Shocks, inflation, and the policy response – speech by Dave Ramsden

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Dave Ramsden discusses recent shocks that have hit the UK economy, including the recent financial market turbulence, and what they might mean for inflation and the setting of monetary policy.

Speech

Thank you very much for the invitation to speak today. As one of the nine members of the Monetary Policy Committee (MPC) I am going to use my time today to set out my thinking on the shocks that are hitting the UK economy, what these mean for the outlook for inflation and what the MPC is doing in response to return inflation sustainably to our 2 per cent target in the medium term. Fulfilling our remit matters for everyone in the UK and for everyone attending this conference. Because history tells us that low and stable inflation provides the best conditions for durable investment and innovation, which are in turn key ingredients for sustainable growth.

I gave a speech back in February also on the theme of shocks. That there is enough material for a sequel less than eight months later highlights just what an unusual period this is in terms of the number and scale of shocks and the impacts they are having.

Let me start by saying what I mean by shocks. Economists, along with other professions, have lots of different ways of identifying and categorising shocks and their implications[1]. For today's purposes shocks are new, unanticipated developments which are clearly distinguishable from more routine developments.

As an MPC member I want to try and bring out how I've been thinking about each shock in terms of the impact on demand or supply in the economy and the time frame over which these impacts persist. Demand being what we actually observe in terms of output, income and expenditure. Supply being more about the capacity of the economy. In terms of inflation, if a shock pushes up demand relative to supply then inflationary pressures are likely to build. Similarly if an unanticipated development pushes up supply relative to demand then inflationary pressures will subside.

Back in February I focused on Brexit, the coronavirus pandemic and energy prices as three major shocks which were working through the economy. Today I want to cover four developments since then: the Russian invasion of Ukraine, the fall in UK labour market participation, UK fiscal policy and financial market turbulence. All four of these shocks matter to differing degrees to the economic outlook and to our policy response.

Four shocks

My February speech was two days before Russia began its illegal invasion of Ukraine. Today is Day 225 of the ensuing war and over that period global energy prices (as well as food and other prices) have risen further and also been highly volatile, particularly in the case of wholesale gas prices.

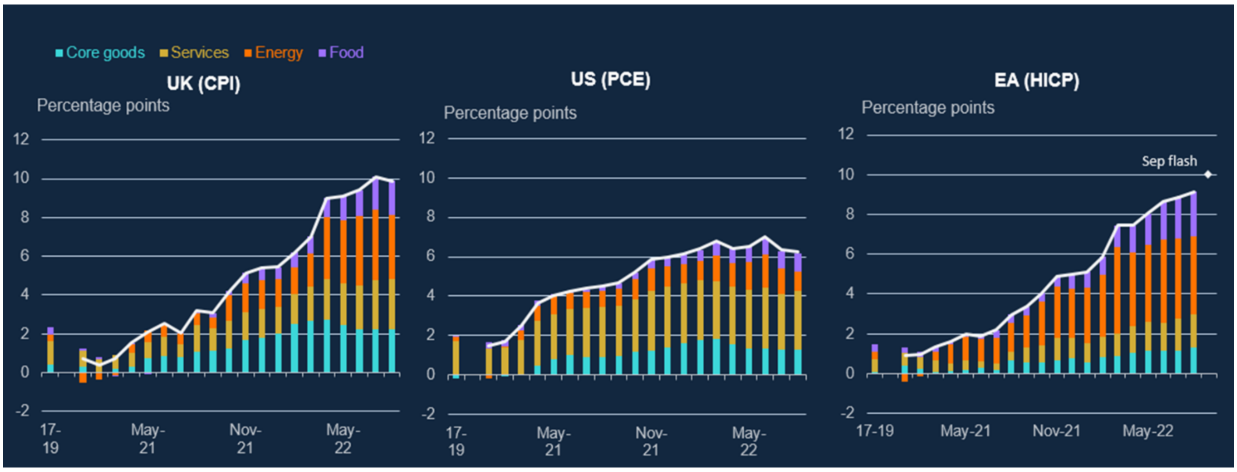
To illustrate this, at the time of the MPC's last forecast in August 2022 the gas futures price for 2022Q4, the quarter we have just started, was seven times higher than what was expected in our August 2021 forecast. Gas prices have been very volatile since. At the time of the August MPR, Bank staff estimated that the annual energy bill for a typical household under the OFGEM price cap would rise from just under £2000 to around £3500 from 1 October, a 75 per cent increase and three times higher than the equivalent bill in October 2021. In the face of these very large prospective increases, on 8 September the Government announced an Energy Price Guarantee, which came into effect on 1 October, a fiscal shock which I will come back to.

