BANK OF ENGLAND

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Dear Chancellor

On 12 April, the Office for National Statistics (ONS) published data showing that twelve-month CPI inflation was 0.5% in March. As required by the Remit of the Monetary Policy Committee, this letter – which will be published alongside the May Inflation Report – addresses the following.

- The reasons why inflation has moved away from the target and the outlook for inflation.
- The horizon over which the MPC 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 MPC is taking in response.
- How this approach meets the Government's monetary policy objective.

The forthcoming referendum on the United Kingdom's membership of the European Union makes addressing a number of these issues more challenging than usual.

Why has inflation moved away from the target?

Twelve-month CPI inflation stood at 0.5% in March, 1.5 percentage points below the target. As in my previous letters to you, Table 1 shows a breakdown of the arithmetic contributions of different components of CPI inflation to the deviation from the target.

Table 1: Arithmetic contributions to March 2016 CPI inflation relative to the pre-crisis average

Percentage points	1997-2007 average	March 2016	March 2016 difference from average	Memo: difference in February 2015 open letter(b)
Energy	0.3	-0.5	-0.8	-0.8
Food, non-alcoholic bevs.	0.2	-0.3	-0.5	-0.4
Other goods(a)	-0.1	-0.1	0.0	0.2
Services	1.6	1.3	-0.2	-0.5
Total	2.0	0.5	-1.5	-1.4

(a) Adjusted for the close to 0.4 percentage point downward bias from clothing that existed until 2010.
(b) Relates to the December 2014 CPI release.

As I have noted in previous letters, the underlying causes of the below-target inflation of the past year and a half have been: sharp falls in commodity prices, the past appreciation of sterling, and to a lesser degree the subdued pace of domestic cost growth.

In fact, as Table 1 indicates, more than four-fifths of the deviation is accounted for by food and energy prices alone, with the most quantitatively significant factor remaining the sharp fall in energy prices between the middle of 2014 and beginning of 2016. Notwithstanding the most recent increase in the sterling price of oil, on average in March it stood around 25% below the level of a year earlier. Similarly, while the sterling price of wholesale gas has risen during the past two weeks, it had declined by almost 40% in the twelve months to March. These movements have resulted in a contribution of domestic energy prices to the latest CPI inflation figure some 0.8 percentage points lower than seen on average in the decade preceding the financial crisis and, on its own, this accounts for roughly a half of the deviation of inflation from the target.

A further third of the deviation of inflation from the target reflects the continued decline in food prices, itself a consequence of reductions in the prices of the underlying commodities, the past appreciation of sterling and continued intense competition amongst food retailers.

The sterling effective exchange rate index appreciated by over 15% between the summers of 2013 and 2015, and the impact of the consequent reduction in imported costs on retail prices is still evident beyond the food and energy components. In March, the contribution of other goods prices to CPI inflation, although now at its average in the ten years prior to the financial crisis, remained lower than when I first wrote to you in February 2015. It is also possible that the effects of the earlier appreciation continue to be felt in some of the more import-intensive consumer service sectors. Nevertheless, given the recent recovery in some indicators of imported input prices, as well as the most recent depreciation of sterling, it is possible that the negative impact of the 2013-15 sterling appreciation on retail prices is now past its peak.

Although these factors explain the vast majority of the deviation of inflation from the 2% target in March, subdued domestic cost growth remains an influence. This can be seen in the continued weakness of consumer service-price inflation.[1] Muted domestic cost growth can be seen more directly in the subdued rates of pay growth that have persisted despite the tightening of the labour market over the past few years. The unemployment rate has now fallen back to the level prevailing before the financial crisis. There are a number of possible explanations for the continued weakness of pay growth, as set out in my previous letters and the Bank's *Inflation Report*. The weakness of productivity growth since the recession, shifts in the composition of the workforce and the low level of consumer price inflation are all likely to have played a role. The net result has been that both pay and unit labour cost growth remain below historical norms and, in the judgement of the MPC, below the rates consistent with inflation being at the target.

[1] Particularly after accounting for what will very probably turn out to be a temporary boost to the inflation rate of these components partly from the sharp increase in airfares in March related to the proximity of the CPI price collection date to the Easter holidays.

The outlook for CPI inflation

The twelve-month CPI inflation rate of 0.5% in March was a little higher than anticipated at the time of the February *Inflation Report* and my letter to you three months ago. As described above, in Footnote 1, this probably reflects a higher Easter-related spike in airfares than expected. This is likely to prove temporary and the MPC expects that CPI inflation will fall back in the April data, before rising gradually thereafter.

The outlook for inflation over the next three years is set out in detail in today's May *Inflation Report*. The MPC's projections are normally conditioned on asset prices prevailing in the run-up to each *Report*. However, as set out in the box on page 40 of that *Report*, current asset prices are likely to have been affected by market participants' perceptions about the consequences of the forthcoming referendum on the UK's membership of the European Union. In particular, there is evidence that the referendum is having a marked influence on the sterling exchange rate. The evidence in that box suggests that roughly half of the 9% fall in the exchange rate since its November 2015 peak might be accounted for by referendum effects, including uncertainty about the outcome together with concerns that a vote to leave might reduce the openness of the UK economy and its long-run potential supply. Once the uncertainty over the outcome is resolved it is possible that the exchange rate will adjust again, consistent with market participants' view of the outlook at that time.

Following its usual approach, which is to assume government policy is followed, the MPC's May projections are conditioned on an assumed continuation of EU membership. The Committee has therefore taken a judgement not to let that part of the fall in the exchange rate that appears to have been associated with the referendum feed through to its growth or inflation projections.

