Bank of England

Andrew Bailey
Governor

The Rt Hon Rishi Sunak
Chancellor of the Exchequer
HM Treasury
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Dear Rishi

The Bank of England condemns Russia's unprovoked invasion and the suffering inflicted on Ukraine. The Bank is working closely with the UK Government to support its response in coordination with international authorities. The Bank's Monetary Policy Committee (MPC) supports this condemnation and welcomes these actions.

On 16 February 2022, the Office for National Statistics (ONS) published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 5.5% in January. As required by the remit for MPC 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?

Prior to Russia's invasion of Ukraine, the economic effects of Covid-19 (Covid) were uneven, with significant changes in both demand and supply, as well as their composition, over time. This led to a volatile evolution of price pressures. CPI inflation was at or below 1% during the first year of the pandemic, before rising rapidly towards, and then materially above, the MPC's 2% target over the recent period. As set out in recent Monetary Policy Reports and the minutes of MPC meetings, inflation has been expected to rise further above target in the near term. In the February 2022 Report, CPI inflation was expected to peak at around 7¼% in April, and to average around 6¼% over 2022 as a whole. CPI inflation was 5.5% in the January data that have triggered this letter, marginally above the expectation incorporated into the February Report. Core CPI inflation, excluding energy, food, alcoholic beverages and tobacco, has increased further, to 4.4%.

Even before Russia's invasion of Ukraine, consumer prices were pushed upwards by global factors, particularly the economic recovery from the worst of the pandemic and supply constraints in certain sectors. Rates of consumer price inflation in the euro area and the United States were also elevated at the start of the year. Euro-area annual HICP inflation increased to 5.8% in February. In the United States, annual CPI inflation rose to 7.9% in February.

Household energy price inflation eased in the January CPI release, reflecting a temporary softening in sterling oil prices having been passed on to the cost of motor fuels. Overall, however, the contribution of energy prices to CPI inflation remained elevated in January, at around 1½ percentage points. Taken together, energy and core goods inflation accounted for over four fifths of the overshoot of UK CPI inflation relative to the 2% target in the January release.

Pressures from global supply chain bottlenecks, due to strong global demand for goods and inelastic supply, have also been passing through to consumer prices. The United Kingdom has contributed relatively little to the global dynamics, but these cost pressures have nevertheless been passed through to some UK consumer goods prices.

Supply shortages of specific goods, such as semiconductors, appear also to have affected some UK consumer goods prices indirectly. For example, semiconductor shortages have disrupted new car production, which has led to an increase in demand in the used car market. Twelve-month used car price inflation rose to a record high of 28.7% in January.

Twelve-month food price inflation has continued to rise, reaching 4.3% in January its highest rate since 2013. The increase in food price inflation also partly reflects developments in global markets.

Consumer services price inflation eased slightly, to 3.2% in January. While this was still some way above its pre-Covid level, it is broadly in line with the contribution from services inflation to headline CPI over a longer time horizon. The recent strengthening in consumer service prices has occurred alongside the recovery in UK demand and rising cost pressures.

The outlook for inflation

The February Monetary Policy Report projections were characterised by above-target inflation over much of the forecast period, and the opening up of a margin of spare capacity and a prospective increase in unemployment. Developments since the February Report are likely to accentuate both the peak in inflation and the adverse impact on activity by intensifying the squeeze on household incomes. The invasion of Ukraine by Russia has led to further large increases in energy and other commodity prices including food prices. It is also likely to exacerbate global supply chain disruptions, and has increased the uncertainty around the economic outlook significantly. Global inflationary pressures will strengthen considerably further over coming months, while growth in economies that are net energy importers, including the United Kingdom, is likely to slow.

UK CPI inflation is expected to rise further to around 6% in February and March, before increasing to around 8% in 2022 Q2. The latter would be around 1 percentage point higher than expected in the February Monetary Policy Report. The majority of this news can be attributed to energy prices, including Ofgem's announcement of slightly higher than expected increases in gas and electricity price caps in April, which were based on wholesale gas and electricity prices that pre-dated Russia's invasion of Ukraine. In addition, recent increases in oil prices associated with the invasion have been reflected in prices of petrol and heating oil.

If sustained, the latest rise in gas and electricity futures prices means that Ofgem's utility price caps, when reset in October 2022, could be substantially higher than expected in the February Report. Wholesale prices have, however, been exceptionally volatile and the six-month observation window relevant for the October price cap calculation, which runs from February to the end of July, has only recently opened.

