Bank of England

Policy Challenges

The SNB and Its Watchers

22 November 2024

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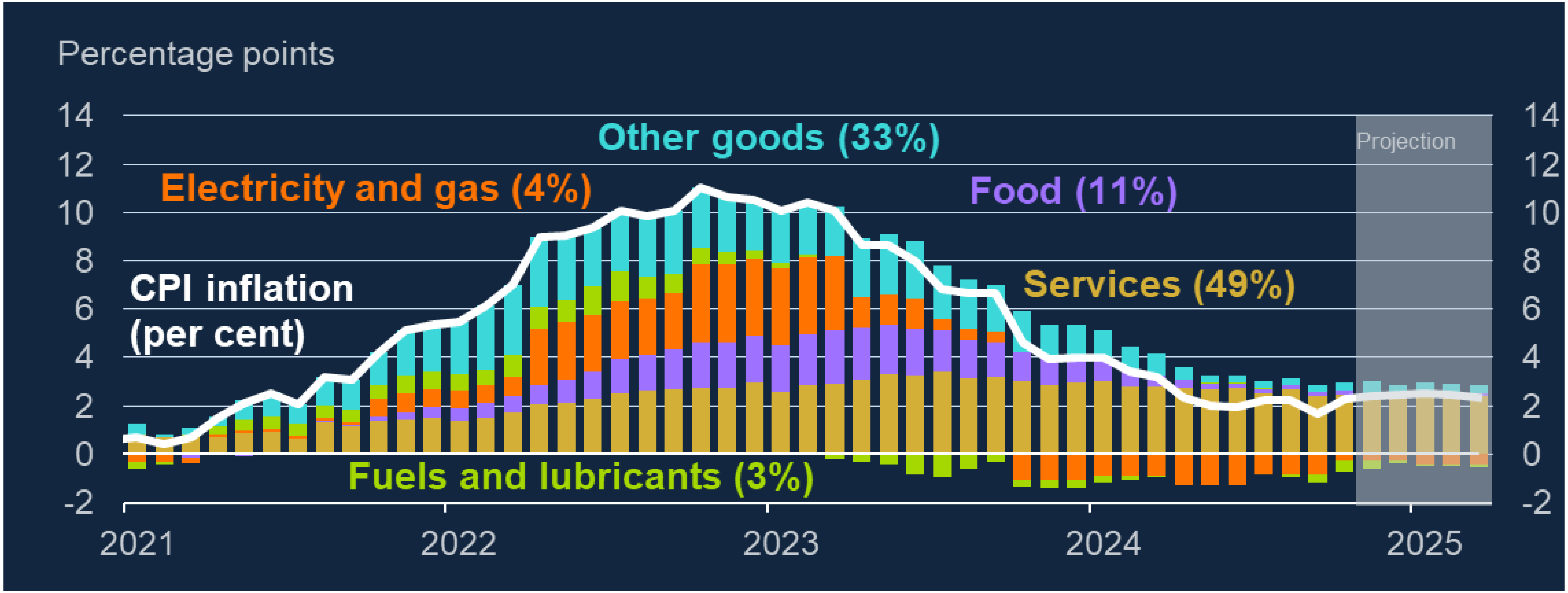
Waves of UK inflation

Contributions to CPI inflation[(a)]

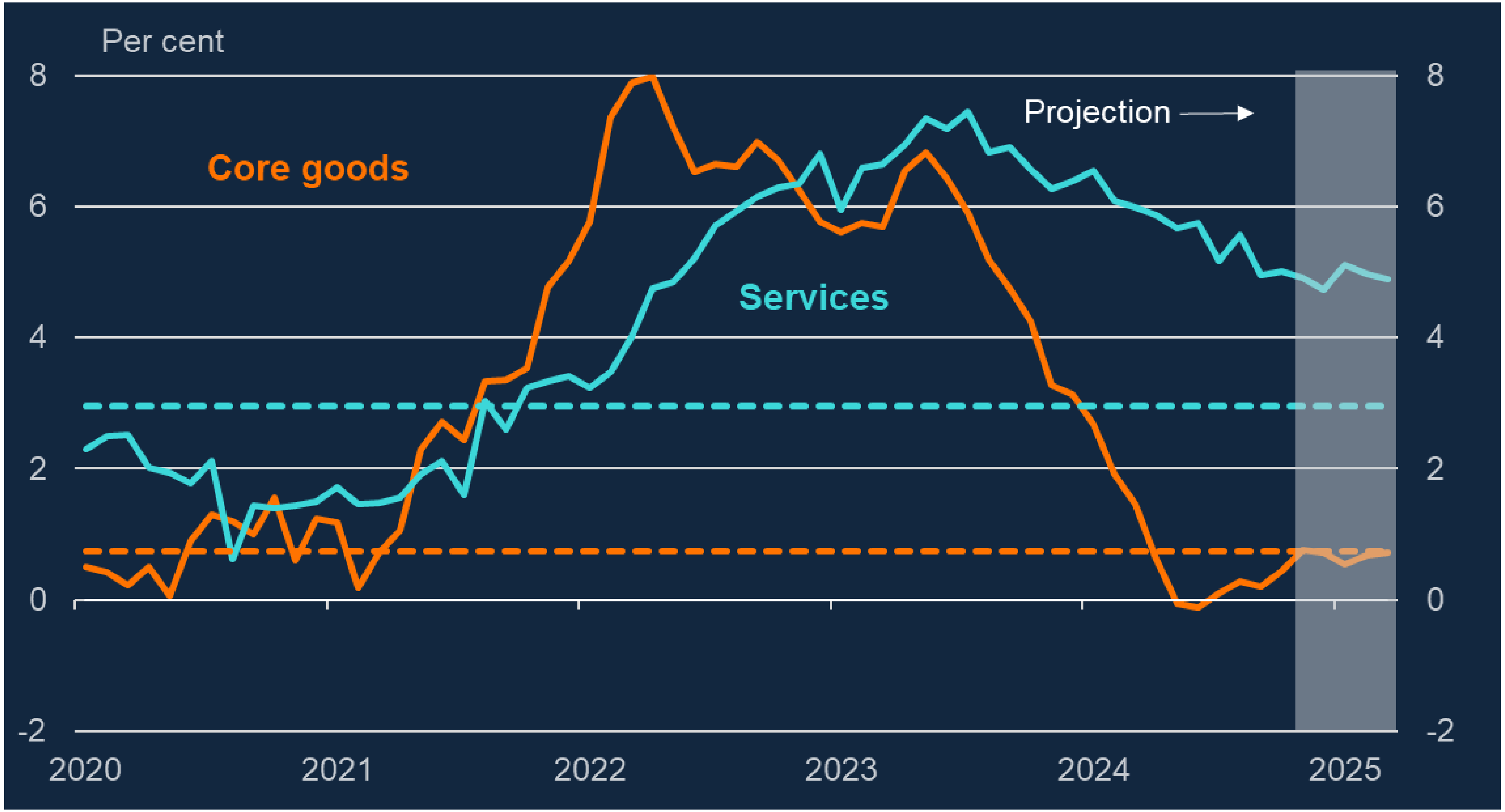


Sources: Bloomberg Finance L.P., Department for Energy Security and Net Zero, ONS and Bank calculations.

(a) Figures in parentheses are CPI basket weights in 2024. Data to October 2024. Component-level Bank staff projections from November 2024 to March 2025. The food component is defined as food and non-alcoholic beverages. Fuels and lubricants estimates use Department for Energy Security and Net Zero petrol price data for October 2024 and are then based on the sterling oil futures curve.

