BANK OF ENGLAND

Speech

Shocks, uncertainty and the monetary policy response

Speech given by

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With thanks to Tom Smith for his assistance in preparing these remarks, and to my fellow MPC members and numerous Bank colleagues, including Natalie Burr, Harry Gladwin, Amber McAlone, Clair Mills, Tuli Saha, Ali Schomberg, Saugata Sen and Luc Tucker, for their many helpful contributions.

It's a pleasure to be here today and to be speaking at this NFU conference. And a particular pleasure to be able to be here in Birmingham and speaking to you all face to face on behalf of the Bank of England. I know how pleased my late mother would be too: she was born on a mid-Wales hill farm, and throughout her life maintained a strong link to her roots.

These are challenging times for the economy and for the farming industry in particular. The issues you are discussing at this conference – uncertainty, cost pressures, food security and sustainability – are crucial ones for the UK's economic resilience and future prospects.

I recognise that starting the day with a speech on monetary policy may be a bit of a departure from more usual NFU conference topics. But given the current outlook for inflation and the very real challenges that will be posing for many of you I hope you will find it useful. What I want to use my time here today to do is to set out how the Bank of England Monetary Policy Committee (MPC) is thinking about the outlook for the economy in the face of the shocks which are impacting it, including my own perspectives as one of the nine members of the MPC, and to explain what actions we are taking in response.

Challenges for the farming industry

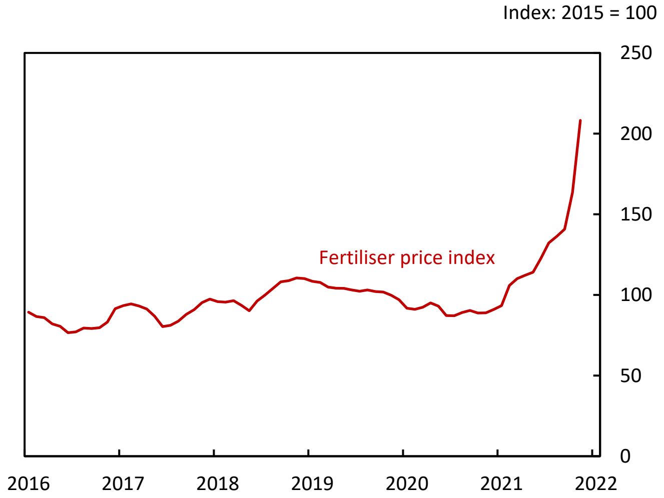
I want to start with some of the key challenges facing NFU members today. The MPC sets monetary policy for the economy as a whole. But to be able to do that we need to understand in detail what is happening across all sectors of the economy, and in all regions and nations of the UK. That includes farming, both as an important sector in its own right and as the key link in the broader agri-food supply chain. Agriculture contributes almost £10bn of the UK's GDP and the wider agri-food sector £127bn, or 6½% of national gross value added. Numbers though don't do justice to the wider significance and role of our farming sector, not just for the economy but for wider society. Nor do they bring out the diversity of subsectors and business models that make up the farming industry.

One way we build our understanding is through our network of local Agents. Our Agents engage with hundreds of businesses and organisations right across the economy – including the NFU – to gather intelligence and insight into what is actually happening on the ground. The intelligence they gather is incredibly valuable in helping policy makers like me understand the detail behind the economic statistics. I personally find it a really useful source of evidence when making my own policy decisions; alongside participating in your Conference today I will be speaking with a number of local businesses to hear their take on developments.

The themes coming through from our Agents' intelligence from the farming sector, and from my own discussions with people in the industry and related sectors, will no doubt be familiar ones to many of you today. Some are structural, perennial issues, while others are more specific to the current situation.

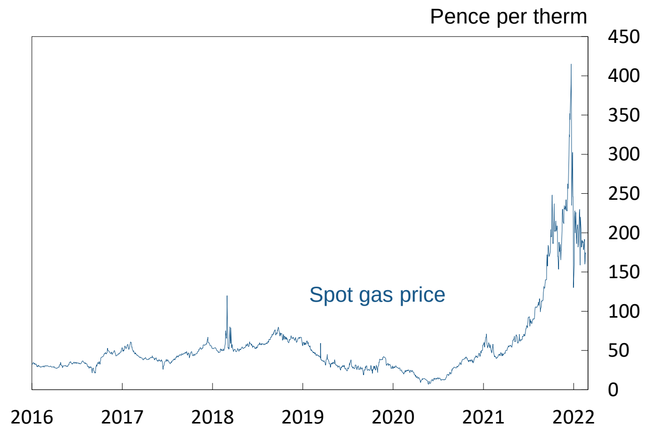
The main theme is the immediate cost challenges facing the sector. The price of raw materials and key inputs has risen sharply over the past year – we hear for instance of fertiliser prices having more than doubled, and of feed prices doubling (**Chart 1**). Energy and fuel prices, especially gas prices, have also risen even more sharply in recent months (**Chart 2**). And while output prices may have risen as well, that isn't always enough to cover cost increases in a sustainable way. The tight labour market also poses challenges, with a labour shortages and rising wages in the wider economy all making recruitment difficult and putting upward pressure on agricultural labour costs.

