MONETARY POLICY REPORT PRESS CONFERENCE

Thursday 1 August 2024

Opening remarks by Andrew Bailey, Governor

Thanks, Katie. Let me start by welcoming Clare to her first press conference.

Today, we have cut Bank Rate by 0.25 percentage points, to 5%.

This was a finely balanced decision.

Inflation has been exactly on our 2% target for two consecutive months. And inflationary pressures in the UK economy have eased much as expected. This is very welcome news.

At the same time, the UK economy has been stronger in recent months. This is very welcome too. But it adds to the risk that inflation could be higher than expected if we cut interest rates too much or too quickly. Despite easing, services price inflation and domestic inflationary pressures remain elevated.

We need to make sure that inflation stays low. We need to put the period of high inflation firmly behind us. And we need to be careful not to cut rates too much or too quickly – all the while monitoring the evidence on how inflationary pressures are evolving.

The best and most sustainable contribution monetary policy can make to growth and prosperity is to ensure low and stable inflation – and an economy where people can plan for the future with confidence and in which money holds its value.

We have truly come a long way in returning inflation to target.

Chart 1 shows the development of twelve-month consumer price inflation since 2019 (white line). Inflation has fallen significantly from its peak. Over the past year alone, it has fallen from nearly 8% in June last year to 2% in the latest data for May and June.

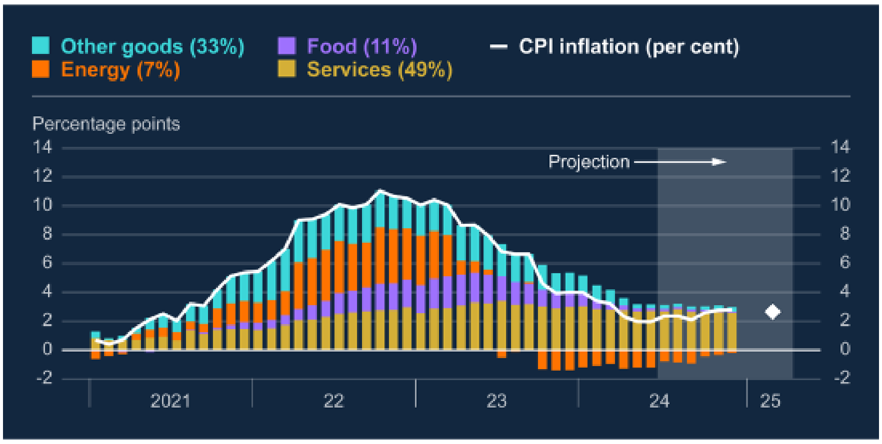
We expect consumer price inflation to edge up again in the second half of the year, perhaps to around 2¾% (as you can see in the shaded area). But we then expect inflation to revert towards the 2% target over the next year.

Under the surface, the decline in the headline number has been driven by lower goods price inflation – as reflected in negative contributions from energy prices (orange bars) and fading contributions from food and other goods (in purple and blue). As the effects of lower energy prices fade over the coming months, more of the headline inflation number will be driven by services price inflation (in yellow).

So the stories behind the headline inflation numbers really only emerge as we dive deeper into price developments for goods and services.

Chart 1: Inflation fell to the 2% target in May but is expected to rise somewhat

Contributions to consumer price inflation



Sources: Bloomberg Finance L.P., Department for Energy Security and Net Zero, ONS and Bank calculations

The story on energy prices is worth repeating. After sharp rises following the start of the war in Ukraine, household energy prices fell significantly in the second half of last year with large declines in Ofgem price caps. These declines are currently pulling down on the annual measure of inflation. In the latest number for June, household energy price inflation was -27%. With a weight of 4% in the consumer price index, that currently subtracts about a percentage point from headline inflation. As last year's declines drop out of the annual comparison over the rest of this year, this negative contribution from household energy prices will fade.

That is the main reason why we expect headline inflation to edge up in the coming months.

As **Chart 2** shows, core goods price inflation has also fallen sharply over the past two years (orange line), and we expect it to remain muted in coming months (in the shaded area). These are goods traded in international markets, and with supply chains restoring themselves with signs of deflation emerging in some key supplier countries, most notably China, global goods price inflation should help keep goods price inflation low for UK consumers.

