MONETARY POLICY REPORT PRESS CONFERENCE

Thursday 3 August 2023

Opening Remarks by Andrew Bailey, Governor

Today's monetary policy decision

Consumer price inflation fell further to 7.9% in June. That is what we expected to see. It is good news. And inflation will continue to fall over the coming months.

Monetary policy is restrictive. It is working to bring inflation down.

Our job is to make absolutely sure that inflation falls all the way back to the 2% target and stays low.

So today we have increased Bank Rate by 0.25 percentage points, to 5.25%.

Low and stable inflation is the foundation of a healthy economy. High inflation hurts the least well off the most.

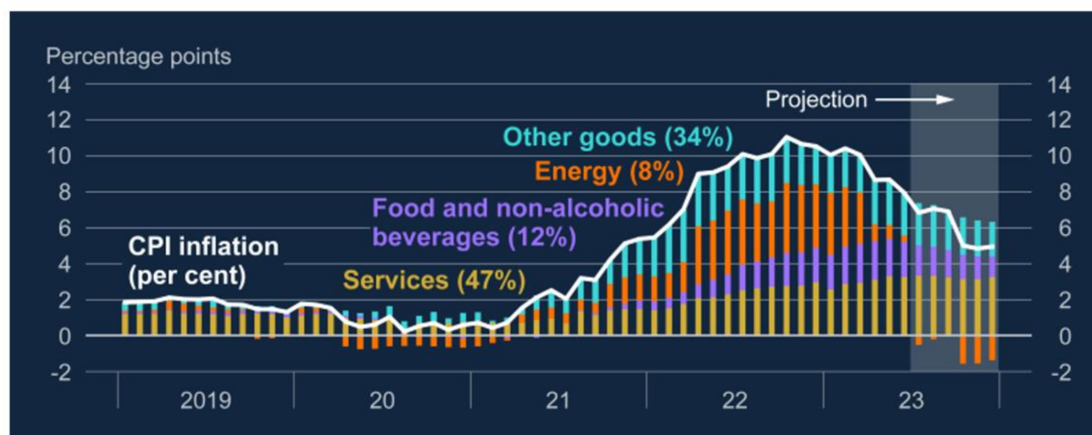
The projection we present today is very much in two parts. I will begin with the first part – the near-term outlook for inflation over the remainder of this year – before turning to the second – the medium-term outlook and the implications for monetary policy.

The near-term outlook for inflation

Chart 1 shows the evolution of consumer price inflation – and its components – since 2018. It shows how inflation has come off its October peak. It continues to fall over the rest of this year in our near-term projection, shown in the shaded area.

Chart 1: Consumer price inflation has fallen and is projected to fall further

Contributions to consumer price inflation



Source: Bloomberg Finance L.P., Department for Energy Security and Net Zero, ONS and Bank calculation

This fall can be attributed in large part to a falling contribution from energy. Fuel prices have declined, and electricity and gas prices have stabilised, albeit at a higher level. The dark orange bars show how the contribution from energy prices is falling and turning negative in the coming months.

Given Ofgem's price cap on electricity and gas bills – and the way it slows down the passthrough of wholesale energy prices to consumer bills – we expect inflation to take a further step down in July's data published in two weeks' time, to around 7%, followed by another larger step down in October's data, to around 5%.

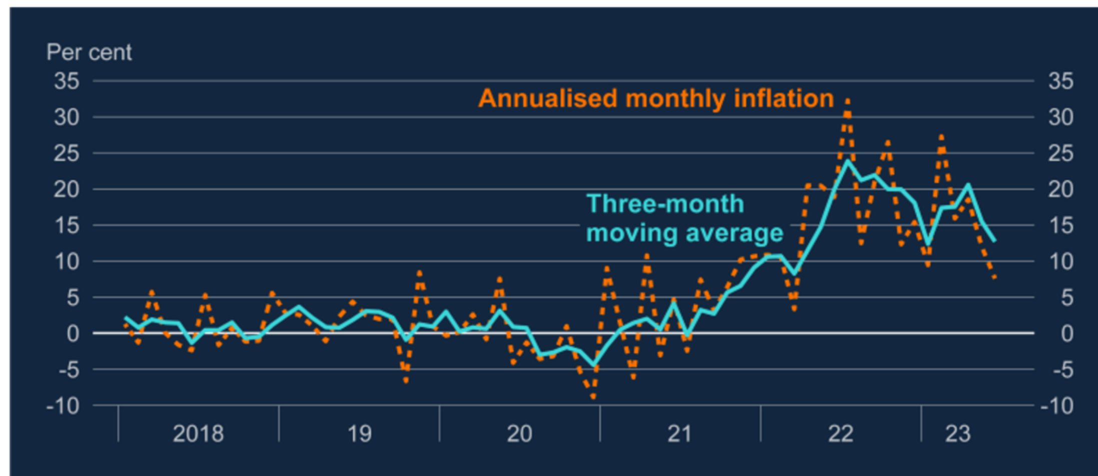
This more gradual passthrough also substantially helps to explain the difference between current headline inflation in the United Kingdom and the euro area, where wholesale energy prices feed more directly through to consumer prices.

