Report to the Treasury Select Committee

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Throughout my second year on the Monetary Policy Committee, research by Bank staff using innovative methods and micro data has been an important complement to my assessment of incoming data and the model forecasts. I continue to focus on these relatively fast-moving and granular indicators that presaged the relatively stronger-than-expected activity, and associated much more persistent inflationary pressures, both of which informed my votes over the year.

Against the backdrop of tight labour markets and fiscal support to counter the energy shock, both of which supported demand and firms' pricing power, the series of external shocks from 2021 has become embedded in domestic inflationary dynamics. This has proved difficult to wring-out. And, although economic activity has slowed in just the few recent months and headline inflation has come down, I continue to see upside potential for sales and employment in the forward-looking business indicators, as well as continued strong wage and services price growth through next year at least.

My concern is that high inflation, well above target for such a long duration, risks generating some degree of backward-looking price and wage setting behaviors. Staff research finds that inflation inertia has slowed the deceleration of services inflation. Financial market measures of inflation compensation indicate that trend inflation exhibits some drift from 2%. These suggest that tighter monetary policy will be needed both to reduce inflation itself and to align inflation expectations with the remit.

My colleagues and I are committed to fulfilling the Bank of England remit to bring inflation to target sustainably in the medium term. For me, because the staff research confirms that a more forceful monetary policy stance can influence inflation dynamics independently from the well-known and lagged channel of aggregate demand, the appropriate path is one that exhibits a higher peak in Bank Rate, with an inversion later. In my view, this path would cement our commitment to the remit.

Economy and Voting Record

The path of policy that I have voted for over the past year generally has been somewhat 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 resolute policy was required especially in light of a labour market that remained very tight, activity that was stronger than projected, and inflation that was much more persistent than projected, remaining 2 or even 3 times target for more than a year. Acknowledging that inflation is more sticky on the way down than on the way up, and with typical forecast models not constructed to capture non-linearities and asymmetries in the data, I judged that the central forecast was over-stating the likely pace of disinflation in core measures. A comparison of forecast vintages confirmed this assessment and my votes have tended to reflect the view that more monetary tightening would be required to bring inflation back to the 2% target in the medium term.

Going into the **September 2022** decision, gas prices had been highly volatile, although uncertainty about consumer-facing prices had fallen on the government's announcement of the Energy Price Guarantee (EPG). The labour market had continued to tighten over the summer, with inactivity remaining higher than anticipated. Inflation showed signs of more persistent pressures than in August 2022, and medium-term measures of inflation expectations remained high. In assessing the EPG, it likely cut the top off of measured inflation outturns, as well as moderated expectations and boosted consumer confidence. But, I worried that it would support consumption of non-energy goods and services relative to what was projected in the August forecast, and this would support inflation into 2023. I voted for a stronger tightening in Bank Rate than the majority of the Committee, as faster policy tightening at that time would have helped reduce the risk of more extended and costly tightening later.

At this meeting the Committee also voted to begin a program of Quantitative Tightening by gradually, over 12 months, reducing the stock of purchased UK government bonds by £80 billion. I agreed with this program.

The **November 2022** forecast predicted a further increase in inflation to a peak of 11% in Q4, though lower than expected in the August forecast on account of the EPG. UK-specific factors played a significant role in this period, resulting in a forecast conditioned on a yield curve that was around 2.25 percentage points higher than at the time of the August forecast. Against these assumptions, GDP was predicted to decline -0.75% during the second half of 2022, reflecting the real income squeeze from higher energy and good prices and the higher yield curve. Risks to inflation were judged to be skewed to the upside, reflecting the possibility of more persistence in wage and price setting despite the negative GDP forecast. I believed forceful action was required at this meeting, which is why I voted with the majority of the Committee, to increase Bank Rate by 75 basis points.