Chart 1. Fertiliser prices have doubled in the past year…



Source: ONS

Chart 2. … and wholesale gas prices have quadrupled



Sources: Bloomberg Finance L.P. and Bank calculations

A second theme we hear is one of disruption – not just from Storms Dudley, Eunice and Franklin – but from the adjustments required to a wide range of shocks hitting the economy. Although the Omicron wave does thankfully appear to have passed its peak, Covid rates remain high and that continues to disrupt production and demand. The continuing adjustment to post-Brexit trading arrangements is also posing challenges for some businesses, while over the longer term the opportunities from new trade deals, and the move to a new Environmental Land Management scheme, will be a key factor shaping farming business models. Disruption to global trade is also having an impact, with global supply bottlenecks leading to delivery delays and shortages of key inputs and capital goods such as machinery.

A third theme from our engagement with the sector is a clear and open-minded focus on the future – as exemplified by the "blueprint for the future" theme of this year's conference. We hear about a farming sector keen to adopt new technologies to invest in that future, whether that is electrifying heavy machinery or applying the latest artificial intelligence and machine learning techniques. And we hear about a sector eager to provide responsible stewardship for our landscape and for the environment, and to play its part in responding to climate change and supporting the transition to a net zero economy.

I know the last of these in particular is something that has been a priority for the NFU for some time. And while it isn't the main subject of my speech today, I do want to emphasise that climate change is also a priority for the Bank of England.

I would highlight two of our climate change work programmes in particular. The first is our ongoing work to ensure banks and financial firms identify and address climate-related financial risks, including scenario analysis to help them understand the risks to their own balance sheets. And the second is our work to 'green' the £20bn portfolio of corporate bonds that we currently hold for monetary policy purposes. We are adjusting our investment approach so as to incentivise the companies whose debt we hold – and the wider investment community responsible for managing trillions rather than billions of assets – to change their behaviours in meaningful and lasting ways, to the benefit of the economy as it transitions to net zero.

Three shocks to the economy

The economic challenges facing the farming sector and the wider UK economy are many and varied. But many of them share a common economic cause. What we are seeing is the impact of an economic expansion coming up against the ongoing effects of three major economic 'shocks' from the past five years: Brexit, Covid and now the energy shock. A key question for the economic outlook is whether the recovery can prove resilient to the risks posed by these three very significant shocks.

What do I mean by economic resilience? I gave a speech in Inverness three years ago where I defined it as the ability of an economy to withstand and recover from shocks, in other words unexpected economic difficulties. It is a hard concept to capture in a single number – though a lot of my focus today will be on two numbers, GDP (a measure of the UK's national income) and inflation. And indeed I would say that focusing on narrow measures of resilience was one reason we missed the broader economic vulnerabilities that were revealed in the Global Financial Crisis.

The role of the Bank of England in supporting the UK's economic resilience is clearly laid out in its mission: "to promote the good of the people of the United Kingdom by maintaining monetary and financial stability". The Bank's Monetary Policy Committee works to maintain monetary stability by keeping price inflation low and stable, close to its target rate of 2% per year, while minimising undesirable volatility in output. And the Bank's Financial Policy Committee (FPC) works to maintain financial stability by making sure the financial system has the capacity to continue providing financial services to the wider economy in bad times as well as good.

