BANK OF ENGLAND

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Governor

The Rt Hon Philip Hammond
Chancellor of the Exchequer
HM Treasury
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8 February 2018

Dear Chancellor,

On 12 December 2017, the Office for National Statistics published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 3.1% in November. As required by the remit of the Monetary Policy Committee (MPC), this letter – which will be published alongside the February *Inflation Report* and the minutes of the Committee's February meeting – 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 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.
- The policy action that the MPC is taking in response.
- How this approach meets the Government's monetary policy objectives.

Why has inflation moved away from the 2% target?

As set out in recent *Inflation Reports* and MPC minutes, the MPC has expected that inflation would rise over the course of 2017, peaking above 3.0%. Consistent with that expectation, twelve-month CPI inflation reached 3.1% in November, 1.1 percentage points above the 2% target. Since then, on 16 January, the Office for National Statistics has released data showing that CPI inflation fell to 3.0% in December.

Sustained above-target inflation remains almost entirely due to the effects of higher import prices that resulted from the depreciation of sterling following the vote to leave the European Union. Sterling's effective exchange rate is currently around 16% below its level in late 2015. This largely reflects the judgements of financial market participants about the likely impact of Brexit on the United Kingdom's relative economic prospects. This is evident in other asset prices such as UK-focused equity prices, which have significantly underperformed international indices.

The depreciation of sterling has raised the cost of imports, with sterling non-energy import prices rising by 10% between 2015 Q4 and 2017 Q3. As companies have passed on those higher costs, CPI inflation has also

picked up. Table 1 indicates that the deviation of inflation from the target can be more than accounted for by above-average rises in the prices of food and other goods, which are relatively import-intensive. More broadly, the inflation rate of components of the CPI which tend to have a high proportion of imports in their production has risen sharply.

More recently, the rise in global oil prices has added somewhat to external cost pressures. In conjunction with increases in retail electricity prices that occurred in 2017, this has meant that the contribution of energy to CPI inflation is currently a little above its pre-crisis average.

In contrast, domestic cost growth has been muted, with a range of measures of domestically generated inflation growing below rates likely to be consistent with the 2% inflation target at present and the contribution of services prices to CPI inflation being somewhat below its pre-crisis average (Table 1). Overall, subdued pay growth has been weighing on the growth of unit labour costs in recent years.

As explained below, the relative contributions of domestic and imported inflation are expected to change over the next few years.

Table 1: Arithmetic contributions to November 2017 and December 2017 CPI inflation relative to pre-crisis averages

Percentage points	1997-2007 average	November 2017	December 2017	November 2017 difference from average	December 2017 difference from average
Energy	0.3	0.3	0.4	0.0	0.1
Food, non-alcoholic beverages	0.2	0.4	0.4	0.2	0.2
Other goods[(a)]	-0.1	1.0	1.0	1.1	1.1
Services	1.6	1.4	1.2	-0.2	-0.4
CPI[(a)]	2.0	3.1	3.0	1.1	1.0

(a) Adjusted for the close to 0.4 percentage point downward bias from clothing that existed until 2010.

The outlook for inflation

In its February *Inflation Report*, published today, the MPC sets out its updated assessment of the outlook for the economy. In the MPC's central projection, conditioned on a market-implied path of Bank Rate that increases to 1.2% in three years' time, twelve-month CPI inflation is expected to fall back gradually over the forecast, but remain above the 2% target in the second and third years of the MPC's central projection.

In the near term, inflation is projected to remain close to recent levels, reflecting higher oil prices. It is possible that inflation could rise temporarily back above 3%. Inflation is then expected to fall back gradually as the effects of the past depreciation of sterling on inflation diminish. While import price increases continue to be passed into retail prices and push inflation up for some time, the extent of that positive contribution is expected to decline.

As unemployment has continued to fall, recently reaching its lowest level since 1975, pay growth has picked up. In the February *Inflation Report*, domestic cost pressures are expected to build further in coming quarters, as

modest demand growth is sufficient to exceed diminished growth in potential supply. That means the small margin of remaining slack is absorbed and a small margin of excess demand emerges by early 2020 and builds thereafter. That supports a gradual rise in pay growth and building domestic inflationary pressures.