Services inflation remains elevated relative to its pre-Covid average

Annual inflation rates for components of CPI[(a)]

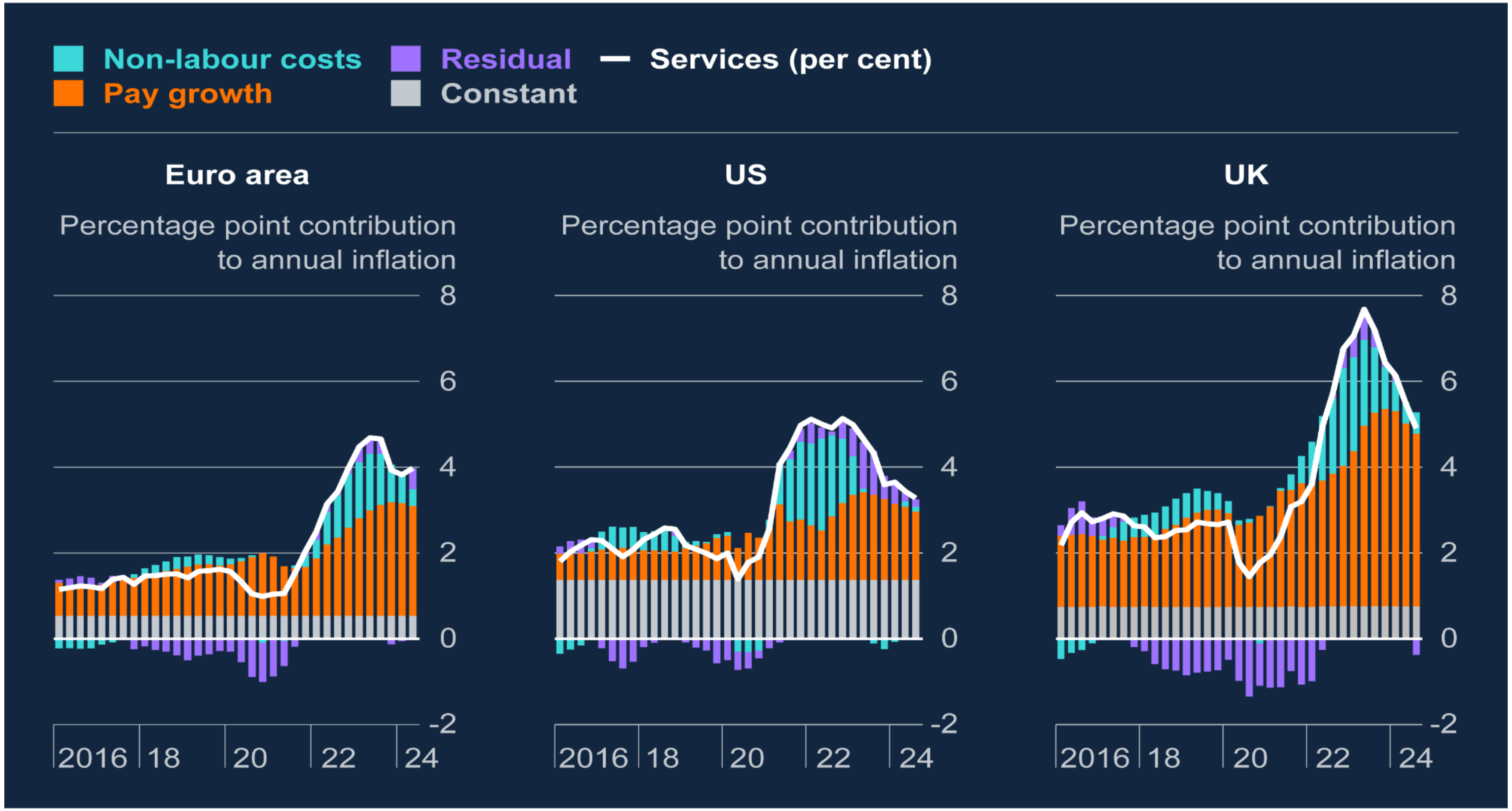


Sources: ONS and Bank calculations.

(a) The core goods component is defined as goods excluding food and non-alcoholic beverages, alcohol, tobacco and energy. Data are to October 2024. Bank staff projections from November 2024 to March 2025. Dashed lines represent 2010–19 averages which are 3.0% and 0.8% for services and core goods respectively.

UK services inflation elevated, driven by pay growth

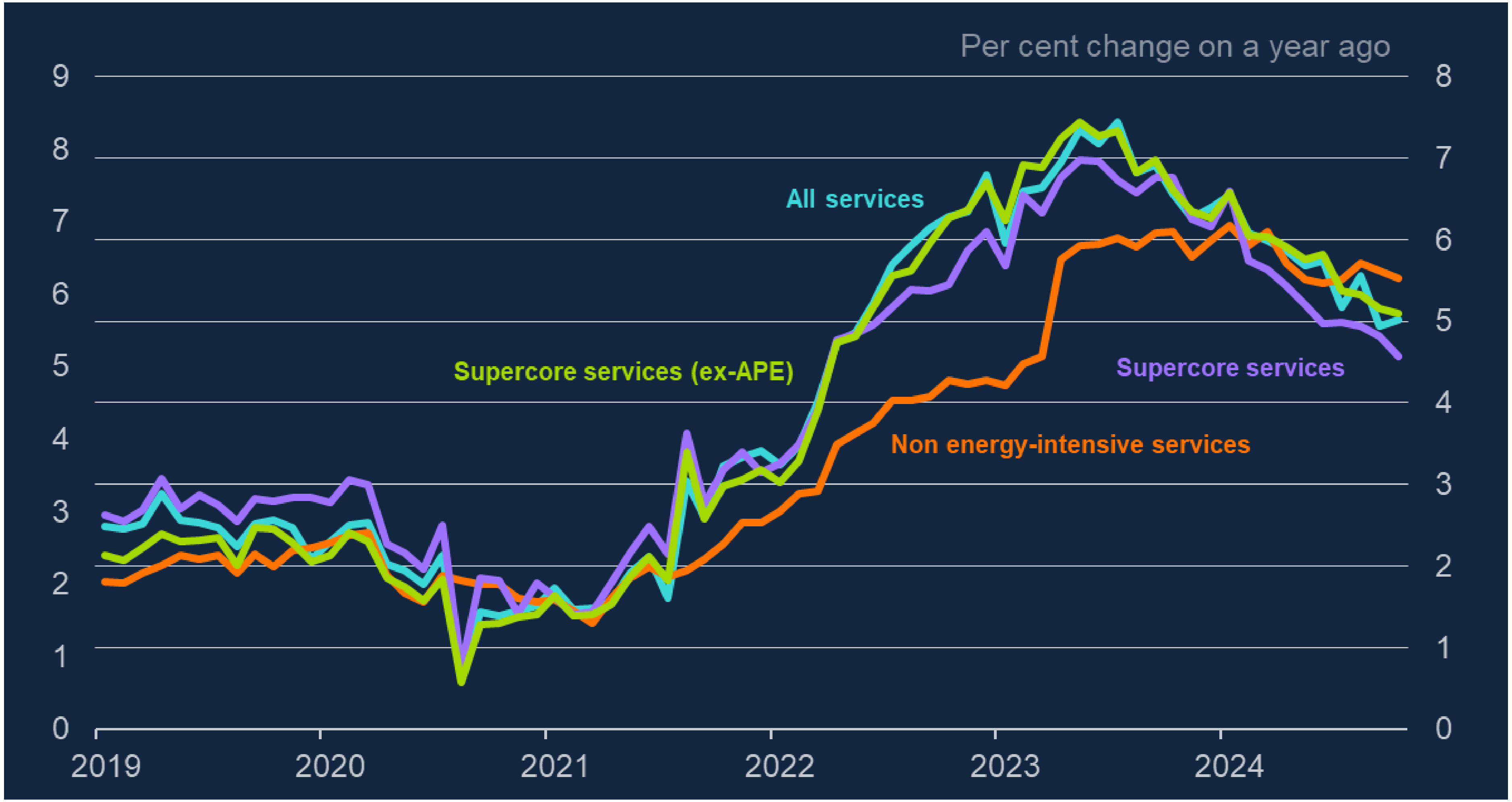
Contributions to annual core services price inflation(a)



Sources: Eurostat, ONS, US Bureau of Economic Analysis and Bank calculations.

(a) The data shown are HICP core services inflation for the euro area, PCE services inflation excluding energy and housing for the US, and core services inflation excluding rents for the UK. The latest data are for 2024 Q2. Estimated contributions to services inflation are based on autoregressive distributed lag regressions of services inflation on metrics of pay growth (orange bars) and manufacturing PPI inflation (aqua bars). See also Greene (2024) and Mann (2024). Note that services inflation in the US has also been boosted by continued strength in housing services inflation. This has been stripped out of these data.

