What if things are different? – speech by Clare Lombardelli

Given at the Bank of England Watchers Conference, London

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In this speech Clare sets out her current view on the outlook for inflation and what this means for monetary policy. She then turns to how scenarios can help monetary policymakers consider how the economy may differ from a baseline and explores some of the issues raised by scenario analysis.

Speech

Good morning. Thank you for inviting me. It's a pleasure to speak again at the Bank of England Watchers Conference.

Today I'm going to talk about two things: the outlook for inflation and reforms to our monetary policy processes.

My messages are: first, if you consider all the economic news, noise and bumpiness, underlying inflation pressures for the UK economy have continued to fall. So, it is sensible for us to continue our gradual and careful approach to reducing policy restrictiveness, including through another cut in Bank Rate by 25bps last Thursday.

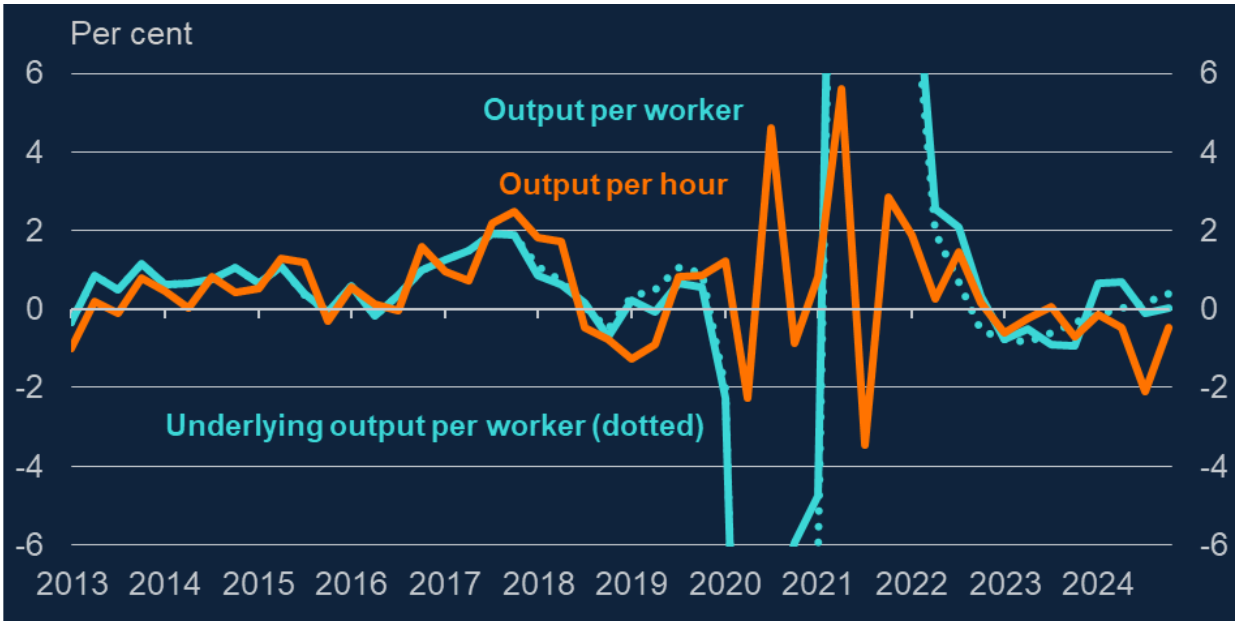
And second, in reforming our monetary policy processes, we are putting risks and uncertainty more explicitly at the centre of our policy framework. This means important roles for scenarios and wider risk considerations alongside the central outlook. We are developing a wider framework and suite of analytical inputs to build uncertainties and risks into our policy deliberations when appropriate. In that context, I will talk this morning about how we used scenarios in our most recent policy round.

