House of Commons

Treasury Committee

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

Monday 16 May 2022

Ordered by the House of Commons to be published on 16 May 2022.

Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Harriett Baldwin; Anthony Browne; Gareth Davies; Dame Angela Eagle; Emma Hardy; Kevin Hollinrake; Julie Marson; Alison Thewliss.

Questions 418-535

Witnesses

I: Andrew Bailey, Governor of the Bank of England, Sir Dave Ramsden, Deputy Governor, Markets and Banking, Bank of England, Jonathan Haskel, External Member, Monetary Policy Committee, Bank of England and Michael Saunders, External Member, Monetary Policy Committee, Bank of England.

Examination of witnesses

Witnesses: Andrew Bailey, Sir Dave Ramsden, Jonathan Haskel and Michael Saunders.

Q418 **Chair:** Good afternoon and welcome to this Treasury Committee hearing looking at the May report of the Monetary Policy Committee. We are very pleased to be joined by four witnesses—all members of the MPC—including the Governor of the Bank of England. Will you very briefly introduce yourselves to the Committee, please, starting with Andrew?

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

Jonathan Haskel: I am Jonathan Haskel of Imperial College. I am an external member of the MPC.

Sir Dave Ramsden: I am Dave Ramsden, Deputy Governor for Markets and Banking.

Michael Saunders: I am Michael Saunders, an external member of the MPC.

Q419 **Chair:** Welcome. Michael, I believe this is your last appearance before the Committee because you are about to stand down. We will miss you,

but, as some wit said a moment ago, they are not sure that you will miss us. Thank you very much indeed for all your service with the Bank of England over the years. It has been very valuable indeed.

Governor, could I start with you? There has been much comment in the press, and much comment from Conservative Members of Parliament in particular, expressing dissatisfaction with where the Bank of England is on inflation. As we know from your May report, we are now looking at forecasts of above 10% in the autumn—a much higher figure than was suggested in the last report back in February—and indeed, the ability of the Bank to forecast inflation seems to have been rather amiss for a considerable time.

Could you comment on the assertion that many are beginning to make, which is that you have really been asleep at the wheel; that you should have done far more far earlier on the monetary side to get on top of this inflation; that we should not be in the position we are in at the moment; and that this could have been avoided had you been smarter in what you have done? I will ask you, in answering that, to take it as read that we accept that there is a lot of uncertainty, particularly around what has been going on in Ukraine, energy prices and supply-chain bottlenecks and so on, and to focus particularly on the overheated labour market.

Andrew Bailey: I will certainly try to do that. I really have to say that we have to take our monetary policy decisions based on the facts and the evidence at the time. I do see comments around hindsight, but obviously, we have to take decisions based on how we see the facts and the evidence at the time.

You mentioned the issue of external supply shocks. I think the best way I can put a sort of calibration on that is to say that at the forecast peak in inflation that we currently have, which comes in the fourth quarter of this year, when I'm afraid it goes over 10%—I should emphasise that I do not feel at all happy about that; it is a bad situation to be in—it is notable that 80% of the overshoot over the target at that point is due to energy and tradeable goods. That is the piece that I would put into the category of "things that have happened"—particularly the impact on global prices that is coming through to this country.

As you said, there has been a series of supply shocks going on, including, most recently—this really is a big factor in the change since we were last here, and in the May report—the impact of Russia's invasion of Ukraine. Of course, we find, like others, that we cannot predict things like wars. As I think you were implying, that is not really in our power; I am not sure it is in anybody's power, really. It is well-established practice to accommodate supply shocks where they are expected to be transient but then to not accommodate the so-called second-round effects of those shocks.

Before I move on to the labour market, which is important, I would also say that a sequence of shocks like this, which have really come one after another with no gaps between them, is almost unprecedented, I think. Let me turn to the remaining 20% of this—

Q420 **Chair:** Before we move on to the labour market stuff, can I just be very precise about the shocks that have come through? Are you saying that, really, it is fine with hindsight to say that things perhaps could have been done differently, but that, as the information was being revealed to you through time in the past, it would not have been reasonable to have expected you to have done anything differently?

Andrew Bailey: On that part, I don't think we could. I don't think we could have foreseen a war in Ukraine. Another factor that we are dealing with at the moment is a further leg of covid that is affecting China, which I am sure you have read about and which appears to be affecting it more seriously than the effects that we saw previously. This has obviously been a large new issue. The zero covid policy that China has pursued up till now has caused dislocations in China, but our assessment is that, actually, those dislocations have not caused major economic effects. That is not what we are seeing now. There were some very weak numbers out of China this morning, and the closure of Shanghai at times is having a real effect—there is no question about that.

Q421 **Chair:** If I can go back a bit further than what is happening in China today, sticking with the supply-side stuff, is there no sense that you misjudged the impact of things like bottlenecks; the shift in demand from services to goods and the extent to which that happened; or the effects of the rapid rise of the economy as we came out of lockdown—the inflationary implications?

Andrew Bailey: The shift in the mix of demand from services to goods is interesting because, in the UK economy, that has pretty much largely now corrected itself. Where it has not corrected itself is in the US. The US still has a mix of demand that is skewed towards goods. If anything, the progress that the US was making in readjusting that balance has been disrupted by the recent rise of covid again. We had been seeing the US correcting that balance and shifting back to the pre-existing services-goods mix, but that has now stopped and appears to have been held up in recent months.

Again, it is not just about what the shocks are; it is essentially about what effect they are going to have. Covid outside this country has been a factor in that issue. The reason the US is important is that, globally, the increase in goods demand is hugely concentrated in the US. We published a chart on that, I think in the February Monetary Policy Report. Of course, that drives world prices—these are world markets, and they are world supply chains and world shipping capacity, for instance, so it does affect us in that sense. In the UK, however, we have seen—as we thought and hoped we would—a shift back. Again, putting the "transient" label on it in the UK has not been out of place.

Q422 **Chair:** Okay. You were going to move on to the labour market.

Andrew Bailey: Yes. It is wrong to say that the other 20% is all the labour market, but obviously the labour market is important here and we have a very tight labour market. I think that the last time we were here, I talked about the uncertainty around the impact of the end of the furlough

scheme in terms of the timing of our decision making. There were a million jobs remaining on the furlough scheme right to the end, which was well in excess of what we had expected there to be, and we had been uncertain what the effect of the ending of the scheme would be, but of course we now know that you cannot really see the ending of the furlough scheme in the unemployment data. The unemployment rate has continued to come down and is now at 3.8%. In the forecast we published in the report, we think it will come down a bit further before starting to rise again.

I want to pick out something else that I think is important and that I want to discuss with the Committee, because it has been a very difficult judgment that we have wrestled with: we have seen a fall in the size of the labour force. Since the end of 2019—before covid—we have seen a fall in the size of the labour market of around 450,000. That is about 1.3% of the labour force. Put like that, you may say that is not a very big number, but at the margin in the labour force, it is a big number—it is a very big fall in the labour force by historical standards—and it reflects a 3% increase in the number of economically inactive people. An economically inactive person is somebody who does not have a job and is not searching for one, as opposed to an unemployed person who is searching for one—that is the distinction.

The persistence and scale of this drop has been a surprise to us. We have seen an increase in long-term sickness in that number of about 320,000 people, so, in the main Monetary Policy Report, we have lowered the projected view of labour participation. Our thinking now is to assume that labour participation remains flat at around 63% of the working age population, whereas we had been assuming it would recover, at least somewhat. We had thought in February that we would put in a recovery at about 63.5%.

Q423 **Chair:** In terms of the 320,000 that did not go back into the workforce, why did it take you by surprise, and what mistakes did you make that led you to not—

Andrew Bailey: I'll tell you the sort of thinking. The question you pose, rightly, is: was it reasonable to assume that there would be more of a recovery in participation and thus an easing of the pressure on the labour market that came from that? The scale and persistence of the fall has been very unusual. If you go back to the period after the global financial crisis, there was a much smaller fall in the labour force, but it recovered much more quickly after that. The notable difference this time, as I was saying—Michael included this in a very interesting speech that he made last week—is that we have got this quite large long-term sickness element in there.

I have to be honest: we don't know much, really, about what is behind that. We have discussed it with health experts. We have asked: is it long covid? Is it, as some health economists have suggested to me, people with other pre-existing conditions who feel insecure about going to work in the covid era? It is possible. If you trace those things out, you reach somewhat different conclusions about what they mean for the return to

participation in the labour force in an era when covid is declining. I readily admit that this is an area where we have to be scrutinised, but these are very fine and pretty hard judgments to make, to be honest.

Q424 **Chair:** I suppose what I am driving at is that, looking back—which is fine; hindsight is great—you misjudged that element of the labour market, which may now be part of the reason why we are looking at inflation being rather higher than it might have been had you worked that out earlier. I suppose I am trying to unpack what you could have done differently. What mistakes, if that is the term, might you have made in not having identified those figures accurately?

Andrew Bailey: I am not sure it is identifying the figures, if you don't mind my saying so. It is the judgments you make about how they are going to evolve.

Q425 **Chair:** By figures, I mean that it took you by surprise that so many did not return to the labour market.

Andrew Bailey: Or haven't yet returned to work. There is a judgment there. We have not seen something like this happen before. We obviously have not been in a pandemic before.

Q426 **Chair:** Andrew, with respect, you have made that point. I am asking something slightly different—not whether it is unusual or it has been seen before, but why was it that you missed that trick? Why was it that you missed the fact that—

Andrew Bailey: We took a view that this fall in participation would unwind to some degree and we would return to something more like the labour market that we had pre-covid.

Chair: But it didn't happen.

Andrew Bailey: But it didn't happen.

Q427 **Chair:** What I am asking is: why didn't you see that it wasn't going to happen? Was it just impossible?

Andrew Bailey: The question, in a way, is how long do you give it? How long does it take for this thing to demonstrate that it is going to unwind or not unwind?

Sir Dave Ramsden: Can I come in to give a bit of framing on this and put it in a slightly longer-term perspective? At the back of the MPR we did what we always do: in annex 2, we accounted for our forecast performance over the last year. We looked at last February's forecast—February 2021—and what the actual outturn was. You have to remember that last February we were assuming that the furlough scheme would end, because that was the plan at that point. The furlough scheme was then extended through to last autumn and then ended.

The reason I am saying this is that last February we forecast that unemployment was going to be 6.4% at the end of last year, because we assumed that the furlough scheme would end, the labour market dynamics

would be as in the past, participation would be higher, and some people would lose their jobs as a result of the furlough scheme, so you would have much higher unemployment. As it was, unemployment came in at 4.1% and it is even lower now, as Andrew says.

Through that period last autumn, we and lots of other forecasters were trying to work out what different trends were taking place, while having to deal with the furlough scheme finally ending. As Andrew says, there were a million people still on the furlough scheme right up until near when it ended. We were trying to judge how many of those people who were on the furlough scheme would re-enter the labour market, as in go back into their jobs. As it turned out, a lot more did, but equally, at the same time, we and others were discovering this trend towards lower participation. I think we all learned more last year about, for example, long covid than we knew earlier on last year.

I have been trying to analyse the labour market throughout my career in public service, but the impact that something like a pandemic is going to have both directly on health but also on people with pre-existing health conditions, as Andrew says—these are quite challenging things to make sense of in real time. What we think we have now—Michael's speech brings it out—is a much better handle, at least on the numbers, of just how many people have left the labour market and how many of those are long-term sick.

All these trends are happening. Meanwhile, the economy is recovering, when normally people would have been brought back into the labour market and you would get the encouraged-worker effect.

Andrew Bailey: We talk to Sir Chris Whitty every round. I don't want to hold him responsible, as he is not responsible for our judgments, but every time we have talked to him about long covid, and I think it is fair to say that he has been very open with us that the understanding of the physiology of long covid has evolved a lot over the last year.

Q428 **Chair:** Was there any survey work of that million? Was it possible to do that to try to work out what they were going to do? I want to bring Jonathan in on that point as well.

Jonathan Haskel: If I may, to amplify what Andrew and Dave have just been saying about the rise of 320,000 in the long-term sick who didn't want a job, what is interesting and puzzling about all of this is if you asked the question how many more people are long-term sick than before, the answer is much less than that—it is actually 265,000. In fact what has happened, as Dave was pointing out, is we have had to guess not only the number of people who increased their long-term sickness, but also the working status of the people who are long-term sick. The point was that before, 30% of those people worked, and that has now dropped to 20%. We have had to get advice on both the increase in sickness and the participation rate of those who are sick.

I will say one more thing, if I may. As you know, the ONS does the coronavirus infection survey. That has been extended and we now have a handle on the number with long covid, which was around 322,000, if I remember correctly, in February. What we don't have is that data matched to their labour participation, so we have been unable to go from that data to exactly what their labour participation is to unravel all this. I hope that gives a sense of it. There are a lot of moving parts in this.

Q429 **Chair:** How significant is the other cohort that hasn't gone back—the people, typically over 50, who just decide that they want a change in lifestyle and they just don't want to go back to work? How significant is that? What did you do to look at that group and try to estimate how big it is?