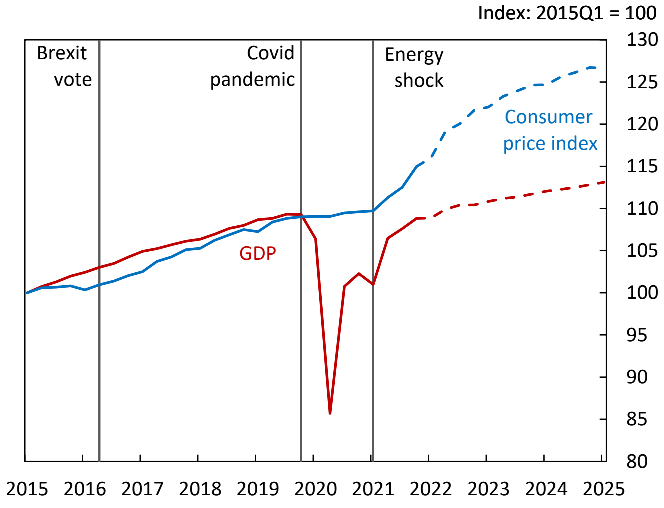
I'm speaking primarily about the monetary stability side of our work today. But the financial stability side is just as important; it is the work of the FPC that means that the events that we saw in the global financial crisis didn't repeat themselves in the face of the Covid shock, and that the very serious health and economic crisis that we faced was not accompanied by another financial one of the sort we saw from 2007-09.[1]

The three major shocks that I mentioned – Brexit, the coronavirus pandemic, and energy – are all very different. Each has had a different cause; has affected the economy in different ways and on different timescales; and has required very different responses from policy makers.

Covid has had by far the largest impact on GDP (**Chart 3**); and it would have been even larger were it not for the fiscal, monetary and financial policy response of much of the last two years. The impact of Brexit has been less immediately obvious as the economic adjustment to that is a slower and ongoing process. The impact of the energy shock meanwhile has, so far at least, mainly been seen in the upward pressure it has put on consumer prices since the start of 2021.

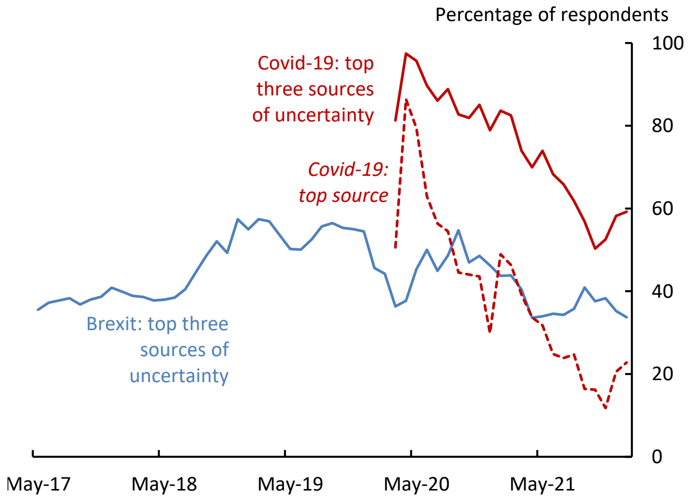
[1] The Bank's Governor, Andrew Bailey, set out his thinking on this in a recent speech.

Chart 3. The economy has had to respond to three major economic shocks



Sources: ONS and Bank calculations

Chart 4. Brexit and Covid have been major sources of uncertainty

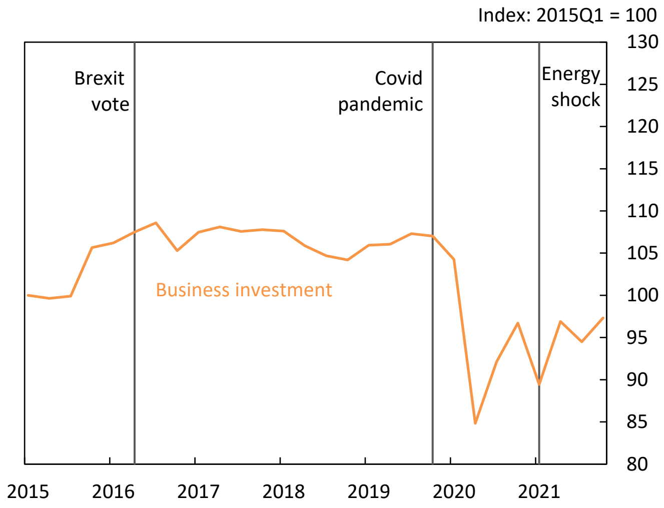


Sources: DMP Survey and Bank calculations

The Decision Maker Panel (DMP) is a survey of Chief Financial Officers from small, medium and large UK businesses. We use it to monitor developments in the economy and to track businesses' views.