The outlook for inflation

When I spoke at the Watchers conference in November I talked about the disinflation process, the underlying drivers of inflationary pressure, the need to see further progress on that and the expectation that we would. That has broadly played out, allowing restriction to be reduced gradually. Monetary policy is still restrictive and the current stance reflects a balance between the need to continue to squeeze out underlying inflationary pressure and managing the risks of lower demand in the economy. It is preferable to conduct monetary policy in a steady and predictable way, contributing stability to the environment for other economic decision makers. And we have been able to do that over the last year or so.

When thinking about the process of disinflation, my focus is on wages, as they are the largest component of the prices set by domestic services firms, and so a key driver of moves in underlying inflation. Wage growth is still too high to be consistent with inflation at target. Annual growth in private sector regular AWE was 5.9% in February. This is likely to reflect persisting second-round effects from the period of high inflation and the presence of supply constraints generating inflationary pressures. Productivity growth has been very low over the past couple of years (Chart 1) but that hasn't been reflected in a substantial decline in wage growth. I will say a bit more on this later when I come to discuss alternative scenarios for the economy.

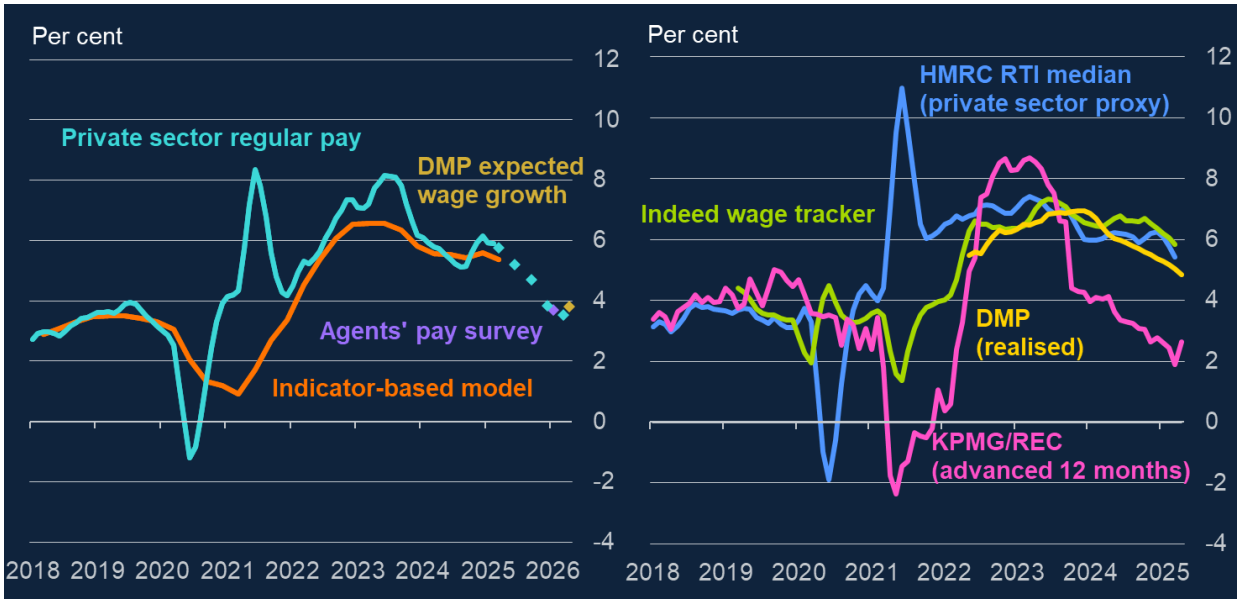
Chart 1: Labour productivity growth has been very weak



Sources: ONS and Bank calculations. Final data points are for 2024 Q4. Underlying output per worker is based on Bank staff's underlying measures of GDP and employment based on indicator-based models (see Charts 2.8 and 2.12 from **May MPR**).

