



The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

5 November 2015

Dear Chancellor,

In August I wrote a third letter to you when CPI inflation remained more than one percentage point below the 2% target. Three months later, as expected, that is still the case: on 13 October, the Office for National Statistics (ONS) published data showing that twelve-month CPI inflation was -0.1% in September. In line with the Remit of the Monetary Policy Committee (MPC), I am writing this open letter to be published alongside the November *Inflation Report*. In accordance with the Remit, this letter describes:

- the reasons why inflation has moved away from the target and the outlook for inflation;
- the horizon over which the Committee judges it appropriate to return inflation to the target;
- the trade-off that has been made with regard to inflation and output variability in determining the scale and duration of any expected deviation of inflation from the target;
- the policy action that the Committee is taking in response; and
- how this approach meets the Government's monetary policy objectives.

Why has inflation moved away from the 2% target?

In September, twelve-month CPI inflation stood at -0.1%, slightly over two percentage points below the inflation target. **Table 1** contains a breakdown of the arithmetic contributions of different components of CPI inflation to the deviation from the target.

Table 1: Arithmetic contributions to September 2015 CPI inflation relative to the pre-crisis average

| Percentage points | 1997-2007 average | September 2015 | September 2015 difference | Memo: Difference in February Open Letter ^(b) |
|----------------------------|-------------------|----------------|---------------------------|---|
| Energy | 0.3 | -0.7 | -1.0 | -0.8 |
| Food, non-alcoholic bevs. | 0.2 | -0.2 | -0.5 | -0.4 |
| Other goods ^(a) | -0.1 | -0.3 | -0.2 | 0.2 |
| Services | 1.6 | 1.1 | -0.4 | -0.5 |
| Total ^(a) | 2.0 | -0.1 | -2.1 | -1.4 |

(a) Adjusted for the close to 0.4 percentage point downward bias from clothing that existed until 2010.

(b) The December 2014 CPI release accompanied the February 2015 open letter.

The underlying causes of below-target inflation are unchanged since my previous letter: falls in commodity prices; the appreciation of sterling; and, to a lesser degree, below-average growth of domestic wage costs.

The single most important reason for below-target inflation remains the sharp falls in energy prices since the middle of last year. Oil prices have fallen further over the past three months and in September they were around half the level of a year earlier in sterling terms. That has dragged energy price inflation down further. The contribution of fuels and domestic gas and electricity prices to CPI inflation was -0.7 percentage points in September, a full percentage point below its pre-crisis average. Food price inflation also remained weak, at -2.3%, reflecting the continued effects of lower farm-gate prices and more intense competition amongst retailers.

Together with muted growth in world prices, the appreciation of sterling has pulled import prices down more broadly. The sterling effective exchange rate index rose by around 15% in the two years to the end of August 2015 and the resulting reduction in import costs is gradually feeding through to consumer prices. This is evident in the fall in the contribution to CPI inflation of other goods prices, beyond food and energy.

Overall, these factors can explain around four-fifths of the deviation of inflation from target, a slightly higher proportion than in my previous letter. The remainder reflects the impact of past spare capacity weighing on domestic cost growth, particularly unit labour costs.

In recent months, pay growth has recovered, in part due to the narrowing of slack in the labour market. The same is true of growth of unit labour costs, albeit to a lesser extent, given the recent improvement in productivity growth. However, both pay and unit labour cost growth remain below their average rates prior to the financial crisis, and therefore below the rates consistent with inflation being at target.

The outlook for CPI inflation

Over the past three months, inflation has moved broadly in line with the MPC's central forecast in the August *Inflation Report*. The Committee's updated forecasts are published today in the November *Inflation Report*.

In the absence of further falls in commodity prices, inflation rates close to zero are unlikely to endure much beyond the end of the year. CPI inflation is judged likely to begin to rise at that point as past falls in energy prices begin to drop out of the annual comparison. The MPC judges it likely that, were Bank Rate to follow the very gradually rising path implied by market yields, the remaining slack in the economy would be used up over the next year and domestic cost pressures would continue to build. CPI inflation is nonetheless likely to remain below 1% until the second half of next year, reflecting the continuing drag from commodity and other imported goods prices. Thus, it is likely that I will have to write further open letters to you over the coming months.

Compared with the Committee's recent projections, the return of inflation towards the target is expected to be somewhat more gradual. That reflects new developments in recent quarters.

Primary among these is a further fall in the expected future path of commodity prices on which the Committee's inflation forecast is conditioned. For example, sterling energy prices in the middle of 2016 are expected to be 15% lower than had been expected in the Committee's first forecast made this year, in February. Moreover, some of these declines are expected to feed through only gradually to the prices faced by consumers. Lower

energy prices alone explain the majority of the difference between the Committee's inflation projection for 2016 made in February and the projection published today. The remainder is accounted for by the further 4% appreciation of sterling over that period. Domestically generated cost pressures are broadly in line with our previous expectations.

Over what horizon is it appropriate to return inflation to the target? And what trade-off has been made with regard to inflation and output variability?

The MPC's Remit is clear that the inflation target is symmetric: deviations of inflation below the target are to be treated with the same importance as deviations above it.

The Remit is also clear that the inflation target applies at all times. It recognises, however, that there will be occasions when inflation will deviate from the target as a result of economic shocks and disturbances. In such situations, it would not be feasible to bring inflation back to the target immediately since it takes time for monetary policy to affect the economy. The peak effect of monetary policy on inflation is generally estimated to occur with a lag of between 18 and 24 months. Moreover, attempts to return inflation to the target too quickly could lead to undesirable volatility in output.

