

2 March 2022



BANK OF ENGLAND



The economy and policy trade-offs

2nd March 2022

Economic Research Council

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Key points

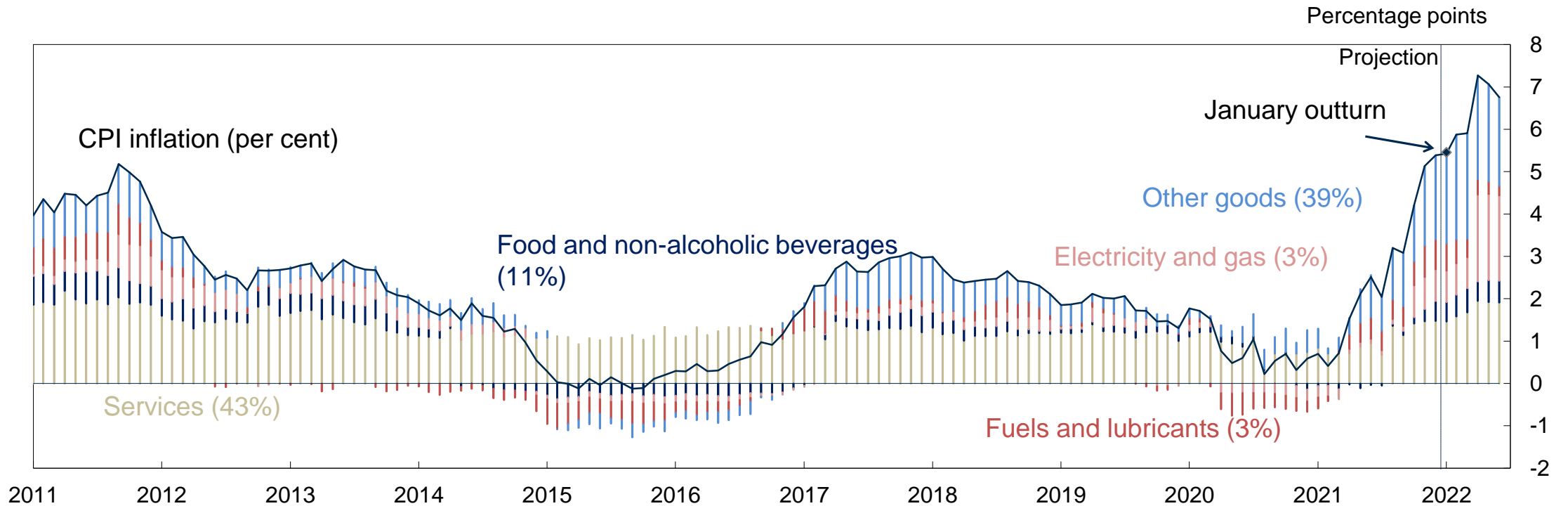
- Major aftershock of the pandemic has been a negative supply shock, with increases in the prices of energy and tradeable goods.
- This pushes up on prices, while lowering real incomes and aggregate spending. It creates a **trade-off** for monetary policy, as recognised in the MPC remit.
- Energy prices not something we can reliably forecast. But even if anticipated, policy could not prevent the reduction in real incomes. Fully offsetting the inflation impact would have driven the economy into a deep recession. I would have viewed this as inconsistent with the remit.

Monetary policy trade-offs

<i>Shock</i>	<i>Effect on inflation, GDP</i>	<i>Examples</i>	<i>Policy response</i>
Persistent increase in demand (relative to supply)	Up, Up	Increases in consumer confidence, global or UK government spending, lower taxes	Offset entirely
Temporary supply fall/cost rise	Up, Down	Worsening in the terms of trade	Balance inflation and output in the short-run, bring inflation back to target in the medium term
Very short-lived demand increase	Up, Up	Unseasonable weather	None, unless effects likely to persist
Very short-lived supply fall/cost rise	Up, Down	Petrol price increase	None, unless effects likely to persist

Inflation and real incomes (I)

