Money's Too Tight (To Mention)[1] – Swati Dhingra

Given at Market News International Connect event

21 February 2024

[1] Based on the words of John and William Valentine and the track by **Simply Red** in May 1985.

Speech

Introduction

At the February meeting of the MPC, I voted to cut Bank Rate by 25bps. In this note, I discuss the reasoning behind my vote to start normalising Bank Rate. I first note that monetary policy needs to be forward-looking because moderation of the policy stance requires time to implement and to feed through to the real economy.

I then discuss trends and developments in the economy that suggest the outlook for headline inflation is bumpy but downwards. Consumer price inflation is on a firm downward path, and has been for some time now. Producer price inflation, which tends to lead consumer price inflation, suggests there is more to come, including in non-energy services.

I finally argue there are downside risks to living standards from keeping policy tight. Despite an easing in inflation and some real wage recovery, consumption remains below its pre-pandemic level. This is in striking contrast to the Euro area and the United States where consumption bounced back some time ago.

The evidence to err on the side of overtightening is not compelling in my view as it often comes with hard landings and scarring of supply capacity that would weigh further on living standards.

Looking Ahead

In the MPC's remit, the inflation target is forward-looking to ensure inflation expectations are firmly anchored in the medium term. This is because there are lags in the transmission of Bank Rate to consumer prices, with typical estimates of about 18 to 24 months from when rates are changed to when their peak impacts are felt on inflation (**Pill 2022**). Consequently, the MPC has typically looked ahead and acted early, while learning along the way from observations in the rear view mirror of economic data (**Bean 2007**, **Broadbent 2023, Broadbent 2023**).

This becomes more difficult following a sequence of large shocks, and amidst considerable data uncertainty. The ability to promptly and accurately assess the impacts of shocks and their subsequent transmission to prices is diminished. Consequently, determining the appropriate path for policy to meet the inflation target over a subsequent two to three year horizon becomes inherently more difficult.

After the large shocks associated with the pandemic and the energy crisis, these challenges have intensified to levels unprecedented in the history of the MPC. Policy has therefore needed to rely more than in the past on certain indicators of inflationary pressure to come to an assessment of the appropriate path for Bank Rate (**Broadbent 2023**). Such indicators are by their nature a bit more lagging and more affected towards the end of the transmission chain from Bank Rate to the real economy.

Late-cycle indicators, including wage growth and relatedly services price inflation (which contains a higher share of labour in costs than goods), are useful for understanding the evolution of domestic inflationary pressures. They provide information on the direct impacts of external shocks, such as energy price increases in the recent episode, on labour markets. They also provide critical insights into second-round effects on inflation that arise when wages rise in response to the original shock and lead to further demand and cost pressures. It is these second-round effects that monetary policy acts early to mitigate, to prevent inflation from persisting after the shocks have dissipated. By the time these late-cycle indicators are affected by monetary policy or have run their course of adjustment and begin to revert to their pre-shock levels, monetary policy is playing catch up with price developments in output markets. Monitoring late-cycle indicators therefore naturally bakes in a risk of overtightening policy.

The current tightening cycle entails the sharpest rise in Bank Rate in the MPC's history. With the rate of change of increments applied on the way up, it took 14 meetings from December 2021 to August 2023 to get to the current level of Bank Rate. Moderating this sharp tightening and having its effects feed through to the real economy will take time and Bank Rate will continue to remain restrictive for a period following the onset of policy normalisation.

Price Developments

Consumer price inflation is already, and has been for some time, on a firm downward trajectory. Twelve-month CPI inflation remains above the MPC's 2% target but declined from a peak of over 10% in early 2023 to 4% in December 2023. The downside news has been broad-based, reflecting lower fuel, core goods and services price inflation (**February 2024 MPR**). The path of inflation is unlikely to be smooth, but it looks to be clearly downwards and in line with disinflation in other advanced economies owing to some of the common global shocks that have occurred.

This represents a notable departure from circumstances in June 2023. Many economic commentators then labelled the UK as a global outlier on inflation. Despite a decrease from over 10%, the May headline inflation figure of 8.7% showed no progress since the previous month, when Ofgem energy prices had been reduced. Additionally, average weekly earnings growth came in half a percentage point higher than expected at the time of the May Report, with average regular pay growth for the private sector at 7.6% in February to April 2023.

