BANK OF ENGLAND

Monetary Policy Committee

Monetary Policy Report

August 2021

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Monetary policy at the Bank of England

The objectives of monetary policy
The Bank's Monetary Policy Committee (MPC) sets monetary policy to keep inflation low and stable, which supports growth and jobs. Subject to maintaining price stability, the MPC is also required to support the Government's economic policy.

The Government has set the MPC a target for the 12-month increase in the Consumer Prices Index of 2%.

The 2% inflation target is symmetric and applies at all times.

The MPC's remit recognises, however, that the actual inflation rate will depart from its target as a result of shocks and disturbances, and that attempts to keep inflation at target in these circumstances may cause undesirable volatility in output. In exceptional circumstances, the appropriate horizon for returning inflation to target can vary. The MPC will communicate how and when it intends to return inflation to the target.

The instruments of monetary policy
The MPC currently uses two main monetary policy tools. First, we set the interest rate that banks and building societies earn on deposits, or 'reserves', placed with the Bank of England – this is Bank Rate. Second, we can buy government and corporate bonds, financed by the issuance of central bank reserves – this is asset purchases or quantitative easing.

The *Monetary Policy Report*
The MPC is committed to clear, transparent communication. The *Monetary Policy Report* (*MPR*) is a key part of that. It allows the MPC to share its thinking and explain the reasons for its decisions.

The *Report* is produced quarterly by Bank staff under the guidance of the members of the MPC.

This *Report* has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

The Monetary Policy Committee

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PowerPoint™ versions of the *Monetary Policy Report* charts and Excel spreadsheets of the data underlying most of them are available at www.bankofengland.co.uk/monetary-policy-report/2021/august-2021

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Contents

Monetary Policy Summary

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 4 August 2021, the Committee judged that the existing stance of monetary policy remained appropriate. The MPC voted unanimously to maintain Bank Rate at 0.1%. The Committee voted unanimously for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted by a majority of 7–1 for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion.

The Committee's updated projections for activity and inflation are set out in the accompanying August *Monetary Policy Report*. They assume that, despite the spread of the Delta variant, the impact of Covid on the UK economy fades further over time. They are also conditioned on the market path for interest rates.

Global GDP growth is estimated to have risen sharply in 2021 Q2, as Covid vaccination programmes gathered pace and restrictions were eased further. Partly reflecting the spread of the Delta variant, global growth in Q3 is expected to expand at a slower pace than anticipated in the May *Report*. Global price pressures have continued to build, reflecting the speed and unevenness of the recovery in activity, and disruptions to supply chains.

UK GDP is expected to have risen by 5% in 2021 Q2, leaving it around 4% below its pre-pandemic level and slightly stronger than expected in the May *Report*. After the MPC's previous meeting, the number of Covid cases continued to rise but has subsequently shown signs of falling back, although there has been a sharp increase in the number of people being asked to self-isolate temporarily. The majority of remaining domestic Covid restrictions have now been lifted. Faster indicators of household spending have been broadly flat, at close to pre-Covid levels, but the housing market has remained strong. GDP is expected to grow by around 3% in Q3, somewhat weaker than expected in the May *Report*, with a small negative impact from recent developments in the pandemic. UK GDP is projected to recover further over the remainder of the year, reaching its pre-pandemic level in 2021 Q4, with demand growth boosted by a waning impact from Covid. Further out, the pace of GDP growth is expected to slow towards more normal rates, partly reflecting the gradual tightening in the stance of announced fiscal policy.

The Labour Force Survey unemployment rate was 4.8% in the three months to May, 1 percentage point higher than at the end of 2019. The inactivity rate was also 1 percentage point above its level at the end of 2019. The number of full and part-time furloughed jobs has continued to decline as demand has recovered, but remained at around 2 million at the end of June. The stock of vacancies has increased further, as have indicators of recruitment difficulties. There appear to have been difficulties in matching available jobs and workers. These frictions are for a period reducing effective supply in the economy. Overall, the MPC judges that spare capacity has been eroded over the past couple of quarters, as demand has outstripped growth in effective supply. Frictions in the labour market are judged likely to dissipate over the forecast period, boosting growth in effective supply capacity. There is uncertainty around these judgements, including how the economy will adjust to the end of the furlough scheme.

Private sector regular pay in the three months to May was over 7% higher than a year earlier, and annual growth is projected to have peaked at around 8½% in 2021 Q2. Adjusted for the impact of the furlough scheme, the changing composition of employment during the pandemic and annual base effects, underlying pay growth appears to continue to be around pre-Covid rates.

Twelve-month CPI inflation rose to 2.5% in June, above the MPC's 2% target and 0.8 percentage points higher than expected in the May *Report*. Core CPI inflation has also risen further, to 2.3%, as building global input cost pressures have been passed through to some consumer goods prices and, to a lesser degree, the reopening of the economy has led to a pickup in some consumer services and goods prices. CPI inflation is projected to rise temporarily in the near term, to 4% in 2021 Q4, owing largely to developments in energy and other goods prices, before falling back to close to the 2% target.

The Committee's central expectation is that current elevated global and domestic cost pressures will prove transitory. Nonetheless, the economy is projected to experience a more pronounced period of above-target inflation in the near term than expected in the May *Report*. And, alongside temporary constraints on supply, the rapid recovery in demand has eroded spare capacity such that the economy is projected to have a margin of excess demand for a period. In the medium term, conditioned on the market path for interest rates, inflation is projected to fall back to close to the 2% target, and demand and supply are expected to return broadly to balance.

The MPC has had policy guidance in place specifying that it does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably. Some members of the Committee judge that, although considerable progress has been made in achieving the conditions of that guidance, the conditions are not yet met fully. The other members judge that the conditions of the guidance have been met fully, but note that the guidance made clear that these have only ever been necessary not sufficient conditions for any future tightening in monetary policy.

All members confirm that in judging the appropriate stance of monetary policy, the Committee will, as always, focus on the medium-term prospects for inflation, including medium-term inflation expectations, rather than factors that are likely to be transient. In particular, the Committee will not put undue weight on capacity pressures that are frictional in nature and likely to be temporary. The Committee will be monitoring closely the incoming evidence regarding developments in the labour market, and particularly unemployment, wider measures of slack and underlying wage pressures. In addition, there remain two-sided risks around the central path for inflation in the medium term. Risk management considerations continue to have some force.

The Committee judges that, should the economy evolve broadly in line with the central projections in the August *Monetary Policy Report*, some modest tightening of monetary policy over the forecast period is likely to be necessary to be consistent with meeting the inflation target sustainably in the medium term.

At this meeting, the Committee judged that the existing stance of monetary policy remained appropriate.

1: The economic outlook

In the Monetary Policy Committee's (MPC's) central forecasts, global GDP continues to rise in the near term, although the outlook varies somewhat across regions. UK GDP is also projected to continue to recover over 2021, with demand growth boosted by waning Covid effects. Further out, the pace of GDP growth slows as that boost wanes and partly reflecting a gradual tightening in the stance of announced fiscal policy. The evolution of the pandemic, and the responses to it, will continue to be an important driver of the economic outlook.

The recent rapid recovery in demand has exceeded the pace of supply growth, which has been temporarily constrained. There is projected to be a period of excess demand in the near term, before demand and supply return broadly to balance as demand growth slows and constraints on supply growth dissipate.

CPI inflation has risen markedly, to above the MPC's target of 2%, and is projected to rise temporarily to 4% in the near term. The rise largely reflects the impact of the pandemic as the economy recovers. This has led to higher energy and goods prices, which in turn reflect rising commodity prices, transportation bottlenecks, constraints on production, and strong global demand for goods. As such, above-target inflation is expected to be transitory, as commodity prices stabilise, supply shortages ease and global demand rebalances. As a result, inflation is expected to fall back, and, conditioned on the market path for interest rates, is projected to return close to the 2% target in the medium term.

Taking together the evidence from financial market measures and surveys of households, businesses and professional forecasters, the Committee judges that UK inflation expectations remain well anchored. There are two-sided risks around the central path for inflation in the medium term.

1.1: Recent developments

Global and UK GDP increased in 2021 Q2, with growth slightly higher than projected in May.
Both UK and global GDP increased in 2021 Q2 as restrictions to control the spread of Covid were loosened in many countries. Bank staff estimate that UK-weighted world GDP rose by 1.3% in 2021 Q2, slightly stronger than projected in the May *Report*, reflecting stronger-than-expected activity in the euro area (Section 2.1). The continuing recovery means that world GDP in Q2 was only around 0.5% lower than its 2019 Q4 level, prior to the pandemic.

In the UK, GDP is expected to have risen by around 5% in 2021 Q2, also higher than projected in May. The recovery was driven by a marked pickup in consumer spending as Covid-related restrictions were eased. In 2021 Q2, the level of UK GDP is expected to have been around 4% lower than in 2019 Q4.

Global and UK GDP are expected to increase further in 2021 Q3, although higher Covid cases linked to the Delta variant weigh on activity a little.
Covid cases have risen in some countries since the May *Report*, linked to the Delta variant. That is expected to weigh on activity a little, for example as some households voluntarily restrict some activities in response. Nonetheless, surveys suggest that global GDP continued to expand, and UK-weighted world GDP is expected to rise by around 1½% in Q3.

UK GDP is expected to increase by around 3% in 2021 Q3. Activity increased markedly during Q2, although high-frequency indicators, such as retail footfall and card spending, have levelled off somewhat more recently (Section 2.2). This may in part reflect Covid-related effects, related to the increase in cases in the UK over the past few months. Those effects are expected to be a little bigger than in the May *Report*, but are still expected to remain less than seen earlier in the pandemic.

Supply capacity increased alongside demand in Q2…
As restrictions on activity eased over Q2, supply recovered sharply, with more businesses opening and the number of furloughed workers falling. Some companies report that their ability to increase production has been somewhat constrained in recent weeks (see Box D). In part, that reflects shortages of some materials and other components, in turn reflecting global supply-side constraints on production. For some firms, it also reflects shortages of staff and required skills. Supply growth is expected to slow somewhat in Q3, in part reflecting a judgement that more people being required to self-isolate will temporarily weigh on labour supply.

…although the MPC judges that spare capacity has been eroded.
The MPC judges that spare capacity has been eroded over the past couple of quarters, although both supply and demand are expected to continue to grow rapidly in the near term. The unemployment rate has declined over the past couple of quarters, to 4.8% in the three months to May, although it remains around 1 percentage point higher than its pre-Covid rate (Section 2.3). In addition, the number of vacancies posted by companies and survey indicators of recruitment difficulties have picked up materially recently. Some increase in recruitment difficulties would be expected as unemployment falls, but the pickup is also judged to be likely to reflect some frictional difficulties in matching available jobs and workers across sectors, geographical areas, or firms. Moreover, while average earnings growth has been materially boosted by both compositional and base effects, underlying wage growth stripping out those effects also appears to have picked up to around pre-Covid rates (Box C). Taken together, the MPC judges that spare capacity is likely to be eliminated in Q3.

Inflation rose by more than expected to 2.5% in June, above the MPC's target…
CPI inflation rose sharply from 0.7% in March to 2.5% in June. Some of this rise reflects base effects as prices are compared against the low levels that prevailed early in the pandemic, as well as subsequent increases in energy prices. But the rise in inflation has been substantially larger than expected in the May *Report*, primarily due to faster-than-expected rises in goods prices, such as cars and clothing and footwear. Strong global demand for goods, supply shortages for some specific products, and increases in shipping costs all appear to have added to price pressures. Services prices also account for some of the news in CPI inflation since May, however, with services inflation having picked up towards pre-pandemic rates (Section 3).

…and is expected to rise temporarily to around 4% in the near term, before falling back to close to the 2% target.
CPI inflation is expected to rise materially further in the near term. Most of that rise reflects further expected increases in the inflation rates of energy and other goods prices. Above-target CPI inflation is expected to be temporary, however, as global demand rebalances and supply shortages ease. As a result, inflation is expected to fall back subsequently to close to the 2% target, but there are two-sided risks around that judgement (Section 1.3).

1.2: The MPC's projections

Table 1.A: Forecast summary(a)(b)

	Projections			
	2021 Q3	2022 Q3	2023 Q3	2024 Q3
GDP(c)	7.7 (8.0)	4.0 (3.4)	1.3 (1.3)	1.3
CPI inflation(d)	2.7 (1.9)	3.3 (2.2)	2.1 (1.9)	1.9
LFS unemployment rate	4.7 (5.4)	4.4 (4.5)	4.2 (4.2)	4.2
Excess supply/Excess demand(e)	0 (-¾)	+½ (+¼)	0 (0)	-¼
Bank Rate(f)	0.1 (0.0)	0.2 (0.1)	0.4 (0.4)	0.5

(a) Modal projections for GDP, CPI inflation, LFS unemployment and excess supply/excess demand. Figures in parentheses show the corresponding projections in the May 2021 *Monetary Policy Report*.
(b) Unless otherwise stated, the projections shown in this section are conditioned on: Bank Rate following a path implied by market yields; the Term Funding Scheme and Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises; the Recommendations of the Financial Policy Committee and the current regulatory plans of the Prudential Regulation Authority; the Office for Budget Responsibility's assessment of the Government's tax and spending plans as set out in *Budget 2021*; commodity prices following market paths for two quarters, then held flat; the sterling exchange rate remaining broadly flat; and the prevailing prices of a broad range of other assets, which embody market expectations of the future stocks of purchased gilts and corporate bonds. The main assumptions are set out in the 'Download the chart slides and data' link at *Monetary Policy Report* – August 2021.
(c) Four-quarter growth in real GDP. The growth rates reported in the table exclude the backcast for GDP. Including the backcast 2021 Q3 growth is 7.7%, 2022 Q3 growth is 4.0%, 2023 Q3 growth is 1.3% and 2024 Q3 growth is 1.3%.
(d) Four-quarter inflation rate.
(e) Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.
(f) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.

The MPC's projections assume that the impact of Covid on the economy continues to fade over time.
The outlook for the economy remains uncertain. It is dependent on the evolution of the pandemic and the measures taken to protect public health. It will also depend on how governments, households, businesses and financial markets respond to those developments.

Many Covid restrictions were lifted across the UK over the past few months, and the MPC's projections are conditioned on an assumption that significant, widespread restrictions on economic activity are not reimposed. As in the May *Report*, some households are expected to restrict some activities in the near term, although that effect is projected to be a little larger than three months ago. The effect fades over the next few quarters. Uncertainty about the outlook remains somewhat heightened due to Covid, and that is expected to wane gradually.

Elsewhere in the world, it is assumed that the spread of the Delta variant weighs on activity in affected regions, with the impact varying according to progress on vaccinations. Economic activity is expected to continue to show lower sensitivity to any given level of restrictions than observed last year, reflecting adjustments made by households and businesses.

Fiscal policy supports demand in the near term.
Fiscal measures are assumed to evolve in line with announced policies. In *Budget 2021* on 3 March 2021, the UK Government announced a further loosening of fiscal policy in 2021/22, adding to the substantial support announced since the beginning of the pandemic (Box C of the May *Report*). Fiscal policy is estimated to continue to support UK demand in the near term, with the policy stance gradually tightening over time in line with government announcements. Fiscal policy measures are also boosting demand in some other countries around the world. The US economy has seen a particularly large fiscal stimulus by international standards.

The market path for interest rates is broadly similar to three months ago; the sterling exchange rate has appreciated a little further since the May Report.
The MPC's projections are conditioned on the market path for interest rates, which rises gradually over the forecast period (**Table 1.A**). The market path is broadly similar to that underlying the forecasts in May, although it implies that a rise in Bank Rate to 0.25% will occur somewhat earlier than was expected three months ago. The sterling exchange rate has appreciated a little further since the May *Report*.

Risky asset prices are at a similar level to May, while household credit conditions have eased.
Equity prices in the UK are at similar levels to May. They increased during June and the first half of July before falling back as concerns about the economic impact of the Delta variant rose. Household credit conditions in the UK have eased somewhat since May, with mortgage rates and spreads falling. Mortgage spreads are expected to narrow a little further over the forecast period. While SME credit conditions tightened in Q2 with the ending of some government lending schemes, conditions for the corporate sector are judged to be little changed overall. Taken as a whole, credit conditions in aggregate have loosened in recent quarters, and are looser than expected in the May *Report*.

Energy prices have risen sharply since May.
Sterling oil prices have increased by around 15% since the run up to the May *Report*, while wholesale gas prices are up around 60%. In its projections, the MPC's conditioning assumption is that oil, gas and electricity prices follow their respective futures curves for the first two quarters of the projection, and beyond that remain flat (as set out in Box 5 of the August 2019 *Report*).

The global outlook

Global GDP continues to rise in the near term as Covid vaccination programmes progress.
UK-weighted world GDP continues to rise robustly in coming quarters as the impact of Covid continues to wane, supported by vaccination programmes. The near-term path for growth varies across regions, however, in part reflecting recent developments in Covid cases and progress in vaccinating people, as well as variations in policy stimulus. The pace of the expansion in UK-weighted world GDP slows over 2022, with growth returning to around pre-Covid rates in the latter years of the forecast period. In the central forecast, UK-weighted world growth is 5% in 2021, 4¼% in 2022 and 2¾% in 2023 (**Table 1.B**).

Global inflationary pressures are forecast to remain strong in the near term, but are expected to be transitory and wane as supply and demand imbalances ease.
Global price pressures have picked up further since May, reflecting rising commodity prices, supply-side constraints and transportation bottlenecks, as well as strong demand for goods. These have started to become apparent in consumer prices in some advanced economies: inflation outturns in the US and the euro area have been stronger than expected in recent months. These developments have also been reflected in world export price inflation, which has picked up sharply. On a UK-weighted basis, world export prices, excluding fuels, are projected to rise by around 6% in 2021 as a whole. The strength in global inflationary pressures is expected to be transitory, however (Key judgement 1). Beyond the very near term, energy and commodity prices are assumed not to continue rising, and these inflationary pressures should therefore dissipate over 2022. Moreover, supply chain disruptions should ease, in part as production increases in response to higher prices. And the imbalance between supply and demand is also expected to ease as consumers rotate some of their spending away from goods and back to services during the continuing recovery from the pandemic. As a result, world export price inflation is projected to fall back subsequently.

UK GDP growth

UK GDP grows by 4% over the first year of the forecast, with the pace of expansion slowing over time.
UK GDP continues to grow materially in the very near term, as the impact of Covid continues to dissipate and activity is supported by government spending (**Chart 1.1**). It is projected to get back to its 2019 Q4 level in 2021 Q4. Subsequently, the pace of expansion eases (Key judgement 2). Four-quarter GDP growth is around 1¼% in the second and third years of the forecast period (**Chart 1.2**). Over the forecast period, consumption is supported by households running down around 10% of the additional savings they have accumulated in aggregate while spending on some activities has been restricted. Business investment rises over the first half of the forecast period as sales recover and uncertainty declines, and is supported by the Government's capital allowance super-deduction.

Excess supply/demand

Supply growth is estimated to have been strong, but somewhat less rapid than demand growth, in part reflecting frictions in the labour market.
Supply growth is estimated to have recovered markedly in Q2 and Q3 as firms have reopened and employees on furlough have returned to work. Supply growth is judged to have not kept pace fully with demand growth, however, given the pace of the recovery in demand and some temporary constraints on supply growth. For example, recent sharp rises in indicators of recruitment difficulties despite unemployment remaining above its pre-Covid rate might suggest that there have been frictions in matching available workers with job vacancies. Those frictions are judged to have contributed to a rise in the medium-term equilibrium rate of unemployment.

The fading effects of Covid continue to boost supply growth somewhat in the very near term, but dissipate over time, and supply growth slows. Supply growth slows by a little less than demand growth, though. In part that reflects the dissipation of temporary constraints on supply growth as the economy normalises, as well as waning support to demand from fiscal policy. Over much of the forecast period, potential supply grows at close to the relatively subdued rates seen before Covid. There are some longer-lasting scarring effects which weigh on the level of supply capacity over the forecast period, such that it is around 1% lower than it would have been in the absence of the pandemic at the forecast horizon.

Chart 1.1: GDP projection based on market interest rate expectations, other policy measures as announced

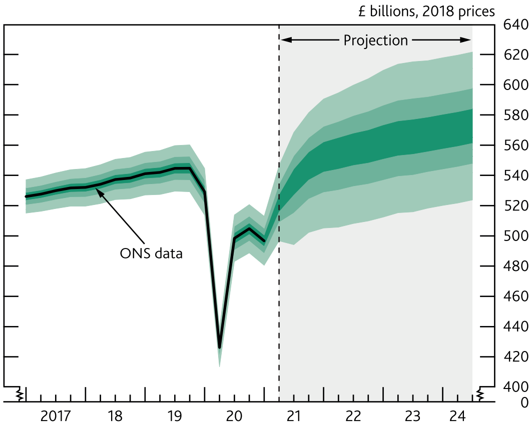
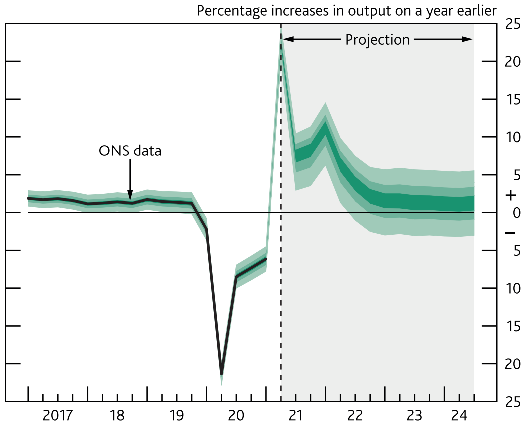


Chart 1.2: GDP growth projection based on market interest rate expectations, other policy measures as announced



The fan charts depict the probability of various outcomes for GDP and GDP growth. They have been conditioned on the assumptions in **Table 1.A** footnote (b). To the left of the vertical dashed line, the distribution reflects uncertainty around revisions to the data over the past. To aid comparability with the official data, it does not include the backcast for expected revisions, which is available from the 'Download the chart slides and data' link at *Monetary Policy Report – August 2021*. To the right of the vertical line, the distribution reflects uncertainty over the evolution of GDP and GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP (in **Chart 1.1**) or GDP growth (in **Chart 1.2**) would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter green areas on 30 occasions. In any particular quarter of the forecast period, GDP or GDP growth is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP or GDP growth can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents.

Excess demand is projected to emerge in the near term, before being eroded as supply grows somewhat more quickly than demand.

