



## Economic Affairs Committee

### Corrected oral evidence: The UK labour supply

Tuesday 8 November 2022

4 pm

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Members present: Lord Bridges of Headley (The Chair); Viscount Chandos; Lord Fox; Lord Griffiths of Fforestfach; Lord King of Lothbury; Baroness Kramer; Lord Layard; Lord Monks; Baroness Noakes; Lord Rooker; Lord Skidelsky.

Evidence Session No. 11

Heard in Public

Questions 95 - 104

#### Witness

I: Huw Pill, Chief Economist and Executive Director for Monetary Analysis, Bank of England.

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## Examination of witness

Huw Pill.

**Q95 The Chair:** Good afternoon and welcome, Huw Pill, to our inquiry on where all the workers have gone. We have a lot of questions to get through this afternoon in a relatively short space of time, so I will crack on and pass over to Lord King for a follow-up question to mine, which is to allow you to set the scene, Mr Pill. It is a very basic question, in certain ways, but it is core to where we lie. When you look at the UK economy and the level of labour shortages, what overall impact do you see that having on inflation and growth? Lord King wants to come in on wage growth in particular, but if you could paint a broader picture for us, that would be very helpful to start with.

**Huw Pill:** First, it is a great pleasure to be here, so thank you for the invitation.

Obviously, this is precisely the lens that we look through when we address these issues at the MPC from a monetary policy perspective: our focus is on achieving our inflation target, and we are exploring and evaluating developments in the labour market, in concert with other developments, in order to come to an overall assessment of what we should be doing with monetary policy to achieve that target. Tightness in the labour market is a concern for us, as part of that overall context, in the sense that we currently face very elevated levels of headline inflation, largely as a result of the increase in wholesale gas prices in Europe over the last 12 months or so. That has raised the prospect, or the risk, of the emergence of second-round effects in wage-setting behaviour, price-setting behaviour and the evolution of costs.

Crucially, those second-round effects will induce greater persistence in the inflation process and create a self-sustaining momentum in inflation, keeping it above target even as the original impulse coming from higher gas prices recedes, and will extend the inflationary period long enough such that, despite the lags in monetary policy, which we see as 18 months to two years, inflation will persist long enough that actions taken today with monetary policy will still be relevant in addressing inflationary developments at that sort of horizon.

Those second-round effects, which create the persistence, are key to our assessment. Our view, which is quite standard, is that the likelihood of seeing those second-round effects in the wage process is increased at a time when the labour market is tight, and that is putting pressure on wages and giving some bargaining power to those who may raise wages.

However, I emphasise that it is not only wages that will contribute; wages are one part of the cost base that leads to more persistent inflation. Of course, there are other parts of the inflation process. The price-setting behaviour in the corporate sector and the pricing power enjoyed by firms along the value chain in the corporate sector are also elements that can feed into this inflation. We have to be cautious about

mechanically linking wage developments stemming from the tightness of the labour market to inflation, but, in our view, there is definitely a contribution coming from that source and, in particular, there is potential for those second-round effects to emerge, leading to this persistence.

**The Chair:** Very good. On that point, I will bring in Lord King straightaway to ask about wage growth.

Q96 **Lord King of Lothbury:** You said that the rise in energy prices was the original impulse for inflation. I cannot resist asking whether you think there was not some element of an initial impulse from decisions about quantitative easing taken before you joined the Bank that boosted money growth to very high levels for a period. That affects the timing of how all this passes through.

Secondly, looking at the interaction between wage pressures and inflation, to what extent is your concern based on wages being pushed up because inflation expectations have become somewhat de-anchored, perhaps, from the inflation target? To what extent is it a concern about the actual tightness in the labour market at present?

Finally, if you are worried about tightness in the labour market, do you think that a 3% interest rate will be anywhere near enough, given that inflation is at 10%?

**Huw Pill:** Those are challenging questions; I did not expect anything less. On the first, if you asked me why headline inflation is 10.1% today, which of course is unacceptably high, given our target and so forth, I would have to attribute a large part of the overshoot in inflation target to the impacts of higher gas prices. In the forecast we published last week, the direct implications of higher gas prices through utility bills contribute about 4 percentage points to the level of inflation. We typically estimate that around a third of that would come through in indirect effects because of the impact of higher energy prices on goods and services in the UK economy.

Of course, that 5 percentage point contribution is a contribution to the level of inflation, not to the overshoot, but it is still a significant amount, and it is driven by external forces to the UK, such as the invasion of Ukraine. I should recognise that that focus is on energy; food and other things have a similar external source.

That begs the question, "That does not explain all the overshoot, so where is the rest of it coming from?" It is a combination of two things. One is other developments in the past, including—it is fair to say—choices over monetary policy. As you know much better than me, running monetary policy with the benefit of hindsight is always attractive, but it is very difficult to implement in practice. We are operating in real time. As you said, I was not at the Bank two or three years ago when some of the decisions on the rounds of QE were undertaken in 2020. Whether they would be chosen now is an open question, but, overall, that may be only one part of what is going on.

