Huw Pill: Monetary policy - an anchor in challenging times

Speech by Mr Huw Pill, Chief Economist and Executive Director for Monetary Analysis of the Bank of England, at the Scottish Council for Development and Industry, Glasgow, 12 October 2022.

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Good afternoon everyone.

It is a great pleasure to be with you in Glasgow today. My thanks to the Scottish Council for Development and Industry for their invitation to speak, to the University of Strathclyde for hosting us, and of course to all of you for taking the time to attend. I am looking forward to our discussion.

I have spent the past couple of days here in Scotland talking with firms, speaking to business leaders and engaging with our Citizens Panel. As you can imagine, some of those discussions have been challenging.

We are living through challenging times.

The invasion of Ukraine has led to a dramatic rise in European wholesale gas prices. Household incomes are being squeezed by higher energy bills. Company profits are being squeezed by higher energy costs. And headline inflation has risen to unacceptably high levels.

For a net importer of energy like the UK, the rise in global energy prices weighs on national income: the cost of what we are buying from the rest of the world has risen dramatically relative to the price of what we are selling. You don't need to be an economist to understand the implications of this for domestic demand. Higher energy prices dampen household spending, and weigh on economic activity.

On top of all this, the strength of the labour market has pushed up costs through wage inflation. And recently we have seen greater volatility in financial markets: both globally and, with particular force, here in the UK. That has intensified in some market segments over recent days.

As someone who joined the Bank's Monetary Policy Committee (MPC) just over a year ago, it has certainly been something of a baptism of fire.

More profoundly, the past year has been difficult for all of us. Compared with twelve months ago: household utility bills are much higher than expected; the prospect of higher mortgage payments looms larger; and the outlook for economic activity looks weaker. None of this is good news.

But, there is at least one constant in the face of all these challenges. The MPC remains fully committed to delivering on its mandate – to maintain price stability – by fulfilling its remit – to return inflation to the 2% target. Despite difficult circumstances, that commitment is unwavering. Monetary policy really is an anchor in these challenging times.

And these are not just empty words.

In pursuit of its inflation target, the MPC has raised Bank Rate in each of its last seven meetings. It has brought QE to an end and started to run down its holdings of gilts accumulated for monetary policy purposes. And it has changed the nature of its communication.

We have moved away from the forward guidance that signalled Bank Rate would remain floored at its effective lower bound that met me when joining the MPC last year. In its place, the MPC has emphasised that its policy decisions are driven by the evolution of the data, while signalling a willingness to respond more forcefully to signs of greater persistence in inflation, should that prove necessary. At every juncture, the MPC has remained committed to a medium-term view that stabilises inflation around the 2% target.

In that spirit, a couple of weeks ago I argued at a talk in London that the significant market reaction and economic implications of recent macro news – including recent fiscal policy news – was likely to prompt a significant monetary policy response at the MPC's next meeting on 3 November.

Of course, that rendezvous is still some time away. And, of course, much can happen in the intervening period, with markets exhibiting volatility and the geo-political and economic environment uncertain. Anyway I can only speak for myself today, not for the nine-member committee as a whole.

But as things stand, I stand by my London statement. Given where we are, I continue to expect a significant monetary policy action at the MPC's next scheduled meeting.

So in the body of my remarks this afternoon, I don't want to dwell further on what we are trying to achieve or whether we are working towards it. I hope I have made my views on those two questions very clear.

Rather I want to discuss how the MPC is working towards achieving the 2% target.

The institutional framework for monetary policy

Just as no man is an island, no economic policymaker works completely in isolation. Let me start with a few comments on this observation, starting with the interactions between monetary and fiscal policies.

Monetary policy is a potentially very powerful tool, central to achieving stability in the overall price level by steering inflation back to target. But monetary policy is also a pretty blunt tool, ill-designed to deal with the distributional consequences of relative price changes – changes in the price of one good compared with another.

Recent experience in the face of dramatic increases in energy prices illustrates this point.

Monetary policy has been tightened to ensure that the impulse to headline inflation coming from higher utility bills does not become embedded in broader inflationary developments. It has weighed against the incorporation of so-called second-round effects in price, wage and cost setting behaviour. In other words, monetary policy has addressed the danger that self-fulfilling dynamics lead to overall price inflation remaining persistently above target, even as the original impetus to inflation from energy prices recedes.