Going into **December 2022**, significant news of fiscal support measures had been announced at the Autumn Statement. The EPG was to be extended, in addition to other near-term support. Bank staff estimated that this would increase the level of GDP by 0.4% over the year ahead, supporting inflationary pressures in the short term. Thinking about the monetary transmission mechanism and the impact of Bank Rate rises to date, I was concerned that changes in the monetary stance had not transmitted sufficiently to broader financial conditions, the first step of the transmission mechanism, and hence to output and inflation. In order to reinforce the tightening cycle and lean against embedded inflation, I believed a more activist approach was necessary, which is why I voted for more tightening than the majority of the Committee.

At the **February 2023** meeting, I voted with the majority of the Committee to increase Bank Rate by 50 basis points. The background to this meeting was continuing high global inflation rates, but with tentative signs of a peak. Wholesale gas prices were falling, but UK domestic inflationary pressures had been firmer than expected by many, with private sector regular pay growth and services CPI inflation notably above the November forecast. GDP growth had surprised to the upside. The forecast predicted CPI inflation to fall sharply, reaching 4% by the end of 2023 and 2% by Q2 2024.

I worried that this outlook for inflation was too optimistic, in that staff research had been noting asymmetric behavior of inflation (slower on the way down than on the way up), which would tend to keep inflation too high for too long. Firms' price expectations continued to be stronger than consistent with the inflation remit and were skewed to the upside. Households continued to expect inflation to be elevated for longer, supporting firms' pricing power. Contrary to headline CPI, core CPI showed no signs of normalisation, and was running at more than 3 times the target-consistent rate. Also, in its annual supply stocktake, the MPC reduced its estimate of potential supply even as actual output came in stronger than expected, yielding excess demand (and therefore inflation support) in recent quarters.

The **March 2023** meeting took place shortly after large and volatile moves in global financial markets, associated with the failure of Silicon Valley Bank and in the run-up to UBS' take-over of Credit Suisse. There also had been moderation in measures of inflation expectations, which I judged key for my decisions. So I voted with the majority for a 25 basis point increase. In absence of such tightening, I worried that the monetary policy stance alone did not imply particularly tight financial conditions. Consistent with that assessment, the economy continued to be robust, with notable fiscal support, and consumer demand, labour markets, and overall production had not weakened as much as expected. Also, headline CPI inflation had surprised significantly on the upside and core measures showed no signs of normalisation.

At the **May 2023** forecast meeting, the Committee flagged the risk that second-round effects of external cost shocks on inflation in wages and domestic prices could take longer to unwind than they had to emerge. It had also become clear that we should expect only a small impact from the tightening in credit conditions related to global banking sector developments. There was also a material revision to the demand forecast since February, with stronger employment growth and a lower path of unemployment.

To me, sources of persistence and the materialisation of upside risks to inflation were evidenced in repeated surprises on the resilience of demand and the stickiness of non-energy inflation, resulting in significantly revised forecasts of inflation. I placed significant weight on staff research on asymmetries in pricing and on exchange rate pass-through which had pointed to upside risk to goods prices even as supply-chain costs returned to normal and energy prices started to fall. Evidence of persistence was also contained in measures of underlying inflation and core inflation which remained stubbornly high, and survey evidence from the Decision Maker Panel survey on firms own price and inflation expectations, which remain well above target-consistent levels. This led me to vote for a 25 basis point increase in Bank Rate.

At the **June** meeting, I joined the majority of my colleagues in voting for a 50 basis point increase in Bank Rate to 5%. The June MPC minutes highlight that the MPC monitors closely indicators of persistent inflationary pressures in the economy as a whole, including the tightness of labour market conditions and the behaviour of wage growth and services price inflation. Headline CPI inflation and services inflation, as well as wage data had surprised significantly to the upside, indicating more persistence in the inflation process. This amplified my concerns that the longer the various inflation measures stayed elevated, the less realistic was the rapid pace of deceleration as predicted in the May MPR.

