BANK OF ENGLAND

Andrew Bailey
Governor

The Rt Hon Rishi Sunak
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

17 December 2020

Dear Rishi

On 16 December 2020, the Office for National Statistics (ONS) published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 0.3% in November. As required by the remit for the Bank of England's Monetary Policy Committee (MPC) when inflation moves away from the 2% target by more than 1 percentage point in either direction, this letter – which will be published alongside the minutes of the Committee's December meeting – addresses the following:

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

Why has inflation moved away from the 2% target?

As set out in recent *Monetary Policy Reports* and the minutes of MPC meetings, the Committee has been expecting a period of low inflation in the near term, including readings below 1%. The effects of the Covid pandemic have been associated with a sharp reduction in economic activity in the United Kingdom and globally, reducing UK inflation through a number of channels. Since August, CPI inflation has also been affected by the temporary cut in VAT for hospitality, holiday accommodation and attractions that will now remain in place until the end of March 2021.

The pandemic has led to lower global growth, which has weakened oil prices. Despite its recent partial recovery, the sterling oil price remains around 25% weaker than at the beginning of this year. As a result, the prices of motor fuels were 10% lower in November than in the same month a year earlier, and lower oil prices will also have been having indirect effects on inflation by reducing input costs in other sectors of the economy.

The prices of electricity, gas and other fuels have fallen by around 9% compared with the same month a year earlier.

The Covid-19 shock has also led to a significant rise in spare capacity in the UK economy, evident for example in the sharp drop in hours worked and rising unemployment. Underlying pay growth has slowed and business surveys also suggest that, in aggregate, companies have a sizeable amount of spare capacity. Sectors in which demand has been much lower than usual have already experienced weaker inflationary pressures. For example, accommodation services prices in October were 7% lower than a year earlier, although they rose strongly in November based largely on data that was imputed due to the renewed Covid restrictions. Clothing and footwear goods prices were particularly weak in November and around 4% lower than a year earlier. There have been differences in the impacts of the pandemic on demand and supply in different sectors of the economy, however. For example, second-hand car prices have risen strongly recently, reflecting an increase in demand during the pandemic and tight supply conditions in that particular market.

The outlook for inflation

The outlook for the economy remains unusually uncertain. It depends on the evolution of the pandemic and measures taken to protect public health, as well as the nature of, and transition to, the new trading arrangements between the European Union and the United Kingdom. It will also depend on the responses of households, businesses and financial markets to these developments.

The MPC's central projections in the November *Monetary Policy Report* assumed that the pandemic would weigh on near-term spending to a greater extent than projected in the August *Report*, leading to a decline in GDP in 2020 Q4. Household spending and GDP were expected to pick up in 2021 Q1, as restrictions loosened. The level of activity in 2021 Q1 was expected to remain materially lower than in 2019 Q4. UK trade and GDP were judged likely to be adversely affected as the United Kingdom leaves the Single Market and Customs Union on 1 January 2021 and was assumed to move immediately to a free trade agreement with the European Union.

Over the remainder of the forecast period, GDP was projected to recover further as the direct impact of Covid on the economy was assumed to wane. Activity is also supported by the substantial fiscal measures already announced and accommodative monetary policy. The recovery was expected to take time, however, and the risks around the GDP projection were judged to be skewed to the downside. The unemployment rate was expected to peak at around 7¾% in 2021 Q2. Beyond that point, spare capacity was expected to be eroded as activity picked up, and a small degree of excess demand emerged over the second half of the forecast period.

Since the November *Report*, the near-term UK outlook has evolved broadly in line with the Committee's expectations. The main news has been the successful trialling of some Covid vaccines and initial plans to roll them out widely over the first half of next year. This is likely to reduce the downside risks to the economic outlook from Covid previously identified by the Committee. It could also diminish the uncertainties facing businesses and households, boosting future UK and global activity.

CPI inflation is expected to be at or slightly above ½% during most of the winter, before rising quite sharply towards the target as the effects of lower energy prices and VAT dissipate. This is consistent with recent measures of core inflation.

Over the first half of the November *Report* forecast period, slack in the economy was expected to dampen domestic price pressures. In the near term, the MPC continues to judge that the impact of spare capacity on inflation will be a little less than usual while activity is particularly weak. That judgement partly reflects research on price-setting which finds that firms are less able to increase demand for their goods and services by reducing prices when demand is low.

As slack is eroded, and excess demand emerges, domestic price pressures are expected to pick up. In the November *Report* central projection, conditioned on prevailing asset prices, inflation was projected to be 2% in two years' time.

The MPC is continuing to monitor closely developments in indicators of inflation expectations, including those of households, businesses and financial markets. Overall, the Committee judges that inflation expectations remain well anchored and consistent with inflation close to the 2% target.

What policy action is the Committee taking in response?

The MPC sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment.

The MPC's remit is clear that the inflation target applies at all times, reflecting the primacy of price stability in the UK monetary policy framework. The framework also recognises that there will be occasions when inflation will depart from the target as a result of shocks and disturbances. In circumstances when shocks to the economy are particularly large or the effects of shocks persist over an extended period, the Committee may be faced with significant trade-offs between the speed with which it aims to bring inflation back to the target and the consideration that should be placed on the variability of output.

Since the onset of the Covid-19 shock, the MPC has, complementing the responses of other parts of the Bank of England and the UK Government, taken a number of actions to fulfil its mandate. The Committee has reduced Bank Rate to 0.1%; has introduced a Term Funding scheme with additional incentives for Small and Medium-sized Enterprises (TFSME); and announced a £300 billion increase in the stock of UK government bond and sterling non-financial investment-grade corporate bond purchases in March and June.

At its November meeting, the MPC judged that a further easing of monetary policy was warranted. The Committee agreed to increase the target stock of purchased UK government bonds by £150 billion in order to meet the inflation target in the medium term, taking the stock of government bond purchases to £875 billion and so the total target stock of asset purchases to £895 billion. The Committee will keep the asset purchase programme under review.

In the current unprecedented circumstances, the economy has been subject to very large shocks, some of which could persist over an extended period. Unemployment is likely to rise well above recent levels and to remain elevated for some time, while CPI inflation is below the 2% target. The Committee's approach is to set monetary policy so that inflation returns sustainably to its target at a conventional horizon of around two years.

The MPC will continue to monitor the situation closely. If the outlook for inflation weakens, the Committee stands ready to take whatever additional action is necessary to achieve its remit. The Committee 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.

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

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

The MPC has statutory objectives to maintain price stability and, subject to that, to support the economic policy of the Government including its objectives for growth and employment. The Government's economic policy objective is to achieve strong, sustainable and balanced growth. Price stability is an essential pre-requisite to achieve this objective.

In the current circumstances, and consistent with the MPC's remit and meeting the inflation target in the medium term, monetary policy is aimed at supporting businesses and households through the crisis, and limiting any lasting damage to the economy. The MPC's contribution has been reinforced by the actions taken by the Financial Policy and Prudential Regulation Committees. 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,

Andrew Bailey

Copy to The Rt Hon Mel Stride MP, Chair of the Treasury Committee