Strategy and stance – remarks by Huw Pill

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Remarks

Thanks very much to our hosts at the London campus of the University of Chicago Booth School of Business today.

My last public remarks were delivered on St. David's Day in Cardiff. Today, I am speaking on St. George's Day in London. There is a pattern emerging here!

In my comments this morning, I plan to discuss what has happened in the intervening eight weeks.

Overview

I don't want to hold you all in suspense, so let me start with my main message: in my view, against the background of a welcome decline in headline inflation, the outlook for UK monetary policy in the coming quarters has <u>not</u> changed substantially since the beginning of March.

As regards the MPC's **monetary policy strategy**, the recent publication of Ben Bernanke's review of the Bank of England's macroeconomic forecasts (and their role in the monetary policy process) is a significant event. But it is one that will influence policy over a matter of years, rather than in the shorter term.

As I said in Cardiff – and as has been underscored by subsequent remarks of the Governor and others – the Bernanke review represents a once-in-a-generation opportunity to renew and improve the MPC's framework for monetary policy and its communication.

It will provide significant impetus to the work that has already started to re-build the technological and data infrastructure for monetary policy analysis at the Bank. And it will be a catalyst for the new thinking we need to make the MPC's policy process more robust to the heightened and profound uncertainties that face – and will continue to face – monetary policymakers globally.

I am an enthusiastic supporter of the MPC's decision to embrace Dr. Bernanke's twelve recommendations and to act upon them decisively in the coming months and years.

Turning to more immediate matters, the flow of conjunctural data over the past couple of months has offered little relevant news to alter my assessment of the **monetary policy stance**.

For sure, the world has not stood still. Events in the Middle East are a reminder of potential external risks to UK inflation, even if their impact thus far on energy prices or international supply chains remains modest – at least in comparison with the impact of the pandemic or invasion of Ukraine on these inflation drivers in recent years.

As I anticipated in Cardiff (and based on the most recent vintage of data), in recent months economic growth in the UK has resumed, albeit at a modest pace, following the technical recession we experienced in the second half of last year.

Headline consumer price inflation has fallen further, largely on the back of external and base effects. Given what will happen to utility bills in the coming months owing to the continuing correction in European wholesale natural gas prices, we can be increasingly confident that – as the MPC has long expected – headline CPI inflation will fall close to the 2% target in the coming months.

But the MPC's framework for assessing the inflation outlook rightly remains more focused on the persistent component of consumer price inflation, as assessed through developments in the three key indicators of inflation persistence identified by the Committee: services price inflation, pay growth, and the tightness of the UK labour market.

The evolution of this persistent component will determine whether inflation returns to target on a lasting and sustainable basis. Establishing the resulting environment of price stability will support efficient investment and spending decisions, thereby driving the economic innovation, dynamism, and productivity growth upon which all our living standards ultimately depend.

Evaluating the MPC's key indicators of inflation persistence – and looking through the unavoidable month-to-month noise in the data (compounded at present by concerns about the reliability of certain key indicators in the face of statistical challenges) – my reading is that there has been little news in recent months.

As a result, I see little reason to deviate from my assessment in Cardiff. We are now seeing signs of a downward shift in the persistent component of inflation dynamics. But we still have a reasonable way to go before I am convinced that the persistent momentum in underlying inflation has stabilised at rates consistent with achievement of the 2% inflation target on a sustainable basis.

While that persistent component of inflation continues to threaten the lasting achievement of the 2% inflation target, the MPC will need to maintain a degree of restrictiveness in its monetary policy stance. That is necessary to squeeze the persistent component out of the system.

In Cardiff, I concluded that, while we are making satisfactory progress in returning inflation to target, in my baseline scenario the time for cutting Bank Rate remained some way off.

That justified my vote to keep Bank Rate unchanged at the MPC's February meeting and underpinned my subsequent decision to vote similarly in March.

Taken together, the absence of news and the passage of time have brought a Bank Rate cut somewhat closer. But the same absence of news gives me no reason to depart from the baseline that I established in Cardiff.