For the UK economy a key characteristic of the global energy shock is that it depresses supply. The UK is a net importer of energy so national income will be lower; the UK economy is poorer. These effects were already apparent before Russia's invasion of Ukraine but the war has exacerbated them, and even with the Guarantee households and businesses will be worse off due to higher energy bills than they were a year ago, intensifying the problems associated with the cost of living.

The increase in energy prices has been a significant contributor to inflation over the last year in the UK and the Euro area. In August UK CPI inflation was 9.9%, and a third of the total was directly accounted for by energy **(Chart 1)**. The further indirect effects are likely to be material and have been a factor in the marked pickup in CPI services inflation to 5.9% in August, contributing over 2% to the total.

Chart 1: Decompositions of headline inflation rates

Contributions to annual consumer price inflation

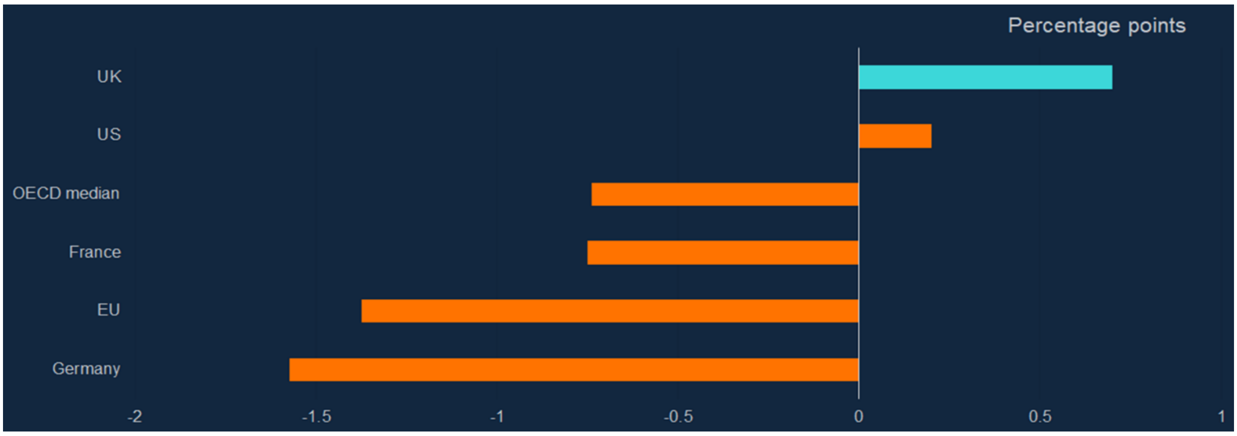


Sources: ONS for the UK, BEA for the US, Eurostat for the EA and Bank calculations.

The second noteworthy development is the trend in UK labour participation. This looks like being one of the most significant economic legacies of the pandemic. Around the turn of the year there were signs that the recovery in the economy was bringing people back in to the labour market; a version of the "encouraged worker" effect which is often seen during cyclical upturns.

However these signs petered out, and by July 2022 there were about 500,000 fewer people classed as participating in the labour market than pre-pandemic. In this way the UK stands out compared with most other major economies; the UK participation rate is 0.7 percentage points lower than 2019 levels whereas the median OECD country participation rate is 0.7 percentage points higher[2] **(Chart 2)**.

Chart 2: Change in inactivity rate between 2019 and Q1 2022



Sources: OECD and Bank calculations.
Notes: UK inactivity rates published by ONS typically use the age band 16-64, but 15-64 are used here for international consistency. 'OECD median' is the median change in inactivity across 38 OECD countries.