In the near term, excess demand is projected to emerge, as the pickup in demand is projected to continue to be a little more rapid than that of supply. Over 2022, however, as supply growth slows by a little less than demand growth, excess demand is eroded. Demand and supply return broadly to balance in the third year of the forecast period, conditioned on the assumptions outlined above.

The continued recovery in demand in the near term is largely met by firms increasing the average hours of their existing staff and the utilisation of their existing capacity. As demand growth slows, pressure on those resources declines. Companies increase their staffing numbers over time, with labour market inactivity falling and unemployment declining gradually back towards pre-pandemic rates over the forecast period (**Chart 1.3**). Over the forecast period, the medium-term equilibrium rate of unemployment is also projected to fall back, consistent with frictions in the labour market reducing over time (Key judgement 3).

CPI inflation

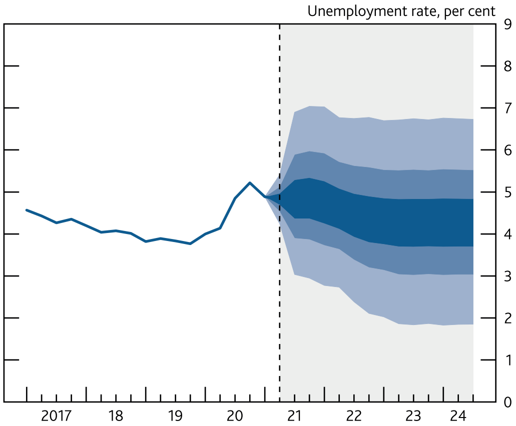
CPI inflation rises temporarily to around 4% in 2021 Q4 and 2022 Q1, driven largely by energy and goods prices.

CPI inflation is projected to rise from around 2½% in 2021 Q3 to around 4% in 2021 Q4 and 2022 Q1 (**Chart 1.4**). Around half of the expected near-term rise in inflation is accounted for by the direct effects of higher energy prices. Goods price inflation is also expected to rise further. Rises in commodity prices, increases in shipping costs and supply shortages have together pushed up goods prices globally, in addition to some upward pressure from the shift in the composition of demand from services towards goods during the pandemic. Those factors have led to increases in world export prices and UK import prices.

Above-target CPI inflation is expected to be temporary and inflation is projected to return to around the 2% target in the medium term.

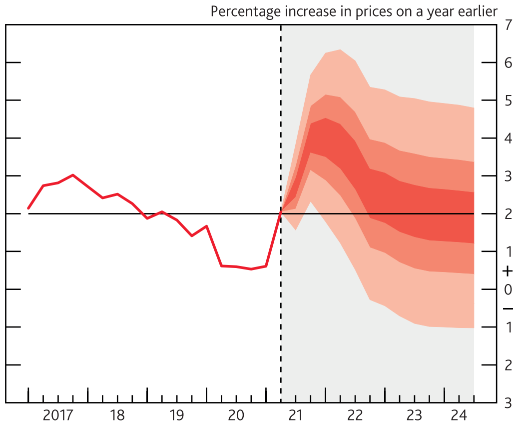
The direct effect of higher energy prices on CPI inflation is likely to be transitory. Unless oil and gas prices go on rising, the effect on inflation will fade after a year or so. Goods price inflation is also expected to decline, reflecting an easing of supply chain disruptions and the normalisation of spending back towards services. Consistent with that, import prices are expected to fall back over time (Key judgement 4). Domestic price pressures are expected to strengthen, reflecting the impact of the narrowing of spare capacity that has occurred over the past few quarters, and the temporary emergence of a margin of excess demand. But the subsequent erosion of excess demand leads to those pressures fading towards the end of the forecast period.

Chart 1.3: Unemployment projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for LFS unemployment. It has been conditioned on the assumptions in **Table 1.A** footnote (b). The coloured bands have the same interpretation as in **Charts 1.1** and **1.2**, and portray 90% of the probability distribution. The calibration of this fan chart takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to unemployment in one quarter will continue to have some effect on unemployment in successive quarters. The fan begins in 2021 Q2, a quarter earlier than for CPI inflation. That is because Q2 is a staff projection for the unemployment rate, based in part on data for April and May. The unemployment rate was 4.8% in the three months to May, and is projected to be 4.8% in Q2 as a whole. A significant proportion of this distribution lies below Bank staff's current estimate of the long-term equilibrium unemployment rate. There is therefore uncertainty about the precise calibration of this fan chart.

Chart 1.4: CPI inflation projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumptions in **Table 1.A** footnote (b). If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

Comparison with the May *Report* projections

The projection for UK GDP is little changed compared to May.

The projections for global and UK GDP are little changed since May (**Table 1.B**), although the level of UK GDP at the end of the forecast period is a bit higher. That in large part reflects a slightly smaller scarring effect from the pandemic, in particular reflecting a judgement that productivity has not been adversely affected by developments in corporate credit conditions during Covid.

The near-term projection for CPI inflation is much stronger than in May, but the medium-term outlook is similar.

CPI inflation is projected to be around 1½ percentage points higher in 2021 Q4 and 2022 Q1 than in the May *Report*. Around a third of this news is accounted for by the direct effects of higher energy prices, reflecting continued pass-through from the recent rises in oil and wholesale gas prices. Other external price pressures also account for some of the upward revision: import prices are expected to be higher than was previously projected over the forecast period, particularly in the near term. CPI inflation in the medium term is projected to be close to the MPC's target, very similar to the May *Report*.

Policy decision

At its meeting ending on 4 August 2021, the MPC judged that the existing stance of monetary policy remained appropriate. The Committee voted to maintain Bank Rate at 0.1%. The Committee voted for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion. The factors behind that decision are set out in the Monetary Policy Summary on pages i–ii of this *Report* and in more detail in the Minutes of the meeting.

1.3: Key judgements and risks

Key judgement 1: global inflationary pressures are strong in the near term – reflecting the continued recovery in world demand, higher commodity prices, and temporary supply bottlenecks – and should subside thereafter.

The outlook for global activity will be affected by how the pandemic evolves.
In the MPC's central forecasts, UK-weighted world GDP continues to rise robustly in coming quarters as the impact of Covid continues to wane, before the pace of expansion slows to around pre-Covid rates. While the recent rises in Covid cases in some countries weigh on activity in affected regions, it is generally assumed that activity is not substantially restrained. In part that reflects fewer significant restrictions on activity being reinstated as vaccination programmes continue, as well as an assumption that activity continues to be less sensitive to the virus, as households and businesses have adapted. There is uncertainty around the evolution of the pandemic and how people respond, however. It is possible that there could be a greater impact from rises in Covid cases on activity. There is also a risk that further new variants of the virus emerge for which there is significantly lower vaccine efficacy. And the outlook is likely to be sensitive to countries' progress on vaccination. Different developments could have material effects on the paths of global and UK activity.

Global inflationary pressures could persist for longer if demand for goods remains robust...
The recovery in world demand so far has been more highly concentrated in goods than in services.(1) For example, across the OECD as a whole, consumption of services in 2021 Q1 was still well below pre-pandemic levels, but spending on goods was significantly higher. That has contributed to upward pressure on the global prices of retail goods. As the impact of the pandemic on the economy recedes, the MPC expects some rotation of spending away from goods and back towards services. There is some evidence that this is beginning to happen – for example, consumption of durable goods in the US appears to have levelled off recently, and in the UK, high-frequency indicators suggest that spending on consumer-facing services has picked up faster than that on goods since the economy reopened over the past few months. There are risks around that assumption, however. Some changes to the mix of demand might not unwind,(2) and, if there are persistent frictions in reallocating resources in the economy away from some service-producing sectors to those that produce goods, these upward price pressures might last for longer than projected.

...but could ease by more than projected if production increases substantially.
Global price pressures have also reflected the impact of rising commodity prices, transportation bottlenecks and some supply-side constraints on goods production. In the MPC's central forecast, commodity prices are generally assumed to be broadly flat over the forecast period, so that, by the second half of the projection, they stop exerting material pressure on inflation. There are risks around those assumptions on both sides. At present, though, futures curves for many commodities are downward-sloping. Futures prices for shipping costs suggest that they will decline from around the end of this year too. The MPC's forecast is also consistent with supply-side constraints on goods production easing. That reflects a judgement that supply in some of these goods markets is likely to increase as higher prices encourage higher production over time. There is evidence of this occurring already for some products, such as lumber and semiconductors. That process could prove more rapid than expected, or lead to prices falling by more than expected, which would pose a downside risk to the MPC's projections.

Overall, the MPC's forecasts are consistent with upward pressure on world goods and export price inflation continuing in the near term, but unwinding over time. There are judged to be two-sided risks to those profiles.

(1) See 'Mismatch', Broadbent (2021) and 'The inflation outlook', Saunders (2021).
(2) See Section 3 of November 2020 *Report*.

Key judgement 2: UK activity continues to recover in the near term, as the impact of Covid continues to wane and policy stimulus supports demand, with the pace of expansion slowing as those effects dissipate.

While the impact of Covid on activity is projected to continue to wane, the MPC's central case forecasts include a judgement that Covid effects weigh on UK activity a little in the near term.
As in the rest of the world, the outlook for the UK will be sensitive to developments related to Covid. While GDP is projected to continue to recover as the impact of Covid continues to wane, the MPC's central case forecasts include a judgement that Covid effects weigh on UK activity by a little more, and for a little longer, than expected in May in the near term. That judgement is consistent with a greater impact on activity from people self-isolating – which would weigh on labour supply as well as consumption – and people voluntarily restricting social activities, to allay health concerns and perhaps reduce the risk of self-isolating. More broadly, some effects of Covid on demand – including via its impact on uncertainty about the outlook – take some time to wane. There is an upside risk to activity arising from a more rapid reduction of those effects. However, on the downside, there could be a greater impact from Covid on activity, especially if any further new variants of the virus emerge for which there is significantly lower vaccine efficacy. In the near term, the risks to UK GDP are judged to be skewed to the downside of the central forecast.

Throughout the forecast period, spending is supported by households running down some of their accumulated savings and there is uncertainty about the degree to which that happens.
The path of consumer spending over the forecast period will depend on the extent to which households adjust their savings behaviour. Since the beginning of the pandemic, the saving ratio has been elevated compared with before the pandemic, as consumption fell by much more than household incomes while spending on some activities was restricted. As a result, households in aggregate have accumulated a substantial amount of savings. The household saving ratio is expected to have declined markedly as restrictions on spending eased, and is projected to continue to fall during the first year of the forecast. And over the forecast period, households in aggregate are assumed to spend around 10% of their additional accumulated savings. That is broadly consistent with the latest Bank/NMG survey evidence. That survey also suggests that households' expectations about their own finances and the general economy have continued to improve; if that continues, some households might increase their spending by more than projected, posing an upside risk to the MPC's forecast for demand. But there remains a significant minority of individuals who do not expect their spending to recover to pre-pandemic levels for some time. So it is possible that fears about the virus could continue to drag on spending for longer than expected in the MPC's central projections.

Key judgement 3: the economy's supply capacity continues to recover in the near term as the impact of Covid wanes; in the medium term, supply growth returns to around longer-term trend rates.

There are two-sided risks around the MPC's projection for supply growth.
In the MPC's central projections, potential supply continues to recover in the near term as the impact of Covid wanes. As the boost from the waning impact of Covid dissipates, the pace of supply growth slows, to around the subdued rates seen in the few years before Covid. There are two-sided risks around the outlook for supply growth.

Labour supply growth could be constrained by persistent frictions in matching workers and jobs...
The MPC's central projection includes a judgement that some frictions in the hiring of workers have contributed to a rise in the medium-term equilibrium rate of unemployment during the pandemic. That effect is expected to dissipate over the forecast period. The size and pace of changes in activity resulting from the pandemic might have been expected to result in some increase in labour market frictions, as companies have to adjust their production and staff rapidly. As the economy normalises, those frictions would be expected to fade. Indeed, measures of the mismatch between job postings and available workers across industries – which were previously elevated – have already begun to decline. But there is a risk that labour market mismatch has been more substantial in other dimensions, for example across geographical areas or firms, and could persist for longer. Contacts of the Bank's Agents report that recruitment difficulties have continued to intensify over the past few months, across a broadening set of companies. As a result, it is possible that labour market frictions could be bigger than projected, and persist for longer, slowing the pace of decline of unemployment relative to the MPC's central forecast and reducing the economy's supply capacity.

…and there are risks around the projection for labour market participation.
During the pandemic, the proportion of people not participating in the labour market by either working or actively looking for a job has increased. Over the forecast period, the MPC expects that proportion to decrease, for example as the easing in restrictions enables more people to search for a job. It is not unusual for the proportion of those that are not active in the labour market to rise in downturns and subsequently fall back. There are risks around this judgement, though. On the one hand, more young people now report that they are inactive in the labour market due to study, compared with 2019 Q4, and some of those could stay in education for some time, leaving labour market inactivity higher. Moreover, inactivity in the labour market has increased among older age groups, which could prove persistent if some workers have chosen to take early retirement, for example. On the other hand, there has been a fall in the number of women reporting that they are inactive in the labour market for reasons of looking after the family or home. That may be linked to an increasing ease of working from home, which could prove to be long lasting, increasing labour market participation.

There is also uncertainty around the projection for productivity growth.
In the MPC's central forecast, weak investment growth during the pandemic weighs on innovation, and so on productivity growth. However, some of the weakness in investment growth reflects lower investment in buildings and structures, with investment in intangibles, such as research and development, holding up better, which might provide more support to future productivity growth.[3] In addition, the Covid crisis may have encouraged greater investment in digital technologies to support new business models and practices. For example, respondents to the DMP Survey suggest that Covid is likely to boost expenditure on IT in the medium term. That could support investment spending, and pose an upside risk to the MPC's projection for productivity growth. On the downside, however, there could be frictions in reallocating capital across sectors, if the pandemic leads to material, persistent changes in the structure of the economy, and that could weigh on the growth of productivity.

Key judgement 4: inflation rises further above the target in the near term, largely reflecting the impact of transitory factors; in the medium term, supply and demand are broadly in balance and inflation is around the target.

There are risks around the projection for UK import price inflation…
As discussed in Key judgement 1, the MPC's forecasts are consistent with upward pressure on world goods and export price inflation continuing in the near term, but unwinding over time, as global demand rotates back towards services and away from goods, commodity prices stabilise and supply bottlenecks ease. Reflecting those developments, UK import prices are expected to rise somewhat further in Q3, before declining. UK import prices have risen by more than might have been expected given developments in world export prices and the sterling exchange rate over the past few years. The MPC has made a judgement to unwind some of that strength in import prices, but somewhat more slowly than it might normally. As a result, the decline in UK import prices is relatively gradual. There are two-sided risks around that judgement, which pose upside and downside risks to the projection for CPI inflation.

…and around the expectation that the near-term emergence of excess demand will be temporary.
Domestic price pressures are currently judged to be limited, as the pandemic led to a degree of spare capacity in the economy. Those pressures are expected to strengthen over time, given the recent narrowing of spare capacity, and the projected emergence of a margin of excess demand leads to a degree of upward pressure on CPI inflation in the second year of the forecast period. But that upward pressure is expected to be temporary, as excess demand is eroded over time. As discussed in Key judgement 3, there are some risks around the projection for supply growth, and some of those might affect the expected path for the degree of excess demand in the economy. For example, if there were more persistent frictions in the labour market, or the rise in those not active in the labour proved to be longer-lasting than is expected, the degree of spare capacity in the labour market might be reduced. That would exert a greater degree of upward pressure on wage growth and CPI inflation than is in the MPC's central projections. Alternatively, some bottlenecks to production could ease more quickly than projected, if they largely reflect the impact of demand increasing rapidly as the economy reopened. If that is the case, such inflationary pressures might moderate to a greater extent over coming months than currently projected.

(3) See 'Will the pandemic "scar" the economy?', Haskel (2021).

Inflation expectations are judged to remain well anchored and the MPC will continue to monitor indicators closely.

Inflation expectations are a key determinant of inflation: when people believe that inflation will be at the target in the medium term, they are likely to set wages and prices in a way that is consistent with those beliefs. Short-term inflation expectations generally move up and down fairly frequently as shocks hit the economy, and some near-term measures tend to be correlated with inflation outturns. At the moment, indicators of near-term inflation expectations vary across households, businesses, professional forecasters and financial markets. But most are not elevated, although they might rise over the coming months, reflecting the impact of the cost shocks affecting the near-term outlook for inflation. Medium-term expectations should remain more stable, as the MPC is expected to adjust monetary policy to achieve the inflation target. At present, taking all the measures together, inflation expectations appear to be well anchored and there is little evidence to suggest that higher expectations will add to the persistence of the near-term overshoot in inflation. The MPC will continue to monitor these indicators closely.

Overall, the risks to the MPC's inflation projection are judged to be broadly balanced.

1.4: Constant rates

In the MPC's projections conditioned on the alternative assumption of constant interest rates at 0.1%,[4] activity is projected to be slightly stronger, unemployment to be somewhat lower by the end of the projection and CPI inflation to be a little higher.

(4) The assumption is that Bank Rate remains at 0.1% throughout the three years of the forecast period, before moving towards the market path over the subsequent three years..

Table 1.B: Indicative projections consistent with the MPC's forecast(a)(b)

	Averages			Projections		
	1998–2007	2010–19	2020	2021	2022	2023
World GDP (UK-weighted)(c)	**3**	**2¼**	**-4¼**	**5 (5)**	**4¼ (4½)**	**2¾ (2½)**
World GDP (PPP-weighted)(d)	4	3¾	-3¼	6 (6¼)	4¾ (4¾)	4 (3½)
Euro-area GDP(e)	2¼	1½	-6½	4½ (3¾)	5 (5½)	2¼ (2¼)
US GDP(f)	3	2¼	-3½	6½ (6¾)	5 (4¼)	2¼ (1¾)
Emerging market GDP (PPP-weighted)(g)	5¾	5	-2¼	6¾ (7)	5 (5¼)	5½ (4¾)
of which, China GDP(h)	*10*	*7¾*	*2½*	*8½ (9¼)*	*5½ (5½)*	*5½ (5¼)*
UK GDP(i)	**3**	**1¾**	**-9¾**	**7¼ (7¼)**	**6 (5¾)**	**1½ (1¼)**
Household consumption(j)	3¼	1¾	-11	5½ (5¼)	9¼ (9¼)	1½ (1¾)
Business investment(k)	2¾	3¾	-10¾	3 (7)	18¾ (13½)	¾ (1¼)
Housing investment(l)	3¼	3¾	-12½	13¼ (13½)	6¼ (4¾)	3¼ (3¼)
Exports(m)	4¼	3¼	-16½	2 (1)	4¾ (4½)	5 (4½)
Imports(n)	5¾	3½	-17¾	4¾ (8½)	13¾ (10)	4 (4)
Contribution of net trade to GDP(o)	-¼	-¼	¾	-¾ (-2¼)	-2½ (-1¾)	0 (0)
Real post-tax labour income(p)	3¼	1¼	1	0 (-¾)	-¾ (1½)	½ (¾)
Household saving ratio(q)	8	8½	15¾	12¾ (12)	5½ (6)	5½ (6)
Credit spreads(r)	¾	2½	2	1¾ (2¼)	1¾ (2)	1¾ (2)
Excess supply/Excess demand(s)	**0**	**-1¾**	**-2**	**-½ (-¾)**	**+½ (+¼)**	**+¼ (+¼)**
Hourly labour productivity(t)	2¼	½	1	¾ (¼)	½ (½)	1 (¾)
Employment(u)	1	1¼	-2½	1½ (1¼)	1¼ (1¼)	½ (¾)
Average weekly hours worked(v)	32¼	32	30¼	32 (32¼)	32 (32)	32 (32)
Unemployment rate(w)	5¼	6	5¼	4¾ (5)	4¼ (4½)	4¼ (4¼)
Participation rate(x)	63	63½	63½	63¾ (64)	64 (64)	64 (64)
CPI inflation(y)	**1½**	**2¼**	**½**	**4 (2½)**	**2½ (2)**	**2 (2)**
UK import prices(z)	0	1½	2¾	¾ (-1½)	-1 (0)	-¼ (¼)
Energy prices – direct contribution to CPI inflation(aa)	¼	¼	-½	1¼ (¾)	¼ (0)	0 (0)
Average weekly earnings(ab)	4¼	2¼	4¾	2¼ (-½)	1¾ (2¾)	2¾ (2¾)
Unit labour costs(ac)	3	1½	11¾	-5¾ (-8)	¾ (2¼)	2 (2¼)
Private sector regular pay based unit wage costs(ad)	1¾	1¾	9¼	-4¾ (-4½)	1½ (1)	3 (3)

Sources: Bank of England, Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, Eurostat, IMF *World Economic Outlook* (*WEO*), National Bureau of Statistics of China, ONS, US Bureau of Economic Analysis and Bank calculations.