Most of our measures of underlying services inflation have ticked down in recent months

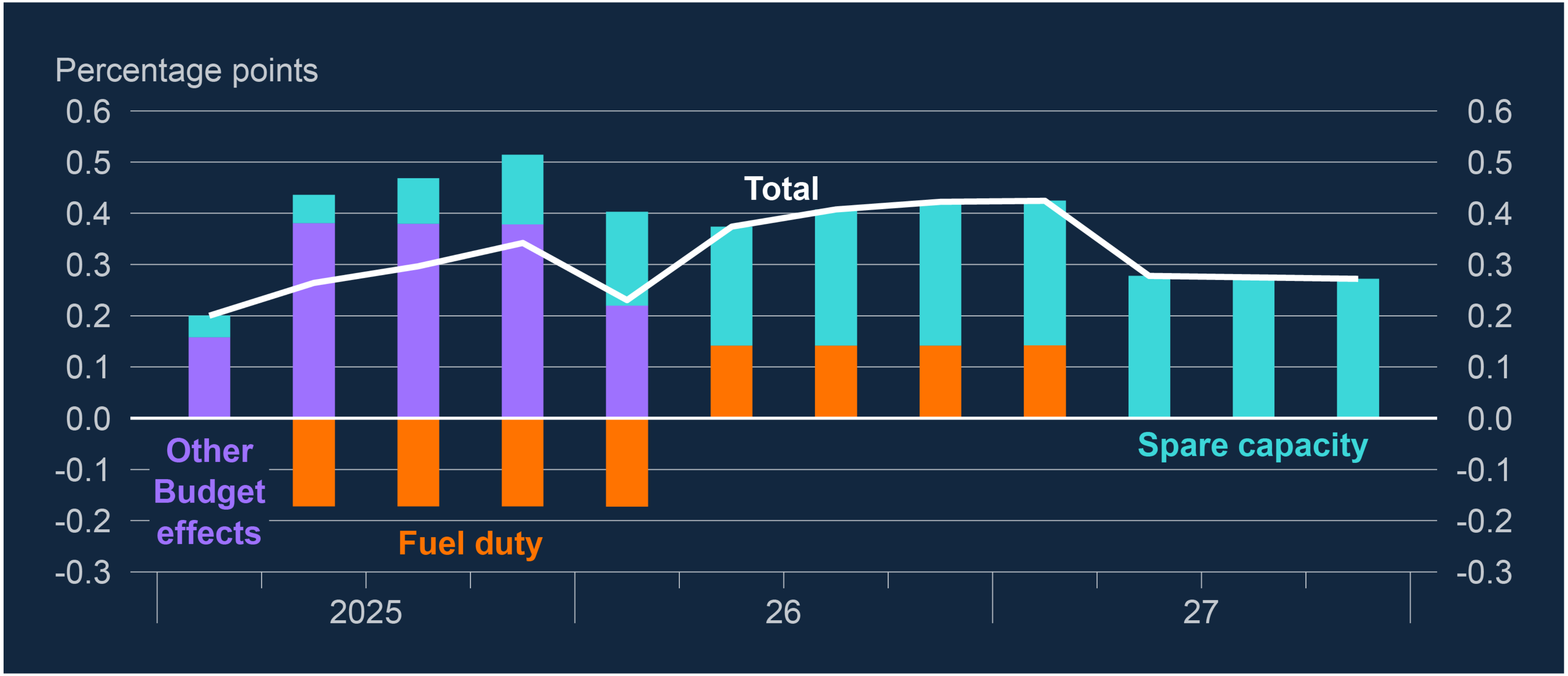


Sources: ONS and Bank calculations.

(a) Supercore services excludes rents, airfares, accommodation and package holidays; supercore services (ex-APE) excludes airfares, package holidays and education. Data are to October 2024.

Policies included in the Budget are expected to raise CPI inflation by just under ½ of a percentage point at their peak

Impact of Budget on CPI inflation forecast[(a)]



(a) The 'other Budget effects' bars account for the effects of the rise in the cap on single bus fares, the rise in vehicle excise duty, the introduction of VAT on private school fees and Bank staff's estimates for the CPI impact of the change in employer NICs. The 'fuel duty' bars account for the extension of the freeze and the 5p cut to fuel duty rates, followed by the assumption that the 5p cut will expire and fuel duty will rise in line with RPI from 2026 Q2. The 'spare capacity' bars capture the impact on inflation of changes to excess supply as a result of fiscal policy.

Firms expect further declines in services price inflation, but still elevated

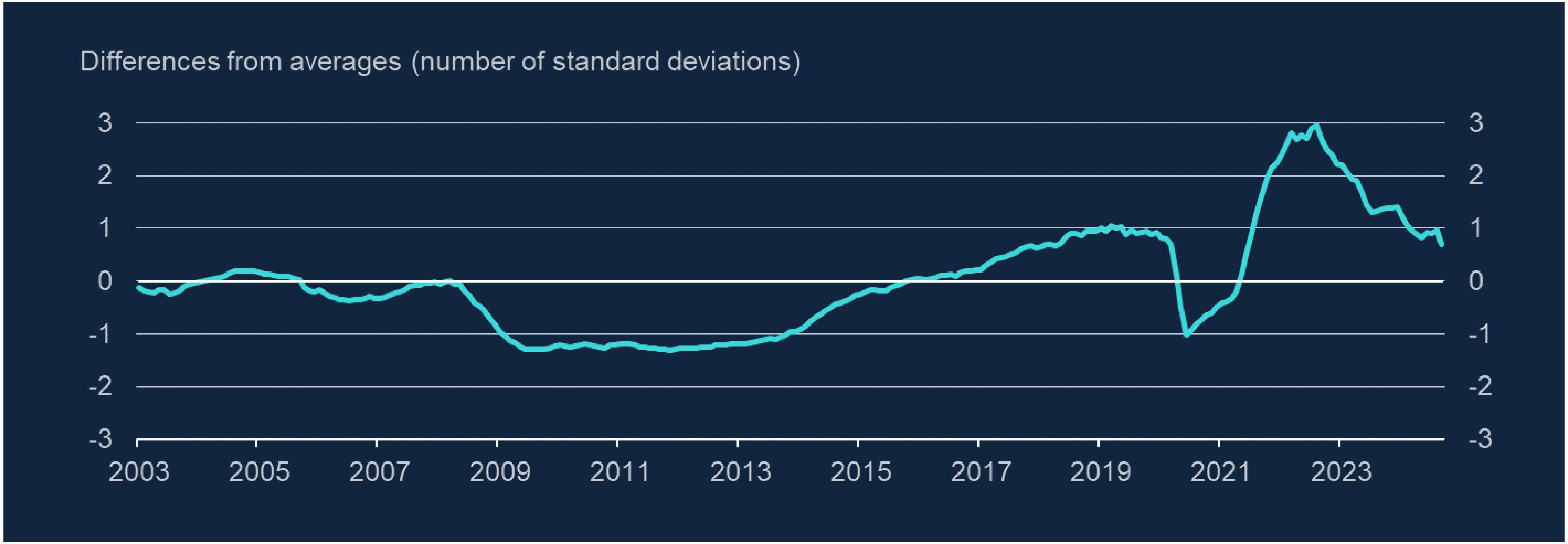
Annual consumer service price inflation, realised and expected[a]

Sources: DMP Survey and Bank calculations.

(a) Data are three-month averages and the final realised data point is October 2024. The diamonds show expectations for the year ahead from successive survey waves.

Tightness in the labour market continues to ease, although at a slower pace than in 2023

Vacancies to unemployment ratio(a)

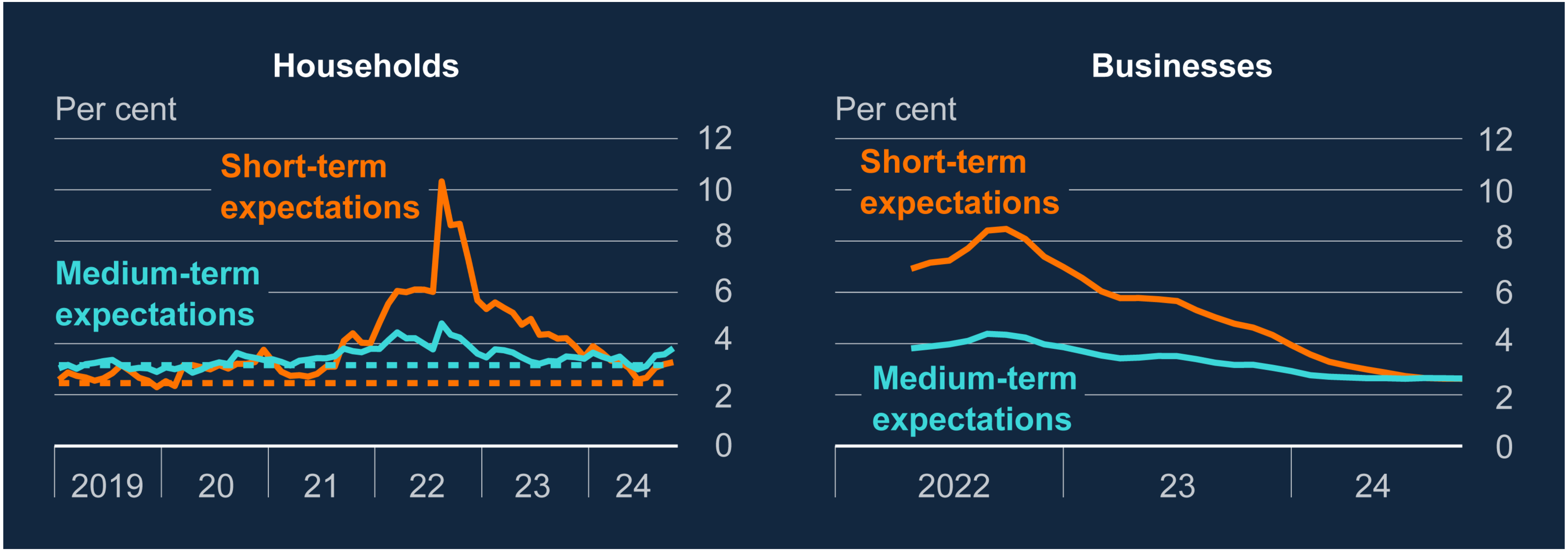


Sources: ONS and Bank calculations.