At the **August** 2023 meeting, it was notable that some key indicators, such as wage growth and services inflation, showed signs that risks of more persistent inflationary pressures had begun to crystallise. In its forecast, the Committee decided to bring some of the upside risks to inflation into its modal projection, pushing up on this inflation projection in the medium term. Despite accounting for the realisation of some of the upside risks to inflation included in past MPC forecasts, I continued to see the likelihood of longer inflation persistence. In particular, GDP growth had remained positive, and consumption had remained resilient. The labour market remained tight and unemployment low which would translate into more purchasing power and therefore to price inflation. Further, as the duration of inflation above target lengthened, the potential for backward-looking wage and price formation would contribute to even more persistence in inflation and the potential for a drift in inflation expectations. Together with a projection for core and services price inflation to remain elevated in the near term, this led me to vote with the majority for a 50 basis point increase in Bank Rate.

At the **September** 2023 meeting, incoming data on inflation surprised on the downside, and activity data such as PMIs were weak. On the other hand, August inflation rates of headline at 6.7%, core goods at 5.2%, and services inflation at 6.8% all remain much too high, and forward-looking PMIs were more buoyant. Further, although I agreed with the assessment that monetary policy had become restrictive, it had become restrictive only very recently, and not by much, as witnessed by the modest and recent weakening in real-side data and with inflation remaining sticky at multiples of target-consistent rates. Monetary policy had definitely been tightening, but from very accommodative initial conditions. Policy decisions inevitably are risky. Given what we have learned from the data and from research over the past 2 years about resilience of demand, as well as time-varying stickiness and asymmetries in the inflation process, in my assessment, further monetary tightening was needed. Therefore, I voted for a 25bp increase in Bank Rate, whereas the majority voted to hold Bank Rate.

At the September meeting, I agreed with the decision to increase the pace of the asset sales from the balance sheet to £100 billion, to be undertaken in a gradual and predictable way so as to maintain Bank Rate as the primary policy lever.

Most data coming into the **November** meeting were not much different from September. There was definitely a soft patch in the measures of real activity, such as retail sales and GDP. But the weak PMIs noted at the September meeting had subsequently been revised up. Other forward-looking indicators, such as from the Decision Maker Panel, pointed to continued strong employment growth at 3% with employment growth next year exceeding pre-Covid rates. With the writing-up of the natural rate of unemployment (NAIRU), this means that the labor market is still tight. Various measures of wage inflation continued to come in at around 7%. Services inflation has now been at 7% or more for more than a year. Inflation expectations remain at the top end of the target-consistent range for financial markets, firms, and households. Quite a bit of embedded inflation needs to be wrung out of the system. In my view, additional monetary tightening is needed so I voted for a 25bp increase in Bank Rate, in contrast to the majority vote for no increase.

Macroeconomic Outlook

I am more optimistic on the outlook for demand than that which is associated with the latest forecast of 7 quarters of zero GDP growth. That said, anaemic is how I would characterize growth prospects. On the other hand, inflation is projected to fall to 4.6% by the end of 2023, as food and other goods prices decelerate and energy prices outright fall, in part governed by the Ofgem price cap. After that, I suspect that inflation will get stuck again. Regular pay growth as surveyed by both Agents and Decision Maker Panel, is expected to decline by the end of the year but remain at just over 6%. However, risks to this forecast, particularly to the inflation outlook on the upside, are parameterized by a still-large skew. This includes the risk of second-round effects in continued high services inflation through domestic wages and other input prices, as well as the documented slower unwind of past momentum. In the August MPR, there was agreement that some of these risks had crystallized and the August 2023 forecast brought about half of this risk into the modal projection, reflecting consistent under-prediction of inflation in previous forecasts. In the November MPR, the risks to inflation, as parameterized by the skew, still remain large, and quite likely to materialise as more persistence, especially in services inflation.

To me, the prospects for more persistent inflation imply a need for tighter monetary policy. While I acknowledge that the monetary policy stance has started becoming restrictive, it is so only recently and not by so much. Indeed, comparing August financial market data to the readings around the November MPR, financial conditions have in fact eased as Bank Rate hikes have paused.