Conditional on those assumptions, the broad outlook for inflation described by the MPC's projections is in most respects similar to the one I described three months ago. The MPC continues to expect that CPI inflation will pick up over the next year or so as the impact of past reductions in commodity prices fades from the twelve-month calculation and as the effect of the earlier appreciation of sterling on import-intensive goods and services wanes. That recovery in inflation is likely to be supported by the recent increase in oil prices and some additional stimulus from lower market interest rates.

Further ahead, if the path of demand evolves as described in the central forecast – supported by low interest rates and a gradual pick-up in nominal wage growth – then it is likely that the remaining margin of spare capacity in the economy will be used up during 2016, in turn raising domestic costs. In the conditional projections set out in today's *Report* the Committee judges it likely that these factors will be sufficient to return inflation back to 2% by mid-2018.

The most significant risks to this forecast concern the referendum. A vote to leave the EU could have material economic effects – on the exchange rate, on demand and on the economy's supply potential – that could affect the appropriate setting of monetary policy.

The recent behaviour of the foreign exchange market suggests that, were the UK to vote to leave the EU, sterling's exchange rate would fall further, perhaps sharply. In isolation, this would boost inflation over the policy horizon.

Demand may also fall, in the face of tighter financial conditions, lower asset prices, and greater uncertainty about the UK's trading relationships. Households could defer consumption, firms delay investment, and global financial conditions could tighten, generating potential spillovers to foreign activity that, in turn, dampen demand for UK exports. All else equal, lower demand would tend to dampen inflation over the policy horizon.

Over time, there may be negative effects on supply, including slower capital accumulation and the need to reallocate resources across the economy in response to changing trading and investment patterns. All else equal, such supply effects would tend to boost inflation over the policy horizon.

Taking these together, it is likely that their combined effect would be to lower growth materially and raise the rate of inflation notably over the MPC's policy horizon. In such circumstances, the MPC would face a trade-off between stabilising inflation on the one hand and stabilising output and employment on the other. The implications for the direction of monetary policy will depend on the relative magnitude of the demand, supply and exchange rate effects.

Beyond the uncertainty over the result and impact of the EU referendum, there remain a number of other uncertainties surrounding the outlook, to which the MPC will also remain alert: the prospects for global growth; the resilience of UK households and corporate spending; the path of productivity growth; and the precise balance between the effects on CPI inflation of the waning drag from external costs and the anticipated recovery in domestic costs. These risks are described in detail in Section 5 of today's May *Inflation Report*.

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 because 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 12 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 depends 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.

In my previous letters I noted that returning inflation to the target required balancing the persistent drags from sterling's past appreciation and muted world export price growth with increases in domestic cost growth. In the main, and conditional on the UK's continued membership of the EU, the forecasts published in the May *Inflation Report* continue to reflect those effects, with domestic cost growth having evolved broadly in line with the MPC's projections made at the time of the February *Inflation Report.* In that light, fully offsetting the drag on inflation from external factors over the short run would, in the Committee's judgement, involve too rapid an acceleration in domestic costs, one that would risk being unsustainable and involve undesirable volatility in output and employment. Given that trade-off, the MPC will continue to set monetary policy to ensure that growth is sufficient to absorb remaining spare capacity in a manner that returns inflation to the target in around two years and keeps it there in the absence of further shocks.

However, as described above, the referendum on the UK's membership of the European Union could have material implications for the outlook for UK activity and inflation and, in particular, a vote to leave the EU would have the potential to change significantly the trade-off faced by the MPC.

Were inflation to rise above the target and output growth to weaken following a vote to leave the EU, the MPC would need to judge the appropriate horizon over which to return inflation to the target without generating undesirable volatility in output and employment. That horizon would depend on a range of factors, including the likely magnitude and persistence of the pass through to inflation of any exchange rate change, together with the scale of the adjustment necessary to bring demand back in line with supply. In responding to whatever outlook materialises, the MPC would have to make careful judgements about the net effects of these potential influences on the path of demand, supply and inflation in determining the course for monetary policy necessary to deliver the inflation target.

In the event of a vote to remain in the EU, the MPC would reassess the appropriate stance of monetary policy given the constellation of asset prices, the speed with which uncertainty effects dissipate and the underlying momentum in the economy.

The policy action the Committee is taking in response

If the outlook evolves as envisaged in today's *Report*, the MPC will conduct monetary policy so that the margin of spare capacity is absorbed and inflation returns to the 2% target. In line with this outlook, 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 November 2015 *Inflation Report*, 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%.

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 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 inflation. Complementing this, the Bank more broadly continues to provide support to the healthy functioning of credit markets through the Funding for Lending Scheme.

The central projections set out in the *Inflation Report* today are conditioned on a gentle rise in interest rates over the forecast period. Under that central case, the MPC judges it more likely than not that Bank Rate will need to be higher at the end of that period than at present in order to return inflation to target in a sustainable manner.

These projections assume continued membership of the EU. However, the existence of the referendum and the associated uncertainty over its outcome makes macroeconomic and financial market indicators less informative than usual at the current juncture. In light of that, in advance of the referendum, the MPC has indicated that it will react more cautiously to incoming data than would normally be the case. Although some of this uncertainty will dissipate once the referendum result is known, it is possible that some of its effects will persist for some time thereafter.

Whatever the outcome of the referendum and its consequences, the MPC will take whatever action is needed to ensure that inflation expectations remained well anchored and inflation returns to the target over the appropriate horizon.

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,