Andrew Bailey: I think there is an important question, the answer to which we don't yet know. We know that there has been a build-up in saving during the covid period, and we know that it isn't at all evenly distributed among the population, so the question that immediately occurs is, what proportion of that group is going to use that saving to support itself for some period of time but expects after a while to go back to work, and what proportion has said, "Actually, I'm going to recalculate my lifetime outlook and my assumptions for retirement income, and retire permanently"? It seems to me that there is no reason why those people should be fixed in their view on that over time. They can change their mind on that over time. Again, I just have to say to you that it a very hard judgment to make.

Q430 **Chair:** But what were the Bank and the MPC doing to try to establish in your own minds how big that cohort might be?

Andrew Bailey: Well, we do a lot of taking of the evidence. We start with the quantitative evidence and then we look at surveys. There are useful surveys out there, of course, of people's intentions, but they do change over time. So we have formed views on that to embed in our surveys. By the way, I don't think that retirement question is particularly the issue, necessarily, in where we are on the forecast—at least not yet, anyway; of course, it could change over time. I think the health—

Q431 **Chair:** Sorry, Andrew—thank you. I am just conscious of my time and there is one other thing I want to address.

Michael and Jonathan, you both supported a rather larger hike in the interest rate, compared with Andrew and Dave. Perhaps I can come to both of you but start with Michael. Why was there the difference in judgment, do you think, between you and our other two witnesses today and, indeed, most of the rest of the committee? What is it that you think that they are not actually signing up to, as it were?

Michael Saunders: Well, if we step back for a minute, the MPC loosened monetary policy significantly during 2020 as the economy shrank and the pandemic developed, in order to support the economy and to head off risks of below-target inflation, a big rise in unemployment and lots of business failures. And I think that was completely the right thing to do. I

think that policy easing was very important in supporting the economy through that period.

But it's a matter of public record that I was voting to withdraw some of that stimulus from the middle of last year and have been through the first half of this year. I felt that as the balance of risks around the economy shifted—the tightening in the labour market—we should move more rapidly back towards a more neutral policy stance.

At the moment, the economy has a significant amount of excess demand. Capacity pressures are widespread across firms. The labour market is very tight. Underlying pay growth has picked up, to above a target-consistent pace. It's the same with service-sector inflation. And inflation expectations are uncomfortably high. So I would rather that we moved back to a more neutral policy stance. I think the advantage of doing so would be to try to ensure that that mix of relatively strong pay growth, service-sector inflation and inflation expectations does not become more firmly embedded.

Q432 **Chair:** Do you feel that your views on the dangers of an overheated labour market—that you were getting on top of that notion rather quicker than other members of the committee? Is that effectively the position? You don't have to be modest.

Michael Saunders: No, but I think it's easy to see these things with hindsight. At the time, we were all making decisions, which were often quite fine judgments, amidst great uncertainty. So I think one has to be careful about doing the hindsight view. And I do think the rise of long covid and the drop in workforce participation has been a major development that it would have been hard to foresee a year ago, but as the evidence has come through, we have tried to take that into account in our forecasts.

Q433 **Chair:** If your view had prevailed in this meeting and previous meetings where you appear to have had a rather more concerned view of what has been happening in the labour market than perhaps other committee members, how much better a position do you think we might be in as a consequence, when you think about inflation and the de-anchoring of inflationary expectations from the 2%, which is where we seem to be at the moment? Do you think it would have made a big difference?

Michael Saunders: I think we might be in a somewhat better place in terms of inflation expectations. To be fair, though, I think had we ended the QE programme early, the current inflation rate and the prospective inflation rate through this year really would not be very different.

The scale of the energy price shock, the rise in food prices and the rise in global goods prices, which is largely driven by events outside the UK, is such that even a slightly tighter monetary policy stance through last year would still this year leave us with inflation well above target. There is really no sensible monetary policy that could have been put in place a year or two ago that could have kept inflation at the 2% target this year.

Q434 **Chair:** But had there been earlier action, it would have helped in trying to anchor down inflationary expectations, and perhaps would have cooled down the labour market and the wage inflationary pressures that we are now seeing coming through.

Michael Saunders: Somewhat, but I want to stress that the judgments have been made amid uncertainty. There is a risk of looking back with the certainty of hindsight.

Sir Dave Ramsden: Like Michael, I was voting for a modest tightening a little earlier—through the autumn of last year. In fact, just after I came to this Committee in August last year, I started to join Michael in voting in the minority for a tightening, but I want to associate myself with the thought that it would make a difference only at the margin, if it made a difference at all.

As Andrew was saying, 80% of the overshoot is to do with first round effects—the shocks that have hit the economy—so you are talking about the behaviour of firms and bargainers in the labour market only for the other 20%. You are talking about a very small part of the inflation overshoot that we have seen.

Q435 **Chair:** Is that to go as far as saying that almost anything you did on the monetary side with interest rates in the past could not have been expected to have brought inflation much closer to its target because that 80% is beyond the reach of monetary policy? You can't control energy prices, and therefore we are where we are because monetary policy was never really going to do the job.

Sir Dave Ramsden: Monetary policy was not going to do the job in these circumstances. That is a very important point. The tightening we have been doing in monetary policy since December is having an effect. It is putting up the cost of borrowing, so it is dampening—I suspect we will come on to that.

Monetary policy can have an impact, but we have to recognise the first round effects coming from these shocks. We import a lot of goods, so all the supply chain effects we were talking about previously—China has come back in—count, and then you have the energy price shocks that we were seeing before the invasion of Ukraine. These are things that, typically, throughout its history the MPC has looked through. It looked through those kinds of effects and those energy price shocks after the global financial crisis.

What has happened this time, as Andrew said in his opening remarks, is that we have had a series of these shocks, which then plays into Michael's point about inflationary expectations and second round effects. If you are a business thinking about what price you can set if you are in the labour market, you keep seeing these shocks hit and there is the risk that your perception—your inflation mentality—may change. You may think that we are in a more inflationary environment because you get one shock after another and you think it is going to be sustained.

All of us on the Committee are absolutely focused on making sure medium-term inflation expectations don’t de-anchor, which would take us away more persistently from the target.

Q436 **Chair:** Very finally in my section, Jonathan, do you want to come in on the point about your position on the interest rate?

Jonathan Haskel: In the interests of time, I will not repeat what has been said because I agree with much of it. I will say one thing very quickly, since you are asking us to account for ourselves. I made a speech in Glasgow in November that looked at the status of the labour market. We had data until September, and at that point unemployment was falling and vacancies were rising very sharply, but those numbers seemed to be in line. That is to say that the increase in vacancies did indeed reduce unemployment as those unemployed people filled the vacancies.

What I said in that speech was that I would become more worried about the labour market if vacancies were to carry on going up and unemployment were to stop falling quite so quickly, and that is indeed what we have seen. There is a chart in the latest MPR that essentially sets that out. There are a lot of vacancies around, obviously, and relatively few unemployed. That has come as a surprise to me, but I tried to indicate that that is where I would go and I followed that logic.

Q437 **Gareth Davies:** I want to talk about the future and your projections for inflation. Governor, what do you see as the main risks to your projections going forward?

Andrew Bailey: Let me just put the picture in the future in terms of what is driving the picture of inflation, and then I will tell you what I think the risks are. The main driver of the profile of inflation—particularly what brings it down—is the very big real income shock that is coming from these outside forces, in particular from energy prices now and still global goods prices. That real income shock will obviously have an effect on domestic demand and damp activity. I am afraid, as we say in the projection, we think that it will increase in unemployment. That will have a much bigger effect than the effect of increases in the Bank rate that we do—that is the big driver in the downward pressure.

By the way, that is also what is putting us in this challenging position at the moment. We have got this trade-off, where the pressure upwards on inflation is matched by downward pressure from the real income shock coming in. Managing our way through that—I have used the analogy of walking a very narrow path—is a very challenging environment to be in. That is the backdrop. As I said before, the remaining pick-up that we will see this year, other things being equal, is coming predominantly—with 80%—through energy and traded goods. I am afraid Ukraine is the biggest driver of that.

Now, the risks, as you said. As we said in the report, our central case is that inflation comes back to target—in fact, it goes below target in the third year—but there are risks. We put the balance of risks on the upside. The risks there are, unfortunately, quite a number, both domestic and

non-domestic. The domestic risk is exactly what we have been talking about, which is that the labour market does not cool down. We might get more dis-saving—people will use more than we expect of these savings to support demand for longer—and that is possible because there has been this build-up in saving. Again, it is a very challenging judgment, because we have not seen that type of pandemic-related saving before.

It is worth saying that when I go around the country, as I do a lot, and talk to businesses, they are still very focused on, "How do I hire people?" There is a very interesting conversation we have where they want to talk about how they hire more people and we are talking about the concerns we have about the shock to real income and what it will do. That is domestic risk.

On the overseas side, I think that we have risks from all the things we have at the moment: clearly, we could get more supply-chain disruption in China, and then Ukraine is, I am afraid, the big one in a way. I will boil that down to two things: one is a further energy price shock. I think that would now come more from the cutting off of gas and distillate supplies—that is distillated products like diesel. From both Ukraine and Russia, I should say, because it is a combination of the two of them. Crude oil is not so much the issue, I think; it is what would happen with that disruption.

The second one, and the one that I guess I will sound rather apocalyptic about, is food. I was in Washington at the IMF/World Bank spring meetings a month or so ago, and we had the Ukrainian Finance Minister there. I did spend most of my time in meetings—people think that I spend most of my time walking out of meetings, but I didn't actually, or only when the Russian Finance Minister came on.

However, I have to tell you about what I think is a big concern. The Ukrainian Finance Minister said two things: first, that Ukraine does have food in store, but it cannot get it out at the moment; and, secondly, while he was pretty optimistic about crop planting, interestingly—as you know, Ukraine is a major supplier of wheat and cooking oils—he said, "At the moment, we have no way of shipping it out", and that, as things stand at the moment, it is getting worse. That is a major worry, and not just for this country, but for the developing world as well. Sorry for being apocalyptic for a moment, but that is a major concern.

Q438 **Gareth Davies:** You mentioned the United States a couple of times. In this country, the Government have announced a series of measures to tackle the cost of living, and some are calling for even more measures. To what extent have you factored in fiscal policy risk to your projections?

Andrew Bailey: We always use announced Government policy as a conditioning assumption. We do not speculate on what Government policy might be in the future; we only use announced fiscal policy as the conditioning assumption.

Q439 **Gareth Davies:** So you have not factored in the fact that there may be additional measures coming down the track.

Andrew Bailey: No. That is a long-held MPC policy, and I think it is the right one. It is not for us to speculate on what the Government might do.

Q440 **Gareth Davies:** On Ukraine, to what extent are economic sanctions a part of your projections going forward?

Andrew Bailey: All the things I have just been saying, of course, get picked up because we use market prices for commodities. We use market prices for energy and for food.

Just to give you an example, the world wheat price has gone up just under 25% since we were last here, at the last hearing. We use those prices, and of course those prices will therefore include a view of what could evolve, but I have to tell you that based on what we have seen over the last year and going back to our earlier discussion, there is a lot of uncertainty around this situation.

Let me take the natural gas price, which is the best example. Natural gas prices have fallen over the last month or so; they were very high during the early invasion period. The spot price has fallen, but the forward price has not anything like as much, and of course the Ofgem calculation is based on forward prices, which is why, I'm afraid, we've got a leg-up in that later this year. Interestingly, the UK spot price is now well below the continental European spot price, because we have had a big inflow of liquefied natural gas. It is great work by the people who are doing this. If we could keep that up—but next winter is the critical period for that.

Q441 **Gareth Davies:** From reading the report and in your responses to our Chair, it struck me that 80% of CPI—I think you said—is due to external factors. To a certain degree, you say, raising rates would have had a very limited impact. Have you felt a bit helpless through this period?

Andrew Bailey: Well, yes. It is more than uncomfortable; I am trying to think of a word that is even more severe than that. It is a very, very difficult place for us to be. To forecast 10% inflation and then say, as we were saying a few minutes ago, "There's not a lot we can do about 80% of it" is, I can tell you, an extremely difficult place to be. We have to recognise the reality of the situation we face.

Let me be clear: please do not interpret anything I have said as a criticism of the situation in Ukraine. I am very supportive of what is going on in Ukraine. We have to live with it and deal with it.

Q442 **Gareth Davies:** You are saying, basically, that raising rates will have—

Andrew Bailey: No, don't interpret it that way.

Sir Dave Ramsden: Can I come in on that? You were saying you were looking ahead. A really instructive comparison is that obviously we publish our central forecast based on the market rate for interest rates, but we also put detail in the document—in the Monetary Policy Report—about what the path for the key forecast variables would be if we took interest rates as constant. If you look at the constant rate path, you need to compare it with the main market rate path. The market rate path has

inflation falling from the peak at the end of this year to 6.6% in quarter 2 2023, and then 2.1% in quarter 2 2024, so two years out.

If you take the constant path—so you don't assume that market rate path, but assume rates are at 1%—inflation would be 2.9% in that scenario. In two years, that is inflation still well above target, so that does show that policy does have an effect. We are not saying policy has no effect at all. Policy can have an effect, and in our forecast is having an effect. That is very important, both to bring actual inflation down and to ensure inflation expectations stay anchored.

Michael Saunders: If I can come in on this, monetary policy cannot prevent the rise in energy prices and global costs from pushing inflation up during the course of this year, thereby reducing living standards, but it can ensure that as that shock fades, inflation returns to the 2% target. It is to ensure that that we have been raising interest rates, in order to make sure we get back to 2% inflation on a sustained basis.

