BANK OF ENGLAND

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Governor

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HM Treasury
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6 August 2015

Dear Chancellor,

In May I wrote a second letter to you when CPI inflation remained more than one percentage point below the 2% target. Three months later, as expected, that is still the case: on 14 July, the Office for National Statistics (ONS) published data showing that twelve-month CPI inflation was 0.0% in June. In line with the remit of the Monetary Policy Committee (MPC),[1] I am writing another open letter, to be published alongside the August *Inflation Report.* This letter describes:

- the reasons why inflation has moved away from the target and the outlook for inflation;
- the horizon over which the Committee 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 Committee is taking in response; and
- how this approach meets the Government's monetary policy objectives.

Why has inflation moved away from the 2% target?

In June twelve-month CPI inflation stood at 0.0%, two percentage points below the inflation target.

Qualitatively, the underlying causes of below-target inflation are broadly the same as those described in my last letter: past falls in prices of commodities and some other imported goods and, to a lesser degree, below-average growth of domestic unit wage costs.

Table 1, a version of which was included in my previous letters, helps to illustrate the point. It compares the arithmetic contributions to CPI inflation over the year to June of two broad sub-aggregates of the Consumer Price Index: (i) energy, food and other goods, and (ii) services - with their respective averages between 1997 and 2007.[2] [3]

[1] http://www.bankofengland.co.uk/monetarypolicy/Documents/pdf/chancellorletter180315.pdf

[2] This comparison is instructive because, adjusted for measurement changes, CPI inflation in that earlier period averaged close to the 2% target. The unadjusted average was 1.6% between 1997 and 2007 but, in 2010, the practices regarding the collection of clothing prices were changed, boosting CPI inflation, according to Bank staff estimates, by close to 0.4 percentage points. Consequently, the configuration of price increases that brought about an average inflation reading of 1.6% in the decade leading up to the crisis would now produce an aggregate CPI inflation rate of around 2%.

[3] The arithmetic contribution of a change in a subcomponent of the CPI to the total is not the same as its ultimate impact, once its effects on other parts of the index are taken into account. So the figures in Table 1 can be only indicative. But they do bear out the major influences on CPI inflation.

Table 1: Arithmetic contributions to June 2015 CPI inflation relative to their pre-crisis averages

Percentage points	1997-2007 average	June 2015	Difference
Energy, food and other goods[(a)]	0.4	-1.1	-1.5
Services	1.6	1.0	-0.5
Total[(a) (b)]	2.0	0.0	-2.0

(a) Adjusted for the close to 0.4 percentage point downward bias from clothing that existed until 2010.
(b) Totals may not sum exactly due to rounding.

As was the case three months ago, the most important single reason for below-target annual inflation is the sharp drop in energy prices during the second half of last year. Despite a recovery from the lows seen in January, the sterling price of crude oil was 39% lower in June than a year earlier. The average price of a litre of unleaded petrol fell by 10% during that period, from £1.30 to £1.16. Wholesale gas prices have also declined and the major utility companies reduced the retail price of gas by an average of 4% in the first half of this year. Overall, the energy component of the CPI contributed -0.5 percentage points to headline inflation in June, compared with a pre-crisis average of +0.3 percentage points, so dragging by around 0.8 percentage points on headline inflation relative to target.

Food prices, which rose by 1.9% a year during the 1997-07 decade, also fell in the year to June, by 2.2%. That reflects a combination of factors, including lower wholesale prices and more intense competition among retailers.

Together with some downward pressure from sterling's appreciation after mid-2013, which continues to depress import prices, these shocks explain about 1½ percentage points – so around three quarters – of the deviation of inflation from the target. That is unchanged from when I last wrote to you in May. While the drag from food and energy has eased slightly over the past three months, there has been further weakness in other goods prices. This reflects the continued pass-through of lower import prices.

In the judgement of the MPC, the remaining half a percentage point of the deviation from target reflects the impact of spare capacity dragging on domestic cost growth, particularly of unit labour costs. The combined weakness in domestic costs and imported goods prices is evident in subdued core inflation, which is currently around 1%.

In the three months to May whole economy average weekly earnings were 3.2% higher than a year earlier. While this is around 1 percentage point higher than had been expected in the May *Inflation Report*, it remains lower than the 4-4½% annual growth generally observed prior to the crisis. Weak wage growth has been matched in part by weaker productivity growth so growth in unit labour costs has been relatively subdued; in the year to the first quarter of 2015 it was 0.6%.[4]

That weakness is likely to reflect past levels of slack in the domestic economy, elevated unemployment in particular. Its impact is evident in the contribution of services prices to annual CPI inflation which is likely to be most sensitive to slack within the UK and which, in June, was ½ percentage point below its historical average (Table 1). That figure is unchanged from when I last wrote to you three months ago.