By contrast, the fiscal response to energy price developments has been more targeted. It has addressed the risk that those households and firms which consume more energy as a proportion of their income and/or lack the savings or access to external finance that might help them deal with the cash-flow implications of sharply higher energy bills – in other words, less well-off households and small businesses – could not manage the dramatic energy-driven cost-of-living squeeze that threatened over the summer.

The UK Government's Energy Price Guarantee (EPG) is the main vehicle here. Decisions such as these are, rightly, in the domain of the government and not for independent central banks to make. However, I will discuss the implications for our economic forecasts in a moment.

But I want to flag that the MPC's most recent baseline projection published in the August Monetary Policy Report incorporated the significant increases in European wholesale gas prices we experienced over the summer, but – owing to the pause implied by changes in political leadership– did not incorporate a fiscal policy response to those increases. This reflected the MPC's usual conventions and assumptions underlying the production of its forecasts, but – in the specific circumstances faced at the time – resulted in a baseline projection with debateable internal consistency. The Committee took the unusual step of distancing itself from that baseline in August, and relied more heavily on complementary analysis in scenarios and variants in motivating its decision.

Now that the UK Government's fiscal energy measures have been announced, the more comprehensive, integrated assessment that will be embodied in our November forecast can resume its central place in our analysis for, and communication of, monetary policy decisions.

The EPG has capped the expected average energy bill at £2500, for the next two years, a substantially lower level than the earlier Ofgem price cap mechanism would have implied given the evolution of wholesale gas prices. Steps have also been taken to help firms. Higher gas prices will now increase the (indirect) government subsidy to energy users, rather than the utility bills they pay. This shifts the main macro risks stemming from gas price rises away from higher headline inflation and a squeeze on household real incomes towards greater pressure on the fiscal deficit and ultimately the public finances more widely.

Ensuring that this shift – in concert with other fiscal policy actions – does not bring the longer-term sustainability of the public finances or respect for the wider institutional

framework for macroeconomic policy into question remains key: both in and of itself, but also because maintaining the credibility and integrity of that framework supports the effectiveness of monetary policy in pursuing its own objectives.

In this context, it is welcome that the role played by the Office for Budget Responsibility (OBR) in scrutinising the Government's fiscal plans will be resumed in the forthcoming budget statement. Its independent, external scrutiny of the outlook for the public finances will bolster the credibility of the process, thereby helping to add stability in what is a volatile environment at present.

The need for a balance between, on the one hand, targeted and timely action on other dimensions to complement monetary policy decisions (which, by nature, have a broader and more medium-term impact) and, on the other hand, wider respect for the institutional framework for macro policy, also arises in the context of actions taken by the Bank and other actors to support the functioning of financial markets for financial stability purposes.

Monetary policy works through the financial system. Monetary policymakers therefore have a stake in liquid and well-functioning markets as vehicles for the transmission of their policy decisions. More widely, the Bank of England as a whole has an obvious interest in maintaining orderly markets that support healthy price formation and an efficient allocation of capital and resources. The Bank also has a statutory responsibility for financial stability, which it takes very seriously.

In the face of dysfunction that has emerged in some specific market segments in recent weeks, the Bank is conducting a set of temporary and targeted financial stability operations to support the gilt market. Their goal has been to permit an orderly deleveraging of positions held by so-called liability driven investment (LDI) funds, which became vulnerable in the volatile market conditions we have seen of late.

In taking this action, the Bank has sought to prevent the emergence of a self-sustaining vicious spiral of collateral calls, forced sales and disappearing liquidity from emerging in a core segment of the financial markets. Restoring market functioning helps reduce any risks from contagion to credit conditions for UK households and businesses.

Such actions preserve the effective transmission of monetary policy. But crucially they are not monetary policy actions in themselves.

Were monetary policy to be re-oriented towards serving financial stability ends, not only would it be less effective in addressing dysfunction than more temporary and targeted interventions in specific dis-orderly market segments, but it would also be distracted from its central task of maintaining price stability and returning inflation to the 2% target.