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? What policy action is the Committee taking in response?

The MPC's remit is clear that the inflation target is symmetric and applies at all times. The remit also stresses that, in exceptional circumstances, shocks to the economy may be particularly large or the effects of shocks may persist over an extended period, or both. In such circumstances, the MPC is likely to be faced with more 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 remit requires the MPC to set out in its communication the horizon over which it judges it appropriate to return inflation to the target.

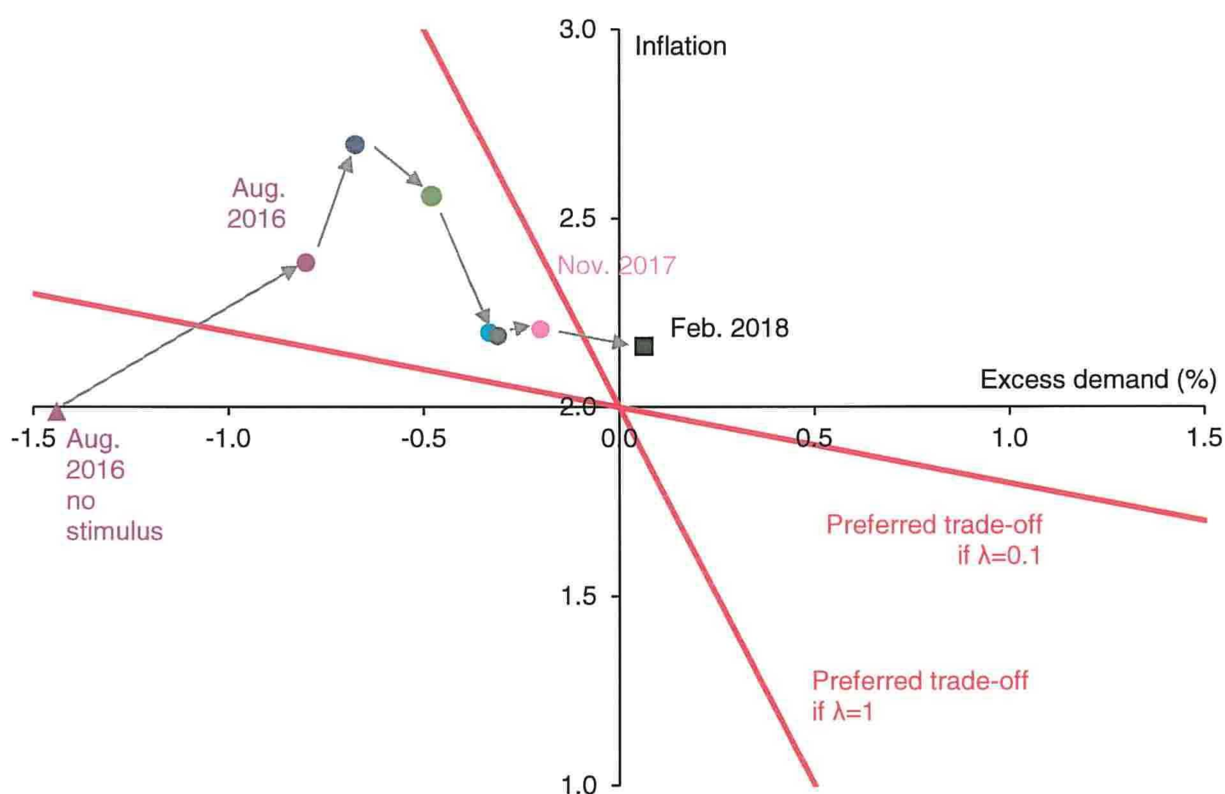
Developments regarding the United Kingdom's withdrawal from the European Union remain the most significant influence on, and source of uncertainty about, the economic outlook. The overshoot of inflation throughout the forecast predominantly reflects the effects on import prices of the referendum-related fall in sterling. Brexit-related uncertainties are weighing on domestic activity, which remains modest even as global growth has risen significantly. And the United Kingdom's withdrawal from the European Union may constrain supply growth, reinforcing the marked slowdown that has been increasingly evident in recent years in the rate at which the economy can grow without generating inflationary pressures.