Both Brexit and Covid have also been significant sources of uncertainty for businesses, as they tell us in their responses to our Decision Maker Panel survey (**Chart 4**). Uncertainty is particularly relevant as a key driver of business investment, which accounts for roughly a tenth of total GDP, and has been particularly hard hit by the succession of shocks (**Chart 5**). At the end of 2021 business investment was still more than 10% below its level before the pandemic struck. The energy shock is one of the newest sources of uncertainty that firms, as well as we on the MPC, are currently grappling with. Against that backdrop it seems hardly surprising that today's first panel session asks whether uncertainty is the new normal for business.

Chart 5. Business investment has been hit hard by shocks

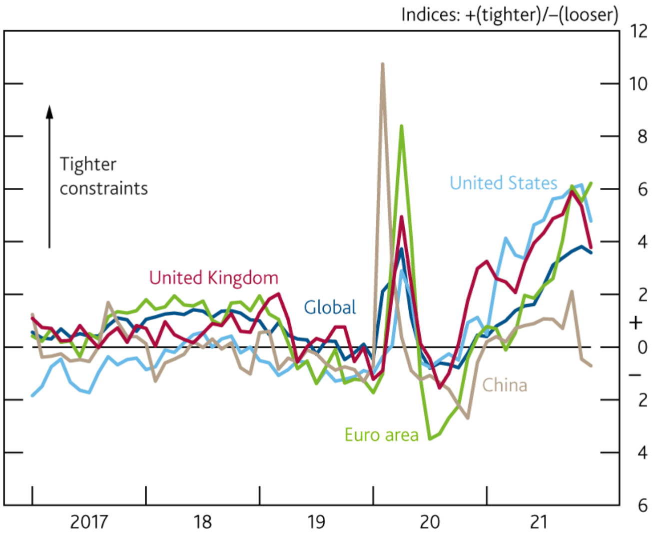


Sources: ONS and Bank calculations

The shock of the coronavirus pandemic has been with us for two years now. In that time we have seen multiple waves of Covid infections, most recently the Omicron variant. Case rates in the UK have fallen from their peak at the turn of the year, and most measures to contain the virus have now been lifted. So although Omicron depressed GDP somewhat in December and January, its direct economic impact is now likely to be limited and of short duration, with output likely to return to its pre-pandemic level – though not its pre-pandemic trend - once again by the end of the first quarter of 2022.

The wider economic impacts of the Covid pandemic are, however, very much still with us. Bottlenecks have re-emerged in global markets through the course of 2021 as economies have recovered (**Chart 6**).

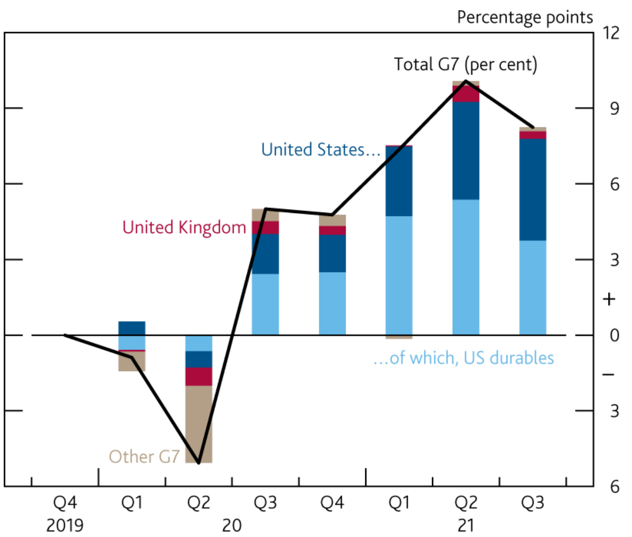
Chart 6. Global bottlenecks may be peaking



Sources: IHS Markit, JPMorgan, Refinitiv Eikon from LSEG and Bank calculations.

Indicators are estimated by Bank staff using principal component analysis on a range of PMI indicators for supply constraints in the manufacturing sector (supplier delivery times, stocks of purchases, stocks of finished goods, input prices and backlogs of work). Before principal components are estimated, these indicators are regressed on the new orders PMI to control for movements in demand. Latest data are for December 2021.

Chart 7. Goods demand in advanced economies remains robust



Sources: OECD, Refinitiv Eikon from LSEG and Bank calculations.

Global consumer spending, especially in the United States, has rotated away from services and towards goods (**Chart 7**). That has put additional pressure on global supply chains which had already been disrupted by Covid outbreaks, which in turn has led to sharp increases in input and transport costs, as well as backlogs and shortages in production. These global trends are one of the key drivers of the economic challenges affecting the farming sector that I mentioned earlier.