Q443 **Anthony Browne:** You mentioned your frustration about inflation going up to 10% and not being able to control it in the short term with monetary policy. I presume that you don't advocate the policies that we had when we last had rampant inflation, like price controls and wage controls.

Andrew Bailey: No.

Q444 **Anthony Browne:** But do you think that there is anything else that could have been done to control inflation, or is there really nothing and we just have to see it rise to that level before it comes down again?

Andrew Bailey: Going back to what I was saying a moment ago, I am very careful that I don't advocate policies that the Government should adopt and I don't think that the Government have things in their hands that they could do, particularly.

What I will say is that I think that, with the really impressive work that has been done on gas supplies, we need to keep it up. I mean, if you look at what we did on vaccines, you see that the procurement made a huge difference. So, I think that ensuring gas supplies is important. Obviously, I am by no stretch of the imagination a military strategist, but whatever can be done to help Ukraine get its food out of the country would be a huge contribution.

The third thing that I will say—again, I am not advocating Government policy—is that, going back to the very interesting conversation that we had at the beginning about the labour market, the more we can do to understand what will shape people's participation in the labour market going forward, the better. Understanding it is a good thing.

Sir Dave Ramsden: We talk a lot to businesses through the agents' network. I made a visit to Wales the week before last and what was striking from talking to a number of businesses is how they are looking to build the supply of their supply chains. So, in a sense, it is the behavioural

response to what we've seen. For example, they are reshoring, where possible, supply chains, so you get that certainty of supply.

It may come at greater cost in the short term, because globalisation created the more extended supply chains in the first place, which were more efficient. Then, when you see the kind of shocks that we have seen from the pandemic and now from the war in Ukraine, there is less confidence about those very extended supply chains.

So, it's not just about what policy could or couldn't do; you're seeing the private sector respond and considering how it can build resilience. Now, that may be at a cost in the short term, but it may give you less of a response of the economy to whatever the shocks are that will inevitably hit in the future.

Q445 **Rushanara Ali:** Governor, you seem to be getting it in the neck lately, from Conservative politicians in particular, because of inflation; it's come from Liam Fox and some members of this Committee, and I am sure it will continue. It seems like a bit of a co-ordinated attack on the Bank in my view. How do you feel about that? And do you think that the independence of the Bank is at risk?

Andrew Bailey: Well, I don't live in the world of anybody's politics, actually. I'm afraid that it's not a world that I particularly respond to at all; I read about it, but I don't respond to it.

Q446 **Rushanara Ali:** But you have read about it?

Andrew Bailey: I have read about it, yes; I do read newspapers.

Q447 **Rushanara Ali:** Going on to the more substantive point about independence, Cabinet Ministers are reported to have had to come in and reaffirm the independence of the Bank in light of some of these criticisms. Are you concerned that there is this chipping-away at the Bank's legitimacy in the current context?

Andrew Bailey: I am always concerned about ensuring that the Bank's independence is preserved and understood. I have to say that this is the biggest test of the monetary policy framework that we have had in its 25 years; there's no question about that.

What I would say to these people is that this is when the independence of the Bank, and the target framework and the nominal anchor, matter more than ever, frankly—more than in the good times or the easy times. This is the point at which it is.

People often talk about the 1970s and ask what the difference is between now and the 1970s. One of the big differences is that we didn't have a nominal anchor in the 1970s; we didn't have a monetary policy anchor. And what you got in the 1970s was a high rate of inflation that persisted across the whole decade.

Q448 **Rushanara Ali:** Does anyone else want to come in on this point about independence and some of the criticisms of the Bank that we have heard

about in the press?

Jonathan Haskel: Merely to agree with what Andrew just said: the importance of independence and the target is even greater in times of maximum stress.

Q449 **Rushanara Ali:** They need to call off the dogs, do they?

Sir Dave Ramsden: All I would add is that the discussions today are critical to that legitimacy. Not only do we have an independent MPC but a central part of the reforms done in 1997, and subsequently consistently applied, was transparency and accountability. We try to put as much information as we can out there—including, for example, that forecast comparison I gave you—and then you hold us to account for it, through discussions such as this and wider debates in Parliament and throughout society. That accountability, whether in Parliament or through our efforts with the public, is central underpinning to sustain the position we are in.

Q450 **Rushanara Ali:** My next question is about wages. As the Chair mentioned, wage pressures on inflation have been referred to in the past. There was a particular policy decision that the Government made about City bonuses, which is the subject of an article reporting the IFS study, which said: "the return of bumper finance industry payouts meant the top 1% highest-paid workers were beginning to pull further away from the rest of the UK workforce despite the cost of living crisis hitting the country at large." That is not a decision the Bank made; that was a Government policy decision.

There is a discussion about wage inflationary pressures and demands for an increase in wages, which is understandable if you have had wage freezes for a decade, but the Government make a decision in parallel to allow for City bonuses. What do you say to that? Are there inconsistencies in the way we talk about wage pressures? I know you ran into hot water when we last talked about wage pressure, but is there some rampant hypocrisy here? People are attacking central banks such as yours while failing to act to bear down on wage pressure that is a direct consequence of Government policy.

Andrew Bailey: I am not quite sure which Government decision you are referring to. When we onshored the EU financial services legislation, we inherited the bonus cap. The bonus cap is still with us—nothing has changed. Obviously, that is for the Government; it could be changed but it has not been, and I am not aware of any move at the moment to do so. So that has not changed. I am not quite aware of what Government policy that is.

Let me say on the second part of your question that my view—I was asked about this in an interview the other day—is that I do think that people, particularly people on higher earnings, should think and reflect on asking for high wage increases. It is a societal question; I am not preaching about this. I was asked if I have taken a pay rise myself this year and I said, "No"—I had told the Bank not to give me one, because I thought that was the right thing for me personally, but everyone must make their own

judgment. It is not for me to go around telling people what to do in that sense. I may have been interpreted as doing that at the time, but I was not saying that. What I was saying is that I think people should reflect on it, particularly people in that situation.

Q451 **Rushanara Ali:** To turn to the question of labour market pressure, Adam Posen talked about the impact on the UK, arguing that inflation is likely to be more sustained in the UK than in the European Union because its labour market is tighter due to lower levels of immigration into the UK from leaving the European Union. Do you agree?

Andrew Bailey: I think the point Adam was making was that if the UK becomes a more closed market post Brexit, it becomes somewhat more inflexible. I think the challenge at the moment in judging that—it sort of goes back to what we were saying earlier—is that the biggest impact so far in the labour market appears to be covid-related. We think there is a net migration number there as well, but it is a smaller number. It is a hard number to calculate at the moment, because the data are not very good.

Secondly, it is very hard at the moment to separate the impact of covid and the impact of Brexit in this area, because both of them have reduced the cross-border flow of people and migration, which is certainly what employers tell me when I talk to them. In time we will know the answer to that, but at the moment it is very hard to make that judgment, because covid is having the same effect.

Q452 **Rushanara Ali:** Sir Dave or Jonathan Haskel, do you want to come in on labour shortage?

Sir Dave Ramsden: It goes back to the point I made earlier about my most recent visit to a set of businesses in north Wales. Again, you are seeing businesses adapt to the world that they are in, so you are seeing more and more examples of businesses having to do their own training in order to deal with, for example, skills shortages.

To pick up on something that we talked about when I was last here, you particularly see it in the haulage sector—more and more HGV companies are now growing their own, as it were, by taking people from warehouses and developing their skills so that they can then, over time, pass the qualifications and become HGV drivers. You are seeing the private sector adapting, supported by policy—changes in regulations and stuff—at the margin.

Going back to Andrew's central point, with so much going on as the economy responds to a whole series of shocks and changes—Brexit, the pandemic, energy, and the war in Ukraine—it is impossible to disentangle different effects and the interplay of different forces.

Rushanara Ali: Jonathan, and then Michael.

Jonathan Haskel: I just wanted to say a word about bonuses, which you asked about. You are quite right to say that they make a difference. Excluding bonuses, the average wage index, year on year to February,

was 4.7%; including bonuses, it was 6.4%. Actually, it turns out that we do not measure all the bonuses you might want to measure, such as signing bonuses, in that. If you put those into a more comprehensive measure, you get 7.3%.

But the point I was going to make is that those bonuses have spread out a long way beyond financial services. While it is true that, in normal times, financial services account for the lion's share, they have spread out a long way beyond that. I believe there is a story in *The Times* about easyJet offering a £1,000 bonus, conditional upon various things, to some of their crew. I think it is not just the financial sector that is paying these bonuses, actually.

Michael Saunders: Brexit has reduced the UK's potential output through adverse effects on business investment and hence on productivity, and also on labour supply. It may also have increased the extent to which, if there is excess demand in the economy, inflation picks up, because the UK's labour and product markets are less open. But it is wrong to think that this will be a cause of persistently high inflation in the UK.

The MPC has the tools to ensure that inflation returns to the target, and we have shown our willingness to act accordingly. You could regard it as a factor affecting potential output, but not as a reason for persistently high inflation.

Q453 **Rushanara Ali:** Actually, I was making a point about wage pressures and the supply of labour—the earlier discussion about labour shortage, and your point about bonuses being offered. In substance terms, obviously energy prices are the main drivers of inflation, according to your own report, but I am just trying to better understand where all these different pressures are coming from. Individually, each may not be the significant one, but they play a part, do they not?

Michael Saunders: There is an issue of domestic capacity pressures across all sectors. The recovery in the economy, which is welcome, has outpaced the economy's potential outputs; hence you see capacity pressures across all sectors. We see it in the labour market, in the capacity use in firms, in pay growth—not just at the top end, because there is a widespread pick-up in pay growth—and in services inflation. Monetary policy is really trying to ensure that domestic inflation pressures do not remain persistently high.

Q454 **Rushanara Ali:** What impact is there of a fall in sterling on inflation?

Sir Dave Ramsden: Because we import a lot of goods, a fall in sterling will put up the price of those goods. Going back to Michael's central point, there are all these things going on in the economy. It is an unusual period for that, certainly when you compare it with the first 10 years after the MPC was created. One of Andrew's predecessors dubbed it "the nice decade", and it was also known as "the great moderation" globally, as China entered the global economic system.

Nevertheless, whatever is going on, including with the exchange rate, the Monetary Policy Committee have the tools to bring inflation back to the target in the medium term. That is the critical thing. Through the 25-year period that we have been in existence, we have seen a lot of exchange rate moves—the exchange rate has depreciated over time—but inflation has averaged 2% over the whole period. There has been quite a lot of volatility, particularly recently but also in some of the earlier energy shocks, but inflation has averaged 2%.

We will deal with what happens with the exchange rate. We are an inflation targeter. We have to take account of the exchange rate, and we will deal with it to ensure we get inflation back to target in the medium term.

Andrew Bailey: It is worth noting that, although of course we measure it against a basket of currencies, the biggest depreciation has been against the dollar, but that has been true for many other currencies. The reason is that, whereas we are in a trade-off situation, as I talked about earlier, with growth going one way, the US is in a different place. It has a demand shock, effectively—demand and inflation are going up—and that is why the Federal Reserve has given stronger messaging about its interest rate path, and indeed has raised it by 0.5%. I think that a lot of that relative change in interest rate expectations has influenced the movement in the exchange rate.

Q455 **Emma Hardy:** I have a really quick question. Sir Dave, you were talking about the private sector adapting to the labour market shortage. Are you seeing a move towards recruiting more remote workers as a way of opening up new labour markets in response to that labour shortage?

Sir Dave Ramsden: Depending on the sector, you are certainly seeing that being another factor that employers have to take account of. I visited Airbus 10 or so days ago, and obviously their workers can't be remote because they are manufacturing wings up at Broughton to the highest possible standards.

But then you go to another sector—professional services or something like that—and you see much more evidence of hybrid models and workers expecting to be able to work remotely. Then you might go into some sectors like technology, which is a global sector with global talent, and a lot of people in that sector expect to work remotely 100% as they are doing code or something like that, so you have that kind of spectrum. You then have people in very manual work—farming communities and that kind of thing—who have to be there all the time.

It is a range, but what you are seeing is that it comes back to how businesses and workers are having to adapt to the new normal, particularly post pandemic, which was a completely unprecedented event and has created all these different expectations.

As Andrew was saying at the outset when we were talking about labour market participation, it has also generated new concerns for people. If you

have a health concern, whether long-standing or related to covid, and you can now work remotely, that must be a huge reassurance, compared with having to travel on public transport. We pick that up in every discussion with businesses that we have.

Andrew Bailey: In some parts of the economy, it is changing regional wage differentials. I will give you an example from visits I have done. Regional law firms now say they have to compete with London law firms at London law firm rates. London law firms are saying to lawyers in Cardiff and Leeds, "You don't actually have to come to London"—often—"and we'll pay you the London rate to be a lawyer in Cardiff or in Leeds."

Emma Hardy: Brilliant news.

Jonathan Haskel: I am simply going to add—this goes back to the earlier discussion that we had with Mr Browne about what could actually be done—that 30% of people who reported themselves long-term sick before the pandemic were actually working and participating. You would think, with the increase in remote working, as Dave has just described, that number might go up, because there are more opportunities for those people. Actually, it has gone down to 20%. That adds to the puzzle, but maybe that means that there are some possibilities out there for meeting this difficulty.

