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Report to the Treasury Select Committee

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This report covers the period since my last annual report, submitted 8 February 2022.

1. Looking back: the economy and voting record, February 2022 to February 2023

Ahead of the **March 2022 meeting**, Russia launched a military invasion of Ukraine on 24 February. This was front of my mind as we were making policy at that time, and continues to be relevant today. Like many others I was forced to realise the importance of Russia and Ukraine for supplies of oil, natural gas, food stuffs, and various chemical products, for global (and particularly European) markets. I judged the effect of the war to be a substantial cost-push shock and disruption to supply chains. Of course it also increases further the price of oil and gas, which had been climbing a little before the invasion but now increased even further.

The war also made the evolution of the economy much more uncertain, since so much of our outlook on energy prices and other matters would be determined by geo-political events which we were not in control of. I thus gave increasing thought to how to respond to different types of uncertainty through the year. The war also prompted me to focus less on headline inflation and more on measures of inflation that are likely to be more persistent and relative in the medium-term, such as core inflation (which strips out various more volatile components, such as energy and food) and services inflation (which is more associated with domestic production).

The jump in energy prices at this time was very unfamiliar, and our standard macroeconomic models were based on historical data and relationships which had never seen such an escalation. As a committee we gave some thought at this time about how best to include the future path of energy prices in our forecast, such as contrasting the futures curve and a random walk assumption.

The forecast for inflation was clearly affected by the spike in energy prices, and became more two-sided as a result – with inflation rising rapidly over the first half of the forecast, before falling very sharply thereafter due to the expected fall in energy prices further out, and by base effects as the previous increases dropped out of the annual calculation.

I thus gave greater attention to data on wages and services inflation. Wage data came from our Agents network, which expected average pay settlement growth to increase from around 3.5% in 2021 to 4.8% in 2022. I noted that services contributed 4% to the overshoot relative to the 2012-2019 average in January, but the staff's short-term forecast expected that share to rise to 14% by the summer. In light of these indicators of inflation momentum I voted to raise rates by 25bps, in line with most of the rest of the committee.

In **April**, covid cases in China were rising and I noted the potential for supply chain disruption as a result. The rotation of US demand back to services (having seen elevated goods demand since the start of the pandemic) also seemed stalled, and thus pressure on goods supply chains from higher demand there seemed persistent. I again considered measures of medium-term inflation including various pay measures. I noted that while the headline measure of private sector regular pay (from Average Weekly Earnings) had increased by 4.7% in the year to February, the measure of total pay (which includes bonuses) had increased by 6.4% over the same period, reflecting very large bonus payments. These bonuses seemed related to, and indicative of, a very tight labour market and competition for workers.

In light of the very tight labour market I considered the role of real wage resistance, whereby workers resist a fall in their consumption wages as inflation rises. While there was no evidence for such an effect in the recent past, the sharp rise in energy prices caused me to draw parallels with the 1970s when much more real wage resistance is evident. I thus judged the potential for some upside risk to our standard forecast if some of that dynamic returned.

At this time we also considered the stock of asset purchases, and I supported communications that set out a plan for sales later in the year. I was clear that Bank Rate should be the primary policy tool of the MPC, since the effects of quantitative tightening are still quite uncertain.

Given concern with further supply chain disruption and the tightness in the labour market leading to increased inflation momentum stemming from wage setting (with the potential for some real wage resistance), I voted to increase Bank Rate by 50bps, but was in a minority of 3, and instead the committee voted to increase Bank Rate by 25bps.

At the **June meeting** I again voted to increase Bank Rate by 50bps, and was again was in the minority of 3. My reasoning was much the same as in May. Data on wage growth, services inflation, and firms' price setting expectations from the Decision Maker Panel continued to point towards underlying inflation pressure. Additionally, the government announced a Cost of Living support package at this time, which was estimated to add 0.3% to GDP over the next year, providing a demand stimulus and thus the potential for more demand-pull inflation. I wished to lean against these factors with faster rises in Bank Rate.

At this time I began work to understand the rise in economic inactivity that had been seen during and since the pandemic. Much of this was apparently among people reporting that their "main reason" for inactivity was long-term sickness. Through research work with Josh Martin, we discovered that this *understated* the true role of long-term sickness, since many people would report to have a work-limiting long-term health condition, but be categorised under a different "main reason" for their inactivity in the official figures. Thus the true story, as I saw it, was an even greater rise in long-term sickness in the population and amongst the economically inactive, a larger proportion of whom stated that they did not want a job. As such, I judged that the labour market was even tighter than it appeared when looking at measures based only on the unemployment rate.