(a) The profiles in this table should be viewed as broadly consistent with the MPC's projections for GDP, CPI inflation and unemployment (as presented in the fan charts).
(b) Figures show annual average growth rates unless otherwise stated. Figures in parentheses show the corresponding projections in the May 2021 *Monetary Policy Report*. Calculations for back data based on ONS data are shown using ONS series identifiers.
(c) Chained-volume measure. Constructed using real GDP growth rates of 188 countries weighted according to their shares in UK exports.
(d) Chained-volume measure. Constructed using real GDP growth rates of 189 countries weighted according to their shares in world GDP using the IMF's purchasing power parity (PPP) weights.
(e) Chained-volume measure. Forecast was finalised before the release of the preliminary flash estimate of euro-area GDP for Q2, so that has not been incorporated.
(f) Chained-volume measure. Forecast was finalised before the release of the advance estimate of US GDP for Q2, so that has not been incorporated.
(g) Chained-volume measure. Constructed using real GDP growth rates of 155 emerging market economy countries, as defined by the IMF *WEO*, weighted according to their relative shares in world GDP using the IMF's PPP weights.
(h) Chained-volume measure.
(i) Excludes the backcast for GDP.
(j) Chained-volume measure. Includes non-profit institutions serving households. Based on ABJR+HAYO.
(k) Chained-volume measure. Based on GAN8.
(l) Chained-volume measure. Whole-economy measure. Includes new dwellings, improvements and spending on services associated with the sale and purchase of property. Based on DFEG+L635+L637.
(m) Chained-volume measure. The historical data exclude the impact of missing trader intra-community (MTIC) fraud. Since 1998 based on IKBK-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBK.
(n) Chained-volume measure. The historical data exclude the impact of MTIC fraud. Since 1998 based on IKBL-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBL.
(o) Chained-volume measure. Exports less imports. GDP data based on the mode of the MPC's GDP backcast.
(p) Wages and salaries plus mixed income and general government benefits less income taxes and employees' National Insurance contributions, deflated by the consumer expenditure deflator. Based on [ROYJ+ROYH-(RPHS+AIIV-CUCT)+GZVX]/[(ABJQ+HAYE)/(ABJR+HAYO)].
(q) Annual average. Percentage of total available household resources. Based on NRJS.
(r) Level in Q4. Percentage point spread over reference rates. Based on a weighted average of household and corporate loan and deposit spreads over appropriate risk-free rates. Indexed to equal zero in 2007 Q3.
(s) Annual average. Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.
(t) GDP per hour worked. GDP data based on the mode of the MPC's GDP backcast. Hours worked based on YBUS.
(u) Four-quarter growth in LFS employment in Q4. Based on MGRZ.
(v) Level in Q4. Average weekly hours worked, in main job and second job. Based on YBUS/MGRZ.
(w) LFS unemployment rate in Q4. Based on MGSX.
(x) Level in Q4. Percentage of the 16+ population. Based on MGWG.
(y) Four-quarter inflation rate in Q4.
(z) Four-quarter inflation rate in Q4 excluding fuel and the impact of MTIC fraud.
(aa) Contribution of fuels and lubricants and gas and electricity prices to four-quarter CPI inflation in Q4.
(ab) Four-quarter growth in whole-economy total pay in Q4. Growth rate since 2001 based on KAB9. Prior to 2001, growth rates are based on historical estimates of AWE, with ONS series identifier MD9M.
(ac) Four-quarter growth in unit labour costs in Q4. Whole-economy total labour costs divided by GDP at constant prices, based on the mode of the MPC's GDP backcast. Total labour costs comprise compensation of employees and the labour share multiplied by mixed income.
(ad) Four-quarter growth in private sector regular pay based unit wage costs in Q4. Private sector wage costs divided by private sector output at constant prices, based on the mode of the MPC's GDP backcast. Private sector wage costs are average weekly earnings (excluding bonuses) multiplied by private sector employment.

Box A: The MPC's strategy for the mix of monetary policy instruments to deliver tighter policy

Introduction

Since the financial crisis, many central banks have set their policy rates at low levels and used asset purchase programmes to support economic activity and meet their inflation targets.

Since the financial crisis, central banks around the world have used a variety of monetary policy tools, including short-term policy rates and asset purchases, to support economic activity and meet their inflation targets. Those policy actions have been necessary responses to a persistent decline in the 'equilibrium interest rate' – the interest rate at which monetary policy is neither expansionary nor contractionary. Part of the reduction in the equilibrium interest rate can be explained by structural factors such as an ageing global population and declining trend productivity growth (see Box 6 of the August 2018 *Inflation Report*). As well as those forces, a range of cyclical, but persistent, headwinds – including those resulting from the impact of Covid – have required monetary policy stimulus to ensure that inflation is close to target sustainably.

In the UK, the Bank of England's policy rate, Bank Rate, has been 0.1% since March 2020 and the MPC has provided further stimulus to the economy by purchasing assets, which also serves to lower the interest rates facing households and businesses. The target stock for asset purchases currently stands at £895 billion.

At some point, the stance of UK monetary policy may need to tighten to achieve the 2% inflation target. The MPC has a number of tools to do that.

As always, the MPC will set monetary policy to meet its remit to achieve the 2% inflation target and, subject to that, to support growth and jobs. At some point, monetary policy may need to tighten so that the MPC can meet its remit. In principle, that tightening in monetary policy could be achieved by increases in Bank Rate, by a reduction in the stock of purchased assets, or some combination of the two.

This box sets out the factors influencing the MPC's strategy for the mix of its monetary policy tools and its intended approach to using the instruments in its toolkit to deliver any tightening in the overall stance of policy, should that be required.

The factors influencing the MPC's strategy for the sequencing of monetary policy tools to deliver tighter policy

The Committee's preference is to use Bank Rate as its active instrument in most circumstances.

The MPC has greater certainty around how changes in Bank Rate affect the economy compared with its other policy tools. Changes in Bank Rate can also be operationally easier and quicker to implement. As a result, the Committee has a preference to use Bank Rate as its active policy tool when adjusting the stance of monetary policy in most circumstances. There is therefore a benefit to maintaining the stock of purchased assets until Bank Rate has reached a level from which significant reductions could be made if, subsequently, policy needed to be loosened. That level depends on a range of factors that are likely to vary over time. Those include the likely size of the shocks to which the economy is exposed, the probable impact of policy changes, and the MPC's judgement about the 'effective lower bound' (ELB) for Bank Rate (the ELB is the point at which further cuts in the policy rate no longer provide stimulus or even have adverse effects). Starting to reduce the stock of purchased assets at a higher level of Bank Rate would lower the probability that any such process has to be amended or reversed to provide monetary stimulus in response to a negative economic shock.

There is uncertainty about the impact of reducing the stock of purchased assets on monetary conditions, but the MPC judges that, when conducted in a gradual and predictable manner and when markets are functioning normally, it is likely to be smaller than that of asset purchases.

The judgement about when and how it is appropriate to begin the reduction of the stock of purchased assets is also affected by its expected impact. It is likely that the MPC will judge it appropriate to begin to reduce the stock of purchased assets at a time when markets are functioning normally. And it intends that any reduction in the stock of purchased assets would happen in a gradual and predictable manner, so as to prevent disruption to the functioning of financial markets. Overall, although there is inevitably a degree of uncertainty surrounding these judgements, the

MPC believes that the impact on monetary conditions of a reduction in the stock of purchased assets in such a manner is likely to be smaller than that of asset purchases on average over the past. That is for two reasons.[1]

First, increasing the target stock of purchased assets may have provided a signal about the MPC's aim to loosen the overall stance of policy in the past, depressing the expected path of Bank Rate. In contrast, the MPC would not intend to use its decisions about the process of reducing the stock of purchased assets to signal a need for a higher path for Bank Rate.

Second, asset purchases have, at times, been made during periods of market stress, when their effects tend to be more powerful.

The MPC judges that there are benefits to reducing the stock of purchased assets by initially ceasing to reinvest maturing assets.

The MPC judges that there are advantages to reducing the stock of purchased assets initially by stopping the reinvestment of maturing assets that the Bank's Asset Purchase Facility already holds. This would have the benefit of providing a predictable and gradual path for the reduction in the stock. It would also be operationally straightforward. For illustration, over 2022 and 2023, just over £70 billion of government bonds held by the Asset Purchase Facility will mature, and over 2024 and 2025, around a further £130 billion will mature. At some point, the MPC could actively sell assets it has previously bought. Any such active asset sales would also be conducted in a predictable manner over a period of time, with the pace dependent on conditions at the time.

The MPC's current approach to the sequencing of monetary policy tools

Weighing the above factors together, the MPC intends to begin to reduce the stock of purchased assets, by ceasing to reinvest maturing assets, when Bank Rate has risen to 0.5% and if appropriate given the economic circumstances.

Taking the above factors together, the MPC intends to begin to reduce the stock of purchased assets when Bank Rate has reached 0.5%, if appropriate given the economic circumstances. The MPC judges that the reduction in the stock of purchased assets should initially occur through ceasing the reinvestment of maturing assets, to allow the reduction to occur at a gradual and predictable pace.

That level of Bank Rate is lower than was previously assessed…

That level of Bank Rate is lower than the MPC's previous assessment of the threshold for reducing the stock of purchased assets: in June 2018, the MPC had stated that it intended not to reduce the stock of purchased assets until Bank Rate reached around 1.5%.[2]

…in part reflecting the MPC's judgement that setting a negative Bank Rate is now part of its monetary policy toolkit…

Previously, the MPC had judged that the ELB for Bank Rate was close to, but a little above, zero. In February 2021, the MPC decided to add a negative Bank Rate to the monetary policy toolkit.[3] At its August 2021 meeting, the MPC had been briefed that technical preparations internally and by PRA-regulated firms had progressed sufficiently that a negative Bank Rate could be implemented by the system as a whole, with or without tiered reserve account remuneration, if warranted.

…as well as its view that the impact on monetary conditions of reducing the stock of purchased assets is likely to be smaller than that of asset purchases on average over the past.

An additional motivation for starting the reduction in the stock of purchased assets at a lower level of Bank Rate than previously announced is the MPC's judgement that the impact on monetary conditions of a reduction in the stock of purchased assets, when conducted in a gradual and predictable manner and when markets are functioning normally, is likely to be smaller than that of asset purchases on average over the past.

(1) See 'The central bank balance sheet as a policy tool: past, present and future', Bailey *et al* (2020) for an overview of the evidence on the role for state dependence in determining the impact of asset purchases. Haldane *et al* (2016) suggests that the economic impact of asset purchases was larger during periods of elevated market stress. And Vayanos and Vila (2009) recognise state dependence in their theoretical model, where portfolio balance effects vary with agents' risk aversion.
(2) As set out in the *Minutes* of the MPC's June 2018 meeting.
(3) See Box 1 of the August 2020 *Report* for more discussion of negative policy rates.

The MPC will consider actively selling some of the stock of purchased assets only once Bank Rate has risen to at least 1%.

Reflecting its judgement that there are advantages to reducing the stock of purchased assets initially by ceasing reinvestments, the MPC envisages considering beginning the process of actively selling assets only once Bank Rate has risen to at least 1%, and depending on economic circumstances at the time. Any asset sales would be conducted in a predictable manner over a period of time so as not to disrupt the functioning of financial markets.

The MPC will monitor the impact of the reduction in the stock of purchased assets, and may amend or reverse the process if needed to meet its 2% inflation target…

The MPC will monitor the impact of the reduction in the stock of purchased assets once the process has begun, and has the flexibility to amend the parameters of the process in order to meet its remit. Decisions on Bank Rate will be based on the economic circumstances at the time, and will take into account the impact of the intended profile for the stock of purchased assets on overall monetary conditions. If potential movements in Bank Rate are judged insufficient to achieve the inflation target, or if prevailing conditions are ones in which asset purchases might be particularly effective – for example if there is market dysfunction – the reduction in the stock of purchased assets can be amended or reversed.

…and it intends to review the unwind process no later than two years after it has begun.

While the MPC will monitor the reduction in the stock of purchased assets on a continual basis, it also intends to review its parameters no later than two years after the process begins. This will enable the MPC to take stock of progress on the reduction in the balance sheet and the impact of the process on monetary conditions.

When Bank Rate has risen to 0.5%, and if appropriate given the economic circumstances, the MPC intends to reduce the stock of purchased assets by initially ceasing the reinvestment of UK government bonds.

The MPC's current target stock for purchased assets of £895 billion consists of a target stock of £875 billion of UK government bonds and £20 billion of sterling non-financial investment-grade corporate bonds. When Bank Rate has reached 0.5%, and if appropriate given the economic circumstances, the MPC intends to reduce the stock of purchased assets by initially ceasing the reinvestment of UK government bonds. The MPC will take a separate decision on the corporate bond portfolio in due course.

In steady state, the Bank's balance sheet is likely to be materially larger than it was before the financial crisis.

Over time, the Bank will also assess the level of reserves in the monetary system against the level demanded by market participants, and how future reserves demand would be met. The Bank's balance sheet is currently significantly larger than it was prior to Covid.(4) It is likely to be some way in excess of the level of reserves demanded by participants in the Sterling Monetary Framework at the prevailing level of Bank Rate. But at some point, a reduction in the stock of purchased assets could mean that reserves have fallen to the level demanded by participants in the Sterling Monetary Framework at the prevailing level of Bank Rate. That level of reserves is highly uncertain, and will vary in response to financial and economic conditions. While it is likely to be some way below the current level of reserves, it is also likely to be materially higher at any given level of Bank Rate than it was before the financial crisis, given a range of changes over that period, such as changes to funding markets and liquidity regulation.(5)

Conclusion

The path of Bank Rate and the stock of purchased assets over the next few years will depend on economic developments. The overall stance of monetary policy will, as always, be set to meet the 2% inflation target, and in a way that helps sustain growth and employment. At some point, the MPC may need to tighten monetary policy to meet its remit.

At present, the MPC intends to begin to reduce the stock of purchased assets when Bank Rate has reached 0.5%, if appropriate given the economic circumstances, by ceasing reinvestments of maturing UK government bonds. The MPC will also consider beginning to sell actively some of the stock of purchased assets only once Bank Rate has risen to at least 1%. Any reductions in the stock of purchased assets will happen in a predictable manner. The MPC can amend the process of reducing the stock of purchased assets if necessary to meet its remit. The MPC will continue to monitor the factors affecting these judgements and will revisit them if necessary.

(4) See 'The central bank balance sheet as a policy tool: past, present and future', Bailey (2020), for a discussion of the reasons for this.
(5) For more information, see 'Finding the right balance', Ramsden (2018) and 'Waiting for the exit: QT and the Bank of England's long-term balance sheet', Hauser (2019).

Box B: Monetary policy since the May *Report*

At its meeting ending on 22 June 2021, the MPC voted unanimously to maintain Bank Rate at 0.1%, and for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted by a majority of 8-1 for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion.

Since the May 2021 *Report*, global GDP growth had been somewhat stronger than anticipated, particularly in advanced economies. Global price pressures had picked up further, reflecting strong demand for goods, rising commodity prices, supply-side constraints and transportation bottlenecks, and these had started to become apparent in consumer price inflation in some advanced economies. Financial market measures of inflation expectations suggested that the near-term strength in inflation was expected to be transitory.

Bank staff had revised up their expectations for the level of UK GDP in 2021 Q2 by around 1½% since the May *Report*, as restrictions on economic activity had eased, so that output in June was expected to be around 2½% below its pre-Covid 2019 Q4 level. This recovery in activity had been most pronounced in the consumer-facing services for which restrictions had been loosened in April. Output in a number of sectors was around pre-Covid levels, although it remained materially below in others. The housing market remained strong, and indicators of consumer confidence had increased.

The LFS unemployment rate had fallen slightly to 4.7% in the three months to April, although it was likely that labour market slack had remained higher than implied by this measure. Some individuals had stopped looking for work during the pandemic, and were therefore recorded as inactive. There was uncertainty around how many of these individuals would resume their search for a job, and when. The number of furloughed jobs had declined faster than expected, as demand had recovered. Overall, there was judged to be spare capacity in aggregate in the economy at the time of the *Report*. However, vacancies had risen above pre-Covid levels, and there were increasing signs of recruitment difficulties for some businesses, and in some locations and sectors.

Private sector regular pay in the three months to April was 5.6% higher than a year earlier. Measured pay growth had continued to be boosted by compositional effects, given that job losses had been skewed towards lower-paid employees during the pandemic. In addition, the base effect of the drop in pay in Spring and Summer 2020 would continue to distort the annual comparison, such that, even if the level of private sector regular pay were to remain unchanged in May and June, 12-month pay growth would still rise to close to 8% in the second quarter. Underlying pay growth had appeared to be around pre-Covid rates.

12-month CPI inflation had risen from 1.5% in April to 2.1% in May, above the MPC's 2% target and 0.3 percentage points higher than expected in the May *Report*. Core CPI inflation had also risen from 1.3% to 2.0%. Building global input cost pressures had increasingly been passed through into manufacturing output prices and non-oil import prices. CPI inflation was expected to pick up further above the target, owing primarily to developments in energy and other commodity prices, and was likely to exceed 3% for a temporary period.

The Committee expected that the direct impact of rises in commodity prices on CPI inflation would be transitory. The Committee's central expectation was that the economy would experience a temporary period of strong GDP growth and above-target CPI inflation, after which growth and inflation would fall back. There were two-sided risks around this, and it was possible that near-term upward pressure on prices could prove somewhat larger than expected. Taking together the evidence from financial markets, households, businesses and professional forecasters, the Committee judged that UK inflation expectations remained well anchored.

At this meeting, the Committee judged that the existing stance of monetary policy remained appropriate.

2: Current economic conditions

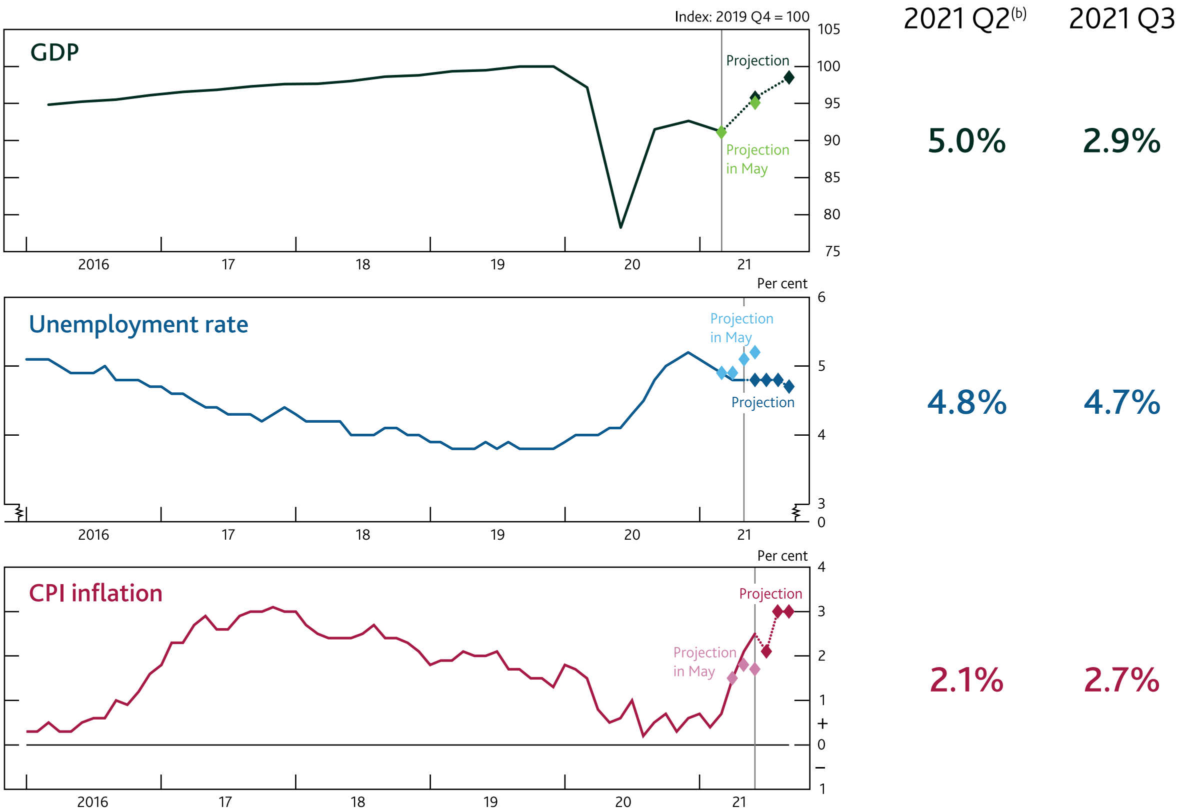
The global economy has continued to recover, boosted in recent months by vaccination programmes and the easing of restrictions. Economic growth is expected to continue, although increased Covid cases linked to the Delta variant may weigh on activity in some places. The global recovery has contributed to higher rates of inflation in many countries, although there are reasons to expect inflationary pressures to ease.

UK GDP is expected to have risen by 5% in Q2, reflecting a marked rise in consumer spending. GDP is expected to continue to grow in Q3, albeit at a slower pace, and is expected to get back to its 2019 Q4 level by the end of the year.

The unemployment rate has declined 0.4 percentage points since 2020 Q4 to 4.8%, while vacancies and recruitment difficulties have risen rapidly and wage growth has picked up. CPI inflation was 2.5% in June, up from 0.7% in March, and is expected to rise further in the near term.

Chart 2.1: GDP is expected to increase in 2021 Q3; unemployment is expected to fall a little; and inflation is expected to rise further above the 2% target

Near-term projections[(a)]



Sources: ONS and Bank calculations.

(a) The lighter diamonds show Bank staff's projections at the time of the May 2021 *Monetary Policy Report*. The darker diamonds show Bank staff's current projections. Projections for GDP are quarterly and show Q2 and Q3 (May projections show Q1 and Q2). Projections for unemployment and CPI are monthly and show June to September and July to September respectively (May projections show March to June and April to June respectively).

(b) GDP and unemployment projections are based on official data to May. CPI inflation figure is an outturn.

2.1: Global developments and financial conditions

Covid cases have risen in many places, driven by the Delta variant.

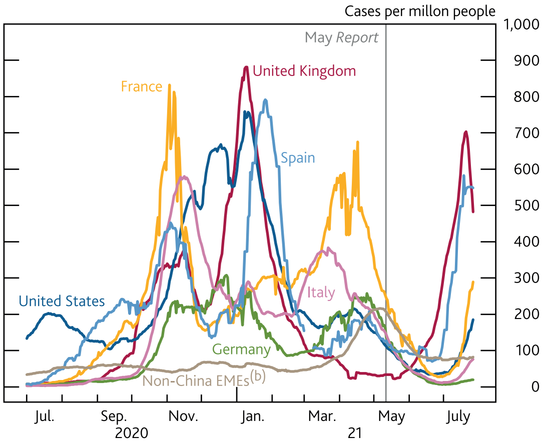
An important determinant of activity in the global economy since the onset of the pandemic has been the prevalence of Covid. At the time of the May *Report*, the number of Covid cases was declining in many of the largest advanced economies. More recently, case numbers have risen again in many places (**Chart 2.2**). The latest wave has seen a sharp increase in cases linked to the Delta variant, which is thought to be more transmissible. The experience of emerging market economies (EMEs) since the May *Report* has been varied: India has seen cases subside following a peak in May but cases in some countries, such as Indonesia and Russia, have increased.

Some countries have made significant progress on vaccination programmes.

Vaccination programmes are under way to counter the effects of the pandemic. Many advanced economies have made further progress on this front since May. The UK had fully vaccinated over half of its population by early July. The US was approaching this milestone in the run-up to the August *Report*. Europe's vaccination programme was initially slower than in the UK and US, but has accelerated in recent months (**Chart 2.3**). Vaccination is currently much less widespread in most emerging markets.