The outlook for CPI inflation

Over the past three months inflation has moved in line with the MPC's central forecast in the May *Inflation Report*. Its updated forecasts are published today in the August *Inflation Report*. In the view of the MPC, inflation is likely to remain close to its current rate over the next few months. It is therefore likely that I will need to write further open letters to you in the coming months.

[4] This estimate is constructed using the MPC's backcast for GDP growth. Given the roughly 40% share of labour costs in gross output, a shortfall of this order of magnitude would be consistent with a drag on CPI inflation of around ½ a percentage point relative to target (0.4 x (2.0-0.6) = 0.6 percentage points).

In the absence of further falls in commodity prices, however, inflation rates close to zero are unlikely to endure beyond this year. CPI inflation is judged likely to rise around the turn of the year as past falls in energy prices begin to drop out of the annual comparison.

Although the proportion of the CPI's components (excluding food and energy) showing positive inflation is now lower than during the decade between 1997 and 2007 (57% compared with 67%), probably reflecting the impact of sterling's recent appreciation, developments more broadly do not point to a more general deflationary trend. If anything, nominal wages have grown more strongly than we had expected in May, consumer confidence remains close to its highest level in over a decade and consumption growth was solid in the first quarter of 2015. A range of measures suggest that medium-term inflation expectations remain well anchored. More generally, the economy is growing and unemployment has fallen substantially over the past two years. Combined with a strong pick up in earnings since the middle of last year, falls in commodity prices have significantly boosted households' real take-home pay. In 2015 households' real income is expected to rise more strongly than in any year since 2007.

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 judging the horizon over which to return inflation to target, it is important to distinguish between the temporary impacts on CPI inflation of falling oil and food prices, and factors with more persistent effects on inflation such as the remaining degree of spare capacity in the UK economy and its impact on wage growth.

Monetary policy takes time to affect the economy: its peak effect on inflation is generally estimated to occur with a lag of somewhere between 18 and 24 months. The effect of the fall in food and energy prices is expected to ease early in 2016. Attempting to return inflation to 2% over such a short horizon would require relatively sharp changes in the stance of policy and would risk unnecessary volatility in output.

Beyond this, the appropriate horizon for returning inflation to the target will depend on the trade-off between the speed with which inflation returns to target and the consequences of that speed for output and employment.

That trade-off looks quite similar to three months ago: inflation is currently below the target while unemployment is still above its long-run sustainable rate. To return inflation to the target in a sustainable manner it is necessary to eliminate the remaining degree of economic slack and to bring about the necessary increase in firms' costs. It is therefore appropriate to return inflation to the target as quickly as possible after the effects of energy and food price movements have abated.

With some underutilised resources remaining in the economy and with inflation below the target, the Committee intends to set monetary policy in order to ensure that growth is sufficient to absorb the remaining economic slack so as to return inflation to the target within two years.

The policy action the Committee is taking in response

The MPC will conduct monetary policy to eliminate the margin of slack and return inflation to 2%.The MPC has taken significant steps to support the UK economic recovery and eliminate the margin of slack. Bank Rate has been at a historically low level of 0.5% for more than six years. Between 2009 and 2012 the MPC purchased £375 billion of assets financed by the issuance of central bank reserves, and the Committee continues to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility in order to keep the total stock at £375bn. A forward guidance framework was announced in August 2013.

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 UK economy has recovered. Interest rate expectations have fallen markedly across advanced economies since the start of 2014, which has reduced the cost of borrowing for many firms and households in the UK and helped to support demand and take inflation back towards the 2% target.

As set out in its *Inflation Report* today, the MPC judges it likely that a gradual rise in interest rates, such as that currently implied by market yields and which is used as a conditioning path for the MPC's forecast, is consistent with slack in the economy being absorbed over the next year or so and inflation returning to the 2% target within two years.

There are risks to the outlook in both directions. To the downside, the fall in near-term inflation could be more persistent than the Committee currently expects. Though growth in advanced economies has picked up recently, there remain risks to global growth particularly emanating from China and Greece. And were low inflation to depress inflation expectations, it could become self-reinforcing. In these cases, the MPC would need to provide more support to return inflation to the target over the appropriate horizon.

Were these downside risks to materialise, market expectations of the future path of interest rates could adjust to reflect an even more gradual and limited path for Bank Rate increases than is currently priced. The Committee could also decide to expand the Asset Purchase Facility or to cut Bank Rate further towards zero from its current level of 0.5%.

To the upside, inflationary pressures could be greater if lower oil prices were to provide greater stimulus to global and domestic growth, or if domestic costs grew more rapidly than expected in the August *Inflation Report* central projection.

If these risks materialise, it would be appropriate for Bank Rate to increase more quickly than embodied in current market yields, though it remains likely that those increases would still be more gradual and limited than in previous tightening cycles.

The MPC stands ready to take whatever action is needed, as events unfold, to ensure inflation remains likely to return to target in a timely fashion. Under the central case set out in today's *Inflation Report* the MPC judges it more likely than not that Bank Rate will increase over the forecast period.

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,