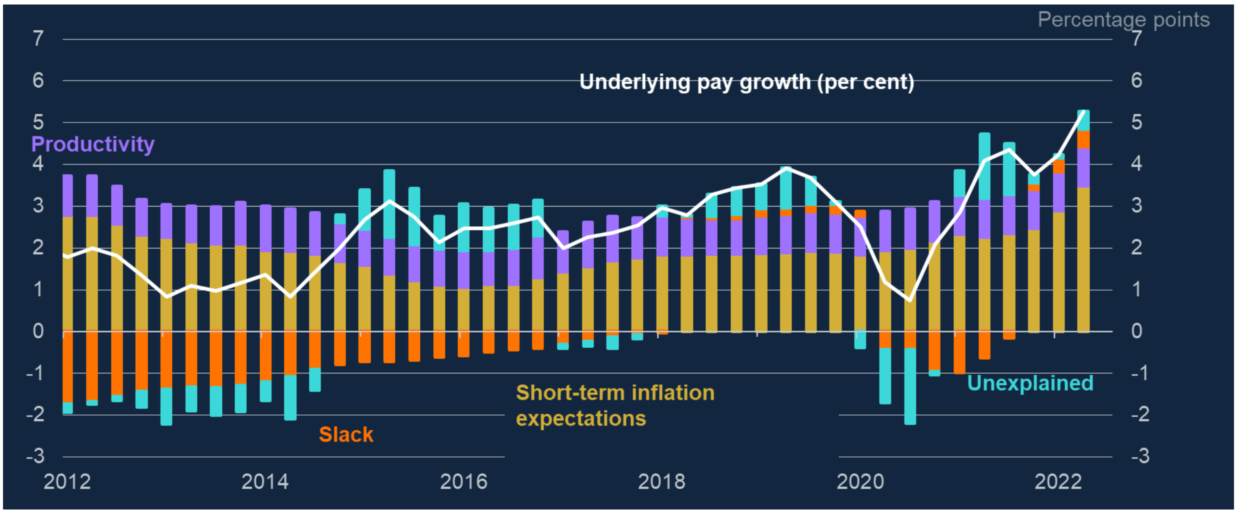
It's not clear what is driving this participation puzzle[3]. But whatever is behind it, low participation is a key component of the tightness in the UK labour market. Employment growth has slowed but unemployment has fallen to 3.6% - the lowest rate since 1974 - the number of vacancies also remain close to record highs and the redundancy rate remains close to its record low.

Moreover, regular pay growth in the private sector has continued to rise to 6% in July 2022. The decline in participation is another negative supply shock which is at present impacting on an already tight labour market and adding to the upward pressure on nominal wages.

The MPC has made successive revisions to our assessment, each time forecasting the labour market will stay tighter for longer. This tightness has been a key consideration in my MPC votes over the last year[4].

Models estimated by Bank staff indicate that the pickup in underlying private sector pay growth so far has been driven not just by the tightening labour market but also the rise in short term inflation expectations **(Chart 3)**. While the latter probably reflects higher headline inflation itself, a point I will come back to, these factors are expected to push up pay growth in the near term. This would be consistent with the message of the latest surveys by the Bank's Agents which suggest pay growth will strengthen further.

Chart 3: Annual private sector underlying regular pay growth



Sources: OECD and Bank calculations.
Notes: Wage equation based on Yellen (2017). Short-term inflation expectations are based on the Barclays Basix Index and the YouGov/Citigroup one year ahead measure of household inflation expectations. Slack is based on the MPC's estimate of the unemployment gap. Productivity growth is based on long-run market sector productivity growth per head. The unexplained component is the residual. Underlying pay growth represents Bank staff estimates of private sector regular pay adjusted for furlough and compositional effects.

The third development I want to draw out is the significant recent news on fiscal policy. But before explaining why this matters for monetary policy I will make a couple of points about the role of the MPC and how we treat fiscal policy in our forecasts.

First, it is not part of the remit of the MPC to comment on whether a particular tax or spending policy is the right action to take or whether the overall stance of fiscal policy is appropriate. However it is part of our job to comment on and respond, as necessary, to the impact individual measures or the overall stance of fiscal policy have on demand and inflation. Fiscal policy rightly came to the fore during the pandemic, and the furlough scheme in particular was a major fiscal intervention which provided very significant support to demand and to the labour market, up until it ended a year ago. Second there is a long-standing convention that the MPC only factors announced fiscal policy into its forecasts and actions.

With those two points in mind I want to distinguish between two types of fiscal news over the last month; those that the MPC has factored in to its decisions already and those that it has yet to.

In the first category on 8 September the government announced the Energy Price Guarantee scheme which will cap energy bills to £2500 for the typical household and for businesses. The Guarantee will therefore insulate households and businesses and the broader economy from the direct impacts of further shocks to energy prices. As such it represents another very significant fiscal intervention, which can be thought as a shock which supports demand relative to what it would otherwise have been. The MPC was able to take account of the Guarantee, based on an initial assessment of its impact, at its September meeting.

In the second category of fiscal news which the MPC has not yet incorporated, on 23 September the Government announced its Growth Plan which contained a range of fiscal measures, particularly on the tax side. The Government has followed this up with further policy announcements, and has also set out that it will publish its Fiscal Plan on 23 November, alongside an updated forecast from the Office for Budget Responsibility.