Contributions to CPI inflation

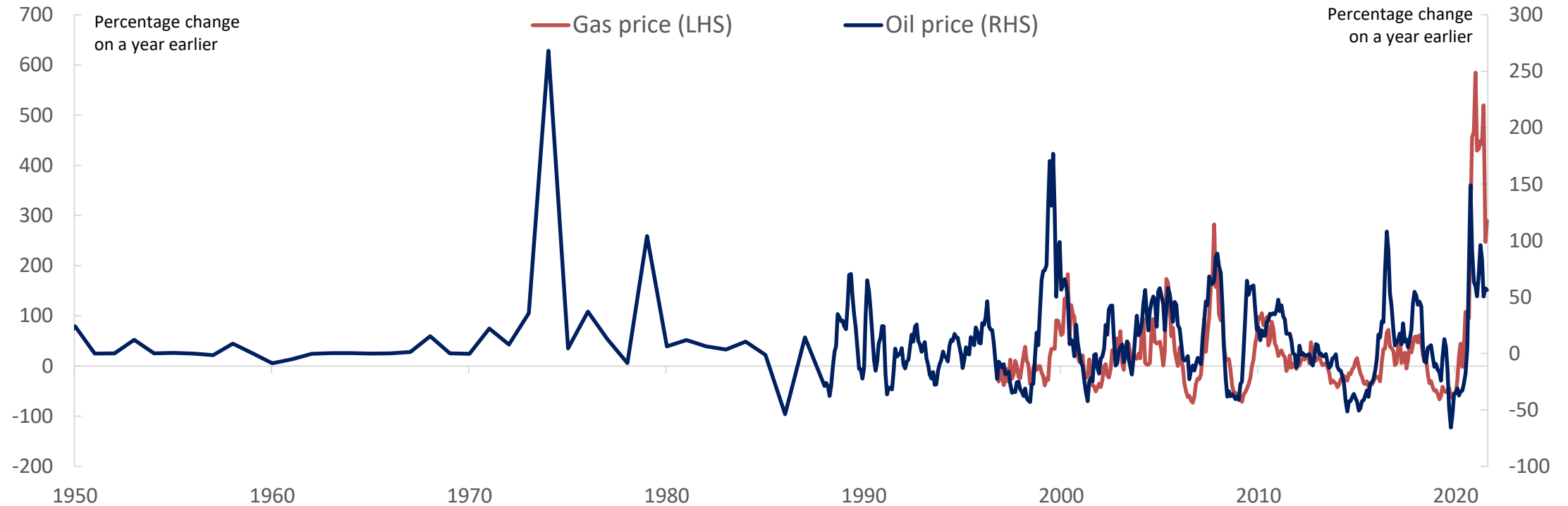


Sources: Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, ONS and Bank calculations.

Notes: See notes to Chart 2.19 in the February 2022 MPR. January 2022 outturn shown for aggregate CPI inflation only, all other data from January to June 2022 are Bank staff's projection at the time of the February Report.

Inflation and real incomes (II)

Monthly average of sterling energy prices



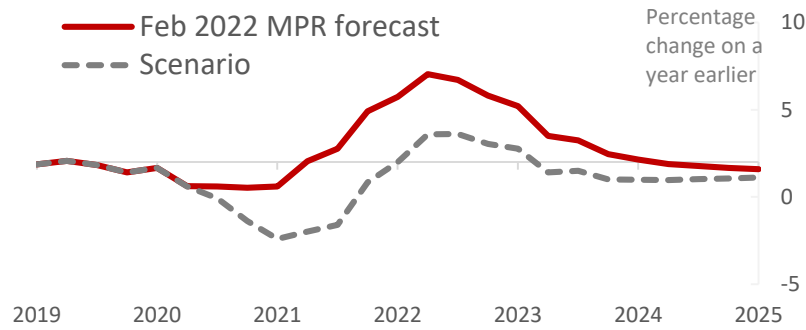
Sources: Bloomberg Finance L.P. BP Statistical Review of World Energy 2014, Thomas and Dimsdale (2017) and Bank calculations.

Notes: Oil price inflation rate calculated using monthly average in £ per barrel from July 1987, spliced with annual average from 1950 to 1987 (Arabian Light until 1983, Brent thereafter). Gas price inflation is calculated using monthly average spot price in £ per therm from April 1997. February 2022 averages use data to February 18.

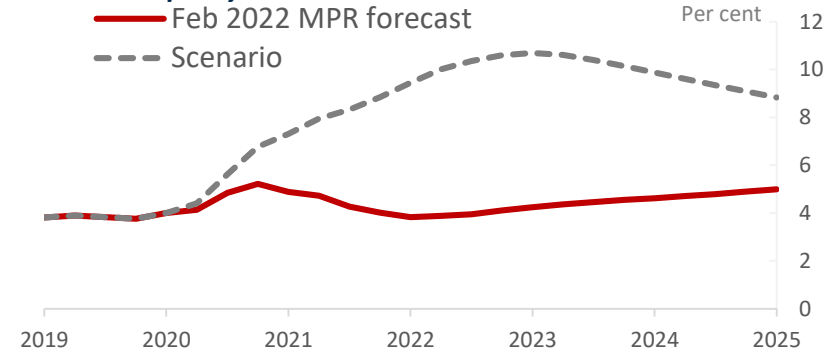
Inflation and real incomes (III)

