BANK OF ENGLAND MONETARY POLICY REPORT PRESS CONFERENCE

Thursday 5 May 2022

Opening Remarks by Andrew Bailey, Governor

Introduction

Welcome to this presentation of the May *Monetary Policy Report*.

The main development since our last *Report* in February has been Russia's unprovoked and illegal invasion of Ukraine. The Bank of England condemns Russia's actions and the suffering inflicted on Ukraine. The Bank is working closely with the UK Government to support its response in coordination with international authorities.

Global inflationary pressures have intensified sharply in the build up to and following the invasion. This has led to a material deterioration in the outlook for world growth. Concerns about further supply chain disruption have also risen, both due to the invasion and to Covid developments in China. These developments have exacerbated greatly the challenges already facing the UK, and many other economies, from the series of adverse supply shocks we continue to face.

Monetary policy must, therefore, navigate a narrow path between the increased risks from elevated inflation and a tight labour market on one hand, and the further hit to activity from the reduction in real incomes on the other.

While these shocks are global in nature, there are important differences in the way they are impacting different economies. To characterise the situation, the United States is facing what looks like a demand shock, with a strong domestic labour market, strong domestic demand and relatively less exposure to the energy price shock given its position as a major gas producer. The euro area by contrast is facing a supply/cost shock, as it starts with a somewhat weaker domestic labour market, and is heavily exposed to the rise in gas prices. In the UK we are seeing elements of both. Like the euro area, we are experiencing a sharp terms of trade shock emanating from the rise in the price of tradable goods and energy. But our strong labour market is more akin to that in the US.

The outlook for inflation

Turning to our latest projections, this is a forecast of two halves: with inflation well-above target in the near term, but subsequently falling back to end the forecast below the target, as global inflationary pressures fall sharply and domestic activity weakens. This is similar in nature to our February forecast, although developments since then have increased the size of these swings.

In line with the MPC's conventions, the projections are conditioned on a market-implied path for Bank Rate that rises to around 2½% by mid-2023, 1.1 percentage points higher than in February, before falling to 2% at the end of the forecast period.

Wholesale energy prices are assumed to follow their respective futures curves for the first six months of the projections and remain constant beyond that. Given that path for wholesale prices and Ofgem's published method for calculating the retail gas and electricity price caps, Bank staff currently forecast that household energy prices would rise by a further 40% in October.

UK CPI inflation rose to 7.0% in March. The strength of inflation relative to the 2% target mainly reflects previous large increases in global energy and tradable goods prices, owing to the build up to and subsequent Russian invasion of Ukraine, and to the continuing effects of the pandemic on the pattern of global demand and disruption to global supply chains.

In the MPC's central projection, CPI inflation is expected to rise over the remainder of the year, averaging slightly over 10% at its peak in 2022 Q4. The majority of that further increase reflects higher household energy prices. The price cap mechanism means that it takes some time for changes in wholesale gas and electricity prices to be reflected in retail energy prices. That means consumer price inflation is likely to peak later in the United Kingdom than in many other economies, and may therefore fall back later.

Though responsible for less of the current and projected rise in inflation, domestic inflationary pressures have also increased. The Labour Force Survey unemployment rate fell to 3.8% in the three months to February, consistent with a continuing tightening in the labour market. Underlying nominal earnings growth has risen to around 4 to 4½% and is expected to strengthen further in coming months to average 5¾% in 2022, given the further tightening of the labour market and some upward pressure on wage growth from higher price inflation. Consistent with this, there has been some increase in the inflation rates of more domestically supplied services.

UK GDP growth is expected to slow sharply over the first half of the forecast period. That predominantly reflects the significant adverse impact of the sharp rises in global energy and tradable goods prices on most UK households' real incomes. It is a measure of the scale of the shock that total real household disposable income is projected to fall by 1¾% in 2022 which, apart from 2011, would be the largest contraction since comparable records began in 1964.