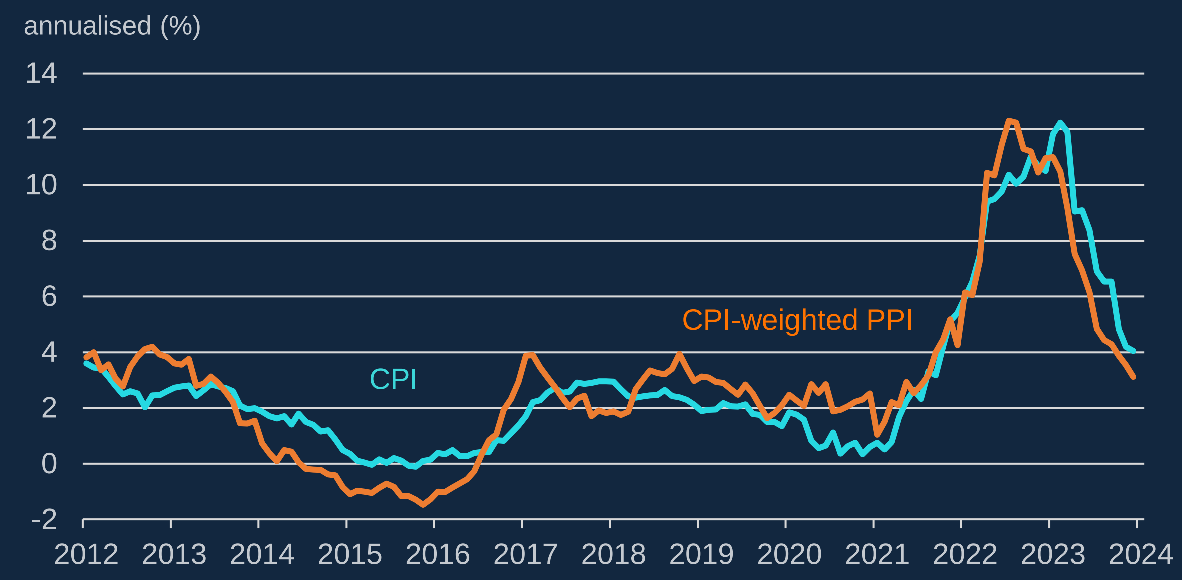
Yet amidst these inflation surprises, there were sharp falls that had occurred in both input and output producer price inflation (PPI). The annual rate of change in input PPIs had fallen from a peak of over 20% in mid-2022 to 0.5% in May 2023. Output PPI inflation had followed the drop in input PPI inflation, falling from a peak of about 20% in mid-2022 to 2.9% in May 2023. Their monthly changes had gone into negative territory, and it raised key questions of how these might be consistent with the positive inflation surprises and how they might feed through to consumer price growth.

Developments in producer price inflation provide a key indicator for gauging future inflationary pressures. Producer and consumer price inflation have mostly co-moved tightly over the past 70 years. And, when sizable external shocks have occurred, they continue to co-move but with disparities in their rates of change and timing. These disparities are evident across three episodes of large shocks: the early to mid-1970s (marked by the occurrence of major oil price shocks); the global financial crisis (when shocks to many commodity prices occurred); and the current period, marked by large fluctuations in energy and other commodity prices due to the combined effects of the pandemic and ongoing conflicts. In each of these periods, increases in consumer price inflation lag increases in producer price inflation. The same occurs on the way down too. And these patterns are also evident in other advanced economies such as the US, although possibly with shorter lags in the recent episode. I expected that this must surely have implications for where we were then, and where we were going to go next (**Dhingra 2023**).

Looking ahead, there was reason to expect that the sharp drops in producer price inflation would be reflected in lower consumer price inflation as they did in previous inflationary episodes. And given the increased importance of supply chains today, there was sound economic logic in producer price disinflation feeding through to reduced consumer price inflation. But it was hard to be precise about the lags because of greater fragmentation of production along supply chains since the early inflationary episodes. With consumer price inflation at such elevated levels, there was a need for caution in extrapolating from past economic relationships. As more data has come in, it has become apparent that over the course of this high inflation episode, changes in consumer price inflation, both on the way up and down, have lagged changes in producer price inflation. Importantly, producer price inflation in services have also been falling and consumer price inflation in a service item has tended to lag producer price inflation in its corresponding service industry.

Since the December meeting, we have two more data points, including one for services producer prices for the last quarter of 2023, to examine the co-movement in producer and consumer price inflation. As a small open economy, the sectoral mix of the production and consumption sides of our economy are different. For example, while services dominate our production side, they make up less than half of our consumption basket. The ONS publishes detailed consumer and producer price indices for different goods and services, including the prices that are paid to import them from abroad. This lets us examine how producer prices of a particular consumption item are evolving. For several months now, almost every item in the consumption basket, including in services, has followed a drop in its PPI inflation. And, we can also examine whether headline consumer price inflation is tracking producer price inflation for the items that are in our consumption basket. This is done by weighting the PPI inflation of each individual item in the consumption basket with the consumption weights of the CPI basket to construct a “CPI-weighted PPI inflation”. Weighting the 105 goods (output) and services producer price indices with consumption weights shows that CPI inflation has lagged this composition-adjusted CPI-weighted PPI inflation by about 6 to 8 months and tightly followed it (Chart 1).