Hypothetical policy scenario, inflation at target in 2022 Q1

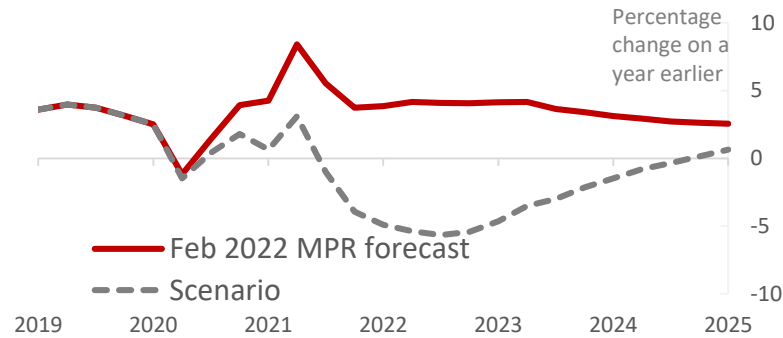
CPI inflation



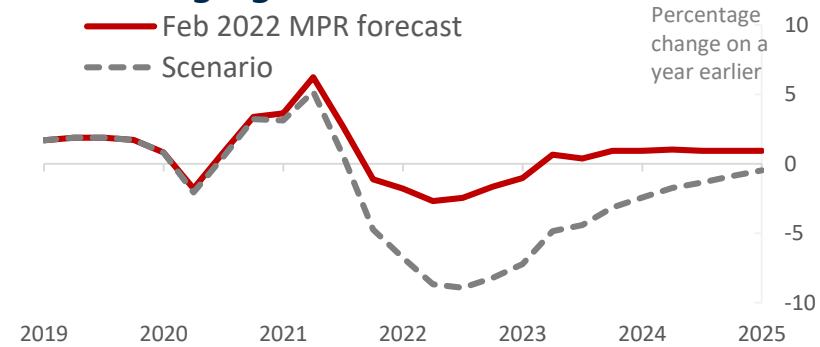
Unemployment



Nominal wage growth



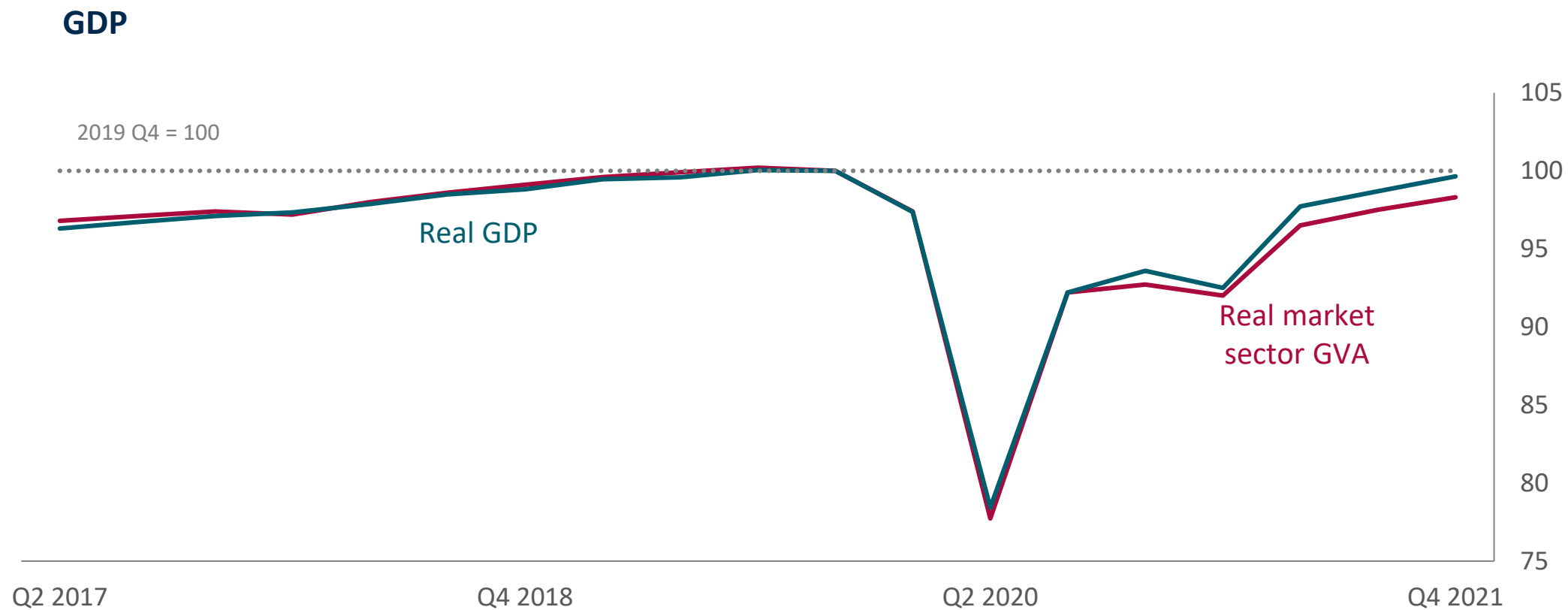
Real wage growth



Source: ONS and Bank calculations.