By comparison, services price inflation (in blue) is declining more gradually. The continued strength in services inflation reflects more persistent inflationary pressures in the UK economy. So-called base effects from irregular falls in volatile components last year may even cause services inflation to rise slightly in August before we can expect it to ease again throughout the rest of the year.

While goods price inflation has been a little lower than we expected in May, services price inflation has been somewhat higher.

Chart 2: Services price inflation remains above pre-Covid average

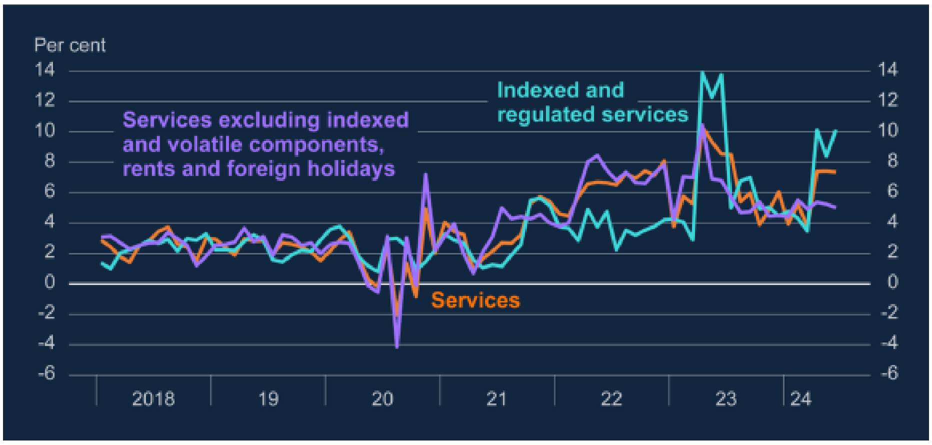
Annual inflation rates for components of CPI

Sources: ONS and Bank calculations

As **Chart 3** shows, these surprises have come with an uptick in monthly services price inflation rates (in orange), which can be indicative of momentum in price increases over the very near term. However, much of that strength has been driven by an increase in the components of the services basket that are index-linked or regulated (in blue), often resulting in price rises in April. Monthly services price inflation excluding these components, along with other volatile components such as airfares and hotels, have been lower (in purple). This may be a better guide to the direction for services inflation over coming months.

Chart 3: Volatile high-frequency measures of services price inflation have risen

Three-month averages of seasonally adjusted monthly annualised inflation rates



Sources: ONS and Bank calculations

But we need to watch this very carefully. The Monetary Policy Committee continues to pay close attention to services inflation as an indicator of persistence in domestic inflationary pressures, along with a range of other economic indicators.

This does not, however, mean that we should adjust our course with every data surprise that comes in. What matters for our policy decisions is the accumulation of evidence about the medium-term outlook for inflation: what the data add to our understanding of the underlying dynamics in the UK economy that ultimately determine the future path for consumer price inflation. And given the time it takes for monetary policy to have its full effect, we need to be forward-looking in determining how restrictive monetary policy should be to return inflation sustainably to the 2% target.

A further factor in the MPC's assessment is the recent strength in economic activity. GDP growth has been noticeably stronger than expected over the first half of this year, following a period of weakness in the second half of last year. The Committee sees it as most likely that underlying momentum has remained more steady, and that the balance between demand and supply has remained stable. This judgement is supported by various indicators which suggest that capacity utilisation and labour market tightness has moved by much less than the GDP numbers.

The job of monetary policy is to squeeze the persistent element of inflation out of the system in a way that is consistent with returning inflation to target on a timely and sustained basis. That is what we did by increasing Bank Rate to 5.25% and keeping it at that level for a year. That has leaned heavily against second-round effects from global inflationary shocks on domestic inflation persistence. But we still face the question of whether the persistent element of inflation is on course to decline to a level consistent with inflation being on target on a sustained basis and what it will take to make that happen.

