Bank of England

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Governor

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Dear Jeremy

On 20 September 2023, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 6.7% in August.

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.

The MPC voted to maintain Bank Rate at 5.25% at its September meeting. Since my previous letter, sent in June, there have been increasing signs that the restrictive stance of monetary policy is working to bring inflation down. This is good news. But there is absolutely no room for complacency. I can assure you that the MPC will stay the course and keep monetary policy sufficiently restrictive for sufficiently long to return inflation to the 2% target in the medium term – in line with the primacy of price stability in the Government's monetary policy objective described in the MPC's remit. Low and stable inflation is the foundation of a healthy economy.

Why has inflation moved away from the 2% target?

Twelve-month CPI inflation reached a peak of 11.1% in October last year. As I have described in previous letters, the increase in consumer price inflation mainly reflected a sharp rise in external cost pressures originating from the pandemic and Russia's invasion of Ukraine. But steep rises in import prices in 2021 and 2022, and their effect on real incomes, led to elevated domestic inflationary pressures too through indirect and second-round effects. These effects interacted with a resilient UK economy and a tight labour market.

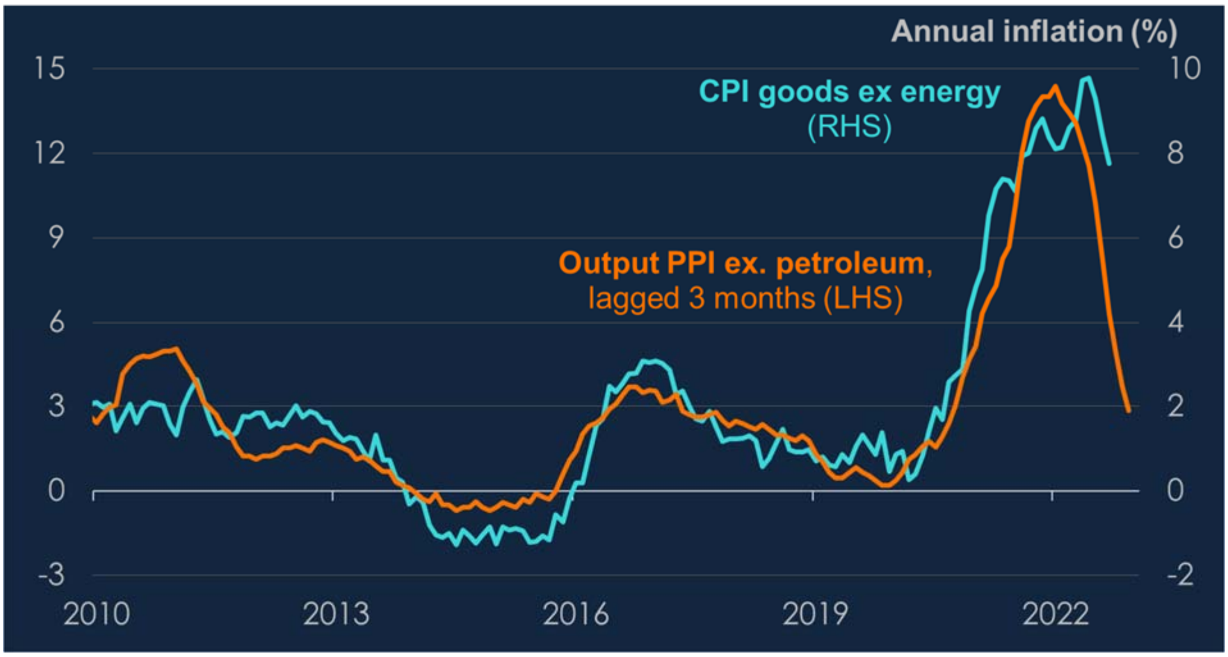
External cost pressures – while still affecting UK consumer prices – have started to wane, helping to bring inflation down. Since my June letter, CPI inflation has fallen by a further 2 percentage points, from 8.7% in May this year to 6.7% in August, not least because energy price inflation and food price inflation have declined. Core goods price inflation has also started to fall back.

The effect of energy prices has been shaped by the way Ofgem's price cap on electricity and gas bills slows down the pass-through of wholesale energy prices to consumer bills. As the contribution from energy prices turned negative in July once the Ofgem cap fell below the level established by the Government's Energy Price Guarantee, CPI inflation took a step down to 6.8%.

Food price inflation now appears to have peaked. Following my last letter, annual inflation for food and non-alcoholic beverages has fallen back from 18.3% in May to 13.6% in August. With a CPI weight of around 12%, however, this still accounts for 1.5 percentage points of the overshoot of inflation from the 2% target, and food price inflation has remained very elevated over recent quarters. This rise in food prices has been 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 has also started to fall back more clearly since my previous letter, from 6.8% in May to 5.2% in August. As core goods are mostly tradable, 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. As the Chart below illustrates, the fall in goods price inflation excluding energy follows earlier declines in UK manufacturing output price inflation, reasserting the historical relationship between them. Producer Price Index input and output inflation were -2.3% and -0.4% in August, respectively, down from peaks of 24.4% and 19.6% in mid-2022.

