14 November 2023

Report to the Treasury Committee

Dave Ramsden, Deputy Governor Markets and Banking at the Bank of England

This report covers the period since my last report, submitted on 22 September 2022, as part of my response to my reappointment questionnaire.

Economic developments, September 2022 to November 2023

To help frame my comments on the evolution of the UK economy since my last report in September 2022 I have updated a table which I included in a speech a year ago[1].

Table 1: 2022 Q4 outturns and November 2023 and November 2022 MPR forecasts

	2022 Q4 Outturns	2023 Q4		2024 Q4		2025 Q4		2026 Q4
GDP	0.7	0.6	(-1.9)	0	(-0.1)	0.4	(0.7)	1.1
CPI Inflation	10.7	4.6	(5.2)	3.1	(1.4)	1.9	(0)	1.5
LFS Unemployment rate	3.7	4.3	(4.9)	4.7	(5.9)	5	(6.4)	5.1
Excess supply/excess demand	$\frac{3}{4}$	0	($-2\frac{1}{2}$)	$-\frac{3}{4}$	(-3)	$-1\frac{1}{2}$	(-3)	$-1\frac{1}{2}$
Bank Rate	2.8	5.3	(5.2)	5.1	(4.7)	4.5	(4.4)	4.2
Energy prices direct contribution to CPI inflation	3¾	$-1\frac{1}{4}$	(1)	$\frac{1}{2}$	(0)	$-\frac{1}{4}$	($-\frac{3}{4}$)	$-\frac{1}{4}$
Average weekly earnings	6	$6\frac{3}{4}$	($4\frac{1}{4}$)	$4\frac{1}{4}$	($2\frac{3}{4}$)	$2\frac{3}{4}$	(2)	2

The table helps to illustrate what for me are five key features of UK economic developments over the last year, focussing on the first three columns in the table (I will return to the other five columns in the next section). First, the double-digit peak and subsequent sharp fall back in headline CPI inflation, which has been broadly in line with our November 2022 forecast. Second, the divergent trends in the contributions of the main components of inflation, in particular the greater negative contribution from energy and the greater positive contribution of services inflation, which has been a major indication of inflationary persistence. Third, the greater resilience than expected in activity, linked to the easing in energy price pressures but also the tightness of the labour market: the fourth key development. This in turn has supported higher than expected wage growth, the fifth main development. I have also continued to pay close attention to developments in financial markets, and in particular in the context of this report, market expectations of inflation.

Developments in headline CPI inflation can be split into two phases. In the first phase inflation peaked at 11.1% in October 2022 but remained above 10 per cent until April 2023, reflecting the cumulative impact of two unprecedented global shocks. First, the continuing impacts of the aftermath of the Covid pandemic on supply chains for global traded goods and second, the peak effects of Russia's invasion of Ukraine on energy and food prices. In the second phase since April 2023 inflation has fallen back sharply, falling by over 1% on average in each of April and July as a combination of the resetting of the Government's Energy Price Guarantee and Ofgem's price cap have reduced household energy bills.

[1] See That was the year that was – speech by Dave Ramsden | Bank of England

The resetting of the price cap in October will see the contribution of energy to annual CPI fall into negative territory. As a result headline CPI inflation is expected to fall sharply in 2023 Q4 from its current level of 6.7%, to just below 5%, which would also be slightly below the November 2022 MPR forecast for the quarter.

The encouraging progress on headline inflation masks diverging and significant trends in components of CPI. Falling energy prices have been the key driver contributing to the fall in inflation and as I have highlighted have fallen faster than expected. Core goods inflation and food inflation, which are directly and indirectly impacted by energy prices, have also started to ease, albeit with a lag to the fall in energy prices. And these price categories have contributed most of the downside news to our inflation projections since the August MPR. While the inflation rates in energy and to a lesser extent food prices have fallen back from their peaks, the level of energy and food prices remains high, which means that the cost of living challenges faced by many households continue.

Services inflation has continued to rise through the first half of 2023, peaking at 7.4% in May and July 2023. It has since fallen back somewhat to 6.9% in September 2023, which is still above its average level of 6.5% in 2022 Q4. As a result it is now contributing more to current inflation than the prices of energy, food and other goods and is therefore clearly the largest contributor to current CPI inflation. Services CPI outturns have come in slightly lower than we expected at the time of the August MPR but it is expected to remain elevated in the coming months, as labour costs in particular stay elevated. Services price inflation is a key indication of the persistence of inflationary pressures in domestic wages and prices.

