Report to the Treasury Select Committee

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Throughout my first year on the Monetary Policy Committee, I have evaluated data and considered the macroeconomic relationships between consumers, firms, and financial markets, with particular attention to disaggregated data and to inflation expectations. My focus on relatively fast-moving and granular indicators has enabled me to adapt my assessment to a changing macro-environment. And since my pre-appointment hearing in July last year[1], the macroeconomic landscape has indeed changed dramatically.

The choppy rebound from the Covid-induced recession, which initially yielded subdued inflation, resulted in mixed signals from the spending ratios on goods versus services as well as the recovery in labour markets versus in production. Subsequently, a series of external shocks, all in the same direction, has yielded surging inflation driven by energy, food, durable goods, and international policy spillovers. Against the backdrop of tight labour markets and robust pricing power – in part on account of the changed relationship with the rest of Europe – these external shocks increasingly have become entrenched in domestic inflation outcomes and expectations. Whereas monetary policy arguably can 'look through' external shocks that leave expectations unchanged, it is most definitely responsible for leaning against domestic inflation pressures that threaten the objective of price stability. To some degree, these shocks can be interpreted as having eroded the level of potential output. Even given what that might imply for the long-term standard of living, to be consistent with the MPC's remit, demand must come into line with supply.

My colleagues and I are committed to fulfilling this remit and to bringing inflation down to target sustainably – even in the face of difficult trade-offs and high uncertainty. Our forceful decision in August should be taken as a strong signal that we are willing and able to act on that commitment.

Economy and Voting Record

The path of policy that I have voted for over the past year generally has been more forceful than the one reached by the majority of the committee. My reading of the incoming data and, importantly, relevant research including by Bank Staff, has indicated that a more front-loaded tightening of policy from the turn of the year would have been more likely to deliver a more favourable macroeconomic outcome in the medium term, particularly with regard to inflation becoming embedded.

When I arrived at the Bank for the September 2021 MPC meeting, the dominating concern was the uncertainty around how the labour market would respond to the end of the furlough scheme.[2] At that time, the latest Monetary Policy Report (from August 2021) had predicted a – from today's perspective – relatively benign and short-lived bout of inflation over the winter months. The August MPR also set out the MPC's consensus on the preferred sequencing of policy tools.[3] Therefore, I joined my colleagues on the committee to hold interest rates steady at 0.1 percent.

However, it did worry me that the agreement to finish that asset purchase program could constrain policy when it needed to tighten. In the third and fourth quarter of last year, the flow of asset

[1] See Mann (2021), "CV and questionnaire for the Treasury Select Committee".
[2] See for example Bailey (2021), "The hard yards".
[3] See Box A in the August 2021 Monetary Policy Report.

purchases was likely not particularly stimulative. And, it may have impaired the pass-through of rising policy expectations into borrowing costs as mortgage rates continued falling even as medium-term risk-free rates were on the rise. In looking at the data, I judged that it likely would be necessary to raise Bank Rate as soon as the December meeting and felt it appropriate for gilt purchases to conclude well in advance of any rate hikes. For those reasons I voted at our November meeting to reduce the target stock of gilt purchases while at the same time keeping Bank Rate on hold.

In December then, after gilt purchases had concluded as originally announced by the committee, I joined my colleagues to begin tightening policy via Bank Rate, raising it to 0.25%. Inflation had surprised to the upside and the labour market had remained extraordinarily tight even after the end of the furlough scheme so I judged that a modest degree of tightening was appropriate. The emergence of the Omicron variant did constitute a risk to the near-term outlook, though not great enough to tip the scales in favour of keeping Bank Rate on hold.

Going into February, indicators of underlying economic activity continued to run hot, and high energy prices – already responding to reductions in gas flows from Russia – had pushed inflation higher than anticipated. This dislocation was beginning to show up in measures of inflation expectations of households and firms who were seeing a protracted period of inflation above the target of 2%. Financial markets, too, were pricing in high inflation far out into the future; measures of inflation compensation went above levels consistent with achieving the target.

The staff's work on the relationship between inflation uncertainties and optimal policy has had an important influence on my monetary policy decisions. The relevant literature[4] argues that if the degree of inflation persistence is uncertain or if the distribution of inflation expectations is biased to the upside, then the cost of tightening too much or too early is smaller than mistakenly remaining too loose. If the true inflation process turns out to be less persistent than thought or the distribution of expected inflation is unbiased, activist policy can correct mistakes. The conclusion from the research is that under these conditions a tighter and front-loaded monetary stance is warranted. In order to firmly lean against these rising expectations becoming embedded in near-term price setting of firms and households, I voted to increase Bank Rate by half a percentage point. Together with three other members I flagged in the minutes to the February meeting[5] that if those inflation expectations were allowed to become embedded, inflation would turn out to be more persistent than what was implied by the central forecast.