With the benefit of hindsight, looking back at the impact of the pandemic, one could say that the destruction of demand was overemphasised relative to the destruction of supply. That probably meant that support for demand was stronger than it should have been, from a monetary policy and broader macroeconomic point of view. One of the consequences of that at the global level—many of the forces were global rather than national—was a rise in traded goods prices. The combination of supply chain problems and the creation of demand for goods at home—a particularly American phenomenon, given the very substantial fiscal support provided in America to households—boosted international goods prices. That has been another source of inflation, which is now beginning to dissipate, but you can associate it with policy choices.

Overall, QE and the choices on QE may have contributed. Of course, at the time they were motivated in part as buying insurance against some downside risk. That buying of insurance has a cost, and we may be seeing some of that cost in overly loose monetary policy, but, as I said, I do not think that that is the main reason why we have the levels of inflation that we are seeing today.

On your point about wages and de-anchoring, we try to decompose our understanding of wages. Regular private sector pay growth is running at just over 6%, which is a level that we would regard as too strong to be consistent with our inflation target, given developments in productivity and so forth. We try to explain that level of wage growth; we have various models and decompositions to do so. You are right to point out that, if we try to isolate things through the type of modelling we use, tightness in the labour market is certainly not the only driver, and probably not the main driver, of wage growth at that pace.

You could have a debate about whether it is inflation expectations or the outturns of inflation that are related to whether those wage-setting processes are more forward-looking or more backward-looking. To put it another way: are wage-bargainers trying to catch up with the inflation that we have seen, or are they expecting inflation in the future that is higher than we expect, and certainly higher than target?

All those things are difficult to separate, especially in real time, and even with the benefit of hindsight. At the moment, that dynamic in inflation is probably a more important driver of the strength of wage growth than the tightness of the labour market.

However, it is hard to separate these things. Of course, in the bigger picture, the overall macroeconomic picture, part of the reason why inflation is strong is that there is a tightness in the economy, including the tightness coming in the labour market and maybe some of the bottlenecks that I have discussed in the goods market, and that combination is driving inflation. There can be a sort of indirect effect whereby higher inflation is itself caused by tightness, which then leads to the wage growth that we see. I certainly would not want to downplay the role that tightness in the labour market is playing in nominal wage growth at the moment.

On your third point, which I guess is where the rubber hits the road for current policy thinking, it will not surprise you that, in setting our policy rate, we are taking a view about how demand, supply and monetary dynamics in the economy influence inflation at the two to three-year horizon, which is the horizon where we are able, given the lags in policy, to influence developments in inflation and bring them back to target.

As was relatively clear in the forecast we published last week, at the level of interest rates we see now, we have a constant rate forecast scenario that foresees a recession and a strong decline in headline inflation, partly associated with base effects but also weighing on domestically generated inflation through the emergence of slack in the economy as we enter recession. We think that that level of interest rate is insufficient, given the risk profiles and so forth, to deliver sustainable inflation at 2% in the horizon that we can influence. That is why, at least I would say, and I think my colleagues would say, there is more to do, so in that respect you are right to suggest that there is more to come.

At the same time, and this was perhaps the focus of some people's communication last week, what the markets were pricing, in terms of the outlook for Bank rate at the time when the assumptions underlying our forecasts were finalised, is reflected in the baseline on the market-expected path of Bank rate. We felt that that path of interest rates, which peaked at 5.25%, was probably overly restrictive in terms of the outlook, given the information that we were using at the time. This was reflected in the fact that at that two to three-year horizon, headline inflation was well below target.

That is a slightly long-winded way of saying that I have sympathy with your view—to be honest, I think the committee does too—that 3% is not enough, but it also weighs a little against the idea that we just have to replicate what the market was pricing at the time the forecast was finalised, which remained in part influenced by the dislocations in market that we have seen over recent weeks.

**Lord Layard:** I want to follow up on how to discourage the pass-through of inflation in prices into inflation in wages. Would it not be much easier to discourage that if people were much clearer about the terms of trade loss that has occurred for the British people as a whole, which I believe is something like 5%? Of course, who should bear that is a very big issue, but I am amazed that the terms of trade loss is not talked about every time anybody talks about these issues. I know the governor once got his fingers burned on the issue, but it seems to me an extraordinarily important factual element that should be present in the minds of everybody involved in wage bargaining on either side.

**Huw Pill:** I try to talk about it whenever I can. I have never had anyone pre-empt me talking about it, so I am very pleased that that has happened in this forum. It makes me pleased to have come today, and I could not agree with you more.

To put it in context from my perspective, I joined the Bank just over a year ago. At the time, UK wholesale gas prices were just below 80p per therm. At their peak last August, they were 880p per therm, more than a 1,000% increase. Of course, even if that is a relatively small share of overall consumer spending, or weight, in your CPI index, something that goes up by 1,000% on an annual basis will make a big contribution to inflation. Those were, in a sense, the numbers I gave earlier.

