HOUSE OF COMMONS

Treasury Committee

Oral evidence: Bank of England Monetary Policy Reports, HC 143

Tuesday 23 May 2023

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Watch the meeting

Members present: Harriett Baldwin (Chair); Mr John Baron; Dame Angela Eagle; Emma Hardy; Danny Kruger; Andrea Leadsom; Siobhain McDonagh; Anne Marie Morris.

Questions 802 - 867

Witnesses

I: Andrew Bailey, Governor, Bank of England; Huw Pill, Chief Economist, Bank of England; Professor Silvana Tenreyro, External Member, Monetary Policy Committee; Dr Catherine L Mann, External Member, Monetary Policy Committee.

Examination of witnesses

Witnesses: Andrew Bailey, Huw Pill, Professor Silvana Tenreyro and Dr Catherine Mann.

Q802 **Chair:** Welcome to the Treasury Committee session on monetary policy, following our visit to the Bank last Thursday, where we covered the quantitative tightening inquiry. I am very grateful to you all for coming in and speaking to us again. I should put it on the record right up front that nobody has seen what tomorrow's inflation numbers are going to say. We are having to have this session on inflation without knowing that. I would like to start, Governor, by asking the witnesses to introduce themselves.

Andrew Bailey: I am Andrew Bailey, Governor of the Bank of England.

Huw Pill: I am Huw Pill. I am chief economist at the Bank and a member of the Monetary Policy Committee.

Professor Tenreyro: I am Silvana Tenreyro, professor of economics at the LSE and external member of the Monetary Policy Committee.

Dr Mann: I am Catherine Mann, external member of the MPC and a professor at Brandeis University.

Chair: Professor Tenreyro, I think that this is the last time we have the

pleasure of grilling you, so thank you very much for your time on the Monetary Policy Committee.

Professor Tenreyro: It has been a privilege.

Q803 **Chair:** Given that we do not know what tomorrow's inflation numbers are going to say, I am going to focus on what we have seen since you were last in front of us to talk about inflation, Governor, which was in February. Would you say that inflation today is higher than you were expecting when you were last in front of us?

Andrew Bailey: Yes, it is. We were expecting a gradual decline in inflation up to this point. Of course, we are below the peak of just over 11%, but it is about 0.8% higher than we expected it to be in the February monetary policy report. As you said, we do know what is in tomorrow's release. We know that a large annual base effect will come out tomorrow. That is the annual energy base effect and is a product of the Ofgem six-monthly reset in April last year. We do not know what the number is.

Q804 **Chair:** That would have happened by now, as I recall from your evidence. You thought that things would have turned the corner. We would be in single digits again by now. You have just said that it is 0.8% worse than you were thinking it would be in February. Given that your remit is 2%, that is quite a big margin of error.

Andrew Bailey: I stand by the view that it has turned the corner. I was very careful when I said a few months ago that we were seeing the first signs of that. The peak was 11% and we have seen some of the benefits already of energy prices. It is higher than we expected it to be. There are two underlying reasons for that that we see in the data. The first one is food and the second one is some goods, particularly clothing and footwear.

I should make the point that those are not, it is interesting to note, the elements of inflation that we regard as more persistent. That is more in the services sector, where so far it is tracking more or less as we thought it would in February. You are right to say that we have seen these upsides on these particular two areas.

Q805 **Chair:** What has gone wrong with either your models or your network of agents? It is not something that any of us would have found surprising that food prices, for example, were persistently strong. Our farmers were telling us about how much inputs were costing them and things like that. Something has gone really wrong with your modelling and your network of agents, which is meant to give you this edge in terms of information.

Andrew Bailey: Food is a question that we have spent a lot of time on as well, as you can imagine. February this year was a point when food price inflation was around 15%, if I remember right. That is the food element. The contacts were telling our agents that they thought that that

was the peak and that it would come down from there onwards over the rest of this year. You are right: that has turned out not to be the peak.

We have invested a lot of time and effort, including me going around the country, talking to the contacts again to say, "What has caused this to happen?" They remain of the view that it is going to come down, but it has obviously gone up in the meantime. There are two groups of reasons that they give. They say that they were wrong in this view.

The first group is things that, it is reasonable to say, could not have been expected, in other words events that have happened in the meantime in certain elements of food. They are mainly weather events around the world, frankly. There was a well-known thing with vegetables in, I think, Morocco particularly. Sugar is the one commodity where, across the board, its price is still rising. A series of weather events in other parts of the world was given as the reason for that. There are some things like that. There is also a story about avian flu. Those are things that you genuinely cannot predict from period to period.

The second thing is, however, the question, and it goes to what you were saying a few moments ago. I get told two things. I was on a farm last week, talking to a producer, who is a producer of final output as well. They said two things. One is that the impact of energy prices on businesses is quite unevenly distributed. It is not like household energy prices, which have been, in a sense, set by Government policy. It really depends on when you renew your energy contract. You may pick this up in your constituencies. Some businesses have done much better because the timing of the reset of their energy contract worked in their favour. Some have had the absolutely opposite effect, so it is very uneven.

The second thing is perhaps where the prediction issue comes in. What was possibly underestimated is the degree to which food producers have purchased more forward, in terms of raw material supplies, than they would normally do. In other words, they have locked in higher prices for somewhat longer. The reason they did that is related to Russia-Ukraine. They were worried about actually getting hold of stuff. The farm I was on last week said that it bought fertiliser further forward than it would normally do and locked in a higher price on that.

You are right: it should have been possible to identify that, I think. It is a bit harder to quantify, but it was in there somewhere in the mix, whereas the weather events were not.

Q806 **Chair:** We will be coming back to food later on in the session. I will turn to Huw and ask the same question. Do the responsibilities for the forecasting models fall within your area, Huw?

Huw Pill: Most of them do, yes.

Q807 **Chair:** What has gone wrong with them?

Huw Pill: I would echo a lot of the things that have already been said. It is very difficult to forecast, at very high frequencies, some of the developments we have seen, given the magnitude of the shocks and their pass-through.

Q808 **Chair:** To take an example, in the Governor's letter to us, which we are publishing today, the food price rise is now listed as a fourth shock, added to the list of other shocks that we have heard in evidence from you before. It is linked obviously to what happened with Russia's evil invasion of Ukraine, and yet now it is being listed as a shock when it has been known about for well over a year. Why have you been so wrong in terms of your forecast of inflation? With a margin of error of 0.8%, when your target is only 2%, the errors are so huge relative to your target that it undermines people's confidence in your ability to tackle inflation.

Huw Pill: Perhaps I can take the two points slightly separately. In terms of the aggregate outlook for inflation, I agree with your point that errors of that magnitude relative to our target level are large. As you know, the level of inflation today is very high. It is unacceptably high and well above target. That is a reflection of the magnitude of the shocks that we have faced over the past year or 18 months.

Q809 **Chair:** The Governor told us a year ago that the impact on food prices of the invasion was "apocalyptic". It made headlines at the time.

Andrew Bailey: I said that it could be.

Chair: That was a word that was used. For you to be now surprised by the impact on inflation seems to us to be a surprise.

Huw Pill: This will lead in, I think, to some of the discussion that we will have in a second around the rationalisation of recent policy decisions. The point I would make is that the magnitude of these shocks has not only affected inflation directly, but it has also affected how the pass-through of these shocks may be transmitted through that value chain. The indirect effects of energy price rises, for example, may have been different and had more magnified effects. Also, as is well known, there are the second-round effects, which are feeding through in other costs faced by food producers.

It is crucial that our baseline forecasting framework is based on or developed from the experience of the last 30 years of inflation targeting. That is a period where we have not been exposed to shocks of the magnitude we have seen, be that the energy price shock, food price shocks or, indeed, the shocks to international goods prices that we saw in the aftermath of the pandemic, with the supply disruptions that were associated with that.

This is the difficult question we face in our forecasting: whether the models and forecasting frameworks we have developed on the basis of the experience over the last 30 years capture possible changes in behaviour, given the magnitude of these shocks.

I gave a talk a few weeks ago around how to understand the notion of persistence, which is very key to the way we view inflation. That is precisely because, given the lags in monetary policy transmission that are built into the technology of the policy we have responsibility for, when we change policy today, as you know—this is why forecasts are so key to our framework—we are trying to ensure that we have the appropriate effect on inflation developments at the time those lags unwind.

Q810 **Chair:** Are you saying that, despite the Bank of England having been in existence for over 300 years, you look at only the last 30 years when you think about what the risks are to inflation?

Huw Pill: No, but it is crucial that the inflation-targeting regime that we have been in for the last 30 years has proved quite successful on average. It has had an important effect on behaviour in the economy. We are relying on looking at that behaviour within that regime, which is one that has helped stabilise longer-term inflation expectations and provide a crucial anchor to price developments in the economy. We could debate what constitutes large and what constitutes small, but, over that 30-year experience, we have not seen disturbances to energy prices, food prices and so forth of the magnitude that we are experiencing now.

Q811 **Chair:** Given that we have had a 0.8% error versus a 2% target just in the last three months since you were in front of us, what are you doing to improve your models?

