Report to the Treasury Committee

Andrew Bailey, Governor of the Bank of England

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Economic developments over the past year

The last twelve months have seen the UK economy continue to be buffeted by a sequence of large domestic and international shocks, reflecting the impacts of the Covid 19 pandemic and the Russian invasion of Ukraine. This has generated a difficult economic environment, with significant challenges for monetary policy in navigating the narrow path between the risks from elevated inflation and a tight labour market on one hand, and the hit to activity from the reduction in real incomes on the other.

Considering first developments over the last year. Economic activity has continued to recover from the sharp falls observed earlier in the pandemic. Growth slowed around the turn of the year, due to the emergence of the Omicron variant and associated changes in government restrictions and people's behaviour. These effects were, however, much smaller than during the earlier waves of the pandemic.

UK GDP grew by 0.8% in January and 0.1% in February this year, taking it to 1.1% above its 2019 Q4 average pre-pandemic level. This masks some divergence between government and private sector output. February was the first time market sector output had returned to above pre-Covid levels since the pandemic started. Government output has consistently been stronger than private sector output, having been boosted by pandemic related expenditure, including Test & Trace and the vaccination programme. This has now started to reverse, in line with the government's 'Living with Covid' plan, with government spending on Test & Trace roughly halving in February as Covid-related protocols eased.

Although the direct economic effects of Covid on the UK economy appear to have now largely attenuated, the economic landscape has changed and we are still left with the economic legacy of Covid.

Globally, the rotation of demand towards durable goods has persisted longer than had been expected. Combined with disruptions to global supply chains – attributable to Covid, a number of other more idiosyncratic factors, and more recently Russia's threats and now action against Ukraine – this has led to bottlenecks in many global goods markets, as well as for commodities and energy.

Domestically, the labour market has emerged from the pandemic in a much stronger position than had been expected a year ago. In part this reflects the success of the Coronavirus Job Retention Scheme (CJRS) and other policy measures in keeping workers in jobs throughout the pandemic. We have also experienced growth in public sector employment, which was around 240,000 higher than pre-pandemic levels in 2021 Q4, with the NHS accounting for over half of that increase. There has also been a significant rise in inactivity, which has increased by over 600,000 compared to before the pandemic. There is increasing evidence that long-term sickness is a significant part of this story.

The UK, like many other countries, has also witnessed a large build up in the stock of unexpected savings. Over 2020 and 2021, the household saving ratio averaged over 12% - more than double the rates of around 5% in the couple of years prior to Covid. In absolute terms, that was around a cumulative £230bn of additional savings.

These legacy features continue to have a profound impact on the behaviour of the global and domestic economy, most notably for inflation. Alongside the recovery in activity, we have seen a rapid increase in UK CPI inflation, which rose to 7% in March 2022. The strength of inflation relative to the 2% target mainly reflects the large increases in global energy and tradable goods prices we have experienced. Bank staff estimate that on a UK-weighted basis, four-quarter world export price inflation, including energy, rose to 15% in 2022 Q1. There has also been some increase in the

inflation rates of more domestically supplied services. Taken together, energy and core goods components account for around four-fifths of the overshoot of CPI inflation relative to the 2% target, with the remainder spread across food and services components.

Global inflationary pressures have intensified sharply in the build up to and following Russia's invasion of Ukraine. This has led to a material deterioration in the outlook for world growth. Concerns about further supply chain disruption have also risen. These developments have exacerbated greatly the challenges already facing the UK, and many other economies, from the series of adverse supply shocks we continue to face.

The invasion is causing untold humanitarian harm and it is entirely right that the UK has worked with international partners to impose severe costs to demonstrate the unacceptability of this behaviour. While there are strict limits to the role of an independent central bank, this judgment for me is a matter of basic morality. It follows that the Bank must play its part to the full by dealing, where appropriate, with the economic and financial consequences of Russia's actions and thereby helping to preserve freedom and democracy.

Covid also continues to have a more direct impact in some other economies. In particular, the restrictions in China to contain the latest outbreaks of Covid have also increased concerns about further supply chain disruption, which had previously been expected to improve this year.

