BANK OF ENGLAND

Andrew Bailey
Governor

The Rt Hon Rishi Sunak
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Dear Rishi

On 16 September 2020, the Office for National Statistics (ONS) published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 0.2% in August. 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 September 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%. CPI inflation rose to 1.0% in July, from 0.6% in June, but the temporary cut in VAT for hospitality, holiday accommodation and attractions, together with the Government's Eat Out to Help Out scheme, were expected to lead to a material drop in inflation in August. These effects have transpired.

More generally, 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.

Reduced demand has led to a decline in global oil prices and, despite its recent partial recovery, the sterling oil price remains around 35% weaker than at the beginning of this year. As a result, the prices of motor fuels were around 11% lower in August 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.

The Covid-19 shock has had varied impacts on demand and supply in different sectors of the economy, but overall the effects appear to have reinforced the drag on CPI inflation from lower oil prices. The sharp drop in hours worked indicates that a significant amount of spare capacity has emerged in the labour market, and underlying pay growth has slowed. Business surveys also suggest that, in aggregate, companies have a sizeable amount of spare capacity. Some sectors in which demand has been much lower than usual have already experienced weaker inflationary pressures. For example, accommodation services prices were around 4% lower in July than a year earlier, the largest decline since at least 1997, and remained weak in August.

The outlook for inflation

The outlook for the economy and inflation remains unusually uncertain. It will depend 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 August *Monetary Policy Report* assumed that the direct impact of Covid-19 on the economy would dissipate gradually. They were also conditioned on the assumption of an immediate, orderly move to a comprehensive free trade agreement with the European Union on 1 January 2021. Conditional on those assumptions, following an initial sharp fall, UK GDP was projected to continue to recover over the forecast period. Activity was also supported by substantial fiscal and monetary policy actions. Nonetheless, the recovery in demand was assumed to take time as health concerns were expected to drag on activity. The unemployment rate was projected to rise markedly, to around 7½% by the end of this year, consistent with a material degree of spare capacity, before declining gradually.

Recent domestic economic data have been a little stronger than the Committee expected at the time of the August *Report*, although, given the risks, it is unclear how informative they are about how the economy will perform further out. The recent increases in Covid-19 cases in some parts of the world, including the United Kingdom, have the potential to weigh further on economic activity, albeit probably on a lesser scale than seen earlier in the year. As in the August *Report*, there remains a risk of a more persistent period of elevated unemployment than in the central projection.

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, resulting in downward pressure on UK import prices.

Following its expiry at the end of August, the downward pressure on inflation from the Eat Out to Help Out scheme is likely to unwind in the September CPI data. The temporary VAT cut extends to January 2021, and is likely to reduce the inflation rate over that period, although to a more limited extent than previously assumed. Overall, CPI inflation is expected to remain below 1% until around the turn of the year. It is then expected to rise during 2021, as the direct impact of the recent fall in energy prices 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. In the MPC's central projection in the August *Report*, conditioned on prevailing market yields, CPI inflation was expected to be around 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. In that context, its challenge at present is to respond to the economic and financial impact of the Covid pandemic.

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 has announced a £300 billion increase in the stock of UK government bond and sterling non-financial investment-grade corporate bond purchases.

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. 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. The Committee will continue to monitor the situation closely and stands ready to adjust monetary policy accordingly to meet its remit. The MPC will keep under review the range of actions that could be taken to deliver its objectives. The Committee does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

At its September 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