Although it is still early days, global supply chains do appear to be demonstrating some resilience to this shock. Demand is starting to rotate back towards services; supply chains are beginning to adapt; and shipping costs appear to be flattening off or falling. Full adjustment is likely to take some time, and the ongoing Omicron waves in some countries could delay that process further. But the MPC's overall judgement is that global bottlenecks should fade over the next twelve months or so.

Other consequences of the Covid shock, however, seem likely to be with us for somewhat longer. There are now over 500,000 fewer people in the UK classed as participating in the labour market than there were before the pandemic. Most of that increase reflects people leaving the market due to sickness or study, some of whom will no doubt return over time.[2]

Given that the Covid shock came soon after the UK left the EU on 31 January 2020 (and during the transition period), it is impossible to separate out the effects of Covid from ongoing effects of leaving the EU. The effects of Brexit are expected to build over time and lead to some persistent negative impacts on the level of potential GDP through their impacts on openness and trade; what economists call 'scarring'. Economic scarring means lower incomes and GDP, and a reduction in the amount of demand that can be accommodated without generating inflation.

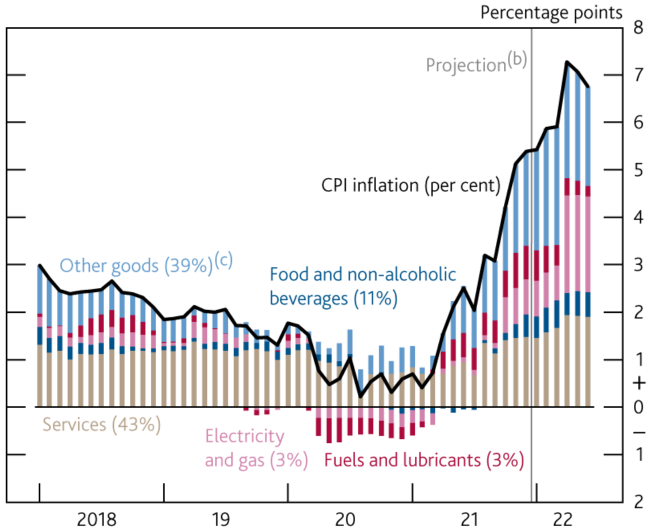
Participation aside, however, the scarring effects of Covid appear likely to be smaller than we might have feared. Partly as a result of the very substantial economic policy measures that were put in place, in particular the Government's furlough scheme, employment has remained resilient, with unemployment falling to 4.1%, only slightly higher than its level prior to the pandemic in 2019Q4. At the same time the successful adoption of working from home technologies could if anything contribute positively to productivity; we set out our latest analysis on this in our November Monetary Policy Report. Reflecting all this, the MPC's estimate for the long-run scarring effect of Covid is now around 1%, about a third of the size of the equivalent estimate for the long-run effects of Brexit. One question that remains to be answered, however, is whether the combined Brexit and Covid shocks have had a more fundamental impact on the flexibility or responsiveness of the UK labour market.

The third shock, and the most immediate of the three, is the increase in energy prices that I have already highlighted. Sterling oil prices are now more than double their levels in 2020Q4, and wholesale gas prices have quadrupled. That has been driven by a combination of higher demand as the global economy has recovered, disruptions to supply, and geopolitical tension. Higher wholesale energy prices means higher fuel bills for households and higher input costs for businesses.

[2] About a third of the rise is related to the aging population and so is both unsurprising and likely to persist.

The increase in energy prices, together with the increase in global goods prices, is already pushing up significantly on UK consumer price inflation. The latest inflation outturn was 5.5%, significantly higher than our target rate of 2%, and the majority of that overshoot was accounted for by energy. And energy will push up further once Ofgem's utility price caps are reset in April, which is likely to see household utility prices rise by as much as 50%, when we expect inflation to rise higher still and peak at around 7¼%. (**Chart 8**)

