Michael Saunders Annual Report to TSC

This Report was submitted to the TSC on 9 May 2022 and does not take account of any developments since then.

Economy and Voting Record

The economy is being affected by a series of major shocks (Brexit, pandemic and energy prices), as well as longer term effects from population ageing. Each of these in isolation would represent a major shock. Their combined effects have been to reduce the economy's potential output and worsen the relation between economic growth and inflation.

A year ago, at the time of my previous report to the TSC, the economy was emerging from the second major lockdown.[1] In early 2021, GDP was well below its pre-pandemic level, unemployment was around 5% (well above its pre-pandemic level) and CPI inflation (averaged over the first four months of 2021) was below 1% YoY, well below the 2% target. The MPC had loosened monetary policy significantly during 2020.[2]

As restrictions eased, the economy recovered markedly. GDP in Q1 this year was a little above the Q4-19 level, just before the pandemic. Unemployment has returned to its pre-pandemic level, just below 4%, and has not been lower since the mid-1970s. Less welcome, inflation has risen sharply, with headline CPI inflation at 7.0% YoY on the March figures, and core at 5.7% (the latest data when this report was completed).

As last year, the ongoing inflation pickup partly reflects higher energy prices, including effects linked to Russia's invasion of Ukraine. The direct effect of energy prices on the CPI is likely to rise further during this year. Part of the inflation pickup reflects buoyant consumer goods prices, resulting from the global imbalance between strong demand for consumer goods and constrained supply. But the rise in inflation has become more broad-based, and partly reflects domestic cost and capacity pressures, because the recovery in activity has exceeded the economy's potential supply. Capacity use in firms is well above average. The labour market is very tight – and has continued to tighten in recent months -- with elevated readings for firms' recruitment difficulties and a high level of vacancies. The pickup in core services inflation – which is relatively less affected by global factors – highlights the role of domestic factors.

It may seem surprising that domestic cost and capacity pressures have escalated so much, and the labour market is so tight, given that real GDP is only slightly above the Q4-19 level. If potential GDP had grown in line with its pre-pandemic pace (around 1½% YoY) since Q4-19, then one would expect the economy to still have some slack.

However, since Q4-19, the economy's potential output has fallen well below its previous trend.

The workforce has shrunk by 440,000 people (1.3%) since Q4-19, and is 2.5% below the January 2020 forecast (and more than 3% below its pre-pandemic trend). The scale and persistence of this

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[1] See Saunders (2021).

[2] During 2020, the MPC cut Bank Rate to 0.1%, implemented successive rounds of asset purchases – quantitative easing – that have totalled £450bn, and introduced the TFSME to provide banks with long-term low-cost loans and incentives to expand lending to small firms. In addition, the BoE Financial Policy Committee (FPC) reduced the amount of capital that banks have to hold against their loans by cutting the countercyclical capital buffer. Fiscal policy measures included, for example, the furlough scheme.

drop in labour supply has been a surprise to many forecasters, including us. The interplay between Brexit and the pandemic has reduced net inward migration (and hence population growth), while participation has fallen markedly (especially among people aged 50-64 years). Since Q4-19, the number of people aged 16-64 years that are outside the workforce and do not want a job has risen by 525,000 (1.3% of the 16-64 age population). This largely reflects increases in long-term sickness (roughly 320,000 people) and retirement (90,000), with smaller contributions from lower participation among students (65-70,000) and short-term sickness (30-35,000 people). The share of the 16-64 population who are outside the workforce and do not want a job because of long-term sickness is a record high, with an especially sharp rise among women. I suspect much of this rise in inactivity due to long-term sickness reflects side effects of the pandemic, for example Long Covid[3] and the rise in NHS waiting lists.

The economy's potential output may have been further reduced since Q4-19 by weakness in business investment and adverse effects from Brexit on productivity. Moreover, changes in the composition of labour supply and spending (in terms of sector, skills and geography) may have exacerbated mismatch between supply and demand in the labour market.

As pressures in both domestic capacity and pricing increased, I have voted for tighter monetary policy at each MPC meeting since the middle of last year. I voted to curtail the most recent asset purchase program (the one that was announced in November 2020) at the meetings of August, September and November 2021, and also voted to lift Bank Rate at each meeting from November last year onwards, including votes for a 50bp hike at the meetings in February and May this year.