It is easy to see why that has an impact on headline inflation. What is less easy to see, and this is why you are right to say that we should communicate it more, is that for a country that although being a producer of gas is a net importer of gas—indeed, given the structure of its energy market, it is quite dependent on gas, which is the situation that the UK is in—the fact that what we are buying from the rest of the world has gone up very significantly in price relative to what we are selling to the world has exactly this terms of trade effect. It eats into UK residents' income and spending power and, ultimately, domestic demand and the dynamics of the economy on the real side.

That is a real phenomenon—a change in a real price about which monetary policy cannot do much, other than manage the transition to the economy adjusting to that. That is the way I see our role. Someone has to bear the cost of that reduction in UK residents' income. Over the last 30 years, we have been in an environment where much of the cost of the terms of trade effect, when it has occurred, has fallen on wage earners. The question is how the distributional effects of that will play out. The tightness of the labour market is, in some sense, allowing wage earners to try to resist taking some of these costs, although, as you know, real wages have declined, so those efforts to resist have not yet played out. Whether that is more appropriately falling on wage earners versus people earning through capital, through profits, et cetera, remains the open issue.

That is why I wanted to emphasise earlier that someone in the UK has to take—other things being equal—the real cost of this terms of trade effect. The question is: who takes that? That is where we need to look at labour market dynamics and wage behaviour not just in isolation but in concert with price setting in corporate behaviour.

**Q97 Lord Layard:** Vacancies are very high, not only absolutely but relative to unemployment—unprecedentedly, I believe. What is your explanation of that? Is it connected, for example, to unusually high rates of turnover, which shifts the relationship between vacancies and unemployment? Is it a one-off post-Covid phenomenon as people catch up with moves that they did not make during Covid, or do you think that more turnover is a new feature of the labour market? That is also relevant to the other part of the question: what is your general expectation for the future movement of vacancies and unemployment?

**Huw Pill:** I hesitate to say this again, but I agree with what you said in the preamble to your first question. That is underemphasised in discussion of these issues. You are right to note that vacancies are high,

the vacancy to unemployment ratio is at record highs, and so forth. What is less emphasised is that not only is the vacancy rate high but the hiring rate is high. That is symptomatic of the fact that we are seeing more churn in the labour market.

I agree with you that part of the reason why we are seeing higher churn now is a consequence most directly—most mechanically, perhaps—of the furlough scheme, but also of other dynamics associated with the pandemic that made it more difficult to switch jobs. People were reluctant to switch jobs because of risk, but it was also hard to conduct interviews because of the lockdown restrictions. People were stuck in jobs that they either did not want to be in or should not have been in. As the lockdown lifted and as demand recovered relatively quickly, there was a need to reallocate labour, and that involved both higher than normal vacancy rates and higher than normal hiring rates as that process took place.

I do not think it was a one-off process; it has been a process of people moving jobs on several occasions, and that has kept both vacancy and hiring rates high for a more prolonged period. Some of it will dissipate as we get a better allocation of labour and better matches, if you like, across different parts of the economy. I expect to see vacancy and hiring rates decline as we get catch-up matching what might have been normal had we not had the big interregnum created by the pandemic and lockdown.

There are other phenomena going on. As I am sure you know, there has been a discussion, as yet inconclusive, about whether vacancies are all the same. In an online world, posting vacancies is cheaper and easier to do, and they tend to be more long-lived, so that may be distorting statistics to some extent. We have looked at that and, to be frank, at this stage we have not been able to draw a very strong conclusion about whether it is affecting the statistics in a profound way. I think that is similar to what our colleagues at the ONS have found; they have not been able to find that.

On your more forward-looking question, I point to the slowdown in the economy that was embodied in the forecast we published last week. We see ourselves in recession, and we see that continuing through the whole of next year into 2024, at least in a forecast conditioned on market rates. That relates a bit to the previous discussion. We expect to see vacancy rates falling. The first signs of that are happening already and we expect unemployment rates to rise over time.

In the first instance, given the tightness of the labour market and the recruiting difficulties we have seen, we expect the weakness of demand to be reflected more in lower hours, and unemployment to rise with something of a lag. In our forecast, unemployment actually rises to above 6% by the end of our forecast horizon in late 2024 to early 2025. Of course, that is substantially higher than we see today.

**Lord Rooker:** Why was the post-Covid recovery quicker than expected?

**Huw Pill:** This is hard for me. It was a period when I was not at the Bank, but I think the slowdown was deeper and the recovery from that slowdown was stronger, so it was just that the amplitude in both directions was more profound. Part of the reason it was quicker goes back to the previous discussion: the support coming from the macroeconomic side. Macroeconomic policy, both fiscal support and monetary support, was very profound.

Q98 **Viscount Chandos:** You have already touched on one of the factors lying behind the labour shortages. Can you expand on the other supply factors, and why they might have had a different impact here than in other major developed economies?