At the time of writing, this distinction between monetary policy actions and actions taken by the Bank to support financial stability has been recognised and priced by market participants.

In the face of a substantial re-pricing of financial assets a few weeks ago, markets originally anticipated that Bank Rate – the active instrument of monetary policy in the eyes of the MPC – might be changed at an ad hoc meeting outside the regular schedule of MPC decisions.

But in the wake of both (1) clear communication that the MPC remained focused on its November meeting, when a comprehensive assessment of the macroeconomic and market news as interpreted through its forecast would be available; and (2) the introduction of temporary and targeted financial stability operations designed to address specific cases of market dysfunction, any inter-meeting rise in Bank Rate was largely priced out.

Market participants had come to understand that monetary policy would remain focused on the outlook for inflation, leaving other mechanisms to address market dysfunction. Going forward, maintaining this distinction remains key to monetary policy's pursuit of the inflation target.

More generally, whether reflecting pressures from the fiscal, financial or other domains, it is essential that the credibility, stability and integrity of the institutional framework governing UK macroeconomic policies are maintained. This is the environment within which the Bank's monetary policy operates most effectively. Preserving that framework requires that policymakers are assigned clearly-defined responsibilities; that they strive to achieve clearly-identified objectives; and that their institutional independence – and that of other policy actors – is fully respected.

A view on the MPC's reaction function

Having set out thoughts about the institutional environment for monetary policy, let me conclude with a few more specific observations about the macroeconomic conjuncture. I'll express these through the medium of my interpretation of what is often called the MPC's 'monetary policy reaction function'.

When coming to monetary policy decisions, I take a 'full information approach'. I don't want to throw out any potentially relevant information on arbitrary grounds.

Consistent with this approach, when asked about the role monetary aggregates play in my policy thinking at a recent Treasury Select Committee hearing, I sought to steer a course between recognising that monetary developments can – and often do – offer important insights into the outlook for the economy and monetary policy, but at the same time noting that money is not a 'summary statistic' that alone can or should determine monetary policy decisions.

Monetary developments need to be incorporated into a wider assessment of the economic outlook, such as the MPC forecast that we publish regularly in the Monetary Policy Report. The importance attached to money in that context will vary over time and depend on interactions with other variables. For example, last year the likelihood of stronger consumption spending by households as we recovered from the pandemic

could be assessed by evaluating the 'monetary overhang' – the stock of household bank deposits held in excess of what might have been expected on the basis of historical norms – that was accumulated during lockdown.

The same thinking applies to any macroeconomic or market information. In principle, it should be considered relevant to the extent that it informs well-designed monetary policy actions. That is why the MPC has placed such weight on its forthcoming forecast round, where a comprehensive and encompassing assessment of all sources of relevant information can be made, which internalises the interactions and interdependencies among various time series.

But I realise that saying all information is potentially equally important runs the risk of suggesting that all information equally unimportant. To give an insight into my decision process, some hierarchy of analysis is required. So, I will highlight here three areas that weigh heavily at present on my thinking.

First, **fiscal policy**. Over the summer, there has been considerable news on this dimension, which the MPC only partially digested in its September policy assessment and decision.

I have already mentioned the Energy Price Guarantee. Relative to where we might otherwise have expected to be early next year on the basis of wholesale gas futures prices, the introduction of the £2500 cap on an average energy bill directly reduces CPI inflation. Of itself, the resulting lower and flatter profile for headline inflation should diminish the risks coming from potential second round effects, and a make shift towards more inflationary psychology less likely. Against that, lower utility bills will support current household real incomes and thereby support consumption demand. With demand pressure more sustained than otherwise, inflationary pressures may prove more persistent than would have been expected. On balance, I would expect the net effect of these various channels to add to inflationary pressures at the traditional monetary policy relevant horizon of around two years.

More recently, the Government announced its Growth Plan a few weeks ago. As with any fiscal package, this plan embodies a variety of demand, supply and market impacts that are relevant for the macroeconomic outlook. We will need to assess all these elements and the interactions among them within our November forecast.