Michael Saunders: Can I add something on this? We have talked about the rise in people who are out of the workforce because of long-term sickness—the very large rise since the end of 2019—but that rise has not been equal. There has been almost no rise in activity due to long-term sickness among graduates; it is all concentrated among people with lower educational attainment and especially among the over-50s. We don't know for sure, because the data is incomplete, but I suspect this is something to do with the types of jobs that are available to people. There are some jobs that adapt better to remote working, and that may go alongside reduced ability for people to work if they cannot be in a job that does allow that.

Q456 **Chair:** Could I just go back to a point that Rushanara was asking about—independence? I would agree with you: I think it is extremely important, particularly in difficult circumstances such as these, that we have an independent Bank. The thought of politicians taking the really tough decisions around interest rates and perhaps a firmer monetary policy, which we might be thinking now would have been appropriate in the past, just doesn't really shape up in my mind. I think it needs to be an independent institution like yours.

There has been a lot of chatter and a lot of comments made in the press, and I know you don't like to comment on your discussions with Government and Ministers and so on, but have you had any signalling from Government at all around the independence of the Bank?

Andrew Bailey: No. I am happy to be clear on that—no. No member of the Government has raised it with me.

Chair: Very good. I'm very pleased to hear it. Thank you.

Q457 **Julie Marson:** I would like to go back to some of the global factors and particularly Ukraine to start with, Governor. The European Commission has said it is going to phase out supplies of Russian oil "in an orderly fashion". What is your assessment of the impact that that is likely to have in the UK on energy prices and on growth and inflation?

Andrew Bailey: Well, I suppose it depends on what "orderly" means. If "orderly" truly is orderly, then I think we can manage it, but we'll have to see. I haven't seen what the plan is. I think a number of European countries have given views on what, for them, would work. It is worth noting that of course European countries are in very different places in terms of their dependence, particularly on gas. I think oil is less of an issue, because oil is a world market and you have to move it around in tankers mostly. I spend quite a lot of time talking to the commodities trading firms. Frankly, the supply of Russian oil has now declined; people just don't want it. It is trading at a discount. The discount on Urals oil to the world market is now quite marked, apparently.

It is more about gas and, to a degree, as I said earlier, about distillates, because unfortunately Russia has quite large refining capacity. I think gas is the issue because, as we know, commonly, gas comes down pipes rather than through tankers—well, commonly. That shift is taking place, actually—towards the liquefied natural gas market.

The situation, as I understand it, is that there is an interesting mix here. The UK, as I understand it, has a larger capacity to take in LNG but not much storage capacity, whereas a number of continental countries have far less capacity to take it in but far more storage capacity. This is one of the reasons why, at the front end of the market, our price has come down relative to the EU price at the moment—because it comes to us first, as it were; we have got access to it. I know a number of countries are now building LNG terminals. That takes, as I understand it, a year or 18 months, at the minimum. So I think it is a matter of how orderly and over what time the process happens. Of course, there is huge pressure to do it faster because of the impact it would have. There is no question that cutting off Russia's earnings from gas would be a very significant move. We are of course, as I am sure you know, in this position at the moment where there are sanctions on Russia but at the same time they are earning a lot of income from sales particularly of gas.

Q458 **Julie Marson:** Is it possible to strip out the proportion of the energy price increase in the UK that is specifically attributable to the war in Ukraine, or is it just too difficult to do that?

Andrew Bailey: I go back to the 80%. Most of what we are seeing now is related to the war in Ukraine, unfortunately. To put that into perspective, prices started to spike up last November, when the build-up of troops—I think technically it resumed, but it sort of resumed for real at that point. But then they really ramped up when the invasion happened in February—about the day when we had the last hearing, I think. We had a period until just before Easter when prices were very high. They have come off a bit since, but unfortunately the futures prices have not come off anywhere

near as much as the immediate price, and the Ofgem calculation, for obvious reasons, is based on the futures price that will hold in the next period ahead. I should say, although I have not been able to read it thoroughly, that Ofgem floated this morning a new methodology for doing the cap.

Q459 **Julie Marson:** What kind of scenario planning do you look at when looking at the possibilities of what might happen in Ukraine, whether it is a prolonged stalemate or an escalation, for example? Are you looking at that in different scenarios?

Andrew Bailey: Just as we have recruited Chris Whitty to help us on covid, we have had a session with a number of experts in the world of foreign policy and in the gas and oil markets, and we are going to do more of that for the next round. We do that to help us, but I have to be honest with you: it is very hard to do the mapping from, "Let's assume that this happens on the battlefield," to what it means for economic variables in this country. It is a pretty hard thing to do. You can do the general direction, but it is very hard to do an exact mapping in that respect.

Q460 **Julie Marson:** Let me shift to something you mentioned in your opening remarks: the upward pressure on tradeable goods prices, particularly in the USA, and the shift away from services. You mentioned covid in that as well. Could you give us a little bit more about what you expect to happen? Why is it still stuck in the USA? Why has that balance not shifted back, and how do you see the outlook on that?

Andrew Bailey: It's an interesting question. The US has seen a much more extreme version of the shift from services to goods—an increase in goods, certainly. Bear in mind that the US had a different approach to fiscal policy. This, we think, is the real rub. The US, to put it bluntly, handed out money. The UK approach was more to keep people's jobs in existence. You can see that in the demand figures—a big increase in demand for durable goods. As I say, we were starting to see that come back and it has got interrupted.

I was in the US not long ago. Covid is more of an issue in the US at the moment than it is here—much more of an issue. We are, fortunately, on the down slope, and the US isn't. Covid disruption in the US is continuing in ways that we are currently not experiencing.

Global goods pricing interacts with what we are also seeing in China, where, as I have said, it appears now that the economic impact of the zero covid restrictions is greater. Last year we were concerned about it but actually not seeing as much evidence of it; now, there is much more concern about that.

Q461 **Julie Marson:** You mentioned the US and China. Do you look at the potential impact of a resurgence in the UK as well?

Andrew Bailey: Of covid?

Julie Marson: Yes.

Andrew Bailey: Yes, we do. That is why, as I say, we were fortunate to have Chris Whitty's input. I don't think he will mind me saying—it is one of the paradoxes, I must say—that he has given us what I call a seasonal view of it, and UK evidence supports that. It is having more of a seasonal flu type pattern, in that there is more of it in the winter than the summer. The US doesn't seem to have that, and I don't know why that is the case. In the US it is coming up as the weather is getting warmer, but I don't know why that is the case. We will go on monitoring that carefully plus, as I say, getting the benefit of wisdom on the long covid issue as well.

Sir Dave Ramsden: It was very striking last autumn; I remember that we spoke to Chris Whitty before and then after the summer break, and there was a real focus on what was going to happen as the recovery continued with the ending of the furlough scheme. Then we had the omicron variant, and I remember that we had a very sobering discussion with Chris Whitty around the time that it was being released to the public just how infectious this variant was, and the concerns about how serious it was. As it turned out, because of vaccinations and the nature of the vaccinated population in the UK, with quite a high degree of vaccination and focus on getting boosters, the impact on the economy was less than we initially feared.

Having said that, we did put up interest rates last December. If you recall, at the time people were saying, as we were discussing earlier, "Oh, well, the MPC are concerned about inflation," because even in the midst of the omicron wave we were putting up interest rates. We felt that was what the balance of risks required.

What Chris has said to us more recently is that you can't rule out either another very infectious variant or a more serious variant—it will just depend. Equally, they are looking to develop what I think are called polyvalent vaccines, which act against different variants, a bit more like the seasonal flu vaccine. In terms of the current state of the pandemic in the UK, aside from the kinds of discussions we have been having about the labour market and low participation, and companies adjusting their supply chains, the direct effect is still coming through in the prices we are importing, but we are learning to live with where we currently are on covid. But things could change again. As Andrew says, the seasonal nature means we have to be alert as we go into this autumn, and that will be another factor for us to take account of.

Jonathan Haskel: I think it is really important to remember—it goes back to what we were talking about earlier on—that the context of the discussion last Christmas and last winter was around omicron. As Dave has just said, we knew it was very infectious and there was a pretty good bet that it would be very deadly. That turned out not to be the case, but at that time that was one of the guesses we had to make.

I will say one more thing, if I may, which goes back to the China issue. One of the things I have found very helpful that Chris Whitty has talked about is the context in which these things matter. When omicron struck this country, it was in the context of a vaccinated population, as Andrew

just mentioned. Of course, regrettably, the Chinese population is much less widely vaccinated and therefore omicron is much more serious. One often thinks, "Goodness, aren't we done with omicron, covid and all of that?" but Chris Whitty helps us to remember that that context really matters when we are trying to think through what the economic consequences might be.

Q462 **Alison Thewliss:** The Monetary Policy Report states that "it is likely that the strength in pay growth can explain some of the recent rises in services inflation". Governor, how concerned are you that pay growth appears to be feeding into inflation?

Andrew Bailey: Well, we are concerned. That is why the second-round effects are of major concern to us, and that is where, as we were saying earlier, we think monetary policy will have its most effect. I am afraid we can't make a difference to the first-round effects; they are coming. The second-round effects are important, and therefore we pay a lot of attention to pay growth.

In the latest Monetary Policy Report we have increased our assumption on the rate of pay growth coming through this year. That is based on a mixture of things. It is based on evidence from our agents and, obviously, on the path of inflation of itself, because there is a feedback to it. To give you a sense, our view of underlying pay growth back in February this year was probably around 4.5%; it is about 5.5% now. That reflects that mixture of evidence. For each of us, in the way that we think about the decisions that we are taking, it is that that has a very significant effect. We will get more labour market data tomorrow morning.

Sir Dave Ramsden: It is important though to emphasise that it really does differ very much between sectors and industries. It is also linked to the ability of firms to rebuild margins and to pass on higher margins in the final prices, and, equally, the wage bargain that happens in those businesses. You do see this pattern—we have got this from our surveys, because we have surveyed both on wages and, most recently, on pricing—that the closer businesses are to the consumer, the more challenging it is at the moment to pass things on, because it is consumers who are dealing with the cost of living. They are seeing the cost of living challenges in their household outgoings. They had the energy price increases in April and they will be thinking what might be to come. They also have the food price increases. When you talk to retailers, they have the challenge of how to retain and recruit staff, but from what they are seeing in not only, potentially, their low-paid staff but their customers, they are very conscious of the challenge there. They are almost dealing with a similar trade-off to the one that we are dealing with, because they are thinking, "How can we sustain our revenues while seeing what our customers are bearing the brunt of?"

Andrew Bailey: Retaining staff will put pressure on corporate margins. That is one of the effects that will come through.

Michael Saunders: If I may add something, there is no problem with having high pay growth if it is backed by higher productivity growth. That is how living standards rise over time. In a market economy, it is quite normal for some sectors to be doing better or worse and for pay growth in different sectors to be stronger or weaker. The issue that we have for the past couple of quarters is of generalised capacity pressures, strong underlying pay growth, and firms believing that they can pass those cost increases on. I have to say that I am as concerned about firms' pricing strategies—this sense that they think that they can pass those cost increases on. That is a picture that I would like to change.

Q463 **Alison Thewliss:** In your evidence, you highlighted the difficulty with no cumulative growth in labour supply as well. Will you tell me a little more about the problems that that causes? Is there anything that monetary policy can do on that front?

Michael Saunders: I don't think that monetary policy can really affect labour supply in a significant way. An argument gets made sometimes that we should "run the economy hot" in order to draw people into the workforce, but as you can see in the data, the factor that has caused participation to fall is not a lack of job opportunities but a rise in long-term sickness, which is surely linked to the pandemic. If we were to "run the economy hot" in those circumstances, we would just tend to get higher inflation, more embedded inflation expectations and a bigger problem to deal with. The issue of long covid and the pandemic's effects on public health and participation is a very serious issue; it is just not one that monetary policy is well designed to tackle.

Q464 **Alison Thewliss:** There are effects from Brexit as well, with people not coming into the UK to work.

Michael Saunders: Yes, that is right.

Q465 **Alison Thewliss:** You will be aware that we were told by the witnesses last week—economists, including former MPC members—that in the US a wage-price spiral has begun. They believed that we were at the beginning of one here. Would you agree with that?

Andrew Bailey: May I come back to the point that I made a few minutes ago about the different nature of the shocks that are affecting the US and the UK? It is quite helpful to bring in the euro area as well, to paint the whole picture.

The US is experiencing what I said was an upward pressure on demand and on inflation. It is unsurprising that therefore there is a concern about wage pressures; like here, it has a very tight labour market. The euro area, like us, is experiencing this very big real income shock, caused predominantly by energy prices and goods prices, but does not have as tight a labour market as we have. I would draw that distinction. We are a bit hybrid in that sense: we have the US labour market, but we have more or less the same trade-off and shock as the euro area. The distinction I would draw with the US is that because they have the demand shock and

inflation shock, the risk of a wage spiral—I do not like using that word, but I will use it for the moment—is greater.

This goes back to what Michael was saying earlier about how we view each decision on monetary policy. We have to watch this very carefully, because we do have a tight labour market, but we are dealing in this world of a trade-off. As a number of colleagues have mentioned, the business world at the moment, particularly the ones we talk to—I am not saying this critically, by the way; please do not think that—does not see it coming, because they are worried about how they recruit and retain. But there is a very big shock happening. It is not coming; it has already started to come, and as our forecast indicates, that will affect labour market conditions going forwards.

