. Many people are both borrowers and savers and so are affected by both of these. Overall, a higher Bank Rate has resulted in higher aggregate household interest income so far, because the stock of household savings is greater than the stock of mortgages and because changes in Bank Rate do not feed through into most mortgages immediately. Despite this, the changes in net interest income will have dragged on consumption because net borrowers will have experienced a negative income shock while net savers will have experienced a positive one. According to research, peoples' marginal propensities to consume are impacted more by negative income shocks than positive ones.[7]

We think structural changes in the UK mortgage market have slowed the impact of this cash flow channel on consumption, since 85% of UK mortgages are now on a fixed term basis compared with under half prior to 2008. So while households have already seen much of the benefit from greater interest on savings, the full impact of higher interest rates on mortgage payments has not yet passed through. At the time of the **June Financial Stability Report**, over three million households, accounting for 35% of all mortgages, were still paying rates of less than 3%. As shown in **Chart 17**, 30% of mortgage accounts were expected to have their fixed rate expire before the end of 2026 and the typical homeowner was expected to see monthly payments rise by around £180, or 28%. This is a significant additional burden on disposable income that is yet to come for

[6] The latest **GfK consumer confidence report** shows the Savings Index fell to +23, from +33.
[7] As explained in the **November 2023 Monetary Policy Report**, households with large savings are likely to increase consumption relatively little in response to rising savings incomes, but those with mortgages and other loans will reduce consumption materially in response to higher loan costs.

many households, and a smaller proportion will see much larger increases in payments of 50% or more.

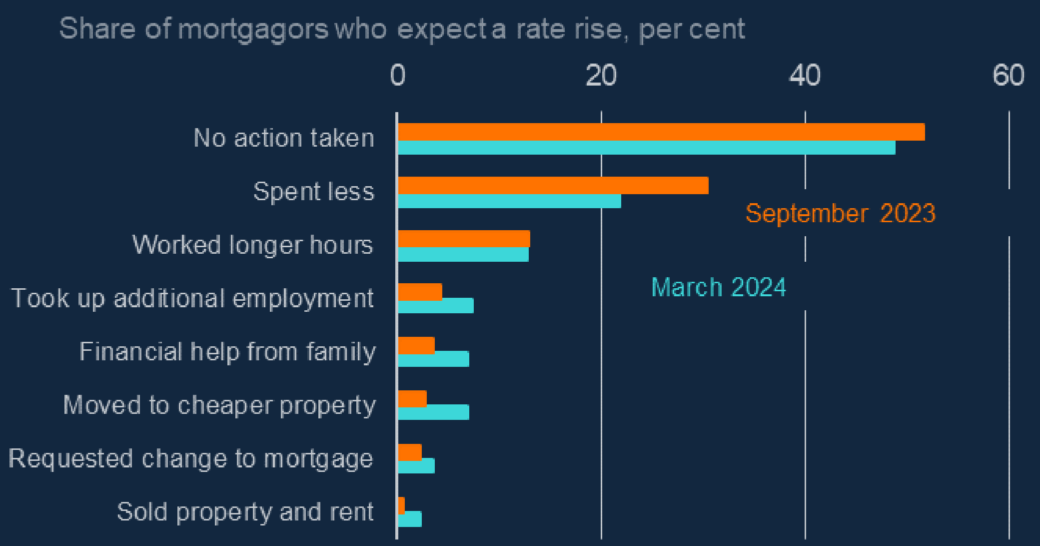
Chart 17: Number of owner-occupier mortgages by estimated change in monthly mortgage costs, by December 2024 and December 2026 (a) (b) (c)

Sources: Bloomberg Finance L.P., FCA Product Sales Data and Bank calculations.

(a) The projection uses the overnight index swap (OIS) curve as at 10 June 2024 and end-2023 data on the stock of outstanding mortgages.
(b) Changes in payments on variable-rate mortgages are calculated using the implied change in the OIS curve, and changes in payment on fixed-rate mortgages are calculated by assuming that mortgagors refinance onto a typical fixed rate implied by the OIS curve at the point that their fixed-rate contract ends.
(c) Mortgages with less than £1,000 outstanding are excluded. These data do not include buy-to-let mortgages or mortgages that are off balance sheet of authorised lenders, such as securitised loans or loan books sold to third parties.

So far then, the cash flow channel has likely pushed up on savings by directly increasing interest earned on savings while dampening consumption for those households who have already started paying higher mortgage rates. Many households will have likely adjusted spending and saving in anticipation of higher mortgage payments too. This is reflected in the latest NMG survey from March 2024, which shows more than half of mortgagors surveyed who expected a rate rise acted in anticipation over the last year (**Chart 18**).

Chart 18: NMG Survey – Share of mortgagors expecting a rate rise who had acted in anticipation last year (a)



Source: Bank of England /NMG Consulting Survey and Bank calculations.