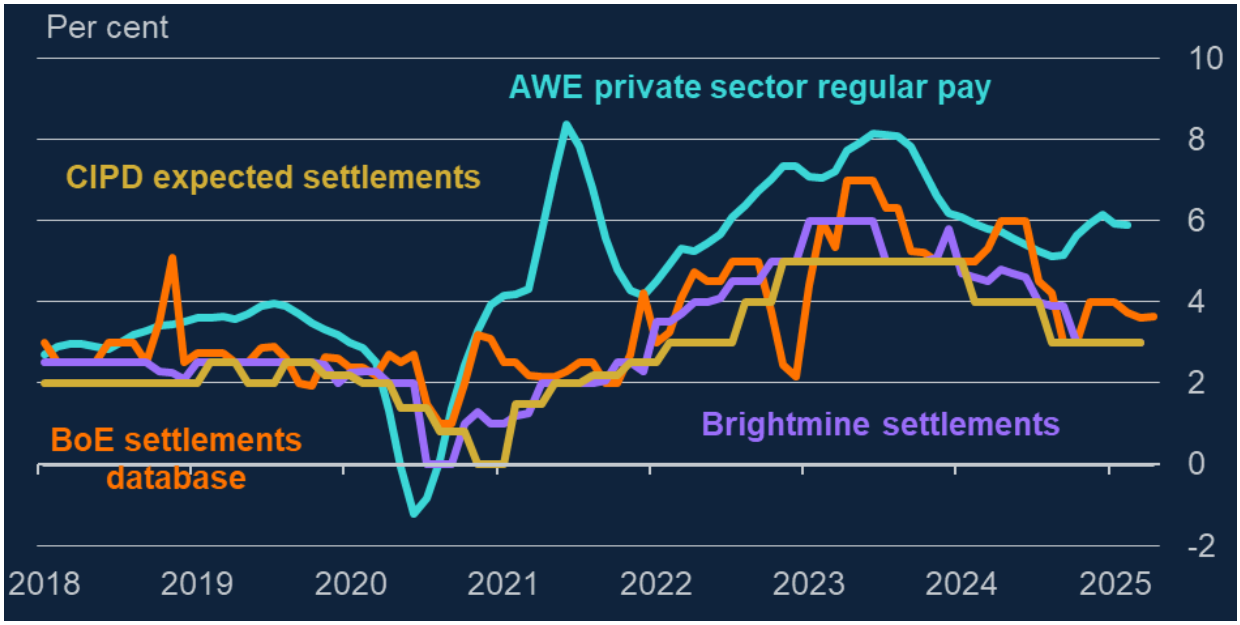
The AWE data are noisy; Bank staff monitor a broader set of indicators and their combined steer for the current rate of underlying wage growth is lower, at 5¼% (Chart 2). And forward-looking indicators point to further progress on disinflation; the Agents' pay survey has pay settlements at 3.7% by end-2025 and expectations for wage growth from the DMP survey are around 4% by year-end. Importantly, the most recent pay settlements data are consistent with these forward-looking steers (Chart 3); the upcoming settlements will provide important information.

Chart 2: Wage growth higher than target-consistent but gradually easing



Sources: BoE Agents, DMP Survey, HMRC, Indeed, KPMG/REC UK Report on Jobs, Lloyds Business Barometer, ONS and Bank calculations. Measures of private sector wage growth. For more details see footnote to Chart 2.16 in **May MPR**.

Chart 3: Latest pay settlements consistent with steer from Agents' survey



Sources: BoE Agents, Brightmine, CIPD, Incomes Data Research, Incomes Data Services, Industrial Relations Services, Labour Research Department, ONS and Bank calculations. Final data points are the three months to February for private sector regular AWE growth, April for BoE settlements database, March for Brightmine settlements and 2025 Q1 for CIPD expected settlements.

