Bank of England

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Governor

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Dear Kwasi

On 14 September 2022, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 9.9% in August. 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 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?

CPI inflation has risen further above the 2% target. Inflation was 9.0% in the April CPI data that triggered the previous letter sent in June. Since then, the MPC set out in the August Monetary Policy Report and the minutes of its August meeting its expectation that inflation would rise to around 10% in 2022 Q3, reflecting strength in energy, food and services prices. Consistent with that expectation, CPI inflation rose to 10.1% in July before falling slightly to 9.9% in the August data that have triggered this letter.

The increase in CPI inflation above the 2% target mainly reflects large increases in global energy prices and other tradable goods prices. The rise in energy prices has been greatly exacerbated by the economic impact of Russia's invasion of Ukraine, which has also raised significantly the wholesale prices of many agricultural commodities.

Before the war, consumer prices were being pushed upwards by global factors, particularly the pattern of economic recovery from the worst of the pandemic, including the rotation of consumer spending towards goods and away from services, most notably in the United States, and 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 in the aftermath of Covid.

The recovery was interrupted, however, by the war in Ukraine, which has contributed to inflationary pressures in the United Kingdom being more persistent than expected. Since my previous letter in June, Russia has caused additional moves in wholesale gas prices by restricting gas supplies to Europe. This has further intensified inflationary pressures in the United Kingdom and the rest of Europe. Rates of consumer price inflation in the euro area and in the United States have also remained elevated for longer than expected. Euro-area annual HICP inflation increased to 9.1% in August. In the United States, annual CPI inflation was 8.3% in August. These high inflation rates reflect the extraordinary sequence and persistence of shocks hitting the global economy.

Not all of the excess inflation can be attributed to global events. There has also been a role for interactions of global shocks with domestic factors, including a tight labour market and the pricing strategy of firms. Inflationary pressures have broadened to more domestically driven sectors. Consumer services price inflation, which is more influenced by domestic costs than goods price inflation, has surprised to the upside, rising to 5.9% in August from 5.7% in July.

In light of continued inflationary pressure, the MPC has also revisited some of the key judgements it had to make in real time as the economy recovered from the pandemic. 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. At the same time, the number of people who are not active in the labour market has remained much higher than before the pandemic. As a result, the labour market has remained tighter for longer than expected a year ago.

The outlook for inflation

Twelve-month CPI inflation is expected to rise further in the near term, peaking at a little under 11% in October. Increasing energy bills, combined with the indirect effects of higher energy costs, mean that inflation is expected to remain above 10% over the following few months. The increase in household energy prices has, however, been significantly reduced by the Government's Energy Price Guarantee, which will cap household unit energy prices for a period of two years. For the period of the Guarantee, this might be expected to reduce the risk that a long period of externally generated inflation leads to more persistent domestic price and wage pressures.

Domestic inflationary pressures are nevertheless expected to remain strong over the first half of the MPC's three-year forecast period. Firms generally report that they expect to increase their selling prices markedly, reflecting the sharp rises in their costs. The labour market has remained tight, with the unemployment rate falling to 3.6% in the three months to July, its lowest level since 1974. Nominal wage growth is expected to pick up further over the second half of 2022.

In the MPC's latest forecasts in the August Monetary Policy Report, inflationary pressures were expected to dissipate over time. In contrast with developments since June, global commodity prices were assumed to rise no further, and tradable goods price inflation was expected to fall back. The United Kingdom was projected to enter recession from the fourth quarter of this year. Although the labour market was expected to loosen only slowly in response to falling demand, unemployment was expected to rise from 2023. Domestic inflationary pressures were therefore expected to subside in the second half of the MPC's forecast period, as an increasing degree of economic slack and lower headline inflation reduced the pressure on wage growth. In the baseline projection, conditional on the path of Bank Rate implied by financial markets at the time, inflation was forecast to fall well below target in three years' time.

Since the August Report, the Government has announced support measures for households and businesses, including the Energy Price Guarantee. While the Guarantee reduces inflation in the near term, it also means that household spending is likely to be less weak than projected in the August Report over the first two years of the forecast period. All else equal, and relative to that forecast, this will add to inflationary pressures in the medium term. As part of its November MPC round, the Committee will make a full assessment of the impact on demand and inflation from these announcements, as well as the Government's forthcoming Growth Plan and other news, and determine further implications for monetary policy.

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 six prior meetings since December 2021.

There have been further signs since the August Report of continuing strength in domestically generated inflation. The labour market is tight and domestic cost and price pressures remain elevated. The Guarantee will lower and bring forward the expected peak of CPI inflation, which will reduce the risk that externally generated price inflation leads to more persistent inflationary pressures, although that risk remains material.

In view of these considerations, the Committee voted to increase Bank Rate by 0.5 percentage points, to 2.25%, at its September meeting.

The MPC will take the actions necessary to return inflation to the 2% target sustainably in the medium term, in line with its remit. Policy is not on a pre-set path. The Committee will, as always, consider and decide the appropriate level of Bank Rate at each meeting. The scale, pace and timing of any further changes in Bank Rate will reflect the Committee's assessment of the economic outlook and inflationary pressures. Should the outlook suggest more persistent inflationary pressures, including from stronger demand, the Committee 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. This includes ensuring that longer-term inflation expectations are anchored at the 2% target.

Yours sincerely,

Andrew Bailey

cc: The Rt Hon Mel Stride MP, Chair of the Treasury Committee