The March meeting took place immediately after Russia had invaded Ukraine which foreshadowed important cross-currents in the macroeconomic situation. On the one hand, overall macro drivers and outcomes were similar to February, with upside news to inflation, and a very robust real economy evidenced in both labour and product markets. Russia's invasion of Ukraine promised to keep energy prices high for longer especially due to the Ofgem price mechanism, but also would raise household inflation expectations due to the particular salience of energy and food prices. On the other hand, there were projected material downside risks to activity and consumption from losses in purchasing power due to this inflation along with the shock of the invasion itself, all of which could temper the strength of domestic markets that had been observed so far. Further, a 50bp increase at this meeting (to 1%) would open the question of commencing Quantitative Tightening through outright asset sales (as outlined in the August 2021 MPR Box), which in the context of such geopolitical and macroeconomic turbulence seemed unwise. Of course, whether to actually begin QT at that point would have been at the MPC's discretion but I thought it prudent not to add another potential source of uncertainty. Therefore, I voted with the majority for a 25bp increase.

By the May forecast meeting and what would continue to be the case for the June meeting, the combined forces of sequential external shocks all in the same direction and domestic embedding of

[4] See references within Mann (2022), "A monetary policymaker faces uncertainty".
[5] See paragraph 54 of the February 2022 Monetary Policy Summary and minutes of the Monetary Policy Committee meeting.

those shocks were clearly evident. Firms' expectations for future prices continued to rise. Financial markets continued to have measures of inflation compensation at the upper end of their historical range. Wage outcomes were robust, and being topped up with bonuses. The projected slowing of activity due to the on-going and projected real income squeeze had not yet materialized as the labour market continued to tighten. Inflation was surging, with an MPR forecast of 6.6% over the next 12 months (which, of course, has now been dwarfed by incoming data). Further, with a hawkish pivot by both Fed and ECB, I was concerned about a further depreciation of Sterling, and additional inflation pressure through that channel.[6] As in previous meetings, in my view, a forceful increase in Bank Rate would temper expectations in the near term, and leave the Monetary Policy Committee in a better position to react in the latter half of 2023 to the erosion of purchasing power if energy prices continued to be high.

The June Minutes included an important change in language: Not only was there an affirmation of the commitment to price stability, but that the MPC would 'act forcefully' if saw more 'persistent' inflation. As noted above, there have been difficult cross-currents in the incoming data and significant uncertainties about the speed and degree of pass-through of energy prices and policy to inflation and the real economy. However, in my reading of these factors, I had concluded some meetings before that inflation was becoming more persistent, which is why I had voted for more forceful Bank Rate moves (excepting only the vote with the majority at the time of Russia's invasion of Ukraine) in May and June.

By the August meeting, both surging energy and food prices were adding to what was a clear increase in measures of underlying trend inflation. The time for front-loaded action was past, but that only increased the need to act forcefully as we said we would in June. The conundrum, of course, was that the modal forecast in the August Monetary Policy Report projected a deep and long-lasting contraction in economic activity starting in late 2022 and continuing through 2023 alongside record inflation. The contraction was projected to be driven by the real income squeeze through persistently high energy prices. The shortening of the Ofgem calculation window meant stronger pass-through of wholesale prices, on top of which came the addition of a proposed backwardation surcharge.

While all that was likely true, I saw upside potential to purchasing power and therefore to price inflation coming from the continued strength in labour markets as well as the large stock of savings held by the upper deciles of the income distribution, which account for a disproportionate share of aggregate consumption. If these households continued to smooth their consumption, there would be more demand than in the modal forecast, and more persistent inflation, particularly of services.

Macroeconomic Outlook

Over the course of the next year, I see a need to balance the uncertainties between, on the one hand, near-term inflationary pressures that have become embedded in domestic expectations and realisations versus, on the other hand, what is projected to be a dramatic deterioration in the real purchasing power of people's incomes in the near and medium term. The challenges will be to track and evaluate the underpinnings of inflation and of demand, and then, to determine how to deploy monetary policy tools to temper the inflationary expectations dynamic so as to reduce the length of time that inflation remains above target, and by doing so to moderate the degree to which monetary policy needs to tighten and affect the real economy later on.

In the normal course of events, the monetary policy decision-maker faces various uncertainties at different time horizons, but often they can depend on some aspects of the transmission mechanism to be relatively stable and similar to historical experience. However, these days we are continually

[6] See Mann (2022), "UK monetary policy in the context of global spillovers".

learning about how economic and financial relationships may be changing on account of the size and set of shocks associated with Brexit, Covid, and the Russia-Ukraine war.

Because of these uncertainties about the nature of economic relationships, it is important to evaluate a full range of data, including particularly distributional accounts, the balance of goods and services consumption, as well as the relationship between income, spending, and production. In other words – get below the macroeconomic aggregates both in evaluating the ongoing macro conjuncture as well as evaluating the model projections. Further, firm and household survey information, which is more timely and even more granular, is a key input to my assessment and prognosis for the economy. Finally, external forces such as trade and financial flows and balances, as well as Sterling exchange rates may well have heightened roles over the course of the next year.