The MPC will be able to make its own assessment of the impact on demand and inflation of the Growth Plan during its next forecast round leading up to its next decision meeting on 2 November. Based on what we know so far, these impacts are likely to be material for the economic outlook over the next three years, which is also the horizon relevant for monetary policy.

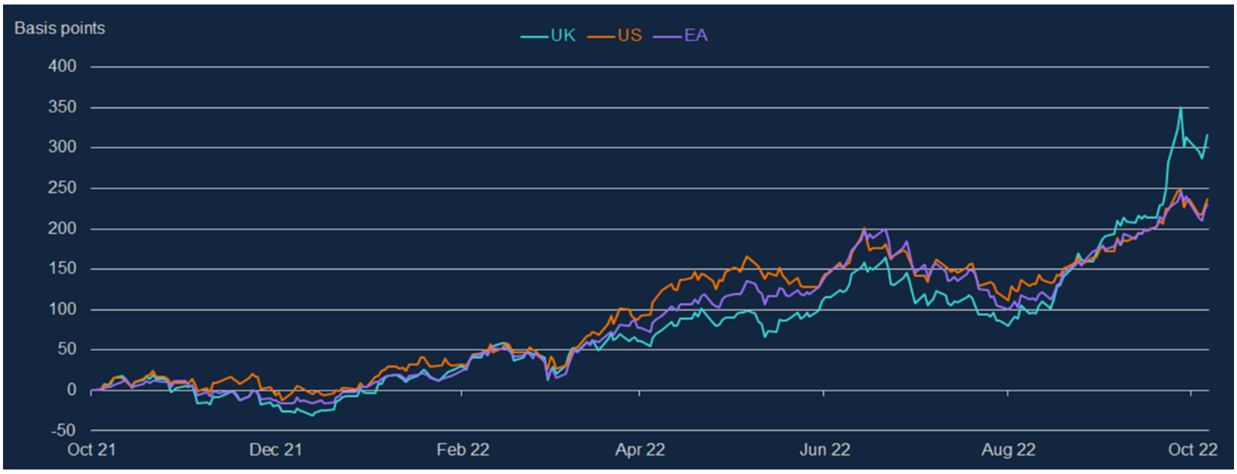
The final shock I want to talk about is the recent turbulence in financial markets. The MPC’s forecasts are conditioned on assumptions for the outlook for various asset prices and so these movements could have a significant direct effect on the November forecasts and for the Committee’s broader assessment of financial conditions.

Financial markets globally have been volatile over recent months, with notable rises in government bond yields, large moves in exchange rates and falls in risky asset prices. Overall the adjustment in market prices has been consistent with tighter monetary policy globally and the deterioration in the economic outlook. These trends were more marked for the UK through August and up to the September MPC meeting. But the UK began to really stand out over the last fortnight, which has seen significant moves in the pricing of UK financial assets. Part of that re-pricing continues to reflect broader global developments. But there is undoubtedly a UK-specific component.

The sterling exchange rate in ERI terms has fallen by 7% since the start of the year, partly in the context of a strong dollar, but while it has continued to be volatile it is broadly unchanged since the September MPC meeting.

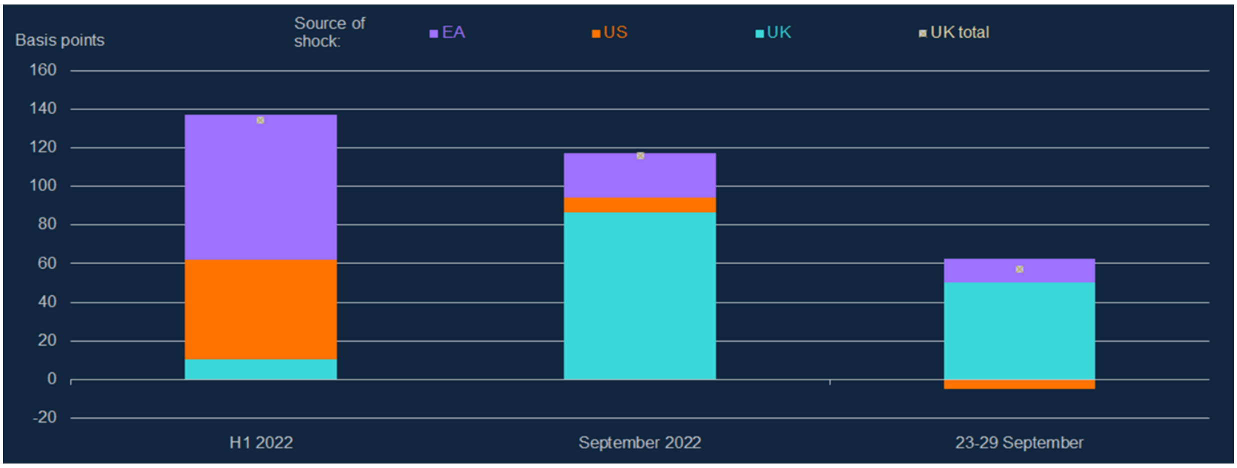
Recent moves in the prices of government bonds, gilts, have been more striking. At the benchmark 10 year point, yields have risen steadily through the year globally **(Chart 4)**. But having tracked US and Euro area yields since the start of the year, UK yields have risen more markedly through August and especially sharply over the last fortnight since the announcement of the Government’s Growth Plan. Decompositions of the drivers of the shock to yields point to domestic UK factors as driving the increase over the most recent period, which is unusual. **(Chart 5)**.