While I saw a greater degree of labour market tightness, I was uncertain as to whether this would lead to more persistent wage pressure and thus inflation. I considered various perspectives on uncertainty at this time. Some preferred to move more cautiously, in the spirit of Brainard (who in a classic paper on economic policy under uncertainty argued for moving relatively slowly), as we waited to find out more about the state of the world. I was more minded to act forcefully against the risk of inflation expectations becoming de-anchored and inflation momentum building, and thus supported a more activist policy than some colleagues at this time.

Just ahead of the **August meeting**, Ofgem announced a change to the calculation of its energy price cap, moving to a quarterly cap rather than one every six months. This would have the effect of passing through changes in wholesale prices to consumer prices more quickly, and thus accelerate inflation on the way up and also make inflation fall faster if energy prices began to fall. This accentuated the two-phased nature of the forecast, and with it made more challenging the trade-off between above-target inflation and a cooling economy.

At this time an additional uncertainty emerged, in the form of the international trade data in the National Accounts. Changes to collection processes for data on the import and export of goods may have caused a break in the time series, causing a misalignment in the expenditure components of the GDP estimate. The ONS inserted an “alignment adjustment”, the treatment of which caused complications for our forecast. I believe we now have a better understanding of this, but at the time of the August meeting I was uncertain that the GDP forecast should have been as negative as it appeared, and to what extent that was driven by statistical anomalies.

I continued to focus on inflation in the medium-term, where monetary policy has most effect given the monetary transmission mechanism. I sought to ‘look through’ the spike in inflation caused by energy prices and focus more on the underlying momentum in inflation that would be left once those effects had come and gone. Of course, higher energy prices also pushed up firms’ costs, potentially increased inflation expectations of households, may affect wage setting, any of which would tend to push up inflation, and thus the energy price shock could become embedded in the domestic inflation process.

In the Minutes of the previous meeting, we had said “The Committee will be particularly alert to indications of more persistent inflationary pressures”. To that end, I continued to focus on indicators of medium-term inflation which might indicate persistence, such as core and services inflation. Services inflation was 5.2% in June, up from 4.9% in May, and well above their average over 2012-2019 of 2.7%. I saw evidence of “more persistent inflationary pressures” and wished to act forcefully against them, by voting again for a 50bps increase in Bank Rate. I also supported the plan for quantitative tightening that was communicated at this time.

The big news in advance of the **September meeting** was the new energy support package, namely the freezing of the average annual household energy bill at the level of £2500 – the so-called Energy Price Guarantee. By its design, and in contrast to the previous package, this would clearly affect the price paid by consumers and thus directly affect measured inflation – reducing the peak in inflation by just over 2pp relative to what would have been the case given prevailing energy prices at the time, and the Ofgem price cap system, and continuing to reduce inflation over the next 12 months.

While this would reduce inflation in the short-run, I was concerned that it would increase inflation in the medium run via a range of mechanisms. First, at the end of the cap period (initially two-years, and later reduced to six-months), energy bills would revert to the Ofgem price cap and thus potentially ‘jump’ to that level, imparting an impulse of inflation at that point. This would serve to delay, but not eliminate, the inflation caused by high energy prices. Second, I viewed this as merely swapping an external price shock for a domestic fiscal shock, in the form of fiscal stimulus. This would also tend to have more long-lasting effects on inflation than a purely externally-generated shock. Finally, I was mindful of political economy considerations, namely that the government may not want to leave consumers at a ‘cliff edge’ come the end of the policy, which might imply further fiscal support at a later date (although that was not announced and therefore not in the MPC’s forecast, I judged it a risk). Thus, I saw the policy as generating more inflation in the medium run, even if it mechanically cut headline inflation in the short-run.

By the September meeting we had had also two additional CPI releases, and in both cases services inflation had surprised to the upside. Other indicators of underlying inflation, including new work from Bank staff on an ‘Underlying Inflation Measure’ were also elevated and increasing. Taking this and the energy policy news together, I judged that we had again seen “indications of more persistent inflationary pressures” per the MPC minutes, and thus voted to increase Bank Rate by 75bps.

Shortly after the September meeting came the fiscal event (“mini budget”) on 23 September which caused considerable market turbulence, and led the Bank to intervene to support market functions on financial stability grounds. I was notified of the decisions of the Financial Policy Committee, in line with the concordat between the FPC and the MPC, and considered the impacts of that intervention on my monetary policy stance. While the purchase of government gilts could be interpreted as quantitative easing, which would run against the path of Bank Rate, I judged that the spillover effects on my monetary policy stance were minimal. The purchases were temporary and time limited, and have since all been sold off, such that I think the effects on inflation are now negligible. The Bank executive deserve enormous credit for their effective and decisive actions.