(a) Comparisons in the vacancies to unemployment ratio over long periods are uncertain because, for example, the falling average cost of posting a job vacancy may have affected the number of vacancies posted for a given level of labour market tightness. The series is shown relative to the 2002 to 2024 Q2 average. The final data point is the three months to September 2024.

Inflation expectations have largely normalised, although some measures have ticked up in recent months

Survey-based measures of household[(a)] and business[(b)] inflation expectations



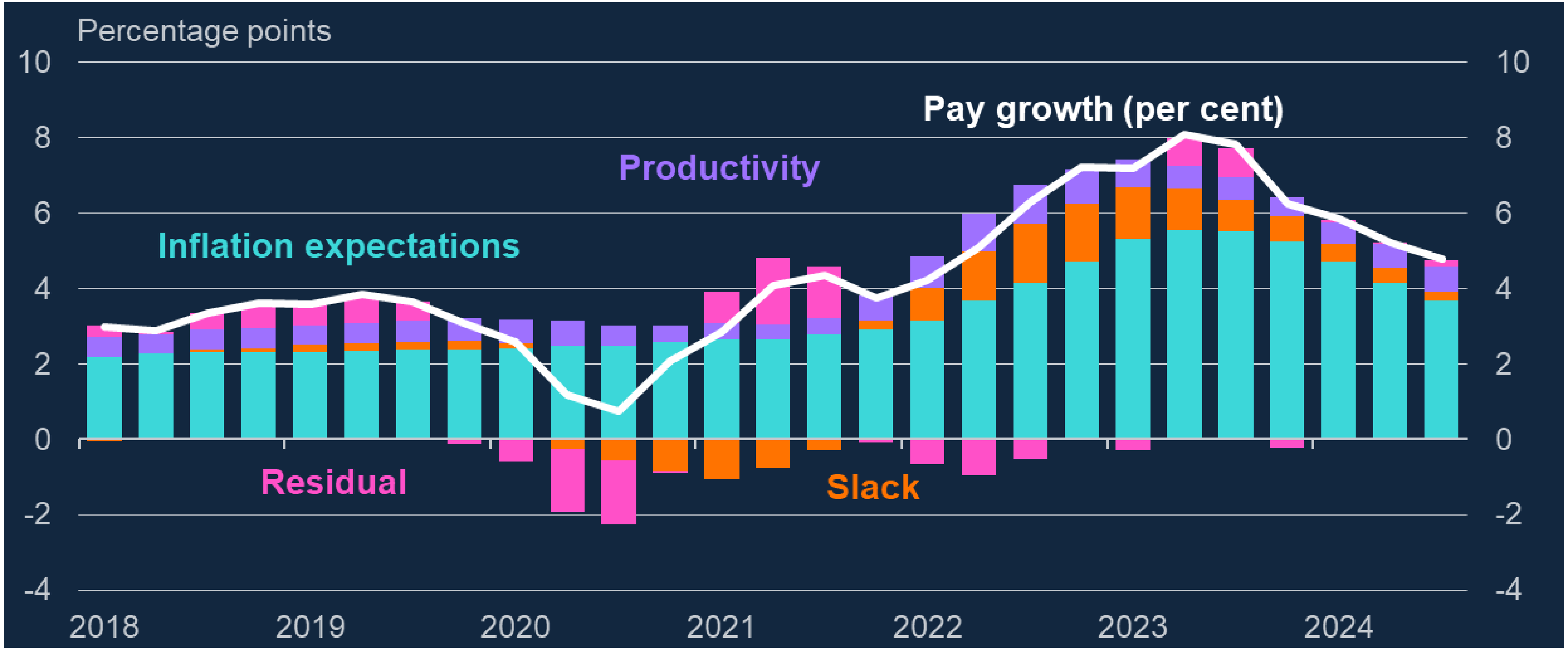
Sources: Citigroup, DMP Survey, YouGov and Bank calculations.

(a) Data shown are the 1-year and 5–10-year inflation expectations measure from Citi. Dashed lines represent the series averages over 2010–19. The latest data points are for October 2024.

(b) Data shown are from the DMP Survey and are based on three-month averages of responses to the question: 'What do you think the annual CPI inflation rate will be in the UK, one year from now and three years from now?'. The latest data points are for October 2024.

Falling inflation expectations and a looser labour market have contributed to lower wage growth

Contributions to annual private sector regular pay growth(a)