Sir Dave Ramsden: To build on that, as Michael has referred to, you are seeing some evidence in recent quarters that there is some inflationary influence coming through on wage bargaining. We have all referred to this, I think, and Andrew mentioned the figure: the forecast we put out for wages—for earnings—sees them growing by 5.75% this year, which is up from the 3.75% we were forecasting in February.

You are seeing the beginnings of concerns around inflation influencing wage bargaining, so it is really important that we take the actions that we can to make sure that does not become embedded, whether in wage bargaining or, equally importantly—as Michael says—in the pricing behaviour of firms. We have to avoid that inflation mentality, which you are beginning to see the signs of taking hold. That is why we have tightened policy in four successive meetings and the Bank rate has now gone up to 1%.

Q466 **Alison Thewliss:** Is that having an effect, though?

Sir Dave Ramsden: Yes, it is.

Alison Thewliss: You are talking about it going up and going up, and the report also suggests that it will go up again.

Sir Dave Ramsden: It is having an effect—we document this in the Monetary Policy Report—in the usual ways, in that if you want to borrow money to buy a house, for example, the most popular mortgages have gone up by over a per cent. over the last year. For two-year fixed and five-year fixed, those rates have gone up by over a per cent., so if you are remortgaging now, it is going to cost you a lot more than if you were remortgaging a year ago, and that means you are going to have less to spend on other things. That is just one example, and as it reduces demand in the economy, you will see the pressure easing—not just for those who are borrowing money, but more generally. It is having an effect, and it will continue to have an effect.

Q467 **Alison Thewliss:** Can I ask a little bit about expectations of inflation? Kristin Forbes, professor of global economics at MIT, told us last week that public expectations of inflation in the medium term are higher in the UK than in the US and the euro area. Do you agree that higher inflation

expectations are a greater risk in the UK or elsewhere, or how much of this is a source of concern?

Andrew Bailey: Oh, it is a source of concern. It is something we watch extremely carefully. It is not surprising, given the increase in current inflation, that it does feed through to expectations.

By the way, it feeds through more to short-run expectations than it does to long-run expectations, and our relative concern is more on medium and long-term expectations, because that is where it can become embedded. That is why, obviously, the most important thing we can do in that respect is get inflation back to target—get it back to target without unnecessary disruption to the economy, but we have to get it back to target. That is clear.

Q468 **Alison Thewliss:** Michael Saunders, you mentioned in your written evidence that "the process of re-anchoring price expectations could be very costly". Could you tell me more about what that would mean?

Michael Saunders: This is in terms of the cost of monetary policy action versus inaction. I would not say that inflation expectations are de-anchored at the moment.

Q469 **Alison Thewliss:** You said there were uncomfortably high expectations.

Michael Saunders: They are uncomfortably high, yes. When we are making our policy decisions, with the various uncertainties that we have talked about, the potential cost if monetary policy does not tighten promptly is that inflation expectations could rise further. You reach a point at which getting inflation expectations back on target, and hence, getting inflation back on target becomes increasingly costly in economic terms. That is a scenario that I would want to avoid.

Q470 **Kevin Hollinrake:** Andrew, can I ask you about forward guidance? I guess it is tricky at the best times, and particularly tricky right now. You got into a bit of trouble last November at another central bank meeting, when you said that because of inflation pressures we will have to act and that action would come in monetary policy meetings. About two weeks later, on 4 November, you were persuaded not to act, based on furlough—

Andrew Bailey: I did not say when we were going to act and, of course, we have acted.

Q471 **Kevin Hollinrake:** Okay. That was not really my question. You were not precise about when it would happen, but the markets had the indication that you were going to. That is the key to this: what the market will reasonably expect from what you have said. There were uncertainties around the furlough scheme, but there was other evidence, wasn't there?

The minutes of the meeting from November said that the ratio of vacancies to unemployment is the highest for 20 years and that companies are reporting "acute shortages in a range of occupations." There were some uncertainties, but also a huge amount of pressure that

most employers seemed to experience. Was that not a factor? Should you have put interest rates up at that point?

Andrew Bailey: I think I said at a previous hearing that it was a very difficult, closely argued and close decision. The question weighing on us was that at that point in time, we had no read of the labour market post the end of the furlough scheme. The furlough scheme ended at the end of September, and it was not until the December meeting that we had a read of the labour market that did not have the furlough scheme in it.

The question that I weighed very carefully was: is it November or is it December? How much confidence do I need to have around the impact of the end of the furlough scheme? Dave said earlier about just the sheer scale of use of the furlough scheme right up to the end of it. We were puzzled whether, really: are these 1 million people going to reabsorbed back into their jobs, or are they not? That would have created very different outcomes.

Kevin Hollinrake: I think you said earlier that the more understanding of different factors we have, the better. One of the factors that did not seem to be in those minutes, was not in your written submission to the Committee for this session and was not mentioned until Rushanara asked a question on it earlier, was Brexit and net migration.

You said the net migration figures are uncertain, but the figures are pretty certain that in 2020 they dropped by 88%, from 271,000 to 34,000. Yet that is not mentioned anywhere.

Andrew Bailey: I am not sure how certain that is. The ONS—again, no criticism—stopped the passenger survey during covid, so we went for quite a long time without having the line of sight, I would say. You say Brexit; as I said earlier, the challenge is in that area, but Brexit and covid were having the same effect. You can argue that both were causing a fall in mobility of people. Covid was the more proximate one at the time because the restrictions were doing that. Indeed, that is what many employers tell us.

Going back to the numbers we were talking about at the start—we talked about inactivity numbers in the range of a bit over half a million people—the sort of numbers I have seen for net migration are something like 100,000-odd in that period. Now, we may be looking at very different numbers, because the numbers are—

Q472 **Kevin Hollinrake:** Those are the ONS figures from 2020. I wondered whether you are looking at this now—is it changing?—because that is a massive reduction.

When Members of Parliament go round to talk to our businesses, everybody says similar things. You have your agents out there, and indeed you go out and see businesses. Businesses all say that the ready supply of employees they used to get from Europe—whether it is people picking fruit off trees or people working in pubs and restaurants—is just not happening. What I don’t understand is why it doesn’t feature in any

of your guidance. It is not mentioned anywhere.

Andrew Bailey: I don't think it is as big as the inactivity effect we were talking about earlier. If you like, I will happily write back. We will go and gather together all the numbers we have, and I will see what we can set out. I would be happy to do that.

Sir Dave Ramsden: It has featured in our analysis. I said earlier that it is very difficult to disentangle the interplay. Our guidance, which is where you started—going back to last autumn, and our use of guidance at different times—is about building on that analysis to then trying to communicate, framed by the analysis, the message you want to get across about where policy is going. Then there is a question of what you actually do on policy.

Our current guidance—this is implicit in what we have all said today—is that most of the members of the Committee think that further tightening in policy will be required, but that comes back to the point about labour market tightness. The part that Brexit or something else plays in that is an issue, but our guidance is framed by that analysis of the labour market and firms' pricing policies. It is there; it is just not the top line of the guidance.

Andrew Bailey: The number I quoted right at the beginning was the total size of the labour force.

Q473 **Kevin Hollinrake:** I don't dispute that. It is a key factor, yet it doesn't seem to be something that you are dealing with in any material way.

According to the IMF, the UK is going to be much worse over the next two years on average, in terms of inflation—100 basis points. The UK is 6.3%, the US is 5.3% and Germany is 4.2%. Adam Posen, who was mentioned earlier, says that 80% of that differential is down to Brexit factors—non-tariff barriers and labour—yet it does not feature in any of your statements.

Andrew Bailey: The second Brexit issue is trade. The Bank of England has not changed its view on Brexit and trade for some time. We have built into our view of the future that there is a negative impact. My predecessor was unpopular for saying that.

Q474 **Kevin Hollinrake:** But that's my point.

Andrew Bailey: Hang on; we haven't changed our view. In fact, on the basis of the evidence we have seen so far, which is hard to pick out from covid, we have not seen anything to change our view on the path that we laid out some time ago, which was that there would be a negative effect on trade, and that it would take a long time for the economy to adjust to that, but it would over time because real convergence does occur. That negative effect is built in.

Q475 **Kevin Hollinrake:** That was my question, I guess. Is it because it made your predecessor unpopular that you are steering away from it? You are steering away from it; that is quite clear.

Andrew Bailey: No, we haven't changed it; it is there.

Q476 **Kevin Hollinrake:** But you have stopped mentioning it. If it is still a factor, surely you should keep talking about it. You shouldn't be afraid of it. We all know that this whole inflation thing is pretty short term—it is transitory, in your words. Adam Posen said that 80% of the difference is to do with these factors; this is very significant.

Sir Dave Ramsden: Can I just put some data into this, rather than some possible forecasts? If you look at the data for the US, the euro area and for the UK for inflation in the first quarter of this year—that is the latest quarter for which we have data—the US, on the personal consumption expenditures or PCE measure, is 6.29%, or 6.3%; the euro area is 6.2%; and the UK is 6.2%. So, those three big economic areas have got the same inflation at present, coming at—

Q477 **Kevin Hollinrake:** So you don't think that Brexit is having an impact on inflation?

Sir Dave Ramsden: No, I didn't say that. I said it's very difficult to disentangle the interplay from the pandemic on global supply chains, on imported goods and on energy prices, but clearly inflation is a global phenomenon at the moment. Those three big economic areas all have the same inflation.

Q478 **Kevin Hollinrake:** I suppose it is the differential impact that is the point. I mean, I know it's maybe baked in, in your view; everyone knows about that stuff and we're trying to get away from Brexit. Nevertheless, it is a factor and it is a factor that might sustain inflation, or keep it above where it could be. It just appears—like you said, the popularity thing. Is it not the fear of upsetting somebody by not referring to it?

Andrew Bailey: No, it's built into our view of the supply side of the economy. The trade share of GDP has declined and it has declined more in the UK than elsewhere; that's a fact. It's built into our view of the supply side of the economy. It has been for a long time.

There is a point that we probably tend to focus on the things that are new influences more than on the things that are long-lived, but that's not surprising in a way; otherwise, we would be writing a vast tome every quarter.

Q479 **Kevin Hollinrake:** But don't you think it should feature a little bit more heavily in future, if this is a potentially—even potentially and even if you can't distil it, in terms of covid and labour issues—

Jonathan Haskel: Could I add one more thing, Andrew, if you don't mind? One of the issues of Brexit is the uncertainty that the whole Brexit process brought to firms. Of course, we ask firms what their top sources of uncertainty are and over the time of Brexit and so forth, and in our decision maker panel survey it was a very high source of uncertainty. Regrettably, because of all these other horrible shocks that have been going on, it has become less of a source of uncertainty—

Andrew Bailey: Relatively.

Jonathan Haskel: Relatively. Thank you; that's right.

So there is a sense in which we naturally write a bit less about it because those other things have occurred, but that's based upon the evidence that we gather on what firms think.

Q480 **Kevin Hollinrake:** But it is still potentially a material effect—

Jonathan Haskel: Indeed.

Q481 **Kevin Hollinrake:** So, would it not be sensible in future to refer to it?

Andrew Bailey: We'll take that all up.

Sir Dave Ramsden: The most material effect, as Andrew was saying, is the trade intensity point, where, as a result of lower trade intensity, we made estimates before that the long-run impact of Brexit would be about 3.25% off GDP in the long term. I mean, I remember that when I was here back in September. I gave Rushanara Ali that figure.

That figure hasn't changed, but that's a long-term impact and it's very hard to track that from one quarter to the next, whereas I guess what Andrew is saying—what we are all saying—is that these shocks have subsequently come along that we think are having more impact—for example, in the labour market, because that Brexit effect was all about trade intensity. That was like a 15 or 20-year estimate for it, so you're not going to spot it from one quarter to the next, whereas what we are seeing and why we are emphasising them to you are these very significant effects on labour market participation, for example, from the pandemic.

Q482 **Kevin Hollinrake:** One final question, if I may, Chair. The Chairman of the Economic Affairs Committee in the Lords, Lord Forsyth, has accused you of being ostrich-like about this. He says that the first thing you should acknowledge—looking back; so, with the benefit of hindsight—is that we were wrong not to increase interest rates in that November meeting, and then move on from there. So, at least we say we got it wrong and then we move on. Is that fair, or not?

Andrew Bailey: I think that would be retreading the ground we covered earlier, if you don't mind my saying so. I have said that the November meeting was a very close call. I have explained why, certainly for my part, I took the view that I did. That was based on the facts that we had at the time.

Sir Dave Ramsden: And we did put up rates in December, with omicron happening. Would a difference between November and December really have made a huge difference to where inflation is now? One can debate that.

However, we did put up interest rates in December. People commented on the fact that we were doing it even though we were in the teeth of omicron, and we have put them up at every meeting since.

Andrew Bailey: We made a big call on omicron—that it wasn't going to have as big an effect.

Chair: Can I go, please, to Harriett Baldwin?

Q483 **Harriett Baldwin:** Thank you very much, Chair.

