

Bank of England

Taking a walk on the supply side

Remarks at the OeNB / SUERF conference 'Monetary policy and structural tectonic shifts'

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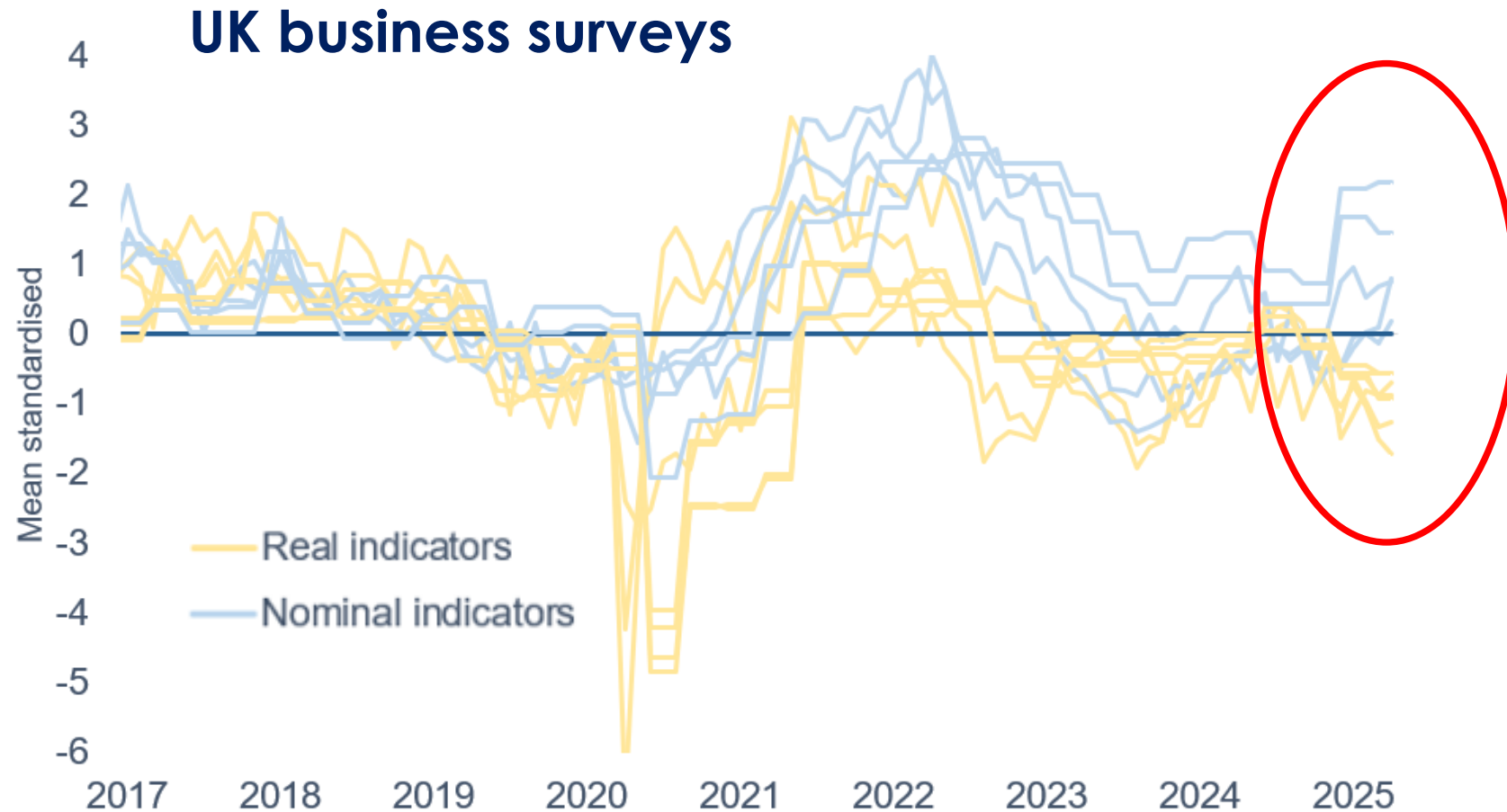
22 May 2025



'Tectonic shifts' embody many shocks

- (Temporary) demand shocks » **'Divine coincidence'**
Blanchard and Gali, 2007
- (Temporary) supply shocks » **'Trade-off inducing'**
Tenreyro, 2022
- Explanations of the 'Great Inflation' *Orphanides, 2002*

A puzzle? Or more supply concerns?