**Huw Pill:** Of the ones I have touched on, the pandemic is, of course, an overarching thing, but it is related to health issues. If we look at why inactivity has risen, which I think is what you are getting at, many of these questions were more about vacancies, perhaps more on the demand side.

Focusing on the supply side, there are a number of issues. One is that in the UK we have an ageing population, so different behaviours across countries have to correct a little for the demographics. Given the ageing population, if inactivity rates had stayed the same in each of the population buckets, just the ageing of the population would have increased inactivity by about 0.7 of a percentage point from the beginning of the pandemic until now. In reality, the inactivity rate has risen by 1 percentage point, so you could, in that sense, attribute quite a big part of the rise in inactivity just to demographic effects, which were anticipatable and were largely anticipated.

You have to keep in mind, however, that in the past there have been trend increases in participation, particularly among 50 to 65 year-olds, associated with rises in the pension age, particularly for females, so comparing like for like by just assuming that participation rates would have stayed the same is probably not the right thing to do. None the less, that gives you a sense that demographics is a big part of what is going on, and we should not ignore that. It is probably not, of itself, directly related to the pandemic and its fallout.

**Viscount Chandos:** But there had been a rising participation trend, as you said, among certain demographics, until the pandemic, and that seems to have reversed, particularly in the 50 to 64 age group.

**Huw Pill:** That is 100% correct. Some of that decline and the modelling that we put into our forecasts reflects the fact that we were assuming, which is perhaps a bad reflection on us, that that rise in participation was trend-like, to the extent that it was associated with increased female participation as pensionable age rose, was unified and then went up, and by nature would run into the sands, as it caught up. Our view was that that trend would have diminished through time, so the underlying demographic effects would have then kicked in. There would have been a

slowing in the type of phenomenon that you are describing, even in the absence of the pandemic.

**Viscount Chandos:** Other developed economies, certainly other European economies, see similar demographic trends but do not appear to have had the same rise in inactivity.

**Huw Pill:** Relative to their underlying trends, that is true. That forces us to look at two other dynamics, which we are exploring in this context. The second is the role played by long-term sickness. I know that other people who have appeared before you in this context have discussed this at some length, slightly reflecting things I said earlier about decomposing the drivers of wage growth. Of course, ultimately these things are interrelated, so it is hard to separate age effects from illness effects, because people are more likely to be long-term sick as they get older, so that makes the statistical separation of these things quite complicated. None the less, our interpretation is that the rise in long-term sickness, which, again, is a trend that predates the pandemic, was accelerated by the pandemic and seems to be one explanation of rising inactivity rates.

**The Chair:** We will come on to that in a moment, but to pick up on Viscount Chandos's point, are you saying that long-term sickness is the reason why we are an outlier compared with other EU countries, let us say?

**Huw Pill:** I am cautious about saying that that is the cause. To be frank, I do not think the evidence is clear enough to say that there is one cause. It is certainly a contributor to the rise in inactivity, and you could make the case that there is an element that it contributes to cross-sectional variation, but that is more of an open question.

The third driver I want to mention, and this is clearly a UK-specific thing, is migration and the impact of Brexit. Again, that is a separate issue, but it is hard to separate from the pandemic yet at the same time it probably had some effect.

**The Chair:** We will come on to that.

**Baroness Kramer:** I am always very interested in the demographic issues, which you said had all been planned and expected, although I question that. Have you anything more to add on that? We have been fairly blindly ignoring where that is going. Have you seen anything to suggest a change in attitude, behaviour or values, or some sort of reshaping that might be driving that change in participation? If that is true, we have to look at what happens next in a very different way.

**Huw Pill:** I should clarify what I said. I do not want to make a strong comment about whether demographic effects have been incorporated well into broader policy. What I was trying to say was that, in the Bank of England forecasts, which are probably the least important things in this context, we none the less had some assumptions that were based on demographic trends when we looked at labour supply. They incorporated

the type of discussion we have just had; they were trying to take account of the fact that as the population aged, if you have the same level of activity in each age bucket, the buckets get bigger as people get older. That was included in our forecasts for what activity would do.

Since then, and not included in our forecasts, we have woken up to the increase in activity in the group of 50 to 65 year-olds coming from the rise in pension age. We thought that rising trend would be everlasting, which does not seem to make much economic sense, so we have revised that assumption now, but, again, it is a recognition of some of the demographic effects that are at play.

There may be other questions to this effect, but there is a question about how much of what we have seen in the 50 to 65 bucket, where the main contribution to the decline in activity is, comes from long-term sickness versus people choosing to retire early.

**Q99 Lord Fox:** I think I heard you say that demographics explains 70% of the shortfall, if we want to describe it that way, which leaves 30%. How much of that is caused by long-term sickness?

