Bank of England

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Governor

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Dear Rishi

On 18 May 2022, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 9.0% in April. 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 June 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 materially further above the 2% target. That mainly reflects previous large increases in global energy and other tradable goods prices. However, not all of the excess inflation can be attributed to global events. There has also been a role for interactions with domestic factors, including the tight labour market and the pricing strategies of firms.

Inflation was 5.5% in the January CPI data that had triggered the previous letter sent in March and, at that time, it was expected to increase to around 8% in 2022 Q2. Since then, the MPC set out in the May *Monetary Policy Report* and the minutes of its May meeting its expectation that inflation would rise to just over 9% in 2022 Q2, reflecting strength in energy, core goods, food and services prices. Consistent with that expectation, CPI inflation was 9.0% in the April data and that has triggered this latest letter. Energy and core goods inflation continue to account for around 80% of the overshoot of CPI inflation relative to the 2% target.

The rise in global energy prices has been greatly exacerbated by the economic impact of Russia’s invasion of Ukraine, which has also raised significantly the wholesale price of many agricultural commodities. Even before the war, however, 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 succession of global shocks has contributed to inflationary pressures in the United Kingdom being more persistent than expected. Rates of consumer price inflation in the euro area and the United States have also been elevated during the first half of this year. Euro-area annual HICP inflation increased to 8.1% in May. In the United States, annual CPI inflation was 8.6% in May.

In the United Kingdom, the Ofgem price cap mechanism means that it takes some time for increases in wholesale gas and electricity prices, and their respective futures curves, to be reflected in retail energy prices. Given the operation of the price cap, consumer price inflation is likely to peak later in the United Kingdom than in many other economies, and may therefore fall back later.

There has also been a role for interactions of global shocks with domestic factors in explaining the rise in CPI inflation above the 2% target. Consumer services price inflation, which is more influenced by domestic costs than goods price inflation, has strengthened in recent months. In addition, UK core consumer goods price inflation is higher than in the euro area and in the United States.

The outlook for inflation

CPI inflation is expected to be over 9% during the next few months and to rise to slightly above 11% in October. The increase in October reflects higher projected household energy prices following an additional large increase in Ofgem price cap.

In the MPC's central projections in the May Monetary Policy Report, alongside elevated inflation, UK GDP growth was expected to slow sharply over the first half of the forecast period. That predominantly reflects the significant adverse impact of the sharp rises in global energy and tradable goods prices on most UK households' real incomes and many UK companies' real profits. Although the labour market was expected to tighten slightly further in the near term, the unemployment rate was projected to rise to 5½% in three years' time. Excess supply was projected to build to 2¼% by the end of the forecast period.

In the MPC's May forecast, upward pressure on CPI inflation was expected to dissipate over time. In the main, this reflected the stabilisation of the prices of commodities, albeit at elevated levels, and other tradable goods. It also reflected the combined impact of weaker real incomes and tighter monetary policy, as embodied in the rising market-implied path for Bank Rate on which the forecast was conditioned at that time, on domestic demand. CPI inflation was projected to fall to a little above the 2% target in two years' time and to well below the target in three years. The risks to the inflation projection were judged to be skewed to the upside at these points, given the risks of more persistent strength in nominal wage growth and domestic price setting than assumed.

Since then, the Government has announced a Cost of Living Support package, which is expected to mitigate some of the squeeze on real incomes. Initial Bank staff analysis suggests that, all else equal, the package could raise CPI inflation by 0.1 percentage points in the first year, with some upside risks around these estimates given the targeted and front-loaded nature of some of the measures.

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 also recognises that there will be occasions when inflation will depart from the target as a result of shocks and disturbances. Given the lags between any change in monetary policy and its peak impact on CPI inflation, the remit recognises that attempts to keep inflation at target in these circumstances may cause undesirable volatility in output due to the short term trade-offs involved, and that the MPC may therefore wish to allow inflation to deviate from the target temporarily.

The economy has recently been subject to a succession of very large shocks. These shocks have pushed global energy and tradable goods prices to elevated levels. Those price increases have raised UK inflation and, since the United Kingdom is a net importer of these items, will necessarily weigh on most UK households' real incomes and many UK companies' real profits. This real economic adjustment is something monetary policy is unable to prevent.

These global shocks could interact with domestic factors, including the tight labour market and the pricing strategies of firms, and could lead to more persistent inflationary pressures. The role of monetary policy is to ensure that, as the adjustment in the real economy occurs, CPI inflation returns to the 2% target sustainably in the medium term, while minimising undesirable volatility in output. In order to achieve this, the MPC has raised Bank Rate from its trough of 0.1% at each of its four prior meetings since December 2021.

In view of continuing signs of robust cost and price pressures, including the current tightness of the labour market, and the risk that those pressures become more persistent, the Committee voted to increase Bank Rate by 0.25 percentage points at its June MPC meeting, taking Bank Rate to 1.25%.

The MPC will take the actions necessary to return inflation to the 2% target sustainably in the medium term, in line with its remit. The scale, pace and timing of any further increases in Bank Rate will reflect the Committee's assessment of the economic outlook and inflationary pressures. The Committee will be particularly alert to indications of more persistent inflationary pressures, and will if necessary act forcefully in response.

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

Copy to The Rt Hon Mel Stride MP, Chair of the Treasury Committee