Source: PMI, BCC, CBI surveys

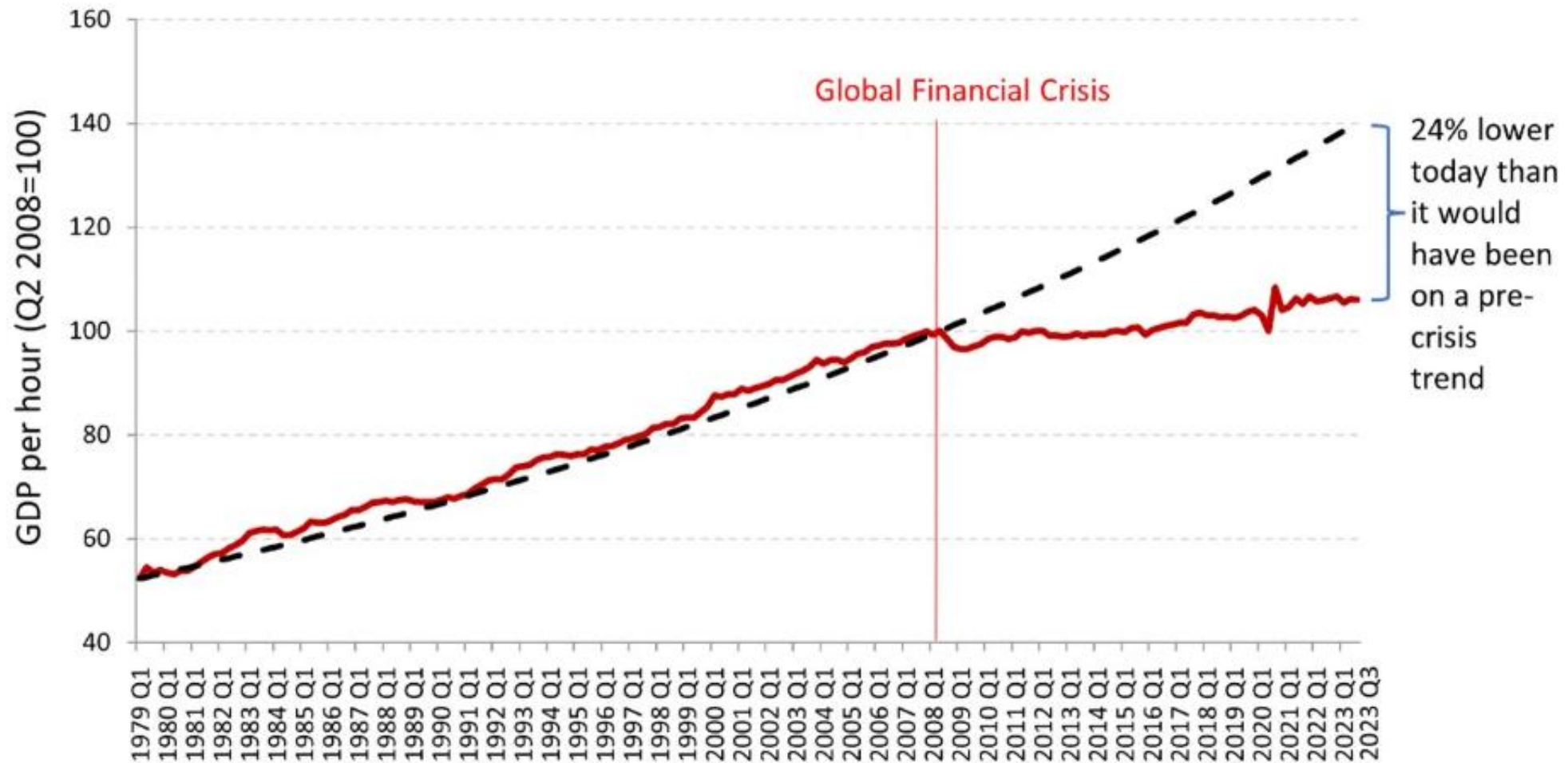
'Halcyon days' of inflation targeting in UK ...