Chart 1: Composition-Adjusted Goods and Services PPI



Notes: Consumer Price Inflation month on month a year ago (blue) and Producer Price Inflation month on month a year ago (orange) for all items in the CPI basket and weighted by CPI weights for each month-year (**Dhingra, 2023**). Services PPI inflation statistics are quarterly and assigned the same value for each month within a quarter. January 2024 is not plotted because quarterly services PPIs are not available for Q1 2024.

Source: Office for National Statistics and Bank calculations.

Mean CPI-weighted PPI inflation has dropped sharply from 6.2% in the second quarter of 2023 to 4.3% in the third quarter and to 3.1% in the last quarter. This is reflected in the drop in CPI inflation which, due to its lagged catchup, has seen sharper drops more recently. The drops and their pace have been broad-based, with the median inflation rates across the 85 CPI items showing similar trends of easing over last year.

Focusing on service items in the consumption basket (that contain no goods in the item mix),[2] annual services CPI inflation and CPI-weighted services PPI inflation have also shown a downwards trajectory. Service items made up 47 percent of the CPI basket in

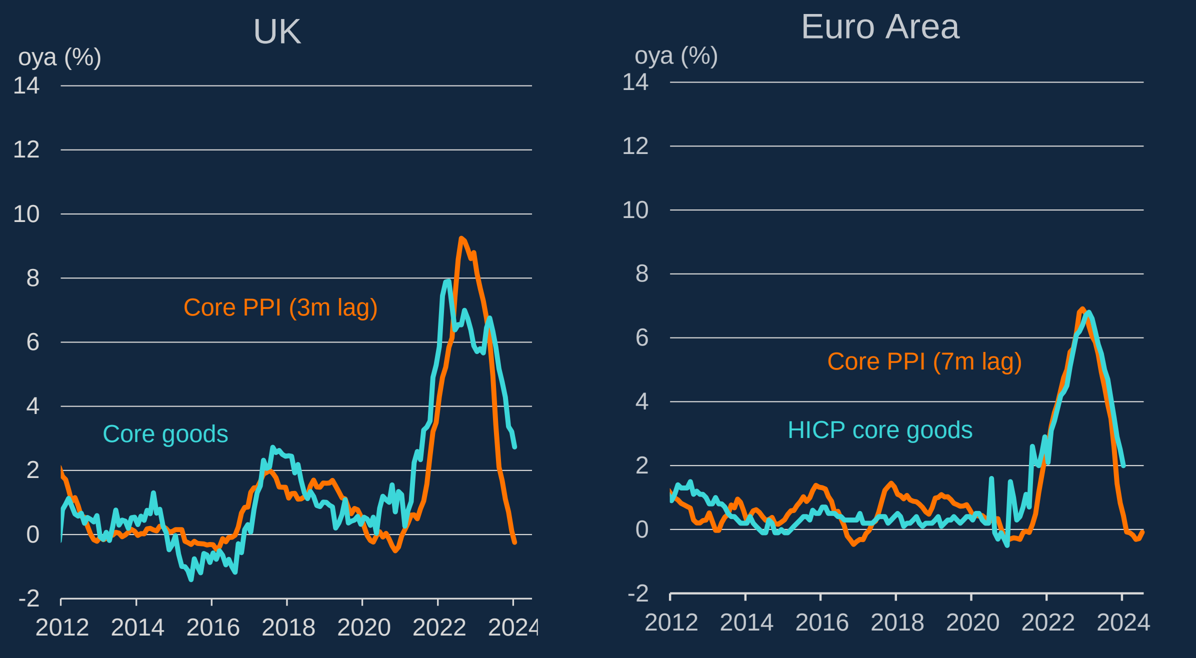
[2] COICOP items that map on to CPA sections A, B and C according to the ONS are excluded to arrive at service items that do not include goods.

2023. Their CPI-weighted services PPI inflation started higher than goods at 8.3% in the second quarter of 2023 and then fell back to 6.2% and finally to 4.3% in the last quarter. CPI services inflation has tightly followed this path and if the relationship is maintained, sharper drops would be expected over this year.