Of course, we might be confronted with new challenges that necessitate an immediate monetary policy response. As a general proposition, we must always be alert to this eventuality and stand ready to act (in either direction) as appropriate.

But if events play out as I anticipated when speaking on St. David's Day – and as I continue to anticipate now on St. George's Day – the conclusions I drew about the inflation and policy outlook in Cardiff would remain valid.

Before turning to your questions, I hope you will allow me to expand a little on four key issues underlying this view of the MPC's appropriate policy stance.

Monetary policy stance

A systematic approach. At the heart of my current assessment of the monetary policy stance lies an application of the framework established by the MPC to assess the persistence of UK inflation.

As I argued in Cardiff, for the MPC to act and communicate in an effective way, it needs to behave in a consistent and systematic manner. That will help to create a mutual understanding of how monetary policy is being formulated between the MPC, on the one hand, and its external audiences in the public, financial markets, and the media, on the other.

Such a common understanding makes monetary policy more effective and helps to coordinate complex private economic behaviour on a socially desirable outcome – price stability.

This is why establishing and following a well-defined framework is so important.

Using the framework helps focus both the MPC's internal discussion and the attention of our external audiences on the right issues: (1) the prospects for the persistent component of inflation, the component that will still be embedded in price developments once the famously long and variable lags in monetary policy transmission have run their course; and (2) the influence exerted by the currently restrictive stance of monetary policy on the evolution of that persistent component of inflation.

In his recent report, Dr. Bernanke pointed to the risk of incrementalism in the construction of the MPC's forecast and analysis. If the Committee remains beholden to the same framework and simply updates its analysis from one meeting to the next based on the data flow, there is a danger that more fundamental changes in the outlook might be missed.

Our assessment of inflation persistence may be particularly prone to this risk. As I have argued in the past, by nature the underlying and persistent component of UK inflation should not change too much on a meeting-to-meeting basis: there is an 'end-point problem' in filtering low frequency signals about persistence from the noisy flow of month-to-month data. The Committee may be lulled into thinking that not much is changing in the nexus of domestic prices, costs, profit margins and wage dynamics that governs the persistence of UK inflation, even as the behaviour of price and wage setters might be changing fundamentally.

The need for challenge. To manage this risk, Dr. Bernanke suggests that the incorporation of data news into our meeting-to-meeting assessment should be complemented by a periodic deeper questioning of the underlying *Weltanschauung* governing our analysis of the inflation process.

As I have already acknowledged, one trigger for that re-assessment would be a big new disturbance to the UK economy. Paraphrasing Keynes' famous dictum: if the world changes, so should our monetary policy.

As a result, all the MPC's policy assessments are conditional – something that is both crucially important and hard to communicate. Those statements – and indeed my own views expressed in these remarks – should be understood as descriptions of a specific scenario rather than promises of what the MPC will deliver. The MPC always needs to be able to do 'whatever-it-takes' to deliver inflation at the 2% target as shocks occur and circumstances change.

Another reason for a change in the inflation *Weltanschauung* could be a reappraisal of the drivers and prevalence of inflation persistence in the domestic price / cost / profit / wage nexus. Even if there is no new data or shock to this system, the Committee may come to view the existing information in a new way – say because of the advent or application of a new model or theory. Rather than seeing different things, we might come to see things differently.

It is certainly important for conventional wisdom to be challenged. Based on excellent analysis conducted by my colleagues on the Bank of England staff, I am sure that the MPC will have robust discussions over the coming weeks about the character of UK inflation ahead of our May decision.

But, for me, the hurdle to changing my assessment of inflation persistence over the coming few months is relatively high. I do think that the persistent component of inflation is being squeezed out of the system by restrictive monetary policy. But I don't see reason to believe that is happening more rapidly or profoundly than I expected six months ago. Most importantly, in my eyes the MPC's framework for assessing that persistent component of inflation remains as sound as ever.