Where there is more uncertainty is around the time it will take the other non-energy components of the consumer price inflation to come down as well.

Price inflation for food and non-alcoholic beverages has been very high. But it does appear to have peaked, and as you can see in Chart 2, there are signs in the monthly figures that it has started to ease. Evidence collected by the Bank's regional Agents suggests that a moderation in food input prices is being passed through the supply chain to consumer prices. So we expect food price inflation to come down gradually over the rest of the year.

Chart 2: Food inflation remains high but has started to slow slightly

Annualised monthly food and non-alcoholic beverages inflation



The contribution from food price inflation falls accordingly in our near-term projection, from about 2 percentage points today to about 1¼ percentage points towards the end of the year.

Similarly, core goods price inflation continues to be broad-based. It is taking time for the fall in energy prices to work through the supply chain, and the prices of imported goods have continued to rise despite a fall in world export prices. That is why, in our central projection, we expect core goods price inflation to come down only gradually.

But let me be clear, we do expect goods price inflation to ease over the rest of the year, and there are indicators that suggest it could happen faster than in our projection.

As you can see in Chart 3, output producer price inflation, which measures the change in the price of goods sold by UK manufacturers, has been slowing significantly since its peak in mid-2022, as indicated by the orange line. That should help to reduce non-energy consumer goods price inflation, shown here in blue, as cost pressures ease in the supply chain. As the Chart shows, that has been the case when producer price inflation have fallen in the past.

Chart 3: Producer price inflation suggests cost pressure for goods are easing

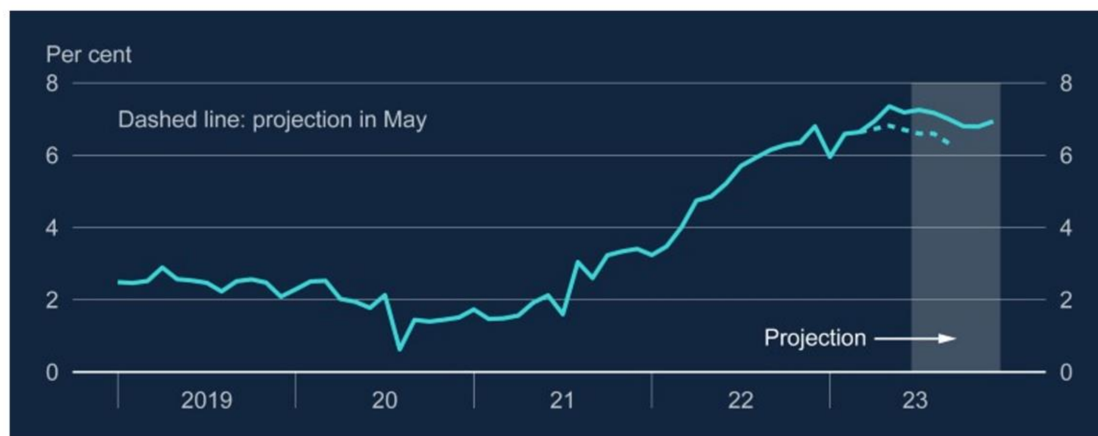
Annual output producer price and consumer goods excluding energy inflation

Source: ONS and Bank calculations

The final component of inflation is services prices, which is now contributing more to inflation than energy or goods. Here, there has been unwelcome news since May. As you can see in Chart 4, service price inflation was 7.2% in June, higher than we projected in May, and it remains high in our near-term projection for the rest of the year.

Chart 4: Services price inflation is projected to remain high

Twelve-month services price inflation



Source: ONS and Bank calculations

The upside surprise was primarily driven by some of the more volatile sub-components of services price inflation, such as airfares and package holidays – and also Vehicle Excise Duty, which is unrelated to the balance of demand and supply in the economy. We should not read too much into this surprise for this reason.

Nevertheless, since other sub-components of services price inflation are closely linked to underlying cost pressures in the UK economy, continued strength in services price inflation may suggest that high inflation could persist for longer.

The medium-term outlook for inflation

So let me turn to the second part of the story – the medium-term outlook.

Over the medium term, of course, monetary policy has to ensure that inflation returns to target in a timely manner. That is why the Monetary Policy Committee is watching services price inflation very carefully, along with other indicators of inflation persistence.