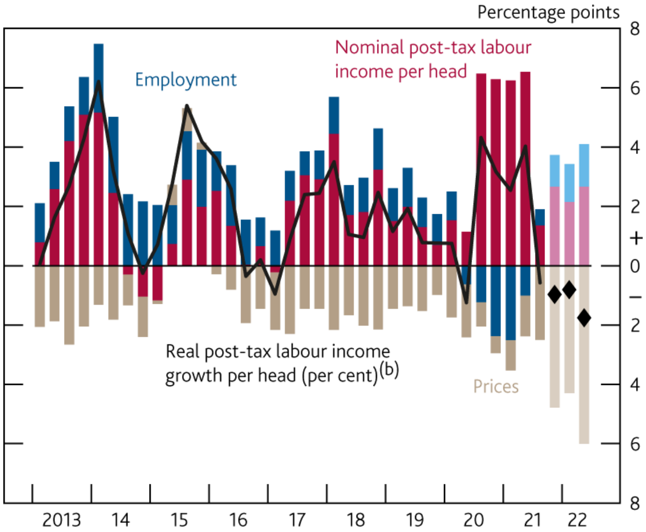
Chart 8. We expect inflation to peak at 7¼%



Sources: Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, ONS and Bank calculations.

The rise in energy prices, together with the rise in goods prices that I mentioned earlier, will put a very significant squeeze on real household disposable incomes, which we expect to fall by 2% in the coming months: the most significant squeeze on real income in thirty years (**Chart 9**). This is an extreme example of what economists call a terms-of-trade shock: an increase in import prices which raises the cost of living and reduces real national income.

Chart 9. The rise in energy and goods prices will push down on real incomes



Sources: ONS and Bank calculations

Assessing the impact of the energy price shock is probably the key judgement in the MPC's latest forecasts, which we published in the February Monetary Policy Report. In a speech last July I highlighted the challenge of forecasting the economy through the Covid shock. And the challenges and the uncertainties associated with forecasting have intensified with the rise in energy prices.

In our latest forecast we assume that higher energy prices and the associated real income squeeze will persist. That in turn, along with tighter economic policy, weighs on consumer demand and output, such that GDP growth slows to subdued but still positive rates. Reflecting that slowing in demand growth, unemployment rises to 5% over the forecast. And inflation, having fallen back to a little above our 2% target within two years, ends the forecast period somewhat below the target at 1.6% (**Chart 10**).

Chart 10. Summary of the February MPR forecast

	Projections			
	2022Q1	2023Q1	2024Q1	2025Q1
GDP growth (%)	7.8	1.8	1.1	0.9
CPI inflation (%)	5.7	5.2	2.1	1.6
LFS unemployment rate (%)	3.8	4.2	4.6	5.0

How monetary policy is responding to the energy price shock

In the near and medium term, what matters for consumer prices and inflation is how monetary policy responds to the energy price shock. The MPC has already taken action: we voted to raise Bank Rate from 0.1 to 0.25% in December, and again to 0.5% in February.

We also agreed to end reinvesting maturities from our stock of UK government bond purchases, consistent with the guidance we gave back in August that we intended to do this once Bank Rate reached 0.5%. Our balance sheet (as well as the government's balance sheet through policies like the furlough scheme), took some of the strain of the Brexit and Covid shocks through our QE programme: we purchased £440bn of government bonds with the aim of lowering long term interest rates. Now that monetary policy is tightening, the time has come to unwind some of our purchases. We also gave guidance in August that we would consider beginning the process of actively selling some of our government bond holdings only once Bank Rate reached at least 1% - though our guidance does not make an automatic link between the Bank Rate threshold and the decision to begin sales.

What I want to do now is explain why we took those decisions to tighten policy, and say a little about how I am thinking about the outlook for monetary policy in future.

The first thing to say is that what monetary policy cannot do is prevent the rises in energy and tradable goods prices, or the hit to real incomes that will follow from them. Those are global shocks, and their drivers are real-world factors like supply chain bottlenecks which an increase in interest rates would do nothing to resolve. What is more, the effects of changes in interest rates come through with a lag, meaning that even if we wanted to we would not be able to offset the immediate and direct impacts on inflation – what economists call the 'first round effects'. I also recognise that these are tough times and that, for some businesses, raising Bank Rate will increase interest payments and so potentially add to the challenges you are facing in the face of the energy price shock.

