ANNUAL REPORT TO THE TREASURY COMMITTEE

Andrew Bailey, Governor of the Bank of England

8 November 2024

Consumer price inflation has fallen sharply in the nearly one and a half years that have passed since my last annual report to the Treasury Committee, from 10.1% in in March 2023 to 1.7% in the latest data for September 2024.

The Monetary Policy Committee (MPC) has maintained a restrictive monetary policy stance throughout this period, increasing Bank Rate further, from 4.5% in May 2023 to a peak of 5.25% in August 2023, and subsequently holding it at that level for a year. The restrictive policy stance has helped to ensure that inflation has fallen back to a level close to the 2% target as the big global shocks that caused it to rise have faded.

With continued progress in disinflation, as external shocks have abated and domestic inflation pressures have eased, the MPC has been able to start reducing the degree of restrictiveness by cutting Bank Rate, to 5.0% in August this year and again to 4.75% at our recent November meeting.

The return of inflation to a level close to target has been faster and smoother than we expected given the situation we were facing in the second and third quarter of last year.

At that time, data outturns were mixed. Headline inflation had started to edge down from its peak, driven by falling contributions from energy price inflation. But key indicators suggested that domestic inflationary pressures could prove more persistent. With the possibility that the second-round effects of external shocks could take longer to unwind than they did to emerge, inflation risks were to the upside.

As we approached the June 2023 meeting, data outturns had been unexpectedly strong across key indicators of domestic inflationary pressure, including employment, wage growth and services inflation. Employment increased by 0.8% in the three months to April 2023, higher than expected at the time of the May 2023 Monetary Policy Report. Annual growth in private sector regular Average Weekly Earnings (AWE) increased to 7.6%, 0.5 percentage points above the expectation at the time of the May 2023 Report. And while headline CPI inflation had fallen to 8.7% in April and remained at that rate in May, services price inflation rose to 7.4% in May, 0.5 percentage points stronger than expected at the time of the May 2023 Report. The MPC responded forcefully to this evidence of more persistent domestic inflation pressure from several indicators by increasing Bank Rate by 0.5 percentage points at the June 2023 meeting, from 4.5% to 5.0%.

Ahead of the August 2023 meeting, wage growth again surprised significantly on the upside with an increase to 7.7% in the three months to May 2023. This was notably stronger than standard models of wage growth would have predicted based on productivity, short-term inflation expectations and labour market tightness, providing further evidence of more persistent inflation pressures. But other data news had been more mixed in terms of its implications for the inflationary pressures over the medium term. While it remained elevated, services price inflation, for example, had come in lower than expected in the period leading up to the August 2023 meeting. So, the MPC responded by increasing Bank Rate by a further 0.25 percentage points.

This was the 14th consecutive increase in Bank Rate since December 2021, and with Bank Rate at 5.25%, it was clear that monetary policy was now restrictive. The MPC expected inflation to fall to around 5% by the end of the year with a further fall in energy prices and, conditional on the market interest rates prevailing at the time, to continue to recede gradually over 2024 as monetary policy weighed on economic activity and domestic inflationary pressures.

But consumer price inflation was still at nearly 8% and there were notable upside risks from lingering second-round effects from the external inflationary shocks on domestic wage and price setting. A key consideration was the extent to which wage setting would start to be based on inflation expectations that took account of the downward path for inflation. We did not have sufficient evidence that at the time that this would be the case. Similarly, we did not have a full understanding of the extent to which firms would seek to pass on higher wage costs to consumer prices. So, the MPC made clear that monetary policy would have to remain restrictive, to a sufficient extent and for sufficiently long, to ensure that inflation would return to the 2% target sustainably in the medium term. If there were to be evidence of more persistent inflationary pressures, then further tightening in monetary policy would be required.

As we approached the September 2023 meeting, however, we had not received a substantial body of news to suggest that a higher level of Bank Rate would be needed. Consumer price inflation fell to 6.7% in the data for August that was published the day before the MPC's September 2023 announcement, nearly half a percentage point below expectations at the time of the August 2023 meeting. And within the headline number, services inflation was 0.3 percentage points below expectations. While wage growth continued to rise, there had been further signs of a loosening on the quantity side of the labour market data with a notable decline in the ratio of vacancies to unemployment.