**Huw Pill:** I want to push back against the premise in the first part of what you said.

**Lord Fox:** Please do, because I wanted to clarify it.

**Huw Pill:** What I am trying to say is that mechanically, if you had the same level of participation in each age group and you just allowed the ageing effect to take place, it would have made a negative contribution of 70 basis points—0.7 percentage points—to the participation rate. A lot of the discussion we have just been having is that, in fact, there were other forces at play, including forces incorporated in the Bank of England forecast, but other forecasts too, that meant it was not right to assume that the levels of inactivity in each wage bucket would have stayed the same. Correcting for that, you would not have such a big percentage. None the less, demographics has a role to play, but probably not 70%. That still leaves another sizeable packet that you have to get, probably bigger than 30% on the basis of what I just said.

I feel that I am repeating myself, but it is very difficult statistically to make the separation between the consequences of early retirement, which might be seen as a form of changing attitudes, and health effects, which might be seen as the fallout from the pandemic and so forth. We do not have a strong view on how to undertake that. We are exploring it further, as are many others, but we do not have a strong, definitive, analytical view on it.

Having said that, it is certainly the case that, if you look at the data, when people in the 50 to 65 year-old category are asked why they are leaving the labour market, they typically say, "We are leaving because we are moving into retirement, we want to become inactive and we're not looking for a job". Historically at least, that would suggest they are not coming back. If you look at the stock of people in the 50 to 65 age group

who are inactive, rather than the flow of people leaving it into inactivity, a lot of them say they are inactive because they are long-term sick. That suggests that the people who were already inactive have moved into long-term sickness, rather than the people who are leaving.

If you take the data *prima facie*, at face value, that is what it is telling you. The difficulty with that is that in the surveys we use, and that I am describing, you are only allowed to offer one explanation. The likelihood is that in practice some people who say, "I'm leaving work and entering retirement, because I'm choosing to retire early", may be choosing to retire early because of health issues.

Similarly, it may be that, among the stock of people who are already inactive, the definition of long-term sickness—for example, in public attitudes towards mental health issues—has changed, and actually been changed quite profoundly as a consequence of the pandemic. Most of the data is self-reported, and it faces the usual difficulty of self-reported data in that it probably means different things to different people.

**Lord Fox:** On 12 October, you described health as "probably a key driver". How key? What scale of driver are we looking at in comparison with other things? There must be some scale that you can put on it or bracket you can put around it.

**Huw Pill:** I am reluctant, for the reasons I have given, to be cornered into a specific percentage. You may find that unsatisfactory. Part of it is that this is not my core business. If you were asking me a question about QE or interest rates, I would do that, but I might do it earlier.

In thinking about labour supply, it is true that health effects from the pandemic are important. The point I am trying to make is that they are hard to separate from demographic effects and what were labelled attitudinal effects. The three things are very interrelated.

When we look at the responses, we see that health effects are reported as things that matter. Long Covid is one issue. That actually seems to be relatively less important. The fact that people who have chronic illnesses, and perhaps already had chronic illnesses but feel less comfortable in working, given the environment of the pandemic and its aftermath, seems to be important. As I just said, mental health issues seem to be particularly important, but it is hard to separate in the self-reporting world the actual rise in long-term mental health issues stemming from the pandemic and so forth from the fact that people's attitudes towards them may have changed.

**Lord Fox:** Was there already a trend of increasing unwellness removing people before Covid that has been accelerated by the Covid epidemic?

**Huw Pill:** Yes, that is absolutely true. We see rising reports of long-term sickness among people in work, people who are inactive and people who are unemployed in the period running up to Covid, and in each of those

three groups reports of long-term sickness were accelerated by the onset of the pandemic.

**Lord Fox:** Not to put words in your mouth, it seems to me that you are saying that it is easier to understand the stocks than it is the flows when it comes to illness and wellness.

**Huw Pill:** I am not sure it is easier; I think they give you slightly different messages. The question is how we should try to interpret all that information in a comprehensive way.

**Lord Fox:** That is what we are pushing at.

**Huw Pill:** I know. The short answer is that it is difficult. I do not have an easy answer.

**The Chair:** On your point about the trend pre-Covid on long-term sickness, is there any way you can show that that is unique to this country as opposed to EU countries—coming back to the trend point about why we are so different now compared with many of our EU partners?

**Huw Pill:** That is a very good question. I am afraid I cannot tell you that. I can look into it.

**The Chair:** It would be very helpful if you could share with us any data that your team has.

Q100 **Lord Griffiths of Fforestfach:** I have two questions. When the Bank's forecasting model came, you said, in answer to Lord Rooker's question, that it did not quite get the recovery from Covid as fast as it happened. It certainly did not get the increase in inflation, which was much quicker. Is the outlook at present slightly better than you are predicting? If I was in the Bank at present, the last thing I would like to do is announce good news because of my record in the past few years.

The price of gas was 400p per therm. It is now down to 100p, and some people think it will go down further. If that is so, you can see a sharp fall in inflation at some stage. If that happens and your estimate of quantitative demand is a certain amount, we will have an increase in output because of the fall in inflation. Therefore, to what extent are you in danger of saying, "We will have so many quarters of recession"? Are you in danger of overestimating it and saying later, "Well, we were very cautious, which is why we took the position we did"?