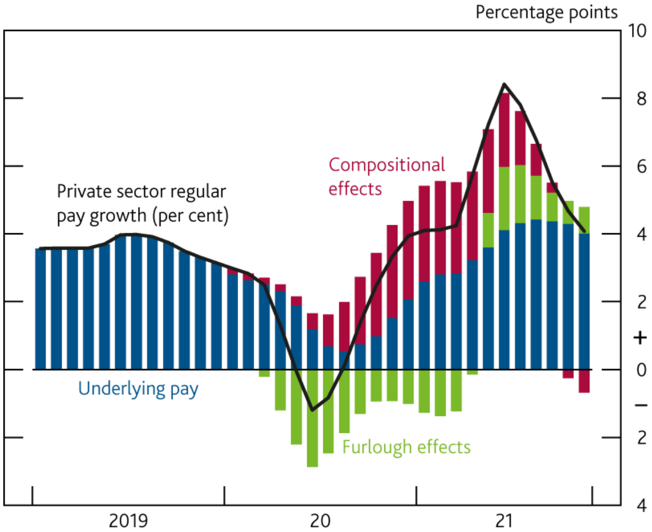
Instead what monetary policy can do is ensure that, as the economy adapts to this shock, it does so in a way consistent with meeting our 2% inflation target, and that current increases in prices do not feed through to further rounds of price increases in the future – what we call 'second round effects'. To make that happen we need to ensure that households and businesses recognise that we could not tolerate persistent overshoots of our inflation target and so do not factor expectations of persistent high inflation in to their own wage and price setting. And if necessary we need to take action to prevent that kind of persistence setting in.[3]

The tightness of the labour market is something I have already touched on in a number of times this speech. At the time of our February meeting unemployment had fallen to 4.1% and we expected it to fall further in the near term to 3.8%. Private sector regular pay growth had slowed to 4.1%, though that headline figure is distorted by the effects of the furlough scheme and changes to the composition of the workforce. Bank Staff estimated that once those effects were excluded, 'underlying' pay growth had remained at around 4 to 4½%, above pre-pandemic rates of around 3 to 3½% (**Chart 11**). Perhaps most strikingly, a survey of firms conducted by the Bank's Agents suggested that the average pay settlement was expected to rise to almost

[3] My MPC colleague Catherine L Mann covered this topic in depth in a speech in January.

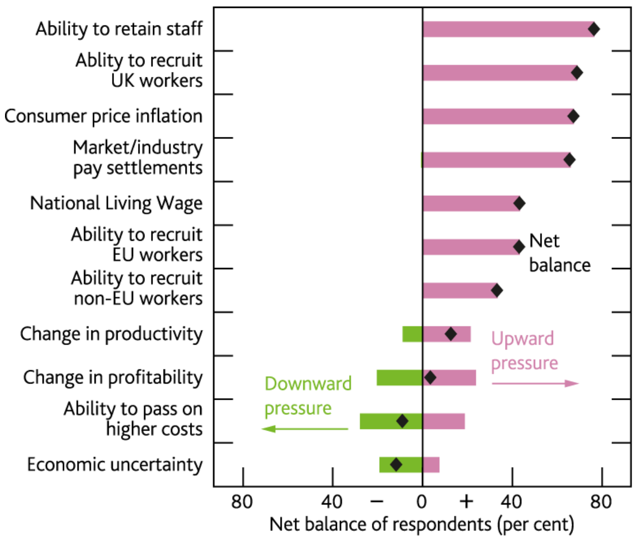
5% in 2022, with the pickup broadly based across different sectors of the economy and firms of different sizes (**Chart 12**).

Chart 11. Wage growth has stayed above pre Covid rates (once compositional and furlough effects are excluded)



Sources: HMRC, ONS and Bank calculations

Chart 12. Labour market tightness is the main driver, followed by higher inflation



Taken from responses to the Agents' survey on pay and costs. Question: 'When considering your 2022 pay increase, how much of an impact are the following factors having/expected to have on your pay decisions?'. Reports of 'slight' pressure were given a 50% weight relative to reports of 'significant' pressure when calculating these balances.

Alongside the tight labour market, measure of households' and companies' short-term inflation expectations had risen further since our previous meeting, as had pricing expectations of firms in the Bank's Decision Maker Panel (which covers nearly 3000 firms across the economy including a significant number in agri-food). Some firms in the Agents' survey also report that they have started passing on their higher labour costs to their prices and will seek to do more so over the next year. And market-based measures of medium-term inflation expectations, which I continue to monitor very closely, remain well above average levels.

Against that backdrop, my view and the view of the committee was that a tightening in monetary policy through an increase in Bank Rate was warranted. Five members voted to increase the rate by 0.25pp, and four of us including me voted to increase by 0.5pp.

Personally I felt that the 0.5pp increase in Bank Rate would have been warranted in February, in line with a watchful and responsive approach to monetary policy. I have been concerned about the emerging inflationary impetus from a tight labour market and from a broadening out in price pressures since last summer, as I set out in a speech last July. As I have seen those risks grow and to ensure they don't become too embedded, I have been voting for some front-loaded tightening in monetary policy since last September. So while it was a finely balanced decision for me, I was persuaded that a full 0.5pp increase in Bank Rate would have been appropriate at the February 2022 meeting.