Chart 4: Cumulative change in 10-year government bond yields



Sources: Bloomberg Finance L.P. and Bank calculations.

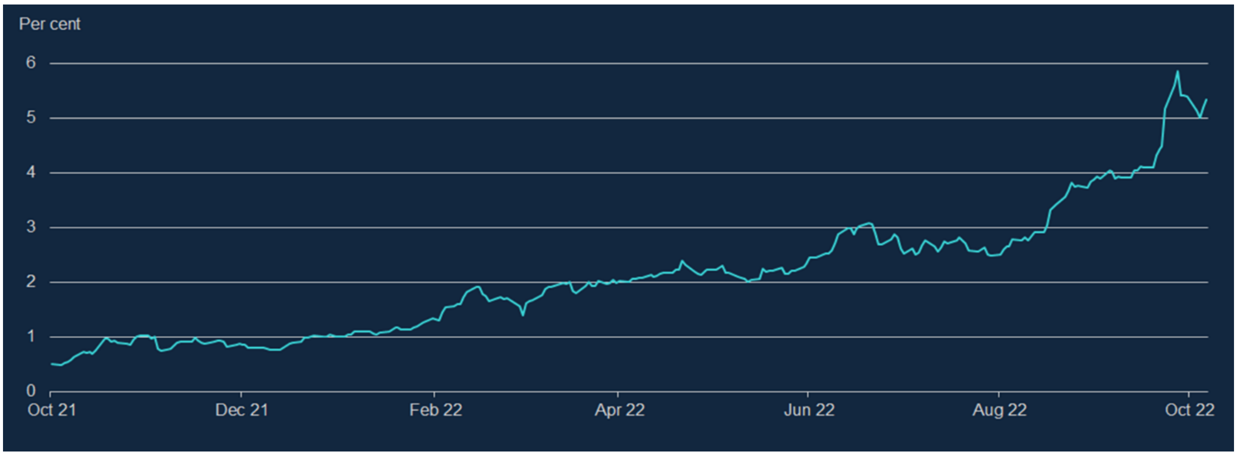
Chart 5: Decomposition of changes in 10-year UK government bond yields



Sources: Bloomberg Finance L.P. Tradeweb and Bank calculations.
Notes: Methodology based on Rigobon 2003: shows how international factors have contributed to the change in ten-year UK government bond yields over the indicated periods. This identification strategy uses the fact that the volatility of asset prices change over time, to identify country-specific shocks in a model.

These longer term trends overlaid by the very recent market turbulence are impacting on the real economy in many ways. A key channel is obviously through the interest rates faced by households and businesses when they want to borrow, for example to buy houses or to invest. Fixed-rate mortgages have become increasingly popular in recent years and now represent 95 per cent of the flow of new lending and 80 per cent of the stock. Two-year fixed-rate products are particularly popular and their cost to the lenders who provide them is derived from two-year interest rate swaps. A year ago the two-year swap rate was 0.5%, a month ago it was 4%, after the 22 September MPC meeting it was close to 4.5% and at yesterday's market close it was around 5.4% having peaked at nearly 6% in the intervening fortnight. **(Chart 6)**.

Chart 6: UK 2-year swap rate



Sources: Bloomberg Finance L.P. and Bank calculators

The Bank's latest figures for quoted mortgage rates in September were published this morning. Because these are averages for the month they lag somewhat market measures, but the increases are still marked. Quoted mortgages rates on two-year fixed rate mortgages increased by around 50bps between August and September and were up by nearly 300bps compared to last September and have been rising further into the start of October. Recently lenders have also withdrawn a large number of mortgage products from the market because of the turbulent market conditions.