It has always been understood that monetary policymakers need to balance the need to follow a systematic approach to responding to data, on the one hand, with a flexible attitude to dealing with previously unforeseen circumstances, on the other.

That is the essence of the "constrained discretion" essential to the Bank of England's inflation targeting strategy from its outset. It also underpins the 'rule-based, but not rule-bound' approach to formulating policy that I discussed in Cardiff. It is crucial that the MPC achieves the right balance between acting systematically within a consistent framework and being pragmatic in the event of unanticipated challenges.

Risk management and moving beyond reliance on a central forecast. One way of thinking about how to manage this trade-off is to adopt a risk management approach.

Dr. Bernanke suggests that the MPC has placed too much emphasis on the central forecast for inflation (and the associated fan chart around it) in the past, both as a vehicle for internal analysis and a framework for external communication of monetary policy. He proposes reducing the importance of the central projection, perhaps by diversifying analysis to embody other scenarios, policy simulations and cross-checks.

Applying such an approach to our current situation points to comparing the implications of easing monetary policy too early when the degree of inflation persistence is greater than assumed in our base case against the implications of maintaining restrictiveness for too long when inflation is less persistent than we assume.

After several years of above target inflation rates and given the threat of persistent inflation dynamics becoming embedded in expectations, in my view there are greater risks associated with easing too early should inflation persist rather than easing too late should inflation abate. This assessment further supports my relatively cautious approach to starting to reduce Bank Rate.

More generally, undertaking such scenario analyses helps to frame and present the key policy issue at present. If we were to continue to focus on a single central forecast and the fan chart around it, we would not have the machinery to explore and explain how different assessments of inflation persistence lead to different views about the policy stance.

Understanding how policy would respond to data news and its implications for the MPC's view on inflation persistence – the "what if" question at the heart of the current policy debate – would be more informative for market participants and the public. Building and refining the analytical machinery to make and present such exercises is an important part of the agenda established by the Bernanke review.

Monetary policy transmission and the timing of Bank Rate cuts. Turning from my assessment of the economic situation to the transmission of monetary policy, it is useful to repeat a key element of my St. David's Day remarks in Cardiff.

As I have already argued, the MPC currently needs to maintain restrictiveness in its monetary policy stance. This is required to squeeze that persistent component of inflation which threatens lasting achievement of the 2% inflation target out of the price and wage setting process.

Much of the decline in headline inflation is attributable to external (or exogenous) developments that are little influenced by the MPC's policy decisions. Seeing headline inflation fall towards target is therefore not a sufficient condition for withdrawing monetary policy restriction. This is inherent to the MPC's current framework and its focus on the persistence of inflation. As such, it is the evolution of the persistent component, which is influenced to a significant extent by the stance of monetary policy, that should drive policy decisions.

The tentative decline in the persistent component of inflation that we have seen thus far owes to the restrictive stance of monetary policy the MPC has established. Any decline in inflation persistence we are seeing is therefore not a reason to think restrictiveness is no longer required. Rather it is an illustration that the restrictiveness of monetary policy is starting to have its desired effect.

The MPC needs to ensure sufficient restrictiveness to achieve the 2% inflation target on a lasting and sustainable basis. Taking into account the lags in monetary policy transmission, the Committee needs to maintain a restrictive stance until it is satisfied that the process of squeezing out the excessive persistent component of inflation is complete. But for no longer.

A cut in Bank Rate from current levels would not entirely undo the restrictive stance of policy. For one thing, real interest rates – which may be more relevant for economic decisions, and thus for the transmission of monetary policy – will rise should inflation and shorter-term inflation expectations ease (as we are seeing). The MPC will need to take this into account in setting Bank Rate. What's more, since we are starting from a restrictive stance, an initial cut in Bank Rate need not imply a shift into accommodative territory, but rather simply an easing to a less, but still, restrictive position.

Monetary policy decisions always involve a balancing the risk of doing too little versus doing too much. The current situation is no different in that respect. How and when I would vote for a Bank Rate cut depend crucially on how such a policy decision transmits to inflation, in particular along the money market yield curve.

