



BANK OF ENGLAND

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Governor

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
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Dear Chancellor,

In November I wrote a fourth letter to you when CPI inflation remained more than one percentage point below the 2% target. Three months later, as expected, that is still the case: on 19 January, the Office for National Statistics (ONS) published data showing that twelve-month CPI inflation was 0.2% in December. In line with the Remit of the Monetary Policy Committee (MPC), I am writing this open letter to be published alongside the February *Inflation Report*. In accordance with the Remit, this letter describes:

- the reasons why inflation has moved away from the target and the outlook for inflation;
- the horizon over which the MPC 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 MPC is taking in response; and
- how this approach meets the Government's monetary policy objectives.

Why has inflation moved away from the 2% target?

In December twelve-month CPI inflation stood at 0.2%, a little under two percentage points below the inflation target. **Table 1** contains a breakdown of the arithmetic contributions of different components of CPI inflation to the deviation from the target.

Table 1: Arithmetic contributions to December 2015 CPI inflation relative to the pre-crisis average

Percentage points	1997-2007 average	December 2015	December 2015 difference to average	<i>Memo: Difference in February 2015 Open Letter^(b)</i>
Energy	0.3	-0.6	-0.9	-0.8
Food, non-alcoholic bevs.	0.2	-0.3	-0.5	-0.4
Other goods ^(a)	-0.1	-0.3	-0.2	0.2
Services	1.6	1.3	-0.2	-0.5
Total ^(a)	2.0	0.2	-1.8	-1.4

(a) Adjusted for the close to 0.4 percentage point downward bias from clothing that existed until 2010.

(b) The December 2014 CPI release accompanied the February 2015 open letter.

The underlying causes of below-target inflation are unchanged since my previous letter: falls in commodity prices; the past appreciation of sterling; and, to a lesser degree, below-average growth of domestic wage costs.

By far the most important reason for below-target inflation remains the sharp falls in energy prices since the middle of 2014. Oil prices have fallen sharply further over the past three months and in December were more than a third lower, in sterling terms, than a year earlier. This has dragged energy price inflation down further. The contribution of fuels and domestic gas and electricity prices to CPI inflation was -0.6 percentage points in December, nearly a percentage point below its pre-crisis average. Food price inflation also remained weak, at -2.9%, reflecting the continued effects of lower input costs and intense competition amongst retailers.

It is now a year since my first letter to you when CPI inflation fell below 1%. As Table 1 shows, the current drag from energy and food is similar to that a year ago, despite the initial falls in these prices having now dropped out of the annual calculation. The continued weakness in inflation reflects sustained downward pressure on retail energy and food prices from notable further falls in commodity prices globally. The further fall in the oil price reflects, in part, considerable increases in its actual and potential supply. This has kept inflation low more persistently than envisaged a year ago.

Together with muted growth in world prices, the earlier appreciation of sterling has pulled down on import prices more broadly. The sterling effective exchange rate index rose by around 15% in the two years to August 2015 and the resulting reduction in import costs is gradually feeding through to consumer prices. This is evident in the fall in the contribution to CPI inflation of other goods prices, beyond food and energy.

Overall, these factors can explain the vast majority of the deviation of inflation from the target in December, and a slightly higher proportion than in my previous letter. The remainder reflects subdued domestic cost growth, particularly unit labour costs.

Pay growth recovered through much of 2015, in part due to the narrowing of slack in the labour market, but it has eased back again over the past three months. The likely explanations for this moderation of wage growth include shifts in the composition of the workforce and the low level of consumer price inflation. Both pay and unit labour cost growth remain below their average rates prior to the financial crisis, and therefore below rates consistent with inflation being at the target.

The outlook for CPI inflation

Over the past three months, inflation has moved broadly in line with the MPC's central forecast in the November *Inflation Report*. The Committee's updated forecasts are published today in the February *Inflation Report*.

Although the recent falls in commodity prices, assuming they persist, will impart an additional drag on CPI inflation in the near term, it is likely that the inflation rate will rise further during the early part of this year. The scale of recent commodity price falls will, however, likely mean that CPI inflation remains below 1% until the end of the year, and it is therefore likely that I will have to write further open letters to you over the coming months.

Despite the slightly weaker near-term outlook, the MPC expects inflation to return to the target in around two years' time. The drags from energy and utility prices, and from the prices of imported non-energy goods and services, are expected to diminish, in the absence of further downside shocks. Also, the MPC's judgement is that, were Bank Rate to follow the very gradually rising path implied by market yields, the remaining slack in the economy will be used up during 2016 and domestic cost pressures will build.