Though responsible for less of the rise in headline inflation, domestic inflationary pressures have also risen, with services price inflation having picked up to its highest rate since November 2012. That is likely to reflect, in part, underlying wage growth which Bank staff's estimate has risen to around 4 to 4½%, above pre-pandemic rates. That, in turn, reflects the tightening in the labour market and upward pressure from the rise in CPI inflation, as firms seek to retain and recruit staff, consistent with the Bank of England's Agents' pay survey set out in the February *Monetary Policy*

Report and the latest reports from the agents' contacts. The Labour Force Survey unemployment rate fell to 3.8% in the three months to February.

The outlook for inflation

Turning to the future, the MPC set out its best collective judgement of the economic outlook in the May *MPR*, and I am in full agreement with that assessment.

It is a forecast of two halves: with inflation well-above target in the near term, but subsequently falling back to end the forecast below the target, as global inflationary pressures fall sharply and domestic activity weakens. This is similar in nature to our February forecast, although developments since then have increased the size of these swings.

In line with the MPC's conventions, the forecast is conditioned on a market-implied path of Bank Rate that rises to around 2.5% by mid-2023, 1.1 percentage points higher than in February, before falling to 2% at the end of the projection. The path implied by financial markets is higher than that expected by respondents to the Bank's latest Market Participants Survey. That is consistent with Market Intelligence conversations, as well as the results of the survey, which highlight upside risks to contacts' central expectations. Over the next year 68% of respondents to the survey saw a higher probability of rates being greater than their central case, rather than below it. This may explain part of the discrepancy, since market rates effectively capture mean expectations, while central expectations in the survey are more likely to reflect median expectations. Contacts also report that uncertainty around the macro outlook and geopolitics, combined with observed increases in market volatility, have led to unusually thin conditions in many short term interest rate markets. This can result in an illiquidity premium, which may explain some of the gap relative to the survey.

Wholesale energy prices are assumed to follow their respective futures curves for the first six months of the projections and remain constant beyond that. Given that path for wholesale prices

and Ofgem's published methodology for calculating the retail gas and electricity price caps, Bank staff currently forecast that household energy prices would rise by a further 40% in October.

On that basis, global inflationary pressures are expected to strengthen considerably further over the coming months, while growth in economies that are net energy importers, including the United Kingdom, is likely to slow. While these shocks are global in nature, there are important differences in the way they are impacting different economies. To characterise the situation, the United States economy is facing what looks like a demand shock, with a strong domestic labour market, strong domestic demand and relatively less exposure to the energy price shock given its position as a major gas producer. The euro area by contrast is facing a supply/cost shock, as it starts with a somewhat weaker domestic labour market, and is heavily exposed to the rise in gas prices. In the UK we are experiencing elements of both. Like the euro area, we are experiencing a sharp shock to the price of tradable goods and energy. But our strong labour market is more akin to that in the US.

In the MPC's latest central projection UK CPI inflation is expected to rise over the remainder of the year, averaging slightly over 10% at its peak in 2022 Q4. The majority of that further increase reflects higher household energy prices. The price cap mechanism means that it takes some time for changes in wholesale gas and electricity prices to be reflected in retail energy prices. That means consumer price inflation is likely to peak later in the United Kingdom than in many other economies, and may therefore fall back later.

Underlying nominal earnings growth is expected to strengthen further in coming months to average 5¾% in 2022, compared to the 3¾% rise expected in the February *MPR*. That reflects the further tightening of the labour market and upward pressure on wage growth from higher price inflation.

UK GDP growth is expected to slow sharply over the first half of the forecast period. That predominantly reflects the significant adverse impact of the sharp rises in global energy and tradable goods prices on most UK households' real incomes. It is a measure of the scale of the shock that

total real household disposable income is projected to fall by 1¾% in 2022 which, apart from 2011, would be the largest contraction since comparable records began in 1964.

I recognise the hardship this will cause for many people in the UK, particularly those on the lowest incomes, often with little or no savings, who are hit hardest by increases in the prices of basic necessities like food and energy.

As a result of the associated decline in activity, although the unemployment rate is likely to fall further in the near term to 3.6% in Q2, it is projected to rise to 5½% in three years' time given the sharp slowdown in activity.