At this stage, I would simply make two preliminary observations. On my reading, these fiscal announcements will, on balance, provide a further stimulus to demand relative to supply over the medium-term, monetary policy relevant horizon. This will add to the inflationary pressure coming from the EPG. And, the volatile market dynamics that followed the announcement of the Growth Plan underline the need to bolster the credibility of the wider institutional framework, in line with my earlier remarks.

Second (and fittingly), **second-round effects**. As I have already mentioned, it is crucial that we prevent higher current headline inflation from becoming embedded in inflation expectations and price and wage setting behaviour, a risk intensified by the current tightness of the labour market. Heading off this risk will prevent the current energy price-driven overshoot of the inflation target from becoming more persistent and requiring a more painful monetary policy response down the road.

As I have already said, the EPG helps somewhat in this regard. But, at least in my view, it remains too early to declare victory on this front.

Inflation remains very high relative both to our 2% target and by the historical standards of the past 40 years. Even if the energy price guarantee has reduced inflation relative to what would have otherwise have seen this autumn, most people's 'lived experience' is a rise in October's headline inflation rate as utility prices increase. While we have good estimates of how the EPG will affect the household utility bills that enter the consumer price index directly, the impact of government relief for the corporate sector on consumer prices is more difficult to assess, as firms seek to re-establish margins and the incidence of the energy price support feeds through the price pipeline.

In this context, medium-term measures of inflation compensation from financial markets have moved around since August, and current market volatility makes them difficult to interpret over recent weeks. But the sustained (and reassuring) downward trend that in market inflation expectations that emerged from early April appears to have come to an end, at least for now. Household and corporate surveys of inflation expectations at various horizons – although subject to methodological shortcomings and offering sometimes inconsistent messages – have, on balance, moved in an unfavourable direction, especially if one points weight on the distribution of views not just the median.

And third, **the labour market**. Yesterday's labour market data showed the unemployment rate falling to 3.5%, the lowest level observed since 1974. While at first read this looks like a rare piece of good news, viewed through the lens of efforts to return inflation to target it is a mixed blessing. Indeed, the association with the mid-1970s is not reassuring in that respect. Tight labour markets support wage growth, currently running at rates above those we typically deem as consistent with the inflation target.

Crucially, the low unemployment rate reflects a fall in labour market participation to a significant extent. In other words, people are choosing to stop working or looking for work. The reasons for this rise in 'inactivity' are still being explored, but the after-effects of the pandemic on health are probably a key driver. Aside from the impact of long Covid, the backlog of operations and lengthening of waiting lists in the health service owing to the pandemic, the rise in mental health issues, and an increased need to provide at-home care for family members have all weighed on labour force participation. This is an area where we need further work, since the UK appears to be something of an outlier relative to its advanced economy peers. Another supply-side driver of labour market development is migration. Understanding the impact of Brexit and new government policies in the area are key.

Demand issues are also now beginning to exert an influence. As the economy slowed through this year, vacancies have turned. Employment has stagnated and is now showing tentative signs of falling. This will help to cool the labour market and contain some of the domestically-driven inflationary pressures that historically have threatened to become more persistent.

Concluding remarks

These are the three main arguments of my monetary policy reaction function at present. Developments on these three fronts will shape my policy decision in November.

As I have hinted, these three elements are not only important in themselves, but they also interact with and feedback from one another, in ways that can only really be captured by an encompassing analysis. That is why it is valuable and necessary to base our next policy decision on the comprehensive assessment embodied in our November policy round, which will ultimately be reflected in the November MPC forecast.

Given the uncertain world and volatile markets we face, November can seem a long time away. At present, I am still inclined to believe that a significant monetary policy response will be required to the significant macro and market news of the past few weeks.

But I will see when we get to November how events have evolved in the meantime. As always, my policy choices will be driven by the data and guided by pursuit of the inflation target.

And with that, I am happy to take your questions.

The views expressed in this speech are not necessarily those of the Bank of England or the Monetary Policy Committee. I would particularly like to thank Saba Alam and Will Dowson for their help in preparing this speech. I have received helpful comments from Andrew Bailey, Fabrizio Cadamagnani, Alan Castle, Swati Dhingra, Jonathan Haskel, Neil Kisserli, Catherine Mann, Martin Seneca and Fergal Shortall, for which I am most grateful.