Report to Treasury Select Committee

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Voting record

Inflation has come down sharply in the past few months. In the main this reflects the reversal of the direct impact of the huge jumps in import prices caused first by the pandemic and then the war. But their second-round effects on domestic wages and prices continue to be felt. Although these too have begun to turn, the MPC believes that monetary policy should remain restrictive for the time being. Any reduction in Bank Rate would require further evidence that these more persistent, domestic components of inflation are sustainably on their way down.

I'll first say a bit more about the behaviour of import prices over the past few years. I'll then describe briefly the origins and importance of these second-round effects, seeking to explain why, over the past year or so, the Committee has paid particular attention to the behaviour of wage growth and services inflation. I will go through my voting record in this context.

Though their origins were obviously very different, the pandemic and the invasion of Ukraine – more particularly Russia's decision to reduce its supply of energy to western Europe – had similar economic effects. They both led to substantial increases in the cost of the UK's imports, boosting directly the equivalent components of the CPI and reducing real incomes.

In the case of the pandemic these increases arose from the combined effects of a big shift in consumer demand around the world, away from services and towards (core) goods and, at the same time, a reduction in the supply of those goods, from East Asia in particular. In the case of the war, Russia's decision to reduce its supply of gas to western Europe and to inhibit exports of grain and fertilizer from Ukraine, led to significant rises in the wholesale prices of energy and food.

It's important to understand quite how large these increases were. Through much of the inflation targeting period the cost of imported goods tended to fall rather than rise. (During the decade leading up to the financial crisis, for example, the average price of goods imports fell by 8%.) By contrast, between the spring of 2021 and the autumn of the following year – so in the space of only eighteen months – they rose by 40%.

This had marked direct effects on retail goods prices. Including those of energy and food, the average price of goods in the CPI rose by around a quarter in the two years to March 2023. Depending a bit on precisely how one defines it, this direct effect was responsible for close to nine tenths of the average overshoot of aggregate CPI inflation, relative to the 2% target, over that period.

More significantly, as far as the persistence of inflation is concerned, these jumps in import prices reduced the UK's real national income. Relative to the price of domestic output, aggregate import prices (including those of services) rose by close to 20% over that 18-month period. Because imports account for around 30% of UK demand, this reduced real national income by around 6%.

Some of this was absorbed by higher government borrowing (used partly to fund cost-of-living payments). But the remaining hit to private-sector income was an inevitable consequence of the reduction in the supplies of tradable goods (and, in the case of core goods, a pandemic-related rise in the global demand for them). One way or other – whether through falls in the first, declines in the second or some combination of the two – there was bound to be a fall during this episode in domestic prices and wages relative to the price of UK's consumption.

It is this hit to real incomes that precipitated a reaction in domestic wages and prices; and it's these second-round effects to which monetary policy has been responding.

These effects were not the only factor putting upward pressure on domestic inflation. Despite relatively weak cumulative growth in output since the pandemic, the labour market was extremely tight through much of this period, particularly in late 2021 and 2022. But the more important influence is likely to have been the real-income squeeze caused by higher import prices. In an attempt to offset it, firms raised the prices of domestic output (for which the services component of the CPI is a reasonable proxy); similarly, employees bid for higher nominal pay. Collectively, these efforts could not succeed (at least as long as import prices remained at those much higher levels): in aggregate, the real income loss was unavoidable. In the meantime, however, it generated additional inflation in domestic prices and wages. Unlike the original shocks to good prices, which are in general quite volatile, inflation in domestic wages and prices tend to persist for some time. It is for this reason, given the lags involved in monetary policy, that the Committee has paid particular attention to these series. And it was in response to the strength of both – during the first six months or so of last year, services inflation and regular private-sector pay growth both rose by a further percentage point – that I was in favour of tightening policy progressively further. Along with most others in the Committee, I voted for five successive increases between January and August, taking Bank Rate from 3.5% to 5.25% over that period.