Huw Pill: One thing we are looking at is discussed at some length in the monetary policy report. Are we focusing on food now or more generally? I do not want to pre-empt the subsequent discussion of food.

Q812 **Chair:** You are attributing the 0.8% to food, but it is a big amount compared to a 2% target.

Huw Pill: At the heart of what we are trying to do is understanding whether the magnitude of the shock that we have faced, and in particular the fact that we have moved a long way from our target because of the magnitude of that shock, is having such an impact on behaviour that the way in which pass-through takes place and inflation reverts to target has changed somehow. The behaviour underlies how different parts of the economy along the value chain pass through the incidence of this shock and ultimately into the consumer prices that we target in aggregate.

Q813 **Chair:** Are you changing your models as a result of that new information?

Huw Pill: We are trying to incorporate new information. I would emphasise that the typical way one would estimate a forecasting model is to take a period of experience where you have the data. We are focused, for the reason I just described, on looking at the data of the last 30 years.

It is almost inevitable, if you add a couple of extra quarters or even an extra year to 30 years of data, that you are not going to fundamentally

change the model. The weight of the model will still be based on that 30-year experience.

We see that these models have led to some of the errors you are describing. We recognise that our forecasts of inflation have been too low and we are trying to understand why we have made those errors, interpret those errors in terms of the behaviour and then make an assessment as to whether that behaviour will continue into the future. Models are essentially taking averages of behaviour in the past. We really only have one observation of how the UK economy responds to having inflation in the inflation-targeting framework at the 10% level.

Q814 **Chair:** You are saying that the inflationary period in the 1970s, because it falls outside your period, is not one that you want to use in your models.

Huw Pill: Let me continue, because I think you make a good point. The question then becomes, "Given that we have inflation at 10% and we have had the magnitude of shock that we have not seen in that 30-year period, has behaviour changed?" One way to look at that is to look in detail at developments that are going on right now. The Governor described how we look in detail at food prices, but we are looking in detail at lots of other parts of the economy.

There are other ways of thinking about that. You gave an illustration. We think about whether we should be using models or revisiting frameworks that were applied to the data of the 1970s and 1980s. Crucially, while there may be something to learn from that, there are also reasons to think that that experience is not immediately relevant here. That goes back to my point that that is an experience in the 1970s and 1980s where there was not an inflation target and, therefore, this anchor for price developments— provided by the inflation target and an independent MPC seeking to get inflation developments back to the inflation target—was absent.

In the 1970s in particular, the 1980s and that period, we see evidence that longer-term inflation expectations became somewhat de-anchored. The evidence of that in this experience is different and importantly so. It is that anchor and the fact that longer-term inflation expectations have not drifted away from target that is providing a core element of our forecasting.

We can learn from some of the experience of the past, but the world is very different from the past in many respects. The structure of the UK labour market is very different. The structure of the economy more widely is different. In particular, the regime in which monetary policy is conducted is very different.

Q815 **Chair:** What really worries me and is slightly making me despair, hearing you talk about looking back over the last 30 years—primarily because that is when you had the Bank of England's inflation target that had

become anchored—is that I remember bankers and traders telling me exactly the same thing in 2007 and 2008. "The last 10 years have been different. Look how low volatility is". There I was, having gone through all the shocks of the 1990s, saying, "No, this could get much worse". I feel that you may have made the same sort of error as bankers and traders did running into the financial crash.

Huw Pill: I think that we will talk about this in a moment. We are producing a baseline forecast—the modal forecast, in the language used in the most recent monetary policy report—which is, essentially, using the experience of the last 30 years. We have introduced some additional judgment collectively, as a committee, in order to induce greater persistence in inflation than the experience of the last 30 years would suggest, but that is a relatively modest increase.

Also, reflecting precisely the concerns that you are describing, we have introduced what we call a skew or some skew to the risks around that baseline forecast. That skew—that possibility that inflation may be much higher or more persistently above the target and take longer to get back down to the target—is not really justified by the modelling of the last 30 years, but it is motivated by a variety of factors, looking at the forecast errors and behaviour we can see in the economy right now, but also by the type of experience and the need to entertain the types of possibilities you are describing.

It is one thing to say that we are concerned about that risk. I do not want to front-run some of the questions that you have in your script coming up. At least for me, and probably in terms of the median person on the committee and the resulting vote of the committee as a whole, that skew in the outlook for inflation towards the upside—the greater likelihood that inflation will run above the modal baseline view than below, based on the experience of the last 30 years certainly—is rationalising and justifying the increase in interest rates we made, for example, at our last meeting. There is an attempt, and it is important to emphasise that it is an attempt, that has to be based, to some extent, on judgment, but one that is entertaining the risks you have just described.

Chair: I am sure that we will come back to this. We will no doubt have an opportunity to hear the point in a moment.

Q816 **Mr Baron:** Good morning, everyone. In looking at the bank rate going forward, some of us, it is fair to say, have long believed that central banks, including the Bank of England, have been well behind the curve with regard to inflation. As the Chair has said, forecasting has been awry. The Bank of England is one among others that has been too slow in raising interest rates, allowing inflation to mushroom well above the 2% target.

I have put it as strongly as suggesting that it has been a woeful neglect of duty. It is causing real pain out there for people and businesses. We should always remember, as we sit in our, sometimes, white ivory

towers, having these debates, that we are talking about people's lives and businesses that are having to grapple with double-digit inflation and interest rates perhaps going up too quickly. I think that you get it, but it is useful to remind ourselves of that.

Why should the public have confidence in your ability to get it right going forward? What lessons do you think that you have learned? What are you going to do differently? I am not hearing a satisfactory answer to that.

Andrew Bailey: There are very big lessons—I think that Huw has already referred to these—about how we operate monetary policy in the face of very big shocks. The shocks that we have faced have been unprecedented, not just in the last 30 years actually. There are big lessons about how we operate policy in that world and in a world of very substantial uncertainty.

I have to say quite often in these hearings that we have to make policy in real time. We do not make policy with the benefit of hindsight. We have had to respond to shocks as they have occurred. There is a genuine debate with food for instance, not so much about the shock itself—I think that at exactly this hearing a year ago, I referred to my concern about food prices and what would happen to them following the invasion—but about the longevity of the pass-through of food prices and what we learn about that. We have a lot to learn about operating monetary policy in a world of big shocks.

I want to say, and Huw has described it very well, that we share the concern of your constituents. No good comes of this. We have to get on top of this and bring inflation back down to target. As Huw said, the reason that we have raised interest rates further and that we are not following the model, so to speak, if I can generalise for a moment about that, is that we are concerned that there are what we tend to call these asymmetric effects as we bring inflation down from very high levels. We have to direct policy at that.

That is why we have taken a conscious decision to aim off that modal case that the model is giving us, because we think that it is too symmetric. Inflation goes up; inflation comes down. We think that there are risks of persistence and we have to respond to those. I would say to everybody who watches what we do with a critical eye—I understand that completely in the world we are in—that that is what we are doing. We are focused very much on what we need to do to guard against what we see as these risks.

Q817 **Mr Baron:** I hear the Bank talk a lot about supply-side shocks and that is a fair point. The biggest one was Russia's invasion of Ukraine. By their very nature, you cannot predict black swan events. I think that Sir David Ramsden misrepresented my position towards the end of our session on Thursday at the Bank of England when he said that we expect you to predict black swan events. We all know that they cannot be predicted.

Andrew Bailey: No, by definition they cannot be.

Q818 **Mr Baron:** One is not saying they can, but one can suggest that forecasting needs to be improved. The biggest black swan event was Ukraine. I put to you the last inflation figures we had prior to the invasion. Inflation was running at 6.2%. The bank rate was still 0.5%. Is the truth of the matter not that you were well behind the curve then, before the biggest shock came along? It is a difficult one to get away from, is it not? The facts would suggest that you were behind the curve before the invasion.

Andrew Bailey: Can I go back over what I call the sequence of shocks that we have had and put it into the context of the judgments we had to make in real time? It is important. The first shock was what we tend to call the supply chain shock coming out of covid. That is a global shock. A lot of it had to with not just disrupted supply chains, but also the switch from demand for services to demand for goods, which are more traded.

That was a shock. I hold my hand up. I made a speech in September 2021 on this subject actually, when that was the dominant shock. You are right: inflation was rising at that point. We took the view at that point that, in a world where that was the shock we were facing, there were grounds for thinking that that shock would be transient.

I want to make an important point. In that speech, I also highlighted my concerns about the labour market in this country. I will come back to that in a moment.

We can now look back and say that, if the only shock that had occurred was the one we were looking at at that point in time—the global supply chain shock—it largely turned out to be transient. Unfortunately, it was then swamped by, as you said, the big shock that came along, which was Russia-Ukraine.

I want to come back to the UK labour market, because that is the important one. We have discussed it many times. In that speech I made in September 2021, I said that I was concerned about the UK labour market and that that was a source of potential inflationary pressure going forwards. The challenge we had at that point—I have been over this ground a few times before, but I want to say it briefly—was that the furlough scheme came to an end at the end of that month, September 2021. Around about a million jobs were furloughed right until the last day of that scheme.