UK-specific factors also have had a particular effect on the price of long-dated UK government debt, which fell very sharply over a very short period, leading to dysfunction which, had it continued or worsened, would have been a material risk to UK financial stability. The Bank started intervening in this segment of the gilt market on 28 September, in a time-limited and temporary way. Because this is not a monetary policy operation – although it involves buying assets I think of it as an operation designed to buy time - I won't say any more about it here[5].

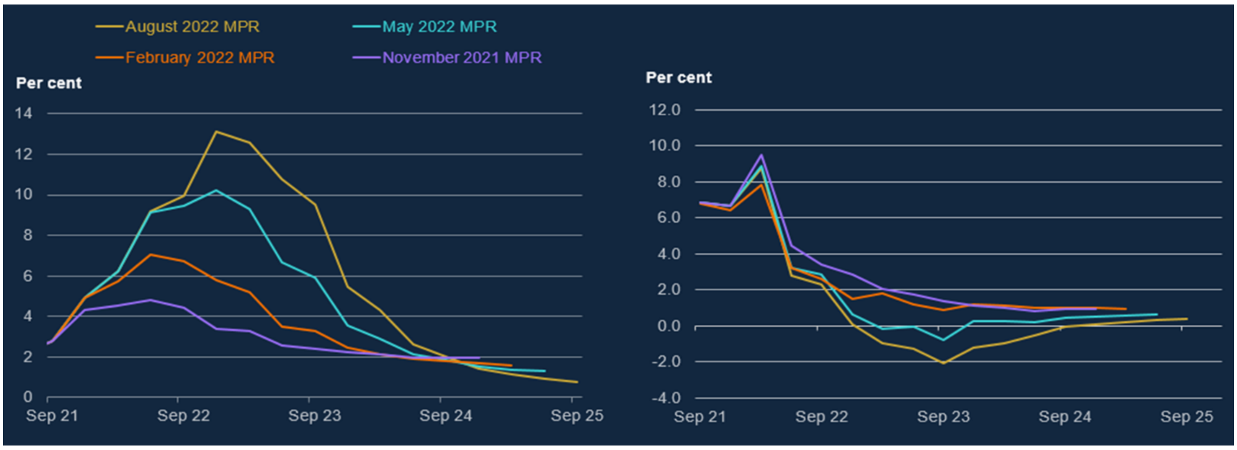
Markets continue to be volatile and so extracting any signals from the noise is even more challenging than usual. One key consideration for the MPC at its upcoming meetings will be whether the recent repricing of UK assets reflects a changed assessment by markets of the UK macroeconomic policy mix between fiscal and monetary policy[6]. The extent to which that can be determined will depend on whether markets settle at a new level, which itself will depend in part on getting a clearer picture on fiscal policy and the fiscal outlook.

Prospects for inflation

What does all this add up to in terms of the overall impact on the economy and on inflation. An obvious starting point might be to look at the evolution of our forecasts over the last year in response to the four shocks I've highlighted and other developments. The picture you get is of successive upwards revisions to inflation and successive downwards revisions to growth, with the energy price shock the principal driver of both **(Chart 7)**.

By the time of the August 2022 MPR, the MPC was forecasting a recession starting in the current quarter and lasting throughout 2023, with a peak to trough fall of GDP of 2.1%. But because the fiscal and financial markets shocks post-date the most recent forecast it wouldn't make sense to extrapolate this trend of forecast revisions forward as a starting point for our November forecasts.

Chart 7: MPC's inflation forecasts and MPC's annual GDP growth forecasts



Sources: ONS and Bank calculations.

In the August MPR we had already noted that that the risks around our projections from both external and domestic factors were exceptionally large, given the very large rise in wholesale gas prices and the consequent impacts on real incomes for households and on inflation.

The MPC's initial assessment of the Energy Price Guarantee, first made at the time of the September MPC, is that it will significantly reduce the degree of uncertainty around the outlook for UK retail energy prices over the period of the Guarantee and therefore also for CPI inflation.

As a result the Guarantee means that CPI inflation is expected to rise by less in the near term, peaking at a little under 11% in October, lowering and bringing forward the expected peak in inflation, relative to the MPC's August forecast. For the duration of the Guarantee this should reduce the risk that a long period of externally generated inflation leads to more persistent domestic price and wage pressures, although the MPC agreed that risk remained material.

At the September MPC we also noted further signs of continuing strength of domestically generated inflation, that the labour market remains tight and domestic costs and price pressures including from businesses are elevated.