**Huw Pill:** I do not need to tell you that economic forecasting is a tricky business. There are many people in the room who have had their hands burnt by economic forecasts in the past. I certainly am not exempt from that critique. The forecast is a useful vehicle for us to have a discussion, and the way you have expressed it has illustrated that using our forecast as a basis for that discussion can help us to deepen our understanding and have an exchange. I certainly do not want to be forced to say, "I sign

in blood that this economic forecast is the way things are going to turn out". That would not be a very sensible thing to do.

I agree with your points about gas prices. The only thing I would say is that I think you are referring to spot gas prices. The build-up of gas reserves in Europe, and the fact that a lot of gas coming into Europe has to come through the UK because we have the LNG facilities to import it, means that there is almost a gas glut in the UK at this point, so that spot price may be somewhat misrepresented over what prices will be in the coming months, and maybe beyond.

Certainly, futures prices, which may not be the best forecast but are a guide, are considerably higher than current spot prices. Although the futures prices that underlay the November forecasts we published last week, relative to what futures prices were at the time we did our August forecast, are a bit lower at the short end, they are much more persistently higher. If you look at the most relevant horizon for monetary policy, there is a less benign interpretation.

Of course, we know that, if it is difficult to forecast the economy in general, it is particularly difficult to forecast commodity prices. We have had plenty of experience of difficulties in forecasting gas prices. In fact, we have given up. We assume either that they are unchanged or that they mechanically follow the futures curve, neither of which has turned out to be a very good predictor of what has happened in practice, in recent times at least. It is certainly the case, and is actually part of our forecast, that headline inflation is forecast to come down pretty rapidly once the base effects from the big increase in gas prices I described earlier fall out of the annual calculation. From the middle of next year, headline inflation is set to fall quite significantly in the UK, on our forecast. Ultimately, at the two to three-year horizon, at least under the assumption that Bank rate follows market pricing as it was a few weeks ago, we will end up with inflation below target, and, in fact, threatening to go below 1%.

To your point that inflation could come off pretty quickly, there are plausible scenarios. Indeed, the baseline scenario of our forecast has exactly that character. The only thing I would say, though—it goes back to the opening discussions—is that, ultimately, we have to focus on the persistence of inflation caused by domestically generated inflation. That is what we can influence through our own policy decisions and is what tends to have a persistent character, and therefore is most important, because it will still be there at the horizons that monetary policy can affect.

One of the backgrounds to our work on the issues being discussed in this inquiry is that against the background of these very volatile moves in energy prices, which are beyond our control and determined in international markets, we need to know how developments in the UK labour market—and, for that matter, developments in the corporate sector in their pricing choices and their ability to have the market power to improve, or at least sustain or retain, margins—will drive domestic components of inflation, and that is really what we are focused on.

That is where the nexus is: "Could you be more optimistic? Could you be less optimistic?" There are risks that would suggest that we could see more momentum in the economy. Fiscal policy may be different; we may see improvements in other parts of the world that help support external demand for the UK economy; we may see improvements in the supply side here, all of which would be favourable. We have not incorporated those in our forecasts. To some extent, we make relatively mechanical assumptions about many of those things. We typically choose to take fiscal policy as previously announced, so there are risks in the direction you are suggesting.

**Q101 Lord Griffiths of Fforestfach:** I have a very quick question to do with the over-50s who are inactive. We have looked at health. Given the excess savings that were almost forced on people because of lockdown and so on, people are discovering as a result of working from home that they are changing their lifestyles. There is a change of preferences that has been formed by lockdown itself. Do you have any feel for the breakdown between excess savings and a change in tastes, so to speak, in economic terms?

**Huw Pill:** I do not think we have a strong view. On the change in lifestyle point—the attitudes point—we have seen people, as I said, elect to take early retirement. That is in the flow data. An interesting other side of that is that you might expect greater use of home working to make it easier for people with long-term health conditions to enter the labour market because they can work from home. We see very little evidence of that. There is a mixed story about the impact of the change in behaviour and the change in attitudes on labour supply. The outturn is more negative for the impact on labour supply.

Your point about excess savings is interesting. There are two things about that. There is a question about how much of the overall stock of savings is accessible. Do we have savings going into relatively illiquid things like pensions? In the data, that is part of savings, but they are probably not accessible. It would help people to retire early if their pension pot was bigger. That works. However, most of those things are also exposed to market risk, and market prices, asset prices, have generally gone in a negative direction.

Secondly, you might think of the money overhang. There has been quite a lot of work done on it. People built up liquid holdings of wealth, largely in bank deposits, as a consequence of being unable to spend during lockdown. The interesting thing about that is that, if you look at those liquid holdings not in nominal terms but in real terms, the unacceptably high rates of inflation that we have seen in the last year and more have eroded a large part of that money overhang.