Chart 2.2: Covid cases are rising in some countries, driven by the Delta variant

Daily new confirmed Covid-19 cases[a]

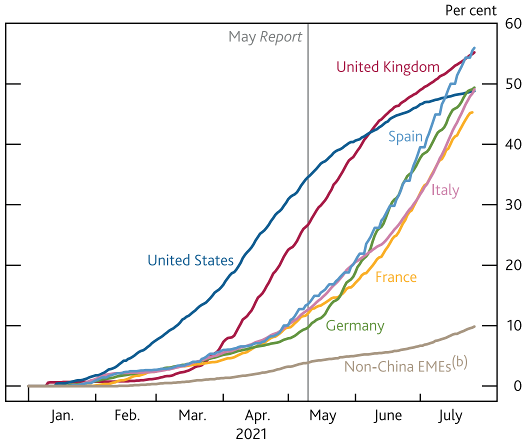


Sources: COVID-19 Data Repository by the Centre for Systems Science and Engineering at Johns Hopkins University, Our World in Data and Bank calculations.

(a) Seven-day moving averages. Data are shown to 27 July and are not seasonally adjusted.
(b) Series includes Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey.

Chart 2.3: An increasing share of the population in advanced economies is fully vaccinated

Percentage of population fully vaccinated[a]



Sources: Our World in Data and Bank calculations.

(a) Share of the total population that have received all doses prescribed by the vaccination protocol. Data are shown to 26 July.
(b) Series includes Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey.

Progress on vaccination has allowed restrictions to be loosened…

The progress of vaccination programmes, and the associated weakening of the link between cases and severe health outcomes, has allowed restrictions to be loosened in many places since May. Most US states now have no official Covid-related restrictions on activity, although mask-wearing is required in some situations. Many countries in the euro area have also removed some social distancing measures in recent weeks. However, changes have not all been in one direction: some countries, such as China and Australia, have imposed local restrictions to tackle outbreaks.

…and the global economy has continued to recover.

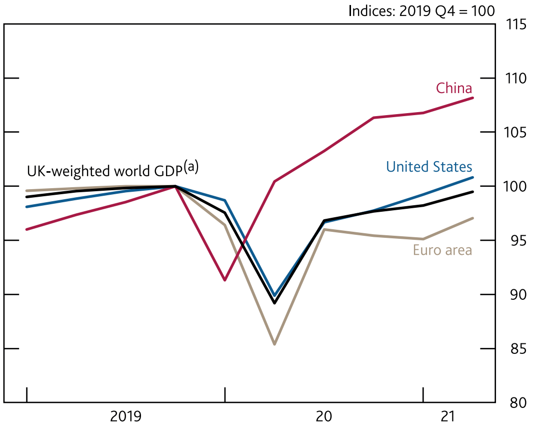
The global economy has continued to recover, boosted by several factors. Vaccination programmes have allowed restrictions on economic activity to be eased, and also reduced the extent of voluntary social distancing. The restrictions that have remained have also had a diminishing economic impact. Fiscal and monetary policies have also been supportive. Bank staff estimate that UK-weighted global GDP rose by 1.3% in Q2 (**Chart 2.4**), slightly higher than expected at the time of the May *Report*, reflecting stronger activity in the euro area. That would mean global GDP was 0.5% below its 2019 Q4 level, prior to the pandemic. Euro-area output grew by 2.0% in Q2, but output remained 3.0% below its pre-Covid level. The US economy, which has seen a particularly large fiscal stimulus by international standards, grew by 1.6% in Q2. China's economy grew by 1.3%. Output in both countries was above pre-Covid levels.

World trade has also grown strongly since mid-2020 (**Chart 2.5**), and by more than its usual relationship with world GDP would imply. Since goods account for a larger share of trade than GDP, the strength in trade partly reflects the supply of goods being less disrupted by the pandemic than that of services. It also reflects stronger demand for goods, as consumers substituted spending on goods for spending on services. The recovery in Chinese goods exports has been particularly strong, as the country benefited from a relatively early reopening of domestic supply chains and strong demand for its products.(1)

The spread of the Delta variant may weigh on growth in the second half of this year.

The increasing number of Covid cases is expected to weigh on activity to some extent in Q3, despite the link between cases and economic activity having weakened. Some governments may reimpose restrictions, and households and businesses may voluntarily restrict their activities in response to higher cases. The impact of higher cases may be more persistent in EMEs, where vaccination rates are relatively low. Bank staff expect UK-weighted world GDP to grow by 1.4% in Q3, lower than expected at the time of the May *Report*.

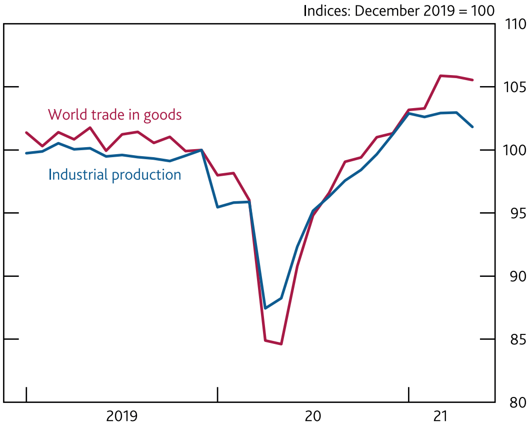
Chart 2.4: The global economy has continued to recover
GDP in selected countries and regions



Sources: Refinitiv Eikon from LSEG, IMF *World Economic Outlook* (*WEO*), National Bureau of Statistics of China, OECD, ONS and Bank calculations.

(a) See footnote (c) of **Table 1.B** for definition. Figure for 2021 Q2 is a Bank staff projection.

Chart 2.5: Global goods trade and industrial production are above their pre-Covid levels
World trade in goods and industrial production(a)



Sources: CPB Netherlands Bureau for Economic Policy Analysis and Bank calculations.

(a) Latest data points are for May 2021.

The recovery has contributed to higher rates of inflation.

The global recovery in demand has contributed to higher rates of price inflation. Stronger demand has pushed up many commodity prices since the start of the year (**Chart 3.3**). The speed and unevenness of the recovery have also led to some global supply bottlenecks, such as in shipping, and some shortages of inputs, such as semiconductors. These have led to higher production costs for firms, and also to shortages of specific consumer goods.

These factors have combined with strong demand for certain goods and services to push consumer price inflation higher in many countries, in many cases above expectations at the time of the May *Report*. The effects have been most notable in the US, where demand for durable goods has been strong for a while, and recent reopenings have also pushed up price inflation in parts of the service sector. CPI inflation rose to 5.4% in the US in June, the highest rate since 2008. Core CPI inflation, which excludes energy and other volatile items, was slightly lower, at 4.5%, although that was the highest rate in almost 30 years. The Federal Reserve's preferred measures of inflation – personal consumption expenditure (PCE) and core PCE inflation – were a little lower, but have still risen markedly (**Table 2.A**).

Inflation has also picked up elsewhere. Euro-area HICP inflation was 1.9% in June and 2.2% in July's flash estimate, up from 0.9% at the beginning of the year. Inflation has also risen in many emerging market economies, such as Turkey, Brazil and Russia. China remains an exception: CPI inflation remained relatively low, at 1.1%, in June.

(1) For more information, see the Bank Overground post 'How has Covid affected global trade?'.

There are reasons to expect part of the rise in inflation to be temporary.

Global inflationary pressures are expected to be strong in the near term, but are expected to ease over time. Because inflation rates are usually annual, current rates are comparing prices with the exceptionally low levels prevailing in pandemic-affected months last year. In addition, some of the supply bottlenecks pushing prices up may unwind over time, as they have tended to in the past. Prices in futures markets imply shipping costs and some commodity prices are expected to fall from their elevated levels. Some prices, such as US lumber prices, have already fallen back from recent peaks. And even if some prices remain at their new higher level, the impact on inflation – the rate of price rises – will dissipate over time. The *In focus* section discusses the outlook for inflation in more detail.

Unemployment remains higher, and participation lower, than before the pandemic in many places.

The medium-term outlook for inflation will depend on the evolution of demand, supply, and spare capacity, particularly in labour markets. Almost all advanced economies have unemployment rates above those prevailing before the pandemic, and many have a lower percentage of the population participating in the labour market (**Chart 2.6**). This may mean there is spare capacity in labour markets, which would be expected to put downward pressure on wage and price inflation over time.

But there could be some more persistent inflationary pressures.

However, there may be some more persistent inflationary pressures, especially if recent changes to the pattern of demand persist. Demand for goods has been relatively high, and demand for services relatively low, during the pandemic. If this persists, production patterns are likely to adjust. But this process takes time, and may lead to greater upward price pressure in growing sectors than downward price pressure in shrinking sectors (Broadbent (2021) and Saunders (2021)). These sectoral shifts may have led to some mismatch between the skills of workers and those demanded by employers. It may also have prompted some people to leave the workforce permanently, for example through early retirement. These could result in higher unemployment and lower participation rates for a while, and greater inflationary pressure for a given level of each.

Table 2.A: Inflation rates have picked up around the developed world

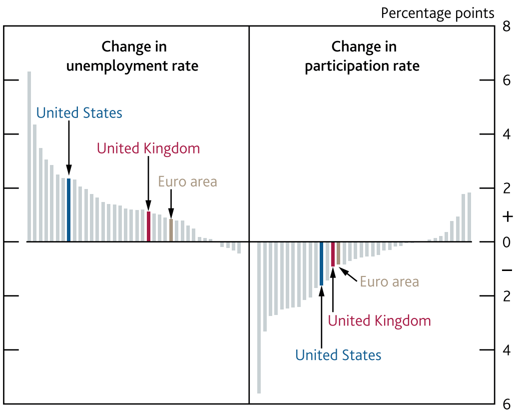
Inflation in the UK, euro area and US

Per cent	Monthly averages 1998–2007	Monthly averages 2010–20	2021 Jan.	Feb.	Mar.	Apr.	May	June
Annual headline consumer price inflation								
United Kingdom	1.6	2.1	0.7	0.4	0.7	1.5	2.1	2.5
Euro area	2.0	1.3	0.9	0.9	1.3	1.6	2.0	1.9
United States[a]	2.1	1.5	1.4	1.6	2.5	3.6	4.0	4.0
Annual core consumer price inflation (excluding food and energy)[b]								
United Kingdom	1.2	2.0	1.4	0.9	1.1	1.3	2.0	2.3
Euro area	1.6	1.0	1.4	1.1	0.9	0.7	1.0	0.9
United States[a]	1.8	1.6	1.5	1.5	2.0	3.1	3.4	3.5

(a) Personal consumption expenditure price index inflation.
(b) For the euro area and the UK, excludes energy, food, alcoholic beverages and tobacco. For the US, excludes food and energy.

Chart 2.6: Unemployment remains higher and participation lower than before the pandemic in many countries

Changes in unemployment and participation rates since 2019 Q4[a]



Sources: OECD and Bank calculations.

(a) Changes between 2019 Q4 and the latest quarterly figure on OECD.Stat; for most countries the latest figure is for 2021 Q1. All OECD member countries, and the euro-area average, are shown, except Germany. Age 15+ unemployment/participation. For the UK, Iceland, Norway, Spain and US the lower age limit is 16.

Prices in financial markets are consistent with inflation expectations being anchored.

Despite the recent pickup in inflation, prices in financial markets are consistent with long-term inflation expectations in advanced economies remaining anchored. The rate of inflation over five years, five years from now, implied by swap prices is consistent with inflation around the 2% long-run target for PCE inflation in the US (Vlieghe (2021)). That expectation has fallen slightly since the May *Report*, having risen earlier in the year.

In the euro area, similar measures of inflation expectations have risen since the start of the year but still appear consistent with HICP inflation below 2%. In July, the ECB announced the results of a strategy review which included the change to a symmetric target for 2% inflation in the medium term. Previously the ECB aimed for inflation to be below, but close to, 2%.

Measures of financial market expectations for medium-term inflation in the UK are slightly above their average since 2010 (**Table 3.A**). Section 3.3 discusses UK inflation expectations in more detail.

Expectations for policy rates are broadly unchanged since May.

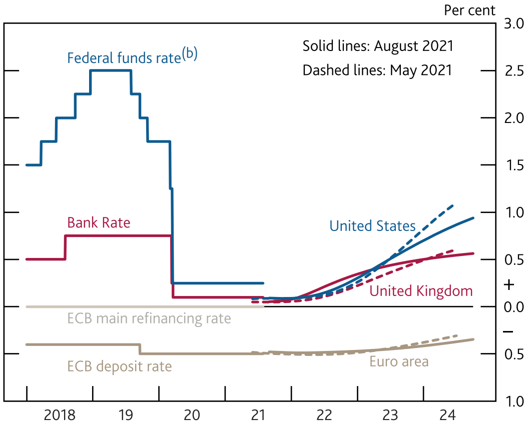
Market participants' expectations for the paths of policy rates have changed little in recent months, although expectations for the US federal funds rate in several years' time have fallen somewhat. Central banks in the UK, US, and euro area are all expected to maintain policy rates at their current low levels for a while (**Chart 2.7**). After that, rates are expected to rise fastest in the US. At its June meeting, the majority of members on the Federal Open Market Committee expected to increase the US federal funds rate twice by the end of 2023.

Longer-term interest rates have fallen since May after rising earlier in the year.

Longer-term interest rates, such as 10-year government bond yields, have fallen since May (**Chart 2.8**). The recent fall has coincided with the uptick in Covid cases driven by the Delta variant, so appears to reflect growing concerns that the pandemic will weigh on economic activity for longer than previously expected. However, interest rates remain higher than at the start of the year.

Chart 2.7: Market expectations for policy rates are broadly unchanged since May

International forward interest rate(a)

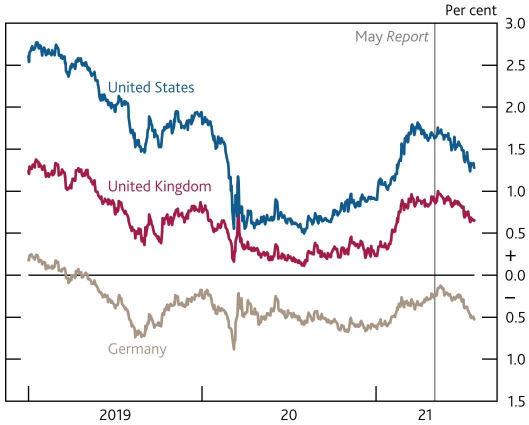


Sources: Bloomberg Finance L.P. and Bank calculations.

(a) All data as of 28 July 2021. The August and May curves are estimated using instantaneous forward overnight index swap rates in the 15 working days to 28 July and 27 April 2021 respectively.
(b) Upper bound of the target range.

Chart 2.8: Longer-term interest rates have fallen after rising earlier in the year

Ten-year nominal interest rates



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

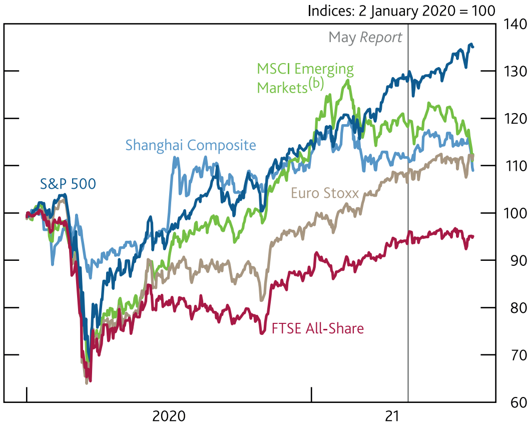
Some risky asset prices have increased since May, despite Covid concerns.

Equity prices in the US have increased since the May *Report*; UK equity prices are at similar levels to May (**Chart 2.9**). Share prices in some sectors that are particularly sensitive to Covid have fallen, reflecting concerns about the impact of the Delta variant. Some emerging market equity prices have fallen as well. The recent moves are relatively small in the context of the recovery seen over the past year: the UK's FTSE All-Share is now almost 50% above its lowest point in 2020 and the US S&P 500 has almost doubled. That recovery partly reflects the better outlook for corporate earnings as the global economic outlook has improved. Expectations that interest rates will remain low have supported valuations as well, as lower interest rates make future profits more attractive. Corporate bond spreads have also remained low by historical standards since May.

The sterling effective exchange rate index has increased slightly since the last Report.

Sterling has appreciated against the euro since the May *Report*, but depreciated slightly against the dollar. The value of sterling against a basket of trade-weighted currencies – the sterling effective exchange rate – was ¾% higher in the run-up to the August *Report* compared to May.

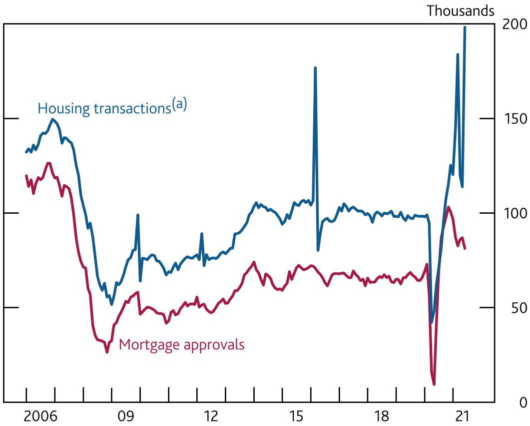
Chart 2.9: Equity prices have risen over the past year
International equity prices[(a)]



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

(a) In local currency terms, except for MSCI Emerging Markets which is in US dollar terms.
(b) The MSCI Inc. disclaimer of liability, which applies to the data provided, is available from *Monetary Policy Report* – August 2021.

Chart 2.10: Demand for mortgages has remained elevated and transactions were very high in June
Mortgage approvals for house purchase and housing transactions



Sources: Bank of England, Her Majesty's Revenue and Customs (HMRC) and Bank calculations.

(a) Residential property transactions for values of £40,000 or above.

The availability of mortgages has improved, and demand has been strong…

In the UK, the availability of secured credit for households has increased in recent months. The number of mortgage products on the market has increased, particularly at high LTVs, since the start of the year. Advertised rates on mortgages have also fallen: the average quoted rate for a two-year fixed-rate mortgage with a 75% LTV has fallen by 18 basis points since May, and has now fallen by over 40 basis points since January. The average quoted rate for a 90% LTV mortgage has fallen by even more, although that comes after a sharp increase during 2020, so the average remains higher than before the pandemic (**Table 2.B**).

Increasing availability has coincided with continued strong demand for mortgages. Over 80,000 mortgages for house purchase have been approved each month since August 2020, well above the 2016–19 average of around 65,000 (**Chart 2.10**). The strength of demand for mortgages reflects a range of factors, including transaction tax holidays (Section 2.2).

…but lending to corporates has been relatively subdued following high levels of borrowing last year.

In contrast, net lending by banks to businesses has been relatively low in recent months, following the record levels of lending last year facilitated by government lending schemes. The most recent scheme – the Recovery Loan Scheme – has seen less uptake than its predecessors. That probably reflects a combination of factors, including its more stringent eligibility criteria, as well as lower demand for credit as a result of high borrowing during in 2020, and firms' improved cash positions, on average (see Section 1.2 of the July 2021 *Financial Stability Report*).

A summary measure suggests financial conditions are slightly looser than at the time of the May Report.

The movements in asset prices, interest rates and exchange rates over the past three months broadly offset one another when combined in the Bank's Monetary and Financial Conditions Index, which weights these movements by their historic association with UK GDP (**Chart 2.11**). The fall in mortgage spreads means that the overall index has fallen a little since the May *Report*, implying a loosening in overall financial conditions.

Table 2.B: New mortgage rates have fallen since the start of the year

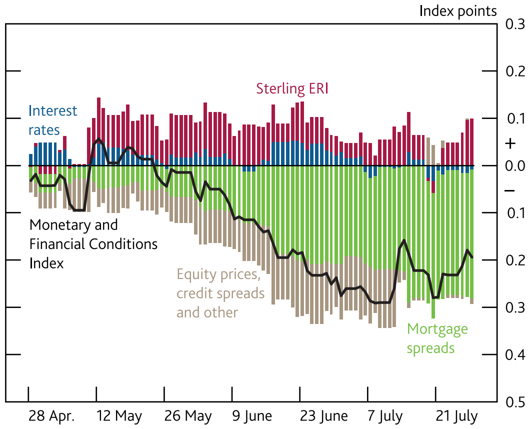
Selected quoted household interest rates[(a)]

	Latest (per cent)	Changes since (basis points) May 2021	Jan. 2021	Jan. 2020	Jan. 2016
Mortgages					
Two-year fixed rate, 75% LTV	1.28	-18	-43	-13	-65
Two-year fixed rate, 90% LTV	2.78	-54	-85	73	-7
Revert-to rate[(b)]	3.62	0	0	-65	-94
Consumer credit					
£10,000 personal loan	3.72	9	3	14	-57
Credit card	21.49	0	50	72	353
Deposits					
Instant access	0.07	1	1	-34	-40
One-year fixed-rate bond	0.26	2	-2	-71	-82

(a) The Bank's quoted rates series are weighted monthly average rates advertised by all UK banks and building societies with products meeting the specific criteria. In February 2019 the method used to calculate these data was changed. For more information, see 'Introduction of new Quoted Rates data – Bankstats article'. Data are not seasonally adjusted. Latest data are flash estimates for July using data to 28 July and are subject to change until publication on 6 August.
(b) Previously known as standard variable rate (SVR).

Chart 2.11: A summary measure suggests that financial conditions have loosened slightly since the May *Report*

Contributions to the change in the UK Monetary and Financial Conditions Index since the May 2021 *Report*[(a)]



Sources: Bank of England, Bloomberg Finance L.P., ICE/BoAML, IMF *WEO*, Money Facts, Refinitiv Eikon & I/B/E/S, both from LSEG, Tradeweb and Bank calculations.

(a) The UK Monetary and Financial Conditions Index (MFCI) summarises information from the following series: short-term interest rates, the sterling ERI, corporate bond spreads, equity prices, and household and corporate bank lending spreads. The series weights are based on the historical association of each variable with UK GDP. The chart shows changes in the MFCI from the average level over the 15 working days to 27 April 2021. An increase in the MFCI signals tighter financial conditions and a decrease signals looser conditions. For more information, see 'How do we monitor UK financial conditions?'.

2.2: Demand and output

UK GDP is expected to have risen in Q2, as most Covid-related restrictions were eased. The level of GDP is expected to have been around 4% below its level in 2019 Q4.

UK GDP is expected to have risen by 5% in 2021 Q2, higher than expected at the time of the May *Report*. Covid-related restrictions were eased during Q2, with most businesses allowed to reopen by mid-May as the UK's vaccination programme continued (**Chart 2.3**). This facilitated a pickup in economic activity, primarily driven by a larger-than-expected increase in household spending. High-frequency indicators such as motor vehicle traffic and retail and recreational footfall recovered materially during the quarter, to around their levels last summer (**Chart 2.12**).