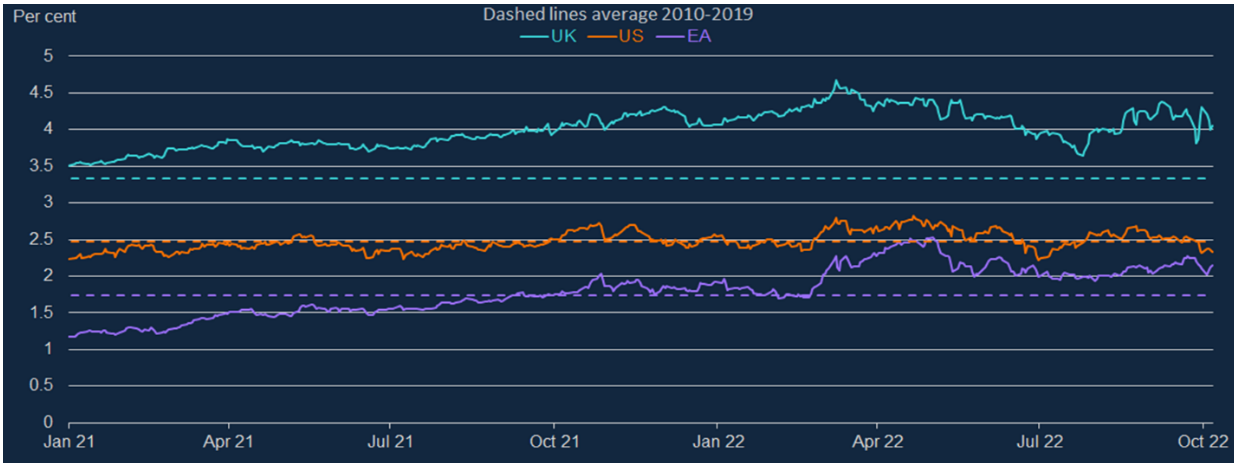
Against that backdrop our initial assessment of the demand impact of the Energy Price Guarantee was that household spending was likely to be less weak than projected in the August report over the first two years of the forecast, and all else equal, relative to that forecast, it would add to inflationary pressures in the medium term.

Since summer 2021, I've been highlighting my concerns about the build-up of inflationary risks[7]. A key consideration in my assessment of the risks that above target inflation persists is what happens to inflation expectations. I have already described how short term inflation expectations may be impacting on the immediate outlook for earnings. These could in turn feed through into prices given the high share of wages in costs, particularly in the services sector. And the same could happen if the current inflationary environment companies attempt to protect or increase their margins.

Because shorter term measures of inflation expectations tend to move with actual inflation policymakers tend to focus on longer term measures. For households, there have been mixed signals from recent surveys, although in most cases their level had also remained elevated relative to historical averages. For instance, the Citi/YouGov indicator of household expectations of inflation in five to ten-years' time has risen, but the Bank's Inflation Attitudes Survey for expectations of inflation in five years has fallen back from earlier on in the year. For businesses, data from the Bank's Decision Maker Panel survey for September was published yesterday and it showed that firms' expectations for inflation three years ahead had risen further to 4.8 per cent, from 4.2 per cent in August[8].

A market-based measure of longer term inflation expectations I have put particular emphasis on is the two-year swap rate for inflation, five years ahead. This was because it was on a sustained upwards trend through 2021 and peaked at 4.7% in March 2022. I took some encouragement from its subsequent fall back into the early summer but it picked up again through August. It has been caught up in the wider market turbulence and in the often illiquid markets of the last fortnight it has been very volatile from day to day. This makes it impossible to get a clean read of the recent trend, but in level terms it still remains well above its longer term average, more so than is the case for the Euro area, whereas the equivalent measure for the US remains around its longer term average **(Chart 8)**.

Chart 8: Financial market medium term inflation compensation (5y2y forward swap)



Sources: Barclays live and Bank calculations.

The Monetary Policy Response

Let me conclude by setting out how in response to these developments the MPC is setting monetary policy to ensure that CPI inflation will return to the 2% target in the medium term. Monetary policy is also acting to ensure that longer-term inflation expectations are anchored at the 2% target.

The MPC started to tighten monetary policy in December 2021, raising Bank rate from 0.1% to 0.25%. So much has happened since but it is worth recalling that last December was less than three months after the end of the furlough scheme here in the UK and was when the rapid emergence of the Omicron variant was a major concern. It was also three months before the Fed started to tighten policy in the US and almost seven months before the ECB began the tightening cycle in the euro area.