Notes: Nominal wage growth is the four-quarter growth rate of private sector regular AWE (including bonuses). Real wage growth is divided by CPI.

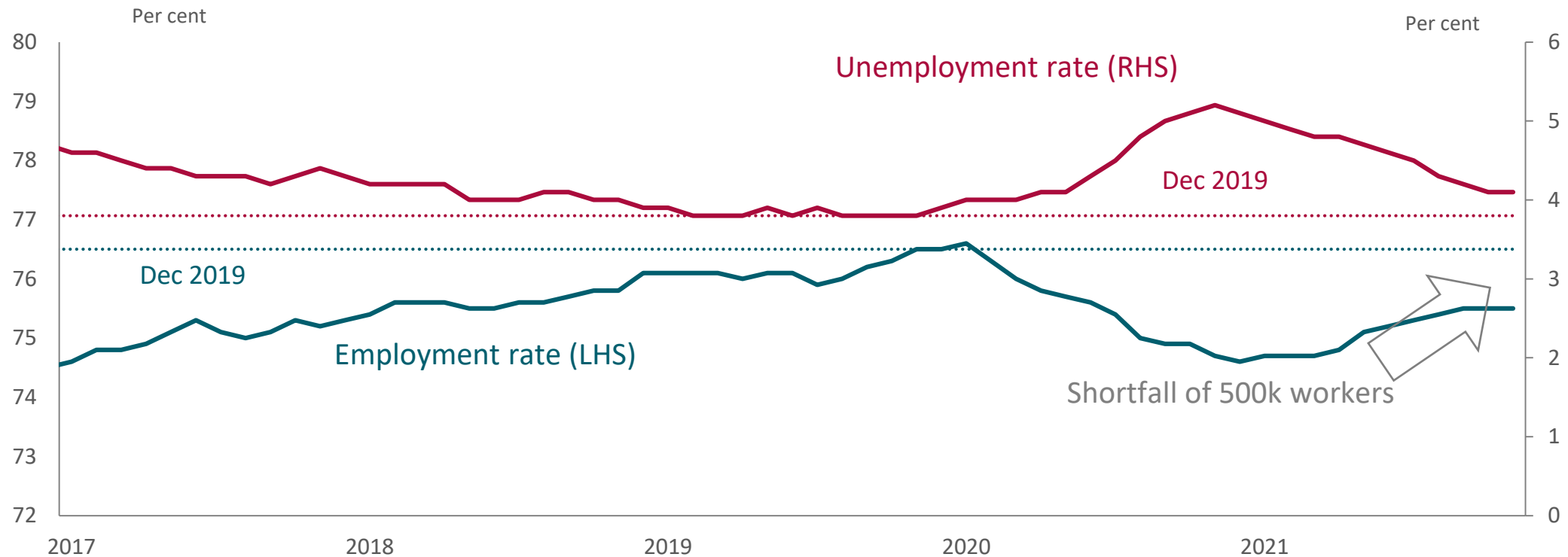
Output



Sources: ONS, Bank calculations.

The labour market (I)