We, along with frankly every other forecaster I can remember outside, had the task of saying, "What is going to be the effect on the labour market of that coming to an end?" I think that all forecasters felt that it was going to cause scarring and an increase in unemployment. It would loosen the labour market and that would have an effect on inflationary pressures. It did not. We now know that it did not.

We hold our hands up and say, "That is a judgment we had to make and it did not turn out right". I want to put it back into the context of the

time. That was a very difficult and unusual period. We made a judgment. I would also say that pretty much every other forecaster made the same judgment and it did not turn out to be the correct one.

Q819 **Mr Baron:** I take it that these are never easy decisions. I mean that. There is seldom black and white in the world. There are always nuances, but I am not interested in other forecasters. I am interested in the Bank of England. That is our responsibility to the British public here.

We talk about history. To my knowledge, and I will be happy to stand corrected, there has never been a period where inflation has hit double digits and, within two years, come back to levels of 2% or 2.5%, which not so long ago—only a few months ago, in fact—a lot of our forecasters here were forecasting. It has not dropped that far within two years. Why did the Bank of England think that it was going to be different this time?

Andrew Bailey: This goes back to what Huw was saying. We have built more persistence into our forecasts. The model would tell you that it would come down much more quickly than that, actually. Like you, actually, we really do not believe that. We think that it is too symmetric. We have built more persistence into the profile of inflation, but there are big effects that are going to work through this year through energy prices.

Q820 **Mr Baron:** Huw mentioned 30 years. You go back and look at inflation over 100 years. It has never gone into double digits and returned to 2.5% or 3% within two years.

Andrew Bailey: If you do not mind me saying, Huw also made the important point that, throughout much of that history, we did not have a regime in which monetary policy was operated to bring it back to target. That is what we are doing. That is what we will do. We have said that it is evidence-driven. If we see more evidence of persistence—we have been very clear in what we are saying—we will have to respond to it.

Q821 **Mr Baron:** You already have, in a way. On 11 May, you increased your end-of-year inflation forecast—correct me if I am wrong—from 3.9% to 5.4%. That is a hell of a jump for any central bank when it comes to forecasting. You are already accepting that inflation is going to be more persistent.

Andrew Bailey: Yes.

Professor Tenreyro: Coming back to your question, I discussed in many of my speeches, and in front of this Committee, what alternative policy decisions would have looked like. In thinking about this, it helps to focus on the fact that monetary policy can reduce inflation by reducing demand, increasing unemployment and reducing nominal and real wages. That is how monetary policy transmits.

Rather than focusing on interest rates, another way of asking the question that you just asked is, "Could the MPC have generated a bigger

slowing down in demand than the one we have seen, with high unemployment, which would have led to lower inflation right now?" I have shown in several simulations what that might have looked like, if we had somehow known about the energy shock or the sequence of energy shocks well in advance, including the Ukraine war.

Q822 **Mr Baron:** You have misrepresented, inadvertently. I am not suggesting that you should have known about the energy shocks in advance. I am saying that we were well behind the curve before the energy shocks.

Professor Tenreyro: That is the point that I want to come to. Suppose we had known, even before. I asked, "How about us increasing interest rates by five percentage points more than we did and starting that increase back in July 2021?", so very early on. In July 2021, inflation was at exactly 2%, but we were expecting an increase to come. I asked about slowly increasing rates to around 8%, starting back then.

Unemployment would have been about three percentage points higher. There are issues about how to get that unemployment with a furlough scheme, but let us leave that to one side. The benefit for inflation right now would have been relatively small, reducing the peak to 9%, which would still have been well above target.

Crucially for our remit, we focus on achieving the target in the medium term. The simulation shows that, if you applied that tighter policy, that would have led to a massive undershooting of the target in the medium term, which would not have been consistent with our remit. This has to do with the shape of the shock, which is an increase in price levels, and the tool that we have, which operates only after a significant lag.

Mr Baron: I will be returning to that later.

Q823 **Anne Marie Morris:** We all recognise that persistence is a big risk. Without wishing to put words into your mouth, I would probably say that it is persistent right now. It seems to me that we may have got to a point where the simple formula that you put the rates up and inflation will come down is, frankly, not fit for purpose. Clearly, in all the work you have done, you have begun to tweak that.

I hear all you say about shock events and the impact, but that has very much focused on the supplier and producer side, not the consumer behaviour side. I think that it was you, Huw, who made the point earlier that this is what is really different. Therefore, my question to you is this: what have you done to dig down into really understanding what that behavioural change is?

Are people just thinking differently because of the impact of covid? Is there a sense that, "If the Government will pick us up out of covid, they will pick us up out of anything, so we will just keep spending because it will be fine"? What is that behavioural change and have we got to a point where that straight intervention by the Bank, effectively using interest rates to get inflation down, cannot work any longer in a vacuum and you

need other things in the mix, from Government or other agencies, to bring inflation down?

Huw Pill: In the spirit of Silvana, can I pick up on a talk I gave quite recently, which I think addresses this point? I agree with you that persistence is the key question in the current environment. There is a sense in which it is always the key question from a monetary policy point of view, given the lags in monetary policy transmission, which have been discussed. It is always that we have to look forward and think about what inflation will still be there at that 18-month to two-year horizon, when what we do with monetary policy today has its maximal effect on price developments.

Persistence is key, but not all persistence is the same. I am repeating back your question a bit, using my language. One form of persistence, which I have called extrinsic persistence, is just that you get a series of shocks, to use Andrew's language, which push inflation up. We have seen the consequences of the pandemic in terms of supply disruption in supply chains at the global level. We have seen the impact of higher energy prices and the tightness of the labour market in the UK associated with maybe pandemic-induced restrictions to labour supply. These are all things that I think we are going to come back to. Of course, there are food prices too, as we were discussing earlier.

Each of those shocks comes through on the supply side. It pushes prices up. It creates a difficult trade-off for monetary policy because prices are going up at a time when the impact on the real spending power of UK residents is being squeezed. This creates exactly the dilemma and the difficulty for households and businesses we were just discussing. Our job is to manage that.

One interpretation is that you have had this sequence of events, one after the other, that have all gone in the same direction and have produced persistence in aggregate inflation but for a series of inflationary shocks, one after the other. Just as you think you are getting through one, another one comes. That is a view where you probably would say, "Yes, we can measure that using our models and our experience of the last 30 years. We cannot predict shocks; otherwise they would not be shocks, so we just have to add up those things".

The key question is whether there are what I would call multiplicative effects across these shocks, so they interact with one another in ways that are not captured by just adding up. I think that Andrew was getting to this point about the tightness of the labour market associated with these disruptions to labour supply, such as early retirement, long-term sickness and so forth. That tightness interacted with the higher cost of energy and of imported goods in ways that created greater persistence in aggregate inflation than we would have expected from previous experience.

Finally getting to your point, on top of that there is the question of whether behaviour is just different. It may be consumer behaviour, but it may also be the behaviour of firms and how they price. It may be the behaviour of banks and how they lend. Lots of parts of how the inflation process works in the economy and how monetary policy actions feed through to the inflation process along the transmission mechanism may have been changed because the way people behave when inflation is at 10% could just be different from the way people behave when inflation is at or close to 2%.

Q824 **Anne Marie Morris:** I challenge you and say that I do not think the change in behaviour is just about the percentage points. It is about the cultural norms, which have changed fundamentally in society following, particularly, covid.

Huw Pill: That is a conjecture. We have talked a lot, and this is a similar but distinct story, about whether we have shifted into a world of slightly more inflationary psychology. That becomes a little self-fulfilling. That is not to say that we have de-anchored longer-term inflation expectations, but, precisely because it seems like inflation is more persistent, people behave in a way that generates greater persistence.

Q825 **Anne Marie Morris:** As a consequence, what is it that can be done to address this? It seems to me that the power to change this is not only in the hands of the Bank of England. It has to be a joint effort between the Bank of England and Government policy. It is that piece that needs reworking.

Andrew Bailey: You raise a really very interesting point. In quite a few hearings since covid began we have been asked questions about scarring, particularly early on. We tended to interpret those questions in a rather traditional sense of scarring in terms of damage to capacity in the economy, often through the failure of firms, for instance. There were quite a lot of questions on scarring, not just in this Committee but generally. The concern was how many firms were going to fail as a result of the impact of covid and what it was going to do to the productive capacity of the economy.

Your question is very interesting because, looking at it today and looking back, it turned out not to be the right way to look at it. The interesting point—I take this to be the sort of point that you are going to—is what impact it has had on the labour market and people’s, in a sense, supply of labour into the market. We see changes. The whole question of participation in the labour force has changed. It is beginning to head backwards, but that heading backwards is very concentrated among the younger workers, not the somewhat older group.

We see changes in terms of the labour supply that we did not predict. It is true to say that these changes have come out of covid. Part of it is a medical story, unfortunately, but there is a bit more to it. The evidence suggests that there is rather more to it than that, probably. You ask a

really interesting question. We are learning things from covid as we go along, in terms of the legacy it is having.