I wanted to open by congratulating the Bank of England on 25 years of independence. I acknowledge that it was Gordon Brown's greatest legacy, so we have some cross-party love over this. Over that 25-year period, you have essentially achieved what you have been asked to do in terms of the 2% inflation rate. I also accept what Michael has said in this session—that it would have been very difficult for monetary policy to keep us on track for 2%, given what has been happening externally. I do accept that as a premise. Back in March 2020, you brought in some very strong monetary stimulus and did a lot more quantitative easing, and of course the Government did a lot of fiscal stimulus.

What I am not going to accept, though, is that there is no opportunity here. You cannot blame hindsight and the war for missing the target. My personal view—I am on the record as having asked you about them—is that there were some tell-tale signs that the risks to inflation were to the upside. As early as September 2020, after the first reopening, we were seeing services businesses, such as hairdressers and theatres, putting up their prices quite significantly. Then I asked you a year ago about the experience of people in my constituency of timber market and cement market prices rises, which were into almost three digits at that point. By November, we were really, with inflation, up at 5%. I was highlighting the vacancy levels in the economy, the living wage, the intention of the Government to raise wages and so on. So I think I have been on the record as saying that there were some significant inflationary risks in the economy, which I am not happy to see come true.

I now want to turn to quantitative tightening and how you will go from here to getting policy back on target. I note some research from ING, which said that a good rule of thumb in terms of quantitative tightening is that for every £25 billion of gilt sales in any given year, there is a comparable tightening effect on financial conditions of about an eighth to a quarter of a per cent. Would you accept that, Governor? Does that sound like a reasonable rule of thumb?

Andrew Bailey: I wouldn't. Let me explain the reason why. One of the things that we have said a lot about quantitative easing—indeed, I have published on the subject—is that its effect is state-contingent, and it has more of an effect in the conditions that you referred to a minute or two ago, where there is dislocation, so it probably had its biggest effect in March 2020 and post the global financial crisis. A lot of what we did thereafter, going through last year, was actually providing a degree of insurance in terms of keeping rates further down the curve.

Q484 **Harriett Baldwin:** Can I just clarify my question? It is about quantitative tightening, not easing.

Andrew Bailey: There is a reason for starting here. The effects are not consistent over time, and they are state-contingent. We know far less about quantitative tightening. We have never done it.

Q485 **Harriett Baldwin:** We know nothing about it, presumably.

Andrew Bailey: We have never done it. The US has done it a little bit. We don't know a lot about it, but let's assume for a moment that it is basically symmetric—let's assume that there is a symmetry between quantitative easing and quantitative tightening. In that case, you would expect the greatest effect of quantitative tightening to be in difficult market conditions, such as when we had messed things up. We have said on the record, and I have said on the record, let's assume that we take the decision to go ahead with it, but we are not going to do it in disrupted market conditions—we will not just blaze away, whatever is going on in the world around us, and just keep doing it, however disrupted markets are. We would do it in what I would call orderly market conditions. We could always suspend it, if necessary.

Q486 **Harriett Baldwin:** You could do a little bit every day, couldn't you? You could just have a very predictable amount.

Andrew Bailey: We will aim to do that. By the way, our staff are now starting a series of engagements with the market to answer those sorts of practical questions—do we still single-stock auctions, and do we do it every day, every week, every month or whatever? My point is this: we will do it to minimise the impact. Bank rate is always our preferred tool of monetary policy, because we know far more about its impact. Our aim with quantitative tightening is not to have another monetary policy tool in operation; it is just very sensible now to unwind the balance sheet over time.

Q487 **Harriett Baldwin:** You have been very clear up to now that you want to use the Bank rate for the first move up to 0.5% and then to 1%. You were very clear that when you got to 0.5%, you would stop renewing the quantitative easing and would let things drift off. Then you said that when you got to 1%, you would think about what you were going to do. In fact, I believed—perhaps I didn't read the fine print closely enough—that when you got to a base rate of 1%, you would start to do quantitative tightening because, arguably, quantitative tightening makes things easier for consumers than raising the base rate, because you are affecting the whole curve, rather than just the short end of the curve on which so many variable-rate mortgages are priced. So, Governor, you don't have a rule of thumb, in terms of every £25 billion—

Andrew Bailey: No, I don't. The vast majority of the mortgage market is now priced off fixed rates; it is not priced off variable rates. Can I make one point about your opening remarks, which I did not make earlier? What we have not seen over the last two years is a massive resurgence of demand in the UK.

Q488 **Harriett Baldwin:** On labour we have. We have record levels of vacancies.

Andrew Bailey: Hang on. I'm talking about output now. We have been talking about the labour market a lot; I am talking about output. Let me give you two figures. On the March GDP release, which came out last week, GDP is 0.6% above where it was pre covid. If you go back to the last Monetary Policy Report that we published pre covid—Mark Carney's last one—and use the path of GDP in it, currently GDP in this country is about 2.4% below where we expected it to be, so we haven't had a big resurgence of demand.

I take the point you are making about inflation, but I think that is really, going back to what we were saying earlier, about judgments about the persistence of these effects—you rightly say that we did see these things happen—given that we thought there would be disruption as the economy came back to life, as it were, post covid. Those are the judgments. We have not seen a resurgence of demand in some sort of "off to the races" way, I'm afraid. It has just not happened.

Michael Saunders: Could I just stress a couple of points? First, I want to stress something that the Governor said. Bank rate is the active tool of monetary policy. That is the tool that will get inflation back to target.

Q489 **Harriett Baldwin:** You always said that you would use Bank rate initially. Is your position now that you will continue to use Bank rate as your primary tool?

Michael Saunders: Yes, Bank rate continues to be the active tool.

Secondly, you raised the idea that you can sort of tighten monetary policy, if you don't do it through Bank rate, in a way that somehow shields consumers. I have to say, I don't think that is the case. Only 5% of the flow of new mortgages are floating rate and about 50% are fixed at five years or longer, so the notion that consumers just borrow at variable rate and companies borrow at fixed rate is not really the case. Households and businesses both borrow more at fixed rates than at floating rates.

Q490 **Harriett Baldwin:** Have you published analysis on this that you can share with the Committee?

Michael Saunders: Yes.

Q491 **Harriett Baldwin:** That is really interesting. I just want to ask about your point that when you got to 1%, that would be when quantitative tightening started—at least that's the way I interpreted it.

Andrew Bailey: We didn't say that, no.

Q492 **Harriett Baldwin:** In this month's report, you have said that you are now going to do a study and you are not going to do anything before August.

Andrew Bailey: No, we haven't changed.

Sir Dave Ramsden: Can I give you the timeline? Last August, we set out the two thresholds that you rightly highlight. The half a per cent. for ending reinvesting maturing gilts in our portfolio was always an automatic

threshold, and we always stressed that. We got to 0.5% in February, and then we didn't reinvest a gilt that matured in March, so we started quantitative tightening in March. The portfolio is still £867 billion, but it is now £18 billion below its peak. What we also said last August—

Q493 **Harriett Baldwin:** So it's gone from £895 billion down to—

Sir Dave Ramsden: £885 billion down to £867 billion. It was a big gilt that matured.

What we said in August, and what we have consistently stuck to since, is that we would begin to consider the case for selling the gilts we own when we got to 1%. We announced in May that we are considering the case. We are going to have this three-month period—

Q494 **Harriett Baldwin:** That is an open consultation period.

Sir Dave Ramsden: It is a consultation with a small c. It's not like a policy or a regulatory change. We are talking to the market. We are already talking to the DMO, because—to go back to this market disruption point—at the very basic level, we do not want to be doing an auction in which we are selling off on the day that they are also selling some gilts. There is some basic co-ordination to do here.

Q495 **Harriett Baldwin:** You will publish that in August, will you?

Sir Dave Ramsden: Staff will come back to us by August. We will set out our plans then, but very much—

Harriett Baldwin: You will publish the plans in August.

Sir Dave Ramsden: Alongside the August MPR. We will say something about what we are going to do, but to your point, everything is about trying to be predictable about this. That means including sticking to principles—as we have since last August—like the Bank rate being the primary tool throughout. We understand it, we know how it works and we know how it works when we tighten, as we said in answer to an earlier question. It does have an impact, but quantitative tightening will be happening in the background, depending on what the committee decides.

Q496 **Harriett Baldwin:** You also have no rule of thumb as to how much £25 billion of sales would be in terms of tightening.

Sir Dave Ramsden: We have done five different episodes of quantitative easing in very different market conditions. The most that I would say is to agree with Andrew's qualitative point, that the quantitative easing that we did starting in March 2009 and again in March 2020 would have had the largest impact, because then markets—including core gilt markets—were at their most dysfunctional, so we probably had the biggest impact on yields at that period. I think that the other episodes had some impact, but not as big as those two.

Q497 **Harriett Baldwin:** Basically, you have no idea how much this could tighten monetary conditions.

Sir Dave Ramsden: On quantitative easing, there are a range of estimates; on quantitative tightening, it is almost unprecedented, but by being gradual in our approach and predictable—we have announced it well in advance—

Q498 **Harriett Baldwin:** Is there not a risk that by being gradual and predictable, you are, again, getting behind—

Sir Dave Ramsden: No, sorry, I meant gradual in our approach. We set out last August, "Here's our strategy. Here are our thresholds." It is a graduated approach. We will do whatever it takes with our primary active instrument, the Bank rate, to ensure in the medium term that inflation gets back to target, meanwhile running off the balance sheet in the background—

Q499 **Harriett Baldwin:** Without knowing how much that might be affecting monetary tightening.

Sir Dave Ramsden: What we will see is financial conditions. We can look at gilt yields. The 10-year gilt at the moment is 1.74%, as of the end of last week or this morning. That is a 10-year gilt yield, and we buy 10-year gilts. Markets might be making some kind of projection as to what they think we will do with that part of our portfolio. There might be a little bit priced into that, for whatever they are assuming, but we have told them that Bank rate is the primary instrument, so we cannot pull out of that market pricing of gilt yields the marginal bit that might be due to whatever their expectation is of QT, alongside what they think will happen to the economy and what they think that the DMO is going to issue based on the Government's borrowing needs. It is impossible to bring it out, but we are confident that it is a contextual background factor, whereas Bank rate is effectively where the action is going to be.

Andrew Bailey: Once we are—

Q500 **Harriett Baldwin:** We shall continue to scrutinise closely. I am out of time, but perhaps you will allow the Governor to reply, Chair?

Chair: Yes, of course. Andrew?

Andrew Bailey: Assuming that we announce a schedule of sales, we will be able to observe how the market curve reacts to that. That is a simple point.

Chair: Harriet, thank you. Anthony.

Q501 **Anthony Browne:** My questions will be about fiscal policy, monetary policy and their interaction—cause and effect. We still have a big national budget deficit, so fiscal policy is tightening. Do you think that current fiscal policy is inflationary, deflationary or neutral?

Andrew Bailey: Well, we are not the experts on fiscal policy. That is really a question for the OBR.

Q502 **Anthony Browne:** But you have a view on what impact it might have on inflation.

Andrew Bailey: We take announced Government fiscal policy and use it, as it were. Frankly, in terms of our judgment on the effects of fiscal policy, we regard the OBR as the experts in that respect.

Q503 **Anthony Browne:** The impact of fiscal policy on inflation—you must look at that.

Andrew Bailey: There is a part for fiscal policy—currently announced fiscal policy—

Anthony Browne: Yes, currently announced fiscal policy—what impact do you think it has on inflation?

Andrew Bailey: In terms of activity in the economy, I think it has a stimulatory effect, certainly throughout this year, but it does tail off then. But, of course, that is the announced policy. Policy can change, clearly.

Sir Dave Ramsden: That is based on the super deduction coming to an end. That is supporting stimulus at the moment, but I think towards the end of the forecast, fiscal policy as treated in the forecast is a headwind.

Jonathan Haskel: Because that super deduction comes off.

Sir Dave Ramsden: Because the super deduction ends next spring.

Q504 **Anthony Browne:** So it is a headwind in terms of being deflationary from next year.

Andrew Bailey: It is a headwind to activity, yes.

Q505 **Anthony Browne:** In terms of the impact of inflation on fiscal policy—I know you are going to say this is the OBR as well—it is clear that inflation has increased debt interest payments to the Government, but on the other hand, fiscal drag means there are increased tax receipts by some amount. The IMF said recently that this fiscal relief, which is what they call it, is probably transitory. Do you think that is right?

Andrew Bailey: Fiscal—?

Anthony Browne: Fiscal relief, the IMF called it. Because of fiscal drag, tax receipts go up more than the interest payments for the Government, but they said they thought it would be transitory. Do you think that is right?

Andrew Bailey: Well, that would depend on the path of economic activity and how that developed over the course of that transitory path, plus obviously the path of fiscal policy. I do not think I have a lot to add to what the IMF concluded on that, frankly. It is not something that we explicitly look at.

Q506 **Anthony Browne:** On the impact of inflation on fiscal policy, or the Government trying to reduce its deficit, presumably you agree with the OBR that inflation increases tax receipts more than it increases interest payments.

Andrew Bailey: The OBR are the experts on this. I must say, when I read the last OBR report, I did not think they were saying that it would lead to a tightening of fiscal policy. I think they had the debt ratio going up in that period, actually. I might be wrong on that, but I think that was the case.