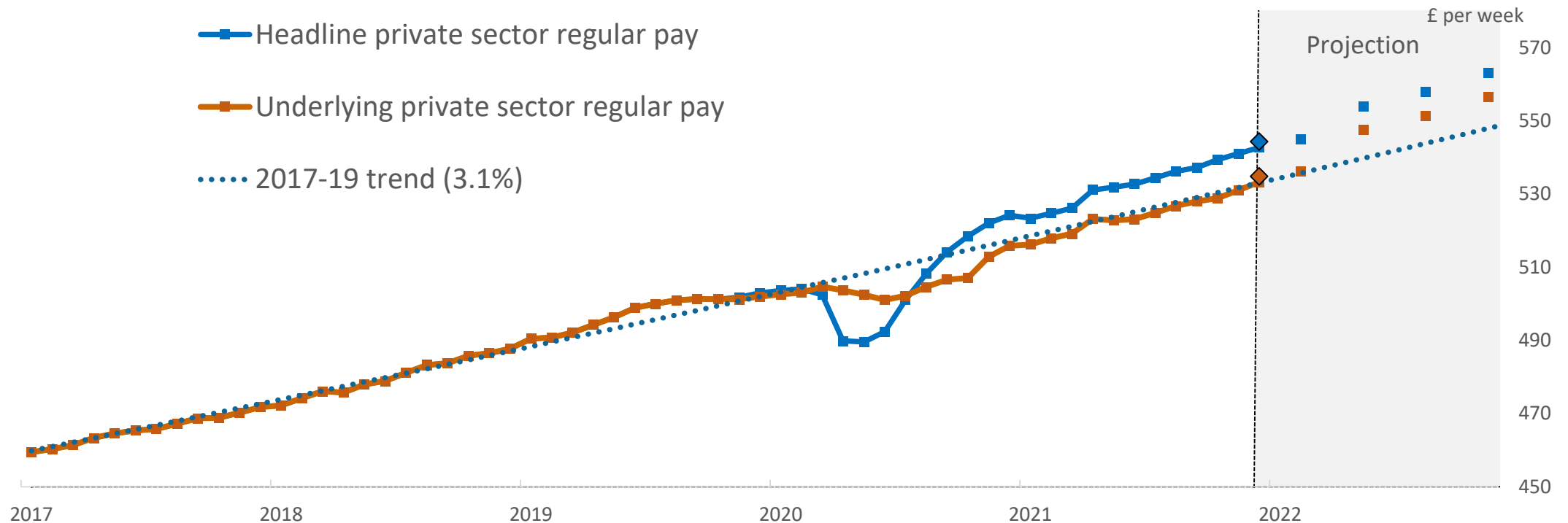
Unemployment and employment



Sources: ONS, Bank calculations.

The labour market (II)

Headline and underlying private sector pay (excluding bonuses)

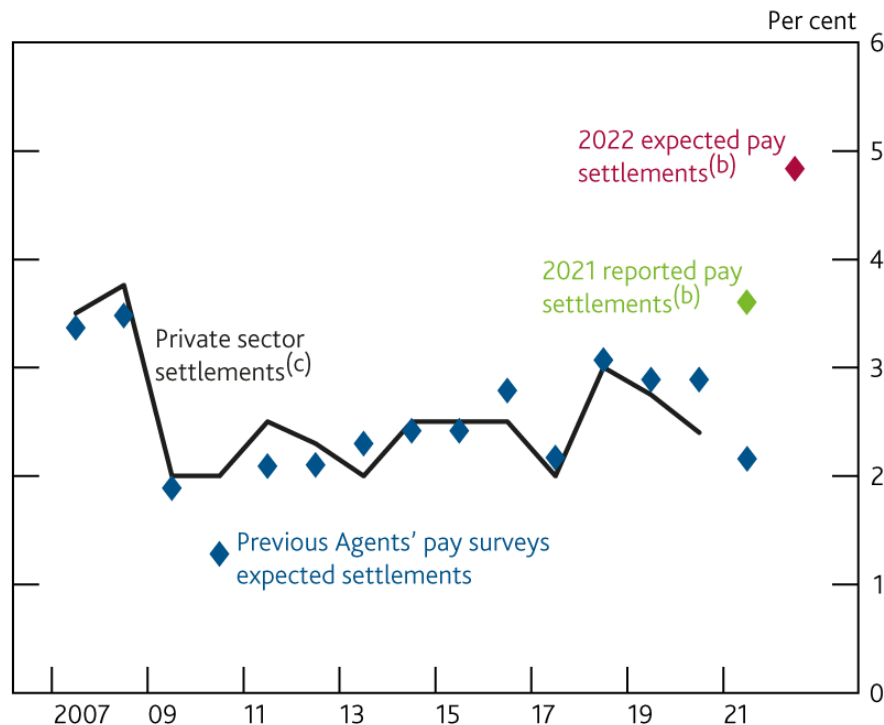


Sources: ONS and Bank calculations.

Notes: Blue line shows Private sector AWE excluding bonuses and arrears. Orange line shows Bank staff estimates of private sector regular pay adjusted for furlough and compositional effects. Data are monthly wage levels, projections show quarterly averages consistent with the February 2022 MPR forecast and diamonds show December outturns.