With regard to the path for monetary policy, how that affects inflation expectations and how the accumulated tightening so far is transmitted through financial markets to affect economic activity will be relevant as the next year unfolds. A more forceful set of moves in Bank Rate earlier on opens the potential for a policy hold, or even reversal, later depending on the evolution of both inflation and demand relative to supply. How long inflation stays above the 2% target will be important for my Bank Rate assessment. And, of course there likely will be more shocks and other policy decisions which will affect the outlook and the appropriate monetary policy path.

Quantitative tightening likely also will be a feature of the overall monetary policy stance this year. Although, compared to the changes in Bank Rate already taken, its impact is expected to be small and Bank Rate will remain the primary indicator of the monetary policy stance. Nonetheless, it will be important to pay close attention to the financial market reaction to any asset sales as they take place.

Explaining Monetary Policy

Over the course of the year, I have given four on-the-record speeches. In my inaugural speech to the Official Monetary and Financial Institutions Forum in January 2022 titled 'On returning inflation back to target', I argued that inflation was likely to stay strong for longer than projected. I constructed a volatility-based measure of underlying inflation which showed a broadening of inflation pressures as more categories outside the very volatile ones evidenced positive moves. I also presented scenarios where, if wage and price inflation followed 2021 patterns in 2022 (which was speculative at the time but ultimately turned out to be the case), inflation was likely to remain strong for longer rather than quickly dissipate and return to target on its own. I concluded that a robust policy move to short-circuit the inflation ratchet was appropriate.

A Bank webinar speech in April 2022, 'A Monetary Policymaker Faces Uncertainty', detailed how the uncertainties about the transmission of monetary policy in the near, medium, and long-term affect the appropriate monetary strategy and therefore the policy decision. The speech noted that if the degree of inflation persistence is uncertain or if the distribution of inflation expectations is biased to the upside (which is the case when reviewing the DMP surveys) then the cost to both inflation and output of making a policy mistake is larger than if the true inflation process is less persistent or the distribution of expected inflation is unbiased. Given the conditions, I argued that a front-loaded tightening path was warranted.

The June 2020 speech to Market News International addressed 'UK Monetary Policy in the Context of Global Spillovers'. The global financial factor, principally driven by US monetary policy, is relevant for the trade-off between inflation and economic activity in the UK, and therefore for the monetary policy stance. In the current conjuncture with a robust tightening undertaken by most advanced economies' central banks, there likely would be further depreciation pressure on Sterling. A comparison of stylized monetary policy reactions to the high inflation and potentially inflationary spillovers via the global factor revealed that a nimble and activist strategy (robust in the near term, and then reversing in the medium term) both would contain inflation in the near term and respond to deteriorating real activity in the medium term.

By early September, I will have given a keynote speech at the 53rd Annual Conference of the Money, Macro, and Finance Society at the University of Kent, titled 'Inflation Persistence and Monetary Policy'. In this speech, I present analysis of various Philips Curve models with varying degrees of forward- and backward-looking behaviour over the short, medium, and long term. Matching data to these horizons shows a worrying drift in medium-term inflation expectations for firms, workers, and financial markets, as an increased weight on backward-looking inflation expectations implies more intrinsic persistence. Even though long-term expectations appear to remain consistent with the target of 2%, the drift in medium-term expectations warrants a tighter monetary policy stance to avoid the possibility of a fraying of the anchor.

In addition to speeches, I have done five virtual Agency visits (West Midlands, North West, South West, Central Southern, Yorkshire and Humber) which included one on one company visits and round-tables with Agency contacts, business organizations, and Chambers of Commerce. I also gave two high school presentations (at Formby and at Twynham) and a Citizen panel (at Yorkshire and Humber). Given my high regard and frequent use of the DMP and household surveys, these visits with Agency contacts and citizens are particularly important to me. I also very much wanted to hear about economic activity and inflation issues from an outside-London perspective. As for the high school presentations – I always look forward to talking with young people about economics! I want them to care as much as I do about how the economy works, and what kinds of careers they can have as an economist.

Finally, as part of my on-going contribution to the economics profession, and to a better understanding of the conjuncture and policy challenges, I regularly participate in panel discussions, as moderator and commentator at events for academic, finance, business, and policy audiences. Policy audiences included, among others: "G20 Global Financial Stability Conference 2021"; UK G7 Presidency Conference on Safe Openness in Global Trade & Finance at BoE; Euro 50 Group Coping with the Legacy of the Covid-19 Crisis – a focus on inflation; Cleveland Fed Conversations on Central Banking; Executive Leadership Development Program, Canada School of Public Service

Business and finance audiences included, among others: Australian National University, Crawford Leadership Forum – After the recession: How should we renew our economies?; 3rd Bund Summit, China – Asset prices, inflation expectations and exit from economic stimulus; CEO Meeting with WTO Director General – Global Supply Chains Forum; IIF/McKinsey – The Costs, Risks and Rewards of the Net Zero Transition; FN100 Most Influential Women in European Finance.