As compared with the November forecast, additional weakness in world activity and prices is expected to add to the downward pressure on inflation over the course of the next two or three years. Also, wage growth has been surprisingly subdued, given the apparent tightness of the labour market, and the MPC judges that it is likely to pick up more slowly than previously thought. But counterbalancing these forces are the recent fall in the exchange rate (in trade-weighted terms, the path of sterling on which the MPC's forecasts are conditioned is 3% lower than was the case in November); and some additional stimulus from a lower expected path for Bank Rate in financial markets.

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 a result of economic shocks and disturbances. In such situations, it would not be feasible to bring inflation back to the target immediately because it takes time for monetary policy to affect the economy. The peak effect of monetary policy on inflation is generally estimated to occur with a lag of between 12 and 24 months. Moreover, attempts to return inflation to the target too quickly could lead to undesirable volatility in output.

The appropriate horizon for returning inflation to the target depends on the trade-off the MPC faces between the speed with which this can be achieved and the consequences of doing so for output and employment. That trade-off depends on the nature of the disturbances that caused inflation to deviate from the target in the first place.

For conventional demand disturbances, including modest changes to the consumption plans of households, or for one-off shocks to the price level, such as a one-time fall in oil prices, a relatively rapid return of inflation to the target would usually be appropriate.

As recognised in your Remit letter, when there are trade-offs between returning inflation to the target and avoiding undue volatility in output and employment, this horizon can be extended.

That is the case at present because achieving a return of inflation to the target requires balancing the persistent drags from sterling and world export prices with increases in domestic cost growth. Fully offsetting the drag on inflation from external factors over the short run would, in the Committee's judgement, involve too rapid an acceleration in domestic costs, one that would risk being unsustainable and involve undesirable volatility in output and employment. Given these considerations, the MPC intends to set monetary policy to ensure that growth is sufficient to absorb remaining spare capacity in a manner that returns inflation to the target in around two years and keeps it there in the absence of further shocks.

Domestic costs are expected to rise a little less quickly than thought at the time of the November *Inflation Report*, contributing to a slower recovery in inflation. In part, the recent softening in wage growth may reflect low headline inflation moderating the increase in wage pressure. The mechanical return to higher rates of inflation as past falls in energy prices begin to drop out of the annual comparison, supported by the recent fall in the sterling exchange rate and some additional stimulus from lower market interest rates, should in time reverse this effect and support wage gains. The MPC judges that inflation expectations remain well anchored, though it remains watchful for signs that low inflation is having more persistent second-round effects on wages.

The policy action the MPC is taking in response

The MPC will conduct monetary policy so that the margin of spare capacity is absorbed and inflation returns to the 2% target. The Committee continues to take significant steps to support the UK economic recovery and so eliminate the remaining slack. Bank Rate has been at a historically low level of 0.5% for more than six years. In addition, the MPC purchased £375 billion of assets financed by the issuance of central bank reserves between 2009 and 2012 and continues to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility (APF) in order to maintain the total stock at that level. As described in the November 2015 *Inflation Report*, the MPC's preference is to use Bank Rate as the active marginal instrument for monetary policy, and expects to maintain the stock of purchased assets at £375 billion until Bank Rate has reached a level from which it can be cut materially. The MPC currently judges that such a level of Bank Rate is around 2%.

The MPC has provided its assessment of the likely outlook for policy. 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 more gradually 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 domestic and global economic expansions have evolved. Expected interest rates have fallen further since the November *Inflation Report* and are now markedly lower than they were at the start of 2014. That has lowered borrowing costs for many UK households and companies, helping to support demand and so inflation. Complementing this, the Bank more broadly continues to provide support to the healthy functioning of credit markets through the Funding for Lending Scheme.

Consistent with the projections set out in its *Inflation Report* today, the MPC judges that a gradual rise in interest rates over the forecast period is likely to be consistent with its objective of returning inflation to the target in a sustainable manner.

There are risks to the outlook in both directions.

On the upside, inflation could be higher if the recent weakness in wage growth reflects temporary factors that may be obscuring the impact that the underlying tightness in the labour market is having.

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

On the downside, there are risks, including to UK households' and companies' spending decisions, stemming from the global environment and in particular from emerging economies. The crystallisation of such risks could also be associated with further weakness in external price pressures; this would directly depress inflation and would also increase the risk of a self-reinforcing fall in inflation expectations and domestic cost growth.

On balance, the projections published in today's *Inflation Report* indicate the MPC's collective view that the risks around its central forecast for inflation lie to the downside in the near term but are balanced in the second and third years of the projection.

Were these downside risks to materialise, market expectations of the future path of interest rates could adjust further to reflect an even more gradual and limited path for Bank Rate increases than is currently priced. The Committee could also decide to extend the Asset Purchase Facility or to cut Bank Rate further towards zero from its current level of 0.5%.

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 set out in today's *Inflation Report*, the MPC judges it more likely than not that Bank Rate will need to increase over the forecast period in order to deliver this.

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 essential prerequisite 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.

Yours sincerely,