The Economic Outlook

The central forecast in the May MPR is (as usual) conditioned on the market interest rate path, and assumes that wholesale energy prices follow the path implied by futures for the next six months and are stable thereafter. In that forecast, there is a further sizeable rise in the Ofgem price cap in October and hence CPI inflation rises slightly above 10% later this year. Weakness in real incomes hits spending and, with softer activity, firms reassess their staffing plans and cut back on hiring abruptly. As a result, unemployment starts to rise later this year. Supply constraints ease through reduced bottlenecks in global goods markets and some recovery in UK workforce participation. Even so, it is worth noting that in the MPR, the level of the workforce remains below the pre-pandemic peak (early 2020) throughout the next three years (ie to mid-2025). By contrast, the workforce grew by over 4% in the five years before the pandemic. The UK has not experienced a five-year period with no cumulative growth in labour supply since the early 1990s. In the MPR forecast, with further monetary policy tightening (reflecting the market curve used for the MPR), and a modest widening in credit spreads, demand slows and falls well short of the recovery in supply. Inflation is still slightly above the 2% target two years out, but falls a greater margin below the 2% target 3 years ahead. An alternative scenario in the May MPR, which assumes that wholesale energy prices follow the path

[3] Long Covid is also known as Post-Acute Sequelae of COVID-19, or PASC. ONS data suggest that 1.9% of the adult population (1.2 million people) report that their activity is limited "to an extent" or "a lot" by Long Covid, with higher figures (above 2½%) among people aged 35-69 years. The number who report their activity is limited ("a little" or "a lot") by Long Covid is up by 55% from six months ago. Common symptoms include fatigue, shortness of breath and difficulty concentrating – all factors that could impede the ability of some people to participate in the labour force. See, for example, APPG Coronavirus (2022), ONS (2022), PHOSP (2022), Thomas et al (2022), House of Commons Library (2021) and the House of Commons debate on "Long Covid: Impact on the Workforce" on Thursday 31 March 2022.

implied by futures markets for the full forecast period, shows inflation further below target 3 years ahead, but with a smaller amount of spare capacity than the central forecast.

There are many uncertainties around that forecast, reflecting uncertainties around the effects of the various shocks (Brexit, Covid, energy prices, demographics), interactions between them, as well as the (inevitably uncertain) responses of households businesses and financial markets.

There are some downside risks to activity and prices relative to that MPR forecast, especially from the possibility that worries over job losses and credit risks might lead to a sharper rise in household savings and/or bigger rise in credit spreads that could weigh further on demand. In this case, disinflationary pressures -- and the possibility of a medium-term undershoot of the 2% inflation target – could eventually prove even greater than the MPR forecast.

But, while recognising those downside risks, at present I put more weight on risks of a more persistent period of excess demand and above-target inflation than the MPR forecast.[4]

My hunch is that activity will be more resilient than the MPR forecast. For example, if consumers regard this year's squeeze on real incomes as a oneoff, they may be more likely to reduce their savings to a greater extent over the forecast period (supporting consumption), especially given the sharp rises in accumulated savings and household wealth in recent years.[5] At the same time, supply constraints may be more persistent, especially the drop in workforce participation, given the rise in longterm sickness and possible effects of Long Covid. Either or both of those shocks could shift labour market dynamics. Rather than a vicious circle in which weak consumer confidence drags down spending and triggers job losses, we may see a more benign circle whereby firms will be reluctant to shed workers even if growth slows -- partly because they have a sizeable backlog of unmet hiring needs at present and partly because they may worry they will find it difficult to find new staff in the future. In this case, continued low unemployment and strong labour demand would support household incomes and limit the weakness in spending. Moreover, continued above-target inflation this year and in 2023 may, unless accompanied by tighter monetary policy, lift inflation expectations further and leave a lasting imprint on inflation expectations in coming years. In this case, even if the output gap closes, firms' pricing strategies and pay growth would probably remain above target-consistent rates.

Such a scenario -- continued tight labour market, elevated or rising longer-term inflation expectations – would, unless offset by tighter monetary policy, probably threaten to cause a more persistent inflation overshoot than the MPR forecast.

The MPC's mandate is to return CPI inflation to the 2% target on a sustained basis in a way that supports output and jobs. Monetary policy cannot prevent the surge in energy prices from further lifting inflation near term and thereby reducing real wages and profits (for non-energy producing sectors). In line with our remit, the role of monetary policy is to ensure that inflation expectations

[4] See Saunders (2022).

