Bank of England

Andrew Bailey
Governor

The Rt Hon Jeremy Hunt
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Dear Jeremy

On 14 December 2022, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 10.7% in November. As required by the Monetary Policy Committee's (MPC) remit 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?

CPI inflation remains elevated. Inflation was 9.9% in the August data that triggered the previous letter sent in September. Since then, the MPC set out in the November Monetary Policy Report and the minutes of its November meeting its expectation that inflation would rise to around 11% in October, as retail gas and electricity prices increased to levels consistent with the Government's Energy Price Guarantee, and would remain elevated through the remainder of this year. Consistent with that expectation, CPI inflation rose to 11.1% in October, before falling to 10.7% in the November data that have triggered this letter.

The increase in CPI inflation in the aftermath of the pandemic mainly reflected large increases in global energy prices and other tradable goods prices. The pattern of recovery pushed up on consumer prices globally with a rotation of consumer spending towards goods and away from services, in particular in the United States, leading to supply constraints in certain sectors. This was expected to be temporary as the pattern of demand around the world was projected to revert to its previous balance between goods and service as the economic outlook improved. The recovery was interrupted, however, by Russia's invasion of Ukraine, which has greatly exacerbated the rise in energy prices as well as wholesale prices of many agricultural commodities. These external factors continue to add significantly to inflationary pressures in the United Kingdom.

Since my last letter, food and non-alcoholic beverage price inflation has reached a 45-year high of 16.4%. With a weight in the CPI of nearly 12%, this accounts for around 1.8 percentage points of the overshoot of inflation from the 2% target. The rise in food prices is a global phenomenon, exacerbated by adverse climate conditions and supply constraints caused by the war in Ukraine, including rising energy and fertiliser costs in food production. These global food prices have passed through to UK prices.

CPI inflation has, however, increasingly been driven also by factors that are more domestic. The labour market, in particular, remains very tight. The end of the Coronavirus Job Retention Scheme in the second half of last year turned out to have a very small impact on unemployment. Meanwhile, the number of people who are not active in the labour market in has remained much higher than before the pandemic. This marked increase in inactivity reflects the ageing of the population, early retirement decisions as well as an increase in long-term sickness

As firms have passed on rising labour and other costs to consumers, inflationary pressures have broadened to sectors in which price setting is driven more by domestic costs than traded goods prices. Consumer services inflation, for example, remained high at 6.3% in the November data.

The outlook for inflation

The MPC's latest projections suggest that twelve-month CPI inflation has reached its peak. Household energy prices have been significantly reduced by the Government's Energy Price Guarantee, which has limited the increase in CPI inflation. But inflation is expected to remain very high in the next few months as global and domestic factors continue to push up on consumer price inflation.

CPI inflation is then expected to fall gradually into the spring of next year. A significant part of this expected fall reflects so-called base effects as previous increases in energy prices start to drop out of the calculations of the twelve-month rate. At the same time, some non-energy commodity prices have fallen back from recent peaks, and there are signs that bottlenecks in global supply chains are starting to ease. Survey indicators of costs and prices, such as the composite input and output price PMIs, have tended to moderate in recent months. While the labour market remains historically tight, there are also tentative signs that conditions may be softening. The rate of unemployment in the Labour Force Survey edged up to 3.7% in the three months to October, and the number of vacancies posted by firms has fallen somewhat.

In the MPC's November Monetary Policy Report projections, the UK economy was expected to be in recession for a prolonged period. From mid-2023, inflation was expected to fall sharply as previous increases in energy prices dropped out of the annual comparison. It was then expected to decline to some way below the 2% target in years two and three of the projection. This reflected a negative contribution from energy prices, as well as the emergence of an increasing degree of economic slack and a steadily rising unemployment rate.

The risks around that declining path for inflation were, however, judged to be to the upside. In part, this reflects the possibility of more persistence in wage and price-setting as domestic wage and price pressures have strengthened and global inflationary pressures remain elevated. Annual private sector regular wage growth, in particular, has come in higher than expected and is likely to remain high at around 7% in the coming months. A number of contacts of the Bank's Agents expect further upward pressure on pay growth next year. With continued pass-through of labour and other costs, including energy, services inflation has strengthened over the second half of the year.

The policy action the Committee is 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 recognises that there will be occasions when inflation will depart from the target as a result of shocks and disturbances. The economy has been subject to a succession of very large shocks. Monetary policy will ensure that, as the adjustment to these shocks continues, CPI inflation will return to the 2% target sustainably in the medium term. Monetary policy is also acting to ensure that longer-term inflation expectations are anchored at the 2% target. In order to achieve this, the MPC has raised Bank Rate from its trough of 0.1% at each of its eight prior meetings since December 2021.

At its December meeting, the Committee voted to increase Bank Rate by a further 0.5 percentage points to 3.5%. The labour market remains tight, and there has been evidence of inflationary pressures in domestic prices and wages that could indicate greater persistence and thus justifies a further forceful monetary policy response.

The majority of the Committee judged that, should the economy evolve broadly in line with the November Monetary Policy Report projections, further increases in Bank Rate may be required for a sustainable return of inflation to target.

There are considerable uncertainties around the outlook. The Committee continues to judge that, if the outlook suggests more persistent inflationary pressures, it will respond forcefully, as necessary.

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.

The Committee will continue to act as necessary to ensure that CPI inflation returns to the 2% target sustainably in the medium term.

Yours sincerely,

Andrew Bailey

cc: The Rt Hon Harriett Baldwin MP, Chair of the Treasury Committee