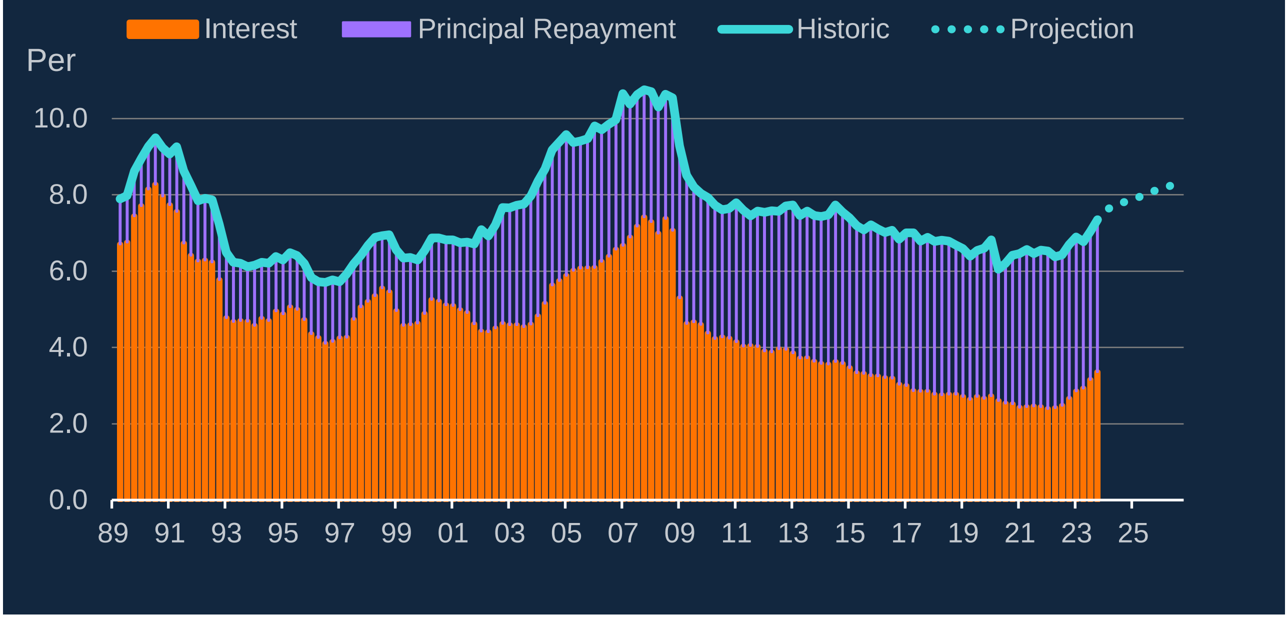
(a) Share of mortgagors reporting which actions they have taken over the 12 months prior to March 2024 and September 2023, respectively, in anticipation of higher mortgage repayments.

Looking ahead, the aggregate household mortgage debt servicing ratio, which is the proportion of income paid on mortgage repayments, is expected to continue increasing to above 8% (**Chart 19**).[8] Almost all the increase in the debt servicing ratio is due to the interest component rather than greater principal repayment. This would ultimately mean that as more people pay higher mortgage rates, this channel would continue to push down on consumption - even as Bank Rate falls in a rate cutting cycle. At the same time, this channel may also push down on savings rates because only principal repayment counts towards savings. Unlike the impact of precautionary savings and the intertemporal substitution channel, which should see consumption rise as Bank Rate falls, this channel is likely to continue to drag on consumption for longer.[9]

[8] As projected in the June Financial Stability Report

[9] Greater support from lenders for households struggling to meet mortgage payments, [announced by the FCA](), may have a mitigating impact on this channel, which otherwise would otherwise drag on consumption even more.

Chart 19: Aggregate household debt-servicing ratio (DSR) and staff projections [(a)] [(b)]



Sources: Bank of England, Bloomberg Finance L.P., FCA Product Sales Data, ONS and Bank calculations.

(a) Calculated as mortgage interest payments plus principal repayments as a proportion of nominal household post-tax income. Household income is defined as disposable (post-tax) income adjusted for changes in pension entitlements, which is adjusted to exclude gross operating surplus and the effects of financial intermediation services indirectly measured, and to add back in interest paid. Mortgage interest payments before 2000 are adjusted to remove the effect of mortgage interest relief at source.
(b) For the illustrative projections to mid-2027, projections for household post-tax income consistent with the **May 2024 MPR**. Payment increases are projected using market expectations for Bank Rate based on the OIS curve as at 10 June 2024, taking into account the distribution of fixed-deal terms from the FCA Product Sales Data and assuming the aggregate mortgage debt to income ratio remains constant.

