Annual report to the Treasury Select Committee

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23 May 2025

Overview

It has been a little over eighteen months since I joined the Monetary Policy Committee in November 2023. In that time, inflation has fallen from 6.7% to 3.5% and we have cut Bank Rate by 100 basis points to 4.25%.

The key issues that have guided my policy over this period are the progress of the waves of adjustment in the economy following the large inflationary shocks of the past few years, and the degree to which slack is opening up. I have been looking through the noise in the individual data releases and focusing on what we have been learning in the round about the outlook for medium-term inflation. In doing that, I have considered it important to understand what price and wage data is telling us about the adjustment to past shocks, given different components of inflation will adjust naturally at different rates, and I have been focused in particular on understanding the extent to which disinflation is a bit bumpy or persistently sticky. In addition, I have been looking for signs of weaker real economic activity and a loosening of the labour market, which could indicate that slack is opening up. As time has progressed, I have gained greater confidence that the disinflationary process is progressing at a steady pace, and that new shocks have not materially knocked it off course. The economy appears to be moving gradually into excess supply. I have responded by voting to loosen monetary policy four times over the past year, all of which have been in line with the majority.

Looking ahead, I will continue to be guided by evidence on inflation persistence, emanating particularly from the outlook for firm input costs such as wages and the evolution of inflation expectations. I will also be focused on the degree of slack opening up over the forecast horizon, as well as any signs of the 'hump' in inflation leading to additional persistence. As we approach a neutral policy stance, evidence of restrictiveness will become less clear, and the decision to further loosen policy will require a greater degree of certainty that inflation is on track.

In my time as an MPC member, there have been a few recurring themes in how I have approached policymaking:

- Engaging in **scenario analysis** to explore a wider range of policy relevant outcomes than focusing only on the most likely outcome[1]. This is an approach I had often used in financial stability, where policymakers are inherently interested in extreme outcomes rather than the most likely case. The use of qualitative intelligence has

[1] Monetary policy as engineering? – speech by Sarah Breeden | Bank of England

also been invaluable in supplementing Staff models in guiding me on monetary policy in a period of heightened uncertainty.

- Applying what we see in the **real world to challenge and supplement our models.** This has been particularly helpful in guiding my view on the loosening in the labour market and, more recently, on the likely impact of tariffs on the UK economy. Within this, my **financial stability experience** has helped me judge how the mortgage market is responding to changes in Bank Rate, including through behavioural channels like refinancing and term extension.
- **Evaluating economic outturns against past forecasts** to guide my understanding of the current economy environment, helping me gain confidence on key variables in the forecast[2]. This has been particularly useful when interrogating the paths for the output gap and the savings rate in our forecast.

Looking ahead, these approaches will continue to aid me in setting policy.

Voting Record

As I came to my first interest rate decision in **November 2023**, I viewed the potential distribution of inflation outcomes as wider than normal. In the face of this uncertainty, I found scenario analysis a helpful tool to guide my policy decision. I had two scenarios is mind:

- In one (low inflation) scenario, I examined the consequences of demand weakening much more quickly than expected as the MPC's previous tightening in monetary policy took hold.
- In the other (high inflation) scenario, I looked at what might happen if inflation remained stubbornly persistent as a result of continued and strengthened second-round effects.

As I set out in a speech[3], I placed more weight on the high inflation scenario when forming my policy strategy at the time. Not because I felt it more likely, but rather because I thought the costs of such a scenario would be much greater given the risk of high inflation expectations becoming embedded. I was also conscious of the structural changes that had occurred in the UK mortgage market over the preceding decade, most obviously the increased proportion of households on longer fixed rate mortgages, which could alter the scale and pace of transmission. With that in mind I stood ready to vote for further tightening if there were evidence of more persistent inflationary pressures.

Placing greater weight on the high inflation scenario continued to drive my policy strategy into **December**; however, as we approached the **February 2024** decision, my focus turned to how long Bank Rate would have to be maintained at 5.25% before it could be cut.

[2] Reading between the lines – speech by Sarah Breeden | Bank of England
[3] Monetary policy as engineering? – speech by Sarah Breeden | Bank of England

Nominal data had surprised materially to the downside. And it was clear that global inflationary pressures were abating faster than initially expected, with energy prices having fallen significantly and imported goods prices no longer pushing up inflation as they had done. Inflation now looked likely to hit its target later that year, driven by a negative contribution from energy. There still hadn't been evidence of a change in domestic inflationary pressures, however, including from services inflation which was still running around 6.4%.