Demand growth had proved much more resilient during the first half of 2023 than we had forecast in the November 2022 MPR with quarterly GDP growth remaining positive. One prominent driver of this resilience has been the fall-back in household energy prices and fiscal support from the government, boosting household real incomes (though the fiscal support was largely anticipated in the November 2022 MPR). More recently GDP growth has slowed to zero in 2023 Q3, and the weakness in demand is also increasingly evident in consumption, consistent with the recent weakness in indicators of consumer confidence and retail sales. Overall rather than a significant degree of spare capacity (or excess supply as its labelled in Table 1) opening up through 2023, the UK has experienced excess demand, although this is diminishing as the economy has slowed and is forecast to have been eroded in the current quarter. This does not just reflect the relative strength of demand but also the relative weakness of supply, reflecting the judgements made by the MPC in its annual supply stocktake in February 2023, and in the last two forecast rounds.

A key underpinning for the resilience of demand and the increased persistence in inflation has been the tightness of the labour market. Given the increasing uncertainties surrounding the ONS LFS data it is important to note that the MPC continues to consider a wide range of data to inform its view on developments in labour market activity, rather than focusing on a single indicator. Notwithstanding these uncertainties employment growth has been robust until recently and unemployment has not risen by as much as was expected, even allowing for the relative strength of demand. In a speech I gave a year ago I highlighted my scepticism about the near-term rise in unemployment in the November 2022 MPR, which forecast unemployment would rise by more than 1 percentage point over the year to 4.9% by 2023 Q4. Against a backdrop of subdued activity, employment growth is likely to have softened over the second half of 2023, but the MPC's latest November 2023 forecast is for a much more modest rise in unemployment to 4.3%.

The MPC has increasingly focussed on the ratio of vacancies to unemployment as a measure of labour market tightness, as this measure does a better job of explaining the recent strength in wages in our estimated equations for modelling wage behaviour. Although the number of vacancies has continued to ease in 2023 and unemployment has picked up since the end of 2022, the V/U ratio is still higher than it was pre-Covid. Falling vacancies and surveys indicating an easing of recruitment difficulties also point to a loosening in the labour market. Contacts of the Banks agents have similarly reported an easing in hiring constraint although persistent skills shortages remain in some sectors.

Although we do not have alternative data sources on participation to the LFS, I am confident that changes in participation since 2019 continue to contribute to the tightness in the UK labour market. I remain concerned about the level of inactivity in the UK and its implications for labour supply. Labour participation has increased from its trough in mid-2022, partly driven by a return of students to the labour force, but the number of people saying they are unable to participate in the workforce due to sickness remains elevated and is just over half a million higher than before the pandemic.

The strength in the labour market and resilience of economic activity have supported strong pay growth, significantly stronger than forecast, and second round effects have contributed to inflation persistence, particularly in the more labour intensive services sector. Total average weekly earnings (AWE) growth (including the public sector) is forecast to be 6¾% in 2023 Q4, higher than a year ago and more than 2% percentage points stronger than the November 2022 MPR forecast, which showed wage growth falling back as the labour market loosened. The annual rate of growth of AWE private sector regular pay, which should give a better indication of underlying labour market pressures, remained high at 7.8% in 2023 Q3, slightly lower than its peak of 8.1% in August but still above the level of 7.3% in 2022 Q4. While pay growth has remained high across a range of indicators the recent rise in growth in the AWE is not apparent in other survey based series. Although there remains uncertainty about the near term path of pay some forward looking indicators suggest that wage growth will start to moderate and wage growth is projected to decline in coming quarters.

Given my responsibilities at the Bank for financial markets I will flag three relevant market developments over the last year.

- First core bond markets have been characterised by a relatively high degree of volatility over this period. For UK gilt markets, this was most evident during the LDI episode last autumn, which I commented on in my re-appointment hearing in October 2022, and which has been extensively covered elsewhere. But volatility has remained a feature, and reflects continued uncertainty about the economic and particularly inflationary consequences of the significant global shocks as they have worked through the system, the likely policy responses and also ongoing geopolitical concerns.

- Second since spring 2023 there has been a significant repricing of global bonds, with yields rising materially, particularly at the long end. Since the summer this has been particularly marked for US Treasury yields. In the November MPC minutes, we highlighted that this was likely to reflect market expectations that global policy rates would remain higher for longer during the current cycle. In addition there was the possibility that market perceptions of the equilibrium real interest rate had risen. Bank staff models also suggest that a rise in term premia, the additional compensation that investors required to hold longer-term bonds, have contributed to the most recent rise in longer term global yields. That might be because of increased uncertainty around the economic outlook and interest rates, as well as a reassessment of the balance of supply and demand in government bond markets. Since we completed the November MPR forecast there has been some fall back in global yields which may reflect a partial unwinding of some of these shorter term factors.