Services above include housing and household services, which crucially contain energy bills of households. Removing them, services still make up 35 percent of the CPI basket.[3] Even with housing and household services taken out, which crucially excludes base effects from energy, the broad patterns in services prices hold, though naturally with smaller but appreciable drops of 1.9% in their producer price inflation from the second quarter to the last quarter of 2023 and a corresponding fall of 1.6% in consumer price inflation. The Bank's Short-Term Inflation Forecast suggests that these shallower declines are expected to keep inflation from falling below target over the first half of this year.

Putting the price developments in international context also provides compelling signals of future disinflation. Core inflation and services inflation, which are considered less volatile and more representative of domestic inflationary pressures, have eased substantially in the US and the Euro area. The UK was about 6 months behind these economies in peak core and services inflation and had much sharper peaks of over 10% (compared to around 6 or 7%). In these economies, disinflation has occurred rapidly, and the UK now looks more similar to the November 2023 numbers for the US, though still higher than the Euro area (Charts 2 and 3).

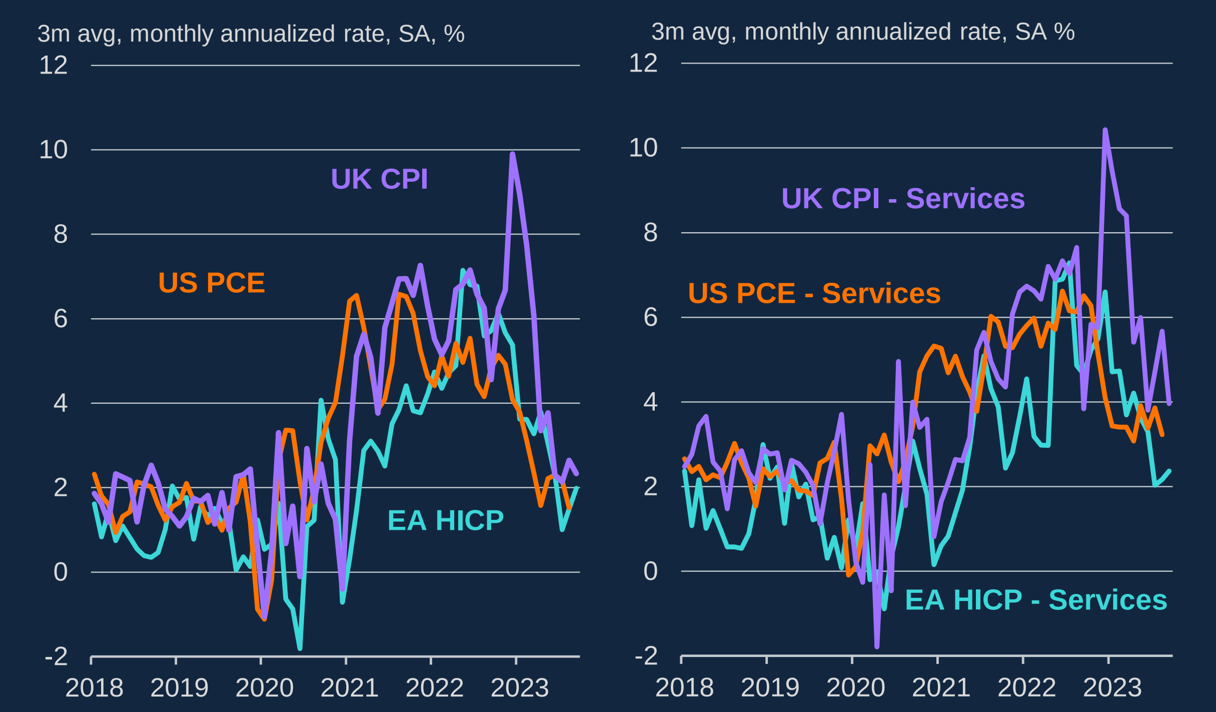
Chart 2: Core PPI and CPI for the UK and Euro Area



Source: Office for National Statistics, Eurostat and Bank calculations.

[3] COICOP category 04 is excluded to arrive at non-housing/energy services.

