Bank of England

Megan Greene – Q&A follow up to her speech: Who's buying? The outlook for consumption in a rate cutting cycle

Given at The North East Chambers of Commerce, Newcastle on 25 September 2024.

Chair: Earlier when you spoke about the weakness in consumption on the aggregate, is there any evidence to suggest that certain households spending has been more or less responsive to the shocks that we've seen?

MG: So we've disaggregated the data to try to look at how, lower income households are responding to higher monetary policy and the outlook versus higher income households.

And what we found is that, unsurprisingly, wealthier households make up the brunt of spending in the economy and in pure levels terms, but actually their consumption has fallen the most because they had the most to spend on discretionary items during the pandemic, and everyone pulled back on buying discretionary items.

what we've also seen at the same time is that lower income households have the highest marginal propensity to consume, so they're spending most of their incomes.

And because of the cost of living crisis, they were hit the hardest because so much had to go to food and energy, which you can't really pull back.

So we've seen that play out in the data as well.

Lower income households tend to be net borrowers.

And so they've had a negative income shock from higher rates.

And as I mentioned earlier, people tend to respond much more to a negative income shock than a positive one.

And so that's partly why we've seen consumption, remain so incredibly weak.

Higher income households, on the other hand, had a positive income shock.

But they haven't responded with much higher spending.

In fact, their spending has fallen the most.

And so this kind of provides a two way risk, to our views on consumption, because it's possible that as bank rate comes down, lower income households will start spending more.

But as I said, you know, households tend to respond less to a positive income shock structure at the same time.

Spending among wealthier households is significantly down still, even from pre-pandemic levels.

So there's an upside risk if they decide to spend more.

There is a big unknown, though, and that is whether people have been scarred by these two huge shocks that we've had, and whether their spending is actually fundamentally just different now.

And we can't possibly know that just yet, whether it's just taking us a while to get back to old spending patterns or whether this represents a structural shift.

So you can learn a lot by looking under the hood at the disaggregated data.

But the risks aren't exactly clear because they seem to be two way for our consumption and our outlook.

Chair: It is interesting that split between the lower income and higher income and the top areas you pointed out in the slides, you see that differential. It was it was quite stark, I think. You've mentioned as well about the persistent change in the spending patterns with people continuing to spend more on the discretionary services than they did prior to the pandemic. Do you expect this to continue? What does it imply for services inflation?

MG: So it is again difficult to know whether we're just very slowly going back to the spending patterns that we had before or whether this is a structural break.

There is some indication that, that's what we're seeing now is, is a bit more normal than what we had been seeing. So if you look at spending on discretionary services, the revenge travel is a thing!

And so you are seeing that's it's not surprising that it was strong after we were all let out from lockdowns.

What's surprising is that it's remained so strong.

But if you look at trends, it's actually back to the pre-pandemic trend.

So discretionary spending on services is roughly where you might expect it to be had we not had a pandemic.

Chair: So that suggests that is sort of just going back to normal?

MG: That's right. And then what we're seeing as I mentioned is big ticket items.

It's something people have really pulled back on.

More recently, there's been a little bit of movement on that, and so that might be a nascent recovery there.

But it's too early really to tell.

Chair: The area I thought was another interesting area was the differential in Covid assistance between the UK and the US and the difference in the government approaches at the time. Do you think that suggests that without that intervention, the governments intervening in two different ways, that it would have been even between the two countries, the US and UK?

MG: So I don't think it would have been even.

But part of the reason is, as I mentioned, the responses to the pandemic were so different and there needs to be more research done on this.

But it does seem that people tend to respond to a windfall.

So to getting a check in the mail differently than they respond to continuing to receive their wages even if they're not working the same for it

So they tend to go ahead and spend that check much more than the wages, which they tend to go ahead and save in the midst of a pandemic.

So I do think that's part of it.

Part of it's also the scale of the response.

So the US response as a percentage of GDP was just much bigger than the UK.

And so as a result, you know, I showed that chart showing that Americans are saving now.

But they had a lot more savings at the beginning to spend down and go ahead and save.

So I think that partly accounts for the increase in consumption, that we've seen in the US, but not really in the UK since pre-pandemic levels.

And then finally, it's worth highlighting that the energy mix in the US and the UK is pretty significant.