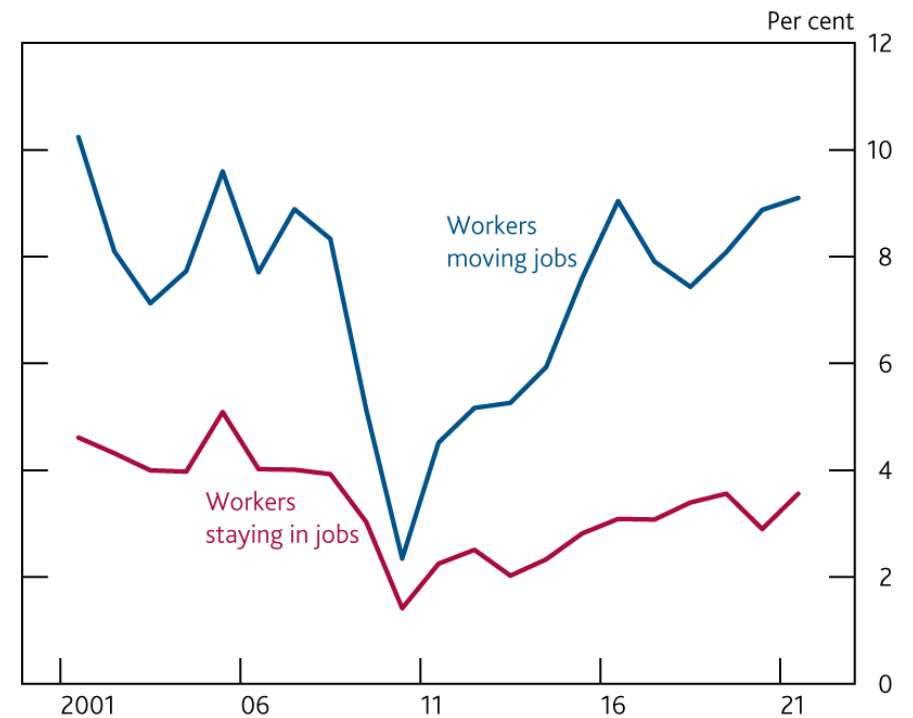
The labour market (III)

Pay settlements



Source: Bank of England, including the wage settlements database (which draws on information from the Bank's Agents, Incomes Data Research, Incomes Data Services, Industrial Relations Services and the Labour Research Department).
Notes: See notes to Chart 3.9 in the February 2022 MPR.

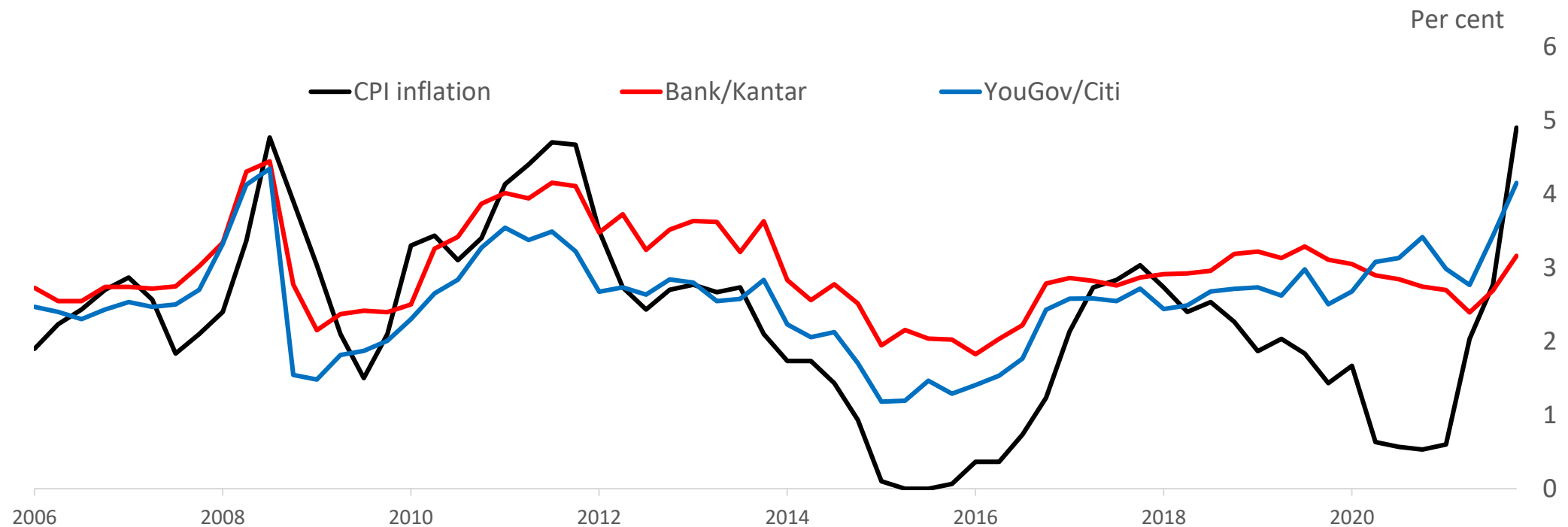
Median annual growth rates of pay



Sources: ONS Annual Survey of Hours and Earnings and Bank calculations.
Notes: See notes to Chart 3.6 in the February 2022 MPR. Latest data point is for April 2021.