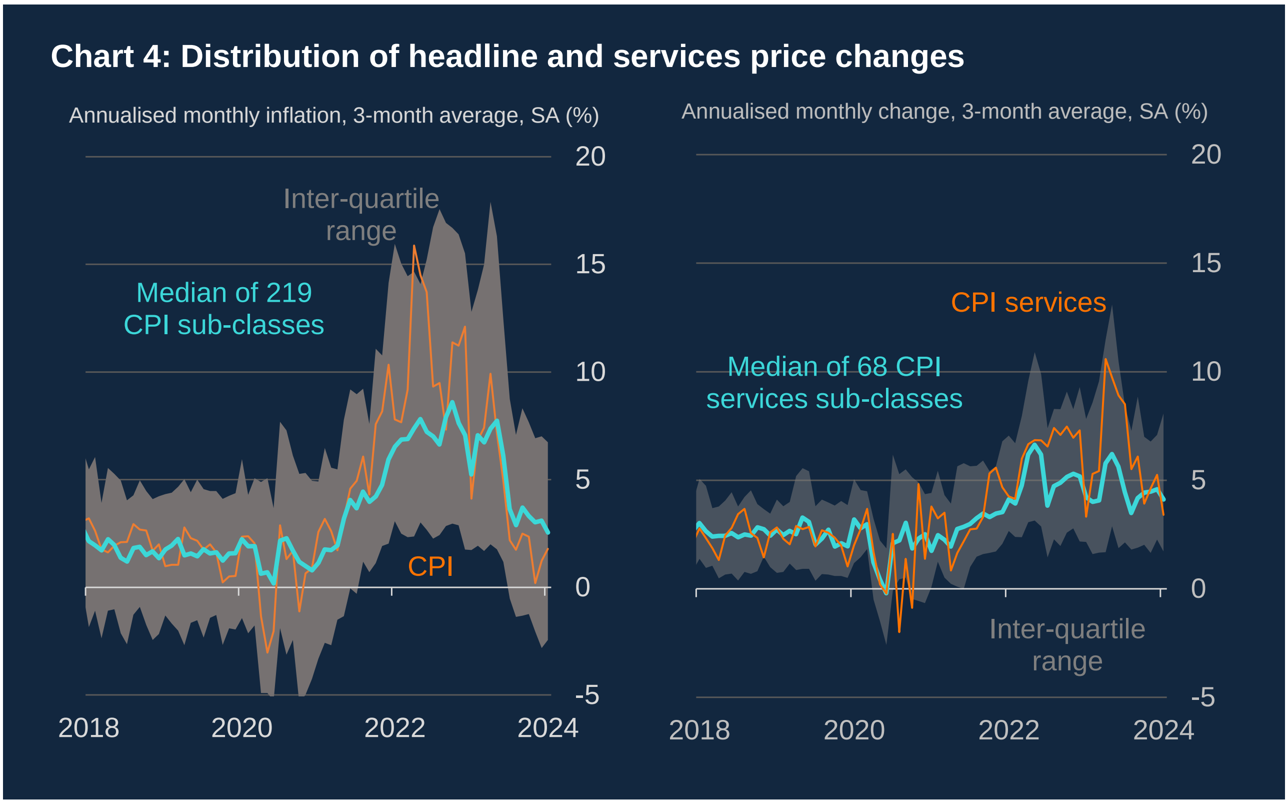
Chart 3: Headline and services price indices for UK, US, and Euro Area



Source: Office for National Statistics, Bureau of Economic Analysis, Eurostat and Bank calculations.

Note: UK series are not seasonally adjusted.

Looking beyond average statistics to Staff analysis of the distribution of price changes also provides some reassurance that inflationary dynamics are receding (Chart 4). The 5th, 25th, 50th, 75th and 95th percentiles of month-on-month consumer price changes across all items typically average -0.95, -0.11, 0.17, 0.44 and 1.36 (based on 3-month moving averages of month-on-month seasonally adjusted consumer price growth between 2017 to 2019). This distribution had shifted considerably to the right in 2022 with the 5th percentile moving to -0.63 and the 95th percentile to 2.76. The distribution has since normalised to -1.1, -0.21, 0.21, 0.55 and 1.45 in January 2024. Similarly sharp renormalisation has occurred over the distribution of core inflation. Services price change distributions have also been re-normalising though remain higher than their 2017 to 2019 averages.



Source: Office for National Statistics and Bank calculations.

Evidence from granular producer prices, including in services that tend to lag shocks in goods prices, are therefore pointing to substantive easing of consumer price pressures in the future. Nevertheless, the downward path for inflation is unlikely to be smooth due to the timing of various base effects. And, it remains important to note that there may be a potential upside offset arising from geopolitics. These events are hard to anticipate and would likely present difficult trade-offs for policymakers.

Outlook for Demand

The outlook for demand remains weak and less resilient than previously assumed. This further diminishes the likelihood of sustained inflationary pressures, as indicated in forward- looking indicators of domestic relative prices, such as monthly annualised rates of nominal pay growth in recent months and Banks' Agents' surveys that suggest lower pass-through of costs to prices.

