BANK OF ENGLAND

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Governor

The Rt Hon Rishi Sunak
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Dear Rishi

On 15 December 2021, the Office for National Statistics (ONS) published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 5.1% 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?

The economic effects of Covid-19 (Covid) have been uneven, with significant changes in both demand and supply, as well as their composition, over time. This has led to a volatile evolution of price pressures. CPI inflation was at or below 1% during the first year of the pandemic, before rising rapidly towards, and then materially above, the MPC's 2% target over the recent period. As set out in recent *Monetary Policy Reports* and the minutes of MPC meetings, inflation has been expected to rise further above target in the near term. In the November 2021 *Report*, CPI inflation was expected to peak at 5% next spring, and to average around 4½% over 2022 as a whole. CPI inflation rose to 5.1% in the November data that have triggered this letter, 0.6 percentage points higher than expected in the November *Report*. Core CPI inflation, excluding energy, food, alcoholic beverages and tobacco, has also increased further, to 4.0%. Relative to the November *Report* projection, there has been significant upside news in core goods and, to a lesser extent, services price inflation.

Inflation has continued to be affected by global developments, particularly the economic recovery from the worst of the pandemic, and supply constraints in certain sectors.

Consumer energy price inflation has risen further over recent months, as previous increases in wholesale electricity and gas prices were reflected in Ofgem's caps on household energy prices in October, and as the previous strength in oil prices has been passed on to the cost of motor fuels. Overall, the contribution of energy prices to CPI inflation rose to around 1½ percentage points in November.

Disruption to supply chains, alongside elevated global demand for goods, has led to bottlenecks, which have exerted upward pressure on inflation globally. Commodity prices have risen sharply since their troughs in 2020, accounting for some of that increase. Households in the United States have driven almost the entire increase in durable goods consumption across G7 economies during the pandemic, with the United Kingdom contributing relatively little to these dynamics. Those cost pressures have nevertheless been passed through directly to some UK consumer goods prices. For example, household goods inflation rose to 6.7% in November, with significant rises in the prices of furniture, furnishings and household appliances. Clothing price inflation rose sharply to 3.8% in November, though in large part reflecting the weakness of these prices during the base period of November 2020, a time when restrictions on economic activity were more stringent.

Supply shortages of specific goods, such as semiconductors, appear also to have affected some UK consumer goods prices indirectly. For example, continuing semiconductor shortages have disrupted new car production, which has led to an increase in demand in the used car market. Twelve-month used car price inflation rose to 27.1% in November.

As well as these global pressures, some consumer service prices have picked up recently, though to a lesser degree than goods and energy price inflation. For example, accommodation and catering services inflation were 8.3% and 4.6% respectively in November, in part likely to reflect the increase in VAT for these items at the start of October alongside the continuing recovery in demand and cost pressures. Aggregate services price inflation rose to 3.3% in November, some way above its pre-Covid level.

The outlook for inflation

CPI inflation is expected to remain around 5% through the majority of the winter period, and peak at around 6% in April 2022. The latter would be around one percentage point higher than expected in the November 2021 *Monetary Policy Report*.

The further rise in inflation next spring is in large part expected to reflect current developments in wholesale gas and electricity futures prices, which will feed into Ofgem's updated retail price caps from April. Movements in wholesale prices over much of the period following the November *Report* have been broadly consistent with Bank staff's baseline assumptions of how much these caps are likely to increase, but gas and electricity futures prices have picked up sharply in the days leading up to the MPC's December meeting which implies additional upside pressure on utility price inflation if this persists. The fall in oil prices since the MPC's previous meeting will have a small, and only partly offsetting, negative effect on energy price inflation over coming months.

Core goods inflation is expected to remain well above its pre-Covid average in the near term, accounting for the majority of the remainder of the projected above-target inflation. Food price inflation is expected to rise further, reflecting cost increases over recent months. Services price inflation is projected to remain at above pre-Covid rates and increase somewhat further. Indicators of cost and price pressures have remained at historically elevated levels recently, and contacts of the Bank's Agents expect further price increases next year driven in large part by pay and energy costs. CPI inflation is still expected to fall back in the second half of next year.

In the November *Report* projections, and conditioned on the market-implied path for Bank Rate at that time and the MPC's current forecasting convention for future energy prices, upward pressure on CPI inflation was expected to dissipate over time, as supply disruption eased, global demand rebalanced from goods to services, and energy prices stopped rising. As a result, CPI inflation was projected to be a little above the 2% target in two years' time and just below the target at the end of the forecast period. In an alternative scenario that was conditioned on energy prices following forward curves throughout the forecast period and as set out in a Box in the November *Report*, CPI inflation fell back towards the target more rapidly than in the MPC's central projection, and was materially lower over the second half of the forecast period.

Since the November MPC meeting, the Omicron Covid variant has emerged. It appears to be spreading rapidly within the United Kingdom and around the world. The new variant appears to be much more transmissible than the Delta variant and, on the basis of current knowledge, poses new risks to public health. The Omicron variant poses downside risks to activity in early 2022, although the balance of its effects on demand and supply, and hence on medium-term inflationary pressures, is unclear.

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.

In the recent unprecedented circumstances, the economy has been subject to very large and repeated shocks. Given the lag between changes in monetary policy and their effects on inflation, the Committee, in judging the appropriate policy stance, will as always focus on the medium-term prospects for inflation, including medium-term inflation expectations, rather than factors that are likely to be transient.

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.

At its November meeting, the Committee judged that, provided the incoming data, particularly on the labour market, were broadly in line with the central projections in the November *Monetary Policy Report*, it would be necessary over coming months to increase Bank Rate in order to return CPI inflation sustainably to the 2% target. Recent economic developments suggest that these conditions have been met. The labour market is tight and has continued to tighten, and there are some signs of greater persistence in domestic cost and price pressures. Although the Omicron variant is likely to weigh on near-term activity, its impact on medium-term inflationary pressures is unclear at this stage.

The Committee judged that an increase in Bank Rate of 0.15 percentage points was warranted at the December MPC meeting.

The MPC will review developments, including emerging evidence on the implications for the economy of the Omicron variant, as part of its forthcoming forecast round ahead of the February 2022 *Monetary Policy Report*. The Committee will, as always, continue to focus on the medium-term prospects for inflation. The Committee continues to judge that there are two-sided risks around the inflation outlook in the medium term, but that some modest tightening of monetary policy over the forecast period is likely to be necessary to meet the 2% inflation target sustainably. The Committee will reach its assessment on the balance of the risks to medium-term inflation in light of the relevant data as they emerge.

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 all parts of the United Kingdom and sectors of the economy.

Consistent with the MPC’s remit, the Committee sets monetary policy to meet the inflation target sustainably in the medium term. An essential part of the MPC’s strategy is a consistent and transparent approach to achieving the 2% inflation target, which is vital in responding to the very large shocks that the economy has faced recently, and is reflected in this exchange of letters. Raising Bank Rate when the Omicron variant is set to weigh heavily on public health in the near term is a difficult decision for the Committee to make. With the goal of returning inflation sustainably to its 2% target in the medium term, the Committee judges that it is through acting to maintain price stability that monetary policy, in accordance with the MPC’s remit, makes its contribution to the resilience of the UK economy.

Yours sincerely,

Andrew Bailey

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