To use language that I have occasionally used in my previous incarnation looking at monetary data at the ECB, the real money gap—which is a measure of excess money holdings relative to what you might expect, deflated by the fact that over the last two years that nominal stock of deposits was built up—has been eroded by the inflation we have seen, so

the spending power embodied in that overhang is not as big as it might be.

**The Chair:** Building on that, as you look ahead and see the cost of living crisis biting and mortgage rates going up, and you look at the group of people who have become inactive, what are you seeing and modelling on how many of them may want to return to the labour market?

**Huw Pill:** The story I just told, which is a story we hear from some of the surveys we read and so forth, is that people say that the impact of the higher cost of living will cause people to work more hours and perhaps come back into the labour market. There is a little bit of survey evidence. We had a chart and some analysis in the main monetary policy report suggesting that. Against that, there are two things.

First, the evidence we get from our contacts with the agency networks—our colleagues who talk to companies around the country—is that they do not report that. We ask them quite a lot, but they do not report people who chose to retire early coming back into the labour market. That relatively structured evidence, albeit anecdotal, does not go in that direction.

Secondly, and this goes back to the statistics, among the people who elected to leave the labour market there has been quite a strong movement from employment into inactivity, which, in a sense, is a reflection of the early retirement. Historically, when you have moved directly from employment into inactivity, you have tended not to come back. The behaviour that we have seen is consistent at least on the basis of past regularities and those people not coming back. I know this is unhelpful, but the evidence is mixed is the short answer.

**The Chair:** It is very helpful.

Q102 **Baroness Noakes:** Sticking with this territory, we have talked about the impact that demographic trends have had on the way in which the workforce has evolved recently, but, starting to look forward, what assumptions are you making about how the workforce will be impacted by those demographic trends? I am particularly interested in the extent to which you are using those trends as previously understood, or trends as possibly emerging, such as an increase in early retirement of 50 to 64 year-olds, and whether that is baked into your current views on the workforce. Linked to that, do you think the pension reforms have had any impact on that 50-plus section of the workforce?

**Huw Pill:** The short version of the answer is that we are about to conduct a big supply side stocktake, which we do once a year, and one aspect of that supply side stocktake is to look into our assumptions about the behaviour of the labour market. We are basically on the cusp of doing many of the things that you are asking. Historically, we have extended trends in that. You are right to suggest that mechanical extension of recent trends, or historical trends, is perhaps not the right way to proceed at this point, because we have seen disruptions to those trends

that we have spent most of the last hour discussing. We are looking more closely at that than we have in the past, but I do not have the fruits of that deliberation for you at this point.

**Baroness Noakes:** If I look at the current Bank forecast, I will see trend-based analysis.

**Huw Pill:** Yes, that is right. The last time we did this we incorporated the discussion that we had earlier about the fact that we had been extrapolating more activity, or less inactivity, and greater participation in the 50 to 65 age bucket on the grounds that the changes in the pensionable age, which is a version of pension reform, although perhaps not the one you were focused on, are leading to greater participation, particularly by females as their retirement age rises. We were extrapolating that as though that trend would continue for ever, whereas obviously the increase in the retirement age would eventually reach 65.

Thinking a bit more about that led us to take that, which I would regard as an anomaly, out of the system, and that was the appropriate thing to do. I was going to say that we do not have the capacity. I hope we have the capacity, but we have not yet addressed specifically the effects of the health and other issues that we have discussed and/or the impact of institutional changes to the pension system. Those have not been incorporated, beyond looking at the trends.

**Baroness Noakes:** When would one see the output from the annual stocktake?

**Huw Pill:** The plan is to incorporate that into our supply side assumptions for the February forecast. To be clear—I do not want to set too great expectations—there are a lot of things that go in. This is all analysis that will ultimately go into taking our view of what trend growth in the potential of the UK economy is. By the nature of what monetary policy is concerned about, we generally look at cyclical developments in the economy. It will not be central to our focus unless we come up with some big revision that leads us to think in a totally different way about the behaviour of the economy. That is a reflection of the fact that it is not the focus of what the Bank of England is doing to look at some of these things. We are users of others' analysis rather than producers of it.

Q103 **Baroness Kramer:** I want to follow up on a factor that you referred to almost in the "other" category, which is migration trends since Brexit and the pandemic, and what effects those have on labour supply.

**Huw Pill:** On the overall level of migration, we have seen substantial inward migration, but there has been a change in the composition of that migration away from EU immigration and into non-EU immigration. Just in numbers, we have seen less impact. Part of our supply stocktake exercise is looking at the impact of Brexit on the supply side of the UK economy and reviewing the assumptions that were made about the impact of Brexit on the supply side of the UK economy back in 2016 when this analysis was baked into our forecasts. There is an open question

from the perspective of what is being discussed here as to how fungible non-EU migrants are relative to EU migrants.

It is not just about numbers; it is more anecdotal from our agency network rather than a formal analysis. EU migrants in a free movement context were more flexible and fungible both across sectors and across jobs, whereas non-EU immigrants are more expensive in terms of the administration of getting them into the labour force and, partly as a result, they are less fungible. You cannot just count it one for one. From our perspective at the Bank on how much it eases bottlenecks in the labour market and so forth, the flexibility accorded by EU migrants in a single market context is probably higher.