Economic activity has shown some unexpected resilience over recent quarters. But the increases in Bank Rate we have implemented weigh to an increasing degree on UK economic activity. There is evidence that monetary policy is restrictive.

As we look into 2024, GDP growth is projected to be weaker than expected in the May Monetary Policy Report. And the balance of demand and supply is shifting in our projection. An increasing degree of economic slack is emerging after the middle of next year.

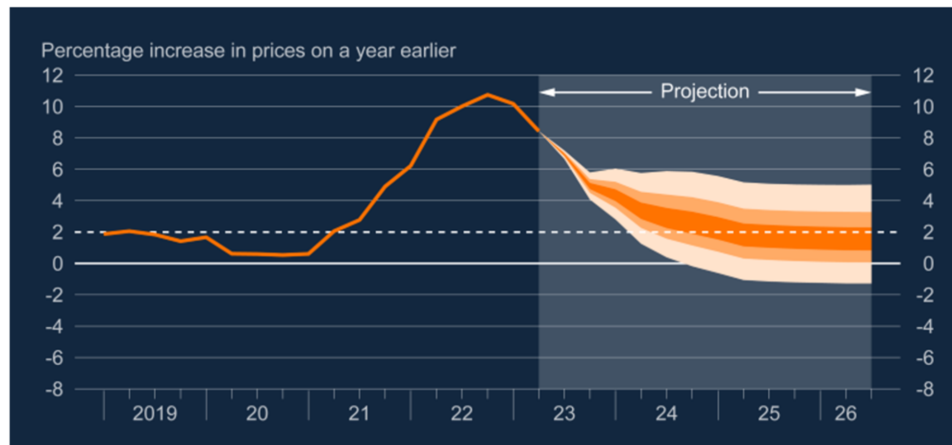
This will help to reduce inflationary pressures in the UK economy.

As the Chart 5 illustrates, in the MPC's projection for consumer price inflation, which is conditional on the market path for interest rates, inflation is more likely to end the forecast period below the 2% target than above it, if only slightly. In the modal – or 'most likely' – case, inflation is 1.7% in two years' time and 1.5% in the third quarter of 2026. The Committee continues to judge, however, that risks around that central case are skewed towards higher inflation. Adjusting the modal projection for the balance of risks, the mean – or 'expected' – path for inflation is close to, albeit just below, the 2% towards the end of the forecast period.

The projection for inflation is broadly similar on the alternative assumption of a constant level of Bank Rate at 5.25% throughout the forecast period, as discussed in the Monetary Policy Report. This illustrates that different paths for Bank Rate can secure a return of inflation to target. The market curve is higher than the current level of Bank Rate in the coming quarters but then falls below it further out, averaging just under 5½% over the next three years.

Chart 5: CPI inflation projection

Based on market interest rate expectations



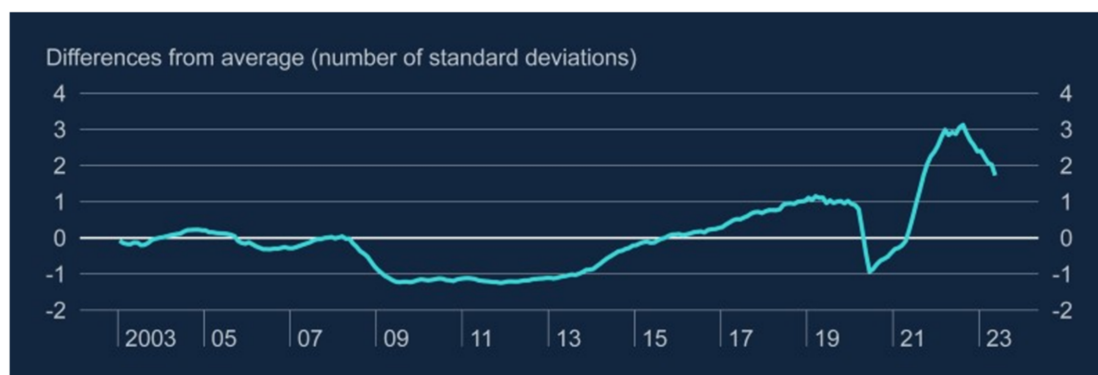
Source: ONS and Bank calculations

A lot will depend on what happens in the labour market, and to pay.

There are signs that the labour market is loosening. The unemployment rate rose slightly to 4.0% in the three months to May, and the ratio of vacancies to the number of unemployed job seekers – the so-called v/u ratio, an important measure of labour market tightness – has continued to ease, as shown in Chart 6. But the labour market remains strong. The v/u ratio is still significantly higher than before the pandemic.