Looking ahead, like the rest of the Committee I judge that if the economy develops broadly in line with the February MPR forecast, some further modest tightening in monetary policy is likely to be appropriate in the coming months. The word "modest" is significant here though – I do not envisage Bank Rate rising to anything like its pre-2007 level of 5% or above, let alone to the kind of levels we used to see before the MPC was formed in 1997.

Of course there are always uncertainties around any forecast and new shocks can arise – we did not foresee the recent rise in energy prices, and as we meet today the crisis in Ukraine is intensifying – and so we should remain humble about the possibility that things might turn out differently. Two of our forecasting assumptions are particularly relevant here.

The first is our convention of assuming wholesale energy prices will stay constant beyond the first six months. As I set out earlier, the uncertainty around this assumption is very high at the moment and it is quite possible that they could fall back significantly or even rise further.

In the Monetary Policy Report we published an alternative scenario in which wholesale energy prices do fall back along the path implied by market futures prices. In that scenario real incomes are less squeezed, GDP growth is stronger and unemployment does not rise as much. But inflation is significantly weaker, ending the three-year forecast period ¾pp below our 2% inflation target at 1.2% (**Chart 13**).

The second important assumption is the path of Bank Rate itself. In our central forecast Bank Rate is assumed, in line with the usual convention, to follow the path implied by financial market expectations of monetary policy, which in February meant assuming Bank Rate peaked at 1.4% in mid-2023. Market rates have risen significantly more since we published that forecast, and now have Bank Rate peaking at almost 2%. As a sensitivity analysis, in an alternative scenario in which Bank Rate followed the current market path (but keeping other assumptions, including the constant energy price assumption, unchanged), inflation would fall below our 2% target within two years and end the forecast at just 1.4% (**Chart 13**).

Chart 13. There are risks to our inflation forecast in the medium term

	Projections			
	2022Q1	2023Q1	2024Q1	2025Q1
Central projection				
GDP growth (%)	7.8	1.8	1.1	0.9
CPI inflation (%)	5.7	5.2	2.1	1.6
LFS unemployment rate (%)	3.8	4.2	4.6	5.0
Alternative energy price scenario				
GDP growth (%)	7.8	1.8	1.6	1.2
CPI inflation (%)	5.7	5.1	1.2	1.2
LFS unemployment rate (%)	3.8	4.2	4.3	4.5
Alternative Bank Rate path scenario				
GDP growth (%)	7.8	1.6	1.0	0.9
CPI inflation (%)	5.7	5.1	2.0	1.4
LFS unemployment rate (%)	3.8	4.4	4.9	5.3

The additional uncertainty around these assumptions makes it particularly difficult to make predictions about where monetary policy might be headed in the medium term. In the near term as I have set out some further tightening seems likely to be needed, to prevent current high inflation becoming embedded in wage and price setting, which would create further upside risks to inflation. But as the alternative energy scenario illustrates, there are also downside risks to inflation ahead. And as the alternative Bank Rate scenario shows, there are also risks from tightening monetary policy too much. The energy price shock has created a particularly challenging trade-off for the MPC to manage, between strong inflation and weakening growth. We will need to remain watchful and responsive to events as they unfold.

Conclusion

These are challenging times for the UK economy and for UK households and businesses, including in farming industry. But the UK economy, like the farming industry, has so far proved resilient, notwithstanding the scarring effects of Covid and Brexit, and has weathered the shocks and returned to pre Covid levels of output. A central question for the outlook is whether the UK economy can build on the resilience shown to date and continue to expand in the face of the ongoing effects of energy prices and other shocks in this age of uncertainty. How best the UK can take advantage of the opportunities in a post-pandemic, net zero future, and what the blueprint for that future should look like, will depend on policies well beyond the remit of the Bank of England's MPC.

What the MPC can do is ensure a stable foundation for future developments. We are currently experiencing a period of inflation which is higher than we have seen for many years – the biggest challenge on inflation since the Bank gained operational independence for monetary policy in 1997. And that will have real consequences for UK households and businesses. But unlike earlier inflationary episodes, where we saw more persistence in inflation caused by ineffective policy and policy frameworks, this time we have a framework which empowers us to take action, and to set monetary policy so as to achieve the 2% CPI inflation target sustainably in the medium term.