BANK OF ENGLAND

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Governor

The Rt Hon Philip Hammond
Chancellor of the Exchequer
HM Treasury
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Dear Chancellor,

On 15 November, the Office for National Statistics published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 0.9% in October. As required by the remit of the Monetary Policy Committee (MPC), this letter – which will be published alongside the minutes of the Committee's December policy meeting – addresses the following:

- 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 by the MPC 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.
- How this approach meets the Government's monetary policy objective.

Why has inflation moved away from the 2% target?

Twelve-month CPI inflation stood at 0.9% in October, 1.1 percentage points below the 2% target. The underlying causes of below-target inflation over the past two years have been: sharp falls in commodity prices; the earlier appreciation of sterling; and, to a lesser degree, the subdued pace of domestic cost growth.

Around three-fifths of the deviation of inflation from target in October was accounted for by food and energy prices alone. Falls in the prices of food and non-alcoholic beverages made the most quantitatively significant contribution to the deviation of inflation from the target. These, in turn, reflect reductions in the world prices of the underlying commodities and sterling's appreciation during 2013-2015, together with continuing intense competition amongst food retailers. In addition, energy continued to account for part of the deviation of inflation from the target, although its significance has waned following increases in the sterling oil price.

Although the inflation rates of imported goods and services have been subdued for some time, their prices have begun to rise following the 10% depreciation in sterling since the vote to leave the European Union. In October, petrol and diesel prices were 3% higher than they were in June, while household gas and electricity prices as measured in the CPI were 0.6% higher.

Partly as a result of these increases, higher frequency estimates of aggregate inflation have begun to pick up. In June, on an annualised and seasonally adjusted basis, the level of prices was 0.8% higher than three months earlier. That figure rose to 1.5% in the three months to October. These more elevated rates of three-month-on-three-month inflation will soon lead, arithmetically, to a pickup in the twelve-month CPI inflation rate. Indeed, on

13 December, the Office for National Statistics published data showing that CPI inflation was 1.2% in the twelve-months to November.

The outlook for CPI inflation

I shall describe the outlook for inflation with reference to the projections made by the MPC in its November *Inflation Report*. In those projections, twelve-month CPI inflation had been expected to reach around 1½% by the turn of the year and to rise further to around 2¾% in mid-2018. Thereafter, inflation had been expected to fall back gradually over 2019, reaching 2½% in three years' time, before returning close to the target over the following year.

Inflation had been expected to pick up primarily as a result of two factors.

First, as discussed above, the combined effect of past falls in global energy prices dropping out of the twelve-month calculation together with the more recent increase in global energy prices, especially in sterling terms, was expected to push up fuel prices over the coming months.

Second, the depreciation of sterling was expected to raise the prices of tradable goods and services more generally. There was uncertainty over the extent and speed with which this increase in imported costs would be passed through into final consumer prices. Given the size of the fall in sterling and its association with a weaker outlook for supply, however, it was possible that pass-through to CPI inflation would be relatively brisk.

At the same time, domestic cost pressures were expected to remain moderate over the near term, pay growth in particular. It remained to be seen to what extent pay growth would rise with inflation, and to what extent it would continue to be restrained by subdued productivity growth. The margin of slack likely to result from the softening in demand growth described in the November *Inflation Report* projections was also likely to be important in determining the outlook for pay.

Since the November *Report*, sterling's trade-weighted exchange rate has appreciated by over 5%. As a result, a slightly lower path for inflation than envisaged in November is now more probable. Nonetheless, the exchange rate is still materially weaker than in recent years and, as a result, inflation is still likely to overshoot the target later in 2017 and through 2018.

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 and applies at all times. The remit recognises, however, that there will be occasions when inflation will deviate from the target as a result of economic shocks.

Such factors will typically move inflation away from target temporarily. In such circumstances, it would not be feasible to bring inflation back to the target immediately because of the time it takes 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 remit also recognises that, in exceptional circumstances, shocks to the economy may be particularly large, or the effects of shocks may persist over an extended period. In these situations, the MPC is likely to face a more significant trade-off between the speed with which it aims to return inflation sustainably to the target and the consideration that should be placed on the variability of output. In forming and communicating its judgements, the remit requires the Committee to explain the monetary policy trade-off it faces, including the horizon over which the MPC judges it appropriate to return inflation to the target.