It was at the **February** decision that I thought it important for us to start placing more weight again on the 'most likely' forecast of the economy in both guiding and communicating our policy decisions, rather than relying on the three indicators of inflation persistence that had been a central part of our communications in the preceding months. Wage growth and services price inflation were lagging indicators. As the shocks had unwound and uncertainty had cleared somewhat, my confidence in the 'most likely' forecast had increased.

In the run up to our **March** and **May** meetings**,** nominal data was coming in as we had expected in the MPR forecasts and I was gaining an accumulation of evidence to suggest that the disinflation process was evolving in line with our central expectations, supported by lower energy and goods prices. We had learnt just how weak demand had been over the second half of 2023 and it was clear from discussions with businesses that this weakness was also becoming apparent to firms as the "nominal fog" - the difficulty they faced in disentangling nominal and real activity - that had clouded their ability to assess the strength of demand, was lifting. In my view, and in line with intelligence from the Bank's Agents at the time, this weaker demand environment would make it harder for firms to push through cost increases to their customers.

It was at this point that I started to ask myself in what scenario I would consider cutting Bank Rate. One window into this was our May MPR forecast, which was conditioned on financial market expectations at the time of around 150 basis points of rate cuts and had inflation falling below target by the end of the forecast horizon, despite assuming a significant degree of inflation persistence.

Despite some upside services price inflation news in the run up to the **June** decision, overall, I thought persistence was still progressing broadly as expected, just with some bumps along the way. This view was predicated on staff modelling suggesting that this inflation news might only add up to 10bps to its 2-year ahead inflation forecast, and the fact that a large share of the surprise had been driven by components that tend to lag the rest of the CPI basket and can be quite volatile.

The other piece of important upside news we received ahead of the June decision was that demand was looking a little stronger than we had expected. I had been conscious, while evaluating economic outturns against past forecasts, that we had been repeatedly forecasting an emerging degree of slack for a while and this had never materialised. Such uncertainty in the outlook for slack was concerning given that the fall in inflation we expected to see in the future was conditional upon a margin of slack opening up. This uncertainty, alongside the upside news in the inflation data, meant I was not yet ready to start cutting Bank Rate in June.

By **August**, inflation data was once again back in line with our expectations and had been at 2% for two months, which itself helps reduce second round effects. I again turned to a range of real-world data alongside the forecast to supplement my understanding of the economy. Forward-looking indicators of wage growth had fallen, with settlements expected to be between 2-4% over the next year. In light of this, I had become confident that the disinflationary processes had progressed to an extent that it would be appropriate to reduce the degree of restrictiveness a little by cutting Bank Rate by 0.25pp to 5.0%.

Over the next few months as we approached the **September and November** meetings, we continued to see progress on the nominal side with inflation and wage growth coming in either at or below our expectations. The continuation of the waves of adjustment gave me confidence to cut again in November.

Over this time period, I continued to be focused on two key risks. First - on the downside - that the degree of inflation persistence assumed in the forecast – particularly at the two-year horizon – was a little too big given the fall in headline inflation and the now target-consistent inflation expectations. Second, that slack wouldn't open up as expected and that the strong demand environment could threaten the waves of adjustment that we were relying on to bring inflation back to target.

I was also mindful of the employer National Insurance contribution increase announced in the Budget, given the difficulty in knowing how employers would respond to the increase and the different implications for policy of the four main possible channels of impact (absorbing this within their profit margins, passing on the cost to consumers through higher prices, or mitigating the impact by reducing nominal wages or employment).

Over the **December** and **February** meetings**,** it had become clear that activity was weak. There was however some uncertainty about whether that reflected weak demand or weak supply.

As I set out in a speech that January[4], understanding the nature of the shock was vital for understanding how it might affect medium-term inflation and so help guide the right setting for monetary policy. Taking evidence from a range of different models and indicators was helpful here to give a sense of upper and lower bounds, but my best point estimate ultimately remained highly uncertain. That said, while it was clear that supply growth had been weaker than we had thought for a while, I found it difficult to find a narrative or underlying cause that would be big enough to explain the sudden shift down in supply that

[4] Reading between the lines – speech by Sarah Breeden | Bank of England

would be needed to explain the most recent weakness in activity. I therefore ascribed at least some of the weakness to slack, and probably a little more than was factored into the MPR forecast.