The reopening of non-essential retail venues, indoor and outdoor hospitality, and accommodation services led to a marked recovery in services output relative to Q1. That was concentrated in consumer-facing sectors (**Chart 2.13**), which had been particularly affected by Covid-related restrictions. Total service sector output grew by around 4% between March and May. A 10% increase in education output, as schools reopened, boosted government spending over this period. The level of GDP in Q2 is expected to have been around 4% below its level in 2019 Q4.

Household spending appears to have driven much of the increase in GDP in Q2…

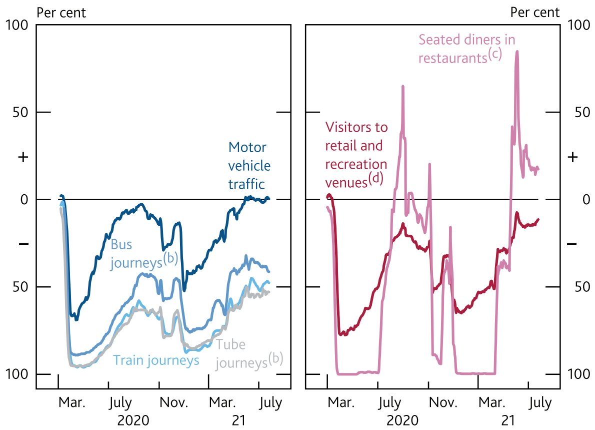
As more workplaces and non-essential shops reopened during Q2, card payments data suggested that consumer spending recovered further. Card spending for work-related items, such as fuel and public transport, delayable spending, for example household furnishings and clothing, and social spending all rose markedly (**Chart 2.14**). Private new car registrations – an indicator of spending on cars – rose to around their pre-pandemic levels in June. Some disruptions to new car production, related to ongoing global semiconductor shortages, may have contributed to a pickup in demand for used cars.

Consumer confidence also rose in Q2, with people reporting increased confidence about the general economic outlook and an improved assessment of their own financial situation. This contrasts somewhat with the more modest improvement in household sentiment recorded last summer after the first lockdown ended. Recent Opinions and Lifestyle Surveys from the ONS highlight a fall in worries about the effect of Covid on people's lives since the start of the vaccination programme.

Overall, Bank staff expect consumer spending to have risen by almost 9% in Q2, a little stronger than expected in May. The level of consumer spending is expected to have been around 6% below its level in 2019 Q4.

Chart 2.12: High-frequency indicators suggest that activity picked up as Covid restrictions eased

High-frequency indicators of economic activity[a]

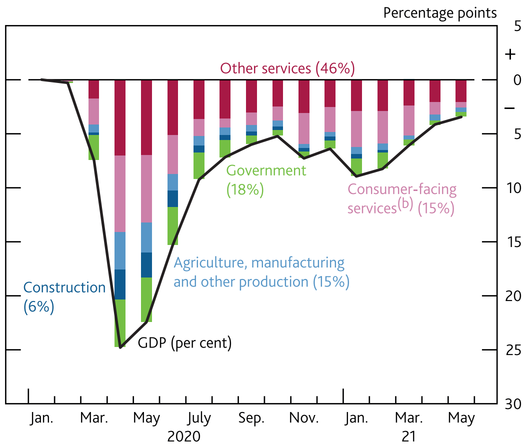


Sources: Department for Transport, Google Covid-19 Community Mobility Reports, OpenTable and Bank calculations.

(a) Seven-day moving averages to 26 July for transport data and 25 July for retail footfall and restaurant bookings. Data are not seasonally adjusted. All data are shown relative to normal levels.
(b) The number of tube journeys is based on Transport for London data and the number of bus journeys does not include London buses.
(c) Seated diners from online, phone and walk-in reservations.
(d) Numbers of visitors to places such as restaurants, cafes, shopping centres, theme parks, museums, libraries and cinemas.

Chart 2.13: Consumer services are expected to have accounted for a large part of the recovery during Q2

Contributions to change in monthly GDP since January 2020[a]



Sources: ONS and Bank calculations.

(a) Figures in parentheses are weights in gross value added in 2018. Weights and contributions may not sum to the total due to rounding.
(b) Includes accommodation and food services, arts, entertainment and recreation, and wholesale and retail.

…but there is some uncertainty around the outlook for spending in the near term.

Some factors should continue to support consumer spending in the near term. The household saving rate rose to 20% in Q1, its second highest level on record after 2020 Q2, given Covid-related restrictions on spending. Since then, the saving rate is likely to have fallen as restrictions have eased and spending has recovered. And respondents to the Bank/NMG survey reported that they expect to spend a portion of the savings they have built up during the pandemic in the near term. Covid also appeared to be having less impact on incomes than before, which may reflect fewer workers being on furlough (Section 2.3).

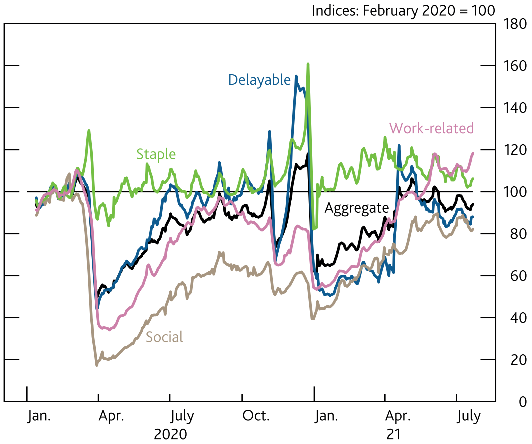
Consumer spending is not expected to rise as sharply in Q3 as it did in Q2, however. High-frequency indicators of mobility (**Chart 2.12**) and card spending (**Chart 2.14**) have either levelled off or fallen slightly in recent weeks. While some of this may reflect a degree of pent-up demand dissipating, it may also be driven by continuing Covid-related concerns. There has been a marked rise in Covid cases in the UK since May (**Chart 2.2**), largely due to the Delta variant. Mobility indicators for more densely populated areas like London remain lower than for other parts of the UK. A recent YouGov survey indicated that many people continued to feel apprehensive about visiting places like gyms and cinemas. This indicates that some voluntary social distancing may persist in the near term, which could dampen consumer spending. Around 15% of respondents to the June Bank/NMG survey were expecting their spending to be lower in Q3 than before the pandemic due to virus-related concerns (**Chart 2.15**), despite the majority of them having received two vaccine doses. Around 20% of respondents expected their spending to be lower for other reasons, such as lower income.

House prices have picked up sharply due to strong demand.

House price inflation has picked up sharply since the middle of 2020 (**Chart 2.16**), with prices rising by around 10% over that period. In the past, house price inflation has been correlated with consumption growth as decisions about whether to spend on housing and consumption share common drivers such as income growth and confidence (see Box 4 of the May 2019 *Report*). But given that the pandemic has weighed on confidence and incomes for some, the recent strength is likely to partly reflect other factors.

Chart 2.14: Aggregate card spending has recovered to around its levels last summer

UK spending on debit and credit cards by consumption category[(a)]

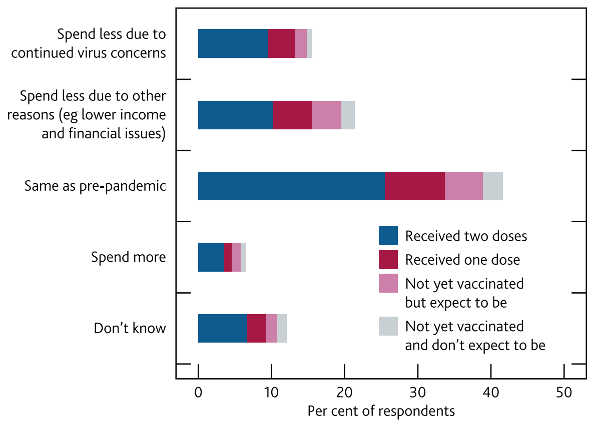


Sources: Bank of England and ONS.

(a) Seven-day rolling averages. Data are nominal, not seasonally adjusted. Latest data point is for the seven days to 22 July 2021.

Chart 2.15: Some households remain cautious about future spending, even after receiving two vaccine doses

Household spending plans over the next three months compared with before the pandemic by vaccination status[(a)]



Sources: NMG Consulting and Bank calculations.

(a) Question: 'Now that many of the government restrictions are being relaxed how much do you think you will be spending over the next three months compared with before the pandemic?'. Responses from those who preferred not to state their vaccination status are not shown. This survey was conducted between 1–23 June 2021.

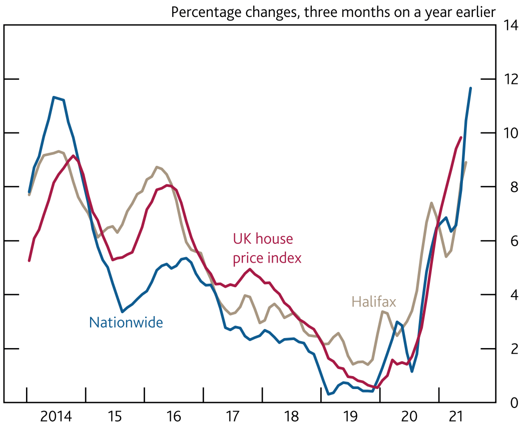
Part of the strength in housing demand is likely to have been driven by the temporary property transaction tax holidays in the UK. According to provisional data, the number of residential property transactions reached a record high in June, ahead of changes to transaction tax thresholds in some parts of the UK (**Chart 2.10**). Research has found that previous reductions in stamp duty also caused a sharp pickup in housing market activity in the UK (Best and Kleven (2018)).

A desire for space as more workers prefer to work from home or live outside city centres may also explain some of the strength in the housing market in certain areas. Intelligence from the Bank's Agents suggests that this may be part of the reason why demand for housing in central London and other city centre locations has remained weak, relative to other parts of the UK (Box D).

It may be that some of the savings built up by some households during the pandemic are flowing into the housing market. Around 20% of respondents who have built up savings in the June Bank/NMG survey noted that they were planning to use a portion of them for a deposit on a property. This channel could continue to support demand for housing and, in turn, house prices in the near term.

Chart 2.16: House prices have risen sharply since the middle of 2020

House prices[(a)]

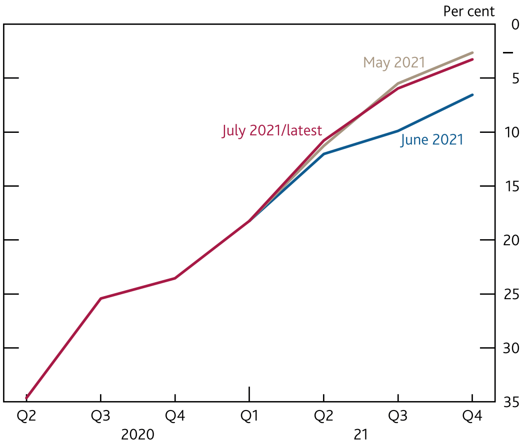


Sources: Halifax house price index by IHS Markit, HM Land Registry, Nationwide and Bank calculations.

(a) Latest data point is May 2021 for the UK house price index, June 2021 for Halifax and July 2021 for Nationwide.

Chart 2.17: The DMP Survey suggests that the impact of Covid on investment became less negative in Q2

Impact of Covid on investment[(a)]



Sources: DMP Survey and Bank calculations.

(a) Question: 'Relative to what would have otherwise happened, what is your best estimate for the impact of the spread of coronavirus (Covid-19) on the capital expenditure of your business in the following quarters?'. Months refer to survey waves. The July survey was conducted between 2–16 July 2021.

Factors such as a desire for more space and an increase in household savings, and the continued low interest rate environment, are likely to help explain why housing markets have also been strong in some other advanced economies as well as the UK.

Business investment is expected to have picked up by around 7% in Q2, and surveys are broadly positive around the outlook.

The ongoing vaccination programmes in the UK and abroad, and the associated reduction in economic uncertainty, are expected to support business revenues and boost investment spending (see Section 3 of the February *Report*). Business investment was around 17% below its 2019 Q4 level in Q1. The business investment data are often heavily revised, but the majority of the fall to Q1 was accounted for by lower investment in buildings and other structures. Investment in intangibles, such as research and development, has held up better over this period (Bailey (2021) and Haskel (2021)).

Business investment is expected to have picked up since Q1, by around 7% in Q2. According to the Decision Maker Panel (DMP) Survey, the impact of Covid on investment was around 7 percentage points smaller in Q2 than in Q1 (**Chart 2.17**), and responses point to a fall in Covid-related uncertainty in recent months.

Business surveys are broadly positive around the outlook for business investment. Investment intentions in plant and machinery have picked up in Q2, according to the BCC and CBI surveys. This may reflect the impact of the capital allowance super-deduction announcement in *Budget 2021* (see Box C of the May *Report*). The latest Agency intelligence also suggests that contacts expect investment to increase over the coming year. That said, there remains some uncertainty around the outlook. While the majority of firms in the July DMP Survey expected Covid-related uncertainty to be resolved by the end of 2022, around 20% of respondents expected it to persist until 2023.

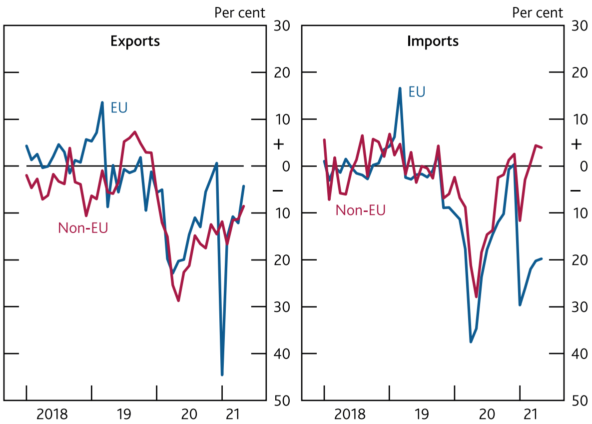
Trade with the EU remained subdued during Q2.

Trade with the EU fell sharply around the turn of the year, when new trading arrangements came into force. The latest official trade data for May suggest that goods exports to the EU – excluding volatile components – have recovered somewhat, with changes since before the pandemic more in line with exports to non-EU countries (**Chart 2.18**). Agency intelligence suggests that some of the Brexit-related issues which had previously weighed on exports were abating as businesses adapted to new requirements, and that there has been an increase in demand from the EU for UK goods. The level of goods imports from the EU in May remained materially lower than their 2019 average, however. Agency contacts highlighted some substitution away from EU imports.

Against the backdrop of a broader recovery in world trade (Section 2.1), UK exports and imports are expected to have increased by a little under 10% in 2021 Q2. This would leave UK exports and imports around 18% and 12% below their levels in 2019 Q4, respectively.

Chart 2.18: Goods exports to the EU recovered somewhat during Q2

Changes in UK trade in goods with EU and non-EU countries relative to 2019 averages(a)

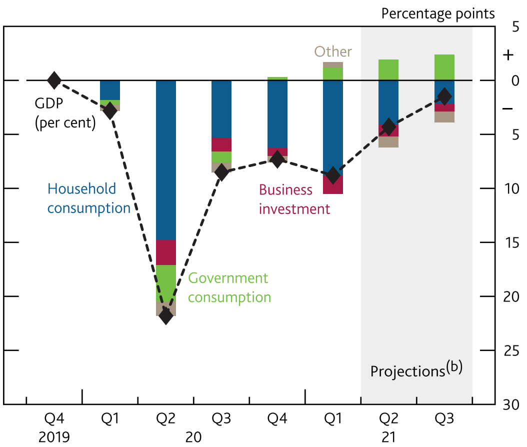


Sources: ONS and Bank calculations.

(a) All data exclude unspecified goods. Latest data points are for May 2021.

Chart 2.19: UK GDP is expected to grow by 2.9% in Q3

Contributions to change in quarterly GDP since 2019 Q4(a)



Sources: ONS and Bank calculations.

(a) Household consumption data include non-profit institutions serving households.
(b) Bank staff projections.

Overall, quarterly GDP growth is expected to slow somewhat, to 2.9% in Q3. GDP is expected to get back to its pre-pandemic level by Q4, as in the May Report*.*

The Government lifted all legal restrictions on social contact in England on 19 July, and there has been an easing in restrictions across Northern Ireland, Scotland and Wales in recent weeks. The easing of restrictions is expected to support growth in Q3 (**Chart 2.19**). One uncertainty around the near-term outlook is the impact of higher Covid cases in the UK (**Chart 2.2**) and the extent to which any voluntary social distancing or an increase in the number of people being required to self-isolate affects activity (Section 1). Overall, quarterly GDP growth is expected to slow somewhat, to 2.9% in Q3. The impact of Covid-related concerns on spending is still expected to remain less than seen earlier in the pandemic, however.

The level of output is subsequently expected to get back to its 2019 Q4 level by Q4, as in the May *Report*. Even if output recovers as anticipated, it would still represent nearly two years of no growth due to the pandemic.

2.3: Supply and the labour market

Alongside the recovery in demand, supply capacity has increased as restrictions on activity have lifted…

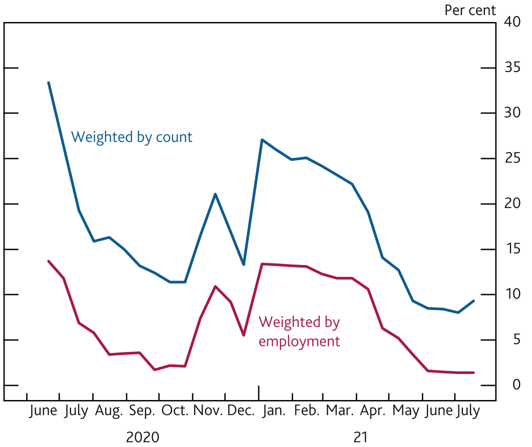
Supply capacity had been materially reduced earlier in the year while Covid restrictions were in place, as some businesses needed to reduce capacity or close temporarily and workers were furloughed. As restrictions on activity have been eased in recent months, supply has recovered. The proportion of firms that have temporarily paused trading fell below 10% in June and July (**Chart 2.20**). Many of the firms which are still not trading are relatively small: only 1.4% of firms, weighted by employment, had paused trading by July.

…and has been supported by continued firm entry and limited firm exits, considering the impact of Covid on activity…

Supply has been supported by more resilient firm entry compared to the financial crisis. Initial evidence suggests that firm entry has held up during the pandemic (**Chart 2.21**). Registrations of new companies at Companies House, which records firm entry at a very early stage, have risen. Additions to the Inter-Departmental Business Register (IDBR) and new VAT registrations, which tend to happen as firms become larger and more established, have been broadly unchanged. Resilient firm entry is partly due to the shifting nature of demand during Covid: new firm entries were particularly strong for internet and mail order retailers for example.

Chart 2.20: Many businesses have resumed trading since Q1

Proportion of businesses which have paused trading[(a)]

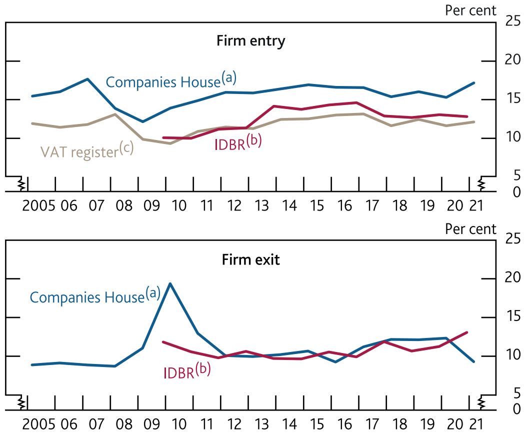


Sources: ONS and Bank calculations.

(a) Final data points are from wave 35 of the Business Insights and Conditions Survey and cover the survey sample period of 12–25 July 2021.

Chart 2.21: Firm entry has held up and firm exits have been limited considering the impact of Covid on activity

Measures of annual firm entry and exit rates in the UK



Sources: Companies House, HMRC, ONS and Bank calculations.

(a) Number of companies incorporated and dissolved as a share of the total Companies House register. Data are for financial years (April to March) to March 2021 and are for the United Kingdom from the 12 months to March 2010 onwards and for Great Britain previously.
(b) Births and deaths of enterprises as a share of active enterprises on the IDBR. Calendar year figures to 2020.
(c) New VAT registrations as a share of the live trader population. Data are for financial years to March 2021.

Firm exits have increased during Covid according to the IDBR (**Chart 2.21**), but this increase is relatively limited considering the impact that Covid has had on the economy. Firm dissolutions and insolvencies have fallen and most measures of firm vulnerability, such as solvency and liquidity risk, have been broadly stable. Many firms have been able to use existing cash buffers or access finance, including through government-backed lending schemes. Firms have also been supported by policy measures such as the furlough scheme and the changes to insolvency regulations. Insolvencies may rise a little in the coming months as some of these measures come to an end (see Section 1.2 of the July 2021 *Financial Stability Report*).

…but growth in supply may have been temporarily constrained recently.

While supply has risen recently, growth may have been temporarily dampened. There have been increasing reports to the Bank's Agents that supply is being constrained for some firms due to supply chain issues and staff shortages (Box D). Some firms report that staff members being required to self-isolate was leading to temporary shortages of labour where staff were unable to work from home. Those factors might weigh on supply growth in the near term.

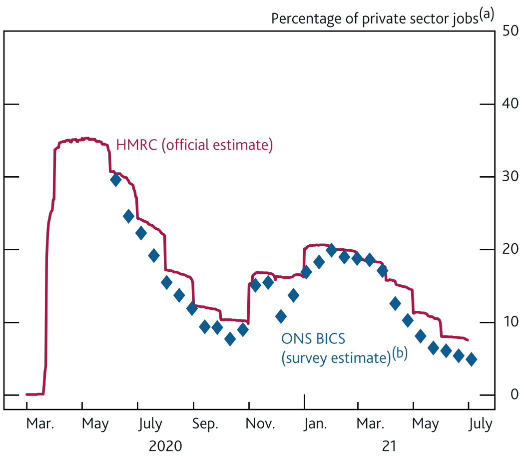
Numbers on furlough continue to fall…

As businesses have reopened, the number of jobs on furlough has continued to decline. According to official HMRC statistics, the number of jobs furloughed fell to below 2 million by the end of June 2021, just under 8% of private sector jobs (**Chart 2.22**). ONS survey data suggest that numbers have continued to decline in early July. From July, employers have needed to contribute to the cost of furloughed employees' wages and the scheme is due to stop at the end of September. This, combined with the further easing of restrictions in July, means that only around half a million jobs are expected to remain furloughed, on average, over Q3.