This was all evidence that the restrictive monetary policy stance we had already put in place was doing its job to return inflation to the 2% target in a timely manner. Mindful of the balance between the risks of doing too little and doing too much as momentum in the economy slowed, that is why I joined a majority on the MPC in voting to hold Bank Rate at 5.25% at the September 2023 meeting.

It was clear, however, that monetary policy would have to remain restrictive for quite some time yet. We continued to watch the incoming data closely in the months that followed predominantly with the question of whether further increases in Bank Rate would be needed in mind. Headline inflation was coming down much as expected, taking significant steps down in the data for August and again in October 2023 as Ofgem's quarterly caps on household energy bills fell in response to lower wholesale energy prices. But wage growth and services price inflation, indicative of domestic inflationary pressures, remained above levels consistent with the 2% target for headline consumer price inflation over the medium term.

Fortunately, the data were increasingly falling in line with our near-term projections over the second half of last year, and we were spared any surprises that would have required a further tightening of monetary policy. If anything, the nominal side of the economy was beginning to ease somewhat faster than we had been expecting towards the end of the year, first with downside surprises in inflation for core goods and food, followed by downside news in private sector wage growth.

As we approached the February 2024 meeting, the latest consumer price inflation numbers had fallen to 4%. This was significant progress. But it remained the case that inflation was coming down primarily because the global inflationary shocks were abating. The prices of traded goods and food were no longer pushing inflation up and falling energy prices were now pulling inflation down. While services inflation had started to ease too, and somewhat more than expected, it remained elevated, testament to continued domestic inflationary pressures. Maintaining the restrictive monetary policy stance by keeping Bank Rate at 5.25% continued to be warranted.

Nevertheless, the February 2024 meeting represented an inflection point for monetary policy. The disinflationary process had advanced enough that the key question for monetary policy was no longer whether further increases in Bank Rate would be needed, but rather for how long Bank Rate would have to be maintained at 5.25% before it could be cut.

With this in mind, the MPC continued to monitor closely indications of persistent inflationary pressures and resilience in the economy as a whole. An absence of data surprise in the run-up to the MPC's three subsequent meetings in March, May and June 2024 meant that we were becoming increasingly confident that the disinflationary process was progressing as intended. But we did not quite reach the threshold for sufficient evidence for a cut in Bank Rate during this period.

Headline inflation continued to fall, reaching the 2% target in May 2024 for the first time in three years. This decline was spread across food, core goods and services. However, it was clear that the negative contribution from energy prices would fade in the second half of the year absent any further major developments in energy markets. The key judgement we had to make during these months was whether

domestic cost pressures and services price inflation were continuing to grind down so that headline inflation would remain around target sustainably.

A complicating factor in making this judgement has been the continuing problems with the Labour Force Survey published by the Office for National Statistics. Estimates of labour market quantities remain subject to considerable uncertainties, and key labour market data remain suspended. It is therefore difficult to gauge the underlying state of labour market activity. In light of this, the MPC has needed to rely more heavily than usual on alternative sources of information to inform its judgements on the labour market, including business surveys and intelligence from the Bank's Agents around the country.

At the August 2024 MPC meeting, I had become confident that the disinflationary process had progressed to an extent that it would be appropriate to reduce the degree of restrictiveness a little by cutting Bank Rate by 0.25 percentage points to 5.0%. It was clear that the MPC would have to remain highly alert to the risk that inflation would prove stickier than expected, however, and proceed gradually. Although the disinflationary process was on track and the risk of persistently high inflation had moderated, key indicators of inflationary pressures remained elevated and recent strength in economic activity had also added to the risk of more persistent inflationary pressures.

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 sustainably. 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 it happen. We still need to see services inflation come further down.

More specifically, we now face the question of whether the remaining domestic inflationary pressure – for instance manifest in services price inflation and pay growth – will dissipate naturally now that the global shocks initially driving up inflation have unwound; or whether achieving this disinflation will require a period of economic slack in the UK economy. Alternatively, are we experiencing sustained changes in the structure of the economy with longer-lasting effects on inflationary pressures? As policymakers, we can think that all three cases are of relevance, albeit to different degrees. That calls for a gradual approach to removing monetary policy restraint.