If the forward-looking indicators are broadly accurate, that would represent substantial progress by the end of the year. Simple ready-reckoners suggest that wage growth around 3% and potentially a bit higher would be consistent with inflation at target (Table 1), if productivity growth returns to rates of around 0.5-1%. This calculation also assumes import price inflation in line with its historical average – while this would be unlikely in the longer term if global trade were to fragment, it may be a plausible assumption over the coming period given the exchange rate moves we have seen and the potential for trade diversion from reduced exports by the rest of the world to the US.

Table 1: Ready reckoners for target-consistent wage growth

Illustrative estimates of wage growth consistent with 2% CPI inflation, based on reasonable assumptions for medium-term import price inflation and labour productivity growth. Calculations assume an import intensity of 25% for the CPI basket (due to both direct and indirect channels, consistent with average COICOP class import intensity) and constant markups, such that labour and capital costs grow at the same rate.

However, caution remains appropriate. I'll be more comfortable when I see material deceleration in the data over a longer period.

The picture for services inflation, which is a simple and observable proxy measure for the persistent component of inflation, is broadly similar to that of wages. The absolute rate of services inflation is still too high, with the annual measure at 4.7% in March, but it's come down from 6% one year ago. Abstracting from volatile items, underlying measures of services inflation have shown modest declines in recent months. But higher-frequency measures have been flatter. So the picture is not entirely reassuring, although we should expect this disinflation to be bumpy. More broadly, looking forward, the evolution of wages should drive services inflation, especially if firms face limited scope to expand margins in an environment of subdued demand.

Most recently, the economic news has been dominated by the US administration's announcements and their implications for the global trade outlook. Higher tariffs and more uncertain US policies will likely reduce growth and inflation over the policy-relevant horizon because of reduced demand and trade diversion from reduced exports by the rest of the world to the US. The exchange rate movements we have seen further support lower imported

inflation to the UK, although exchange rates can shift in response to trade policy news and the evolution of global risk sentiment. In the longer term, if global trade were to fragment, this would reduce output and productivity and would raise inflationary pressures.

Coming into the May policy round I was balanced between holding and cutting rates. Taken together, the combination of further gradual progress on disinflation and the trade developments led me to conclude that a 25bps cut was the appropriate decision for May.

Scenarios

A valuable tool to help us better understand risks and uncertainties and their consequences is scenarios. Scenarios help us to answer 'what if' questions – what if the economy doesn't behave broadly as our central expectation. They are being increasingly used by monetary policymakers and forecasters in response to uncertainties. For example in April the IMF published a forecast and alternative scenarios in its **World Economic Outlook** And in its **April Monetary Policy Report** the Bank of Canada dispensed with a central forecast altogether publishing two alternative scenarios based on different assumptions for trade tariffs, oil prices and the exchange rate.

Scenarios are one of the tools we are developing and experimenting with at the Bank of England in response to Dr Bernanke's review (**Bernanke, 2024**). They are one part of the ambitious reform programme that I've previously talked about (**Lombardelli, 2024**). That will encompass a much wider range of improvements across our infrastructure, modelling toolkit, use of data, culture and communication.

In our recent policy round we began to explore using scenarios to have a better discussion of the economy and policy. We considered two scenarios, more details of which are given in Box A in our **May Monetary Policy Report**.

The first scenario explores the risk that demand weakens more than expected. This could be because the chilling effect of trade policy uncertainty has a greater impact on UK investment and consumption. In our central forecast we expect a material fall in the savings rate from its current elevated level of 10½% to 8½% after three years. But if households become significantly more uncertain about the outlook for the economy and their incomes or job prospects, they may hold back spending, in particular on major purchases. Equally firms may reduce or delay investment if uncertainty about how the economy will evolve leads them to doubt whether investment will be profitable.

In this scenario, we also looked at what would happen if the faster build-up of excess supply triggered a quicker unwind of inflation. This was modelled as a steepening of the Phillips Curve, consistent with a looser labour market in which workers accept a lower rate of pay growth and firms reduce prices more rapidly.