I mentioned that prices of tradable goods, including energy, tend to be more volatile and that their direct effects on inflation often dissipate before monetary policy could do that much to offset them. In addition, on this occasion, many monetary authorities believed that the inflation in core wholesale goods prices during 2021, caused by the pandemic, was unlikely to persist, simply because the pandemic itself would subside.

This proved to be the case. Shipping prices peaked around the end of that year. And in many countries, manufacturing output prices started to level out only a few months later, in the summer of 2022, and have since fallen back somewhat. In addition, much of the huge rise in European gas prices in the months after Russia's invasion of Ukraine has since gone into reverse. In aggregate, the price of UK goods imports peaked in September of 2022 and have since declined by more than 10%. Through most of last year real household income was growing.

Albeit with some delay, it was always likely that this deceleration would then be reflected in the equivalent components at a retail level and, since last spring, we've seen marked declines in the CPI inflation rates of energy, food and core goods. Together they account in full for the 7%-point decline in CPI inflation since its peak in October 2022.

As I said, the MPC has been more focused on the more persistent components of inflation (services and wages). But it looks as though these too may have peaked. Services inflation in December was 6.4%, a percentage point lower than the high point last July. Annual growth of regular private-sector pay was 6.5% in the latest release (for the three months to November), down from 8.2% in the second quarter of last year.

In part, this may reflect the softening of import prices – in other words the reverse of the upward second-round effects we saw in 2022 and the first half of 2023. It is also likely to reflect softer growth in the economy, and a reduction in the tightness of the labour market, themselves the result of tighter monetary policy.

The outlook

The gradual easing in the tightness in the labour market is one indication that monetary policy is now restrictive. Over time, and even without any other influences in the same direction, policy would eventually pull domestic inflation back to rates more consistent with the inflation target. (Indeed, if Bank Rate were to remain at 5.25% indefinitely, the MPC's latest central forecasts suggest that inflation would fall below the 2% target in the medium term.).

In addition, the deceleration in retail goods prices almost certainly has further to go and one might therefore expect the second-round effects to continue to unwind. Just as extremely high headline inflation fed through to growth in domestic wages and prices in 2022 and the first part of 2023, so one might expect lower headline inflation to have a depressive effect on them through the course of 2024. In my view, the question has moved on from one about the degree of policy restrictiveness to one about its duration.

This remains highly uncertain, not least because the scale and extent of these swings in import prices has been pretty much unprecedented. And one should recognise that we're starting from a position where, despite the recent declines, these domestic inflation rates remain well above levels consistent with the 2% target for CPI inflation. So one cannot be precise about how rapidly they will fall back – or therefore, when it will be appropriate to reduce the degree of policy restriction.

In the MPC's main forecasts in February, conditioned on a market path for Bank Rate that involved 100bp of cuts this year and a further 75bp during 2025, projected inflation two years from now was certainly lower than it is today, but still slightly above the 2% target. This certainly doesn't rule out a policy easing at some point this year. In my view that is the more likely direction in which Bank Rate is likely to move. But even if that proves to be the case, the timing of any adjustment can only depend on the actual evolution of the economic data, and in particular the three sets of indicators – the tightness of the labour market, wage growth and services inflation – to which the Committee has paid such close attention through this period.

Explaining monetary policy

Since February 2022 I have given five on-the-record speeches:

30.03.2022	Reliable partners
20.10.2022	The inflationary consequences of real shocks

25.04.2023	Monetary policy: prices versus quantities
26.08.2023	The economic costs of restricting trade: the experience of the UK
18.12.2023	Signal versus noise

On the day of each *Monetary Policy Report*, in addition to answering questions alongside the Governor at the press conference, I host a briefing meeting for private sector economists.

I made seven regional visits (to Northern Ireland, Greater London, East Midlands, Central Southern, West Midlands, Yorkshire & The Humber, Scotland). These have involved meetings and roundtables with local businesses and events at which I have presented, and taken questions on, the *Monetary Policy Report*. I have also conducted a number of outreach events to schools across the country.

Finally, as Deputy Governor for Monetary Policy, I have represented the Bank’s views in international settings, including the G7, Bellagio, and OECD Working Party No3.