Food price inflation is expected to rise further, reflecting the pass-through of cost increases over recent months. Indicators of cost pressures further down the food supply chain have continued to rise. Following the invasion, agricultural commodity prices have increased sharply, which could put further upward pressure on input costs and food price inflation. Russia and Ukraine account for almost 30% of the world's wheat exports.

In the near term, core goods inflation is expected to remain above the average level observed during the previous decade, accounting for the majority of the remainder of the projected above-target inflation. Services price inflation is projected to increase slightly above recent historical averages in the near term. Other indicators of cost and price pressures have remained at historically elevated levels recently. Contacts of the Bank's Agents expect further price increases this year to be driven in large part by energy and labour costs, and as companies seek to protect their margins.

In the MPC's central projections in the February Report, published before the invasion and conditioned on the rising market-implied path for Bank Rate at the time of the February Report and the MPC's current forecasting convention for future energy prices, upward pressure on CPI inflation was expected to dissipate over time, as supply disruption eased, global demand rebalanced from goods to services, and energy prices stopped rising. As a result, CPI inflation was projected to fall back to a little above the 2% target in two years' time and below the target by a greater margin in three years.

In an alternative scenario that was conditioned on energy prices following the forward curves at that time throughout the forecast period and as set out in the February Report, excess supply was expected to be around ½ percentage point lower in the medium term than in the MPC's central projection, and CPI inflation was expected to be around ¾ percentage point below the 2% target in two and three years' time.

As highlighted in the February Report and as has become apparent in the intervening period, there are material risks around these energy price assumptions, and therefore their impacts on the MPC's projections. Developments in energy prices since the February Report could temporarily push CPI inflation around the end of this year above the level projected for April, which was previously expected to be the peak. The prospective squeeze on households' real incomes is now likely to be larger than projected in the February Report, consistent with a weaker outlook for growth and employment, all else equal. Further out, CPI inflation is expected to fall back materially, as energy prices stop rising and as the squeeze on real incomes and demand puts significant downward pressure on domestically generated inflation. That judgement also reflects that monetary policy will act to ensure that longer-term inflation expectations are well anchored around the 2% target.

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. In circumstances when shocks to the economy are particularly large or the effects of shocks persist over an extended period, the Committee may be faced with significant trade-offs between the speed with which it aims to bring inflation back to the target and the consideration that should be placed on the variability of output.

The economy has recently been subject to a succession of very large shocks. Russia's invasion of Ukraine is another such shock. In particular, should recent movements prove persistent, the very elevated levels of global energy and tradable goods prices, of which the United Kingdom is a net importer, will necessarily weigh further on UK real aggregate income and spending. This is something monetary policy is unable to prevent. The role of monetary policy is to ensure that, as this real economic adjustment occurs, it does so consistent with achieving the 2% inflation target sustainably in the medium term, while minimising undesirable volatility in output.

The Committee's approach is to set monetary policy so that inflation returns sustainably to its target over the medium term.

Given the current tightness of the labour market, continuing signs of robust domestic cost and price pressures, and the risk that those pressures will persist, the Committee judged that an increase in Bank Rate of 0.25 percentage points was warranted at the March MPC meeting.

Based on its current assessment of the economic situation, the Committee judges that some further modest tightening in monetary policy may be appropriate in the coming months, but there are risks on both sides of that judgement depending on how medium-term prospects for inflation evolve. The MPC will review developments in the light of incoming data and their implications for medium-term inflation, including the economic implications of recent geopolitical events, as part of its forthcoming forecast round ahead of the May 2022 Monetary Policy Report.

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.

Consistent with the MPC's remit, the Committee sets monetary policy to meet the inflation target sustainably in the medium term. An essential part of the MPC's strategy is a consistent and transparent approach to achieving the 2% inflation target, which is vital in responding to the very large shocks that the economy has faced recently, including from recent geopolitical events, and is reflected in this exchange of letters.

The annual rise in household energy bills from April is set to be large, driving up consumer price inflation as well as squeezing real incomes by significant amounts. In responding to the rise in inflation, the MPC recognises the combined effects of the squeeze on real incomes from higher external prices with the additional, albeit smaller, impact from the tightening in monetary policy needed to contain inflationary pressures.

With the goal of returning inflation sustainably to its 2% target in the medium term, it is through acting to maintain price stability that the Committee, in accordance with the MPC's remit, makes its contribution to the resilience of the UK economy.

Yours sincerely,

Andrew Bailey

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