[5] For example, In the latest Bank/NMG survey, 'saving less' and 'using existing savings' were the most popular answers to a question asking respondents what they would do in response to a hypothetical inflation shock. See section 3.3 of the May MPR. One factor that could encourage such a rundown of savings is that spreads on mortgage loans remain relatively low. Against that, the rise in household savings during the pandemic has chiefly accrued to upper income households, whereas the energy price shock will have its greatest impact on lower income households – who in general have not accumulated extra savings during the pandemic.

are well anchored, and that domestic cost and capacity pressures are consistent with a return of inflation to the 2% target over time as the effects of the energy price surge fade.

As domestic capacity strains have increased, the MPC has tightened policy over recent months. The Committee has increased Bank Rate in steps to 1% and embarked on a gradual rundown of the stock of purchased assets by ending reinvestment of maturing bonds held by the APF. With Bank Rate at 1%, the Committee agreed at its most recent meeting that Bank staff would work on a strategy for UK government bond sales, and the MPC will provide an update at its August meeting. In addition, at the most recent policy meeting, most MPC members (including myself) agreed that, based on the Committee's updated assessment of the economic outlook, some degree of further tightening in monetary policy may still be appropriate in the coming months.

As discussed, my view is that, conditioned on the same interest rate path as that used for the recent May MPR, risks would be tilted on the side of greater and more persistent domestic capacity and inflation pressures than the MPR forecast.

But I also want to emphasise the need to consider the potential costs if the economy does not develop as expected.[6] In broad terms, the MPC faces two alternative risks. One is that monetary tightening which is sufficient to lean against nearterm inflationary pressures may exacerbate the prospective squeeze on activity and leave inflation well below target further ahead. The other is that if monetary policy does not adequately lean against inflation pressures, then we may see a prolonged period of above-target inflation that causes longer term inflation expectations to become further detached from the 2% inflation target. That could ultimately require a sharper adjustment in monetary policy and the economy to return inflation to target, leading to an even worse outcome for real incomes and living standards.

In my view, we should lean strongly against the latter risk (inflation expectations), because if it materialises (not a negligible risk, in my view) then the process of re-anchoring price expectations could be very costly in economic terms. That scenario also could limit the scope for prompt monetary easing the next time the economy needs support. The MPC's ability to use monetary policy to provide effective support to the economy in 2020 rested on the credibility of the UK's inflation targeting framework. That credibility is not infinite and cannot be taken for granted. Conversely, if we hike promptly near term and then find the economy develops in such a way that medium-term inflation risks tilt heavily to the downside, then the Committee could reassess the policy outlook accordingly. Such a scenario is not my central expectation. But if it did materialise, I suspect we would be in a better position than now in terms of inflation expectations.

Against this backdrop, my preference in recent months has been to move relatively quickly towards a more neutral stance in order to prevent the recent trend of higher inflation expectations and rising pay growth from becoming more firmly embedded.[7] That preference for faster tightening early on does not necessarily imply that I believe the terminal rate (ie the level of rates at the end of a tightening cycle) will be above the yield curve used for the May MPR. Indeed, to the extent that

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[6] See Pill (2022) and Mann (2022).

[7] Estimates of the neutral rate are inherently uncertain and the neutral rate may change over time. In late-2019, just before the pandemic, monetary policy remained accommodative, with Bank Rate at 0.75%, to support growth against headwinds from Brexit uncertainties. At present, financial markets imply that Bank Rate will be in a range of roughly 1 ¼%-2 ½% in the next few years, and financial market breakevens do not imply this path would leave CPI inflation below the 2% target.

quicker tightening early on could help ensure that the nexus of inflation expectations, pay growth and firms' pricing strategies return to being consistent with the 2% inflation target, this might help limit the overall tightening cycle (relative to what would otherwise be the case).

Explaining Monetary Policy

I have had a range of meetings with businesses around the UK to hear first-hand about economic conditions. I have also done four major speeches, covering the outlook for the UK economy and monetary policy.

The inflation outlook, July 2021

The outlook for inflation and monetary policy, December 2021

The UK economic outlook and monetary policy, March 2022

The Route Back to 2% Inflation, May 2022

This will be my last Annual Report to the Treasury Select Committee, given that my term as an external member of the MPC ends in August this year. I would like to take this opportunity to thank the TSC members and staff for their role in the accountability of the MPC to Parliament, which is an important element in the UK's monetary policy framework.

References

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