There are two strategies to achieve a tighter monetary policy stance: An increased real tightening via a nominal hold while inflation and inflation expectations decelerate or additional nominal tightening. In my view some further nominal tightening is needed to lock-in a restrictive stance to bring inflation to target sustainably. Research from the IMF warns of ‘declaring victory too soon’. Under the alternative strategy of a hold, I see the risk that inflation gets stuck at rates inconsistent with the target for even longer than already the case, requiring more drastic and more macroeconomically costly tightening later.

Quantitative tightening is part of the overall monetary policy landscape. Compared to the changes in Bank Rate already taken, its impact has been and is expected to continue to be small. Bank Rate will remain the primary indicator of the monetary policy stance. Over the next year, however, there will be additional learning about any relationship between interest rates and balance sheet operations. The small estimated effects of last year’s operations, of maybe 10 basis points, may change or become more salient over the year to come.

Explaining Monetary Policy

Since my last annual report, I have given four on-the-record speeches. In a speech at the 53rd Annual Conference of the Money Macro and Finance Society in September 2022 titled "Inflation expectations, inflation persistence, and monetary policy strategy", I argued that in today's environment, inflation expectations play a central role when taking a view of the inflation process and of the channels through which monetary policy can achieve our remit, alongside the standard channel of aggregate demand and slack. I showed that the Phillips curve is both non-linear and can shift when inflation expectations change. Taking the case in which inflation expectations drift up, keeping inflation at target requires more slack and unemployment, and lower growth in the economy. I walked through households', firms', and financial market measures of inflation expectations, and argued that it is important to pay attention to the distribution of expectations which at the time indicated a drift in medium-term expectations. I concluded that more forceful monetary policy action was required, to ensure that the drift does not become the norm, and to avoid depending on a deeper and longer contraction to return inflation to target.

In a speech given at the Lámfalussy Lectures Conference in February 2023, titled "Turning Points and Monetary Policy Strategy", I discussed indicators of cyclical turning points, and how challenging it is to identify these in real time, even more so to foresee them ahead of time so that policies can be adapted to the future path of the macroeconomy. I showed various indicators which I monitor for turning points, including inflation and its subcomponents, where I argued that while headline inflation was beginning to turn, many of its subcomponents were not. I discussed inflation in the context of demand and supply across the UK, US and EA, the UK being notable in failing, in forecasts made at the time, to return to pre-Covid levels of GDP, accompanied by high inflation, and a weaker outlook for potential supply. I discussed the importance of monitoring real interest rates, which are a function both of nominal interest rates and expectations of future inflation. I concluded there was evidence for material upside risks to the inflation outlook and that from a risk-management point of view, monetary policy had to lean against these upside biases.

At the Resolution Foundation, in February 2023, I gave a speech titled "Expectations, lags, and the transmission of monetary policy", where I challenged the conventional wisdom on 'long and variable' lags of the monetary policy transmission mechanism. I argued that there are two steps in the transmission mechanism, the first from a change in the policy rate through to financial markets, and the second describing the pass-through of changes in financial conditions to the real economy. I presented empirical estimates of the impact of monetary policy shocks on the real economy from an empirical model which showed that – in normal times – changes in interest rates very quickly pass through to prices. But, when persistently high inflation above target translates to a high degree of backward-looking expectations formation in the economy, the effectiveness of monetary policy is greatly diminished. I concluded that more tightening was needed, and cautioned that a pivot in policy was not imminent, contrary to much of the commentary at the time.

Finally, in September 2023, I gave a speech at the annual meeting of the Canadian Association for Business Economics, titled "Inflation Models and Research: Distilling dynamics for monetary policy decision-making" This speech gave me the opportunity to showcase Bank staff research relevant for the monetary policy decision-making, particularly research that helped inform in the areas where standard modelling is challenged by the series of shocks that the economy has experienced over the last two years. Much of this research emphasizes the asymmetries in inflation dynamics and the drifting trend inflation away from 2%. Against that backdrop of research findings, I examined current monetary and financial conditions, arguing first, that the initial conditions at the start of the hiking cycle were deeply accommodative (appropriate to the Covid shock) so that the hiking of more than 500bp in this cycle commenced from a likely negative effective rate; second, that although real rates have been rising, they were negative over the last two years, on account of high inflation; and third, that the neutral level of real interest rates has risen. For all these reasons, monetary policy was not as tight as it might appear by some measures. For both reasons of inflation persistence and monetary conditions, some further tightening was required to bring inflation back to the 2% target in the medium term.