Bank rate has been increased at every MPC meeting since December 2021 and was increased by 0.5% at both the August and September meetings, to its current level of 2.25%[9].

Along with two of my MPC colleagues I voted for a larger 0.75% increase in Bank Rate, to 2.5% at the September 2022 meeting. At the time the three of us highlighted that the recent data outturns had already registered more persistent inflationary pressures and that medium-term measures of inflation expectations remained high. We welcomed the reduction of the near-term peak in inflation which will result from the Energy Price Guarantee but noted that the additional support it is providing to households will add to demand pressure.

My September vote was informed by three particular aspects of what I've set out for you today. First the greater certainty we have about household spending, because of the greater support to demand being provided by the Energy Price Guarantee. Second the trends I've observed in domestically generated inflation, including in labour costs, in firms' pricing and in the broadening out in inflationary pressures with services price inflation now contributing more to overall CPI inflation. And third, higher medium-term inflation expectations and the risk that a more inflationary mentality takes hold throughout the economy.

In my view a faster policy tightening at the last MPC meeting would have helped to bring inflation back to the 2% target sustainably in the medium term and would reduce the risks of a more extended and costly tightening later.

Our November decision and latest forecasts will be published in just under four weeks time. In the intervening period we will be seeking answers to a range of questions to inform our assessment of how quickly inflation will return to target in the medium term. For me questions include: is there any evidence that the tight labour market is easing; what is the revised outlook for demand in view of the Government's fiscal announcements; are domestically generated inflation pressures consistent with returning inflation to the 2 per cent target; and what do financial market developments tell us.

The MPC was clear in its language in September that should the outlook suggest more persistent inflationary pressures, including from stronger demand, the Committee would respond forcefully as necessary. In the context of the developments I've set out for you, today I think the central question for all nine of us on the MPC is how forceful do we need to be, to ensure inflation does return sustainably to the 2% target in the medium term.

These are very challenging times for the UK economy and millions of households and businesses are experiencing real hardship as a result of the cost of living crisis. On the MPC we are acutely conscious that for many our monetary policy actions are adding to the difficulties caused by the current situation.

We know from past periods in our history the damage to households and businesses that would result if high inflation persisted. Unlike earlier inflationary episodes, where we saw more persistence in inflation caused by ineffective policy and policy frameworks, this time we have a monetary policy framework which empowers us to take action. However difficult the consequences might be for the economy, the MPC must stay the course and set monetary policy to return inflation to achieve the 2% target sustainably in the medium term, consistent with the remit given to us.

With thanks to Rupal Patel for her assistance in preparing these remarks, and to my fellow MPC members and numerous Bank colleagues, including Callum Ashworth, Fabrizio Cadamagnani, Alan Castle, Grace Greer, Thomas Jennings, Josh Martin, Maggie Illingworth, Harry Rigg, Andrea Rosen, May Rostom, Martin Seneca, Bradley Speigner, Boromeus Wanengkirtyo for their many helpful contributions.

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1. There is a huge literature on techniques for and applications of the identification of shocks. Different categorisations have been used for a variety of policy purposes. For example whether shocks are common or idiosyncratic was a key consideration for HM Treasury's 2003 Five Tests assessment of whether the UK should join the Euro. Other common categorisations include are they exogenous or endogenous, are they temporary or permanent and are they positive or negative.
2. I am grateful to my MPC colleague Jonathan Haskel for this international comparison.
3. The latest of a series of puzzles about the structural behaviour of the UK economy. The most well-known is the productivity puzzle which has spawned a huge literature including my own contribution, see **The UK's productivity growth challenge - speech by Dave Ramsden (bankofengland.co.uk)**.
4. I voted to tighten policy earlier than the majority of the MPC in September 2021 and November 2021 and to tighten by more than the majority of the MPC in February 2022 and September 2022.
5. See **Bank of England announces gilt market operation | Bank of England**, **Jon Cunliffe response to Mel Stride letter on gilt market operation** and **Message received and understood – speech by Dave Ramsden, Bank of England**
6. See **Recent developments in the economy and markets − speech by Huw Pill | Bank of England**
7. See **Navigating the economy through the Covid crisis - speech by Dave Ramsden | Bank of England**
8. See **Monthly Decision Maker Panel data - September 2022 | Bank of England**
9. In addition, the MPC completed its most recent quantitative easing programme in December 2021 and has since started quantitative tightening, first stopping reinvesting the proceeds of maturing gilts from March 2022 and voting at the September 2022 meeting to start a gilts sales programme which will commence on 31 October, after being delayed because of the market disruption observed in long-dated UK government bond market.