- Third while survey-based measures of household and business inflation expectations in the medium term have fallen back towards or in line with their average levels and so provide assurance that inflation expectations remain well anchored, market based measures give more pause for thought. Although the latest increases in yields seem largely driven by real rates our preferred market-based measure, the UK adjusted 5 year inflation swap five years ahead, remains elevated and at a higher level than at the end of 2022.

Voting record

In the context of these economic developments and what they imply for a sustainable return of inflation to the 2% target I have voted with the majority on the MPC at each meeting since my September 2022 report to the TSC. Bank Rate has been increased by a total of 3 percentage points from 2.25% at the time of the September 2022 meeting to 5.25% now. In terms of the MPC's monetary policy and how it has been communicated I would distinguish three phases over that nine meeting period.

- In the November and December Monetary Policy Summary (MPS), a majority on the MPC continued to use language that I have previously described in a speech in November 2022[2] as indicating our monetary policy "reaction function" based approach to economic developments. We did this by stressing that were the economy to evolve broadly in line with the November 2022 MPR projections then further increases in Bank Rate were likely to be needed, and that if the outlook suggested more persistent inflationary pressures the MPC would act "forcefully". In light of the evidence of greater persistence which I've detailed in the previous section, Bank Rate was increased by 75bp at the November meeting, the largest ever increase in the MPC's 26 year history, and by 50bp at the December meeting.

- At the four meetings between February and June 2023, our language continued to signal our reaction function but became more specific. Each Monetary Policy Summary over this period highlighted that the MPC would "continue to monitor closely indications of persistent inflationary pressures, including the tightness of labour market conditions and the behaviour of wages growth and services inflation. If there were to be evidence of more persistent pressures then further tightening in monetary policy would be required". Over the four meetings between February and June, Bank Rate was increased by a total of 1.50 percentage points with 50bp increases at the February and June meetings and 25bp increases at the March and May meetings. The 50bp increase in June was particularly noteworthy as it followed a deterioration relative to expectations in all of the three groups of indicators, most clearly in the case of CPI services inflation.

- At the August, September and November meetings, the MPC retained this reaction function language but augmented it by highlighting that the current policy stance is "restrictive". There are different ways of thinking about restrictiveness but for me the most straightforward explanation is through the impact policy is having by slowing demand in the economy relative to what it would otherwise be. The Committee also noted that monetary policy will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term. For the majority on the MPC, developments in the indicators of persistence over this period warranted a 25bp increase in Bank Rate at the August meeting and no change at the September and November meetings.

Throughout this period the MPC has continued with its programme of quantitative tightening (QT), underpinned by the three key principles first set out in the August 2021 MPR. QT commenced in February 2022, initially through maturities. In September 2022, the MPC voted to reduce the stock of gilts held in the Asset Purchase Facility (APF) by £80 billion. As first discussed with the Treasury Committee at its May 2023 hearing and as I subsequently set out in a speech in July 2023[3] and in a Box in the August 2023 MPR[4], Bank staff have assessed the evidence on how QT is working. Their

[2] See That was the year that was – speech by Dave Ramsden | Bank of England
[3] See Quantitative tightening: the story so far – speech by Dave Ramsden | Bank of England
[4] See Box A; Bank of England Monetary Policy Report August 2023

assessment is that the QT programme is proceeding in line with the key principles with no indications of a negative impact of gilt sales on market functioning and the impact on yields judged to be modest.

In September 2023, as part of the MPC's annual QT review, the MPC voted to reduce the stock of UK government bond purchases by £100 billion over the next twelve months, to a total of £658 billion, which was in line with my preference for a slightly higher pace of stock reduction[5] because it would leave the pace of gilt sales broadly unchanged relative to the previous year, given some increase in APF gilt maturities.

In addition, the MPC has completed it's unwind of the Corporate Bond Purchase Scheme, with sales concluding on 6 June 2023.

The outlook for the economy and policy

The MPC set out its updated best collective judgement on the economic outlook in its latest MPR in November. I won't go into detail in this report, given this is likely to be the focus for the TSC hearing later in November. But I will make some summary observations on the projections and what they imply for monetary policy.

