



BANK OF ENGLAND

Mark Carney  
Governor

The Rt Hon George Osborne  
Chancellor of the Exchequer  
HM Treasury  
Horse Guards Road  
London  
SW1A 2HQ

12 February 2015

Dear Chancellor,

On 13 January, the Office for National Statistics (ONS) published data showing that twelve-month CPI inflation had fallen to 0.5%. That is more than one percentage point below the 2% target. In line with the remit of the Monetary Policy Committee (MPC), I am therefore writing an open letter to you that describes:

- the reasons why inflation has moved away from the target and the outlook for inflation;
- the horizon over which the Committee judges it appropriate to return inflation to the target;
- the trade-off that has been made with regard to inflation and output variability in determining the scale and duration of any expected deviation of inflation from the target;
- the policy action that the Committee is taking in response; and
- how this approach meets the Government's monetary policy objectives.

Following the new arrangements described in your letter to me on 14 January 2015<sup>1</sup>, this letter is to be published alongside the February *Inflation Report* containing the MPC's latest economic projections.

### Why has inflation moved away from the 2% target?

In December 2014 twelve-month CPI inflation stood at 0.5%. That is the lowest figure since May 2000 and 1½ percentage points below the inflation target.<sup>2</sup>

The MPC's best collective judgement is that roughly two thirds of the deviation from target (around one percentage point) can be attributed to unusually low contributions from movements in energy, food and other goods prices. Around a third of the deviation of inflation from the target (half a percentage point) reflects more generalised subdued inflationary pressures resulting from weak growth in domestic costs.

**Table 1** compares the arithmetic contributions to CPI inflation over the year to December of two broad sub-aggregates of the Consumer Price Index: (i) energy, food and other goods, and (ii) services – with their respective averages between 1997 and 2007.<sup>3 4</sup>

<sup>1</sup> <http://www.bankofengland.co.uk/monetarypolicy/Documents/pdf/chancellorletter150114.pdf>

<sup>2</sup> CPI data have been collected since 1996 and CPI inflation became the official inflation target measure in December 2003. Prior to that the target was for annual RPIX inflation of 2.5%. The current inflation rate of 0.5% matches the lowest figure recorded in the history of the CPI; since 1997, annual CPI inflation has been below 1% 16 times.

<sup>3</sup> This comparison is instructive because, adjusted for measurement changes, CPI inflation in that earlier period averaged close to the 2% target rate. The unadjusted average was 1.6% between 1997 and 2007 but, in 2010, the practices regarding the collection of

**Table 1: Arithmetic contributions to December 2014 CPI inflation relative to the pre-crisis average**

<i>Percentage points</i>	<b>1997-2007 average</b>	<b>December 2014</b>	<b>Difference</b>
Energy, food and other goods <sup>(a)</sup>	0.4	-0.5	-0.9
Services	1.6	1.1	-0.5
Total <sup>(a) (b)</sup>	2.0	0.5	-1.4
(a) Adjusted for the close to 0.4 percentage point downward bias from clothing that existed until 2010.			
(b) Totals may not sum exactly due to rounding.			

The most important single reason for below-target inflation over the past year is the unexpected recent sharp drop in energy prices. Between the middle of 2014 and the time at which the December CPI collection was made, the sterling price of crude oil fell by 40%. The price of a litre of unleaded petrol fell by 10% in the year to December, from £1.30 to £1.17. And in contrast to the previous December, when they rose by over 6% on the month, retail gas and electricity prices were unchanged in December 2014.

Overall, the energy component of the CPI contributed -0.5 percentage points to headline inflation in December, compared to a pre-crisis average of +0.3 percentage points, so dragging by around 0.8 percentage points on headline inflation relative to target.

Food prices, which rose by 1.9% a year during the 1997-07 decade, fell by 1.7% in the year to last December. That reflects a combination of factors, including bumper harvests in 2014, which reduced UK farm prices by 11%, falls in global agricultural prices and more intense competition among retailers.