Monetary policy cannot prevent either the necessary real adjustment as the United Kingdom moves towards its new international trading arrangements or the weaker real income growth that is likely to accompany that adjustment over the next few years. But it can influence how this hit to incomes is distributed between job losses and price rises. And it can support UK households and businesses as they adjust to such profound change.

Chart 1 provides a simple framework for illustrating how the MPC has been managing the monetary policy trade-off that has emerged since the referendum. The red lines illustrate the potential trade-offs that the Committee could strike: mapping the size of the inflation overshoot that it could be prepared to tolerate for a given amount of spare capacity, and vice versa. The flatter the line, the less weight the Committee places on output stabilisation and the more it is willing to tolerate large output gaps in order to eliminate small overshoots in inflation.

Chart 1 also demonstrates how the expected trade-off has evolved in successive MPC forecasts since the referendum. It shows the MPC's central projections at Year 2 for CPI inflation on the vertical axis against those for spare capacity (the opposite of excess demand) on the horizontal axis from successive *Inflation Reports* since August 2016. The projections are conditioned on the market yield curves prevailing at the time the forecasts were made.

Chart 1: The trade-off in successive *Inflation Report* forecasts at Year 2[1]



Notes: Each observation shows the central projection for spare capacity or excess demand at the end of the second year of the forecast period (the 'Year 2' point) on the horizontal axis against the central projection for four-quarter CPI inflation at Year 2 on the vertical axis from successive *Inflation Reports*. The left-most observation (labelled "Aug. 2016 no stimulus") is a counterfactual version of the August 2016 *Inflation Report* forecasts with the effect of the MPC's Bank Rate cut, Term Funding Scheme and Asset Purchases removed. See the "Lambda" speech of 16th January 2017 for further details and discussion.

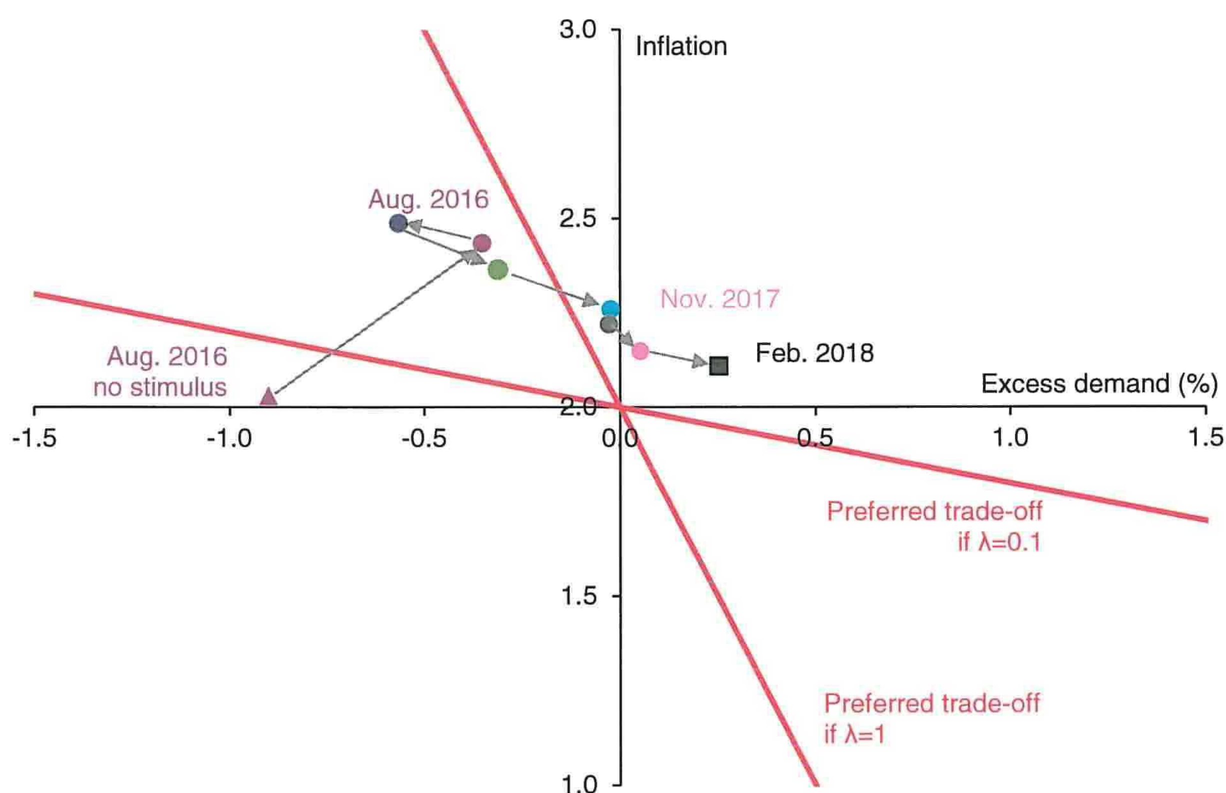
Consistent with its remit, the MPC has judged that it was appropriate to set policy so that inflation returned to its target over a longer period than two years in order to support jobs and activity at a time when uncertainty was elevated and the economy was slowing. It therefore implemented a package of easing measures in August 2016 – shifting the trade-off upwards and to the right (from the purple triangle to the purple dot labelled 'Aug. 2016' in Chart 1).