With monetary policy acting to ensure that longer-term inflation expectations are anchored at the 2% target, upward pressure on CPI inflation is, therefore, expected to dissipate over time. Global commodity prices are assumed to be consistent with the conditioning paths for energy prices and so rise no further in the central projection. Global bottlenecks are expected to ease over time, and the weakening in growth and building excess supply leads domestic inflationary pressures to subside.

Once CPI inflation starts to fall, it is projected to fall relatively quickly; to a little above the 2% target in two years' time, largely reflecting the waning influence of external factors, and to 1.3% in three years, well below the target and mainly reflecting weaker domestic pressures.

Risks to the outlook

Uncertainty around the outlook remains high. There are therefore significant risks around the MPC's projections, which will depend, in large part, on how the war in Ukraine evolves and the implications for energy and commodity prices.

An upside risk in the near term is if the impact of the disruption to supplies of commodities is greater than assumed, for example if energy consumption is rationed in some countries. Another is an even

greater escalation of geopolitical tensions, which would likely be associated with higher general uncertainty about the economic outlook.

A downside risk to energy and other commodity prices further ahead, is if prices fall back to the levels currently implied by futures curves. The futures curves for energy prices are downward sloping, in contrast to the MPC's conditioning assumptions. In an alternative scenario where energy prices follow their futures curves throughout the projection, CPI inflation would fall back towards the target more rapidly than in the central projection and would be around ½ and over 1 percentage point below the target in two and three years' time respectively.

Overall the risks to the inflation projection are judged to be skewed to the upside in the second and third years of the forecast, given the risk that the strength in nominal wage growth and domestic price setting is more persistent than we have assumed.

The latest intelligence from the Bank's Agents suggests that the risks to the projection for wage growth are to the upside over the next year, given the possibility that firms grant larger pay awards than we have assumed, in order to retain or recruit staff given the tightening in the labour market and the sharp rise in CPI inflation. Recruitment difficulties remain acute, with the number of vacancies having risen to a record high. There is a risk that this reflects some frictions in the matching of workers and jobs and has therefore been accompanied by a corresponding rise in the medium-term equilibrium rate of unemployment, which would put further upward pressure on wage growth.

Firms may also be able to rebuild their margins by more than assumed over the projection. Around half of respondents to the Agents' pricing and margins survey reported that they are finding it easier than usual to pass on their higher costs to prices.

Over the past few months, indicators of people's short-term inflation expectations and measures of inflation expectations two to three years ahead have risen as inflation has picked up. Longer-term

inflation expectations measured from financial market and household surveys have also increased in recent months, though by less than short-term measures, and are elevated by historic norms. Professional forecasters continue to expect CPI inflation to be close to target two and three years ahead. A risk to the inflation outlook is that longer-term inflation expectations evolve such that wage and price-setting are not consistent with inflation returning to the 2% target in the medium term. The Committee will continue to monitor measures of inflation expectations very closely and will continue to act to ensure that longer-term inflation expectations are well anchored around the 2% target.

Of course, there are also downside risks to the medium-term prospects for inflation. Demand growth could slow by more than expected if households cut back their spending by more than assumed in the face of the squeeze in their real incomes. In aggregate, households accumulated significant additional savings during the pandemic, which should support their ability to smooth consumption temporarily as real incomes decline. But the rise in savings during the pandemic has not occurred evenly – it is more marked among higher-income households – so not everyone may be in a position to do this. Energy and food bills form a larger share of lower-income households' spending, so their ability to use savings to support their consumption may be limited. In addition, and even for higher-income households, the associated deterioration in the economic outlook may increase households' uncertainty about the future, leading them to increase their precautionary saving and lower their spending further.

Another risk is that some of those who have recently left the labour market return to work to support their income and spending in the face of the real income squeeze. This would increase the supply capacity of the economy and so put downward pressure on inflation.

Monetary policy

Turning to policy, over the last year the MPC has raised Bank Rate from 0.1% to 1.0%. The Committee has also voted to begin to reduce the stock of UK government bonds held in the Asset Purchase Facility, by ceasing to reinvest maturing assets; and to begin to reduce the stock of sterling non-financial investment-grade corporate bonds, by ceasing to reinvest maturing assets and by a programme of asset sales to be completed no earlier than towards the end of 2023 that should unwind fully the stock of corporate bond purchases. Since 3 February 2022, the total purchased assets of the APF have fallen from £895bn to £866.6bn, of which £19.6bn are holdings of corporate bonds and the rest are gilts.