…and the unemployment rate has declined since its 2020 Q4 peak.

Alongside falling numbers on furlough, there have been signs of recovery elsewhere in the labour market. The unemployment rate was 4.8% in the three months to May 2021 (**Chart 2.1**), unchanged from the revised April data.(2) This follows a steady decline from the peak of 5.2% in the three months to December 2020. At the time of the May *Report*, the unemployment rate was expected to rise slightly to 5.2% in Q2 overall. Numbers inactive in the labour market – those without a job and not actively searching for one – were expected to fall as restrictions were eased and searching for a job became easier. This was expected to push up on the unemployment rate. However, inactivity has increased since February (**Chart 2.23**).

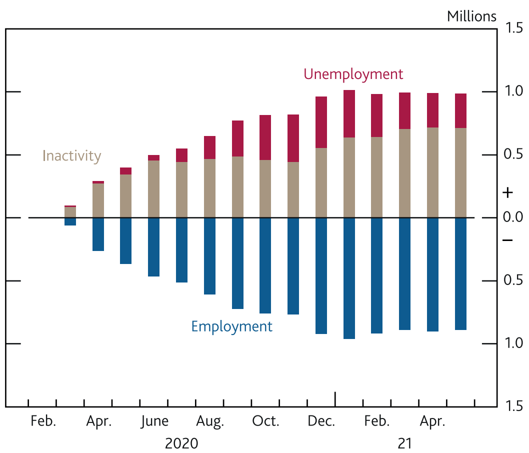
Chart 2.22: Use of the furlough scheme continues to decline
Furloughed jobs



Sources: HMRC, ONS and Bank calculations.

(a) Total employee jobs minus public sector employment.
(b) Business Insights and Conditions Survey. Final data point is from wave 35 and covers the survey reference period of 28 June–11 July 2021.

Chart 2.23: Numbers inactive in the labour market have continued to rise in 2021 so far
Changes in employment, unemployment and inactivity since the three months to February 2020(a)



Sources: ONS and Bank calculations.

(a) Data from the Labour Force Survey and employment includes employees and self-employed. Changes do not sum to 0 as the population is estimated to have increased during the period.

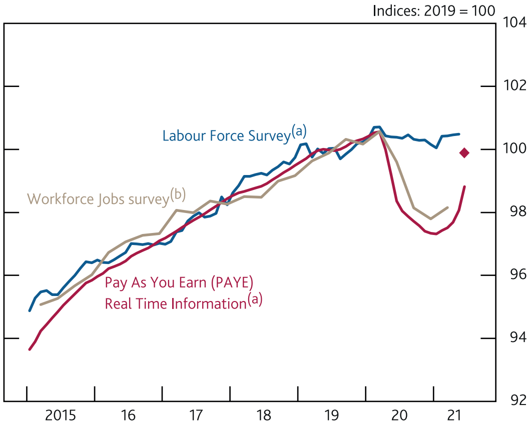
(2) The latest statistics from the LFS have been reweighted to better reflect recent population changes since official population projections were last produced. This has resulted in revisions to labour market data back to the three months to March 2020. See 'Impact of reweighting on Labour Force Survey key indicators, UK: 2020' for more details.

The number of employees has also risen (**Chart 2.24**). Payroll data had previously been implying that employment may have fallen, and unemployment risen, by more than in the LFS data (see Box D of the May *Report*). Sharp rises in the latest June payroll data have eliminated much of the difference between the data sources, suggesting that some of the falls in employment not previously captured in the LFS may have unwound. Despite these improvements in employee numbers, the fall in overall employment remains sizable (**Chart 2.23**), accounted for by falling numbers in self-employment.

While numbers in work remain lower than pre-Covid levels…

Despite the fall in recent months, the unemployment rate remains almost 1 percentage point higher than at the start of 2020. There are around 900,000 fewer people in employment (**Chart 2.23**) and material numbers of workers remain furloughed. The proportion of people not active in the labour market is at its highest level for almost 10 years. While it is likely that some of those currently inactive will return to the labour market as restrictions ease and health risks fade, this unwind has been slower than expected so far. Because of these factors, furlough in particular, total hours worked remained well below pre-Covid levels in the three months to May 2021 (**Chart 2.25**).

Chart 2.24: The number of employees has increased sharply according to payroll data
Number of employees



Sources: HMRC, ONS and Bank calculations.

(a) Three-month moving averages. Latest data point from the Labour Force Survey is for the three months to May 2021. Latest data point for PAYE Real Time Information is the flash estimate for the three months to June 2021 and diamond shows data for the single month of June.
(b) Data are quarterly. Latest data point is for 2021 Q1.

Chart 2.25: Hours worked remain materially lower than pre-Covid levels, primarily reflecting furloughed workers
Total weekly hours

Sources: ONS and Bank calculations.

…vacancies have risen and some indicators point to areas of recruitment difficulties…

Job vacancies exceeded their pre-pandemic levels in the three months to June 2021 (**Chart 2.26**), as firms prepared to reopen or increase capacity during Q2. Because of the rise in unemployment, the number of vacancies as a share of the unemployed has risen a little less. But on both measures, the recent moves have been much sharper than we have seen in the past. The latest single-month data suggest further acceleration, with the number of vacancies at a record high and vacancies per person unemployed returning to early 2020 levels.

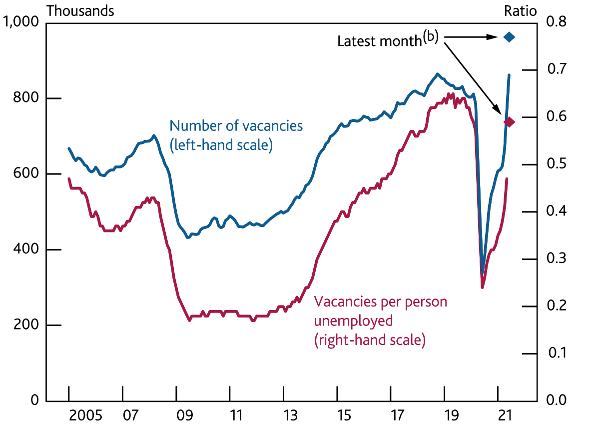
Indicators of difficulties recruiting staff have also picked up materially (**Chart 2.27**). Staff availability in the KPMG/REC *UK Report on Jobs* fell to a series low in June for both permanent and temporary workers. An increasing proportion of the Bank's Agents' contacts have also reported recruitment difficulties across a wide range of occupations, sectors and locations, although some contacts had continued to report that recruitment was easier than normal. Almost 80% of businesses reported that recruitment difficulties increased in Q2 in the *Deloitte CFO Survey*.

…and underlying wage growth appears to have returned to near pre-Covid levels.

While measures of average earnings growth have been artificially boosted by compositional and base effects, underlying wage growth appears to be around pre-Covid rates (Box C). Other measures of wage growth paint a similar picture (Box C, **Chart D**). Over the pandemic as a whole, underlying wage growth has been stronger than expected given estimates of labour market slack.

Chart 2.26: The number of vacancies has risen sharply since March…

Vacancies[a]

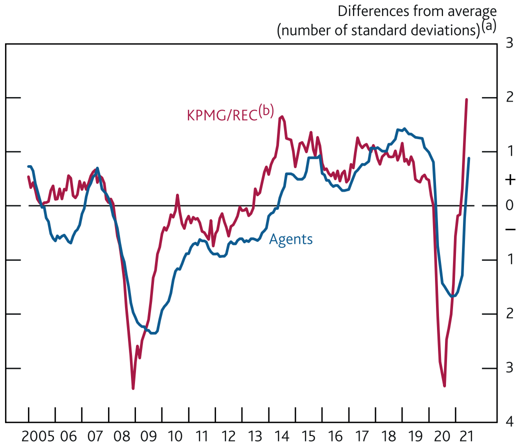


Sources: ONS and Bank calculations.

(a) Three-month moving averages. Latest vacancy data are for June 2021, latest unemployment data for May 2021.
(b) Diamonds show latest available single-month data. Diamond for vacancies shows single month of June. Vacancies per person unemployed uses June single-month vacancies and the estimate of the number unemployed in the single month of May.

Chart 2.27: …and there have been increasing reports of recruitment difficulties

Indicators of recruitment difficulties



Sources: Bank of England, KPMG/REC *UK Report on Jobs* and Bank calculations.

(a) Since 2000.
(b) KPMG/REC Availability of Staff Index, inverted.

This may reflect frictions in the labour market…

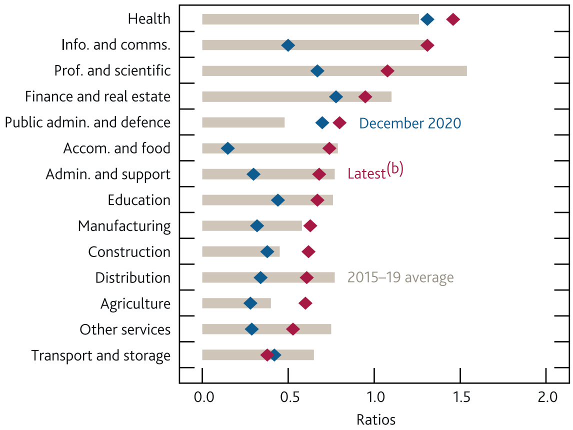
Vacancies, recruitment pressures and wages tend to rise during labour market recoveries, as employers compete to hire more staff from a shrinking pool of those looking for work. However, the timing and scale of the tightening in labour market conditions seems somewhat at odds with unemployment being higher than pre-pandemic levels and the fact that some workers remain on furlough. This might indicate that there are frictions in the labour market, preventing efficient matching of available labour to jobs.

The speed, scale and circumstances of the recovery in labour demand are different to past recoveries. Even if there is enough available labour in aggregate to fill all vacancies it takes time to match workers with jobs. According to the Bank's Agents, the number of reopening businesses trying to hire staff at the same time has been a factor driving the hiring difficulties. A number of contacts have also reported a lower availability of workers born outside the UK, which may be related to staff not being able to return to the UK from overseas due to Covid travel restrictions. If this only became apparent as firms started to reopen, firms may have had limited time to find replacements, leading to recruitment pressures.

The differential impact of Covid across sectors, firms and skills may also be slowing the matching of workers to jobs. Measures of mismatch rose sharply earlier in the pandemic: the dispersion in numbers of vacancies and unemployed across industries was fairly wide at the end of 2020. But this has changed quite rapidly for some sectors in the past few months, with the latest vacancy to unemployment ratios near historical averages in most sectors (**Chart 2.28**). This suggests that sectoral mismatch has fallen recently, although it is still a little higher than pre-Covid levels (Haskel (2021)). Differences between firms within sectors could also be a source of mismatch. Data from the DMP Survey suggest that differences in the degree of reallocation of sales and jobs between firms within the same sector are at least as important as those between sectors (Section 3). Some firms that are yet to reopen fully may have workers on furlough, whereas others could be hiring after recalling all of their furloughed staff. There could also be mismatch between the types of skills held by those workers still on furlough or looking for work and those required for the available vacancies.

In addition, LFS data suggest that the rate of job search for those in employment is lower than before the pandemic (**Chart 2.29**). This would limit the number of job applicants relative to vacancies and may have led to wage pressures as firms competed to recruit staff with the right skills. Workers may be reluctant to move if they are uncertain about job security with a new employer. In addition, workers may be less willing to leave their current jobs while the furlough scheme is operating as they would lose eligibility. While lower job search among the employed may be boosting wages at the moment, while firms are focused on hiring new workers, over time the impact is more ambiguous. Employers tend to be able to offer lower wages to existing staff if most are not seeking better offers externally.

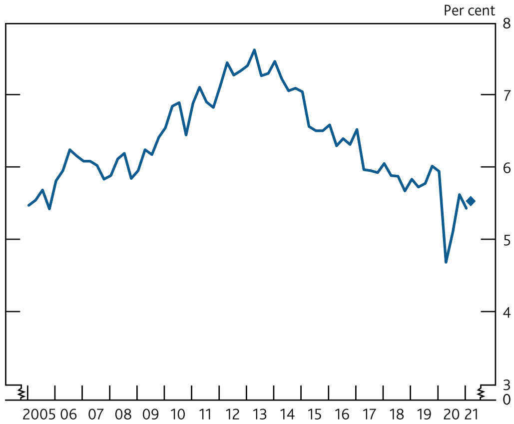
Chart 2.28: The distribution of vacancies and unemployment is wide across sectors
Number of vacancies per person unemployed by industry[a]



Sources: ONS and Bank calculations.

(a) Three-month moving averages. Vacancies in each industry per person unemployed whose last job was in that industry. Unemployment by industry of last job data are not seasonally adjusted.
(b) Latest data point is June for vacancies and May for unemployment.

Chart 2.29: Fewer people in work are searching for other jobs
Proportion of people in employment searching for a job[a]



Sources: Labour Force Survey and Bank calculations.

(a) Data are quarterly to 2021 Q1. Diamond shows latest data for the three months to May 2021.

…and such frictions are judged to have slowed supply growth recently, with spare capacity expected to be eliminated in Q3.

These labour market frictions, alongside supply chain issues and temporary labour shortages due to self-isolation, are likely to have dampened supply growth recently. When taken alongside the rapid recovery in demand, the MPC judges that spare capacity has been eroded over Q2 and Q3. The unemployment rate is projected to decline a little further in the near term, as activity continues to recover, although there is uncertainty around that profile, including how the ending of the furlough scheme affects the labour market. Some of the frictions in the labour market are judged to be likely to dissipate as the economy normalises (Section 1).

CPI inflation was 2.5% in June and is expected to rise further in the near term.

CPI inflation rose to 2.5% in June, materially stronger than the 0.7% recorded in March. Some of this increase had been expected, both because of rises in energy prices and base effects from comparing prices now against low levels earlier in the pandemic. But CPI inflation in June was 0.8 percentage points stronger than the 1.7% expected in the May *Report*, an unusually large three month ahead forecast error. This additional strength primarily reflects faster-than-expected rises in core goods prices, for example vehicles and clothing and footwear. Core goods inflation was 2.7% in June, the highest for almost four years. CPI inflation is expected to continue to rise over the rest of the year, reaching 4% in Q4, before returning to 2% in late 2023, as energy and core goods inflation strengthens further and then falls back (Section 3).

Box C: How strong is pay growth?

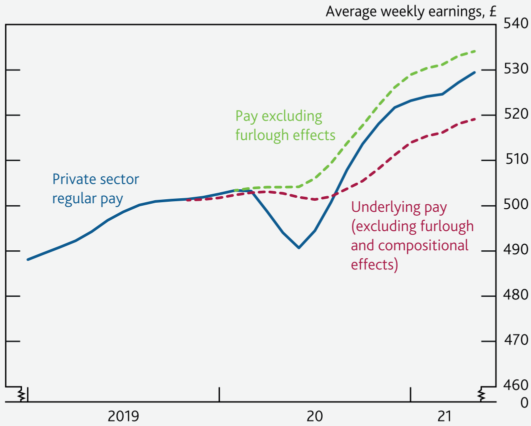
Average earnings growth has been very strong in recent months, partly reflecting Covid-related distortions.
Annual growth in average weekly earnings reached the highest rates since the series began in the three months to May 2021. Growth in private sector regular pay reached 7.2% (**Chart A**), and annual growth to the single month of May was higher still. However, these data have been affected by the significant changes in the labour market caused by Covid. On balance, these are pushing up markedly on wage growth.

Chart A: Annual pay growth has been strong over the past few months in part due to base effects…
Private sector regular pay

Sources: ONS and Bank calculations.

(a) Growth in three-month average pay relative to the same period a year earlier. Diamond shows annual growth in the three months to June if monthly growth (shown in the red bars) were to be zero in June.

Chart B: …while furlough and compositional effects have been distorting the level of pay
Private sector regular pay and estimated impact of furlough and compositional effects[a]



Sources: HMRC, ONS and Bank calculations.

(a) Three-month moving averages. Furlough and compositional effects are Bank staff estimates. Compositional effects are estimated as an impact on growth rates; the impact on the level of pay shown in this chart is an approximation.

The weakness seen in the first few months of the pandemic has boosted recent annual growth rates.
Part of the recent strength can be explained by base effects. The annual growth rates for April and May compare wages to their levels one year earlier when the level of wages had fallen substantially, pushing up the annual growth rate. These effects will continue to affect growth rates: even if the level of private sector regular pay were to be unchanged between May and June, annual wage growth would rise to over 8% (**Chart A**). Average monthly growth since the start of the year has been close to its historical average.

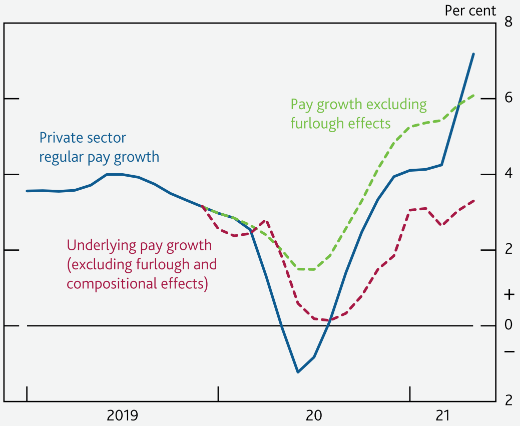
Measured average wages have been pulled down by the furlough scheme…
The furlough scheme has helped workers stay attached to their jobs but generally at lower pay than usual, which has dragged on average wages. The size of this effect has depended on the proportion of employees furloughed and the extent to which employers have topped up wages above the share paid by the Government. The green line in **Chart B** shows Bank staff's estimate of private sector regular pay excluding the effects of the furlough scheme. This estimate is higher than measured average wages at all points, but the gap was widest in 2020 Q2, when use of the furlough scheme was most widespread. There is uncertainty around the precise impact of furlough, for example because the wages received by those on furlough have to be estimated.

…but compositional effects have pushed up on wages, more than offsetting this.
Compositional effects have been acting in the opposite direction, pushing up average wages since the start of the pandemic. The composition of jobs has changed, as job losses have been skewed towards lower-paid roles. These effects are difficult to estimate precisely and can vary depending on the methodology used. Bank staff have combined the steers from several different approaches to estimate the effects. First, analysing compositional trends in the workforce quantities data using Labour Force Survey (LFS) microdata. Second, assessing the evolution of earnings for people that have remained in work, also using LFS microdata. Third, using HMRC data to compare growth in median pay to the median of pay growth, as the latter should exclude most compositional effects.

The red line in **Chart B** shows the estimated level of 'underlying' pay: private sector regular pay adjusting for both furlough and compositional effects. Compositional effects, the difference between the green and red lines, are likely to have grown over time and have been large enough to outweigh the effects of the furlough scheme since September 2020. Given the difficulties in precisely measuring the furlough and compositional effects, there is uncertainty around this estimate of underlying pay.

Chart C: Estimated underlying pay growth is around pre-Covid rates

Annual growth in private sector regular pay and estimated impact of furlough and compositional effects[(a)]

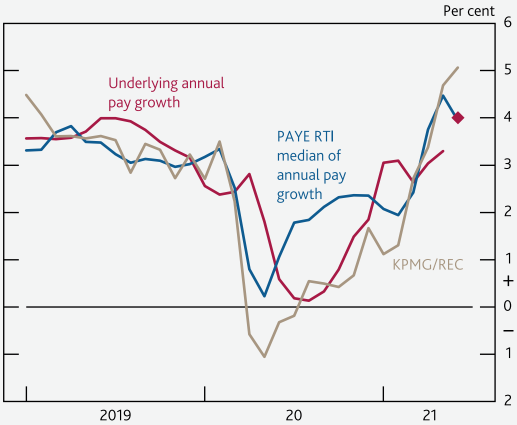


Sources: HMRC, ONS and Bank calculations.

(a) Growth in three-month average pay relative to the same period a year earlier. Furlough and compositional effects are Bank staff estimates.

Chart D: Other measures of wage growth give a similar signal to the estimate of underlying pay

Indicators of pay growth[(a)]



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

(a) Estimated underlying pay growth is growth in three-month average underlying pay relative to the same period a year earlier; data are to May 2021, diamond shows the Bank staff estimate for June 2021. KPMG/REC data are weighted averages, using LFS employee job shares, of diffusion indices of starting salaries for permanent and temporary staff, scaled to match the mean and variance of annual growth in private sector regular pay since March 2001. KPMG/REC and Pay As You Earn (PAYE) Real Time Information (RTI) median of pay growth data are to June 2021.

Underlying annual pay growth is likely to be considerably lower than suggested by the headline data…

Bank staff estimate that underlying annual pay growth is 3.3% – much lower than the 7.2% recorded in the official data in the three months to May (**Chart C**). Because these adjustments remove the sharp fall in wages associated with the furlough scheme, the underlying pay growth measure is less affected by the base effects which are currently boosting the headline data.

…but appears to be close to pre-Covid rates, with a rise expected in the near term.

Underlying annual average pay growth appears to have been close to pre-Covid rates during the first half of 2021. Bank staff expect that underlying annual wage growth will strengthen to 4% in Q2 overall (**Chart D**) and rise further to over 4½% in Q3, supported by the recovery in the labour market.

Other indicators of wage growth point to a broadly similar picture (**Chart D**). According to HMRC payroll data, the median of annual pay growth was around 4% in the three months to June. The KPMG/REC *UK Report on Jobs* suggests starting salaries have increased sharply in recent months, with the Permanent Salaries Index near series highs. Scores from the Bank's Agents on overall labour costs have also picked up markedly, with pay settlements reported to have increased modestly (Box D). Recent calculations by the ONS gave a range of 3.2% to 4.4% for underlying wage growth in the three months to May.[(1)] This range is calculated using a different method, reflecting two approaches to remove base effects which are then also adjusted for some compositional effects, such as occupation. Nevertheless it provides a similar steer for underlying wage growth to the Bank staff estimate for that period.

Underlying pay growth has been a little stronger than expected during the pandemic, given estimates of labour market slack.

The level of underlying wages is estimated to have risen by around 4% in the six quarters since 2019 Q4, implying annual growth of around 2¾%, on average, during the pandemic. This growth has been a little stronger than expected, given estimates of labour market slack over that period.

(1) See 'Far from average: How COVID-19 has impacted the Average Weekly Earnings data' for more details.

Box D: Agents' update on business conditions

The key information from Agents' contacts considered by the Monetary Policy Committee at its August meeting is highlighted in this box, which summarises information gathered in the six weeks to mid-July.

