**BANK OF ENGLAND MONETARY POLICY REPORT PRESS CONFERENCE**

Thursday 4 August 2022

Opening Remarks by Andrew Bailey, Governor

## Introduction

Welcome to the August *Monetary Policy Report* press conference.

The risks around the MPC's forecasts are exceptionally large at present. The source of these risks, and the driver of most of the revisions to our forecasts since our May report, is overwhelmingly energy prices and the consequences of the actions of Russia.

In line with the MPC's conventions, the baseline projections in the August Report are conditioned on: wholesale energy prices following their futures curves for the next six months and then remaining constant; the path of Bank Rate implied by financial markets; and fiscal policy evolving in line with announced Government policies.

There are, however, a range of plausible paths for the economy, which have CPI inflation and medium-term activity significantly higher or lower than in the baseline projections. Therefore, the August Report contains several projections for GDP, unemployment and inflation. The MPC is currently putting less weight on the implications of any single set of conditioning assumptions and projections, choosing to draw more heavily on alternative scenarios as well.

## Energy prices and the outlook for inflation

To illustrate the key aspects of our projections I will be using some charts.

Since our May Report, as shown on this chart (Chart 1), the most significant news has been the further sharp increase in energy prices. Wholesale gas futures prices for end-2022 have nearly doubled since May, and are almost seven times higher than implied by the futures curve a year ago, overwhelmingly as a result of Russia's restriction of gas supplies to Europe and the risk of further curbs.

Near-term inflationary pressures have intensified significantly. CPI inflation is now expected to peak at just over 13% in 2022 Q4, and to remain at very elevated levels throughout much of 2023. The bulk of that further increase reflects higher wholesale prices feeding through to retail energy prices, with a further large rise in the Ofgem price cap projected in October. This takes into account the new method announced by Ofgem this morning. This next chart (Chart 2) shows the direct impact of energy prices on CPI inflation in our recent forecasts, and the extent of the latest upward revision.

This rise in energy prices has exacerbated the fall in real incomes, and so led to another significant deterioration in the outlook for activity in the UK and the rest of Europe. GDP growth in the UK has slowed and the economy is now forecast to enter recession later this year.

As illustrated by the white line in this chart (Chart 3), the projected peak-to-trough fall in output of 2¼% would be similar to that experienced in the early 90s recession, in green, although less than during the global financial crisis, in pink. In marked contrast to these previous episodes, this predominantly reflects the adverse impact of the very sharp rises in global energy and tradable goods prices on UK real incomes and spending.

As shown in the fan chart (Chart 4), these developments have further accentuated the extent to which, in the MPC's baseline projection, UK CPI inflation is well above the 2% target over the first 18 months but well below the target in three years' time.

CPI inflation is projected to fall back somewhat from its peak to 9.5% in a year's time, as rising domestic pressures are outweighed by the assumed stabilisation of global energy prices and falls in tradable goods prices. Inflation then falls sharply to the 2% target in two years' time, as external influences continue to dissipate and domestic factors fade. CPI inflation falls well below the target in three years' time, reflecting a further weakening in domestic pressures.

The uncertainty around the outlook is exceptionally high, however, especially for energy prices. Under our standard conditioning assumption, energy prices would be extremely high by historical standards throughout the three-year forecast period.

Therefore, as in recent Reports, we have also set out an alternative projection in which energy prices follow their downward-sloping futures curves over the forecast period, although they are still above their pre-pandemic levels throughout.

As shown in the cyan line in this chart (Chart 5), under this assumption the lower contribution from energy prices implies CPI inflation around 1 percentage point below the 2% target at the two year point, and even further below at year three. This would result in a smaller fall in households' real incomes and spending, and so GDP would be somewhat higher than in the baseline projection. The economy is still projected to experience a recession, albeit a less deep one, as shown by the cyan line on this chart (Chart 6).

The difference between these forecasts demonstrates the sensitivity of the outlook for inflation to swings in energy prices. The Russian shock is now the largest contributor to UK inflation by some way. There is an economic cost to the war. But it will not deflect us from setting monetary policy to bring inflation back to the 2% target.