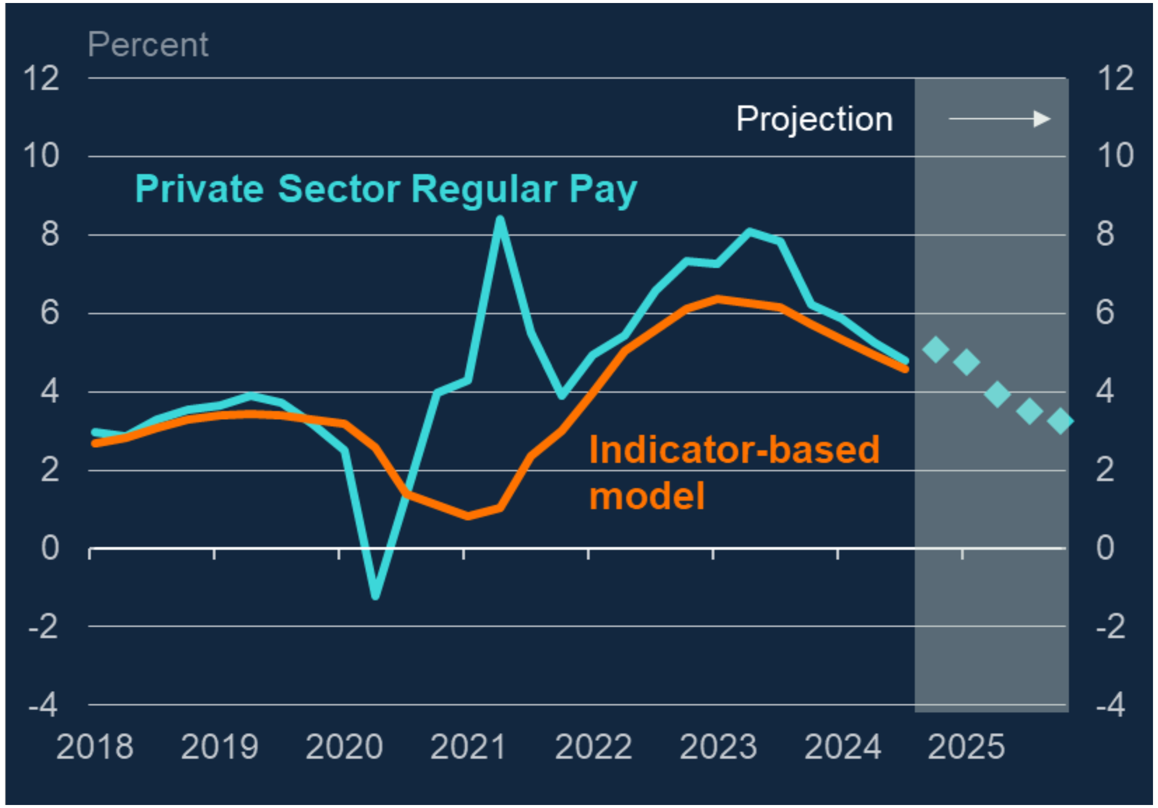


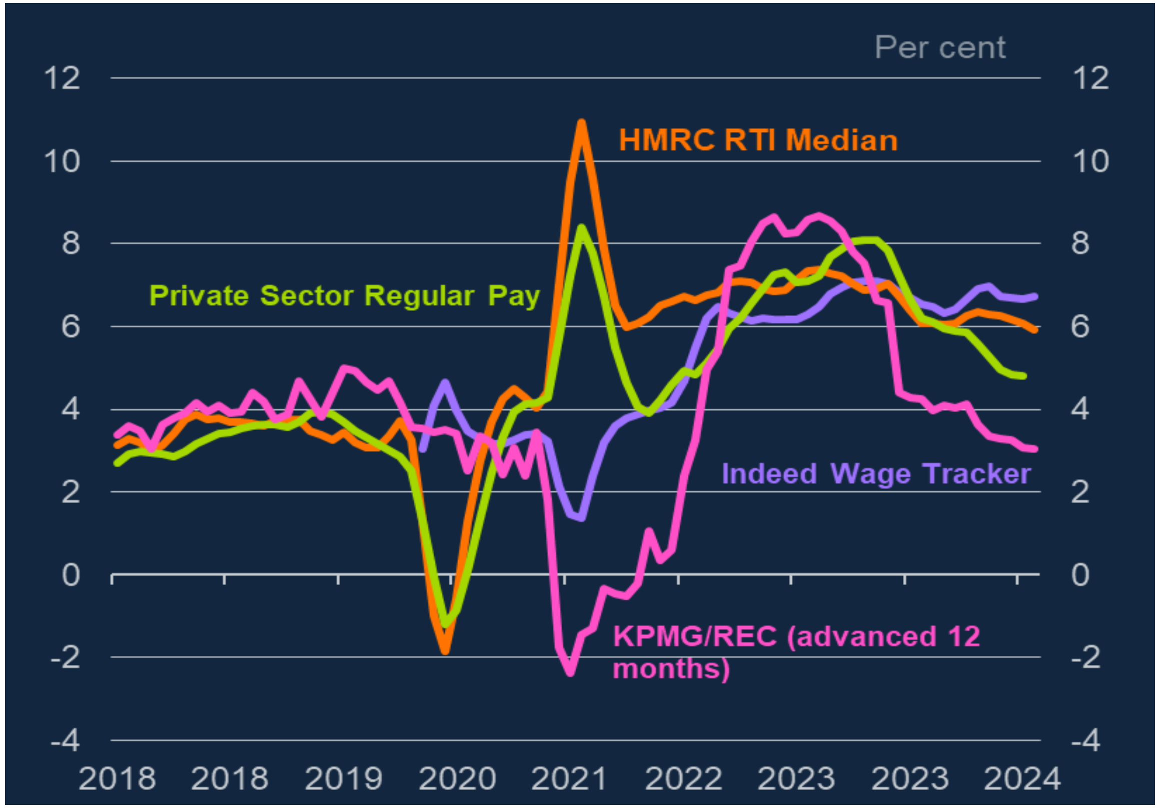
Sources: Barclays, Citigroup, ONS, YouGov and Bank calculations.

(a) Wage equation based on Yellen (2017). Pay growth is Bank staff's estimate of underlying pay growth between January 2020 and March 2022 and the ONS measure of private sector regular AWE growth otherwise. Short-term inflation expectations are based on the Barclays Basix Index and the YouGov/Citigroup one year ahead measure of household inflation expectations and projected forward based on a Bayesian VAR estimation. Slack is based on the MPC's estimates, informed by the vacancies to unemployment ratio. Productivity growth is based on long-run market sector productivity growth per head. The final data point is 2024 Q3.

Most indicators of wage growth have moderated in recent quarters

Measures of annual private sector wage growth[(a)(b)]





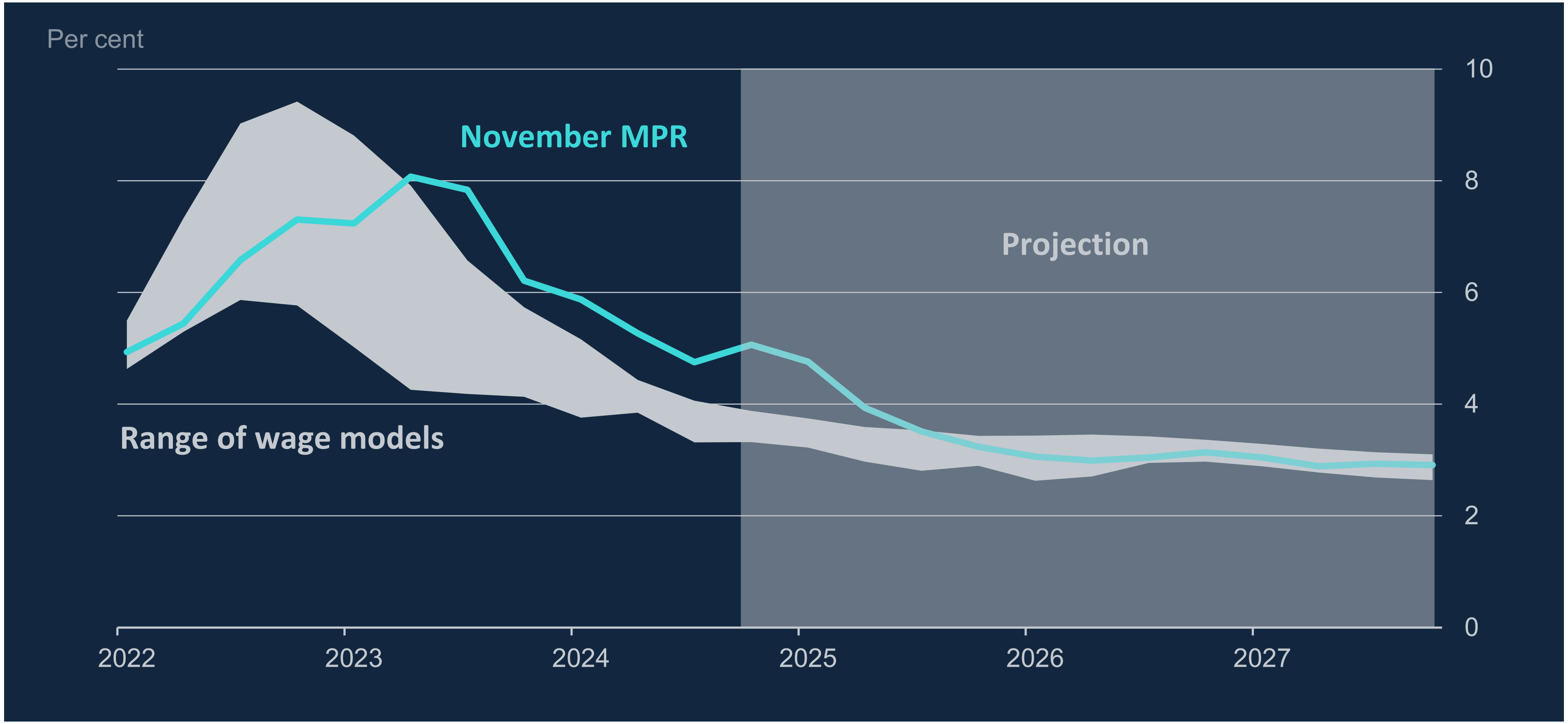
Sources: HMRC, Indeed, KPMG/REC UK Report on Jobs, ONS and Bank calculations.

(a) Series shown in the left-hand panel are at a quarterly frequency. Bank staff's indicator-based model of near-term private sector regular pay growth uses mixed-data sampling (or MIDAS) techniques. A range of indicators inform the model, including series from the Bank of England Agents, the Lloyds Business Barometer, Indeed, ONS/HMRC PAYE payrolls and the KPMG/REC UK Report on Jobs. Indicators are weighted together according to their relative forecast performance in the recent past. Private sector regular pay growth is the ONS measure of private sector regular average weekly earnings growth (quarter on same quarter a year ago). Latest data points are for 2024 Q2, with diamonds showing projections for private sector regular pay growth for 2024 Q4–2025 Q4.

(b) Series shown in the right-hand panel are at a monthly frequency. Definitions of wage growth vary between each of the measures. Private sector regular pay growth is the ONS measure of private sector regular average weekly earnings growth (three-month average on same three-month average a year ago). KPMG/REC shows average starting salaries for permanent staff compared to the previous month. HMRC Real-Time Information (RTI) shows median of private sector employee pay growth. Indeed shows annual average job title matched pay growth for UK job vacancies. The KPMG/REC index is mean-variance adjusted to ONS private sector regular pay growth over 2002–19 and is advanced by 12 months, which better reflects the leading relationship between the KPMG/REC index and the ONS measure of pay growth. Latest data points are October 2024 for Indeed, HMRC RTI and the KPMG/REC index, and the three months to September 2024 for private sector regular pay.