- Supply-side of UK economy was ...
 - Favourable (trend real growth > 2%pa) owing to globalisation, New Economy etc.
 - Stable
 - Predictable
- Demand-side of UK economy ...
 - Drove cyclical developments in economic activity
 - Reliably forecastable around 1 year ahead on basis of composite PMI and £TWI

Financial crisis and the UK 'productivity puzzle'

- After the global financial crisis, labour productivity growth in the UK fell below its previous long-run trend ...
- ... raising the question of whether it would return to that trend or we had seen a 'structural shift' (akin to the 1973 'productivity shock' in advanced economies)
- Implications for monetary policy
 - Less favourable real growth trend
 - Potential output less stable, or at least less predictable
 - To measure resource pressure, focus more on labour market for indications of domestic economic slack
 - Pros – NAIRU less uncertain than potential GDP
 - Cons – Reliance on 'later cycle' indicators

Financial crisis and the UK 'productivity puzzle'



Source: Van Reenen and Yang (2023)

Covid pandemic adds to these challenges ...

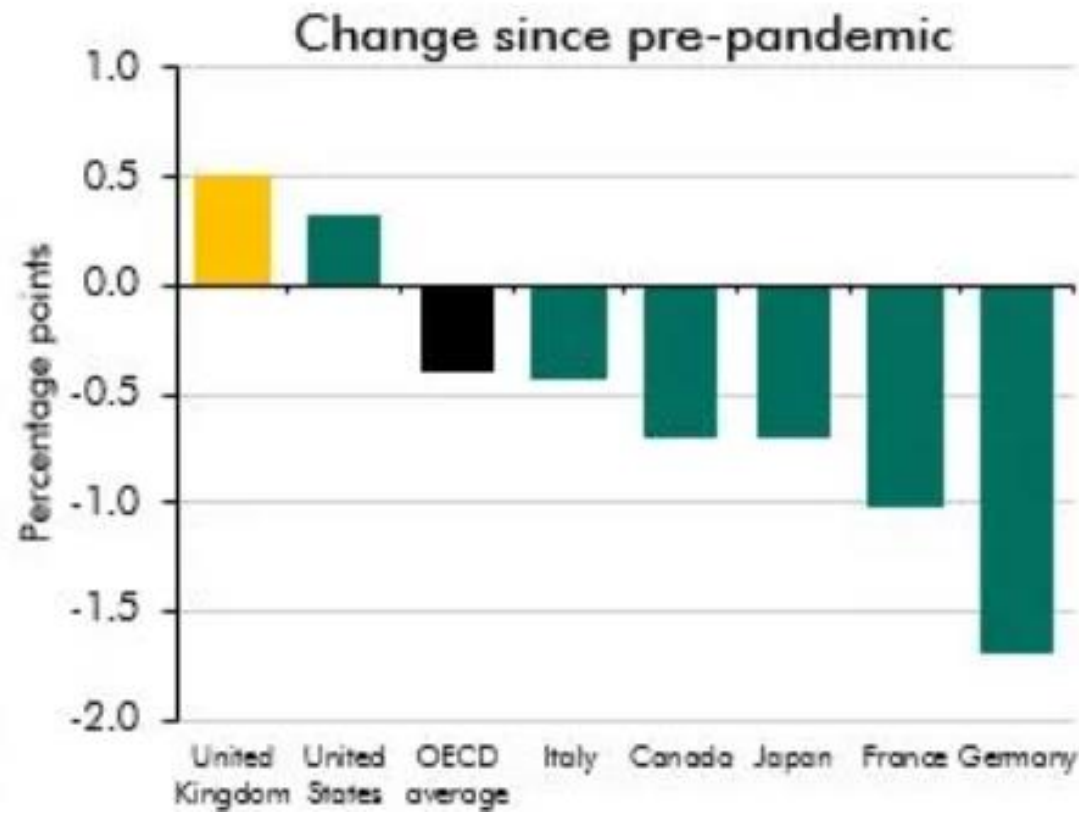
- Further complications

- Unprecedented character and magnitude of the shock
- Distinguishing demand and supply effects in real time ...
- ... especially when also dysfunction in financial markets (and of course health risks)
- Data collection challenges and gaps / deterioration in quality
- Lockdown / furlough impact on the labour market
- 'Great resignation' / fall in labour force participation
- also migration, Brexit, productivity dynamics, etc.

- NAIRU uncertain
- Measures of unemployment uncertain

Covid pandemic adds to these challenges ...

Change in 15-64-year-old inactivity rates



Source: OBR, OECD

Covid pandemic adds to these challenges ...

Potential supply growth has remained weak in recent years



Source: ONS, Bank of England

How should monetary policy makers respond?