Together with some drag from sterling's appreciation after mid-2013, which continues to depress import prices, these shocks explain about 1 percentage point of the deviation of inflation from the target. There is nothing unusual about these shocks. In the past decade, the UK has faced sharp increases in commodity prices and inflation increased to well above the target. What is different is that these shocks, dragging down on inflation, have occurred at the same time as inflation pressures in general have been subdued.

Around one third of the deviation of inflation from the target (half a percentage point) reflects more generalised subdued inflationary pressures that result from weak growth in domestic costs, particularly wages.

In the three months to November average weekly earnings were 1.7% higher than a year earlier, much less than the 4-4½% annual growth generally observed prior to the crisis. Some of that weakness is the counterpart of weak productivity growth but unit labour costs, which measure total labour costs per head relative to productivity, have also been rising slowly: growth over the year to the third quarter of 2014 was only 0.5% and annual growth is expected to have been close to that in the fourth quarter.<sup>5</sup>

That weakness in unit cost growth is the result of a long period since the crisis in which unemployment has been elevated and there has been significant slack in the economy. Its effect is evident in the

---

clothing prices were changed, boosting CPI, according to Bank staff estimates, by close to 0.4 percentage points. Consequently, the configuration of price increases that brought about an average CPI reading of 1.6% in the decade leading up to the crisis would now produce an aggregate CPI inflation rate of around 2%.

<sup>4</sup> The arithmetic contribution of a change in a subcomponent of the CPI to the total is not the same as its ultimate impact, once its effects on other parts of the index are taken into account. So the figures in Table 1 can be only indicative. But they do bear out the major influences on CPI inflation.

<sup>5</sup> Given the share of labour costs in gross output, a shortfall of this order of magnitude would be consistent with a drag on CPI inflation of around ½ a percentage point relative to target. Bank staff estimate the share of wages in CPI-weighted costs to be around 40%. On that basis, cost growth of 1.5 percentage points below the necessary rate might be expected to reduce inflation, relative to target, by  $0.4 \times 1.5 = 0.6$  percentage points.

contribution of services prices to annual CPI inflation, which was ½ percentage point below its historical average in December (**Table 1**).

### **The outlook for CPI inflation**

As described in the February *Inflation Report*, inflation is likely to fall further over the next few months. Sterling oil prices have fallen an additional 13% since the CPI data were collected in December, and petrol prices have fallen to £1.06 per litre on average, a further 9% fall.

Wholesale gas prices have also declined and the major utility companies have announced reductions in the retail price of gas supplied to households. This will mean further falls of just over 4% in the retail price of gas during the early part of 2015. As a result, the MPC now judges it more likely than not that headline CPI inflation will turn negative at some point in the spring and will remain subdued for much of the rest of the year. It is therefore probable that I will need to write further open letters to you in the coming months.

In the absence of continuing falls in commodity prices, negative inflation rates are unlikely to endure for very long, however. On the assumption that energy and food prices stabilise, CPI inflation should pick up notably once earlier declines start to drop out of the annual comparison, towards the end of this year.<sup>6</sup>

A temporary period of falling prices driven by large adjustments in a few specific components of the CPI is a fundamentally distinct phenomenon from ‘deflation’, which is characterised by persistent and generalised declines in prices. The UK is not experiencing ‘deflation’: excluding food and energy, 68% of the underlying categories<sup>7</sup> of the CPI are showing positive inflation, close to the 1997-2007 average of 67%. Inflation expectations remain consistent with the 2% target. At the same time the economy is growing strongly, unemployment is falling and earnings growth has been picking up in recent months.

Indeed, temporarily negative inflation rates driven by falls in commodity prices actually boost households’ real take home pay, particularly if wages are growing. This is clearly the case in the UK at the moment. As described in the MPC’s February *Inflation Report*, the resulting boost to real incomes will help support continued economic expansion and eliminate the remaining margin of spare capacity in the economy.