**Baroness Kramer:** Just to clarify, am I hearing from you that it looks as though, where EU migrants have left particular roles and jobs, those vacancies are proving quite hard to fill because the skill base of those coming in, which is probably higher, does not match that of the people leaving, or is it willingness to go to different parts of the country? What is the non-fungible element that you are picking up? Is it also that it is a cluster who are not easily replaceable by native workers?

**Huw Pill:** Those are all good questions. I am not sure that I have definitive answers, unfortunately, to any of them. The anecdotal evidence we get is a version of all the points you make. Fundamentally, it is a question of the fact that integration into an EU-wide labour market had more flexibility. For a student worker from Spain coming to London, it was much easier to work in a café. This is all a bit of a stereotype, but that was something they could do in a way that the non-EU migrant could not do. Of course, that then has ripple effects through the system. That is the essence of the point made by people we hear from.

**Baroness Kramer:** Do you look at all at the sectoral impact? We heard from sectors such as horticulture that the impact on them was very severe. Are there consequences of potential loss of sectors, as you look forward in your forecast?

**Huw Pill:** Some of the questions you sent in advance point to whether there are bottlenecks in specific sectors or in specific regions. Again, we do not have the data that allows us to explore all aspects of that. The anecdotally based evidence we get from our various surveys, and in particular from the agents, suggests that those bottlenecks and the mismatch factor have been important, although looking over the span of the last couple of years it has become less important of late. That may be because there is some easing in labour market pressures in general, or it may be because a churning has been taking place and getting people in the right places. The combination at least seems to be that that mismatch factor is a bit less.

**The Chair:** Can I jump in with a layman's question? If you piece together that mismatch with those who have been inactive, were they to return to the labour market, am I wrong to say that they would not be able to address that mismatch and meet those vacancies because they have left

from different parts of the workforce, or is that just supposition?

**Huw Pill:** Looking at levels of inactivity and levels of vacancies would be one way. We know which sectors people who moved into activity have moved out of. The place where more people have moved into activity, on the basis of the discussion we have had, would be people in the sector leaving for early retirement. The sectors that have seen more people leave are not closely correlated with the sectors that see the highest level of vacancies. That would suggest that it is not as easy as saying that the people who have left coming back would just slot in, and that would solve all the vacancy problems.

**The Chair:** I wanted to clarify that point.

Q104 **Lord Skidelsky:** We know that the Bank is expecting inflation over the next six to 12 months. What you have been describing is actually what one used to call stagflation in the 1970s. Which do you think is likely to be the dominant policy problem for the Bank, or for policy in general, over this period?

**Huw Pill:** We have one of the architects of that in the room. One of the changes since the 1970s has been that the Bank has been made independent and the MPC has been given a specific mandate, which is price stability in legislation and a remit to get inflation to the 2% target. As a member of the MPC, I do not really see it as, "I have to make choices"; I am told what I have to do. It turns out that that is the right thing to do as well. Our job is to get inflation to 2%.

**Lord Skidelsky:** Are you willing to go a little bit beyond your membership of the MPC?

**Huw Pill:** My membership of the MPC takes up a lot of my life. To quote someone in this room, we are not inflation nutters. We are attempting to return inflation to target in the face of very significant supply shocks and terms of trade shocks, as we discussed earlier, that have real economic consequences. The way I see my job is to ensure that we get inflation back to target in a way that does not impose unnecessary costs on the real economy. It is the transition that we are trying to manage, but the target, the objective, for where we end up is not negotiable.

That is a very significant difference, perhaps the key difference, between what we are experiencing now and what was experienced when I was a child in the 1970s and 1980s. The notion of stagflation then was very much driven by the de-anchoring of inflation expectations and the creation of self-sustaining and self-perpetuating dynamics in wages, prices and costs that fed off one another and were unanchored.

To go back to my first set of responses, the fact that we have an inflation target, the fact that the MPC is committed to that inflation target and that members of the MPC focus on that, all of which is still true, is absolutely key in saying, as I have described, that even in a quite difficult environment where we face very adverse terms of trade shocks that pose difficult challenges for residents of the UK and for monetary policy, we

are focused on achieving the inflation target and, crucially, we are working to ensure that we do not see, whether through the labour market developments that we have been discussing or through corporate pricing behaviour and so forth, the emergence of the second-round effects, self-sustaining momentum and so forth that threaten to create an above-inflation target on a persistent basis. That, to me, is the key difference. I do not want to talk about my predecessors from 40 years ago, but they did not have the anchor of the inflation target that I think is so crucial.

**The Chair:** Very good. Thank you very much. With that, we end the first session. Many thanks, Huw Pill, for coming in and answering our questions so comprehensively.

**Lord Rooker:** And in plain English.

**The Chair:** Thank you.