BANK OF ENGLAND

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Governor

The Rt Hon Rishi Sunak
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Dear Rishi

On 20 May 2020, the Office for National Statistics (ONS) published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 0.8% in April. 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 June 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 the May *Monetary Policy Report* and the minutes of recent MPC meetings, the Committee has expected that inflation would fall below 1% in the near term. Consistent with that expectation, twelve-month CPI inflation declined from 1.5% in March to 0.8% in April, 1.2 percentage points below the 2% target. It fell further in May, to 0.5%, in the data published by the ONS on 17 June.

Measurement challenges related to the actions taken in response to Covid-19 are temporarily increasing the noise in inflation data, and affecting the CPI relative to a normal period. It is nevertheless clear that inflation has fallen over recent months, to materially below the MPC's 2% target.

Current below-target rates of CPI inflation can in large part be accounted for by the effects of the pandemic. This has been associated with a sharp reduction in economic activity in the United Kingdom and globally, and is reducing UK inflation through a number of channels.

Reduced demand has led to a collapse in global oil prices and, despite its recent partial recovery, the sterling oil price remains around 40% weaker than at the beginning of this year. As a result, the prices of motor fuels were 17% lower in May than in the same month a year earlier, and lower oil prices will also have indirect effects on inflation by reducing input costs in other sectors of the economy. Consumer gas and electricity prices also declined in May by 12% and 2% respectively on a year earlier, reflecting past falls in wholesale energy prices.

The sharp drop in domestic activity is adding to downward pressure on inflation through increased spare capacity. Some sectors in which demand has been much lower than usual have already experienced weaker inflationary pressures. For example, clothing and footwear prices declined by around 3% in May compared to the same month a year earlier, with reports of significant excess stock as consumer spending declined. The ONS Business Impact of Covid-19 Survey also suggests widespread weakness in selling prices across the economy. The responsiveness of domestic prices to the Covid-19 shock remains very uncertain, however, and it is too early to assess fully how the shock is affecting consumer prices.

Recent weakness in CPI inflation follows a period prior to the Covid-19 shock when some measures of domestically generated inflation were somewhat below rates consistent with meeting the inflation target in the medium term. Core CPI inflation, excluding energy, food, alcoholic beverages and tobacco, averaged 1.7% over the year to March 2020. It has subsequently fallen, from 1.6% in March to 1.4% in April and to 1.2% in May.

The outlook for inflation

The outlook for the economy and inflation is unusually uncertain. It will depend critically on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these factors.

The emerging evidence suggests that the fall in global and UK GDP in 2020 Q2 will be less severe than set out in the May *Report*. Although stronger than expected, it is difficult to make a clear inference from that about the recovery thereafter. There is a risk of higher and more persistent unemployment in the United Kingdom. Even with the relaxation of some Covid-related restrictions on economic activity, a degree of precautionary behaviour by households and businesses is likely to persist. The economy, and especially the labour market, will therefore take some time to recover towards its previous path.

A persistent margin of spare capacity, in large part reflecting slack in the labour market, is likely to continue to weigh on inflation. However, the MPC judges it likely that, while demand is especially weak, inflation will be affected by a little less than usual for a given degree of spare capacity. That judgement is informed by 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.

In addition to the downward pressure from low demand, the weakness of energy prices is expected to continue to weigh on CPI inflation over the remainder of 2020 and early 2021. Lower oil prices will also push down on world export prices, as will the fall in global demand. The resulting downward pressure on UK import prices is expected to broadly offset the upward pressure on inflation from sterling's past depreciation.

Overall, CPI inflation is expected to fall slightly further in the near term, as the drag from the Covid-related shock builds. It is then expected to rise during 2021, as the direct impact of the recent fall in the oil price drops out of the annual comparison and the downward pressure from domestic factors wanes as demand recovers.

In the medium term, CPI inflation will depend importantly on how domestically generated price pressures evolve. The responsiveness of domestic prices to the Covid-19 shock is very uncertain, given the significant heterogeneity in experiences across sectors.

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. In that context, its challenge at present is to respond to the severe economic and financial disruption caused by the spread of Covid-19.

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.

In the current unprecedented circumstances, the economy has been subject to very large shocks, some of which could persist over an extended period. These shocks have not, however, created a trade-off between the speed with which the MPC is aiming to bring inflation back to the target and the consideration that should be placed on the variability of output. Unemployment is likely to remain elevated for some time, while CPI inflation is below the 2% target. As such, the Committee is setting monetary policy so that inflation returns sustainably to its target at a conventional horizon of around two years. Given the extraordinary nature of the recent shocks, there is nevertheless more uncertainty than usual about the precise policy response that is needed to achieve this aim.

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 has announced a £200 billion increase in the stock of UK government bond and sterling non-financial investment-grade corporate bond purchases.

At its June meeting, the MPC judges that a further easing of monetary policy is warranted to meet its statutory objectives. The Committee agreed to increase the target stock of purchased UK government bonds by an additional £100 billion in order to meet the inflation target in the medium term. The Committee expects that programme to be completed, and the total stock of asset purchases to reach £745 billion, around the turn of the year.

The MPC will continue to monitor the situation closely and, consistent with its remit, stands ready to take further action as necessary to support the economy and ensure a sustained return of inflation to the 2% target. The Committee will keep the asset purchase programme under review.

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