With continued progress in disinflation, the MPC was able to cut Bank Rate again at its recent November meeting, to 4.75%. Inflation has come down faster than we expected a year ago. Consumer price inflation averaged 2.0% in the third quarter of this year, in line with MPC's target. That is more than a percentage points below the

MPC's projection in the November 2023 Monetary Policy Report. At the same time, the real economy has been holding up. GDP growth has been noticeably stronger than expected over the first half of this year, following the shallowest of recessions in the second half of last year. It is striking, and very welcome, that we have seen disinflation effectively at full employment.

Moreover, both inflation perceptions and inflation expectations have continued to fall alongside consumer price inflation itself. Wage growth has moderated further. Annual growth in private sector regular pay eased to 4.8% in the three months to August, down from a peak of just above 8% in mid-2023. This points to a continuing normalisation of wage and price setting dynamics with the fall in headline inflation feeding through over time. So even if second-round effects may take a bit longer to unwind, the evidence is consistent with the view that second-round effects will continue to fade with the easing of external inflationary pressures and the restrictive monetary policy stance we have put in place, supported by the emergence of a margin of slack in the economy.

But there has been some data news that has given me cause to reflect. One year-ahead expectations for wage growth of firms in the Bank's Decision Maker Panel seems to have stabilised at a higher level of around 4% in recent months. And the evidence – such as it is – points to the quantity side of the labour market remaining relatively tight while showing some loosening. Both of these observations could point to lingering persistence in wage pressures beyond what we are assuming in our projection.

I will also note that there are different ways in which the increase in employer National Insurance Contributions announced in the Autumn Budget could play out in the economy. It represents an increase in the cost of employment. There are at least four margins of adjustment. Firms could pass on higher costs to consumer prices, or firms could absorb the increase through lower margins or higher productivity; firms could increase wages by less, or firms could respond by reducing employment.

A gradual approach to removing monetary policy restraint will help us to observe how this plays out, along with other risks to the inflation outlook.

External engagement

Speeches on monetary policy

Getting inflation back to the 2% target given at the British Chamber of Commerce Annual Conference, London, 17 May 2023

Getting inflation back to the 2% target − speech by Andrew Bailey | Bank of England

New prospects for money, London 10 July 2023

New prospects for money - speech by Andrew Bailey | Bank of England

Openness beats fragmentation given at the Central Bank of Ireland's 2nd Financial Services Conference, Dublin, 8 November 2023

Openness beats fragmentation - speech by Andrew Bailey | Bank of England

A measure of wheat for a penny: food price inflation in historical perspective given at the Henry Plumb Memorial Lecture, London, 20 November 2023

A measure of wheat for a penny: food price inflation in historical perspective - speech by Andrew Bailey | Bank of England

Opening remarks at the 50th anniversary of the London Foreign Exchange Joint Standing Committee (FXJSC), London, 29 November 2023

Opening remarks at the 50th anniversary of the London Foreign Exchange Joint Standing Committee (FXJSC) - Andrew Bailey | Bank of England

Loughborough Lecture: Banking today given at Loughborough Business School, Loughborough University, 12 February 2024

Loughborough lecture: Banking today - speech by Andrew Bailey | Bank of England

The importance of central bank reserves, Lecture in honour of Charles Goodhart given at the London School of Economics, 21 May 2024

The importance of central bank reserves by Andrew Bailey | Bank of England

Reflecting on recent times given at the Federal Reserve Bank of Kansas Economic Symposium, Jackson Hole, Wyoming, 23 August 2024

Reflecting on recent times – speech by Andrew Bailey | Bank of England

Regional visits

South West – 16 May 2023

Greater London – 26 May 2023

Central Southern – 13 July 2023

Scotland – 28 & 29 September 2023

Northern Ireland - 19 October 2023

South East/East Anglia – 7 November

North East – 24 November

West Midlands – 28 November 2023

East Midlands – 13 February 2024

South West – 26 March 2024

Greater London – 10 April

Scotland – 10 May 2024

North West – 17 May 2024

Northern Ireland – 28 & 29 May 2024

South East and East Anglia – 20 September 2024

Yorkshire and the Humber – 4 October 2024

Central Southern – 11 October 2024

West Midlands – 17 October 2024