That transmission depends on a number of factors that need to be monitored closely, especially how potential changes in Bank Rate may influence both market and retail rates. One example is the behaviour of mortgage rates.

Over recent months we have seen the rate on a new 5-year fixed rate mortgage decline from the highs seen last autumn (and previously in the context of market dislocations stemming from the LDI episode in October 2022). But for those households refinancing their mortgages at present, the rate at which they are now able to fix their borrowing costs is likely to be significantly higher than what they have been paying for the past two or five years since their previous refinancing. And this has all taken place in a period where Bank Rate has remained unchanged at 5¼% since last August.

Have interest rates fallen? Have they risen? Or have they stayed the same? Based on the previous paragraph, one could make a case to answer 'yes' to all three questions simultaneously. At a minimum, this suggests that assessing monetary policy and its transmission simply through the level of Bank Rate is simplistic and potentially misleading.

Monetary policy strategy

As you have seen, many of the issues raised in Dr. Bernanke's review already weigh on my thinking about our current monetary policy choices.

But I want to caution against expectations that the Bernanke report will lead to a rapid change in how UK monetary policy is presented.

The implications of the Bernanke review are potentially profound. They are likely to have ramifications that run well beyond the construction and communication of macroeconomic forecasts. The Bank of England's response to Dr. Bernanke's report recognised the need for careful consideration of the conclusions and recommendations he makes. The workstreams sketched out in that response will need to be developed further before a full change programme can be formulated.

As I said in Cardiff, a monetary policy strategy plays two roles. (1) It provides a framework for **internal** analysis and discussion that leads efficiently to timely and effective monetary policy decisions. And (2) it creates a structure for the presentation of those policy decisions and their rationale to **external** audiences (the general public, corporate leaders, financial market participants, etc.).

Such a strategy can be likened to an iceberg: a relatively small part of the strategy is visible externally above the waterline, but it sits upon a large internal mass below the ocean's surface.

At the Bank, we have commenced re-building the internal infrastructure for monetary policy analysis. That investment is already underway, but since it is necessarily initially focused on the internal machinery – starting with prosaic issues, such as dealing with technology and data management – this has not been visible to our external stakeholders.

The publication of the Bernanke report provides renewed impetus to that work and ensures that the momentum behind the renewal of the MPC's monetary policy strategy will extend to the more substantial external-facing elements. It signals the need for prioritisation of work on this dimension and empowerment of the staff undertaking that work.

There is a natural sequencing in pursuing this renewal. Getting the basics right in terms of technological, data and analytical infrastructure is an unavoidable prelude to building new models and frameworks that will eventually support the inflation scenarios and policy simulations that Dr. Bernanke believes we should implement to support and augment our forecast framework.

All this calls for patience. In exploiting the once-in-a-generation opportunity to renew the MPC's monetary policy strategy, we need to get the basics right internally before moving forward to the presentational aspects that will be visible externally.

Form should follow substance, not lead it.

Concluding comments

To conclude, I will leave you with my main message.

Against a welcome backdrop of declining headline inflation anticipated by the MPC, the flow of conjunctural data since I last spoke on the monetary policy stance in Cardiff in early March has offered modest relevant news. This suggests little need to amend the assessment of the economic, inflation and policy outlook that I offered then.

In Cardiff, I concluded that, while we are making satisfactory progress in returning inflation to target, in my baseline scenario the time for cutting Bank Rate remained some way off. That justified my vote to keep Bank Rate unchanged at the MPC's February meeting and underpinned my subsequent decision to vote similarly in March.

The combination of little news and the passage of time have brought a Bank Rate cut somewhat closer. But the same lack of news gives me no reason to depart from the baseline that I already established on St. David's Day.

I look forward to your questions.

The views expressed in these remarks are not necessarily those of the Bank of England or the Monetary Policy Committee.

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Opinions (and all remaining errors and omissions) are my own.