Dr Mann: I was the head of macroeconomic forecasting for the OECD and for Citibank, so I know a lot about models and what they can do, what they cannot do, skeletons in the closet and so forth. I started talking about persistence in January 2021. I wrote about my concerns about underlying strength in the economy and the prospects for persistence in price setting and wage setting in my annual report to you folks last August. The committee started talking about persistence in November 2021, so persistence has been on our radar for a very long time.

You know that I have tended to vote not with the majority. I voted for higher bank rate changes at most of the meetings last year. That is because, in my view, we were underestimating the degree of persistence, the persistence of persistence, in our judgment. The model was never telling us about persistence, primarily because it was estimated on historical data. It is linear and, therefore, cannot address some of these behavioural changes that we observe at the micro level.

We get information from our DMP, from our agents and NMG, from our various high frequency and very granular information, but individually we make different judgments about how to incorporate that data into the model forecast and then incorporate additional information that we are getting from our higher-frequency data. Those are the judgments that individually we bring to the committee.

We end up with a best collective judgment. This time around, in our presentation of the modal forecast and the mean forecast, the mean forecast incorporates a substantially higher degree of persistence, coming from more resilient household spending as well as a dynamic between firms as they price in the marketplace and consumers as they choose or do not choose to buy. Some things, everybody has to buy.

Chair: Can I clarify for the record? You said DMP.

Dr Mann: That is the decision maker panel. That is our firm-level survey. It is monthly. We get quite a bit of information from that about what firms are pricing now, but also what they think they can get in the marketplace when they price a year ahead. That is very important information. They can look at households and households are saying, "I think that inflation is going to be 4% or 5% next year". Again, we have surveys of the households.

If the households think that inflation will be 4% or 5% next year, firms say, "Sure, I can price at 4% or 5% next year". It becomes a reinforcing dynamic until consumers boycott and say, "I cannot", because of the purchasing power or cost of living, or, "I will not pay that high price". Ultimately, it is consumers who discipline firms.

Q826 **Anne Marie Morris:** You are absolutely right, Catherine. That contribution was really helpful. To me, it says that there is a big piece that we still do not fully understand and I do not see enough attention being given to. That is the dynamic of behaviour and how you put that into, if you like, the modelling. We recognise that it is an issue, but I do not think that we have found a solution. I am not sure that I have yet seen the hunger to find a way of doing that. Without doing that, I am not sure how we are going to deal with this persistence issue.

Andrew Bailey: I wanted to finish off my response, because you make a very good point. I come back to this point about labour participation. The question of the incentives to participate in the labour force is not something for monetary policy. Obviously I do not comment on fiscal policy, but it is naturally in the territory of fiscal policy.

Q827 **Andrea Leadsom:** Dr Mann, that was really interesting. Have you done any work on whether economic forecasting is dead? Obviously it is an incredibly valuable tool, but you have heard the Committee's unhappiness with it. We have seen how inaccurate it has been. Was it a sixth sense that told you this was going to be more persistent? Do you do scenario testing? Would scenario testing be a better way for members of the public to see, "On the one hand, it could look like this. On the other hand, if this proves true it could look like that"? Do you do some formalised work on looking at ways to predict the future that could be better than an economic forecasting tool that, as you say, is linear?

Dr Mann: Everyone has a linear model, because it is very difficult to do non-linearities and asymmetries in the context of a standard set of economic models. That is why bringing judgment into a forecasting exercise is a requirement and everybody does it.

Q828 **Andrea Leadsom:** I understand that they do, but should they?

Dr Mann: You have heard from Silvana her scenarios. If you look at some of my speeches, you will see my scenarios. In the context of our communication with you and the public, or anybody else who reads the speeches, we provide you with the kind of information that represents scenarios. The question is whether those should be formalised within the context of the, say, monetary policy report.

There was scenario testing back in covid. We also do different assumptions of some of our key assumptions, for example a constant rate assumption versus the market yield curve assumption. There are avenues to do scenario testing.

Q829 **Andrea Leadsom:** Further to that, does it work to have a Monetary Policy Committee where your speeches and Professor Tenreyro's speeches are heard, but your views and hers are not acted upon? Clearly, the consensus view was something different, and we are where we are, but does the MPC work as it is intended to do, or is it ending up with the wrong results, in your opinion?

Dr Mann: The advantage of the structure of the MPC is that we have individual accountability as well as a collective judgment. In the context of individual accountability, everybody knows how we vote. That is not true of other central banks. You know how I vote and you can read speeches that basically tell you why. That provides quite a bit of information to the readers of the speeches.

There are other central banks, the Federal Reserve, for example, where I worked for quite a while, that have speeches and a dot plot, but you do not exactly know how anybody voted. The pattern of individual accountability and communication is a strength of the MPC. It is also valuable as a way of communicating with the public the challenges we face.

Q830 **Andrea Leadsom:** You would stick with it as it is.

Dr Mann: There ultimately has to be a collective judgment. There is only one bank rate and it has to go a certain amount. When I came here to the Committee for my testimony, one of the questions was on the balance between individual accountability, the vote and the collective judgment.

Q831 **Andrea Leadsom:** Professor Tenreyro, would you agree with that? Is the MPC right as it is? Would you change it?

Professor Tenreyro: Let me answer the question you started with, which is whether we can do without forecasts. The answer is "absolutely not". The impact of monetary policy is felt two years or 18 months from now, so we need to think seriously about where inflation is heading over that horizon.

Q832 **Andrea Leadsom:** My question was not whether we should do away with it. It was whether we should move to more scenario testing, so different alternatives, rather than one.

Professor Tenreyro: As Catherine said, we do a lot of scenario analysis. Going back to Mr Baron, the question was what would have happened if you had done things differently. That is where we need to move the conversation from just a qualitative assessment, "You could have moved a month or six months earlier", or whatever, versus, "What would that have done to the outcomes of inflation and the economy?" These are important discussions to have and I am sure that we will see a lot more work going back and assessing, "What could have been done differently?"

Let me just reiterate that there was no escaping a big peak in inflation. Energy alone, at peak, was contributing four percentage points to inflation. If you add food price inflation to that, as well as other tradable goods, you are facing external inflation of eight percentage points at the peak of 11%. This is at peak.

As I said before in this Committee, in order to offset that, we would have needed an enormous deflation, negative inflation, which would have

required bringing unemployment to double digits. There is no escaping, given the enormous size of these shocks, a large peak in inflation, which then triggers the second-round effects, most of which are also unavoidable. Obviously they will wane, but there are many mechanisms in the economy of implicit or explicit indexation that mean that many of those second rounds are well embedded. That is where monetary policy can lean against over time. I just wanted to clarify those points.

Q833 **Andrea Leadsom:** You are happy with the MPC the way it is too. You think that it works as it is.

Professor Tenreyro: The MPC is phenomenal in the sense of bringing in different views and perspectives. We have a very healthy and rigorous discussion of where risks lie. As Catherine said, the system of majority voting, which is very different from other central banks, is very helpful.

Q834 **Andrea Leadsom:** Governor, is the MPC fit for purpose? Secondly, is there a second order, which is banks failing to pass on higher savings rates, leading to an inflationary impact because there is a disincentive for people to save?

Andrew Bailey: Let me start with the MPC. I welcome the comments that Catherine and Silvana made. I am fiercely committed to the fact that there is no groupthink on the MPC and that there is transparency. Deliberation is at the heart of what the MPC does. Different views are expressed. We have not had a unanimous vote for quite a long while. That is not a problem to me. I am fiercely committed to this.

Let me say two things about the forecasting process that I think are important. One has not been said yet. These are always conditional forecasts. They are conditioned on a range of market prices and Government policy, particularly fiscal policy. All our forecasts are conditional and things change.

Let me give you an example. We completed our May forecast—I do not know—about three weeks ago, I guess. The gas price is already 10% lower than it was three weeks ago, so our forecast today would not be exactly what it was three weeks ago.

Q835 **Andrea Leadsom:** Therefore, since you are all, one way or another, central bankers and economists, should you not get some farmers and ex-money market traders into the Monetary Policy Committee? Essentially, you are all saying, "Things moved much faster and further than our models said they would".

Andrew Bailey: That is exactly the point, though. We condition the forecast, not on what we think the gas price is going to be but on what the market thinks the gas price is going to be. In fact, we are embodying the views of exactly those people.

Professor Tenreyro: There is a whole industry focused on making money out of this.

Andrew Bailey: They change their view. That is fine. The world changes. They have changed their view in the last three weeks. It is happening a lot to us at the moment, so we have to deal with that.

The second point I wanted to make, before I go on to saving rates, is that the forecast is the best collective judgment of the committee. There is a tension, because there is obviously a tension between what I said about a fierce commitment to the fact that we are not doing groupthink here and the fact that we have to come together and agree a best collective judgment.

The way we do that, particularly at the moment, is a fan chart with risks in it. As Huw was saying, we have the biggest ever upside risk on inflation at the moment. I know that not all of my colleagues sitting next to me today will take the same view on that. That is okay. We have the challenge—I will be honest with you, and some of this discussion has illustrated this—of how we communicate the fact that it is conditional and a best collective judgment of views. It has a range of views in it. That is a challenge because, if I am honest with you, and I can understand this, there is a natural tendency to want to say, "Just tell me what the number is", as if it is an unconditional view.