Wage inflation has been a key indicator to gauge domestic inflationary pressures for the MPC. After the **surprise** in wage inflation in June 2023, and the contemporaneous surprise in services CPI inflation, Bank Rate was raised by a larger increment of 50bps as there had been significant upside news in the data that indicated more persistence in the inflation process (**June MPS 2023**). Granular wage data suggests there is reason to place less weight on the ONS's Average Weekly Earnings (AWE) data. The June strength in wage inflation was due to concentrated wage growth in specific sectors, and it was unclear whether this would trigger broad-based inflation. Total weekly earnings in three business services industries had increased by 11.3% in the three months to May 2023, relative to a year before.[4] This explained about 3.2pp – or just under half – of economy-wide wage inflation from a sector that makes up about a fifth of the workforce (or only 3 out of 24 industries in the UK economy).[5] Wage inflation across all other sectors was 5.3 percent, implying real wages were continuing to fall. This was in line with Staff expectations and Agency intelligence on pay settlements, which were expected to ease as inflation in salient items fell over time.

Later data revealed that mean pay growth in these business services might not have been as high as suggested by the figures, and was not accelerating. For example, information and communication had the highest growth in average weekly earnings of over 10 percent each month in the six months until the MPC's November meeting. In contrast, the much larger administrative Real Time Information (RTI) data showed a mean pay growth of about 4.3 percent. Despite an AWE sample of over a million employees in the industry, there seemed to be a large upward trend that was not present in the alternative tax records data. Previous research and new Staff analysis shows that there is too much noise in the monthly data to draw firm conclusions about the evolution of wage growth and hence of future price developments (**Georgiadis and Manning 2014**, **Daniell and Moreira 2023)**.

That said, over 2022 and 2023, wage growth has been amongst the highest in the three business services industries. AWE and RTI data suggest their mean pay in 2023 was about 30 percent higher than the level in 2019, and the mean pay was 14-19 percent higher between 2020-2023 on average compared to the pre-pandemic level in 2019. In recent data, lower-paying services - accommodation and food services, and retail trade – have also shown high pay growth of about 17 to 22 percent higher pay in 2023 than their 2019 levels. But their average pay since the pandemic is 6.2 percent and 7.6 percent over the 2019 levels. Though these figures are indicative of lower cumulative pay growth at the lower end of the wage distribution, there has been substantial churn in the economy and more granular data is needed to make composition adjustments so that wage growth is being compared on a like-for-like basis to make inferences about inflation impacts.

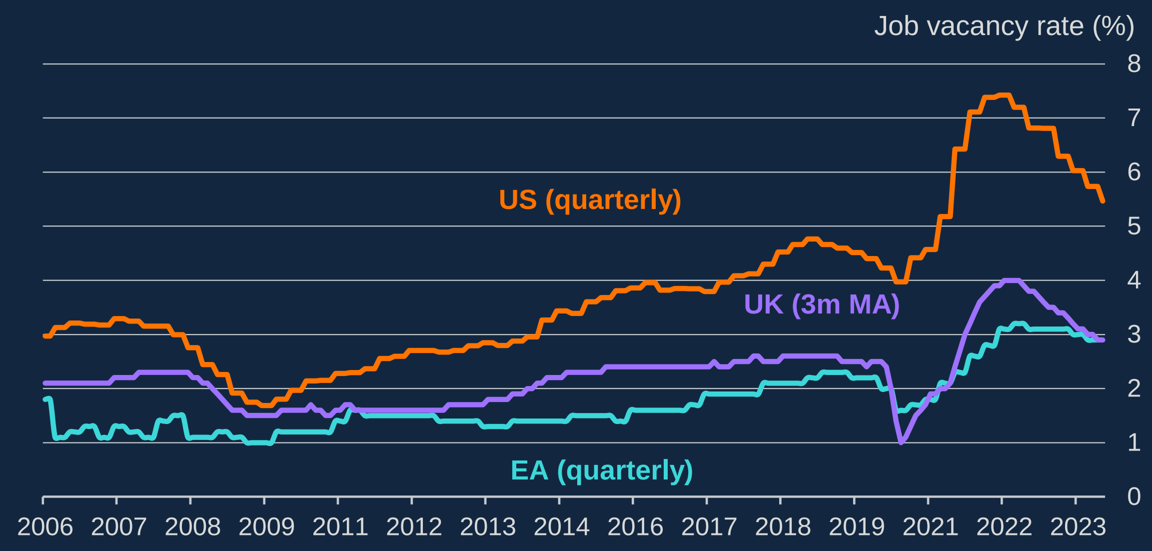
Nominal wage growth remains stronger than in recent history, but the collective steer from several sources of data suggests wage growth is easing, including in higher frequency and forward-looking indicators. Quantity-based measures of the labour market that are available in a timely manner provide further evidence of the reduced likelihood of tight labour markets pushing up on wages and hence prices in the future.