**Domestic inflationary pressures and the persistence of inflation**

Though responsible for much less of the rise in headline inflation, domestic inflationary pressures have also remained strong.

Firms generally report that they expect to increase their selling prices markedly, reflecting the sharp rise in their costs. The labour market remains tight, with the unemployment rate at 3.8% in the three months to May and vacancies at historically high levels. The tightness of the labour market partly reflects the fall in the labour force since the start of the pandemic, which is in part due to the large rise in economic inactivity shown by the orange bars in this chart (Chart 7). As a result, and consistent with the latest Agents' survey, underlying nominal wage growth is expected to pick up further.

Domestic pressures on CPI inflation are nevertheless expected to dissipate thereafter. Although the labour market may loosen only slowly in response to falling demand, unemployment is expected to rise from 2023. And with monetary policy acting to ensure that longer-term inflation expectations are anchored at the 2% target, wage pressures are assumed to adjust down quickly as inflation itself falls back.

There is, however, a risk that domestic price setting proves more persistent than in the MPC's baseline projection.  Therefore, the MPR also contains a scenario in which firms are able to pass on the increases in their labour costs to their prices to a greater extent than normal.

As shown in the purple line in this chart (Chart 8), under this scenario CPI inflation is even further above the inflation target at year 2 but unchanged and still below target at year 3.

**Monetary policy decision**

Turning to the decision.  The mix of high near-term inflation and weak activity leading up to a recession, is a challenging backdrop for monetary policy.  Monetary policy must be set taking into account the scale of the shock to real income, while keeping our focus on inflation and inflation expectations. Returning inflation to its 2% target remains our absolute priority, no ifs, no buts.

At this meeting the Committee voted to increase Bank Rate by 0.5 percentage points, to 1.75%.

The committee judged that a more forceful policy action was justified at this meeting, as there have been some indications that inflationary pressures are becoming more persistent and broadening to more domestically driven sectors.  Companies are finding it easier to increase prices, and the labour market remains tight.  In such an environment, there is a risk that the further jump in energy prices, and the higher and more protracted path for CPI inflation over the next 18 months, will lead to more enduring domestic price and wage pressures, which would be inconsistent with inflation returning to the 2% target.

Overall, a faster pace of policy tightening at this meeting will help to bring inflation back to the 2% target sustainably in the medium term, and to reduce the risks of a more extended and costly tightening cycle later.

Looking ahead, that does not mean we are now moving to a pre-determined path of raising Bank Rate by 50bp per meeting, or indeed any other number.  Policy is not on a pre-set path, and what we do this time does not tell you what we're going to do next time. All options are on the table at our September meeting and beyond.

The MPC will take the actions necessary to return inflation to the 2% target sustainably in the medium term, in line with its remit. The scale, pace and timing of any further changes in Bank Rate will reflect the Committee's assessment of the economic outlook and inflationary pressures. The Committee will be particularly alert to indications of more persistent inflationary pressures, and will if necessary act forcefully in response.

I recognise the significant impact this will have, and how difficult the cost of living challenge will continue to be for many people in the United Kingdom. Inflation hits the least well off hardest. But if we don't act now to prevent inflation becoming persistent, the consequences later will be worse, and will require larger increases in interest rates.

**Asset Purchase Facility**

At this meeting the MPC also provided an update on its strategy for beginning to sell the gilts held in our Asset Purchase Facility portfolio. The MPC is provisionally minded to commence gilt sales shortly after its September policy meeting, subject to economic and market conditions being judged appropriate and to a confirmatory vote at that meeting.

Were it to proceed, the Committee judged that, over the first twelve months of a sales programme, a reduction in the stock of purchased gilts held in the APF of around £80 billion was likely to be appropriate. Given maturing gilts, this would imply a sales programme of around £10 billion per quarter. The planned details of the proposed programme are set out in a Market Notice released alongside the MPR.

**Conclusion**

To conclude, let me reiterate that our job is to hit the inflation target, and in the current circumstances to return inflation to target. To be clear, there are no ifs or buts in our commitment to the 2% inflation target. That's our job, and that's what we will do.

Thank you.