As Bank Rate reached 1% in May,[1] and consistent with the MPC's previous guidance, the Committee is now considering beginning the process of selling UK government bonds held in the Asset Purchase Facility. The Committee recognises the benefits of providing market participants with clarity on the framework for any potential sales programme. The MPC has therefore asked Bank staff to work on a strategy for UK government bond sales, and will provide an update at our August meeting. This will allow the Committee to make a decision at a subsequent meeting on whether to commence sales. I should reiterate that no decision on whether to commence sales has yet been made. The Committee reaffirmed that that decision will depend on economic circumstances including market conditions at the time, and that sales would be expected to be conducted in a gradual and predictable manner so as not to disrupt the functioning of financial markets.

The Committee's preference in most circumstances is to use Bank Rate as its active policy tool when adjusting the stance of monetary policy.

Recent developments have exacerbated materially both the near-term peak in CPI inflation, and the prospective negative impact on activity and medium-term inflationary pressures. Nevertheless,

[1] This was corrected on 17 May to say Bank Rate rose to 1% in May rather than March as originally stated.

given the current tightness of the labour market, continuing signs of robust domestic cost and price pressures, and the risk that those pressures will persist, the Committee voted at its recent meeting in May to increase Bank Rate by a further 0.25 percentage points to 1%.

Based on their updated assessment of the economic outlook, most members of the Committee judge that some degree of further tightening in monetary policy might still be appropriate in the coming months. There are risks on both sides of that judgement and a range of views among these members on the balance of risks. The MPC will continue to review developments in the light of incoming data and their implications for medium-term inflation.

Given the uncertainty around the outlook, and the succession of shocks the UK economy has been hit by, it is unsurprising there were a range of views amongst members of the committee about the extent of tightening required at this meeting and in the coming months. This reflects the narrow path we are navigating, given the magnitude of the risks on both sides of our inflation projections.

Reflecting the risks on one side of that narrow path, at our May policy meeting three members preferred a 0.5 percentage point increase in Bank Rate.

Reflecting the risks on the other side, however, there were also a range of views about the need for, and extent of, any further tightening in policy in the coming months. While most members judged that some degree of further tightening might still be appropriate, some members judged that the risks around activity and inflation over the policy horizon were more evenly balanced and that such guidance was not appropriate at this juncture.

Key issues and judgements

The current environment is clearly a very challenging one for monetary policy. I would like to finish by setting out what I consider to be the key issues and judgments that we have faced and/or expect to face in the months ahead.

1. While the impact of the Covid pandemic on the economy and so the outlook for inflation have been the MPC's primary focus over the past couple of years, we are now reaching a point where the direct economic effects of the pandemic on the UK economy appear to have largely attenuated. That was illustrated by the effects of the Omicron variant, which the MPC judged were likely to have a small direct impact, but in the event the effects appear to have been smaller still. This judgement does not, however, hold for some other economies, most notably China, which is causing further supply chain pressure. Assessing the broader global impacts of these effects will therefore remain important to the outlook for UK inflation.

2. The Covid pandemic and associated policy responses have had a profound impact on the UK labour market. While there was a material rise in unemployment following the onset of the pandemic, this was much smaller than had initially been feared, in large part due to the associated policy response and in particular the CJRS. Until the end of last year there was, however, still considerable uncertainty about how the labour market would respond when the furlough scheme ended. The Business Impact of Covid-19 Survey conducted prior to the closure of the scheme suggested around 1.1 million jobs were still being furloughed in the final ten days of the CJRS at the end of September.

   At our November 2021 MPC meeting, the committee judged that there was, therefore, value in waiting for additional information on near-term developments in the labour market, including official data relating to the period following the end of the CJRS, before deciding when a tightening in monetary policy might be warranted.

   As the UK economy emerges from the pandemic, one of the economic legacies is a tight domestic labour market. Looking ahead, a key judgement will be the extent to which inactivity – which has increased significantly since the start of the pandemic – falls back to more normal levels. We must also continue to monitor closely the hiring intentions of companies as and when the prospective hit on real incomes starts to feed through to activity.