Q836 **Andrea Leadsom:** That is interesting. Are persistent public sector strikes causing problems with the consensus view among the public of where inflation will be? Then can you come on to the savings rates?

Andrew Bailey: There is always a question, which is really a question that the ONS wrestles with, but we have to as well, about what the effects of the strikes are going to be on GDP and outputs. I am sure that they are creating some noise in it. We tend to look through that and try, in a sense, to look at underlying output.

In terms of inflation, we look at the labour market as a whole. We have to, because there is competition across the whole labour market. Going back to the point I was making earlier about persistence, and here I am talking about, particularly, private sector wages, they are not growing more quickly than we thought they would. Over time, there is evidence that they are gradually coming down.

Q837 **Andrea Leadsom:** Are you saying that the strikes are not adding to the persistence of inflation, in your view?

Andrew Bailey: I do not think that we have any sense of that at the moment, no. We watch it carefully, because they introduce some volatility into it.

You asked about saving rates and inflation. The pass-through of our interest rate rises to saving rates has been quite different across different parts of the market. The pass-through to sight deposits has been weaker, obviously. It has been less than we have increased rates by. Since we started increasing rates, I see numbers like 140 or 150 basis points, so

1.4% or 1.5%, whereas we have put rates up by 4.4% now. The pass-through to fixed-term deposits has been much stronger.

Q838 **Andrea Leadsom:** It has been okay. What is the impact of that? Could that in itself be inflationary in terms of consumer behaviour?

Andrew Bailey: Our staff are doing a lot of work and we are spending a lot of time on the transmission mechanism of monetary policy. The bigger element in the transmission mechanism is mortgage rates. Saving rates are lower because savings are concentrated particularly among that part of the population that tends to have a low marginal propensity to consume, so the rates do not have as much of an effect. It is mortgages that are more the issue there.

Q839 **Andrea Leadsom:** You think that it is not having an impact.

Andrew Bailey: I do not think that it is a big factor, no.

Q840 **Dame Angela Eagle:** I am not one of those who thinks you should blame the messenger if the forecasts go a bit awry, when everyone else's forecasts have gone awry and we are in a state of great volatility, so I do not particularly have an issue. Economic forecasting is at least as much art as it is science, and so the more transparent your thoughts are, the better it is for people to understand how the policy makers are making decisions that affect them. I do not have too much of a worry about all of that. I do not think that it is ever a good idea to blame or shoot the messenger.

I want to talk about greed-flation, as it is being called. There seems to have been a breakdown now in the relationship between food producer prices and consumer food prices. Instead of that gap staying the same, it has widened and inflation has gone up. That indicates that there might be some profiteering going on. Have you seen any examples, or are you worried about profiteering?

Andrew Bailey: I will come at it from two angles. In food, certainly, you are right about producer prices. Producer prices are a leading indicator of consumer prices. That is how it should work because it is a chain. It comes back to what we were just discussing earlier, which is this question about why the pass-through is taking longer.

The commodity price level is the start of this chain, and producer prices are the bit in the middle. At the commodity price level, nearly all food prices—sugar is probably the exception—peaked last summer in terms of inflation rates. Wheat would be a good case in point there. That is what led people to think the peak in consumer price inflation would come sooner than it has.

As I said earlier, we hear stories about people buying forward at higher prices for longer. We certainly hear stories about energy costs. Our agents do pick up a story about margins. This is particularly from producers.

HOUSE OF COMMONS

Q841 **Dame Angela Eagle:** They call it "rebuilding margins" rather than "profiteering".

Andrew Bailey: Yes.

Dame Angela Eagle: I wonder where the edge is between one and the other.

Andrew Bailey: You have taken the words out of my mouth. It is a story about rebuilding margins that were squeezed, particularly in the early part of last year.

Let me switch to the other point. At the aggregate level, if we look at the economy as a whole, we do not have as up-to-date data, but you can interrogate the GDP deflator, which is the inflation measure in the GDP statistics, and try to allocate it between wages and profits. This is an extremely hazardous and difficult thing to do, I have to say.

At the top level for the UK, it does not show a particular story. I have to tell you that there are all sorts of assumptions built into that. If you would like, I would be happy to write, but please do not expect it to be an exciting letter.

Dame Angela Eagle: All your letters are exciting.

Andrew Bailey: This will be the one that breaks the mould, in that case. When you look at profit series, interestingly in the UK, we still divide corporate profits into what is called North sea and non-North sea, which is a slightly historic thing. It is really energy versus the rest. As we all know, energy profits have been higher, and the rest do not show the same trend.

If you would like, I am certainly happy to write to you and set out what we know.

Q842 **Dame Angela Eagle:** That will be fine. Food inflation is at a 45-year high. When inflation has been as persistent and as high as it has been, consumers do not get to see or notice the way prices are moving in quite the same way as they would in a more stable situation, which creates a circumstance where, if I could put it this way, margins being rebuilt might stray into profiteering. Is the Bank watching out for that?

Let us face it: the producers, the suppliers and the consumers are the only people who can pay for increased food. It looks like it is all being put on the consumers to me.

Andrew Bailey: As I understand it, the Competition and Markets Authority is looking at this. That is the appropriate place. It has certainly said that this is on its radar.

We pick up information via our agents. We are quite transparent about the information we pick up. We have certainly heard the rebuilding story. We will watch it very carefully. As it evolves and as we get more

information, we will certainly let you know and we will publish what we are getting. That is the best thing we can do.

Dr Mann: Let me add to that. You made the point that, when prices are very volatile, the effects are wide-ranging. It is hard to shop to find a cheaper thing, but you also do not even know how much prices are changing.

Q843 **Dame Angela Eagle:** It is hard for your consumer boycotts, which we were talking about earlier, Dr Mann.

Dr Mann: Yes, I have two points on that. First, included in the information we get from the decision maker panel survey is the entire distribution of prices. We can see how wide that distribution is. The wider the distribution, the more challenging it is for the consumer to discipline those prices. Over the last few months, though, that has tightened. In other words, that creates a stronger main signal for consumers to latch on to.

I would like to bring in a second point, though. I was recently in Wales for an agent meeting. I met the new product development team at a kitchen. I got to eat their new food. It was great. I love those kinds of visits. The point they were making is that they create dishes for restaurants. It is frozen food, but it goes to a restaurant. They had found that restaurants were having a challenge in passing through price increases. The consumers were disciplining the pricing down to this producer level.

Dame Angela Eagle: That is at restaurant level, where there are issues with staff shortages.

Dr Mann: It is at restaurant level, but it is an example.

Professor Tenreyro: I have one observation. There is a global component to all of this. If you look at cumulative price inflation since December 2019, just before the pandemic, food inflation in this country was 25%. In the US it was 24%; in the euro area it was 27%. This is all within the same ballpark. There is a big global component. When we think about the causes or the drivers, we need to keep that in mind.

Q844 **Dame Angela Eagle:** Governor, finally, do you see profit margins and increasing markups as a source of persistent inflation, as you have been warning about wage rises?

Andrew Bailey: If you do not mind me saying, in that comment—this goes to what Catherine was saying earlier—I was really concerned about how firms set prices looking forwards and how they build in inflation expectations. We do believe inflation is going to come down; we believe that strongly.

Catherine has already mentioned the decision maker panel survey, where we ask firms what their output prices are going to be looking forward.

That is a pretty good guide as to how they are thinking about the future and how they are building in inflation expectations. That measure has come down. It has come down by about 2% since last autumn. We do watch that carefully.

That was my point: it was about how firms incorporate both backward-looking costs and forward-looking inflation expectations when they set prices. It was not meant to be directive. It was meant to be, "Look, we have a view. We think inflation is going to come down if for no other reason than the energy price story. How are you going to incorporate that into prices?"

Dr Mann: In addition—this is one of the charts in the box in the MPR—as part of the inflation discussion, we can ask firms, "Do you change your prices every six months or do you change them based on what you think cost structure and pricing discipline is going to be going forward?" That is called state-dependent pricing.

We observed that, when inflation was rising dramatically last year, the state-dependent pricing going forward was above the ones who changed it only every six months. We observe that, when firms are saying, "I am going to look at the environment and decide how I should set my prices", for the ones who use state-dependent pricing—inflation is coming down, in their view, or is going to be coming down in the future—the expected prices one year ahead are one percentage point lower than for the ones who change their prices every six months. Firms are incorporating the expectation that inflation will be lower in the future and they are pricing accordingly.

Dame Angela Eagle: That is good to hear, but it is going quite slowly.

Dr Mann: Yes, it is.

Dame Angela Eagle: The persistence of high inflation, to use the phrase that people have used, is going to be stickier going down than it seems to be going up.

Chair: Yes, that is a very good point.

Q845 **Siobhain McDonagh:** I just want to look at increasing interest rates and the housing market, particularly for owner-occupiers. Compared to 2022, mortgage possession claims have increased from 2,889 to 4,035. Last month, 700,000 UK households missed or defaulted on a rent or mortgage payment. With the costs of borrowing going up again due to your interest rates rising, mortgage holders are under more pressure than ever.