So the US didn't really have the terms of trade shock that the UK suffered.

It did a bit with food prices, but it's the US is a net energy exporter.

And so the spike in energy costs just wasn't nearly as high in the US as it was in the UK.

So I think that the UK's response to that huge terms of trade shock has been more significant or you didn't quite have it kind of levelled out, which you saw on the charts, of course.

Chair: So the services inflation specifically, it's been lower than forecast for two months in a row now. Do you think that domestic inflationary pressures are, abating faster?

MG: So it's great news that services inflation has come in below where we expected it to be for two months.

But if you, go under the hood and kick the tires a little bit, quite a lot of that was in really volatile components.

So accommodation and airfares were big contributors to that.

Particularly two months ago.

So, I don't think we can get out the ticker tape yet.

I also mentioned catering has done quite a lot of heavy lifting for bringing services inflation down.

I guess you notice if you go buy a coffee that costs never actually really goes down or abates.

So those prices tend to be sticky and they tend to be driven in part by the input costs.

So food prices, which you know, jumped significantly during the cost of living crisis, now are coming down.

And so that doesn't really reflect what's going on in the UK domestic economy.

It's more a factor of global food markets.

So that's a concern for me.

Also we have various different series of services, inflation that strip out different things.

And so I mentioned that if you strip out really volatile components, if you strip out indexed components, rents which have been, stubbornly high and sticky. And also holidays related things. Then actually what you see is underlying services inflation that has kind of been stuck between 4 and 5%, for the past year.

So it's certainly moving in the right direction.

But I wouldn't get too excited about services inflation coming in below our target or our expectations for two months.

Just because there are some hints that it's still pretty sticky and we're not surprised that it's sticky.

The biggest component of services inflation is labor, as some people here have mentioned.

So as wages come down, hopefully inflation will come down.

And there are some indications to expect that wages will continue to come down.

Chair: And on that, are you still concerned about the wage and price passthrough?

MG: I am, just because I think this is such a delicate balance that we have in our thinking about the economy between consumption sort of driving the recovery of a fairly weak recovery, but still consumption really picking up and firms not having the kind of pricing power that they've had before.

So, you know, again, wages should continue - Wage growth should continue - to come down. And so that should feed through into some of the pricing.

But if consumption really does recover more than we're expecting, firms might feel like they have higher pricing power.

We could get sort of a resurgence of price increases. And that that would certainly be a negative.

Chair: The MPC has stressed the importance of a gradual approach, which you mentioned. But what does gradual look like to you?

MG: It's a great question.

For me, you know, I think it's worth taking a gradual approach so that because we do have these three cases of the world, as I said, I think there is a probability greater than zero for each of them.

So there's quite a lot of uncertainty about what is really driving some of these domestic inflationary pressures.

And so I think it's worth taking a gradual approach so that we can continue to gather evidence as, as we're, in a rate cutting cycle, we can continue to gather evidence, to, to try to filter, to change the probabilities of risks that we're placing on each of these cases.

So, for me personally, I'm not going to pre-commit to any kind of path, but I think it's quite important that we're gradual so that we can better gauge which case.

Chair: And big question at the end. Where do you think the bank rate will settle?

MG: So it's a related question, right. Because you've got where we are with the path is where we're going to end up. And so I think this is an important question to figure out what the path might be.

My first speech was on the long run, neutral rate, which is R*, which is the long run rate at which we're at full unemployment and inflation is at our target.

So that's equilibrium. And I think there are a number of reasons to consider that this long run neutral rate may have ticked up.

There are a bunch of factors, you know, a whittling down of the savings glut globally that we have an increased public debt in the UK everywhere else as well.

But I think there are a number of these factors that suggest that this so-called R* might have gone up. And if that's the case, then actually rates - the kind of steady state end point where rates end up- will probably be a little bit higher as well.

It's impossible really to put a point forecast on that.

So, you know, trying to estimate it comes with massive bands of uncertainty.

And I think the concept of R* is a little bit more useful in theory than it is in practice.

So we can't estimate this and then aim for that.

But I do think we can sort of determine a direction.

I think over the past couple of years, it's possible that there's good reason to believe that it may have drifted a bit higher, which simply means that, for me at least, rates probably aren't going back to where they were before the pandemic.

They may have been exceptionally low then anyway.