Michael Saunders: If I can come in on this, the idea that inflation is good for the public finances over the long run is completely wrong. The acceptance of that—hopefully quite a long time ago—was one of the foundations of the path down to having an independent central bank with the tools for monetary policy and a clear target for low inflation. High inflation is bad for the economy in many ways, and there is no sense in which it is good.

Q507 **Anthony Browne:** There is some commentary at the moment that in previous decades, before the independence of the Bank of England, Governments were accused of inflating away the national debt, because obviously most of the national debt is in nominal terms.

Andrew Bailey: I don't think that works, as Michael has said, because people have rational expectations. They can see it happening. This, in a sense, is the whole advance in economics that happened in that period, so I am afraid it is ultimately self-defeating. Michael is absolutely right on that.

Sir Dave Ramsden: There is also a mechanical point. More and more of the debt is index-linked now, so you've got those moving parts that change over time, and also your point depends on the structure of the benefits system and of the tax system—which allowances are fixed and so on. I think all of us would just defer to the OBR on their analysis. They were set up to analyse this kind of thing, whereas we were set up to control inflation.

Andrew Bailey: But Michael's point is essentially that any Government that tried to inflate away its debt would find that there would be a risk premium built into the cost of its debt, and it would be self-defeating.

Q508 **Anthony Browne:** One of the founding members of the MPC, Charles Goodhart, who we had in front of us the other day, has written about the great democratic reversal—sorry, demographic reversal.

Dame Angela Eagle: There is also a democratic reversal.

Andrew Bailey: He is a man of many talents, but probably not that one.

Anthony Browne: China's ageing population will push global savings down as people spend their pensions, effectively, with growth going down and interest rates up. We talked about that before, and you said you did not agree with that analysis.

Andrew Bailey: There was a difference of view, yes.

Anthony Browne: Do you think, therefore, that demographics and an ageing population are more likely to lead to lower interest rates in the long run?

Andrew Bailey: Let me give two reasons why I tend to go in the opposite direction from Charles on this. Charles, I think, is putting a lot of weight on what I call the retirement of the baby boomer generation—people like me, actually—but increasing longevity is going in the opposite direction. As people assume increased longevity, they save more because they expect a longer old age. That’s the first point. The second point is that the evidence does not suggest that people dissave—run down their savings—in retirement anything like as much as the pure theory might suggest. In fact, it turns out that, as people age, they want to maintain their assets more than you might think. The model that they run them down to the end is not the way it looks. There is far more retained saving and asset ownership through into older age than that model suggests.

My final point is that the country that in a sense—they probably would not want me to say this—is the leader in this that we can learn from is Japan. Japan has had that ageing of the population ahead of the rest of us, and it has not had a rise in its equilibrium interest rate—far from it.

Michael Saunders: Demographics is going to be really important in the UK. The UK is right now at a very important stage in demographic transition. If you look at the last 10 years, the population aged between 20 and 64, which I think of as prime working age, has risen by an average of between 0.3% and 0.4% a year—a rise over 10 years of 3% or 4%. On the UK’s official population projections, in the next 10 years the total growth will be just 0.4% in the prime working age population—in other words, just one 10th of the pace of the last 10 years—and much more of the population growth will be in the over-65s. That is part of the picture of slow growth in the labour supply that we have talked about.

Over the last 10 years, quite a lot of the UK’s potential output has been driven by the increase in labour supply. When you think of what potential output will be going forward, you can’t really rely on that background growth in the working age population. The emphasis will have to be much more on measures to increase productivity, otherwise potential output growth is likely to be weaker. That is probably the key issue for the next few years rather than the effects on the equilibrium interest rate, which, as Andrew said, is not really that acute at this stage.

Anthony Browne: Okay. That’s great. I have some questions on housing, but colleagues are going to ask about that, so I will wait. That is all I have time for at the moment.

Q509 **Emma Hardy:** My questions are all to do with mortgage interest rates. Since I have one, I am particularly interested in what is going on with them—just declaring an interest.

Michael, you mentioned that about 50% of mortgages are fixed mortgages—I think that is what you said. Bearing that in mind and with the changes in the rate, when do you think people will start to feel the pain of any increase in their mortgage rate? When will they start to notice a difference with the Bank rate going up and cutting those mortgage rates?

Michael Saunders: To be clear, of new mortgages, more than 90% are fixed rate. The figure I cited earlier of 50% is mortgages that are fixed for five years or longer—quite long-term fixed mortgages. The share of long-term fixed mortgages has risen a lot in the last five or 10 years. Anybody who is borrowing now, at two-year fixed or five-year fixed, would see that mortgage rates are notably higher than they were six months ago.

Q510 **Emma Hardy:** But do you have any understanding of when these mortgages are going to mature and the rates come to an end? What I am trying to get at is: when is a general mortgage rate holder going to start to notice a difference, and when will that impact the economy?

Andrew Bailey: One thing I would say is that it does depend. Say you have had a five-year fixed rate mortgage and you are rolling. You are comparing the rate today with the rate when you took out your mortgage originally, so you are comparing the rate with five years ago, let us say. In terms of what you see today, that is the comparison.

Q511 **Emma Hardy:** Okay. I think it was you, Sir David, who talked about how, when people remortgage, it will cost more, and that will have an impact on the economy because that will reduce demand. That is what I am trying to get at. Is there any forecasting being done on that? When will there start to be an impact on the economy? When will these mature, and mortgage holders realise they suddenly have to increase their payments?

Sir Dave Ramsden: It will have an impact all the time. Over the last few years, the two-year fixed rate has been very popular, and then moving to the five-year fixed rate has been very popular. What you have to think of is how, within the stock of mortgage holders, people will be moving off mortgages. I know people who are refinancing their mortgages at present, so they will be the ones—if they can afford it, because people have to pay to reschedule their mortgage—who get a new fixed-rate product.

To give you an example, if it is a five-year fixed rate, last December the 75% LTV five-year fixed rate was at 1.59%. By April it was at 2.34%. Say you had a five-year fixed rate that ran off between December and April, you are going to be paying getting on for 75 basis points extra on that mortgage. If you have got used to paying 1.59%, or whatever you were paying, and you are suddenly paying 2.34%, that is a big hit to your monthly budget and your monthly payments.

You asked if there is there a particular spike of people moving through. There are certain points in time where there might be a very generous offer and lots of people might reschedule their mortgage at that point, but more generally it is a continuous process, so we will see it cumulatively. The effect of our putting up Bank rate will cumulatively feed through into the mortgage market. It will take longer than in the past, when everyone was on variable rate. That is the key point and comes back to Harriett Baldwin's point. Everyone—or the vast majority—used to be on variable rate, so it will take longer but they will run through, and cumulatively

more and more of the households who are on fixed-rate mortgages will be affected by our decisions over time.

Q512 **Emma Hardy:** Okay. If we go with the assumption that some people have got five years fixed, are you expecting to see more and more people's spending power being hit by increased mortgages in the next five years?

Sir Dave Ramsden: Yes.

Q513 **Emma Hardy:** I wonder, because of that, what impact you think that could have on house prices. If we are starting to see mortgage rates going up in line with the Bank of England rate and people paying more and having less income, how will that impact house prices?

Sir Dave Ramsden: Last time I was here, in September, we talked about the housing market. There are so many factors influencing the UK housing market. What our agents tell us, and we published this in a box in the report, is that, at the moment, there is quite a lot of demand. There are new households being created who want to buy houses, so first-time buyers.

Equally, there are a lot of people who are still engaged, I suspect, in what we have called the race for space, whose preferences have changed, to go back to what we were talking about earlier—working remotely. They can move out—

Emma Hardy: Or go abroad.

Sir Dave Ramsden: Yes. Certainly, they are not locked into a commutable distance to London, Birmingham, Manchester or somewhere like that. What we are seeing, and our agents report this, is that there is still demand and people looking to move, particularly in those kinds of areas.

It may not be so true of two-bedroom flats in the centre of urban areas, without much outside space. Certainly, in a number of different housing opportunities where there is space, demand is exceeding supply, which is why you are seeing house price growth up at 10% or so. We haven't published a forecast of what we think is going to happen to house prices over the forecast period, but you would expect that higher mortgage rates at the margin will be one factor, alongside lots of other factors, because remember that buying a house is a long-term decision.

Q514 **Emma Hardy:** I am keen to hear other people's opinions. I am looking at an article in the *Financial Times* that says: "House prices to fall? Definitely, but not quite yet." Everyone is expecting the Bank rate to rise, but Governor, if that rises, are you expecting that to have an impact?

Andrew Bailey: I am not sure I could count the number of articles I have seen over the years saying that UK house prices are going to fall, and I am afraid they haven't fallen much in the past, so I am pretty cautious about this. Yes, it is very reasonable to say that the direction of travel would be that an increase in interest rates would lead to some cooling off

of the housing market, and indeed that is what's in our forecast. We do embed a view of house prices in the forecast. There, the rise is quite strong this year, but it comes off quite a lot—it doesn't go negative, actually, but it's quite strong; it comes off a lot next year. So that's the direction. Having said that—as Dave was just saying—we of course have seen this quite different structural pattern in the housing market in the covid era with the so-called race for space, but also the regional pattern has been very different from the one that we saw over a long time before that, with faster increases outside London and the south-east than in it. So we always have to be a bit cautious about the confidence of our views on the housing market.

Q515 **Emma Hardy:** Jonathan or Michael, do you want to comment on house prices?

Jonathan Haskel: I will just say one thing. Of course, other things being equal, it is true that asset prices fall as interest rates go up. That is the law of asset prices. But of course that is only if other things are equal. There has got to be a reason why asset prices are going up, and if asset prices are going up because the economy is booming and there is growth and so forth, there are other pressures on house prices. That is part of the reason why I think it is rather difficult to net out those two different effects.

Q516 **Emma Hardy:** Charles Goodhart told us last week that it was difficult to see how inflation would come down unless there was a marked reduction in house prices and increased mortgage payments in the UK. Do you agree with that?

Sir Dave Ramsden: Lots of people have attempted to disentangle the relationship between house prices and inflation. What we have said is that, other things being equal, as Jonathan is right to remind us—let's not forget there is also a structural supply issue in the UK, even on top of any kind of race for space: the demand in terms of household creation and the like. That might change a bit with the demographics over time, but it has outstripped supply. So the UK has, uniquely, had increases in real house prices for 20 or 30 years, compared with, say, some euro-area countries. If you just look at the mortgage rate effect, that, other things being equal, will bear down on house price inflation, but other things aren't necessarily equal.

What I would say is that it's not a causative thing that you need house prices to come down, and the housing market to cool, for inflation to necessarily come down. There are lots of other drivers of inflation, as we have been discussing. There are all the factors of inflation that we think will not be long lasting, the short-lived factors that are leading to the peak inflation: imported goods, energy prices—all the things that have been the focus of today's discussion. Then there are the influences coming from the labour market. What we can do—the channels that we can operate through a higher Bank rate and therefore tighter monetary policy are not just the housing market at all. We can act much more broadly through the impact that we can have on demand in the economy—that has unfortunate

consequences as well, as we have discussed. We think that the labour market is going to cool; unemployment is going to go up.

Michael Saunders: Some of this year's rise in inflation will drop out during the course of the next year or two. If we get this further rise in the Ofgem price cap, which we have assumed for later this year, in a year's time after that, unless wholesale energy prices go on rising, inflation will fall sharply as that drops out at the 12-month change. So the debate in policy terms is not about whether inflation will fall next year, because it's highly likely to fall; it's about whether it will drop back to the 2% target on a sustained basis and what level of interest rates is needed to achieve that. If interest rates have to go up further in order to ensure that sustained return of inflation to 2%, you would expect, of course, mortgage rates to rise with that. But I wouldn't emphasise house prices as a key part of the monetary policy transmission mechanism. It's all about trying to ensure that demand and supply in the economy as a whole are in balance, rather than focusing on house prices as such. We forecast inflation, GDP growth and unemployment. We don't really put emphasis on a house price forecast. The aim is CPI inflation.

Emma Hardy: This is one of my continual frustrations. As you mentioned, Michael, mortgage rates are expected to rise. Your report pointed out: "On average, the interest paid on deposits has risen by less than the interest charged on new lending since January, suggesting that banks' net interest rate margins on new lending have increased." Given that banks have raised their mortgage interest rates, shouldn't we also expect them to raise their interest paid on deposits in the near future too?

Andrew Bailey: Well, I would expect that there will be quite a lot of scrutiny of the banks over the coming months, once our effects start to pass through, as to how their net interest margins are moving. I would imagine that they will come under a lot of scrutiny in terms of what is happening. Post financial crisis, interest rates fell so low that there were some slightly unusual effects on interest margins at that time, so it may not be symmetric, but I think they will be under a lot of scrutiny.

Sir Dave Ramsden: And also, related to the kind of issues that Anthony Browne has raised in the past, there are new people coming into the market. We highlighted that instant access accounts are not seeing very large increases in rates, but fixed-term deposits are. But then you have new entrants. I will not mention any names, but if you move your primary account, they are offering much more attractive instant access rates, so you are seeing that market become more contestable, which will be another way. It will not just be through your constituents saying, "Why aren't I seeing any movement in deposit rates?" You are also seeing it through competition. But in an environment where interest rates are rising, it means that, in a sense, there are probably more opportunities for those new entrants to enter the market, because they can see how their business model might work.