The appropriate horizon for returning inflation to the target will depend on the trade-off the MPC faces between the speed with which this can be achieved and the consequences of doing so for output and employment. That trade-off depends on the nature of the disturbances that caused inflation to deviate from the target in the first place.

As noted above, the majority of the current deviation of inflation from the target reflects past falls in food and energy prices, whose effects are expected to begin to dissipate in the first half of next year.

The remainder of the current deviation from target reflects both the appreciation of sterling since mid-2013, which is likely still to be depressing import prices at present, together with the continued drag from the remaining spare capacity in the UK economy on firms' domestic cost growth.

While there is uncertainty around the extent to which changes in foreign export prices and the sterling exchange rate are reflected in UK consumer prices, on balance the MPC expects the effects of these factors on inflation to be protracted, as set out in a box in Section 4 of the November *Inflation Report*. As a result, the dampening influence of the past appreciation of sterling on inflation is expected to diminish only gradually over the MPC's forecast horizon, and is likely still to be affecting inflation in two years' time.

The MPC's objective is to return inflation to target sustainably; that is, without an overshoot once persistent disinflationary forces ultimately wane. Achieving a sustainable return of inflation to the target therefore requires setting policy to ensure that as the persistent drags from sterling and world export prices wane, they are balanced by further increases in domestic cost growth, brought about by eliminating the remaining margin of spare capacity in the economy.

Given these factors, the MPC judges it appropriate to set policy in order to ensure that growth is sufficient to absorb the remaining spare capacity so as to return inflation to the target in a sustainable manner in around two years and to keep it there in the absence of further shocks.

The policy action the Committee is taking in response

The MPC will conduct monetary policy so that the margin of spare capacity is absorbed and inflation returns to the 2% target. The Committee continues to take significant steps to support the UK economic recovery and so eliminate the remaining slack. Bank Rate has been at a historically low level of 0.5% for more than six years. In addition, the MPC purchased £375 billion of assets financed by the issuance of central bank reserves between 2009 and 2012 and continues to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility (APF) in order to maintain the total stock at that level. As described in the *Inflation Report* published today, the MPC's preference is to use Bank Rate as the active marginal instrument for monetary policy, and expects to maintain the stock of purchased assets at £375 billion until Bank Rate has reached a level from which it can be cut materially. The MPC currently judges that such a level of Bank Rate is around 2%. This is a further evolution of the Committee's forward guidance framework, which included guidance on the APF, originally announced in August 2013.

The MPC has provided its assessment of the likely outlook for policy. In the February 2014 *Inflation Report*, the MPC said that, given the likely persistence of headwinds weighing on the economy, when Bank Rate did begin to rise, it was expected to do so more gradually than in previous cycles. Moreover, the persistence of those headwinds, together with the legacy of the financial crisis, meant that Bank Rate was expected to remain below average historical levels for some time to come.

This assessment has shaped financial market expectations of the future path of UK interest rates as the domestic and global economic expansions have evolved. Expected interest rates have fallen further since the August *Inflation Report* and are now markedly lower than they were at the start of 2014. That has lowered borrowing costs for many UK households and companies, helping to support demand and so inflation. Complementing this, the Bank more broadly continues to provide support to the healthy functioning of credit markets through the Funding for Lending Scheme.

Consistent with the projections set out in its *Inflation Report* today, the MPC judges that a gradual rise in interest rates over the forecast period is likely to be consistent with its objective of returning inflation to the target in a sustainable manner.

There are risks to the outlook in both directions. On the downside, there are risks, including to UK households' and companies' spending decisions, stemming from the global environment and in particular from emerging economies. The crystallisation of such risks could also be associated with further weakness in external price pressures; this would directly depress inflation and would also increase the risk of a self-reinforcing fall in inflation expectations.

Were these downside risks to materialise, market expectations of the future path of interest rates could adjust further to reflect an even more gradual and limited path for Bank Rate increases than is currently priced. The Committee could also decide to extend the APF or to cut Bank Rate further towards zero from its current level of 0.5%.

On the upside, inflation could be higher if domestic costs grow more rapidly than assumed in the central projection, perhaps if wages are more responsive to the tightening labour market than assumed or if productivity growth disappoints.

If these risks materialise, it would be appropriate for Bank Rate to increase more quickly than embodied in current market yields, though it remains likely that those increases would still be more gradual and limited than in previous tightening cycles.

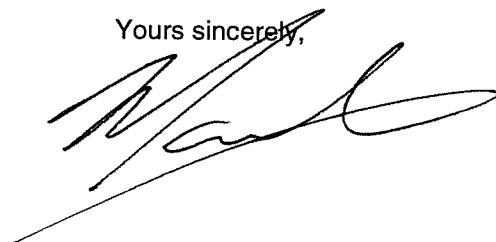
The MPC stands ready to take whatever action is needed, as events unfold, to ensure inflation remains likely to return to target in a timely fashion. Under the central case set out in today's *Inflation Report*, the MPC judges it more likely than not that Bank Rate will need to increase over the forecast period in order to deliver this.

How does this approach meet the Government's monetary policy objectives?

The MPC's objective is to maintain price stability and, subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment. Price stability is an essential pre-requisite for economic prosperity. The MPC is acting to return inflation to the target promptly by eliminating the remaining margin of slack in the economy.

Through co-ordinated action by the MPC, FPC and PRA, the Bank of England is guarding against the build-up of risks and imbalances that could threaten strong, sustainable, balanced growth, and therefore making its most effective contribution to the United Kingdom's economic performance.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'M. G. ...', written over the 'Yours sincerely,' text.