1. Place less weight on inflation forecasts

- Wait for “whites of the eyes” of inflation
- Rely on “key indicators of inflation”
- Emphasise “persistent components of (domestically generated) inflation” to maintain forward-looking element

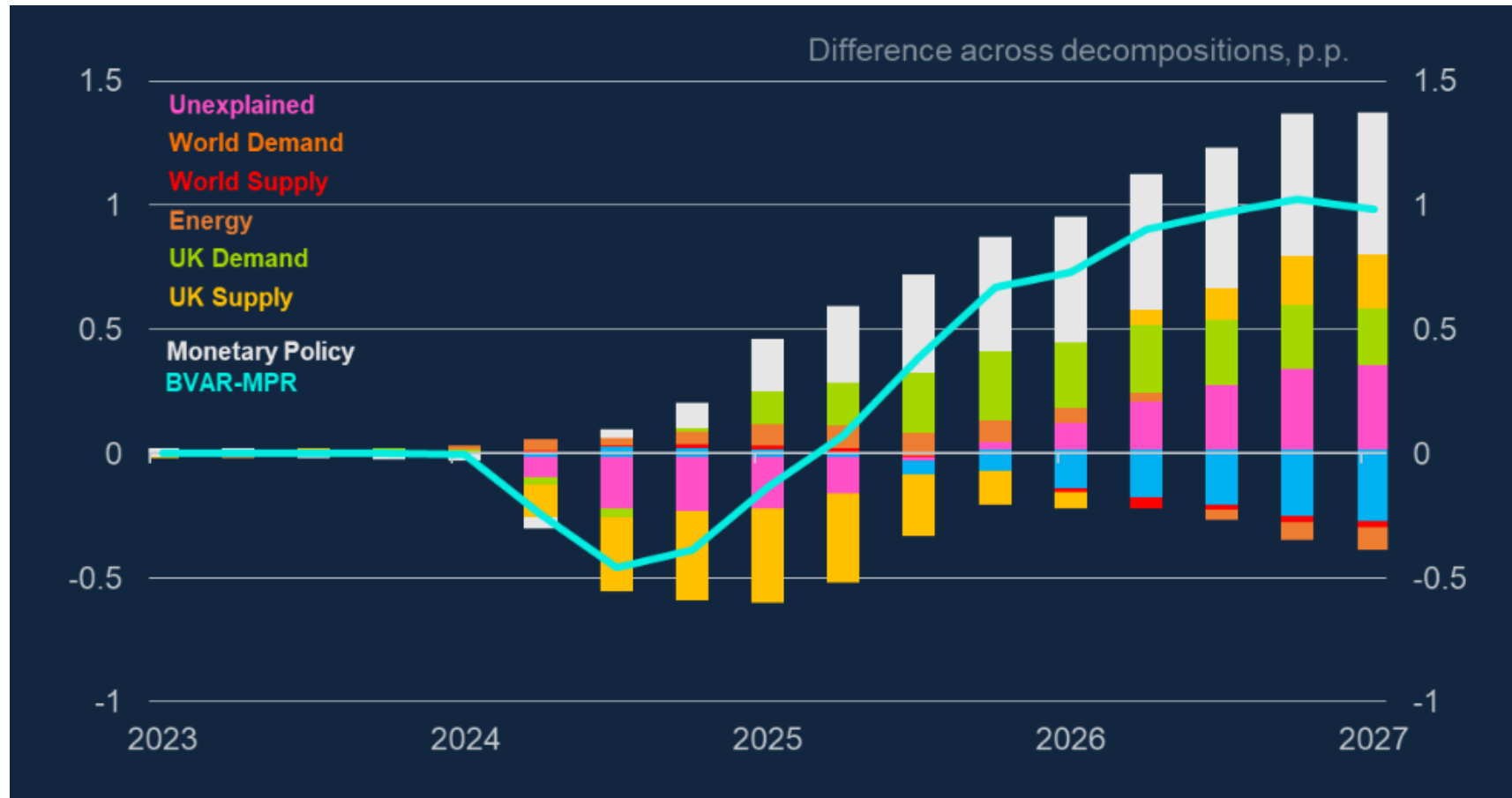
How should monetary policy makers respond?

2. Get better at making inflation forecasts in face of supply-side shifts

- Improve forecasting of structural factors
- BoE's annual "supply stocktake" (retains focus on dynamics of starred variables, like trend productivity growth, which – by nature – typically are not seen to change much at the cyclical frequency)
- Recognise potential for supply disturbances at monetary policy relevant cyclical horizons (e.g. supply chain disruptions)
- Deep dive exercises in real time (e.g. 'structural issues report') – energy markets, competition in food retailing, administered prices
- Models that seek to distinguish supply / demand factors (e.g. [sign restriction S-VARs](#))

How should monetary policy makers respond?