Q517 **Emma Hardy:** Can I just push you a bit on that? You mentioned that

banks will be under intense scrutiny. Could there be lots of scrutiny and pressure on the banks to start delivering the same interest rate rises? It is fundamentally unfair that they are very quick to raise the mortgage rates and not as quick to raise the savings rates. I don't know what further influence you can have on their decisions.

Andrew Bailey: I imagine there will be a lot of scrutiny. There will be a lot public scrutiny, I'm sure.

Q518 **Emma Hardy:** Naming and shaming—is this what you are recommending, Governor?

Andrew Bailey: I think there will be a lot of scrutiny of deposit rates, and I am sure that will involve naming of rates. That has already started to happen; we can observe it.

Emma Hardy: Would anyone else like to add any further comments?

Chair: Thank you. Finally, Angela.

Q519 **Dame Angela Eagle:** Governor, you were talking earlier about apocalyptic issues with food, and you were also talking about the outside shocks that as a Monetary Policy Committee you cannot, understandably, be expected to know were going to happen in advance, such as the outbreak of the war in Ukraine or covid. But there is something that might be reasonably expected to break out in the not-too-distant future: a trade war with the EU, if the Northern Ireland protocol is unilaterally ripped up by the UK. Is that one of your four horsemen of the apocalypse that you are worried about?

Andrew Bailey: We will run out of horsemen. This is going to sound facetious, but I am tempted to say that we condition on the state of Government policy. I read intently what the Government policy is, so I am waiting to see what the Government policy is.

Q520 **Dame Angela Eagle:** But the Government have been threatening to do this since they made the deal in the first place, which was about a couple of years ago.

Andrew Bailey: We condition on actual Government policy, not on threats of Government policy—I think that is the best way of putting it. We will obviously follow that carefully, but I do not think we can incorporate something that has not actually transpired as Government policy. When we think about risks, that is obviously an issue as well. We think about risks quite broadly, though; we do not build them up one by one, because that is quite challenging.

Q521 **Dame Angela Eagle:** Well, you would probably never sleep again. If you built up risks one by one, it would be very difficult to get a rest.

Andrew Bailey: We would never come out of our cavern.

Q522 **Dame Angela Eagle:** But have you done any work on what a trade war with the EU might look like in terms of its effects?

Andrew Bailey: We have done quite a bit. Going back to Mr Hollinrake's question, we have done quite a bit of work over time on the threats to EU trade, so we have work on the stocks that I think we could pretty easily dust down.

Q523 **Dame Angela Eagle:** Is it apocalyptic, or is it acceptable?

Andrew Bailey: It would depend on what it was, I suspect. Obviously, there are shades of intervention in terms of measures that could be taken. I cannot really speculate on that.

Q524 **Dame Angela Eagle:** Our trade with the EU has fallen significantly since Brexit, but the EU's trade with us has not fallen by as much. If there were a trade war, or if there were a retaliation from the EU in the event of the Northern Ireland protocol being ripped up, might that not affect our imports more than our exports, which have already been hit dramatically by Brexit?

Andrew Bailey: The last time I looked—others may have looked more recently—imports from the EU had fallen more than exports. I looked some time ago, so I would have to look again.

Q525 **Dame Angela Eagle:** I hope we do not have to talk about this at the next meeting on the MPC. It would be quite nice, wouldn't it?

Andrew Bailey: We would love not to have another shock, please, but we will see. As I say, we condition on Government policy, and of course that would be on EU policy as well, just to be clear.

Q526 **Dame Angela Eagle:** Your MPC report in May this year effectively says that we will have even higher inflation than you thought, higher unemployment than you had thought, and lower economic growth as a result of these shocks. You only have one real policy lever that you can use, given your answers on the potential quantitative tightening to Harriett Baldwin, and that is interest rates. Do you think that signalling that you will carry on increasing interest rates will be enough to wrestle inflationary expectations that have gone up so high back down towards 2%?

Andrew Bailey: At every meeting we have, we have to take the decision on whether we actually raise interest rates. The signal is only the forward-looking piece; then we actually have to take the decisions. As we said earlier, we have now increased at four successive meetings, which I think is the most the MPC has ever done in a sequence. We will come back to that at the next meeting next month. It is not just forward guidance signalling; these are real moves, because we do have to do that. I am not predicting what we will do in future, but you will have seen—

Q527 **Dame Angela Eagle:** The argument on the committee was whether to put it up to 1% or 1.25%. It was an argument about the size of the increase rather than the fact that there should be an increase.

Andrew Bailey: The minutes show that the committee had two points of difference. One, as you say, was between those who voted for 0.25% and

those who voted for 0.5%. The second was on the question of continuing the forward guidance; the majority of the committee decided to retain it, but some members of the committee thought that it was better not to have that forward guidance. I use the scenario of the narrow path: what that tells you is there are views on both sides of the path. I am not surprised by that.

Sir Dave Ramsden: If you look at our forecasts, they show, as we have stressed repeatedly this afternoon, that inflation does get back to close to target after two years, but it falls quite a long way below target after three years, at 1.3%. That goes to Michael's point about how to get inflation sustainably back to target. Remember, though, that that is conditioned, as I pointed out in answer to a previous question, on the market path for interest rates. The market path for interest rates shows interest rates peaking at well over 2% in the middle of next year. That would imply quite a few further increases in interest rates, but that would have inflation getting below target. That comes back to the debate that Andrew mentioned: the majority of members saw the case for further Bank rate rises, but some members did not want to sign up to that forward guidance.

Q528 **Dame Angela Eagle:** Adam Posen, when he was giving evidence last week, said that in his view, the only way to deal with inflation was by causing a recession.

Sir Dave Ramsden: We have a very sharp slowdown in activity forecast. It does not meet the definition of a technical recession but it is a sharp slowdown.

Q529 **Dame Angela Eagle:** There is a reduction in quarter 4, isn't there, but it doesn't go on in your—

Andrew Bailey: There are two negative quarters, but they are not consecutive.

Sir Dave Ramsden: Yes—quarter 4, because that is when the assumed second increase in household energy bills comes through, and then quarter 3 next year, which is influenced by the ending of the super deduction. Those are two distinct quarters. It is a weak economic forecast, which comes back to Andrew's emphasis on the narrow path.

Q530 **Dame Angela Eagle:** On productivity, with the super deduction coming to an end—for those who are not familiar with it, it is essentially paying companies to invest, and it has still not really had the desired effect in terms of increasing investment to the level that one might have thought it would. What effects do you expect these shocks will have on productivity?

Andrew Bailey: On investment, our agents are telling us two things, and I pick this up when I go around the country. You are right that it is not at the moment having the impact that was expected. We get told two things. First, there is quite a well-established relationship between uncertainty and investment, and the rise in uncertainty created by Ukraine has caused

firms to delay their decisions on investment. I should say that firms say that they still intend to invest, but they are delaying it.

The second thing is supply chain disruptions. Obviously, a lot of investment involves goods of some sort or other, and those supply chain disruptions are interrupting or causing people to postpone investment decisions. That is the message that we get back in terms of the investment profile.

Q531 **Dame Angela Eagle:** It is quite often "mañana" with investment for productivity purposes in the UK, isn't it? There is always an excuse for not investing.

Michael Saunders: The CBI do long-running surveys for both the service sector and manufacturing firms on the factors that discourage investment. What we see at the moment is that the share of firms that say that a lack of profitability is stopping them investing is really low, so firms are not that worried about a lack of profits. The share of firms that say that a lack of labour is stopping them investing is unusually high. That comes back to the tight labour market. If you invest in new machinery or whatever, you probably need new skilled staff to go with it, and firms find the availability of staff really difficult. That is much more of a constraint on investment at the moment than it has been in the past.

Andrew Bailey: That is particularly true of IT investment.

Dame Angela Eagle: Jonathan, I think you had an observation.

Jonathan Haskel: I was going to say exactly that. When one is thinking about investment and productivity, it is interesting to break out investment by asset. The asset that has taken the biggest brunt of the pandemic has been transport and vehicles, not surprisingly—airlines and so on are very big investors. The asset that has gone in the other direction has been R&D and, to a certain extent, as Andrew says, IT, with a question over the software. In some ways, that is a little bit encouraging for productivity.

Q532 **Dame Angela Eagle:** We want a little bit of encouragement.

Governor, you told us last time we met that the least well-off are likely to be hit hardest by inflation, and we know that is true because they pay relatively more as a percentage of their overall income for necessities like energy and food. Can you tell us whether Bank analysis has shown which sectors and regions are likely to be most adversely affected by recent economic events, and which regions or sectors are more likely to benefit? This will have a bearing on this issue of so-called levelling up.

Andrew Bailey: I suppose you can extrapolate from what was said about the income distribution to look at the distribution of incomes in parts of the country. That should carry across. Unfortunately, those parts of the country that have a higher distribution of those on a low income will be more affected, and I must say again that this is a very bad thing. As you say, it is a problem particularly with inflation being focused on core energy and food items.

Dame Angela Eagle: Necessities for people—costs that they can't avoid.

Andrew Bailey: Necessities, yes. A larger share of the consumption basket of the less well-off is necessities, for obvious reasons. It is an obvious point. You tend to find that link in terms of regional distribution of income—and in terms of sectors, again, those with a higher concentration of low-paid staff. It looks like you have some numbers.

Jonathan Haskel: I was just going to go back to the investment issue. Although this doesn't quite speak to your question, Dame Angela, we do have investment by regions as of last Thursday. The biggest disappointments in investment by region are in the east midlands and west midlands, in the north-west and the north-east. I think that maybe helps to round out the picture a bit.

Q533 **Dame Angela Eagle:** Finally, what effect do you think this fall in living standards and the shocks we have been discussing is going to have on consumption? We are an economy that relies on consumption quite a lot to get ourselves growing, and clearly, with the cost of living squeeze, there have to be some worries about that.

Sir Dave Ramsden: Maybe I can start on that. Picking up on the point we were making that the poorest will be hardest hit, it also goes up the income distribution. We hear companies tell us that even people close to median incomes, for example, might be quite over-extended; employees are asking whether there is any chance that they could borrow from their companies, because this is such a shock to their household incomes. For those groups at the lower end of the income distribution, the need to pay for necessities means that they may well not have any income left over to consume other items, so that is one factor in this.

Q534 **Dame Angela Eagle:** And savings is also a very skewed distribution.

Sir Dave Ramsden: That was the other point I was going to make, because those households do not really have any savings; they have not necessarily benefited through the pandemic. However, we know that aggregate savings have increased through the pandemic. It is quite possible that people at the upper end of the income distribution will be relatively insulated from the increases in prices of necessities—from the real income shock—so they may well continue to consume.

What we have is a balance of those factors at the macro level. In a sense, I would argue that there is potentially a downside risk at the lower end of the income distribution—the bottom half—in terms of consumption, but there might be an upside risk further up the income distribution. Those risks feel quite balanced to us, and that is the way we framed it, but you are right that consumption is a key driver of growth. It is why growth is so weak in our forecast; it becomes positive again after next year, but it is a very weak growth forecast.

Andrew Bailey: The other risk in the labour market, which we highlighted earlier, is the extent to which companies, because they have found it so difficult to recruit labour, hang on to labour even when demand turns

down because they are worried about re-recruiting in the future. We don't know, of course, but given that companies are now so focused on the difficulties of recruiting, it is not impossible that they will take lower margins as a result of wanting to retain labour.

Sir Dave Ramsden: So you could get higher household incomes for some.

Michael Saunders: If I can just come back on this question of excess savings, the amounts are very large. If you compare how much—

Q535 **Dame Angela Eagle:** But the distribution is very skewed.

Michael Saunders: Exactly. That makes both the impact across society and the job of forecasting the economy very difficult. If you compare what household savings have done over the past couple of years with what you might have expected had they just stayed in line with the pre-pandemic trend, you have excess savings of around £200 billion, or perhaps a little bit over £200 billion. That is equal to about one sixth of annual consumer spending. If the people who have accumulated those savings spend a large share of them, that would represent a substantial upside surprise to growth.

At the other end of the scale, it is notable that there has been quite a marked pick-up in credit card debt in the past few months. That is a relatively expensive form of debt, so that may be people whose incomes are being squeezed.

Chair: That brings us to the end. Can I thank you all for coming today? It has been a very interesting discussion, and Michael, we wish you well in your future beyond the MPC. We are sorry to see you go, but thank you for your contributions today.

I cannot speak for the whole Committee, but I think there will be a general acceptance that shocks have been very difficult to deal with. There has been a very high level of uncertainty around a number of the factors that have been driving inflation, and indeed, some of those factors are not amenable to monetary policy anyhow. In terms of just how deep the uncertainty is, I thought it was rather charmingly evidenced by Andrew when you said that you felt relatively good about the Brexit effects, because the uncertainty was relatively lower there than around other factors that you are considering. That was quite an interesting observation as to how uncertain things are.

There are some questions, certainly in my mind, still hanging over this whole debate we have had about the labour market and what might have been done—what might, perhaps, have been worked out a little earlier than it was. However, this is a debate that will no doubt run for a long time. It will be informed by the future, which awaits us. Let's hope that you are right about one thing—that graph of inflation starting to come down. Whether it comes down to 2%, 1.3%, or wherever it finally rests, let's hope that we start to see the downward side of that curve appearing in due course. Thank you very much indeed for your time today.

HOUSE OF COMMONS