Our wage forecast remains above estimates from our suite of wage models until mid-2025

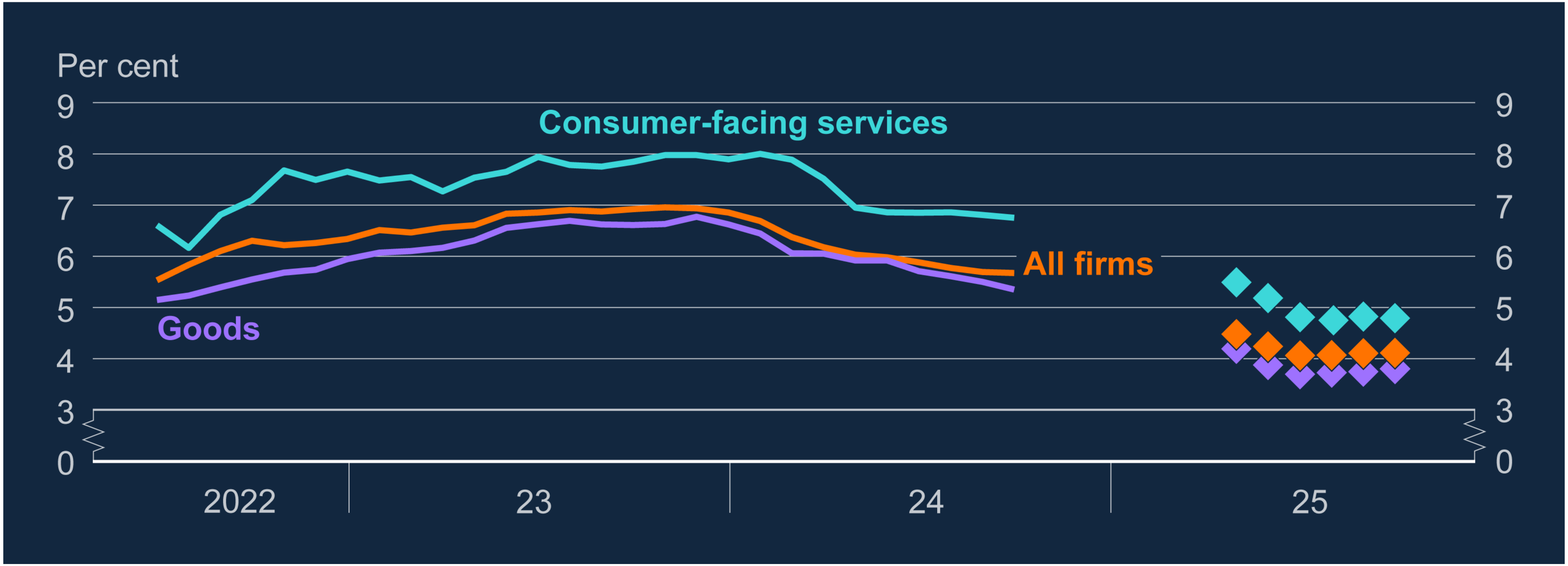
Projections for private sector regular average weekly earnings four-quarter growth[a]



Sources: Bloomberg Finance L.P., Citigroup, ONS, YouGov and Bank calculations.
(a) The shaded range represents a range of projections from three statistical models of nominal private sector regular average weekly earnings growth, including a wage equation based on **Yellen (2017)** as shown in Chart 2.16, a wage equation based on **Haldane (2018)** and a simple error-correction model based on productivity, inflation expectations and slack in the labour market as embodied in the difference between the actual unemployment rate and the Committee's estimate of the medium-term equilibrium rate. The projections are dynamic, multi-step ahead forecasts beginning at a point within the models' estimation periods and are sensitive to data revisions, which can lead to changes in the range over the past as well as over the forecast period.

DMP Survey respondents expect wage growth to decline, but those expectations appear to have stabilised at elevated levels

Realised annual wage growth and 12-month ahead expectations[a]



Sources: DMP Survey and Bank calculations.

(a) The final data point for realised wage growth is October 2024. The diamonds show expectations for wage growth one year ahead.

Monetary policymaking in the face of uncertainty

3 states of the world:

Case 1: As external shocks fade, inflation comes down to target without monetary policy having to do any more heavy lifting

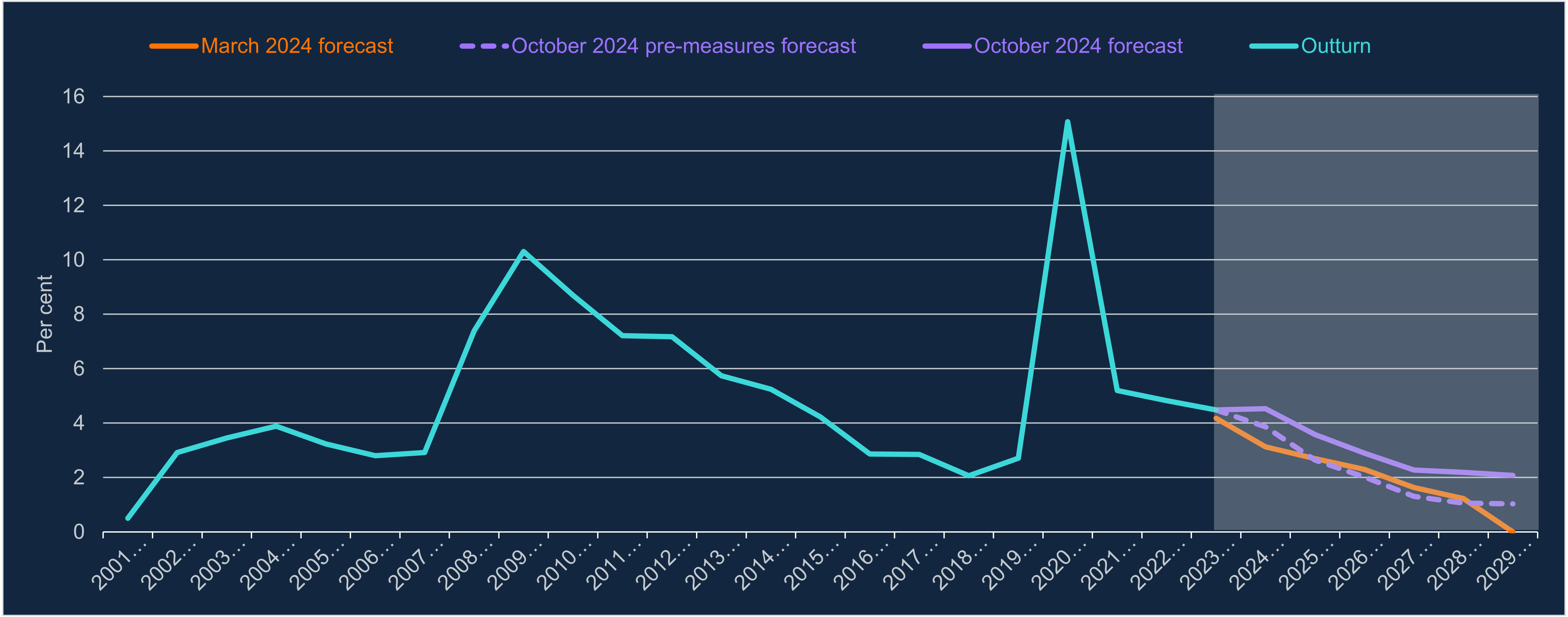
Case 2: Inflation persistence requires monetary policy to weigh on the economy to bring inflation to target over the medium-term

Case 3: Structural shifts in wage and price setting may have caused star variables to shift (r^*, u^* and/or y^*), requiring monetary policy to be restrictive for longer

- Different weights and probabilities, and they aren’t mutually exclusive.
- But these aren’t the only risks, of course

Domestic fiscal policy has uncertain impact on UK labour market

Public sector net borrowing (per cent of GDP)



Source: ONS, OBR

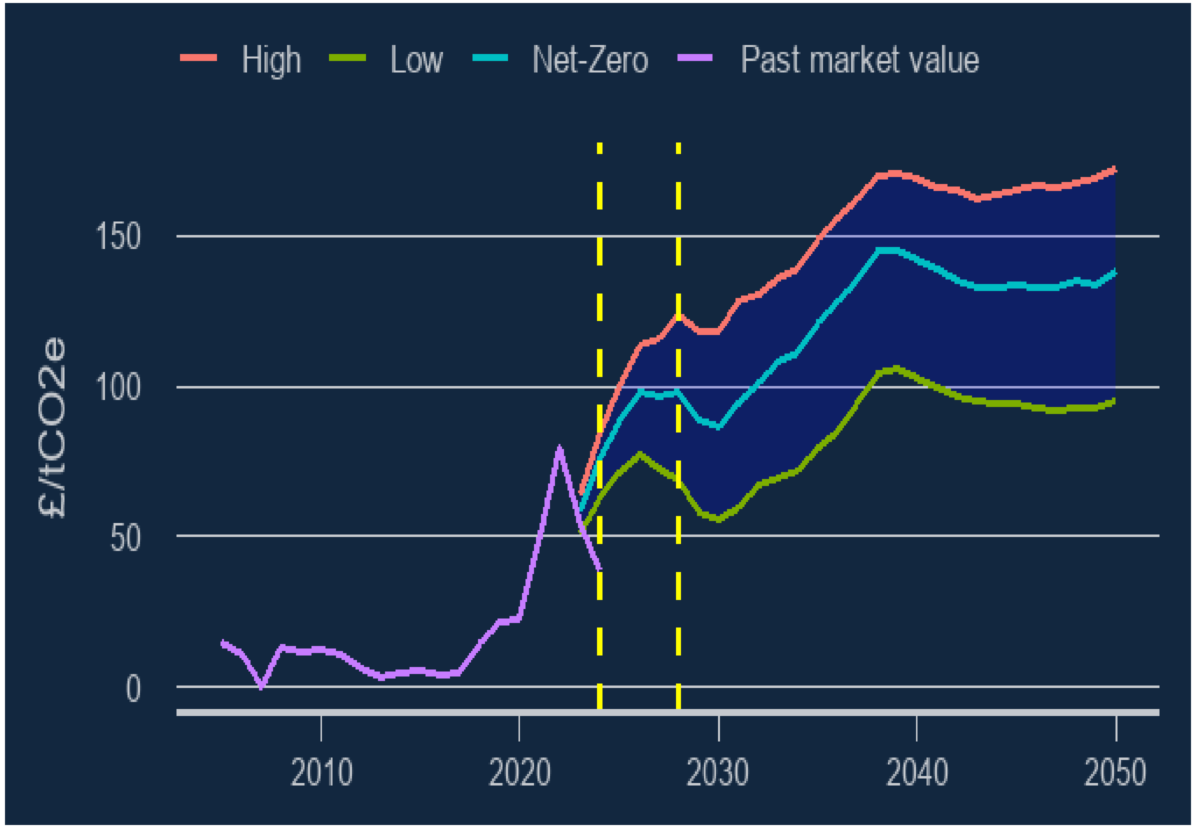
Climate change poses risks to monetary policy – the cost of carbon will rise