By February, it was also clear that inflation would be likely to rise materially above target again in the year ahead – to just over 3½% - driven by wholesale energy prices, a set of indexed and regulated products, food and core goods. Key to my decision in February was a judgment that such a rise, unlike the energy cost shock in 2021, was not expected to lead to additional second round effects on account of the looser labour market, the weaker demand environment and the fact that the rise in headline inflation was significantly smaller in magnitude. I was therefore confident in cutting rates again in February by a further 25 basis points.

There had been little in the data to change my view of the economy by the time of the **March** meeting. In the absence of any significant news to shift my priors that (i) the “hump” in inflation would not lead to additional persistence; (ii) that the lower path for wage growth would lead to a fall in persistence and so services inflation; and, (iii) that an opening of slack would support these two process, I expected that I would vote to cut again in May.

International developments dominated the news in the run up to our most recent decision in **May**. In April, the imposition of tariffs by the United States and the measures taken in response by some of its trading partners had significantly increased global trade policy uncertainty. While this news dominated headlines, we estimated that its impact on the UK economy was most likely to be fairly small, and so I continued to keep most of my focus on domestic developments.

As in March, I was interested in the paths for persistence and slack. On the former, while the rise in household inflation expectations had given me some pause for thought, I was comforted by the fact that we haven’t seen similar moves in firms’ expectations, which I consider to matter most for wage and price setting in the current environment given the loosening in the labour market. On the latter, I was alive to the risk that a greater degree of slack might open up over the forecast horizon, given potential downside risks to the outlook for demand and, in particular, consumption, in part because heightened uncertainty may also act to keep the rate of household savings elevated, which had for some time already been higher than we expected.

Economic Outlook

The May MPR set out an update on our collective judgement on the economic outlook. While I won’t summarise that report, I will set out the key factors I continue to monitor as we move forward this year.

Overall, I see merit in maintaining a gradual and careful approach to adjusting our policy stance as we continue to monitor progress in disinflation, in part given two-sided risks to the disinflation trend and in part as the restrictive stance of policy continues to bear down on activity. As we approach a neutral policy stance, evidence of restrictiveness will become less clear, and the decision to further loosen policy will require a greater degree of certainty that inflation is on track.

Looking forward, the key issues that have guided my policy over this period - the progress of the waves of adjustment in the economy following the large inflationary shocks of the past few years, and the degree to which slack is opening up – will continue to be important. As was the case in May, alongside the usual forecasts, I will continue to be guided by evidence on inflation persistence, emanating particularly from the outlook for pay growth as well as inflation expectations, and the degree of slack opening up, particularly in the labour market.

Although my central expectation is for tariffs to have only a small impact on the economy, they have influenced my view of the risks around the inflation outlook a little. I see downside risks from greater trade diversion, but I also see upside risks from the introduction of supply chain frictions globally. I think this latter channel is likely under-represented in models and so we should see what we can learn from the real world about it.

The development of scenarios by Staff to explore some of these themes in the May round was hugely valuable in helping explore the policy implications of certain constellations of inputs, as well as the risks around our forecasts. We detailed these in the May MPR. Looking ahead, I will also be looking to track outturns against these two scenarios, and other potential combinations of shocks, to help inform my understanding of the current economic environment, just as I did for the first two scenarios I looked at when I joined the Committee 18 months ago.

Explaining monetary policy

I have given eight on the record speeches since becoming DG, three have been on monetary policy:

Monetary policy as engineering given at the Institute of International Finance's Talking policy series, London, 19 December 2023

Monetary policy as engineering? – speech by Sarah Breeden | Bank of England

Engineering revisited given at the UK Women in Economics Annual Networking event, London, 7 February 2024

Engineering revisited - speech by Sarah Breeden | Bank of England

Reading between the lines given at the University of Edinburgh Business school, 9 January 2025

Reading between the lines – speech by Sarah Breeden | Bank of England

List of agency visits

East Midlands – 15 November 2023, including Citizens' Panel

Greater London – 8 March 2024

West Midlands – 10 May 2024, including BBC Radio West Midlands

Essex Community Foundation Citizens' Panel – 6 August 2024

South West – 3 October 2024

Scotland – 10 January 2025

A further 4 trips are currently scheduled for later this year:

Greater London – 19 June 2025

Wales - 30 September 2025

Greater London - 10 November 2025

South East & East Anglia – 4 December 2025