In a second scenario, renewed second-round effects on inflation as well as supply constraints in the UK economy generate a more persistent inflationary environment. We explored a scenario where productivity growth doesn't recover after the recent period of weakness and wage growth continues to outpace productivity gains. Alongside this, households and firms' inflation expectations are more sensitive to the near-term rise in inflation than usual – perhaps because the increase is more concentrated in food and energy prices, which we know are the most salient items, or also because the experience of higher inflation over recent years has made expectations more sensitive to price rises.

The structural mechanism considered here is different to that discussed in the third 'case' in the November MPR, where real income resistance drives up wage demands in the context of reduced labour market contestability.

In the May round, the MPC used analysis of these scenarios, their economic mechanisms and policy implications as part of the regular discussions we have on the latest data, the economic outlook, policy and communications. Reflecting on those discussions, I'll make a few points.

First, these scenarios describe a limited number of specific economic mechanisms. They don't aim to provide a comprehensive view of risks around the outlook. This is intentional, as it allows us to consider in more detail some of the specific risks some members of the Committee are worried about. Enabling us to think through the macroeconomic implications and the potential consequences for policy. Getting into the economics allows us to think harder about not just how plausible these scenarios are, but also how worried about them we should be.

Second, these scenarios aren't just about describing the response of the economy and our reaction function to an economic shock or a different conditioning assumption path, as sensitivity analysis would. They do that, and it's a useful thing.[1] But we can also use scenarios to help us explore uncertainty around key parameters of the economy; for example, around the relationship between the output gap and inflation (the slope of the Phillips curve) in different states of the world. The first of the May scenarios goes some way towards doing that. We plan to do more of this type of analysis in future.

Third, these are not simple "downside" and "upside" scenarios. They both explore circumstances in which economic activity is lower than potential. We are not sending a signal about whether we view the growth forecast as optimistic. But by exploring different mechanisms by which activity may be weaker than we expect, we can explore the different consequences for policy. The first scenario describes a negative demand shock, while the second presents a trade-off for the MPC given the inflationary environment and a negative output gap.

The two scenarios are not mutually exclusive. It is possible, and indeed likely, that members may worry about both scenarios or aspects of them. It would be perfectly reasonable to be concerned that productivity growth does not return to pre-Covid levels and also that demand may be more suppressed by trade policy uncertainty. In this way they are not mutually exclusive states of the world that we can assign probabilities to. Nor does it make sense to place Committee members along a “hawkometer” scale from the downside scenario, through the central forecast, to the upside scenario. And there are other dimensions that scenarios may be useful to tease out, like for example preferences for gradualism or activism when setting policy under uncertainty.

Fourth, the calibration of these scenarios inevitably reflects judgment. We could have produced more or less severe scenarios describing these economic mechanisms. For monetary policymaking, scenarios tend to be more useful when they are different from the central case, but still plausible. This differs from scenarios for the analysis of financial stability risks, for example, where it often makes sense to analyse mechanisms that are more in the tails of the distribution of possible outcomes. Both of the scenarios we considered in May are plausible for the UK economy and so helpful in thinking about the possibility that the economy may evolve differently to our central projection.

Fifth, and taking a step back, there is an ongoing debate among policymakers, market participants and academics on how best to use scenarios to inform monetary policy. This is an important area of research. I don’t want to pre-empt how these discussions may evolve, including with my colleagues on the MPC. But in my view, they are a valuable tool to help us build the analysis of uncertainty more explicitly into our framework. In the recent meetings I found it particularly helpful to use scenarios as a vehicle to discuss the ‘robustness’ of different policy choices to alternative economic outcomes, and the extent to which policy might need to respond as we continue to learn about the outlook.