Evolution of sectoral coverage and free permits

Period	Power	Industry	Aviation	Maritime	Waste
2005–2007	🟢	🟢	⚫	⚫	⚫
2008–2012	🟡	🟢	⚫	⚫	⚫
2013–2020	🔴	🟡	🟡	⚫	⚫
2021– 2024	🔴	🟡	🟡	⚫	⚫
2025–2027	🔴	🟡	🔴	🔴	🔴
2028–2030	🔴	🔴	🔴	🔴	🔴

Key *[Free at primary auction]:* 🟢 Mostly free permits 🟡 Partially free permits 🔴 No free permits ⚫ Not covered

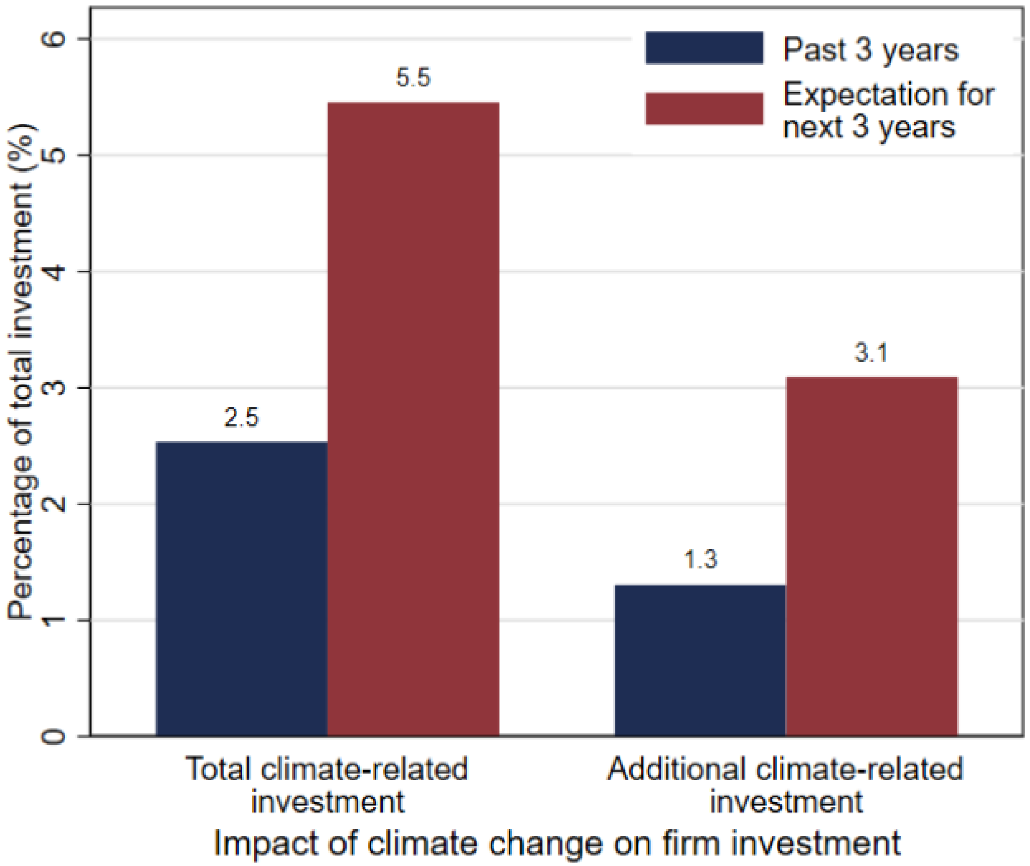
Past and projected carbon prices faced by UK firms



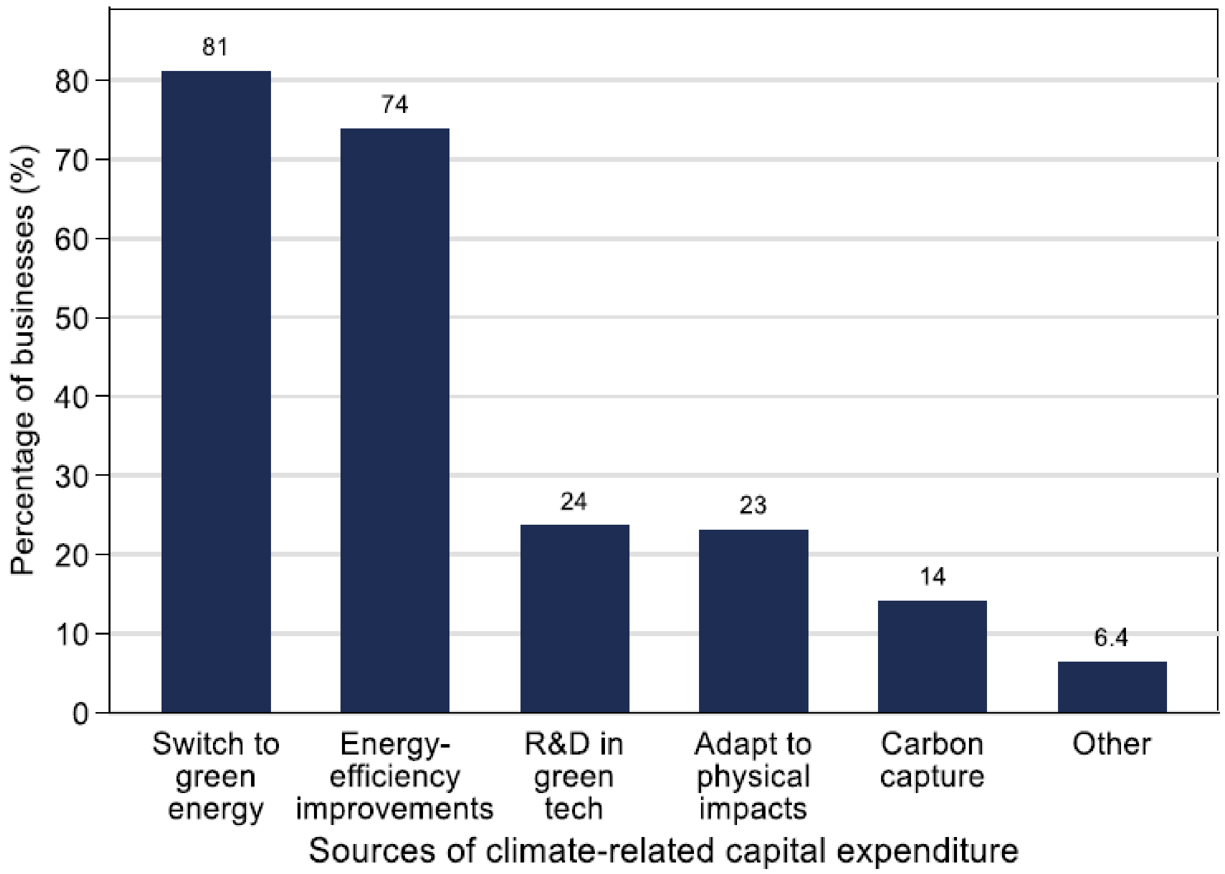
Sources: LHS: ICAP, DESNZ, EU Commission. RHS : Refinitiv and DESNZ (2023) carbon price trajectory.