When you look at interest rises, do you look at the impact they will have on repossessions and mortgage defaults?

Andrew Bailey: We do. If I can put my financial stability hat on for a moment, it is important to us in terms of how it affects the mortgage market and the people involved.

There has been one very good development in this country over quite a lot of years. If you go back to the early 1990s, for instance, when interest rates went up quite substantially, the rate of house repossession was very high. There is now a lot of regulation in place. As you have said, it does happen, sadly, but there is a lot of regulation to limit and try to avoid house repossession wherever possible. I would expect the numbers to be lower this time, but one house being repossessed is not good. It is a bad outcome, as you say. We do look at it very carefully.

If you do not mind, I will just broaden it out. As I said earlier, to the question on the transmission mechanism, the mortgage market is very important. The UK mortgage market has changed fundamentally since the last interest rate rise cycle, which is back before the financial crisis. Back then it was predominantly a floating-rate market; today it is predominantly a fixed-rate market. About 85% of mortgages are now at fixed rates. They are not as long as in the US, but they are still in the two, five or seven-year range.

We look a lot—it has been a big focus for the MPC in the work we do on the transmission of interest rate rises—at how this is going to come through. We said this in the report. There is quite a good chart—I wish I had showed it at the press conference—showing that quite a lot of our interest rate rises have not yet come through in the mortgage market. One-third has come through and two-thirds has not. That is because of the fixed rate resets that are going to happen during the rest of this year and going into next year. We take that into account when we consider the impact of monetary policy. It is important that we do that.

Q846 **Siobhain McDonagh:** One way the mortgage market has particularly changed is the intervention of private renting and buy-to-let mortgages, which are having a huge impact on private renters. One in 20 tenants missed or defaulted on a rent payment last month. The average rent in London is now over £2,000, which is 11% higher than it was last year. In April, 2 million householders missed or defaulted on at least one mortgage rent, loan, credit card or bill payment.

What has the impact of interest rates been on the private rented sector and what will be the impact in the future? From my community's point of view, there has been a huge increase in the number of private tenants being evicted.

Andrew Bailey: I spent time last week with Citizens Advice in Exeter meeting people and hearing just the same stories. I am afraid monetary policy cannot be the answer to that problem, but I agree with you that we have to watch and be very alert to this. Some of the stories I heard last week were very difficult stories, to be honest with you, in terms of the impact on the rental market.

Q847 **Siobhain McDonagh:** We would all agree that scarcity in the housing market is a real issue.

Andrew Bailey: Yes.

Siobhain McDonagh: We have a house-building crisis in the UK. Over the past 40 years, the overall social housing stock has declined by 1.4 million homes. In my borough, Merton, last year we had 72 two-beds to let, 34 three-beds and two four-bedroom properties, with 10,000 families on the waiting list. That tells me—I do not know about anybody else—we are simply not building enough homes or doing enough to encourage new development. With borrowing becoming more expensive again, are we heading towards a further house-building crisis?

Andrew Bailey: Your numbers are ones I hear quite often. I have to be honest: the Bank of England does not build houses. I cannot really go beyond that.

Q848 **Siobhain McDonagh:** The issue is about people having to borrow more with house prices going up. The average house price in the UK is 10 times higher than it was in 1980. That means the size of a mortgage a household takes out has drastically increased. Even though interest rates rose to a high of 15% in the early 1990s, rate rises have a much bigger impact today than they did in the 1980s and 1990s because households are borrowing more. Is the era of cheap money over? If so, what does it mean for people who have incredibly large rents and mortgages?

Andrew Bailey: If you do not mind, I will switch over to the financial stability side again for a minute. I know we have discussed this in financial stability hearings here, but the FPC has in place a policy that limits the proportion of mortgages that can be at high loan-to-income ratios. The FCA also has affordability tests in place.

Those policies are all designed to limit the amount of damage, in a sense, that is done in the situation we are in. I agree with you: none of this can stop the fact that these cases happen. It is unfortunate. Taking a broader policy approach, we need ways to deal with that.

On monetary policy, coming back to this point about the switch in the mortgage market, the transmission of interest rates through the mortgage market is still taking place, but it takes longer to happen because of the switch from floating to fixed rates.

Q849 **Siobhain McDonagh:** Looking at the housing market over the last 12 months, rents in the UK have hit a record high. Mortgages are costing families £1,400 a month in London on average. At the same time, food and energy bills are going up, as we have already discussed. People feel they are being attacked from all angles. Certainly, every week in my advice surgery, I see lots of people who just cannot cope. With mortgages seemingly going up and up, how much more of this can people withstand?

With regard to Catherine's point about consumer power, if you have children, you have to have somewhere to live. How much consumer power do you have?

Andrew Bailey: I am going to say something I have said before, but I think it is important to say it frequently, frankly. All inflation hurts, and it hurts the least well off the hardest. This inflation is particularly hard because it is concentrated in energy, food and housing costs. We are very aware of that. If we do not get it back to target and under control, it gets worse.

That is a hard message. I know it is a very hard message to give. I do not like giving it because I do not like the fact that there are people who are experiencing real suffering. It is the least well off who are seeing the hardest effects, but we have to get this inflation back under control.

Q850 **Danny Kruger:** Some optimism is breaking into the gloomy halls of the Bank of England of late, which is encouraging. Having been very pessimistic about the prospects for the economy, we are now seeing some predictions of not negative and even positive growth. We are still at the pessimistic end of the range of forecasts, but sunshine is breaking in, which is encouraging.

Last week, we spoke a bit about the prospects for supply-side reform and the importance of getting that right. I just wanted to know—I do not know who would like to answer this, but maybe some of the independent members—which primary supply-side reforms we should be hoping for and looking at in order to boost growth in the UK.

Dr Mann: I am not going to comment on policies I do not control. It is very important to take the estimates from the OBR and other independent sources on the prospects for supply-side reforms in fact to yield supply-side changes. I take those as given and incorporate them in my assessment and judgment, but I am not going to make a judgment as to which is the best one to do.

Danny Kruger: Professor Tenreyro, you are stepping down from the committee.

Professor Tenreyro: I am in the same position as Catherine until 5 July. Yes, we take fiscal policy as a given and then act with our tools to get inflation back to target.

Q851 **Danny Kruger:** I am not asking you to comment on policy and certainly not to make recommendations on policy, but, in terms of the different aspects of the supply side of the economy, what are you looking at with either hope or otherwise about what might help to drive growth? Which aspects of the supply side should we be paying attention to?

Professor Tenreyro: Again, I am not going to comment on that. We incorporate what Government do into our forecasts.

Dr Mann: We could talk about what is in the supply side, if you want to take a theoretical approach. It is capital, so business investment is very interesting; it is labour, which we have talked about a lot; and it is innovation. Those are the three elements that are critical ingredients in the prospects for supply-side growth.

I will give a plug for my previous organisation, the OECD. It does a great job at looking at all the different elements that support supply-side growth. They will even produce a recipe that is best for the UK. I would do that if I were still there, but I am not.

Q852 **Danny Kruger:** Thank you. That is helpful. Let me push a little more on the interaction between those three elements of the supply side, then, looking particularly at labour and principally at immigration. It sounds like some big numbers are going to be announced this week in terms of net migration over the last year. Do you recognise that high rates of immigration can inhibit investments either in capital or, indeed, in the skills of the domestic workforce, and that that can inhibit productivity growth in particular?

Andrew Bailey: We do not comment on immigration. Just to be clear, our current forecast takes the ONS population projections into account as they are. As we understand it, those projections are going to be revised this week. This is another point about doing conditional forecasts. We will take the new projections into account, but it is not appropriate for us to comment on immigration. That is not really our forte.

Q853 **Danny Kruger:** Okay, I tried. Going back to these forecasts, I appreciate that there has been a lot of conversation about this. I share the view—Angela has left, I think—that you have to make predictions in real time and you are reacting to extremely volatile circumstances.

I am intrigued to get your sense, being honest, about the effect of pessimistic forecasts. Do they become self-fulfilling? To what extent do you have to consider the effect of what you say in terms of being objective? You are trying to be objective, but there is a dynamic effect as a consequence of your predictions. What has been the effect of the way you have been forecasting?

Andrew Bailey: It is interesting to hear you say that. It is an interesting question. Since November, when we were forecasting not a deep but a long recession, measures of consumer and business confidence have improved. On the face of it, you would say that it does not seem to have had much effect.

I would take a step further than that. Why is that? What has happened during that period? One of the quite sizeable contributors to why we have amended our view on growth in the economy is the fall in energy prices. If you remember, back in November we were looking at very high energy prices and we were not sure whether Europe was going to have enough gas to get through the winter. However, it did. This has been the good news story of the last six months.

We have come through that period. Energy prices are a lot lower. Looking forward, they are over 50% lower than they were back in November. We did get through the winter. We are now going through a period where Europe is much more stocked, particularly with gas, than it has been in recent years. That is probably affecting confidence more than our forecasts. It could be the case, but I do not think it has been in this case.