[4] This has subsequently been revised upwards in the February 2024 release, to 13.5%.
[5] The three business services industries are Information and Communication, Professional, scientific and technical activities and Administrative and support services activities. The Annual Business Survey classifies them as Sections J, M and N in the non-financial business economy.

The three-month ratio of vacancies to employment reported by the ONS was about 32 percent higher in services industries in January 2023 compared to the same period in 2019. This is now at 7 percent in the January 2024 data. There has been some concern that this loosening may not be happening in lower-paying services, namely accommodation and food services and retail trade, but here too vacancies are continuing to fall sharply. The three-month vacancy ratio in accommodation and food services has dropped from being 54 percent higher in January 2023 than its 2019 level to 15 percent in January 2024. In retail trade, the 10 percent higher vacancy ratio in January 2023 has now more than fully adjusted and dropped over 10 percent below its January 2019 level now. Reported concerns over spillovers from a rise in the National Living Wage to wages higher up the distribution have not been widespread in the past and going forwards, price spillovers are expected to be muted due to weak demand (**Machin 2024**, **Low Pay Commission 2023**).

To summarise, the drop in the average three-month vacancy ratio has been sharp throughout 2023. In fact, the fall has been the largest in these data, outside of the financial crisis and the pandemic. The drop has also been much sharper than some other advanced economies. The Euro area has seen falls of about 9.3 percent in the job vacancy rate between June 2022 to September 2023. The comparable number for the UK is a 29 percent drop until December 2023, which is closer to the drop seen in the United States of about 23 percent over a somewhat longer period. In terms of levels, the job vacancy rate in the UK was 2.5 between 2017 to 2019. This increased very sharply to 4 in June 2022 and has now fallen to 2.8. The Euro area looks similar now at 2.9 in September 2023 though it started much lower at 3.2 in June 2022.

Chart 5: Vacancy Rates



Source: Office for National Statistics, Bureau of Labor Statistics, and Eurostat.

Note: The job vacancy rate is defined as the ratio of the number of vacancies to employment level.

With the dramatic rise in import prices that took place after the pandemic and the war, the purchasing power of earnings fell sharply. Nominal incomes rose to make up for some of this deterioration in real incomes. Yet despite an easing in consumer price inflation and recent real wage recovery, consumption remains weak. Consumption has not recovered to its level before the pandemic.

This is in sharp contrast to the robust growth seen in the US and the recovery in the Euro area since 2022. Consumption has grown by 12.35 percent in the US from December 2019 to September 2023 and recovered by 2.17 percent in the Euro area. Consumption in the UK for December 2023 was still 2.25 percent lower than that in 2019. This is unsurprising because there was a sharper rise in utility bills in the UK and they stayed at their peak for a longer period than these other advanced economies (**Broadbent 2023**). Consequently, over the period, consumption was 4.8 percent lower in the UK – 95.2 compared to 100 in December 2019. The levels recovered by 3.3 percent more in the Euro area to 98.5 and by 10.1 percent more in the US to 105.3 (Chart 6).

Chart 6: Utility bills and consumption in the UK, US, and Euro Area

Sources for utilities: ONS, Eurostat, US Bureau of Economic Analysis and Bank calculations. Chart shows price of household energy utilities in UK's CPI, Euro area's HICP and US's PCE.

Sources for consumption: LSEG and Bank calculations.

Recent revisions to the national accounts suggest activity was weaker over 2023 than previously estimated. Though flash output and new order PMIs and retail sales in January provide some reassurance that the contraction last quarter isn't signalling a rapid and imminent deterioration in the demand outlook, GDP per capita has been falling all of last year. Retail sales volumes have been trending down since the second half of 2021 and are still 2.1% lower than January 2020. And there are substantial policy impacts on consumption to come through, according to direct evidence from the Financial Policy Committee's mortgage data analysis that showed 45% of fixed-rate mortgages are yet to come up for renewal and more macro modelling by Staff of various consumption effects (**FPC 2023**).

Overall, the outlook for demand remains weak and less resilient than previously assumed. This further reduces prospects of embedded persistence and raises the downside risks to living standards from keeping policy tight.

The Last Mile?

The data suggests we are approaching the last mile of this inflationary episode but there are naturally reasons to be cautious because of the unprecedented nature of this episode.

Turning to the remaining arguments for waiting longer to moderate Bank rate, one is the risk of losing credibility by having to reverse policy if inflation does not return sustainably to target because of embedded persistence or other shocks to the economy. The logic that has been emphasised several times in this tightening cycle is that the last mile is often the hardest. As inflation recedes from an elevated level, premature loosening could keep it sticky at above-target rates.