Chart 6: The labour market remains tight although it has loosened

Vacancy to unemployment ratio



Source: ONS and Bank calculations

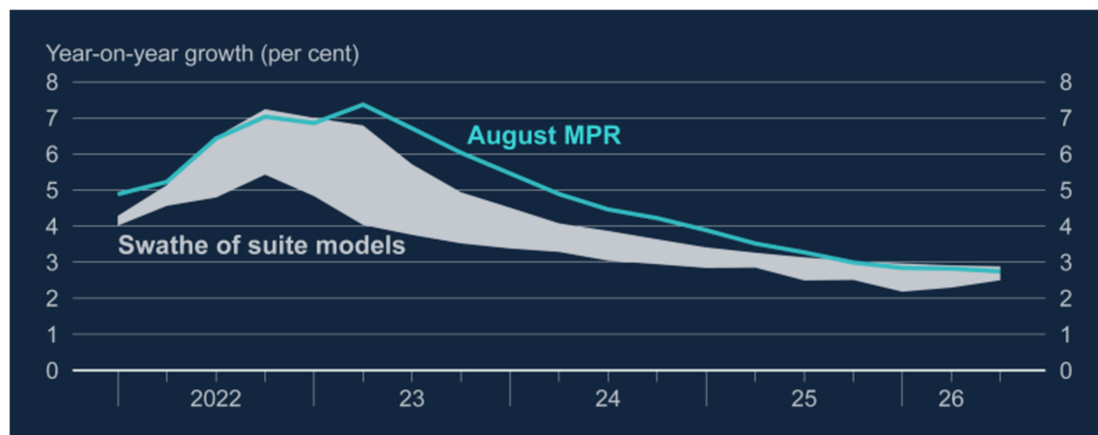
Annual private sector regular pay growth increased further, to 7.7% in the three months to May. This is materially above expectations in May's Monetary Policy

Report, and it is notably stronger than standard models of wage growth based on productivity, short-term inflation expectations and tightness in the labour market would have predicted.

Chart 7 shows a swathe illustrating the range of forecasts from a suite of such wage models maintained by Bank staff, along with the MPC's projection for private-sector regular wage growth. In the MPC's projection, which reflects the MPC's best collective judgment, wage growth is expected to ease more slowly than these models would predict.

Chart 7: Wage growth is expected to ease more slowly than in empirical models

Projection for private-sector regular pay growth



Source: ONS and Bank calculations

In a nutshell, the empirical models illustrate what might happen if wage setting will be based on inflation expectations that take account of the downward path of inflation over the near term. But we do not have enough evidence at present to be sure that wages will be set in this way.

In the MPC's judgement, upside surprises on wage inflation suggest that it will take longer for second-round effects to go away than it did for them to appear in response to the sharp rises in the prices of many imported goods over 2021-22. Interacting with a tight labour market, that is expected to have resulted in greater persistence in wage inflation, and with it in the cost pressures that determine price setting in the UK economy.

This difference between empirical model outputs and the Committee's best collective judgement – which is very clear in the Chart I just showed you – is one illustration of the importance of reflecting on how our processes should adapt in a world in which we increasingly face significant uncertainty.

I am delighted that Ben Bernanke has agreed to lead a review into the Bank's forecasting and related processes. Dr Bernanke is a renowned and award-winning

economist whose distinguished career makes him the ideal person to lead this review.

The policy decision

I will conclude with today's policy decision.

The news to wages and its implications for inflation persistence should be seen within the context of the overall data news since June.

As we approached the June meeting, data outturns were strong across indicators of inflation persistence, including service price inflation and employment as well as wages. The MPC responded to this evidence of more persistent inflation pressure by increasing Bank Rate by 0.5 percentage points at the June meeting.

Since then, while pay growth has come in stronger than expected, other data news has been more mixed in terms of its implications for the persistence of inflationary pressures and thus the outlook for inflation over the medium term. That is why the MPC has voted to increase Bank Rate by 0.25 percentage points today.

Given the significant increase in Bank Rate since the start of this tightening cycle, the stance of monetary policy is restrictive. The evidence is now clear that it is having an impact.

To return inflation to target, policy needs to continue to be restrictive. Today we have taken a decision consistent with that, which will help to return inflation to target.

I am not going to judge what the path of rates will be, not least because – as our Report indicates – more than one path may deliver inflation back to target sustainably. We will judge what is the most appropriate based on the evidence.

The MPC will continue to monitor closely indications of persistent inflationary pressures and resilience in the economy as a whole, including the tightness of labour market conditions and the behaviour of wage growth and services price inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.

The MPC will ensure that Bank Rate is sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term, in line with its remit.

With that, Ben, Dave and I will be happy to take your questions.