Domestic inflationary pressures

One-year ahead household inflation expectations and CPI inflation

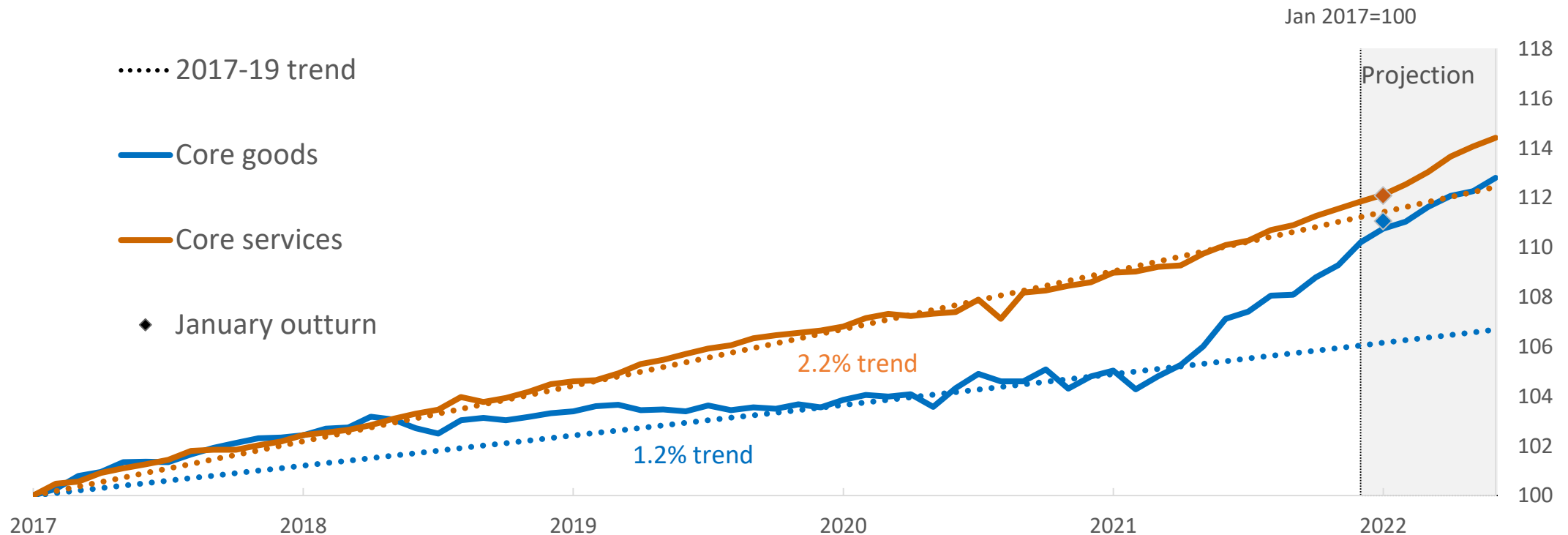


Sources: Bank of England, Citigroup, Kantar, ONS, YouGov and Bank calculations.

Notes: The surveys ask about expected changes in prices but do not reference a specific price index. Summarised as a weighted median. YouGov/Citi data are quarterly averages. CPI inflation are quarterly averages of the 12-month inflation rate.

Domestic inflationary pressures

Core goods and core services price levels (seasonally adjusted)