The market turbulence did, however, make salient the value I place on institutional credibility. The Bank would not have been as effective in this intervention without credibility. Drawing a parallel, I view the potential for persistently above-target inflation as a material risk to the credibility of the MPC, and this tends to make me want to act more forcefully to lean against inflation risks.

The market curve shifted up considerably in response to the market turmoil and had settled only partially by the time of the **November meeting**. We use this curve as a conditioning path for our forecast, and the forecast thus reflected very high expected Bank Rate and the consequent effects on the economy through tighter credit conditions. Like others on the committee I judge this curve to be ‘too high’, and supported the Governor’s intervention at the press conference following the November announcement when he suggested the curve was ‘too high’. The forecast was thus, arguably, too negative on GDP and the output gap since it embodied this very high path for Bank Rate, and I saw greater evidence of stronger demand and thus stronger inflation.

In order to lean against inflation persistence risks, and the considerable risks of credibility loss that I saw in light of recent market turbulence, I voted to increase Bank Rate by 75bps, although I considered seriously an increase of 100bps.

At the **December meeting** I voted to increase Bank Rate by 50bps although again I also considered a stronger increase of 75bps. I was again particularly mindful of measures of inflation persistence as reflected in core inflation and services inflation, which remained high and, in the case of services, often surprising to the upside in recent months. In December China relaxed its covid restrictions, which was expected to lead to a surge in cases and possibly an increase in supply disruptions again, although this was expected to be relatively short lived.

Ahead of the December meeting we also conducted the annual stocktake of the path of supply, including labour supply and productivity. In response to continued increases in inactivity rates over the pandemic, we agreed to reduce the profile for trend participation rates by locking in some of these ‘covid effects’, although they would unwind over the subsequent 5 years or so. My ongoing research work on economic inactivity and long term sickness supported the view that these were permanent or semi-permanent effects on participation, and it was appropriate to capture them as limiting potential supply over the medium run. These are in addition to demographic effects, namely an aging population, which would tend to reduce trend participation independently of the effects of the pandemic.

On productivity, I considered the potential for higher energy prices to reduce productivity growth. There is a mixed literature on this topic. I judged that there were potentially negative effects of high energy prices on productivity, but these would be relatively small and short-lived as firms would be able to adapt by changing their capital assets and production technologies. That said, the energy shock has been very large, so even a small multiplier could still lead to a non-trivial effect on potential supply.

In light of a weak output for supply (which would tend to push up on inflation for a given level of demand by making the output gap more positive), and continuing core and services inflation above target-consistent levels (indicative of inflation persistence), I voted to increase Bank Rate by 50bps.

Ahead of the **February 2023 meeting**, the MPC agreed to a stronger profile for consumption in the forecast, with knock on effects for GDP, inflation and unemployment. One motivation for this was the still very tight labour market, large numbers of vacancies, and low numbers of redundancies. It is typical in an economic downturn for the "separation rate" (rate of job exits) to increase, and thus the unemployment rate to increase, while labour demand (indicated by vacancies) also falls. However, firms tell us they have little appetite to fire workers, given the recent recruitment difficulties. Thus, we might expect unemployment to rise less in this downturn than past historical relationships would suggest. Less unemployment will leave more people in work, giving them more money for consumption and reduce their need for precautionary saving, which in turn would boost demand, the output gap, and inflation. This does not eliminate the forecast for a downturn, but does make it shallower and shorter. It also adds to the forecast for inflation further out, which is consistent with my view of the likelihood of higher inflation persistence relative to previous forecasts.

This judgement, coupled with downside news to the yield curve and energy prices since the November MPR, mean the forecast in the February MPR is considerably more positive for demand, and consequently shows a higher forecast for inflation. The committee also judged that the upside skew to the inflation forecast should be increased, reflecting the view that the balance of risks around the modal forecast is significantly to the upside.

Data news since the December meeting was relatively limited, but what little there was suggests inflation continued to be more persistent that expected. For instance, services inflation in December was 6.5%, surprising to the upside again. Wage growth also surprised to the upside again in November, with private sector regular pay up 7.2%.

In light of my continued worries about inflation persistence, and the committee's revised modal forecast which has stronger inflation at the policy relevant horizon, and a larger upside skew, I voted to increase Bank Rate by 50bps.

2. Looking forward: the economic outlook

Looking to the year ahead, it is helpful to divide up our forecast into this calendar year and the following year.

For this calendar year, the MPC modal forecast in the February 2023 Monetary Policy Report shows inflation falling quickly, from rates of 9.7% at the start of 2023 to 3.0% by the start of 2024. To a large extent this is mechanical and partially determined by factors we are already observing.

This is hard to get across to many people so it's worth restating. The key is that the annual inflation rate (our target) shows the *growth* of prices over 12 months. So if prices go up *and stay up*, the inflation rate *falls* even if the price level stays high.