Policy Implications

UK consumption remains weak, surprising given the terms of trade shock from the pandemic and war in Ukraine has unwound, real incomes have been rising for a year and consumer confidence has broadly improved. Consumers have been pulling back on big ticket purchases and parking much of their higher real incomes in savings, with the savings rate remaining over 10%, well above its pre-pandemic trend. There are a number of factors potentially contributing to this, including higher precautionary savings, an intertemporal substitution effect from restrictive monetary policy and cash flow effects.

There is no precise way to measure how much each channel has contributed to weak consumption. In aggregate, our analysis suggests that monetary policy has stripped 3 percentage points off only 0.8% growth in consumption since the beginning of the rate hiking cycle. These figures are to be considered with wide bands of uncertainty, but it is clear this is significant. As the MPC gradually reduces Bank Rate, what will happen to consumption?

Our August MPR forecasts consumption growth accelerating from 0.5% this year to 1.75% in 2026. If the main drivers of weak consumption are precautionary savings and intertemporal substitution, we can expect consumption to recover over the forecast period as interest rates come down. If the primary driver is the cash flow channel, the structure of the mortgage market suggests it will take longer for consumption to rebound.[10] The reality is it is probably a combination of these factors.

Given we can't know with certainty which driver is playing the biggest role and with what lags it will feed through into consumption, it is useful to consider the balance of risks that consumption might pose to our outlook for inflation. If consumption growth is weaker, the risks to activity and inflation are clearly on the downside and we risk having to cut interest rates more rapidly from restrictive levels. If consumption growth is higher, however, the risks to output and inflation are to the upside. Firms have been telling our Agents they don't have the degree of pricing power this year they did in 2023. But if consumption rebounds more strongly than we expect, firms may feel they can pass costs through to the end user in the form of higher prices. This would necessitate a restrictive monetary policy for even longer to bring inflation sustainably to target over the medium-term.

Of course, our analysis of the channels impacting consumption and the inflection point at which firms feel they have greater pricing power is rife with uncertainty. In fact, much about economic forecasting and policymaking is rife with uncertainty. To incorporate probabilities and risks as we try to determine an optimal path for interest rates, the MPC has delineated a framework for thinking about different potential cases in the economy and risks.

In the first case, the global shocks that drove up inflation continue to fade, and the persistence of inflationary pressures dissipates with a less restrictive stance of monetary policy than in other cases. In the second, a period of economic slack is required to bring inflation sustainably to target in the medium-term. In the third, structural changes in the economy that impact wage- and price-setting require monetary policy to remain tighter for longer.

Like many others on the MPC, I do not fit squarely in any of these cases. I think the probability of each is greater than zero. And the probabilities and risks I have placed on each have evolved over time and, as data comes in, will continue to do so.

At the moment, I place the greatest probability on being in the second case, requiring some slack in the economy to open up in order to return inflation sustainably to target over the medium-term. This view of the world is embedded in our latest forecast. In recent months, indicators of inflationary persistence have broadly been moving in the right direction. Services inflation, while still well above target-consistent levels, has been grinding downwards slowly. Wage growth has been falling as the labour market has

[10] More delayed "general equilibrium" effects from tighter monetary policy may also still come through.

continued to ease, and both the Decision Makers' Panel and our Agents' intelligence suggest this should continue. Inflation expectations are in line with historical averages. GDP growth had surprised to the upside in the first half of the year, but survey data and labour market quantities suggested underlying GDP growth had been lower than the headline figures suggested. Flat GDP growth in June and July supports this. Our August forecast, conditional on a market determined path for interest rates, has an output gap opening up gradually over 2025 and inflation returning to target in 2026 Q1.

That said, I think there is a higher risk of the third case (which involves structural factors pushing the natural rate of unemployment up, potential GDP growth down and the long run neutral rate up) than the first (which involves shocks fading and inflation falling to target without slack opening up in the economy). Services inflation has been moving in the right direction, but catering has accounted for roughly half of this fall since October 2023, partly reflecting falling food price inflation rather than domestic inflationary pressures. The monthly annualised measure of services inflation excluding indexed and volatile components, rents and holidays continues to be broadly stable between 4 and 5% as it has been for the past 12 months. Wage growth has also fallen but remains above what our suite of models can explain. And as I have argued today, I believe the risks to activity are to the upside, which could suggest that the long run neutral rate is higher and - all else equal - our stance of policy isn't as restrictive as we had thought.

Given this risk, I believe it is appropriate to take a gradual approach to removing restrictiveness. This has motivated my most recent vote to hold Bank Rate at 5% in September, after we cut it by 25 basis points in August. Over time, I will be looking for incoming data to provide evidence that the risk of the third case is diminishing and the probability of the second is growing. Until then, I believe a cautious, steady-as-she goes approach to monetary policy easing is appropriate.

The views expressed in this speech are not necessarily those of the Bank of England or the Monetary Policy Committee.

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