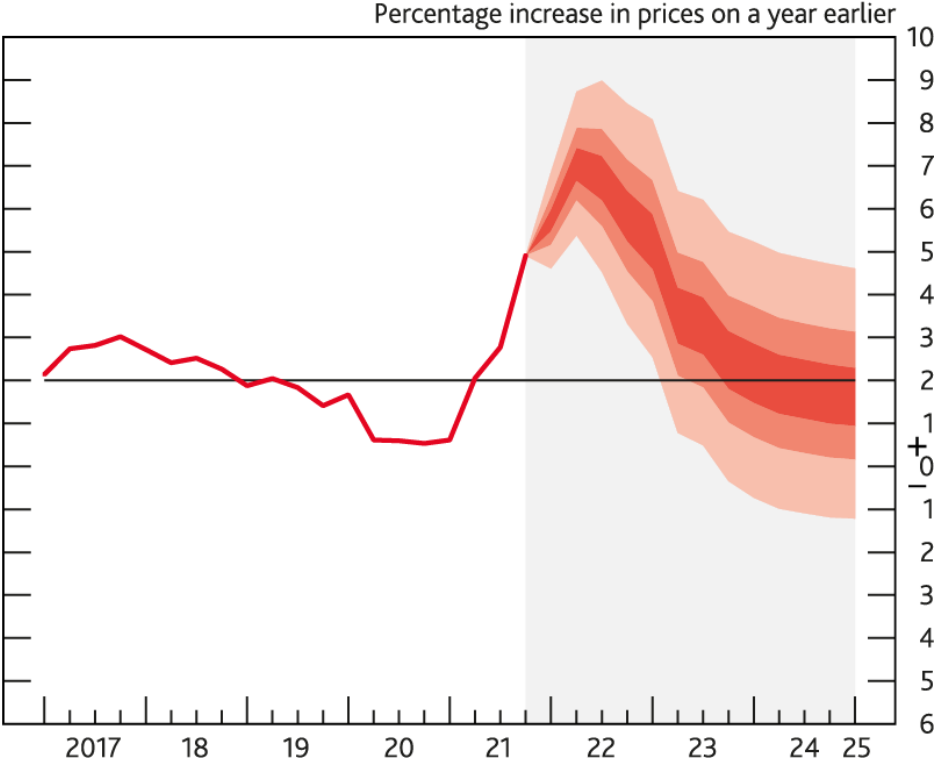
Sources: ONS and Bank calculations.

Notes: Core services CPI excludes airfares, package holidays and education. Core goods CPI excludes energy, food, non-alcoholic beverages, alcoholic beverages and tobacco. Bank staff have adjusted for the estimated direct impact of changes in VAT and there is uncertainty around the precise impact of that adjustment. Projections show forecasts consistent with the February 2022 MPR. January outturns apply the January annual growth rate to the seasonally adjusted level from January 2021.

Monetary policy outlook

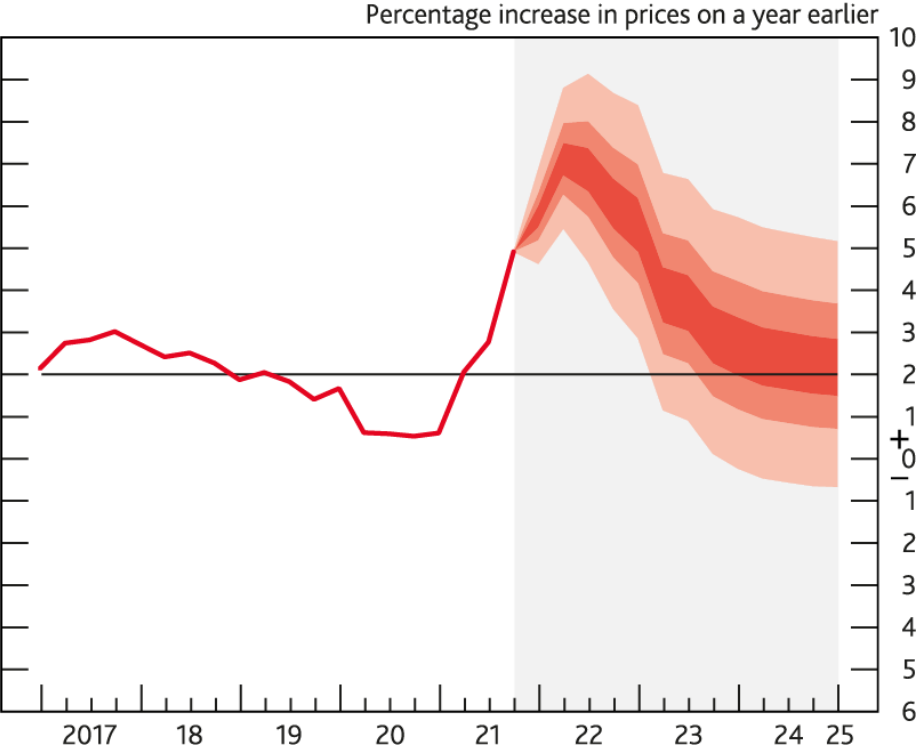
February 2022 MPR inflation forecast

Based on market interest rate expectations



Notes: See notes to Chart 1.7 in the February 2022 MPR.

Based on constant interest rates at 0.5%



Notes: See notes to Chart 1.8 in the February 2022 MPR.



Recent policy votes

Key points

- Major aftershock of the pandemic has been a negative supply shock, with increases in the prices of energy and tradeable goods.
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