So, even if energy prices stay at their current high level, the rate of price growth would *slow* (relative to the world where prices were rising sharply). Prices of imported goods have also eased in recent months and that should pass through to consumer prices over the coming year, reducing inflation somewhat.

The February 2023 MPR also forecasts stagnant economic growth and rising unemployment over the next year. The downturn is expected to be shallow in comparison to past downturns, but with relatively weak growth persisting for an extended period. As a result of the strong labour market at present, and the relatively weak downturn, the increase in unemployment is expected to be quite shallow. The slowdown in growth is driven by high energy prices and tighter financial conditions, weighing on consumption demand, and further out by fiscal consolidation. At the same time, we expect potential supply to be very weak. So the downturn in growth is expected to open up a small degree of excess supply (a negative output gap), which would drag on inflation from 2024 onwards.

Turning to the year beginning 2024, I am less certain about the profile of inflation. I see considerable risks to the upside relative to the central forecast in the February 2023 MPR. The MPC included a historically-large upside skew to the forecast profile of inflation in the November 2022 MPR, and increased that in the February 2023 MPR. Personally I find my expectations for inflation to be towards the upper part of that distribution.

My view of the upside risks is shaped by indicators of inflation persistence, which I have tried to monitor consistently throughout the past year, as set out in section 1 above. Many of these stem from the tightness in the labour market. Current nominal wage growth of 6-7% is very high and well-above target-consistent levels. The Bank's regional Agents network has run a survey of firms and finds that they expect to make similar pay settlements in 2023 as in 2022, which would be consistent with a degree of inflation persistence. In the absence of strong productivity growth these rates of pay growth would be inconsistent with the 2% inflation target. Productivity growth over the past few years, after accounting for distortions created by the pandemic, has been broadly in line with the pre-pandemic norm of slow growth.

Another set of indicators I have monitored closely are measures of inflation which are thought to be related to persistent inflation to a greater degree, such as core inflation, services inflation, and median inflation (inflation of the median item in the CPI basket). These are all running at around 6-7% currently, which again lead me to believe there is considerable persistence in the inflation process. According to data in the February 2023 MPR, the central forecast for inflation excluding the direct effects of energy (a measure which is similar to core inflation) is expected to be above 2% at the start of 2024, and still close to 2% at the end of 2024.

While I view the balance of risks to the upside around this projection for inflation, there is clearly considerable uncertainty about this. The path for inflation will depend on the path of energy prices, import prices, the tightness of the labour market, consumer behaviour, the role of industrial action, the path of for economic growth (which will in turn depend on many things), and many more things besides. Economic theory suggests that uncertainty around the persistence of inflation should be met with more forceful action, and so I shall remain alert to indications that inflation is more persistent than we expected, and act forcefully if necessary.

3. Explaining monetary policy

Since my previous report in February 2022, I have undertaken a number of activities, detailed below. I would note that early in 2022 some events were limited by the pandemic, and more recently there has been some disruption due do industrial action.

- Given two on-the-record speeches on monetary policy – "Current Monetary Policy" at the Society of Professional Economists (6 Oct), and "Recent UK monetary policy in a changing economy" at the Bank of Israel (11 Nov)

- Visited the South West Agency, during which I gave a talk at a school, visited a number of businesses, and spoke with local business and farming representatives (4-5 July)
- Gave two additional school talks, both virtually (3 March and 3 Oct)
- Shared views and insights on monetary policy on Twitter to reach a new audience
- Gave talks on the economic outlook to business economists and think-tanks
- Gave a webinar to the One Surrey Growth Board on the economic outlook and local economic analysis (19 May)
- Continued with duties and responsibilities as a non-Executive Director at the UK Statistics Authority
- Published a book with Stian Westlake titled "Restarting the Future: How to Fix the Intangible Economy", and gave several talks and interviews in promotion of the book
- Continued pursuing academic research on productivity, investment and innovation with a view to better understanding how it affects the economy, monetary policy and the transmission mechanism. To that effect, I attended several workshops and conferences set out below.
    - Presentation to UK Network of Economic Statisticians on intangible assets as part of their Beyond GDP sprint (10 March)
    - Attended NIESR conference – MPC at 25 (30 March)
    - Keynote presentation at EUKLEMS-INTANprod conference on intangible assets (27-28 June)
    - Attended virtually NBER Conference on Research in Income and Wealth (18-19 July)
    - Keynote presentation at World KLEMS conference on intangible assets (12 Oct)
    - Attended various webinars hosted by The Productivity Institute (TPI), Economic Statistics Centre of Excellence (ESCoE), Centre for Economic Performance (CEP), CompNet, Resolution Foundation, Office for National Statistics (ONS), and others