The appropriate horizon for returning inflation to the target depends on the severity of this trade-off which, in turn, hinges on the nature and persistence of the underlying disturbances.

Since the vote to leave the European Union, the balance of forces acting on inflation, and so the trade-off faced by the MPC, has changed markedly. This reflects the effects of the vote to leave the EU on demand, supply and the exchange rate.

On the one hand, growth is expected to weaken and unemployment to rise moderately as a consequence of uncertainty regarding the UK's future relationship with the EU. On the other hand, inflation is expected to rise above the target, for an extended period, as a result of the depreciation of sterling since the referendum together with a period of more modest growth in supply.

In light of those forces, the MPC expects inflation to rise to the target within six months. Given the persistence of these effects, however, the Committee expects thereafter to balance a period of above-target inflation in the second and third years of its forecast, owing primarily to imported price pressures, with a period over which the economy operates below full capacity, which will bear down on domestic costs.

Fully offsetting the persistent effects of sterling's depreciation on CPI inflation would require exerting further downward pressure on domestic costs, including wages, and would therefore involve lost output and higher unemployment. The MPC judges that such outcomes would be undesirable and, consistent with its remit, that it would therefore be appropriate to set policy so that inflation returns to its target over a longer period than the usual 18-24 months. In doing so, the MPC's aim is to ensure that demand growth is sufficient to absorb spare capacity over time, such that inflation returns to the target in a sustainable manner.

Equally, there are limits to the extent to which above-target inflation can be tolerated. Those limits depend, for example, on the cause of the inflation overshoot, the extent of second-round effects on domestic costs, the evolution of inflation expectations, and the scale of the shortfall in economic activity below potential. Inflation expectations at medium-term horizons had, until recently, been somewhat below their past average levels, reflecting the period of below-target inflation. The MPC continues to monitor the evolution of these expectations closely.

The policy action the Committee is taking in response

In August, the MPC announced a package of measures to provide support to the economy. This included: a 25 basis point cut in Bank Rate to 0.25%; a new Term Funding Scheme (TFS) to reinforce the pass-through of the cut in Bank Rate; the purchase of up to £10 billion of sterling non-financial investment-grade corporate bonds issued by firms making a material contribution to the UK economy; and an expansion of the asset purchase scheme for UK government bonds by £60 billion, taking the total stock of these purchases to £435 billion. These measures have been successful in easing borrowing conditions facing UK households and businesses. At its November meeting, the Committee reaffirmed its commitment to this package.

In its December meeting, the MPC agreed unanimously that Bank Rate should be maintained at its current level. It also agreed unanimously that it remained appropriate to continue the previously announced asset purchase programmes, financed by the issuance of central bank reserves.

Earlier in the year, the MPC noted that the path of monetary policy following the referendum on EU membership would depend on the evolution of the prospects for demand, supply, the exchange rate, and therefore inflation. This remains the case. Monetary policy can respond, in either direction, to changes to the economic outlook as they unfold to ensure a sustainable return of inflation to the 2% target.

The MPC remains committed, as always, to taking whatever action is needed to ensure that inflation expectations remain well anchored, and that inflation returns to the target in a sustainable fashion and over an appropriate horizon.

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 pre-requisite for economic prosperity. The MPC is balancing the margin of slack in the economy it expects to arise with a temporary period of above-target inflation, and in so doing is acting to return inflation to target in a sustainable fashion, in accordance with its remit.

The United Kingdom is a highly flexible, dynamic economy. These characteristics will help it to move to a new equilibrium as its future relationship with the European Union becomes clear and new opportunities with the rest of the world emerge. Many of the adjustments needed to move to that new equilibrium are real in nature, and so not the gift of monetary policy makers. Nonetheless, monetary policy can still play a role in smoothing part of this adjustment by appropriately balancing the forces acting to push inflation above the target with those expected to push activity below the economy's new path for potential output.

By promoting price stability in this manner, the MPC is supporting the necessary adjustment of the UK economy. The MPC's contribution is reinforced by coordinated action with the Financial Policy Committee and the Prudential Regulation Authority to guard against any unintended consequences in the financial system.

In these ways, the Bank of England is promoting strong, sustainable, balanced growth and therefore making its most effective contribution to the United Kingdom's economic performance.

Yours sincerely,