In addition to speeches, I have done two virtual (East Midlands and Northern Ireland) and five in-person (North East, Scotland, Wales, Central Southern England, as well as South East and East Anglia) Agency visits which included one-on-one company visits and round-tables with Agency contacts, business organizations and Chambers of Commerce. I also gave five high school presentations (at New College Durham, Loreto College in Coleraine, Coleg Cambria, Gordon's School Woking, and Great Baddow High School) and a Citizens' Panel (North East). Agency visits and Citizens' panels are particularly important to me, to hear about economic activity and inflation issues from an outside-London perspective. I always look forward to talking with young people about economics at my high school visits! I want them to care as much as I do about how the economy works and showcase what kinds of careers they can have as economists.

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: CD Howe Institute's Monetary Policy Initiative, panel on 'The path back to 2 percent'; Canadian Association for Business Economics Webinar 'Global macro conjuncture and challenges facing small open economies'; 30th anniversary of the crisis of the ERM of the European Monetary System (ESM) "1992 :Ground Zero: How the ERM failed - the consequences for Europe"; Bank of England Watchers' Conference session 'Inflation'; The Conference Board's Navigating the Economic Storm, 'Policy solutions: fiscal and monetary'; Women in Economics Event - panel discussion (Central Bank of Ireland); EIB Annual Forum and Chief Economists Meeting, 'Interaction of monetary and fiscal policy and financing conditions'; Peterson Institute for International Economics conference on floating exchange rates 'The post-1973 currency regime and inflation experiences'; Global Interdependence Center Conference 'Ukraine – one year later: How do Monetary Policy makers deal with spillover effects from food, energy and geopolitical shocks that are beyond the policy makers' control?'; NABE in Washington, Inflation and Monetary Policy; The Economics of Climate Change, Brandeis University; CEBRA Annual Meeting in New Work on 'Challenges for Policy After the Return of Inflation: New Directions for Research?'.

Business and finance audiences included, among others: American Enterprise Institute 'The World Economy's Inflation Challenge'; Alliance Manchester Business School Vital Topics Lecture on 'Challenges Facing the UK economy, Challenges Facing Monetary Policy: A Comparative Look'; Alliance Manchester Business School Roundtable on 'Productivity of the North: Prioritising Policy Directions'; Council on Foreign Relations Corporate Conference, New York; Pictet Family Forum, Zurich; Kearney's 2023 CEO Retreat 'What if the global economy fragments further?', SNS Tylösand Summit on 'Creating an Environment for Growth'.

I have also written an essay for the Resolution Foundation's Economy 2030 Inquiry series on 'Economic policy in the turbulent 2020s after the sluggish 2010s: Transitioning from crisis management to structural reform'[1], as well as a chapter 'The ERM crisis: A teachable episode for international macro' in the Centre for Economic Policy Research book 'The Making of the European Monetary Union: 30 years since the ERM crisis'.[2] I have also written a piece on 'Climate Policy and

[1] Mann, C. L. (2023) 'Economic policy in the turbulent 2020s after the sluggish 2010s', Resolution Foundation The Economy 2023 Inquiry.
[2] Mann, C. L. (2023) 'The ERM crisis: A teachable episode for international macro', in Corsetti, G. and Hale, G. (ed.) *The Making of the European Monetary Union: 30 years since the ERM crisis.* CEPR.

Global Challenges: A Monetary Policy Perspective', published in the Journal of Management Policy and Practice.[3]

[3] Mann, C. L. and Burr, N. (2023) 'Climate Policy and Global Challenges: A Monetary Policy Perspective', *Journal of Management Policy and Practice*, 24 (1).