Cross-checking time series and judgemental forecasts of inflation



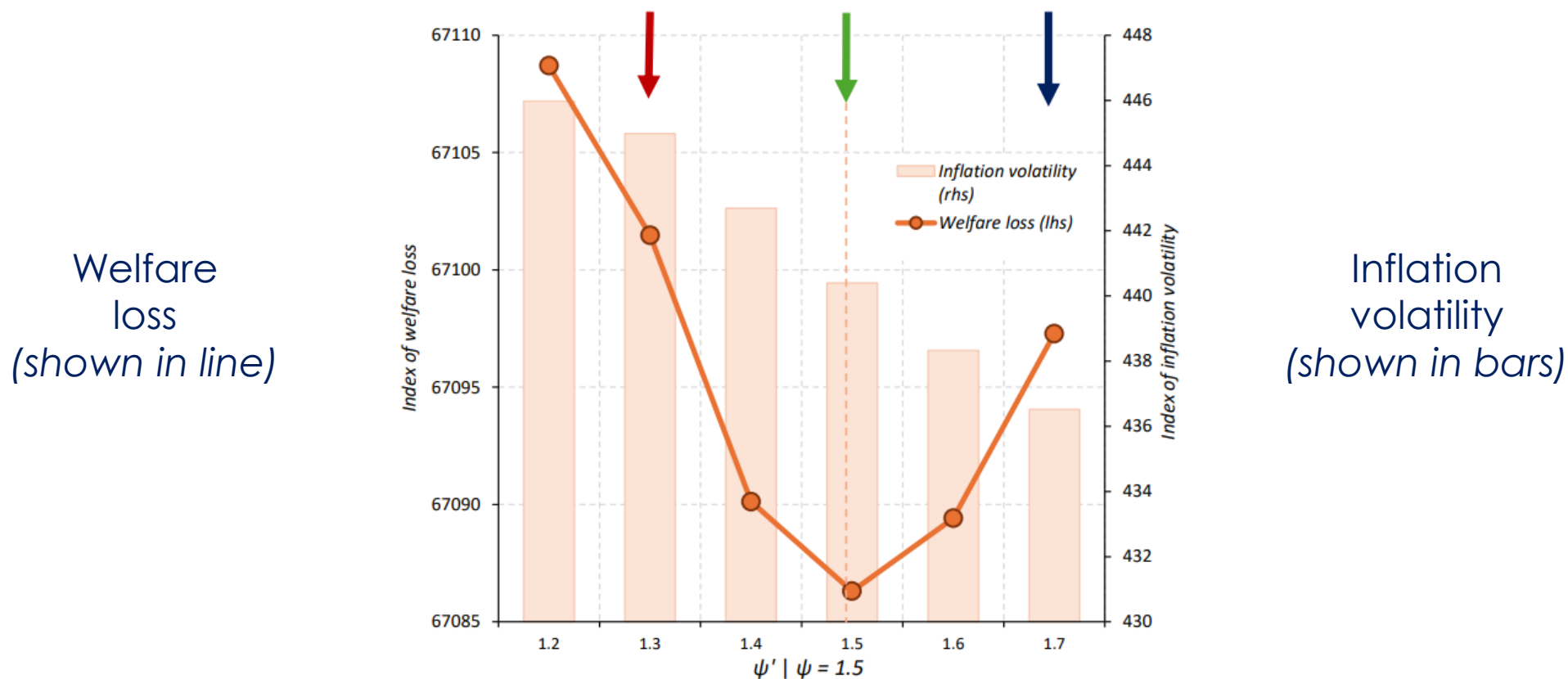
Source: Pill (2024)

How should monetary policy makers respond?

3. Make policy choices more 'robust' to forecasting difficulties

- Use scenarios to conduct "what if" exercises
- Explore how policies will perform across a range of plausible outcomes
- Prefer policy choices that 'do well' across a range of possible structural environments rather than policies that optimise in one environment but perform poorly in others ...

How should monetary policy makers respond?



More 'concern' about intrinsic inflation persistence for a given true (but unobserved) value of such persistence

Concluding remarks

- Do not lose sight of the ‘eternal verities’ of monetary policy making even when the context becomes more challenging in the face of ‘tectonic shifts’
- But regularly assess the procedures and processes used to implement those eternal verities ...
 - You need to show ‘agility’ to respond to structural change ...
 - ... you need to provide confidence via continuity and consistency in support of credibility
 - ... but you also need to recognise that previously successful approaches may need to evolve, perhaps quickly in the face of tectonic shifts