Q854 **Danny Kruger:** Lastly, I just wanted to ask you about the good news on energy costs. At our session earlier in the year, I was even more pessimistic than you, and certainly more pessimistic than the OBR on the forecast for industry prices. They do seem to have fallen. How do you account for this? Have we suddenly discovered some amazing new source of LPG?

Andrew Bailey: A number of things have happened. First of all, some things do go right. The winter was not as cold as it could have been across Europe. Europe is a single market, particularly for gas.

Secondly, our staff produced some quite nice charts for us showing that across Europe, including this country, for a given level of temperature gas consumption has been lower. Thirdly, a lot of work has already been done on supply. There is more liquified natural gas coming in from other parts of the world to Europe.

The experts—I do not include myself as one—would say that it is not yet done and dusted. Certainly, gas suppliers say to me that it will probably take until the end of 2025, at the current rate of building infrastructure, to get Europe to a place where it has broken Russian dependence and can rely on LNG from other parts of the world, but the position has substantially changed already.

Danny Kruger: Maybe it was your pessimism that helped to make people be more abstemious with their energy use.

Andrew Bailey: I think it might be the cost of energy, actually.

Danny Kruger: Yes, but in terms of the forecast.

Chair: You are right to highlight the increase you have made in your growth forecast. The OECD has done something similar. It has been good enough to agree to come in front of our Committee. The IMF has also said today that we are going to avoid a recession in the UK. Unfortunately, it does not submit itself to the same level of scrutiny you kindly do.

Q855 **Emma Hardy:** My questions are going to focus on the labour market. To begin with, Governor, are there signs of an easing in labour market pressures? In your report, you expressed surprise at the extent of the labour market tightness in the forecast. Why were you surprised? Was it not what you were expecting? Are you perhaps more sceptical than you were about the forecast that the labour market situation will ease?

Andrew Bailey: The surprise was that in the early phase of covid, quite a lot of countries saw a reduction in the size of the labour force, with people going into inactivity. Remember, inactivity is people who are not working and not seeking to work, as opposed to unemployment, where they are not working but are seeking to work.

Britain was not unusual in that sense, but most other countries saw that change turn around as we went through covid and people came back into the labour force. That did not happen in this country.

To your question about what we are seeing now—we had some labour market numbers out last week—in aggregate about 60% of that change has reversed itself now. Interestingly, there were two groups in the population that showed greater inactivity originally. One was the student age group and the other was the older, 50 to 64 age group—somewhat older. I do not like saying this because I am teetering at the edge of that range.

Dr Mann: It is a prime age.

Andrew Bailey: Yes, that is right. We are seeing that this reversal is mostly in the student group. It is not so much in the older group. The older group is not coming back into the labour force. Why is that? Ill health is one reason. Long-term sickness went up a bit last week, again, as a reason for not coming back into the labour force. It is not the sole story. Some people have probably chosen to retire early.

By the way, this has to be set against the background of an ageing population. Some of this increase in inactivity would still have happened irrespective of covid. We are talking about the additional element beyond that, really.

Q856 **Emma Hardy:** Huw, the report says that the increased prevalence of people outside the labour force citing sickness—as the Governor just said— as the main cause is yet to show signs of reversing. How much of this is impacted by increased NHS waiting lists, the unmet need for medical treatment and the poor situation with the NHS at the moment? How much of that is making a significant contribution to the inflationary pressures that everybody is feeling the pain of?

Huw Pill: In terms of labour market developments, the Governor has described what we see. There was a certain anomaly or at least a question in the data. If you asked people in the 50 to 64 age group, as they left the labour market to become inactive, why they were doing it, there was a long period through to the end of covid where they were saying it was to take early retirement. If you asked the people who were inactive, the stock of people rather than the flow of people transitioning into inactivity, there was a rising share of people referring to long-term sickness.

In the most recent data, as was said, the former has reversed a little bit, although most of the aggregate reduction in flow into inactivity is coming from the younger ages, particularly the student population. That view about long-term sickness remaining an issue and keeping people out of the labour market is persisting.

In the spirit of trying to identify some good news, we have seen in the most recent data that, in that 50 to 64 age group, the percentage of people who say they have become inactive and do not expect to return to work has declined by a decent amount.

Q857 **Emma Hardy:** Is there an assumption that, if the sickness were dealt with, some of these people would therefore be returning to the labour market?

Huw Pill: That is possible. We do not have information at a granular enough level to know that, but the fact we have seen a decline is consistent with that view. These are separate questions. One question is, "Why are you inactive?" and they may report long-term sickness. There is another question that asks, "Given that you are inactive, are you likely to return to work?" We cannot cross those two things, but nonetheless we do see the consistency.

Q858 **Emma Hardy:** Is there no information anywhere, then, on the number of people within that bracket who are citing long-term sickness as the reason for economic inactivity who would be looking to return to work, if that sickness were dealt with? You do not have any information on that.

Huw Pill: No, not in that form. I see the attraction of having that information, but we do not have it quite in that form.

Q859 **Emma Hardy:** Taking account of the Governor's comments earlier, to what extent has the upgrade to economic growth in this forecast been driven by the higher than expected migration and increased labour market participation?

Huw Pill: As Andrew said, we take the ONS population projections. They are set to be revised, and there is a general consensus on the direction of that revision. The latest revisions, which we incorporated into our forecast, led to an increase in the level of GDP of about two 10ths of a percentage point over our forecast horizon. It is not a dramatic change.

Crucially, the way we treat that in the forecast is an improvement on the supply side, but it also bears higher demand. We have more people in the economy so they are contributing to the productive capacity of the economy and demand in the economy. That washes out in terms of the pressure on resources and, therefore, on inflation.

It really is more of a growth story. That is the magnitude we have seen in the revisions to the population projections thus far.

Q860 **Emma Hardy:** I am just thinking about the labour market in general. Of

course, I am referring to legal migration, people coming here and working. If that number were significantly reduced to tens of thousands, what impact would that have on food prices and inflation, if you are looking to significantly reduce the number of available people to work?

Huw Pill: As I said, our forecasts are subject to all the critiques we discussed earlier, but this is what we use as the basis for discussion. Of course, we do not have good information on illegal forms of migration for obvious reasons, but we would treat it in the same way. We say that, when the population projections rise, that increases the productive capacity of the economy, but it also means there is more demand in the economy. That is a wash in terms of the impact on excess demand, which is the main driver of inflationary pressure.

That is the way we treat this, by default, as the basis for the discussion in our forecast and the starting point for the debate we have had here. That is how I would characterise the role the forecast plays in MPC discussions. It is in that form.

Q861 **Emma Hardy:** Just to open it out to the panel, what are your views on whether the corner has been turned on labour force participation? Are there still concerns about the labour market and how tight it is? What risks do you see or, to be more positive, is there anything we can look forward to in the future labour market?

Andrew Bailey: When I look at our forecasts and how we have revised them over the last year, one of the biggest and most interesting revisions is the profile of unemployment. We have changed our view quite substantially on what the profile of unemployment is going to be going forward, consistent with bringing inflation back to target. It is now a lot lower than it was. That is born of a lot of experience of the data, frankly, and talking to firms around the country about what their plans are.

When I go around the country, one thing that impresses me consistently is that firms say they are going to retain labour. They are not going to make people redundant, because they find it so hard to recruit people in the current economy. The vacancy-to-unemployment ratio is coming down, but it is still high by historical standards. They will adjust hours worked, if they need to, rather than make people redundant. It has certainly caused me to change my view on what the profile of unemployment is going to be.

You can very well put back to me—it would go to Mr Baron’s points earlier on—“What does that imply for the path of inflation downwards and the path of the economy? Is this something that is going to cause us to have to adjust policy?” We watch it very carefully. It is why we say we are evidence-driven. Certainly my view on the profile of unemployment, particularly, has changed a lot in the last year.

Dr Mann: There are two points that are useful to make. First, you commented on skills. We address that in a theoretical format, again, with

data in it. There is a way of thinking about how the problem of matching that means that unemployment can be higher and yet wages can be higher, too. In other words, if you cannot match the skills, you have to look harder and you have to pay more, but everybody is still employed. That is the so-called Beveridge curve.

We look at that and we incorporate that understanding into our assessment. It is the so-called search and matching model. It is a way of evaluating the combination of who is at work and how much they are paid. It does not always fit together the same way over time. The search and matching model is an important ingredient in our understanding about the labour market.

I would agree and emphasise that firms are in some sense scarred from having to work so hard to hire people over the last couple of years that they are retaining their labour force because most of them are still looking; most of them still have open vacancies.

If we want to think about one bright spot from the standpoint of inflation, we have several surveys that look at how much firms are paying workers now and are negotiating for over the next year or so. For the stock of workers, that is about 6%. There are also workers who are changing jobs or getting new jobs. Over the past years, those people were getting 12%. If you change job, you get a 12% wage boost.

In this case, we are looking at a deceleration of new job takers, where their wage increase is in the neighbourhood of 4%. There is some deceleration. That is a measure of some loosening in the labour market that we see recently for the people who are changing jobs.