Policy considerations

That fifth point brings me to the last thing I want to talk about today – how we are beginning to think about using scenarios as an input to our policy deliberations. One way in which scenarios can be used in that way is to assess how policy could respond to their macroeconomic implications. Doing this requires an assumption about how monetary policy is set. There are many ways to do this, each with a differing economic rationale and accompanying pros and cons. For example, two common approaches are empirically estimated simple policy rules (such as that of **Taylor, 1993**) and model-consistent ‘optimal’ policy. It is worth emphasising that none of these approaches provides an accurate guide to what policy should do in the real world given the simplifying assumptions used. Indeed, these approaches add further assumptions to our ‘what if’ thought experiments: ‘what if monetary

policy responded to this scenario in a mechanical, model-based, manner?'. Nevertheless, such experiments can provide useful inputs to policy deliberations, including by exposing the relevant policy considerations.

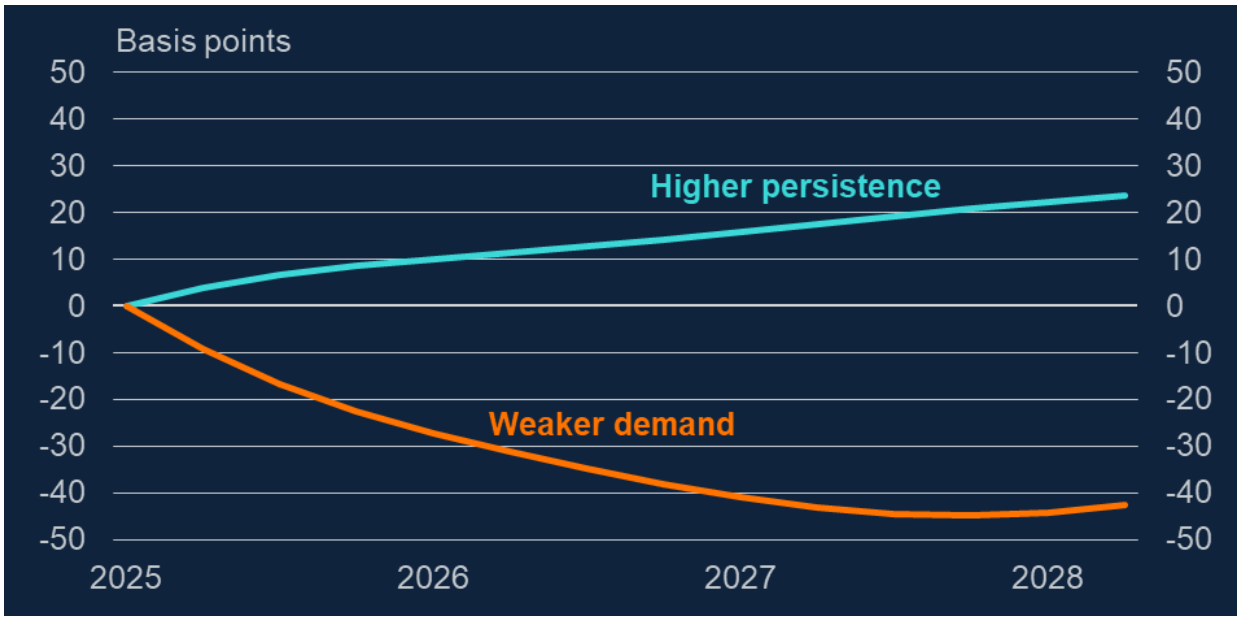
In the May round, we used a version of model-consistent optimal policy. This approach is based on some very strong assumptions. These include that the model is linear, that monetary policy is set to minimise a quadratic "loss function", and that both the private sector and monetary policymaker have full information about each other's behaviour and the shocks hitting the economy.[2] Expanding the breadth of our toolkit for policy simulations is one of the key areas we will be pursuing in response to the Bernanke review. For now, this is just one of a number of possible ways of determining policy paths.

Variants of the central projection that assume model-consistent optimal policy have been among the analytical inputs discussed by the MPC for some time. An additional use of such variants is as the reference points for assessing and understanding the policy response in scenarios.[3]

As I explained earlier, the first scenario is characterised by a standard negative demand shock, with a negative output gap and inflation falling materially below target in the absence of a tailored monetary policy response. While the second scenario presents a trade-off for monetary policy, given inflation above target and a negative output gap.

