Bank of England

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Governor

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Dear Jeremy

On 21 June 2023, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 8.7% in May.

This letter sets out the outlook for inflation and the policy action the Monetary Policy Committee (MPC) is taking in response to high inflation, along with other considerations required by the MPC's remit when inflation moves away from the 2% target by more than 1 percentage point.

In light of stronger resilience in the UK economy and further evidence of persistence in inflation, the MPC voted to increase Bank Rate by 0.5 percentage points, to 5%, at its June meeting. Bringing inflation down is our absolute priority. The MPC will do what is necessary to return inflation to the 2% target sustainably in the medium term, in line with the primacy of price stability in the Government's monetary policy objective and the MPC's remit.

Why has inflation moved away from the 2% target?

Twelve-month CPI inflation reached a peak of 11.1% in October last year. It had fallen to 10.4% in the February release that triggered my previous letter, sent in March. Since then, CPI inflation has fallen by a further 1.7 percentage points, not least because energy price inflation has fallen, as previous large increases have started to drop out of the annual calculations. But CPI inflation remains much too high, and inflation in core goods and services have risen.

As I have described in previous letters, the increase in CPI inflation following the pandemic mainly reflected large increases in global energy prices and other tradable goods prices. The pattern of recovery after the pandemic pushed up consumer prices globally with a rotation of consumer spending towards goods and away from services, leading to supply constraints in certain sectors. This was expected to be temporary, with the pattern of demand around the world reverting 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.

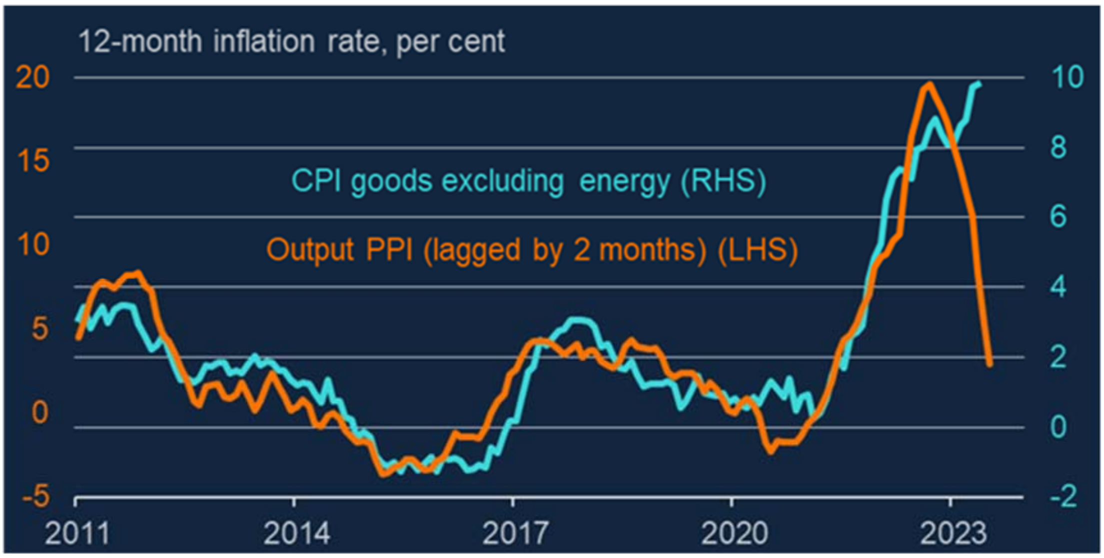
While these external cost pressures have started to wane, they continue to affect CPI inflation in the United Kingdom.

This has been the case for food in particular over recent months. After my last letter, annual inflation for food and non-alcoholic beverages rose from 18.0% in February to 19.1% in March, before easing a little to 18.3% in May. With a CPI weight of around 12%, this accounts for about 2 percentage points of the overshoot of inflation from the 2% target. The rise in food prices is a global phenomenon, largely reflecting steep rises through much of last year, after Russia's invasion of Ukraine, in prices of agricultural commodities, energy and fertilisers.

The rate of inflation in the prices of core consumer goods, while lower than its 2022 peak, has also increased since February, from 5.7% to 6.8%. As core goods are mostly tradables, core goods inflation tends to be driven by price developments in global markets. Disruptions to global supply chains and a sharp rise in raw materials and shipping costs were a key factor in pushing up core goods inflation in 2021 and into 2022. But core goods inflation also tends to be quite volatile, and news in this component is less likely to imply persistent inflationary pressures.