### **Over what horizon is it appropriate to return inflation to the target? And what trade-off has been made with regard to inflation and output variability?**

The MPC’s remit is clear that the inflation target is symmetric: deviations of inflation below the target are to be treated with the same importance as deviations above it.

The remit is also clear that the inflation target applies at all times. It recognises, however, that there will be occasions when inflation will deviate from the target as result of economic shocks and disturbances. In such circumstances the remit calls for the MPC to set out its view of the appropriate horizon over which to aim to bring inflation back to the target.

While the MPC can set policy to expect to achieve the inflation target at some particular horizon, the economy will inevitably be affected by further shocks. The uncertainty around the Committee’s central projection that results is, in general, illustrated in the fan charts published in the *Inflation Report*.

<sup>6</sup> Forward markets, on which the MPC’s *Inflation Report* projections are based, suggest wholesale oil prices are more likely to rise than fall during 2015. If they did, the negative contribution of energy prices to aggregate CPI inflation would diminish more quickly than would otherwise be the case during the remainder of this year.

<sup>7</sup> Four-digit COICOP categories.

In judging the horizon it is important to distinguish between the temporary impacts on CPI inflation of falling oil and food prices, and factors with more persistent effects on inflation such as the remaining degree of spare capacity in the UK economy and its impact on wage growth. There are limits to the speed with which inflation can reasonably be expected to be brought back to target. Monetary policy takes time to affect the economy: its peak effect on inflation is generally estimated to occur with a lag of somewhere between 18 and 24 months. The effect of the fall in food and energy prices is expected to abate in twelve months or so. Attempting to return inflation to 2% within the coming year might require relatively sharp changes in the stance of policy and would risk unnecessary volatility in output.

Beyond this, the appropriate horizon for returning inflation to the target will depend on the trade-off between the speed with which inflation returns and the consequences of that speed for output and employment.

#### *Trade-offs between inflation and output variability*

Following the financial crisis and the subsequent sharp depreciation of sterling, the UK faced a period of high unemployment and weak economic activity and, as sharp rises in import costs were passed through to consumer prices, inflation remained persistently above the 2% target. In that environment there were occasions when the MPC judged it appropriate to aim to return inflation to the target over a horizon longer than two years.

However, the situation today is different. Inflation is *below* the target while unemployment is above its long-run sustainable rate. There is therefore no immediate trade-off between returning inflation to the target and supporting economic activity. In fact, to return inflation to the target it is necessary to eliminate the remaining degree of economic slack. It is therefore appropriate to return inflation to the target as quickly as possible after the effects of energy and food price movements have abated.

In principle, the MPC is able to extend the horizon over which it aims to return inflation to target if the policy stance necessary for a faster return is thought to exacerbate the development of imbalances that the Financial Policy Committee (FPC) may judge a risk to financial stability.

The FPC's macroprudential tools are the first line of defence against such risks, however. And actions taken by the FPC since 2012, in conjunction with the PRA, have materially enhanced the UK banking sector's capital adequacy. The results of the recently concluded UK stress tests underline that the growing confidence in the major UK banks' resilience is merited. The FPC also took targeted action last year to insure against systemic risks from the UK housing market during a prolonged period of low interest rates. As a result, the MPC does not consider it appropriate to extend the horizon on this basis.

Given the nature of the shocks affecting inflation, the MPC judges it appropriate to set policy so that it is likely that inflation will return to the 2% target within two years.

#### **The policy action the Committee is taking in response**

The MPC will conduct monetary policy to eliminate the margin of slack and return inflation to 2%.

The MPC has taken significant steps to support the UK economic recovery and eliminate the margin of slack. Bank Rate has been at a historically low level of 0.5% for almost six years. From 2009 to 2012, the MPC purchased £375 billion of assets financed by the issuance of central bank reserves, and the Committee continues to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility in order to keep the total stock at £375bn. A forward guidance framework was announced in August 2013.