Since then, the Committee has managed policy to diminish steadily the trade-off, increasing employment, using up the expected degree of spare capacity in the economy, and reducing the expected overshoot of the inflation target.

Accordingly, over the course of last year, a steady absorption of slack – evident in the dots showing the successive *Inflation Report* projections in Chart 1 – has lessened the trade-off facing the MPC and reduced the degree to which it was appropriate to accommodate an extended period of inflation above the target. This is evident in Chart 2 where the economy was forecast in November 2017 to move into small excess demand at Year 3 while inflation remained above target (the pink dot).

[1] For the purposes of these illustrations, the slope of the Phillips curve is assumed to be 0.5 and so a policymaker with λ=0.5 would prefer a balanced trade-off between above-target inflation and spare capacity (or below-target inflation and excess demand).

Chart 2: The trade-off in successive *Inflation Report* forecasts at Year 3



Consequently, at its November 2017 meeting, the Committee increased Bank Rate by 25 basis points to 0.5% in order to return inflation sustainably to the target, while continuing to provide significant support to jobs and activity.

Since November, the prospect of a greater degree of excess demand over the forecast period and the expectation that inflation would remain above the target have further diminished the trade-off that the MPC is required to balance (see the black squares in Charts 1 and 2). It is therefore appropriate to set monetary policy so that inflation returns sustainably to its target at a more conventional horizon.

As a consequence, the Committee judges that, were the economy to evolve broadly in line with the February *Inflation Report* projections, monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent over the forecast period than anticipated at the time of the November *Report*.

At its February policy meeting, all members thought that the current policy stance remained appropriate to balance the demands of the MPC's remit. All members agree that any future increases in Bank Rate are expected to be at a gradual pace and to a limited extent. The Committee will monitor closely the incoming evidence on the evolving economic outlook, and stands ready to respond to developments as they unfold to ensure a sustainable return of inflation to the 2% target.

How does this approach meet the Government's monetary policy objectives?

The MPC's objectives are 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 conducting monetary policy to return inflation sustainably to target at an appropriate horizon while supporting jobs and activity in exceptional circumstances.

Developments regarding the United Kingdom's withdrawal from the European Union remain the most significant influence on, and source of uncertainty about, the economic outlook. A principled, consistent and transparent approach to monetary policy, as reflected in this exchange of letters, is the best contribution that the MPC can make to achieve monetary stability and therefore to support broader economic outcomes in these exceptional circumstances.

Copy to The Rt Hon Nicky Morgan MP, Chair of the Treasury Committee