Chart: Goods price inflation has started to fall back following earlier declines in producer price inflation



Sources: ONS and Bank calculations.

While external cost pressures have eased, services price inflation – which depends more on domestic costs – has remained elevated. As it tends to be more persistent, the MPC has paid particular attention to services price inflation in forming its view of the risks to inflation in the medium term, along with other indicators of persistence in domestic inflationary pressures such as wage growth and labour market tightness.

However, while services inflation remained very high at 6.8% in August, it came in 0.5 percentage points below its rate in May and lower than the MPC expected at the time of the August Monetary Policy Report.

Some of this latest downside news reflects prices for airfares and accommodation that tend to be volatile over the summer holidays. Services price inflation excluding travel-related components has been more stable. But there has also been some downside news across the wider consumer basket for services. This fall in services inflation points to some easing of domestic inflationary pressures.

At the same time, the evidence on inflation persistence from the labour market remains mixed. The ratio of the number of vacancies to the number of unemployed people – a key metric of labour market tightness – has fallen significantly from its peak, but it remains above pre-pandemic levels. And annual private sector regular Average Weekly Earnings (AWE) growth remained high at 8.1% in the three months to July, 0.8 percentage points above the projections in August. The recent path of the AWE is, however, difficult to reconcile with other indicators of pay growth, including measures using HMRC payrolls, the Labour Force Survey and the Bank's Decision Maker Panel. Most of these have tended to be more stable at rates of growth that are elevated but not quite as high as the AWE series.

The outlook for inflation

Over the coming months, CPI inflation is expected to fall significantly further, reflecting lower annual energy price inflation, and further declines in food and core goods inflation.

Given wholesale energy price developments since the beginning of the year, the direct contribution of energy prices to CPI inflation is projected to turn more negative from October. At that point, the Ofgem price cap for household gas and electricity bills will fall to £1,923 per year, compared with the comparable figure of £2,500 in October 2022 that was set by the Energy Price Guarantee. Higher oil prices in international markets are, however, putting upward pressure on retail petrol and diesel prices.

Evidence from the Bank's Agents suggests that food price inflation is likely to continue to slow, albeit gradually. Industry contacts expect annual food inflation to fall to around or a little below 10% by the end of the year. As set out in the August Monetary Policy Report, input cost inflation experienced by food producers still remains much higher than usual, and many food producers are also facing significant cost pressures from wages and energy. But cost pressures are falling across the supply chain, and food retailers report a consistent picture of easing product cost inflation.

Consistent with the historical relationship shown in the Chart above, core goods CPI inflation is likely to ease significantly further over the coming months as cost pressures in the supply chain have eased.

Services inflation is projected to remain elevated in the near term, in part reflecting the ongoing strength of nominal pay growth. Over the coming quarters, however, wage inflation is likely to fall back a little. Notwithstanding the recent upside surprise in the AWE, other more forward-looking pay indicators point in that direction. Contacts of the Bank's Agents expect pay settlements to drift down, including fewer additional payments to compensate for a higher cost of living.

Looking further ahead, headline CPI inflation was expected to return to the 2% target by the second quarter of 2025 in the MPC's latest most likely or *modal* projection, presented in the August Monetary Policy Report and conditioned on market interest rates prevailing at the time. It was then forecast to fall below the target in the medium term, as an increasing degree of economic slack was expected to reduce domestic inflationary pressures, alongside declining external cost pressures. The Committee decided in its August Report forecast to bring some of the upside risks to inflation from persistence into its modal projection, pushing up on this inflation projection in the medium term relative to the May Report.

The Committee judged that risks around this modal inflation forecast were skewed to the upside, reflecting the possibility that the second-round effects of external cost shocks on inflation in wages and domestic prices take longer to unwind than they did to emerge. Mean CPI inflation in the August Report, which incorporated these risks, was 2.0% and 1.9% at the two and three-year horizons respectively, similar to the mean profile in the May Report and with a slightly higher probability of inflation being below the 2% target in the medium term than above it.

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.

Developments in key indicators of inflation persistence have been mixed, with the recent acceleration in the AWE not apparent in other measures of wages and with some downside news on services inflation. There are increasing signs of some impact of tighter monetary policy on the labour market and on momentum in the real economy more generally. Given the significant increase in Bank Rate since the start of this tightening cycle, the current monetary policy stance is restrictive. At its September meeting, the Committee voted to maintain Bank Rate at 5.25%.

The MPC will continue to monitor closely indications of persistent inflationary pressures and resilience in the economy as a whole, including tightness of labour market conditions and the behaviour of wage growth and services price inflation. Monetary policy will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term, in line with the Committee’s remit. Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures.

The MPC committed in the minutes of its August 2022 meeting to review the reduction in the Asset Purchase Facility annually and, as part of that to set out an amount for the reduction in the stock of purchased UK government bonds over the subsequent 12-month period. At this meeting, the Committee voted to reduce the stock of UK government bond purchases held for monetary policy purposes, and financed by the issuance of central bank reserves, by £100 billion over the period from October 2023 to September 2024, to a total of £658 billion.

Yours sincerely,

Andrew Bailey

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