Climate change poses a risk – Firms are already responding to transition risk

Total additional investment

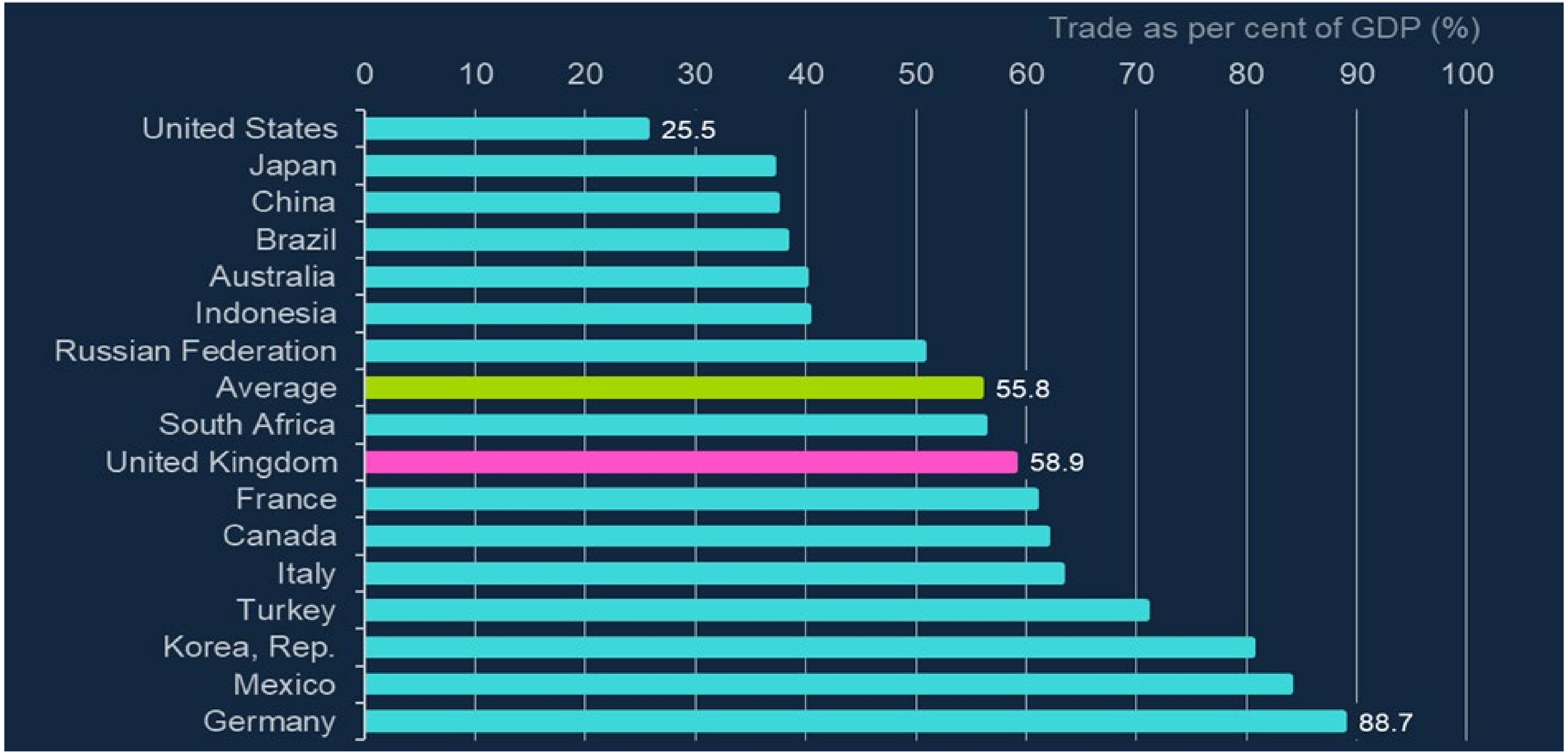


Sources of climate investment



Source: "Firm climate investment: A glass half-full" (SWP 1095, October 2024)

Trade fragmentation raises uncertainty



Source: World Bank.

(a) The latest data points are up to 2021.

Trade fragmentation raises uncertainty

- Trade fragmentation is generally stagflationary.
    - Reorganising supply chains increases the cost of production and leaves them less diversified and more exposed to global shocks.
    - Trade openness raises productivity growth through competition and knowledge spillovers.

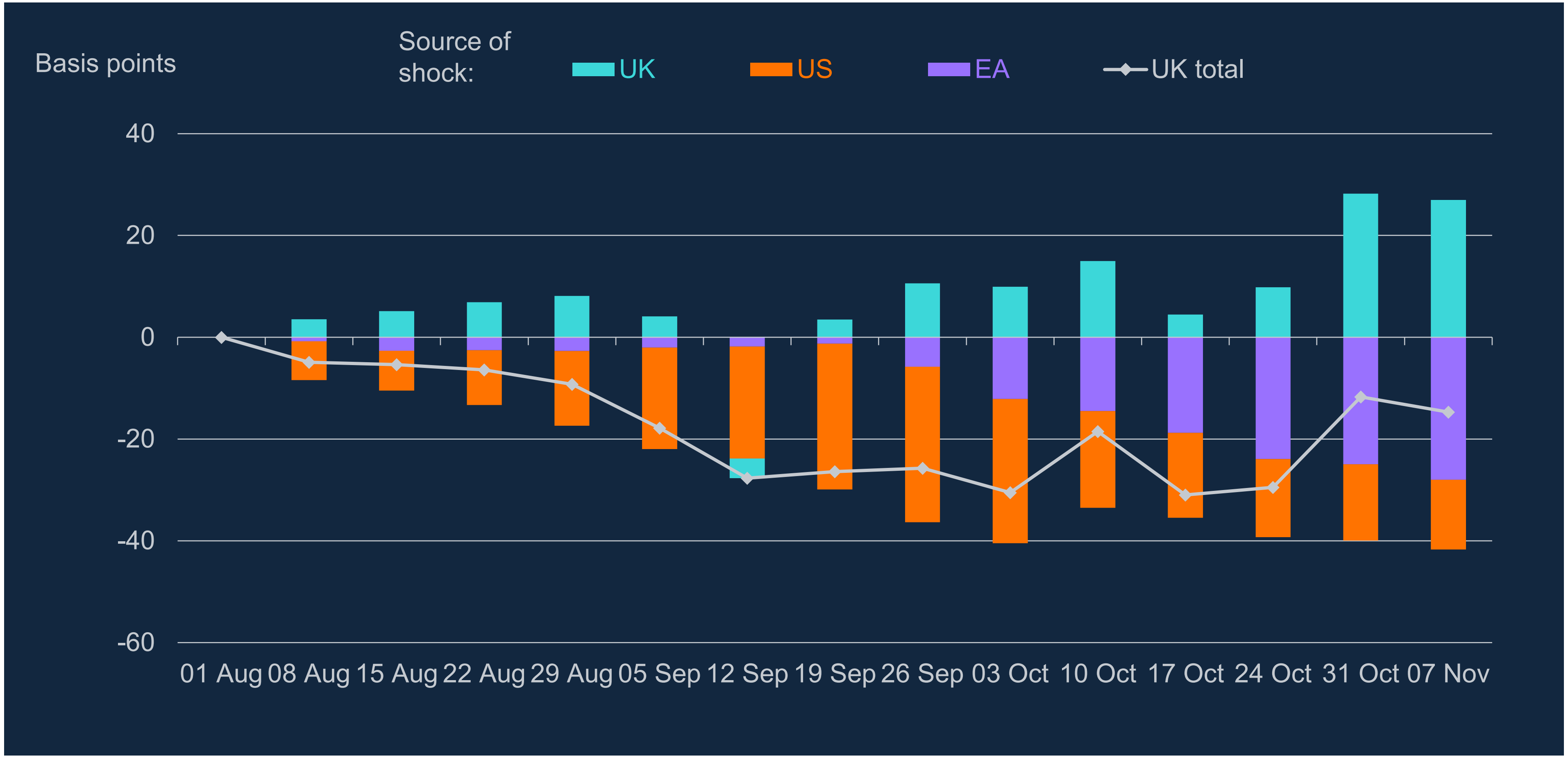
- Impact of US tariffs on UK inflation would depend on what they look like:
    - Cost of UK goods would rise relative to US goods, so would decrease demand for UK goods→disinflationary
    - USD may appreciate, so the UK would be importing inflationary pressures

- As a small open economy, imports and exports account for roughly a third of our GDP.

- The UK has a service-based economy, but 46% of exports in 2023 were goods, and some UK services exports are contingent on goods exports.

Financial spillovers: the UK curve has been shifted significantly by global events

Model based decomposition of UK 1y OIS (change since Aug 2024) (a)



Sources: Bloomberg Finance L.P. and Bank calculations.

(a) Decomposition of UK 1y OIS rate based on a model following Rigobon (2003).