Report to Treasury Select Committee

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Voting record

This is the most challenging period for monetary policy since inflation targeting began in 1992.

Having collapsed in 2020, the economy has only just regained the size it was immediately before the pandemic. Yet, despite what has therefore been zero average growth over that two-year period, the labour market is significantly tighter than on the eve of the pandemic and labour costs have started to accelerate.

More significantly, as far as current inflation rates are concerned, the UK has been experiencing the steepest rise in its import costs for many decades. Pandemic-related factors have for some time been pushing up the global price of many traded goods. More recently, and more dramatically, wholesale gas prices rose precipitously in the second half of last year. They are currently around five times the pre-pandemic average. Retail gas and electricity prices are set to rise by 54% in April, pushing their annual inflation rate to 73%. The steep rises in these global prices account for the significant majority of the overshoot in overall CPI inflation, relative to target, and will also be responsible for most of the additional rise in inflation that is likely to occur over the next three months.

I will have more to say about the outlook for these things in the next section but let me first outline how policy has had to respond to them so far.

Swings in prices of traded goods are not uncommon. We have rarely – if ever – seen increases on this scale in such a short period of time. But these prices are in general more volatile than those of domestic services and, because the UK is a comparatively open economy, they often have a significant and direct impact on inflation. For example, energy accounts for around 6-7% of the consumer basket (and of the CPI) but more than twice that share of its volatility.

However, the orthodox response of monetary policy is to do less in response to these shocks than those emanating from the domestic economy. The main reason is that their direct impact on inflation tends not to persist for that long – a shorter time, in particular, than it takes for monetary policy to have a meaningful impact of its own. The direct impact on inflation of a change in oil prices, for example, lasts barely a year. So there's not much point in responding to it: that would only introduce unnecessary volatility in domestic output. Indeed in some cases – and wholesale gas is an example – there's been in the past a strong mean-reverting tendency in the level of prices. So it's not simply that the direct impact on inflation dies away over time, as prices stabilise. More often than not it's subsequently gone into reverse.

Second, and even if that's not the case – even if the direct impact of higher import prices is expected still to be pushing up on inflation 18-24 months ahead – this would tend to have the opposite effects on domestic incomes and spending. That higher import prices reduce real incomes is unavoidable. If the price of what we (collectively) buy goes up, relative to the price of what we (collectively) produce, this necessarily reduces real

national income. Everyone is affected by it. And, in time, it is likely to weigh on domestic demand. These are "trade-off-inducing shocks": they have one effect on the primary objective of inflation (for however long that lasts) but the opposite effect on the secondary objective of stabilising the domestic economy.

As I say, I will say something shortly about the outlook. There is no guarantee that the inflationary impact of higher import prices will indeed die away relatively quickly (even if that's usually what's happened in the past). But the MPC was certainly conscious of this general property of goods and energy prices and was therefore more focussed last summer and autumn on developments in domestic costs and the labour market. And it's been the continuing signs of tightness in the labour market, and the resulting pick-up in wage growth, that has been the more important factor behind my votes to raise Bank Rate in December and February, rather than the steep rises in import prices (more dramatic though they've been).

Before turning to the outlook, let me make one brief point about these developments in the labour market and the timing of the response of monetary policy. Many labour market indicators – the level of vacancies, for example, were already showing signs of tightness early in the summer. This was pretty striking – and unusual – at a time when output and employment were still well below pre-pandemic levels. One plausible part of the explanation was the presence of the furlough scheme. This had the effect of withdrawing supply from the labour market and there was therefore an obvious risk that this supply would be released, cooling the labour market, when the scheme ended. Even in the last week of the scheme, in September, there were around a million jobs still furloughed. The MPC signalled through the autumn that intelligence on labour market developments after this date would be a critical determinant of the near-term path of policy but that, pending that news, it was likely that policy would have to be tightened. When, in the event, the end of the scheme turned out to have few visible effects on slack in the labour market, the response of policy was immediate.

The outlook

The MPC's latest forecasts were published in the February 2022 *Monetary Policy Report*. I will here try to summarise the main features of, and risks to, those projections.

Many of those uncertainties involve the path of traded goods prices, especially those of energy. For the second MPR in succession the MPC actually published two sets of headline forecasts. The main projections, by convention, assume that the price of wholesale gas follows the path of the forwards curve for the next six months and is flat thereafter. The level of wholesale gas prices would therefore remain far above the pre-pandemic norm. But even on this assumption the direct contribution to rates of inflation would come down quite sharply during the second half of the forecast, simply because wholesale prices, and eventually their retail counterpart, stabilise. On that basis, and given all the other assumptions underlying the forecast, the central projection for inflation two years ahead was 2.1%. And partly because of the effects of high import prices on real incomes and spending, aggregate demand growth was projected to soften and unemployment to rise. By that two-year point, therefore, the economy was projected to be in excess supply. The result of this,

on the central forecast, was that inflation would then fall slightly below target by the end of the three-year forecast period.

The decline in inflation would be more marked if, instead, gas prices were to follow the forward prices throughout the next three years. This is the basis for the alternative scenario in the MPR. I mentioned earlier that, in the past, wholesale gas prices have exhibited a tendency to revert to a mean: big changes in one direction have tended to be followed by big changes in the other. The expected path of gas prices in forward markets has something of this flavour and forward prices continue to decline well beyond the six-month point. Accordingly, inflation in the alternative scenario falls to 1.2% at the two and three-year points. Equally, because in that case the losses in real incomes in 2022 would be partially reversed over the following two years, demand growth too is stronger and, instead of there being excess supply by the end of the forecast, the economy would be in excess demand. This illustrates the "trade-off-inducing" nature of big swings in energy prices and those of imports more generally. It also illustrates the high degree of uncertainty over the outlook. For my part, I continue to believe that a good deal of the strength of global goods prices can be traced back to the effects of the pandemic. This had the effect of shifting consumer demand globally away from services and towards goods. Even in normal times the world economy would have had a hard time meeting a shift on this scale, on the supply side. As it was, the pandemic also led significant impairment of global supply chains. The result has been a very material rise in goods prices.

If that's right, then it's also reasonable to imagine that, as the pandemic itself recedes, so will its impact on the demand for and supply of goods in the global economy. Over the medium term, I therefore think the risks to global goods prices are, like those of energy, skewed somewhat to the downside. But their strength has already persisted for longer than I expected this time last year, so one can only be very cautious in such a view. In the meantime, and for all the reasons I discussed earlier, the MPC will continue to pay close attention to developments in domestic costs. What that means for actual policy decisions remains to be seen. The Committee will ensure that inflation is brought back to target sustainably, and at least cost to the real economy.

Explaining monetary policy

Since February 2021 I have given two on-the-record speeches:

22.07.2021	Mismatch
06.12.2021	Lags, trade-offs and the challenges facing monetary policy

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. During 2021 I also hosted several briefings on the *Monetary Policy Report* for regional Bank of England Agency contacts.

I made three regional visits (to West Midlands, Yorkshire & The Humber, North West). 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.

I have attended a variety of meetings and events with City economists and market participants. 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.