As the Chart below illustrates, the recent increase in goods price inflation excluding energy has occurred despite a sharp recent fall in UK manufacturing output prices. Producer Price Index (PPI) input and output inflation fell to 0.5% and 2.9%, respectively, down from 4.2% and 5.2% in April, and from peaks of 24.4% and 19.6% in mid-2022. The same pattern has been observed in many other economies. UK non-energy import prices appear to have risen further, however, suggesting that core goods manufacturers and retailers could still be facing high input costs in global markets. While data for world export prices have softened of late, Bank staff analysis suggests that elevated world export prices can account for a significant share of high core goods inflation in the United Kingdom.

Chart: Goods price inflation has risen despite a fall in producer price inflation



Sources: ONS and Bank calculations.

The continued pass-through of costs to consumer prices may also be indicative of some rebuilding of profit margins by retailers. In the Bank's Decision Maker Panel, a higher share of manufacturers report an increase in margins over the past year than a decrease. But this is not the case for wholesale and retail businesses. Strength in wage growth and costs of inputs from service sectors appear to be additional factors pushing up on consumer prices for retailers.

More broadly, domestic inflationary pressures remain significantly elevated, and CPI inflation has increasingly been driven by factors that are more domestic. Services CPI inflation, which depends more on domestic costs and tends to be more persistent than core goods inflation, has risen to 7.4% in May, up from 6.6% in February. That said, volatile airfares and package holidays contributed to some of the unexpected rise in services inflation. Signalling broader forces at work, annual private sector regular pay growth has also picked up further, to 7.6% in the three months to April.

These elevated domestic inflation pressures reflect, in part, the second-round effects of the steep rises in import prices in 2021 and 2022, and their impact on real incomes. But they also reflect the relative resilience of the economy and the tightness of the labour market. While the ratio of the number of vacancies to the number of unemployed people has fallen from its peak, it remains significantly above pre-pandemic levels. The rate of unemployment is near historical lows, and employment growth has been stronger than expected in the May Monetary Policy Report.

The MPC pays particularly close attention to such indications of persistent inflationary pressures in the UK economy as a whole.

The outlook for inflation

Looking ahead, the continued pass-through of costs faced by consumer providers, including labour costs, is expected to keep services inflation elevated in the near term. Similarly, core goods inflation is expected decline later this year, supported by developments in cost and prices indicators earlier in the supply chain. Food price inflation, meanwhile, is projected to fall further in coming months, reflecting the waning of pass-through from previous shocks.

Headline CPI inflation is expected to fall significantly further during the course of the year, in the main reflecting developments in energy prices. Recent levels of wholesale gas futures prices will lead to a fall in July and, if sustained, again in October in the Ofgem cap on energy prices faced by households. As a result, towards the end of the year, falls in energy prices can be expected to pull down significantly on annual CPI inflation.

In the MPC's latest projection, presented in the May Monetary Policy Report and conditioned on market interest rates prevailing at the time, an increasing degree of economic slack, combined with declining external pressures, meant that CPI inflation was expected to fall significantly below the 2% target in the medium term.

However, the Committee judged that the risks around that modal inflation projection were skewed significantly to the upside, reflecting the possibility that the second-round effects of external cost shocks on inflation in wages and domestic prices may take longer to unwind than they did to emerge. The mean CPI inflation profile in the May Report, which incorporated this risk, was at or just below the 2% target in the medium term.

Since the May Report, there has been material news in a number of UK economic data outturns, including those that the Committee has noted it will be monitoring closely as indicators of persistent inflationary pressures – in particular wage growth and service inflation – against the background of a tight labour market and continued resilience in demand. Some indicators of future pay growth and goods inflation have weakened, but their properties as leading indicators have not been tested in a similar period of high inflation.

At the same time, there has been a marked increase in market interest rates. At the time of the previous MPC meeting and May Monetary Policy Report, the market-implied path for Bank Rate averaged just over 4% over the next three years. Since then, gilt yields have risen materially, particularly at shorter maturities, now suggesting a path for Bank Rate which averages around 5½%. Mortgage rates have also risen notably.

The Committee is continuing to monitor closely the impact of the significant increases in Bank Rate so far. As set out in the May Report, the greater share of fixed-rate mortgages means that the full impact of the increase in Bank Rate to date will not be felt for some time.

The policy action the Committee is taking in response

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 as set out in its remit. 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. Monetary policy will ensure that CPI inflation returns to the 2% target sustainably in the medium term.

The MPC recognises that the second-round effects in domestic price and wage developments generated by external cost shocks are likely to take longer to unwind than they did to emerge. Given the significant upside news in recent data that indicates more persistence in the inflation process, and against the background of a tight labour market and continued resilience in demand, the Committee voted to increase Bank Rate by 0.5 percentage points, to 5%, at its June meeting.

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

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.

Yours sincerely,

Andrew Bailey

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