Is the decline of persistence now almost baked in as the global shocks that drove up inflation unwind; or will it also require a period with economic slack in the UK economy; or are we experiencing a more permanent change to wage and price setting which would require monetary policy to remain tighter for longer?

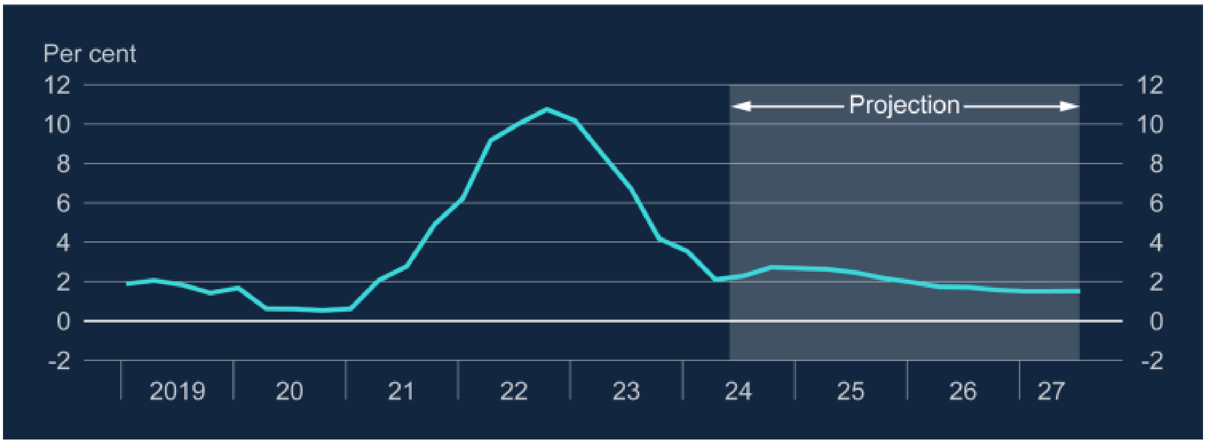
These have become important questions in the MPC's policy deliberations. As policymakers, we can have all three cases in our expectations, with different weights attached – weights that can change over time.

The Committee's collective modal – or 'most likely' – projection of the UK economy is consistent with a relatively benign view of inflation persistence and what it takes from here to squeeze it out of the system and return inflation sustainably to target.

As **Chart 4** shows, in this 'most likely' projection – conditional on a market-implied path for Bank Rate that declines to 3.5% over the three-year forecast horizon – consumer price inflation falls back to 1.7% in two years' time and to 1.5% in three years.

Chart 4: Inflation is projected to fall below target at the end of the forecast

CPI inflation projection conditional on market-implied path for Bank Rate



Sources: ONS and Bank calculations

In this projection, second-round effects in domestic prices and wages are judged to take longer to unwind than they did to emerge, leading to some persistence in inflationary pressures. But against that, a margin of economic slack gradually builds over the forecast horizon despite the recent pick-up in economic growth. As such, the 'most likely' projection encompasses the first two, relatively benign, cases I just described.

So the modal projection reflects the Committee's collective judgement that we are making good progress in returning inflation to the 2% target sustainably.

The progress has become clearly visible in measures of both inflation perceptions and inflation expectations. These are important determinants of consumer price inflation given the role they play in wage and price setting in the economy. We should expect that perceptions of current inflation and expectations of future inflation will play into wage bargaining and price setting.