3. Last year a key judgement was around whether the supply shocks we were experiencing, and so the rise in inflation, would prove to be "transitory". This has become something of a loaded term. To my mind there is no fixed unit of time that is transitory. The critical distinction is whether it is still pushing up on inflation at the time by which a monetary policy decision taken today would have material effect. For many one-off cost shocks, this therefore depends crucially on whether the effects begin to affect medium-term inflation expectations and so wage and price setting processes. Our judgement last year was that the shocks we were witnessing would be transitory, due to the fact that: (i) the contribution of annual base effects caused by very weak activity and prices during the initial stages of the pandemic in 2020, would not last beyond a year as a matter of arithmetic; (ii) demand was expected to shift back from goods to services as the economic effects of Covid waned; (iii) global supply chains were likely to repair themselves in time; and (iv) many commodity prices have demonstrated mean reverting tendencies over time.

   In the event, inflation has increased further, rather than fallen. Part of this can be explained by some of the effects of the pandemic being more persistent than expected. But primarily the further increases in inflation are the results of the series of further adverse supply shocks we have been hit by, including the Omicron variant and the Russian invasion of Ukraine. Of course the end result has been a more prolonged period of even higher inflation. And that is why the MPC has been focussed on the risks of second round effects, particularly against the backdrop of a tight domestic labour market.

4. We are currently witnessing a marked contrast between consumer and business sentiment. There have been signs from indicators of retail spending and consumer confidence that the squeeze on real disposable incomes is starting to weigh on the household sector. Business confidence has been more resilient. Hiring intentions and job vacancies remain strong, consistent with conversations I have had with businesses on my regional agency visits.

Companies generally expect to increase their selling prices strongly in the near term, following the sharp rises in their costs, with many reporting confidence that they will be able to rebuild at least some of their margins. A key question is whether some self-sustaining momentum in domestically generated inflation will remain, even as slack in the economy is expected to open up. The greater the delay between the real income squeeze leading to weakness in aggregate demand and to a turn-around in the labour market, the more risk there is that higher inflation expectations will become embedded in the economy.

External engagement

I have been delighted this year to be able to resume in person regional visits with businesses across the country. Over the past year I have undertaken 11 regional visits – 4 virtually and 7 in person. By the end of 2022 I am scheduled to have visited each region in person. These regional visits provide invaluable insights into the issues facing businesses across the United Kingdom, and have been particularly valuable in helping to assess the impacts of fast moving issues such as the impact of the Omicron variant and the invasion of Ukraine.

I have also participated in broader engagement through hosting Youth and Community Forums.

At the Community Forum I met with representatives from 9 charities based in the South West. The discussion mainly focused on the impact of the increase in the cost of living on the people served by each of the charities and also the longer term future of the charity sector and funding. These forums help the Bank learn about the economic concerns facing those lesser-heard or seldom represented groups.

The Youth Forum's purpose is to provide a new mechanism for the Bank to engage with young adults, who we have traditionally struggled to reach through other forums. I spoke to our members virtually on 20 January, as part of the group's induction programme. I talked about some of the topics the Bank was currently working on, and answered questions from the group. This

engagement has helped us to better understand the channels through which the pandemic continues to affect younger people, and the effects this may have on the wider economy.

I have set out below my speeches, regional visits (both in person and virtually) and attendance at Community and Youth Forums (both in person and virtually).

Speeches on Monetary Policy

"It's a recovery, but not as we know it" given at Mansion House, 1 July 2021
It's a recovery, but not as we know it - speech by Andrew Bailey | Bank of England

"The hard yards" given at the Society of Professional Economists Annual Dinner, 27 September 2021
The hard yards - speech by Andrew Bailey | Bank of England

Regional Visits

Greater London – 25 May (virtual)

North East – 2 July (virtual)

West Midlands – 14 July (virtual)

Yorkshire & Humber – 6 October

Wales – 8 & 10 November (virtual)

South East & East Anglia – 26 November

South West – 15 February

Greater London – 1, 21 & 23 March

Northern Ireland – 1 April

Yorkshire & Humber – 8 April

South East & East Anglia – 17 May

Youth/Community Forums

Youth Forum – 20 January (virtual)

Community Forum – 15 February