Consumer spending remained strong, but continuing supply-chain issues led to long lead times for some goods; in some services, growth was constrained by staff shortages.
Contacts reported robust retail sales, in particular for household goods and DIY products, supported by strong housing market and home-improvement activity. Car dealerships reported high demand for new and used cars. However, supply chains remained stretched due to transport delays and shortages of materials, resulting in longer lead times for some items.

Supermarkets said that while food sales were weaker than a year ago, they had been better than expected, possibly supported by the European Football Championship tournament and some concerns about Covid infection rates leading to less eating out.

Spending on hospitality and leisure continued to strengthen as social distancing restrictions were relaxed around the UK. Contacts reported robust bookings at most hotels, self-catering accommodation, visitor attractions and tourist resorts, partly due to restrictions on foreign travel. Restaurants, bars and personal care services, such as hairdressers and salons, also reported strong demand. However, many contacts reported staff shortages, which in some cases was constraining activity.

Activity in business services continued to pick up; shortages of materials and labour held back growth in manufacturing and construction output.
Contacts in accountancy, legal and consultancy continued to report good levels of demand, as did companies in IT. Recruitment activity was reported to have increased to pre-pandemic levels, partly due to shortages of temporary workers, including from the EU. By contrast, activity relating to business travel, corporate hospitality and events remained subdued. And labour shortages were said to be limiting growth in some sectors, such as logistics.

Manufacturing output was supported by strong demand for food, beverages and construction-related products. However, activity growth was constrained by shortages of materials and labour. Output in the automotive sector continued to be constrained by the shortage of semiconductors. And contacts in some sectors reported stockpiling materials and components in anticipation of continued supply-chain disruption.

Contacts said they were adapting to the new arrangements for trading with the EU. Export demand was reported to have increased, but there was evidence of some EU customers rotating away from UK suppliers. More UK-based contacts said they were setting up hubs in the EU in order to continue selling to customers there. And there was further evidence of some substitution away from EU imports.

In construction, public infrastructure projects continued to support activity. However, output growth was constrained by shortages of materials and labour, in particular among private sector house builders and companies involved in domestic repair and maintenance. Contacts expressed concern that these shortages – and the associated cost pressures – would persist for the remainder of this year.

Housing market activity remained robust even as some transaction tax reductions came to an end. Contacts reported a further tightening in housing supply due to a slowdown in house-building activity and fewer properties being put up for sale. Demand for rental property also continued to be strong in most parts of the UK. By contrast, demand for housing in central London and other city centre locations remained weak, due to subdued demand from overseas buyers, concerns about building cladding liabilities, and a desire for properties with outdoor space.

Investor demand for commercial property was reported to have strengthened in recent weeks, in particular for industrial, logistics and life-sciences premises. There were also some reports of occupier demand for office premises, with contacts downsizing by less than previously expected as they adopted hybrid working arrangements, and for retail premises, following the further easing of social distancing restrictions.

Companies expect to increase investment spending over the coming year relative to the previous year; demand for bank credit was subdued, but some report demand for asset finance to support investment.
Contacts in several sectors said they expected to resume investment projects that had been put on hold during the pandemic, particularly in sectors where demand outpaced capacity. There were widespread reports of investment in automation, particularly in sectors where labour shortages were more acute and labour costs were rising more quickly. There were also increasing reports of contacts expanding facilities and carrying out refurbishments.

Demand for bank credit was subdued among large businesses as they were generally able to raise funds from financial markets. For some small and medium-sized enterprises, there were reports of increased demand for asset finance to support investment. Supply-chain issues led to a rise in demand for working capital finance.

Bank credit was readily available in stable and growing sectors, though some smaller businesses and those in sectors that have been most affected by the pandemic continued to report tight credit availability. And there were some reports of trade credit insurers not increasing cover limits in line with input cost inflation.

Employment intentions and recruitment difficulties are increasing sharply as activity recovers; pay settlements remain moderate but are beginning to increase.
A growing number of businesses expected to increase staff numbers either to meet strengthening demand or because they had paused hiring or reduced headcount by too much during the pandemic. Contacts in some industries noted that increased demand for staff coincided with the supply of labour tightening. This was due to a variety of factors, including: a lower availability of EU migrant workers; candidates opting for jobs offering greater flexibility or fewer hours; or because some furloughed workers had found jobs in other parts of the economy. Companies in a number of sectors reported temporary, but material, staffing issues as a result of employees being required to self-isolate.

Some labour shortages were structural and had existed before the pandemic, for example reflecting a lower availability of skilled workers in engineering and technology. But some shortages were likely to be more short-lived, for example in construction, manufacturing, retail, hospitality and leisure. And some contacts said they were still able to recruit easily, particularly in locations where there had been large-scale redundancies.

Pay settlements increased, with contacts commonly reporting settlements ranging from 1.5%–3%. And there were signs of upward pay pressures emerging more broadly. A number of contacts said they were reviewing pay structures or giving individual pay settlements or bonuses. Some said that competition for experienced professionals was leading to upward pressure on salary packages, and offers of more flexible working conditions.

Input cost inflation continued to rise and is increasingly being passed through to output and retail prices.
Contacts reported further increases in the cost of a wide range of materials and commodities, such as metals, chemicals, plastics, cardboard, agricultural products and construction materials. Freight and warehousing costs also remained elevated. Cost increases were attributed to both a robust recovery in global and domestic demand and a loss of supply capacity, most of which was thought to be temporary. Costs were increasingly being passed through into manufacturers' output prices.

Contacts reported that costs were being passed through to consumer prices to a greater extent than earlier in the year. Non-food retailers said they were discounting less or passing on cost increases in full on products in high demand. Supermarkets expected to put up prices later this year to cover higher commodity prices.

Consumer services prices also picked up, in particular for domestic tourism. And casual dining and leisure firms reported lower levels of discounting than normal due to capacity restrictions and robust demand. However, there was downward pressure on prices in parts of the sector where demand remained weak, such as city hotel accommodation. And prices remained unchanged in sectors where competition is strong, such as estate agencies.

3: In focus – The outlook for inflation

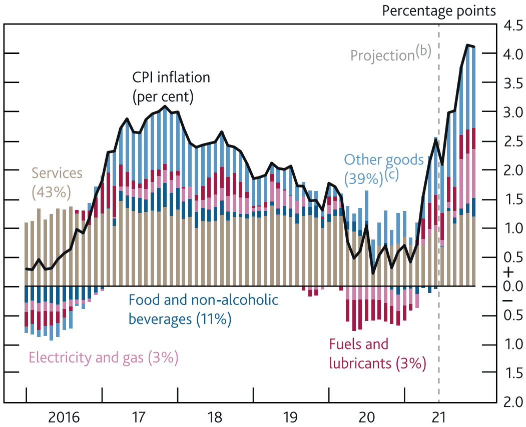
Inflation rose to 2.5% in June, 0.8 percentage points higher than expected in May. Core inflation also rose to 2.3%. Inflation is projected to pick up further in 2021 H2, with above-target inflation mainly reflecting the impact of higher energy and goods prices. In the MPC's projection, inflation falls back to 2% in late 2023. There are uncertainties around that forecast, however, for example around the extent to which strong global goods demand will continue. But the MPC sets monetary policy to ensure that inflation returns to the target sustainably and in the end this will ensure that the inflation overshoot will not persist. Inflation expectations remain consistent with inflation returning to the target in the medium term.

CPI inflation was below the MPC's target over much of the past two years, but it rose to 2.5% in June, and is expected to rise further in the near term (**Chart 3.1**). That is partly due to energy and commodity price rises feeding through to UK prices. The MPC's central projection is that higher cost pressures will be temporary such that inflation falls back towards the target (**Chart 3.2**), but there are uncertainties around that judgement.

This *In focus* assesses the latest evidence on inflationary pressures. Section 3.1 discusses the shocks that have affected global prices recently and their impact on UK consumer prices. Another potential source of inflationary pressure comes from the evolution of spare capacity, which will affect domestic prices, and is discussed in Section 3.2. Developments in inflation expectations could also affect CPI inflation, and Section 3.3 assesses the latest evidence on those expectations. Finally, Section 3.4 summarises the MPC's medium-term inflation projection, with further discussion of the risks set out in Section 1.

Chart 3.1: Inflation has picked up during 2021, and is expected to rise further in the near term

Contributions to CPI inflation[(a)]

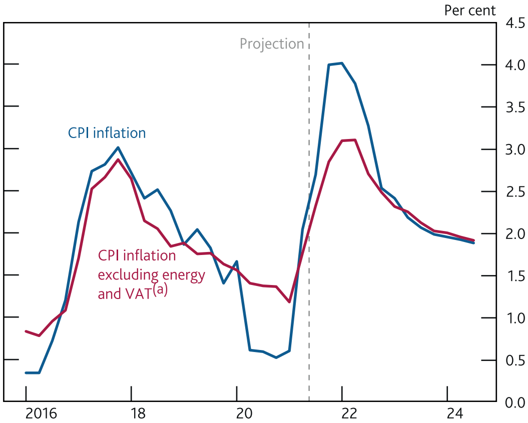


Sources: Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, ONS and Bank calculations.

(a) Contributions to annual CPI inflation. Figures in parentheses are basket weights in 2021 and do not sum to 100 due to rounding.
(b) Bank staff's projection. Fuels and lubricants estimates use Department for Business, Energy and Industrial Strategy petrol price data for July 2021 and then are based on the sterling oil futures curve.
(c) The difference between CPI inflation and the other contributions identified in the chart.

Chart 3.2: The MPC expects the near-term rise in inflation to be temporary

Quarterly CPI inflation including and excluding energy and VAT



Sources: ONS and Bank calculations.

(a) CPI inflation excluding fuels and lubricants, electricity, gas and other fuels. Data also adjusted to exclude estimates of the direct impact of changes in the rate of VAT. There is uncertainty around the precise size of that adjustment.

3.1: Global price rises and their impact on UK inflation

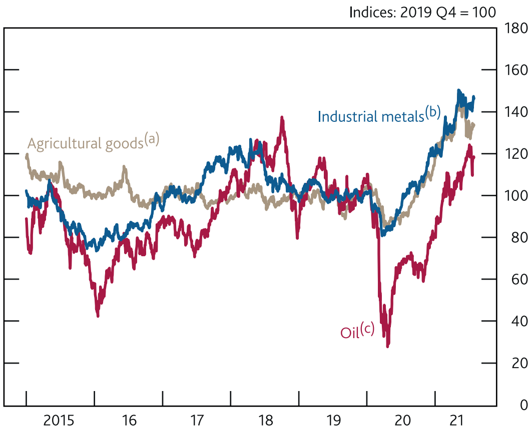
Inflation has increased globally in recent months.

Inflation has picked up recently across many economies, with goods prices in particular increasing around the world. Commodity prices have risen sharply since their troughs in 2020, and account for some of that increase. US dollar oil prices fell by more than 70% at the start of 2020, for example, but have now recovered to above their late-2019 levels (**Chart 3.3**). The prices of some other commodities fell by less at the start of 2020, but have also picked up strongly since April 2020. Metals prices are now more than 40% above their late-2019 levels, for example.

Higher goods prices also reflect the strength of demand, with consumer spending having shifted away from services during the pandemic. Investment in ICT equipment and plant and machinery has also recovered more recently. Higher global goods inflation also reflects increased production costs. Some supply bottlenecks have appeared, which have raised shipping costs, for example (**Chart 3.4**).

Chart 3.3: Oil and other commodity prices have risen sharply over the past year

US dollar commodity prices

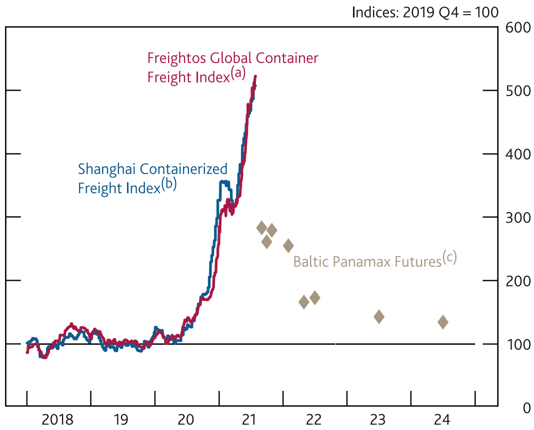


Sources: Bloomberg Finance L.P., Refinitiv Eikon from LSEG, S&P Indices and Bank calculations.

(a) Based on the S&P Goldman Sachs Commodity Index Agricultural and Livestock Spot.
(b) Based on the S&P Goldman Sachs Commodity Index Industrial Metals Spot.
(c) Brent forward prices for delivery in 10–25 days' time.

Chart 3.4: Shipping costs have risen sharply, but are expected to fall back

Shipping costs and forward freight agreement prices



Sources: Baltic Exchange, Freightos Baltic Index, Refinitiv Eikon from LSEG, Shanghai Shipping Exchange and Bank calculations.

(a) A measure of the cost of 40 foot container transport around the world.
(b) A measure of the cost of 20 foot container transport from China.
(c) Forward freight agreements indicating market expectations of future shipping costs on 28 July 2021.

UK inflation has also picked up, partly due to base effects…

UK CPI inflation was 2.5% in June, up from 0.4% in February. The latest data measure the change in prices relative to June 2020, when prices were particularly low, reflecting the impact of Covid. Similar so-called 'base effects' will continue to push up on inflation over 2021 H2.[1] The size of those effects can be illustrated by comparing the evolution of prices over the pandemic as a whole to the 12-month headline inflation rates. Over the past year and a half, so including the initial drop in prices, headline CPI has risen at an annualised rate of 1¾%.

Base effects are notable in energy prices. Retail energy prices are an important driver of UK consumer prices, accounting for over a third of the variance in CPI inflation since 1997, despite only making up 6% of the CPI basket. And retail energy prices tend to reflect changes in wholesale prices relatively quickly. The collapse in oil, gas and electricity prices last spring and their subsequent rebound mean that the contribution of energy prices to the CPI inflation rate increased by almost 1 percentage point between Q1 and Q2.

…but prices, particularly for goods, have also risen by more than expected since the May Report.

The June CPI inflation rate was 0.8 percentage points higher than expected in the May *Report*, an unusually large three month ahead forecast error. Almost half a percentage point of that news reflected higher-than-expected goods price inflation for items such as furniture and household appliances. Services inflation has also risen close to pre-pandemic rates, and contributed 0.2 percentage points to the upside surprise. The distribution of inflation rates within the services basket has widened, however, and prices were lower than a year earlier for over 15% of the basket. Energy prices only accounted for 0.1 percentage points of the news in inflation.

(1) See 'Beware base effects' ONS blog for more details.

Global cost pressures have pushed up on UK prices…

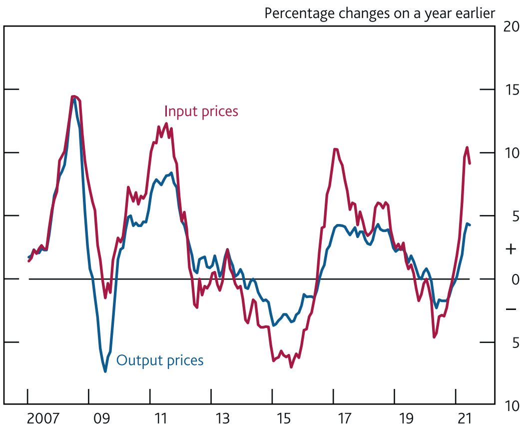
UK firms, like firms elsewhere, have been facing rising cost pressures. The recovery of global demand and supply shortages for some specific products have pushed up on UK firms' input costs. Input price inflation for UK manufacturers rose to around 10% in June, with output price inflation rising to almost 5% (**Chart 3.5**).

There have also been supply shortages of some goods such as semiconductors, which may have affected some specific UK consumer prices indirectly. Used car prices rose by just under 6% in the year to June, for example. This probably reflects in part a shift in preferences away from public transport, but the shortage of semiconductors pushing up the price of new cars is also likely to have played a role.

…and UK import prices have risen.

UK import prices have risen, and are higher than might have been expected given developments in world export prices and the sterling exchange rate.[2] Import prices have risen particularly sharply for some basic materials and manufactured goods, for example, although prices of imported consumer goods have fallen relative to a year earlier (**Chart 3.6**).

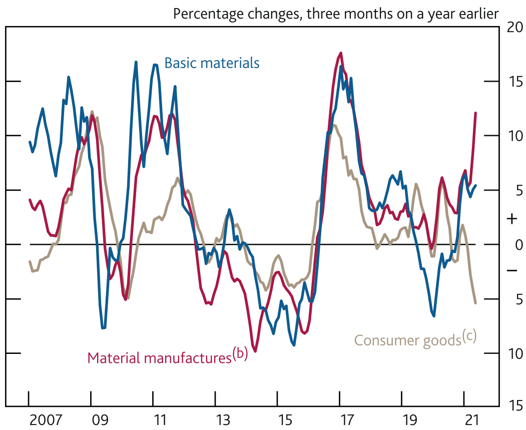
Chart 3.5: Input and output price inflation have both risen for UK manufacturers
Producer prices[a]



Sources: ONS and Bank calculations.

(a) Latest data point is for June 2021.

Chart 3.6: The prices of some imported basic materials and manufactured components have increased sharply in recent months
Import prices[a]



Sources: ONS and Bank calculations.

(a) Latest data point is for May 2021.
(b) Excludes erratics.
(c) Excludes cars.

The direct impact of higher energy and commodity prices on inflation should prove to be transitory.

The direct effects of recent energy price moves on CPI inflation are likely to be temporary. Petrol prices tend to increase when oil prices rise, for example, but they would then usually be expected to stay at similar levels once prices have adjusted. Unless energy prices go on rising, the effect on inflation will fade after a year or so. Other commodity price pressures should also be transitory. In the past, increases in non-oil commodity prices have tended to be followed by below-average rates of inflation for those commodities as demand and supply adjust (Winkelried (2021)).

Strong global demand for goods is expected to ease over time, although it could persist in the near term.

The recovery in demand that has put upward pressure on global goods prices in recent months could continue to do so in the near term. Surveys of manufacturing firms suggest that order books are strong, for example. Agency intelligence also suggests that commodity price pressures could persist into Q3, with contacts noting that supply may take some time to adjust to match higher demand. However, global demand for goods is expected to ease as consumers rotate some of their spending away from goods and back to services during the continuing recovery from the pandemic. There is some evidence that this is beginning to happen. For example, consumption of durable goods in the US appears to have levelled off recently.

(2) In the MPC's projections, for example, around 60% of any sustained rise in sterling world export prices would normally be expected to feed through to UK import prices, with the majority coming through in the first year.

There may also be a lag before consumer-facing firms pass on any higher costs to their retail prices. While that would lower the peak inflation rate in the near term, it would make the impact of the initial cost shock more persistent. Based on past episodes, Bank staff estimate that a sustained 5% rise in non-fuel import prices typically adds 0.8 percentage points to CPI inflation after four quarters, 0.5 percentage points after eight quarters and 0.3 percentage points 12 quarters ahead, for example. This suggests that cost shocks affecting UK import prices have tended to take some time to feed through to consumer prices, although their impact on inflation wanes over time.

In the MPC's projection, the impact of higher energy prices on inflation fades in the medium term…
Overall, Bank staff now expect inflation to rise materially further in the near term, temporarily reaching 4% in 2021 Q4 and 2022 Q1, 1½ percentage points higher than in the May projection. Around a third of that upward revision is due to the direct impact of higher energy prices. Stripping those out, as well as the impact of changing VAT rates, inflation rises to around 3% (**Chart 3.2**).

Beyond the near term, the impact of higher energy prices on inflation is expected to wane. While energy prices could increase further if strong global demand continues, they are not expected to keep rising indefinitely. In its projections, the MPC's conditioning assumption is that oil, gas and electricity prices follow their respective futures curves for the first two quarters of the projection, and beyond that remain flat (as set out in Box 5 of the August 2019 *Report*). As a result, their impact on the inflation projection over the medium term is broadly neutral.

…and goods price inflation is expected to fall back as global price pressures abate.
Global price pressures leading to higher consumer goods prices are a key reason why inflation is higher in the near term than in the May *Report*. The factors pushing these prices higher are expected to subside in the medium term, however. Consumers are expected to rotate some of their spending back to services over time. Supply constraints are also expected to ease, in part as production increases in response to higher prices, which may also reduce cost pressures. Prices in financial markets suggest that shipping costs are expected to fall back over the next three years, for example (**Chart 3.4**). Nonetheless, the decline in UK import prices is relatively gradual, as the MPC has made a judgement to unwind some of the recent strength in import prices more slowly than it might normally assume.

3.2: Spare capacity and domestic price pressures

The degree of spare capacity in the economy is judged to have increased during the pandemic…
The degree of spare capacity in the economy – the difference between actual GDP and potential supply – will also affect inflationary pressure. Spare capacity can be within the labour market, if people are out of work for example, or within companies. The true extent of economic slack is always difficult to estimate precisely, and has been particularly hard to assess during the pandemic, given the impact of the furlough scheme on the labour market and the impact of Covid on both demand and supply. The MPC judges that the pandemic led to a degree of spare capacity opening up, reducing domestic price pressures.

…but slack appears to have fallen in recent months.
The amount of slack appears to have fallen in recent months, and by more than expected in the May *Report*. The unemployment rate is expected to have declined to 4.8% in Q2, for example, leaving it 0.4 percentage points below its late-2020 peak. The number of vacancies relative to the number of unemployed people – another indicator of tightness in the labour market – has also risen sharply in recent months and was back to early-2020 levels in June (**Chart 2.26**).

More acute labour market tightness is observable in some parts of the economy…
The amount of spare capacity seems to vary across sectors, regions and firms. Sharp changes in spending patterns, alongside constraints on supply due to social distancing restrictions could create some mismatch, making it harder for firms to find the right workers. Consistent with that, responses to the Decision Maker Panel (DMP) Survey suggest that the allocation of demand across firms has changed substantially during the pandemic, but jobs have not been reallocated to the same extent (**Chart 3.7**). A large share of that reallocation of demand appears to have happened within sectors rather than between sectors, for example if customers buy similar products from different sources. This may be partly due to regional differences, which would be consistent with evidence that activity has been slower to return in some city centres than in other areas.