Historical evidence from periods of high inflation suggests that successfully resolving high inflation required a median length of three years (**IMF 2023**). Going by this, the current episode is already at this point (**FT 2023**). Importantly, this evidence includes hard landings, such as the experience of the United Kingdom in the 1980s, when inflation was ‘successfully resolved in less than five years’. Bank of England historical data shows Bank rate was kept above its previous levels for about two years (or three years if dated generously) and then tapered down gradually. At the same time, the unemployment rate increased sharply from 5 to 12 percent over five years (**IMF 2023**). In fact, ONS data shows that this unemployment measure remained above its pre-shock level until reaching a trough at 6.9 percent in 1990.

The experience this time is looking very different until now, as inflation has fallen substantially without a corresponding sharp rise in unemployment or a severe immediate contraction in GDP. The nature of the global economy and the domestic labour market have changed dramatically since the last high inflation episodes in the 1970s and 1980s, and the monetary policy framework has also been altered. Therefore, the remaining challenge of meeting the inflation target now may require a different strategy than waiting over the last mile. This becomes more important as the buffer from expansionary policy during the pandemic wanes and the number of vacancies decline further. The economy has already flatlined over the last year, unlike some other advanced economies which have not faced the difficult trade-off between lowering inflation and sacrificing recovery to the same degree as the UK.

There has been some concern that financial market participants might adopt an overly expansionary stance with any signal of a less restrictive approach from central banks, and therefore it would be better to wait to moderate policy (**IMF 2023**). Market overreaction is always likely to be an issue when policy reaches a turning point, whether a hike or a cut. While the waiting argument may apply in a more benign way to the US, given its recent robust economic growth, it entails different policy implications for us, given our distinct economic circumstances since the onset of the pandemic.

Overall, price developments strongly signal that inflation is already on a path of sustainably meeting our target over the medium term. After over two years of above-target inflation, a lot has already been learned about price-setting dynamics. Waiting for lagging indicators of domestic relative price growth to fall sharply before reducing rates comes with a cost of foregone improvements in living standards and a risk of lowering supply capacity for the future.[6] This would have repercussions for the resting point of the economy after this inflationary episode has played out.

Beyond the Last Mile

Financial and real economy participants are increasingly questioning where this new resting place might be. Economic commentary has diverged on whether the economy would return to its pre-pandemic state or revert to the conditions before the Global Financial Crisis. While this is an important question for the future, it provides little guidance for the path for Bank Rate over the policy-relevant horizon. There is broad agreement across stakeholders in the Market Participants Survey of the Bank of England that the current policy stance is restrictive and would continue to be so even at rates near around 3% (**MaPS, 2024**). We therefore have a long way to go before coming to a finely-tuned estimate of the medium-term resting place for Bank Rate. And naturally, if new shocks come along the way, this becomes an even more academic point.

A related question is what target-consistent rates of wage inflation or services inflation might look like in a new steady state of the economy. Economic commentary has often argued that current wage inflation and services inflation rates are not consistent with the 2 percent target. This is based on summary reasoning that multiplying the labour share of about 60 percent with wage growth rates above 3.5 would take us above target. This reasoning is inconsistent with recent historical evidence. The pre-GFC era in the 2000s was marked with high wage growth of 4-5 percent and yet inflation was subdued. The other components of pricing, such as input costs, productivity, and profits, together with the prevailing economic environment, including a higher Bank Rate, all contributed to keeping that higher wage growth consistent with the remit.

[6] **Aikman et al. 2022**, **Jorda et al. 2023**, **Ma and Zimmerman 2023**.

Pinning down target-consistent paths of goods and services inflation is even more contentious due to heightened geopolitical tensions, the rise of industrial policy and the impacts of climate change which are likely to alter some of the stable structural relationships that prevailed during the post-GFC period. Summary reasoning of target-consistent domestic relative price growth often overlooks the policy-relevant horizon and the undesirability of singling out domestic relative price adjustments that provide allocational signals in a market economy. Going forwards, the restrictive stance of monetary policy is expected to continue weighing on economic growth and living standards for more time, even if moderation starts now. In my view, the evidence to err on the side of overtightening is not compelling as it often comes with hard landings and scarring of supply capacity.

Acknowledgments

I would like to thank Jenny Chan, Harry Rigg, Donal McVeigh as well as Andrew Bailey, Lennart Brandt, Sarah Breeden, Harvey Daniell, Chris Duffy, Jonathan Haskel, Josh Martin, Huw Pill, Doug Rendle, Julian Reynolds, Martin Seneca, Nicola Shadbolt, and Fergal Shortall for their comments and help with data and analysis.