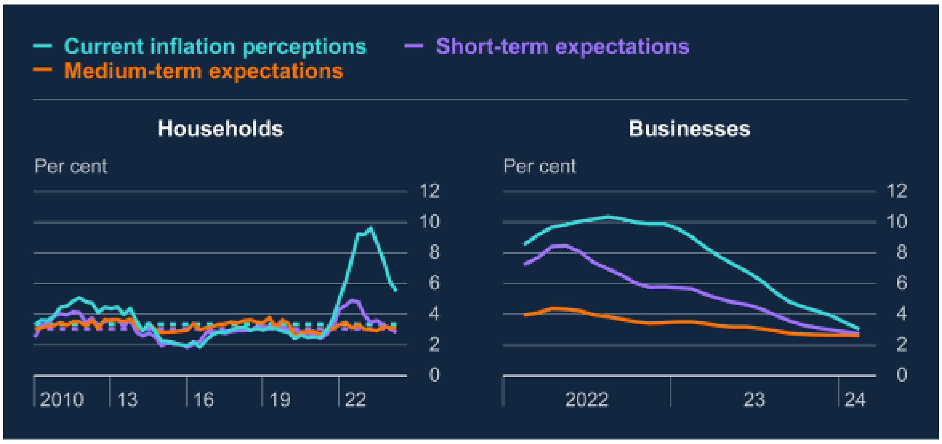
Chart 5 gives a snapshot, based on the Bank's Inflation Attitudes Survey of UK households and its Decision Maker Panel survey of UK businesses.

Short-term household inflation expectations (in purple on the left-hand panel) have continued to fall alongside the observed decline in consumer price inflation, while medium-term expectations (in orange) remain stable. Households' perceptions of the current rate of inflation remain elevated (in blue), but they have fallen sharply and tend to react to headline inflation with a lag.

Similarly, firms' current inflation perceptions and inflation expectations over the short and medium term have also fallen significantly (right-hand panel).

Chart 5: Inflation expectations have continued to fall back

Households' and businesses' inflation expectations and perceptions



Sources: Bank/Ipsos Inflation Attitudes Survey, Decision Maker Panel and Bank calculations

All of this points to a continuing normalisation of wage and price-setting dynamics – that the fall in headline inflation will feed through to inflation expectations and to weaker pay and price-setting dynamics. So even if we judge that second-round effects will take longer to unwind than they did to emerge, the evidence from these indicators is consistent with the view that second-round effects will continue to fade with the restrictive monetary policy stance we have put in place and the emergence of a margin of slack in the economy.

There is, however, an alternative account of the economy which is less benign than our 'most likely' projection. And this account reflects a view that MPC members put some weight on too, albeit to different degrees, when reaching their conclusions on the appropriate degree of restrictiveness in monetary policy.

This view is that the economy is closer to the third, least benign, case I set out earlier – that inflationary pressures have become more engrained in the UK economy as a result of structural changes in product and labour markets – as a lasting legacy of the major shocks we have experienced. One possibility that the Committee has considered is that the rate of unemployment below which inflationary pressures begin to build may have gone up over recent years.

There is also a risk that the recent upside news to economic activity could reflect stronger demand relative to supply, in turn increasing inflationary pressures in the UK economy over the medium term.

We can think of the alternative view as a prototype economic scenario of the kind that Ben Bernanke has recommended in his recent review of our processes in times of high uncertainty. As we develop our response to Dr Bernanke's recommendations, we will be in a position to articulate fully such scenarios. In the Report we present today, giving some weight to an alternative, less benign, view of inflation persistence is reflected in an upside risk, or 'skew', to our inflation forecast. The mean path for inflation is higher than the modal, or 'most likely', path as a result.

Whether we think of the possibility of less benign developments in inflationary pressures as an alternative scenario or as an upside risk, the message remains the same. We need to make sure that monetary policy is sufficiently restrictive for sufficiently long that inflation remains near the 2% target.

Weighing the evidence at this meeting, the Monetary Policy Committee voted to cut Bank Rate by 0.25 percentage points, to 5%.

CPI inflation has fallen markedly over the past year back to the 2% target. The impact from past external shocks has abated and the risks of persistently high inflation have moderated.

So it is now appropriate to reduce the degree of restrictiveness a little to ensure that inflation remains sustainably around the 2% target.

However, key indicators of inflationary pressures remain elevated and recent strength in economic activity has added to the risk of more persistent inflationary pressures. This should give us pause for thought.

Monetary policy will need to remain restrictive for sufficiently long until the risks to inflation remaining sustainably around the 2% target in the medium term have dissipated further.

The Committee continues to remain highly alert to the risks of inflation persistence and will decide the appropriate degree of monetary policy restrictiveness at each meeting.

And with that, Clare, Dave and I will be happy to take your questions.