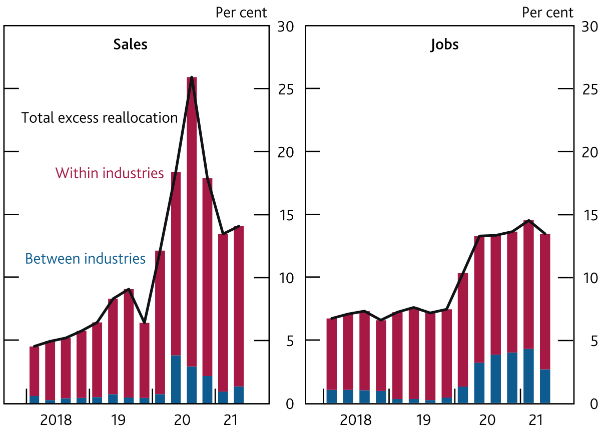
Many firms are now reporting recruitment difficulties (Section 2.3). Agency contacts also suggest that this is happening across a broadening range of jobs and skills. Some indicators of 'mismatch' across industries in the labour market – the extent to which vacancies are in different sectors to those in which unemployed people last worked – appear to have fallen back recently, however.

…which might be pushing up wage growth.

These pressures are likely to put upward pressure on wage growth. Pay growth has recently been very high, although the strength of the latest ONS data largely reflects temporary factors (Box C). Even accounting for those factors, however, pay growth during the pandemic has been stronger than would be expected given wider developments in the economy and above recent *Monetary Policy Report* forecasts. In the KPMG/REC *UK Report on Jobs*, firms report that starting salaries for both permanent and temporary staff have increased markedly (**Chart 3.8**). For permanent staff, the balance is at its highest level since 2014, and for temporary staff it is at its highest since 2004. This could be putting upward pressure on firms' labour costs and adding to inflationary pressures.

Chart 3.7: Spending patterns have adjusted sharply during the pandemic, but there has been less job reallocation

Three-year sales and employment reallocation(a)

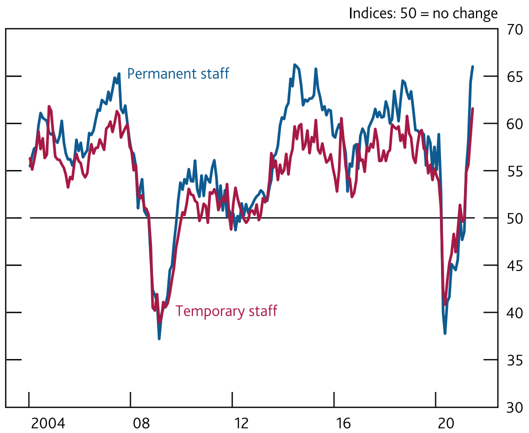


Sources: DMP Survey and Bank calculations.

(a) Excess reallocation is the amount of cross-firm sales and job reallocation in excess of what is required by the aggregate changes in these variables, following a similar method to Barrero *et al* (2021). These are shown as percentages of total sales and employment respectively. Three-year reallocation estimates are based on realised changes over the prior two years and expected changes over the coming year. Latest data point is for 2021 Q2.

Chart 3.8: Pay rates have risen for new permanent and temporary staff

Pay rates for new staff(a)



Source: KPMG/REC UK *Report on Jobs*.

(a) Latest data point is for June 2021.

Some of the frictions currently affecting the labour market could ease relatively quickly…

Some of the upward pressures on pay growth are expected to unwind in the near term. The participation rate has fallen since 2019 Q4, for example, consistent with its past relationship with employment growth (**Chart 3.9**). If more people start searching for work as Covid concerns dissipate, the supply of labour would increase.

…but others may cause more lasting upward pay pressure.

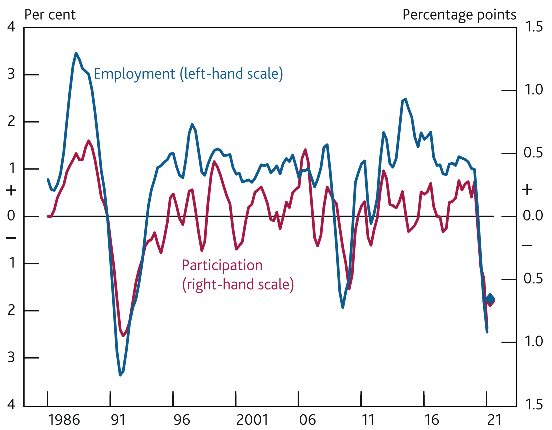
There may be reasons to think that the fall in the participation rate – and the implied increase in inactivity – will put less downward pressure on pay for some time. For example, more young people now report that they are inactive in the labour market due to study, compared with 2019 Q4 (**Chart 3.10**), and some of those could stay in education for several years. In addition, more workers under the age of 65 have chosen to retire, which could lower the participation rate of that age group for a while. There has been an offsetting fall in the number of women reporting labour market inactivity for reasons of looking after the family or home, however. That may be linked to an increasing ease of working from home and so could continue to put downward pressure on inactivity.

Overall, these frictions are expected to dissipate gradually over the forecast period.

Aggregate measures of mismatch have declined over recent months and that is likely to continue over the coming quarters, in part as activity rotates back towards its pre-Covid distribution. That judgement is uncertain, however. Agency intelligence suggests that some of the reasons for recruitment difficulties might reflect more persistent effects on labour supply, for example if people's desire to work in certain industries has changed permanently. Evidence also suggests that a high number of migrant workers left the UK during 2020, and it is hard to predict how many will return.

Chart 3.9: The participation rate has fallen, as would be expected given the fall in employment

Annual employment growth and change in participation rate[a]

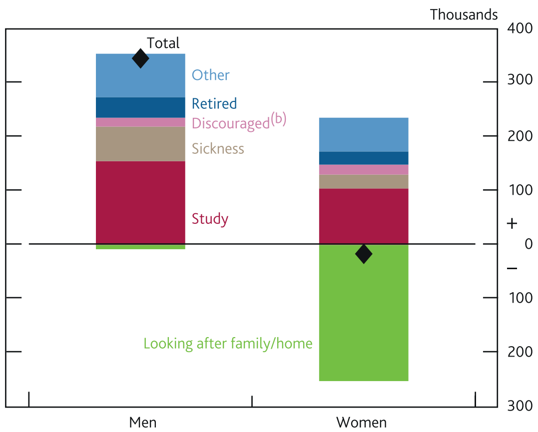


Sources: ONS and Bank calculations.

(a) Two-quarter moving averages. Diamonds are based on Bank staff projections for 2021 Q2.

Chart 3.10: The number of people inactive in the labour market due to study has risen

Changes in inactivity since 2019 Q4 by reason[a]



Sources: ONS and Bank calculations.

(a) Changes between the three months to December 2019 and the three months to May 2021, based on those aged 16–64.
(b) Those who are not looking for work because they believe no jobs are available.

Changes in the pattern of demand across sectors might also have put upward pressure on inflation.

Changes in demand across sectors might also have put upward pressure on CPI inflation directly. When demand is very strong in some parts of the economy and not others, it will tend to push up on average prices, at least until supply adjusts in response, because the rise in costs and prices in areas seeing strong demand tend to be larger than the declines in sectors where demand is weak (Broadbent (2021)). Consistent with that, intelligence from the Bank's Agents suggests that some firms feel like they have more scope to raise prices relative to the past.

That is expected to be transitory, although there are risks around that judgement.

As with global goods prices, these pressures are expected to be transitory, however. Demand across sectors is likely to rebalance as the recovery continues. In addition, over time, supply is likely to adjust to meet any persistent changes in demand across sectors and any bottlenecks should unwind. But it is difficult to be precise about the speed at which these adjustments might occur, and so there is uncertainty about how long these pressures might persist. Moreover, given the uneven nature of the expected recovery, it is likely that there will be temporary periods of excess demand for some goods and services as demand recovers. This could affect the path of inflation over the MPC's three-year forecast period.

3.3: Inflation expectations

Inflation expectations are a key determinant of inflation.

People's expectations for future price changes can affect what happens to prices today. When inflation is expected to rise, for example, workers may demand higher wages to prevent a drop in their real incomes and firms may increase their own prices. If people expect higher prices, they might also adjust their spending choices, which can also affect future inflation indirectly (Coibion *et al* (2021)).

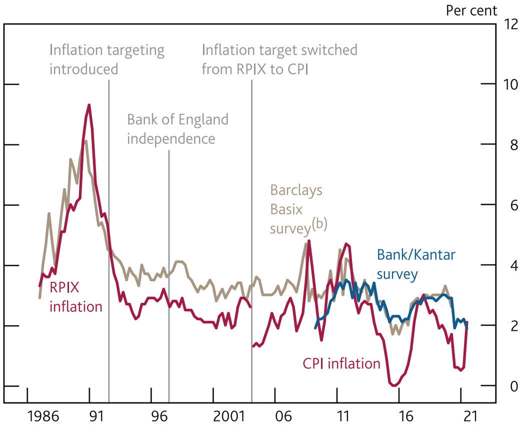
Short-term inflation expectations might be expected to move up and down fairly frequently as shocks hit the economy. But medium-term expectations would be expected to remain more stable, as people expect the MPC to adjust monetary policy to achieve the 2% inflation target. Since inflation targeting was introduced in the UK, expectations have remained well anchored, even when inflation has moved temporarily above or below the target (**Chart 3.11**). Expectations at longer horizons have been particularly stable.

Short-term indicators of inflation expectations have not risen, but may do so as inflation picks up.

Inflation expectations one year ahead currently vary across surveys of businesses, professional forecasters, financial markets and households. Businesses' expectations picked up from low levels in Q1 but remained below their post-crisis average. The Bank's survey of professional forecasters points to higher inflation one year ahead than in May, consistent with the MPC's projection, and financial market indicators have also picked up somewhat (**Chart 3.12**). Household expectations fell back in the latest quarter, however, and do not look elevated relative to the past (**Table 3.A**). Some of these near-term measures of inflation expectations tend to be correlated with inflation outturns (Rowe (2016)), so it is possible that they will increase somewhat as inflation rises over the coming months.

Survey measures of inflation expectations two to three years ahead are generally little changed.
Companies' inflation expectations two years ahead have picked up a little, but are still below where they were in 2020, while households' expectations have fallen. According to the 2021 Q3 survey, expectations of professional forecasters are a little higher than in Q2, although average expectations two and three years ahead are still close to 2% (see annex).

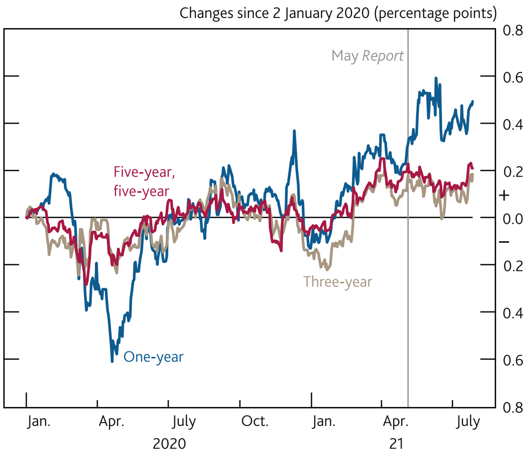
Chart 3.11: Household inflation expectations have been well anchored in the inflation targeting era
Inflation and households' two year ahead expectations[(a)]



Sources: Bank of England, Barclays, Kantar and ONS.

(a) In December 2003 the inflation target was changed from 2.5% based on the RPIX measure, to 2% based on the CPI.
(b) The Barclays Basix survey was suspended in 2020.

Chart 3.12: Measures of financial markets' inflation expectations have risen during 2021
Changes in inflation compensation at different horizons[(a)]



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

(a) Instantaneous RPI inflation one and three years ahead and five-year RPI inflation five years ahead, derived from swaps.

Table 3.A: Inflation expectations remain well anchored
Measures of inflation expectations[(a)]

Per cent	2000–07[(b)]	2010–19	2020	2021 Q1	2021 Q2
One year ahead inflation expectations					
Households[(c)]					
Bank/Kantar	2.4	3.0	2.9	2.7	2.4
YouGov/Citigroup	2.5	2.5	3.1	3.0	2.8
Companies[(d)]	n.a.	1.7	1.1	0.5	1.1
Financial markets[(e)]	2.6	3.0	3.0	3.2	3.4
Two to three year ahead expectations					
Households[(c)]					
Bank/Kantar	n.a.	2.8	2.3	2.2	1.9
Companies[(d)]	n.a.	n.a.	1.4	0.6	0.9
External forecasters[(f)]	2.0	2.1	1.9	1.9	2.0
Financial markets[(e)]	2.8	3.1	3.5	3.5	3.7
Five to ten year ahead expectations					
Households[(c)]					
Bank/Kantar	n.a.	3.3	2.9	2.9	2.7
YouGov/Citigroup	3.5	3.2	3.2	3.3	3.4
Financial markets[(e)]	3.1	3.4	3.6	3.6	3.7
Memo: CPI inflation	1.6	2.2	0.9	0.6	2.1

Sources: Bank of England, Bloomberg Finance L.P., CBI, Citigroup, Kantar, ONS, YouGov and Bank calculations.

(a) Data are not seasonally adjusted.
(b) Averages from 2000, or start of series, to 2007. Financial market data start in October 2004, YouGov/Citigroup data start in November 2005 and external forecasters' data start in 2006 Q2.
(c) The household surveys do not reference a specific price index.
(d) CBI data for the distributive trades sector. Based on the expected price change over the coming 12 months and the following 12 months in the markets in which firms compete.
(e) Instantaneous RPI inflation one and three years ahead and five-year RPI inflation five years ahead, derived from swaps.
(f) Bank's survey of external forecasters, CPI inflation rate three years ahead. See annex for the results of the 2021 Q3 survey.

Medium-term financial market measures of inflation expectations have risen to a little above their past averages.
The price of five-year inflation swaps, five years ahead are an indicator of longer-term inflation expectations derived from financial markets. They tend to be much less volatile than shorter-term financial market measures (**Chart 3.12**),

reflecting an expectation that inflation will be brought back to the target in the medium term. Since the beginning of the year, this measure has risen a little above its average over the previous decade in the UK, in contrast to the US and euro area, where measures are below past averages. The UK measure is little changed since May.

Overall, the MPC judges that inflation expectations remain well anchored.
Taking all the evidence together, inflation expectations appear to be well anchored and there is little evidence to suggest that higher expectations will add to the persistence of the near-term overshoot in inflation. The MPC will continue to monitor these indicators closely.

3.4: The MPC's inflation projection

The MPC expects CPI inflation to rise temporarily to around 4% in the near term, before falling back towards 2%.
In the MPC's projection, inflation rises temporarily to around 4% in the near term, largely driven by energy and goods prices. Inflation starts to decline in 2022, and returns to the 2% target in late 2023 (**Chart 3.2**).

The expected decline in inflation reflects less upward pressure from energy prices, which is likely to be transitory. Goods price inflation is also expected to fall back, reflecting an easing of supply chain disruptions and the rotation of spending away from goods and back towards services. Consistent with that, import prices are expected to fall back somewhat over time. Domestic price pressures are expected to strengthen, as the MPC expects a margin of excess demand to emerge temporarily. But that is eroded subsequently, in part as temporary frictions affecting supply dissipate, and so those pressures fade towards the end of the forecast period.

There are two-sided risks around this central path. Key uncertainties include whether global demand for goods remains robust, the response of global supply, the path of UK import prices and how spare capacity and domestic price pressures evolve. These are discussed further in Section 1.

Annex: Other forecasters' expectations

This annex reports the results of the Bank's most recent survey of external forecasters. Expectations for the near term are summarised in **Chart A**, and those for further out are shown in **Table 1** and **Chart B**.(1)

On average, external forecasters expected quarterly GDP growth to be 3.3% in 2021 Q3 (**Chart A**). The unemployment rate was expected to rise to 5.1% and CPI inflation was expected to be 2.5%. The range of projections remains wide.

Chart A: On average, external forecasters expect GDP to rise by 3.3% in 2021 Q3, the unemployment rate to rise to 5.1%, and CPI inflation to increase to 2.5%

Other forecasters' central projections for GDP, the unemployment rate and CPI inflation in 2021 Q3

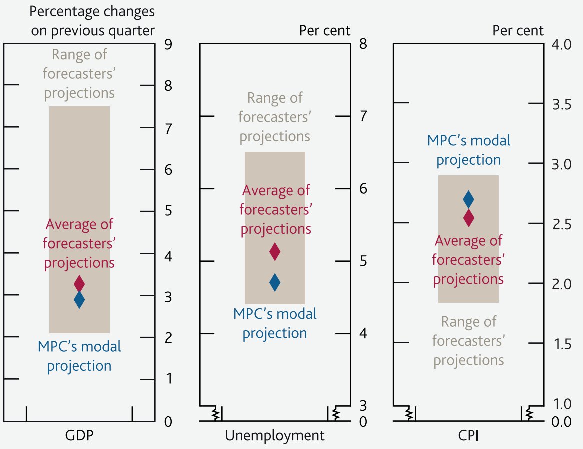


Table 1: Averages of other forecasters' central projections

	2022 Q3	2023 Q3	2024 Q3
GDP growth[a]	3.9	2.0	1.7
CPI inflation[b]	2.2	2.1	2.2
LFS unemployment rate (per cent)	4.9	4.7	4.4
Bank Rate (per cent)[c]	0.2	0.7	1.1
Stock of purchased gilts (£ billions)[d]	876	862	823
Stock of purchased corporate bonds (£ billions)[d]	20	20	20
Sterling ERI[e]	81.9	81.5	80.9

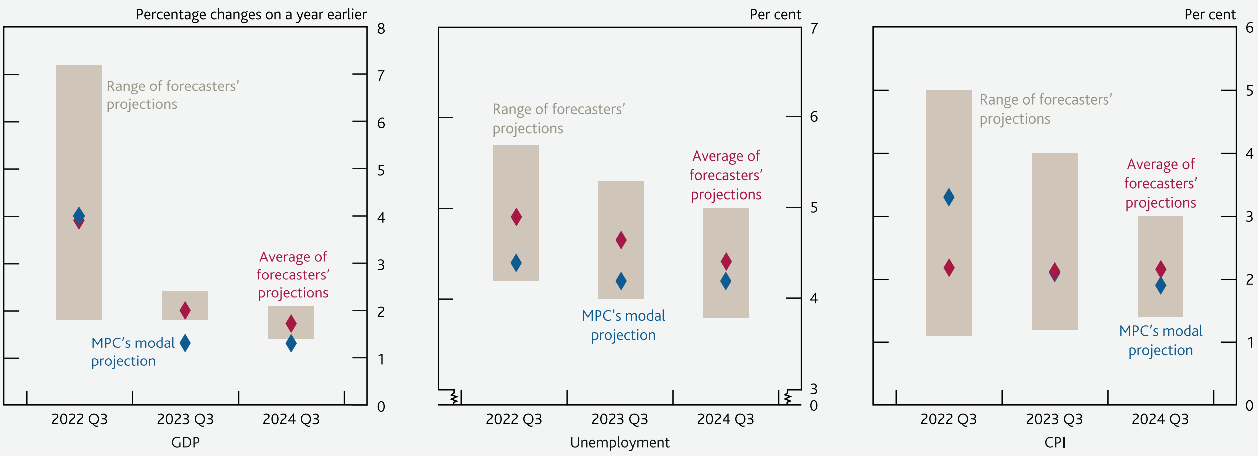
(a) Four-quarter percentage change.
(b) Twelve-month rate.
(c) This projection is markedly affected by one respondent. Excluding that respondent from the sample, Bank Rate is expected to be 0.1% in 2022 Q3, 0.3% in 2023 Q3 and 0.7% in 2024 Q3.
(d) Original purchase value. Purchased via the creation of central bank reserves.
(e) Index: January 2005 = 100.

On average, respondents expected GDP growth of 3.9% in the four quarters to 2022 Q3 (left panel, **Chart B**). Four-quarter GDP growth is then expected to fall gradually to 1.7% by 2024 Q3. The unemployment rate is expected to fall steadily from 4.9% in 2022 Q3 to 4.4% by 2024 Q3 (middle panel, **Chart B**). CPI inflation is expected to be 2.2% in 2022 Q3, and remain close to the 2% target throughout the forecast period (right panel, **Chart B**).

On average, external forecasters expect Bank Rate to be little changed over the next year, before rising over the following two years (**Table 1**). The stock of purchased assets is expected to be unchanged over the next year, before decreasing by about £50 billion by the end of the forecast period.

Chart B: At the three-year horizon, external forecasters expect annual GDP growth to be 1.7%, the unemployment rate to be below 4.5%, and inflation to be close to the MPC's 2% target

Projections for GDP, the unemployment rate and CPI inflation



(1) For detailed distributions, see 'Monetary Policy Report chart slides and data – August 2021' link at *Monetary Policy Report – August 2021*.

Glossary and other information

Glossary of selected data and instruments

AWE – average weekly earnings.
CPI – consumer prices index.
CPI inflation – inflation measured by the consumer prices index.
DMP – Decision Maker Panel.
ERI – exchange rate index.
GDP – gross domestic product.
HICP – harmonised index of consumer prices.
LFS – Labour Force Survey.
MFCI – Monetary and Financial Conditions Index.
PCE – personal consumption expenditure.
RPI – retail prices index.
RPI inflation – inflation measured by the retail prices index.

Abbreviations

BCC – British Chambers of Commerce.
CBI – Confederation of British Industry.
CFO – chief financial officer.
ECB – European Central Bank.
ELB – effective lower bound.
EME – emerging market economy.
EU – European Union.
FTSE – Financial Times Stock Exchange.
HMRC – Her Majesty's Revenue and Customs.
ICE/BoAML – Intercontinental Exchange/Bank of America Merrill Lynch.
IDBR – Inter-Departmental Business Register.
ICT – Information Communications Technology.
IMF – International Monetary Fund.
IT – information technology.
LTV – loan to value.
MPC – Monetary Policy Committee.
MSCI – Morgan Stanley Capital International Inc.
MTIC – missing trader intra-community.
OECD – Organisation for Economic Co-operation and Development.
ONS – Office for National Statistics.
ONS BICS – Office for National Statistics Business Insights and Conditions Survey.
PAYE – Pay As You Earn.
PPP – purchasing power parity.
REC – Recruitment and Employment Confederation.
RTI – Real Time Information.
S&P – Standard & Poor's.
SME – small and medium-sized enterprise.
SVR – standard variable rate.
VAT – Value Added Tax.
WEO – IMF *World Economic Outlook*.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Bank of England or the Office for National Statistics (ONS) and all data, apart from financial markets data and results from the Decision Maker Panel (DMP) Survey, are seasonally adjusted.

n.a. = not available.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.