Against this backdrop, Chart 4 shows how the model-based policy responses to the two scenarios would differ. Bank Rate would be almost 50bps lower after 3 years in the lower demand scenario than under the model-based baseline path. And it would be about 25bps higher in the inflation persistence scenario.[4] In these simulations, monetary policy responds more strongly to the lower demand scenario than to the higher inflation persistence scenario because the policymaker is assumed to place some weight on reducing output volatility in addition to its primary objective of returning inflation to the 2% target. Another way to put this is that a monetary policymaker will tend to respond more strongly to a demand shock than if they have to confront a trade-off between stabilising inflation and reducing output volatility.

Chart 4: Policy tends to respond more strongly to a demand shock than in the presence of a trade-off



Sources: Bank of England, ONS and Bank calculations. Model-based simulations of the endogenous response of monetary policy to the May forecast and scenarios produced by Bank staff. Chart shows the difference between the endogenous model-based Bank Rate path in the higher persistence and weaker demand scenarios, relative to the endogenous model-based path for the central forecast. The model used to produce these simulations is specified in the Annex to **Broadbent (2022)**.

We also used the scenarios to consider the robustness of policy to alternative economic outcomes. We used the toolkit I described a minute ago to evaluate outcomes if the policymaker sets policy expecting a baseline outlook, but the economy evolves like in either of the scenarios. This allowed us to discuss the possible costs of policy missteps if the economy ends up evolving in a different way than the expected.

Applying the analysis to the policy decision, it's consistent with the view that the 25bps reduction to Bank Rate would not lead to large regrets if the economy evolves as in either of the two scenarios. More broadly, the evidence suggests that at 4.25% monetary policy is still restrictive, so if we were to find ourselves in a world with greater inflation persistence than expected, policy would still be providing pressure to squeeze inflation out of the system. And it would be doing that whilst having taken out some insurance against the risk of a larger fall in demand through the 25bps cut in May.

Of course, we will keep experimenting as we continue to work on our response to the Bernanke review. And we are learning from other central banks and economic policymakers. The work of developing and applying scenarios and wider analytical tools and capabilities to

think about uncertainty in a shock-prone world is an essential part of our reform programme. I've shared some of our early lessons today, this will not be the last word, far from it.

Thank you.

I'd like to thank Fabrizio Cadamagnani, Rich Harrison, Jack Page, Michal Stelmach, Matt Tong and Matt Waldron for their help in preparing this speech. Thanks also to Andrew Bailey, Sarah Breeden, Ambrogio Cesa-Bianchi, Catherine Cormack, Iain de Weymarn, Megan Greene, Bob Hills, Lien Laureys, Catherine Mann, Adrian Paul, Andrea Rosen, Fergal Shortall, James Talbot, Danny Walker and Chris Young for their helpful comments.

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1. The Bank has published scenarios of this nature in the past, e.g. see the discussion of an alternative path for energy prices in the **August 2022 MPR**.
2. See **Bank of England Staff Working Paper No. 911** for a technical description of the toolkit used to implement optimal policy, or the Annex to **Broadbent (2022)** for a high-level description.
3. This is necessary for isolating the policy implications of the scenario, since a comparison between a scenario constructed under model-based policy and the market-conditioned baseline would include the effects of different assumptions about both economic shocks (and the mechanisms through which they transmit to the economy) and the behaviour of monetary policy.
4. These differences in policy paths should not be interpreted as implying an expectation that the market-implied path for Bank Rate would adjust by similar amounts if either scenario were to come to pass. First, applying the same assumptions about policy in the baseline forecast implies a different path for rates than the market path. Second and more importantly, as already noted, these policy responses are mechanical responses based on several strong assumptions. As a result, they do not capture all relevant considerations for real-world policymaking.

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