Bank of England

Andrew Bailey
Governor

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

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Dear Jeremy

On 22 March 2023, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 10.4% in February. 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 March 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 10.7% in the November data that triggered the previous letter sent in December. Since then, the MPC set out in the February Monetary Policy Report and the minutes of its February meeting its expectation that inflation would decline gradually during the first half of this year as base effects took hold.

CPI inflation fell to 10.5% in December and to 10.1% in January but then rose to 10.4% in February, 0.6 percentage points higher than expected in the February Report. Services CPI inflation has been marginally weaker than expected at the time of the February Report, while food price inflation and core goods price inflation have been significantly stronger than projected.

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 services as the economic outlook improved. The recovery was interrupted, however, by Russia's invasion of Ukraine, which 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, with annual goods CPI inflation remaining just under 13½% over recent months. Most of the surprising strength in the core goods component of the CPI in February was, however, accounted for by higher clothing and footwear prices, which have tended to be volatile and could therefore prove less persistent.

Since my last letter, annual food and non-alcoholic beverage price inflation has increased further to 18.0%. With a weight in the CPI of around 12%, this accounts for just over 2 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 tight. The unemployment rate remains at a historically low level, while the stock of vacancies relative to the number of unemployed remains high by historical standards. 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. Services CPI inflation, for example, has risen from 6.3% in November to 6.6% in the latest February data.

The outlook for inflation

In the MPC's February Monetary Policy Report projections, CPI inflation was projected to fall sharply by the end of 2023, to just under 4%, reflecting a rapid decline in global price pressures and a greater than previously expected fall in the contribution of household energy prices to CPI inflation. Domestic inflationary pressures were likely to remain strong over the next few quarters. Annual private-sector regular pay growth was expected to decline from the spring, to around 5% by the end of this year.

In the February modal forecast, conditioned on the market-implied path for Bank Rate prevailing at that time, an increasing degree of economic slack, alongside falling external pressures, led CPI inflation to decline to below the 2% target in the medium term. There were considerable uncertainties around the medium-term outlook, and the Committee continued to judge that the risks to inflation were skewed significantly to the upside. This skew reflected the possibility of greater persistence in domestic wage and price setting.

Since the February Report, the Government has announced in the Spring Budget that the Energy Price Guarantee (EPG) will now be maintained at £2,500 for a typical dual-fuel bill for three further months from April. This change in the EPG represents downside news to the near-term outlook for household energy prices relative to the MPC's February projection. Falls in wholesale gas futures prices, if sustained, would mean that the EPG would not bind on household energy bills from July onwards. Instead, Ofgem price caps would set the price of domestic energy bills. Other measures announced in the Budget, such as the freezing of fuel duty, constitutes further downside news to the inflation forecast from April.

CPI inflation is still expected to fall significantly in 2023 Q2, to a lower rate than previously anticipated in the February Report. This lower-than-expected rate is due to the near-term news in the Budget including on the EPG, alongside the falls in wholesale energy prices. Services CPI inflation is expected to remain broadly unchanged in the near term, but wage growth is likely to fall back somewhat more quickly than projected in the February Report.

GDP is still likely to have been broadly flat around the turn of the year, but is now expected to increase slightly in the second quarter, compared with the 0.4% decline anticipated in the February Report. The labour market has remained tight, while the news since the MPC's previous meeting points to stronger-than-expected employment growth in 2023 Q2 and a flat rather than rising unemployment rate.

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 sequence of very large and overlapping 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.

At its February meeting, the Committee voted to increase Bank Rate by 0.25 percentage points, to 4.25%. CPI inflation increased unexpectedly in the latest release, but it remains likely to fall sharply over the rest of the year. Services inflation has been broadly in line with expectations. The labour market has remained tight, and the near-term paths of GDP and employment are likely to be somewhat stronger than expected previously. Although nominal wage growth has been weaker than expected, cost and price pressures have remained elevated.

The extent to which domestic inflationary pressures ease will depend on the evolution of the economy, including the impact of the significant increases in Bank Rate so far. Uncertainties around the financial and economic outlook have risen.

The MPC will continue to monitor closely indications of persistent inflationary pressures, including the tightness of labour market conditions and the behaviour of wage growth and services inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.

The MPC will make a full assessment of all of the news since the February Report, including the economic implications of recent financial market and banking sector developments, as part of its forthcoming May forecast round.

The MPC will adjust Bank Rate as necessary to return inflation to the 2% target sustainably in the medium term, in line with its remit.

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