I recognise the hardship this will cause for many people in the UK, particularly those on the lowest incomes, often with little or no savings, who are hit hardest by increases in the prices of basic necessities like food and energy.

As a result of the associated decline in activity, although the unemployment rate is likely to fall further in the near term to 3.6% in Q2, it is projected to rise to 5½% in three years' time given the sharp slowdown in activity.

With monetary policy acting to ensure that longer-term inflation expectations are anchored at the 2% target, upward pressure on CPI inflation is, therefore, expected to dissipate over time. Global commodity prices are assumed to be consistent with the conditioning paths for energy prices and so rise no further in the central projection. Global bottlenecks are expected to ease over time, and the weakening in growth and building excess supply leads domestic inflationary pressures to subside.

Once CPI inflation starts to fall, it is projected to fall relatively quickly; to a little above the 2% target in two years' time, largely reflecting the waning influence of external factors, and to 1.3% in three years, well below the target and mainly reflecting weaker domestic pressures. The risks to the inflation projection are judged to be skewed to the upside at these points, given the risks of more persistent strength in nominal wage growth and domestic price setting than we have assumed.

The policy decision

I will now turn to the monetary policy decision.

The MPC's remit is clear that the inflation target applies at all times, reflecting the primacy of price stability in the UK monetary policy framework. The framework also recognises that there will be occasions when inflation will depart from the target as a result of shocks and disturbances. The economy has recently been subject to a succession of very large shocks. Russia's invasion of Ukraine

is another such shock. In particular, should the current very elevated levels of global energy and tradable goods prices prove persistent, this will necessarily weigh further on most UK households' real incomes and many UK companies' profit margins. This is something monetary policy is unable to prevent. But what monetary policy can do is to ensure that, as this real economic adjustment occurs, it does so in a manner consistent with achieving the 2% inflation target sustainably in the medium term, while minimising undesirable volatility in output.

Recent developments have exacerbated materially both the near-term peak in CPI inflation, and the prospective negative impact on activity and medium-term inflationary pressures. Nevertheless, given the current tightness of the labour market, continuing signs of robust domestic cost and price pressures, and the risk that those pressures will persist, the Committee voted at this meeting to increase Bank Rate by a further 0.25 percentage points to 1%.

Based on their updated assessment of the economic outlook, most members of the Committee judge that some degree of further tightening in monetary policy might still be appropriate in the coming months. There are risks on both sides of that judgement and a range of views among these members on the balance of risks. The MPC will continue to review developments in the light of incoming data and their implications for medium-term inflation.

Given the uncertainty around the outlook, it is unsurprising there were a range of views amongst members of the committee about the extent of tightening required at this meeting and in the coming months.   This reflects the narrow path we are navigating, given the magnitude of the risks on both sides of our inflation projections.

Reflecting the risks on one side of that narrow path, at this meeting three members preferred a 0.5 percentage point increase in Bank Rate.

Reflecting the risks on the other side, however, there were also a range of views about the need for, and extent of, any further tightening in policy in the coming months. While most members judged that some degree of further tightening might still be appropriate, some members judged that the risks around activity and inflation over the policy horizon were more evenly balanced and that such guidance was not appropriate at this juncture.

Finally, the MPC is providing further information on unwinding the stock of assets previously purchased as part of the QE programmes. As Bank Rate is being increased to 1%, and consistent with

the MPC's previous guidance, the Committee will now consider beginning the process of selling UK government bonds held in the Asset Purchase Facility. The Committee recognises the benefits of providing market participants with clarity on the framework for any potential sales programme. The MPC has therefore asked Bank staff to work on a strategy for UK government bond sales, and will provide an update at our August meeting. This will allow the Committee to make a decision at a subsequent meeting on whether to commence sales. I should reiterate that no decision on whether to commence sales has yet been made. The Committee reaffirmed that that decision will depend on economic circumstances including market conditions at the time, and that sales would be expected to be conducted in a gradual and predictable manner so as not to disrupt the functioning of financial markets.

Thank you. Ben, Dave and I will be happy to take your questions.