Overall my expectations for the outlook for the UK economy and the risks around it are in line with the forecasts presented, as summarised in Table 1, and based on the usual conditioning assumptions set out in the November MPR. And this is more true now that has been the case with recent MPR forecasts, for a number of reasons I set out in summary below and which I can expand on at the upcoming hearing.

Focusing first on the short term outlook through 2024, I see our forecasts as being consistent with recent trends: increasing signs that higher interest rates are weighing on economic activity; resulting in quarterly GDP growth around zero; and further easing in labour market tightness in response with unemployment picking up. In terms of inflation, Ofgem's October price cap means that we can be confident about the contribution from household energy bills to lower inflation over the coming months. But there are upside risks to inflation even in the short term following the tragic events in the Middle East. There are uncertainties about the time it will take other non-energy components of inflation to come down as well but I see the short term risks here as broadly balanced. In terms of headline inflation, in the absence of further shocks, the MPR forecast for CPI inflation to fall below 4% in 2024 Q2 is consistent with my own current assessment.

Looking further ahead, I am as comfortable as it's possible to be, given the uncertainties, with the broad shape of the forecast, with economic slack (excess supply in the Table 1) opening up through 2024 and 2025 as restrictive monetary policy continues to weigh on demand. In the modal, or most likely projection, inflation falls to 3.1% by the end of 2024 returns to target by 2025 Q4 when CPI inflation is forecast at 1.9%. For this forecast to be realised, services inflation will need to fall steadily over the period which in turn will require an easing of underlying price and costs pressures.

That it takes two years for inflation to return to close to target from where we are now is a significant feature of the forecast and reflects three significant new judgements we have made in our forecasts over the last year. First to build in more resilience to demand than our forecasting models would suggest (though slightly less in November 2023 than we incorporated in the August 2023 MPR). Second for a given negative impact on activity we have assumed less of an upwards movement in unemployment than history would suggest, with knock-on effects on inflation. And third given developments in wages over the last year we have assumed more persistence in wage-setting than the determinants of wages in our various models of wages would suggest. This in turn could stem

[5] See Quantitative tightening: the story so far – speech by Dave Ramsden | Bank of England

from various labour market factors, which has led us to revise up our estimate of the medium term equilibrium unemployment rate to 4.5%.

Even allowing for these judgements and in light of the developments relative to the forecast over the last year I, along with the MPC, consider risks to the forecast inflation path to be to the upside. We have allowed for this by building in a skew to the forecast which leaves the mean, or expected inflation rate, just above 2.0 per cent in 2025 Q4.

In terms of my latest monetary policy decision as framed by these latest projections, I voted along with five other members to maintain Bank Rate at 5.25% at the November meeting. I continue to characterise my approach to monetary policy as being watchful and responsive. I will continue to monitor closely the indications of persistent inflationary pressures and resilience in the economy as a whole. On the basis of our latest projections a restrictive policy stance is likely to be warranted for an extended period of time to bring inflation sustainably back to the 2 per cent target. Given my assessment of the outlook and the risks I would not rule out having to raise Bank Rate further in the future but I will continue to make my decisions on a meeting to meeting basis.

Explaining monetary policy

Over the fourteen months since my previous report to the Treasury Committee, I have given five on-the record speeches. Three of these speeches were specifically on monetary policy issues. I am also giving two further speeches ahead of the November Treasury Committee hearing, one on monetary policy and the other on financial stability, given my responsibilities as a Financial Policy Committee member.

- "Message received and understood" given remotely at a conference of Bank Latvia and the Bank for International Settlements, September 2022
- "Shocks, inflation, and the policy response" given at the Securities Industry Conference, London, October 2022
- "Challenge, convene, collaborate and create" given at a G20 presidency event in Bali, Indonesia, November 2022
- "That was the year that was" given at Bank of England Watchers' Conference, London, November 2022
- "Quantitative tightening: the story so far" given at the Bank of England, organised by the Money Macro and Finance Society, London, July 2023

I gave evidence at the Treasury Committee hearings on quantitative tightening in May 2023 and on Silicon Valley Bank in March 2023. I gave an interview to the Times in April and have given numerous off-the-record talks to explain monetary policy and the wider work of the Bank of England.

I have made five visits to different areas of the UK over the last fourteen months, to Scotland, the South West, the Midlands, Wales and the South East. I continue to find these meetings with businesses during these visits very useful in informing my understanding of the UK economy. I have also found the two Bank Community Forums I've taken part in with a range of local charities and other civil society groups, particularly valuable.