Professor Tenreyro: I agree with Catherine's last remarks. We are starting off with a very tight labour market, but there are clear signs of loosening and employment is edging up. Vacancies over unemployment is falling. As Catherine said, forward-looking indicators of pay growth have fallen significantly. They are signalling or indicating 4%, again coming from very high peaks.

Q862 **Emma Hardy:** Finally, Governor, following on from the questions from my colleagues, we were talking about poverty and the cost of living. When you are looking at making decisions about interest rate rises, do you take into account how many more people are going to be pushed into poverty by interest rate rises? Is that a factor in your decision, if you know that a 0.5% rise in the interest rate is going to push this many people into poverty?

Andrew Bailey: We have to strike a very difficult balance in that area. We do not want to do that. Unfortunately, if we do not get inflation down, it will have worse consequences going forward. That is always the thing we have to have in our mind. That does mean we must use the tool of interest rate rises carefully and sensibly.

It comes back to this question about how quickly you want to bring inflation back to target. We have to bring it back to target, and to do so credibly. People have to think, "Yes, we really believe they are going to do it", but we do have choices as to how quickly we do it.

I would not advocate trying to do it by very severe increases in interest rates because it is not just a poverty question; it would be contrary to our remit. It would cause instability in the economy and inflation, and it could well cause an undershoot of inflation thereafter. We take that very much into consideration because it is consistent with our remit.

Huw Pill: Clearly, we are very concerned about poverty. I agree very much that, when we are setting monetary policy to address the risks of inflation, we are bringing inflation back to target in a way that does not induce additional cost and volatility. The margin you are talking about is a very important one that we have to take into consideration when we do that.

One of the main reasons we are re-establishing price stability in a lasting way is to provide some protection to those vulnerable parts of society that are most exposed to the costs of inflation being high. As has been said earlier on, that is particularly acute now, given the forms of inflation we have seen coming through, such as higher energy prices and higher food prices, which are proportionately a higher part of the spending patterns of the less well off in society. We are providing that protection by containing and re-establishing inflation at the 2% target on a lasting basis that can create that confidence.

That also creates an environment—this goes back to other things that were said earlier—in which households across the income distribution and firms of various types can take investment decisions and other longer-term decisions, which allow them to get the education, invest in the factories and create the innovation, dynamism and productivity that living standards in this country ultimately rely on.

Q863 **Emma Hardy:** It is taken directly into account, then, when you are making your deliberations. You take into account the number of people at risk of falling into poverty.

Andrew Bailey: It is embodied in the remit we have as to how we proceed to bring inflation back to target.

Q864 **Mr Baron:** Looking forward, can I explore the possibility that you may now be overtightening with regard to your interest rate rises? As you have just said, that can cause a lot of pain. I agree you should never shoot the messenger, but at the end of the day, one of your key remits is to keep inflation at around 2%, if not below, and you do not have to rely on City forecasts to base your decisions on that remit.

I point to a possible contradiction in the Bank of England's policy. On the one hand, interest rate rises take perhaps six to nine months, if not longer, to have an effect on the economy because of the lag effect. Up to

11 May, when you increased your inflation forecast from 3.9% to 5.4%, you were still raising interest rates despite knowing that the lag effect was going to be there. If you believed in your inflation forecasts, why are you still raising interest rates?

Andrew Bailey: As we said, we are evidence-based. They are conditional forecasts. The world moves on; the conditions move on. As we have discussed this morning, we have seen more evidence of two things. The first is what I hope are shorter-run inflation pressures, but pressures that nevertheless are evident. We had a discussion about food prices earlier. One of the things we have embodied into the forecast is that the unwind of food price inflation is going to take longer than we thought it would, and then we have to consider what the effects of that are.

The second is persistence more generally. Interestingly, the evidence is that areas like wages and service prices in particular, which have a big labour content, have not really gone that far off the course we had in February. As we discussed earlier, we are very worried about the risk—that is why we have put it in the risk, more than the central forecast—that an asymmetrical unwind of inflation will take place.

Certainly for me, if I go back to the decision we took in May and how I voted in that, that was a substantial consideration at that point in time.

Q865 **Mr Baron:** Can I put it in another way very briefly? You made big upward revisions to your growth forecasts and, in fact, your inflation forecast on 11 May. It was a big jump—1.5%—by Bank of England standards, yet the last increase came in at 0.25%. There has been modest moderation. Does that suggest we are nearing the peak in interest rates?

Andrew Bailey: In February, we made a switch in the language we used when we described the reasons for taking the decisions—we had given a clear steer that we thought there was more to come—to saying that we would be evidence-based. We always reach our decisions on the basis of the evidence, but there was not a prior starting assumption. That was deliberate, in my mind.

Although I cannot tell you whether we are near to the peak or at the peak, we are nearer to the peak than we were. Certainly in my mind, we were approaching a point when it was sensible to make that move away from being directional.

Q866 **Mr Baron:** Briefly and very finally, may I just swing to Silvana? In the interest rate decisions, you argued or certainly encouraged for there to be no increases beyond 3%. Given that you have voted for no change in the bank rate, since it was 3%, is monetary policy, in your view, alarmingly tight?

Professor Tenreyro: As always, the question is how best to meet the 2% target in the medium term. The role of monetary policy, once those shocks occur, is to determine how best to move inflation to the target.

The MPC has raised rates very quickly. We know there are important lags in the transmission of policies. In the staff's estimate, about one fifth of the transmission has already happened and the rest is about to happen.

Mr Baron: You think it is too tight.

Professor Tenreyro: My assessment is that, conditional on this path for market rates, we will undershoot the target. That is my judgment. This is why I have been voting for no raises. Again, the logic of any forecast at this point is that the enormous shocks we faced have pushed up on inflation over the past 18 months, with the meteoric increase in the prices of energy and other commodities, and the after-effects of the pandemic.

Those are going into reverse and will pull down on inflation over the next 18 months. There are second-round effects, and there is a concern about how to balance those risks. My judgment is that we are more than on track. I definitely did not think any more was needed.

Q867 **Andrea Leadsom:** The childcare policy has quite a big impact, potentially, on availability of labour in the workforce. To what extent does that have an impact on your forecasting for a couple of years down the line, in the context of whether in fact we are tightening too quickly now?

Huw Pill: In the spirit of the comments made earlier, we do not comment specifically on fiscal policy, but, as an announced fiscal policy, that has been incorporated into the baseline forecast and our forecasting framework. This is in the spirit of what we discussed earlier. We have a forecast, which is the basis for discussion.

The labour market measures in general have been included in the same manner that our colleagues at the OBR have included them in their forecasts. We are relying on their expertise and focus there. In the OBR forecast, that policy raises labour market participation by about 0.3% or just over 100,000 people by 2027-28.

Within our own forecast, which has a shorter horizon because we are looking more at cyclical developments while the OBR is looking more at trend-like developments around the sustainability of public finances, there is a more modest impact of around two 10ths of a percentage point on the level of activity. That partly reflects the fact the roll-out is not immediate but takes place through time.

I would just reiterate the point I made earlier when we discussed the population projections. There is a combination of demand and supply effects here. The feed-through into inflation impact is not one-to-one. There will also be greater employment and so forth, which will have demand effects. The impact on excess demand will be less than the impact on the overall level of activity.

Dr Mann: Huw has set out very well the way we incorporate the possible evolution in employment on both the supply and the demand side from childcare policy.

I would like to respond to the comment about whether monetary policy is too tight. In my speech in February, I set out a two-step framework for the transmission of monetary policy to inflation and real activity. At the time, I cautioned that change in bank rate was an insufficient metric, as it affects many other asset markets and prices. I offered a new financial conditions index, which incorporated bank rate changes as well as the endogeneity of these other asset prices.

The bottom line on that is that tightening and tight are not the same. There has indeed been tightening in financial conditions associated with our change in bank rate, but, in my judgment, financial conditions are not tight. In particular, real rates are still below zero. From that standpoint, we cannot make judgments about the peak and path of the bank rate because it is data-dependent. I agree with that entirely.

We have talked a lot about what data we look at. In particular, I look at inflation and inflation expectations. Those are what I will be looking at for the next round.

Andrea Leadsom: That is very interesting. Thank you.

Chair: Everyone has had their chance at least once. I am going to wrap things up now, if I may. In terms of the evidence we have heard today, none of us knows what tomorrow's inflation number is going to look like. We all hope it will finally show that we are on the path you have been forecasting.

We accept that all these decisions are made in real time. In these sessions, we try to tease out where we think that perhaps more of the contemporaneous evidence could have been taken into account. We are not trying to argue in favour of hindsight, but in favour of the facts at the time.

Today's session has also pointed out just how challenging the act of foresight is and some of the challenges you have had with your modelling. I am not entirely in agreement with my colleague Dame Angela Eagle, who said that we should not shoot the messenger, because we see your role in our economy as being so much more important than just as the messenger of the forecast. You are the actor whose institution has been given the responsibility of meeting the inflation target, and this is a key part of the parliamentary scrutiny in that regard. Your accountability to Parliament means we get to ask these questions on behalf of the British public.

Thank you very much for your time. In particular, thanks to Professor Tenreyro for your time on the committee and your evidence today.