In the February 2014 *Inflation Report*, the MPC said that, given the likely persistence of headwinds weighing on the economy, when Bank Rate did begin to rise, it was expected to do so only gradually and to a more limited extent than in previous cycles. Moreover, the persistence of those headwinds, together with the legacy of the financial crisis, meant that Bank Rate was expected to remain below average historical levels for some time to come.

This assessment has shaped financial market expectations of the future path of UK interest rates as the UK economy has recovered, helping to prevent what might otherwise have been an excessive tightening of monetary conditions. In addition, interest rate expectations have fallen markedly across advanced economies since the start of 2014. In part that may reflect an increase in perceptions of downside risks to long-term growth. It might have reflected falling inflation and increasing expectations of unconventional monetary policy action among advanced economy central banks. Those falls in expected rates have reduced the cost of borrowing for many firms and households in the UK, helping to support demand and take inflation back towards the 2% target. As an example, quoted mortgage rates on 2-year fixed-rate mortgages<sup>8</sup> have fallen by 0.5 percentage points over the past six months and are now at record lows.

As set out in its *Inflation Report* today, the MPC judges it likely that, within two years, conditional on interest rates following the path currently implied by market yields, slack in the economy will be absorbed and inflation will return to the 2% target.

There are risks to the outlook in both directions. To the downside, the fall in near-term inflation could be more persistent than the Committee currently expects. Global activity could continue to disappoint, or if low inflation were to depress inflation expectations, it could become self-reinforcing. In that case, the MPC would need to provide more support to return inflation to the target over the appropriate horizon.

Were these downside risks to materialise, market expectations of the future path of interest rates could adjust to reflect an even more gradual and limited path for Bank Rate increases than is currently priced. The Committee could also decide to expand the Asset Purchase Facility or to cut Bank Rate further towards zero from its current level of 0.5%. The scope for prospective downward adjustments in Bank Rate reflects, in part, the fact that the UK's banking sector is operating with substantially more capital now than it did in the immediate aftermath of the crisis. Reductions in Bank Rate are therefore less likely to have undesirable effects on the supply of credit to the UK economy than previously judged by the MPC.<sup>9</sup>

To the upside, inflationary pressures could be greater if lower oil prices were to provide greater stimulus to global and domestic growth or if slack in the economy were to be absorbed more quickly than in the central projection.

If these risks materialise, it would be appropriate for Bank Rate to increase more quickly than embodied in current market yields but the likelihood is that those increases would still be more gradual and limited than in previous tightening cycles.

The MPC stands ready to take whatever action is needed, as events unfold, to ensure inflation remains likely to return to target in a timely fashion. Under the central case as set out in today's *Inflation Report* the MPC judges it more likely than not that Bank Rate will increase over the forecast period.

### **How does this approach meet the Government's monetary policy objectives?**

The MPC's objective is to maintain price stability and, subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment. Price stability is an

<sup>8</sup> This refers to rates on 2 year fixed-rate 75% LTV mortgages

<sup>9</sup> See paragraph 12 of Charlie Bean's letter of 16<sup>th</sup> May 2013 to Andrew Tyrie:

<http://www.bankofengland.co.uk/publications/Documents/other/treasurycommittee/ir/tsc160513.pdf>

essential pre-requisite for economic prosperity. The MPC is acting to return inflation to the target promptly by eliminating the remaining margin of slack in the economy.

Through co-ordinated action by the MPC, FPC and PRA, the Bank of England is guarding against the build-up of risks and imbalances that could threaten strong, sustainable, balanced growth and therefore making its most effective contribution to the United Kingdom's economic performance.

I am copying this letter to the Chairman of the Treasury Committee, through which we are accountable to Parliament, and will place this letter on the Bank of England's website.

Yours sincerely

A handwritten signature in black ink, appearing to be 'M. G.', written in a cursive style.