BANK OF ENGLAND

**Andrew Bailey**
Governor

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

On 24 March 2021, the Office for National Statistics (ONS) published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 0.4% in February. As required by the remit for the Bank of England's Monetary Policy Committee (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 May 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?**

As set out in recent *Monetary Policy Reports* and the minutes of MPC meetings, the Committee has been expecting a period of low inflation, including readings below 1%. The effects of the Covid-19 (Covid) pandemic have been associated with a sharp reduction in economic activity in the United Kingdom and globally, reducing UK inflation through a number of channels.

The pandemic led to much weaker global activity, which contributed to a period of low commodity prices. Falls in the prices of motor fuels, associated with lower sterling oil prices, subtracted ½ percentage point from twelve-month CPI inflation in May and June 2020, although that drag narrowed to 0.1 percentage points by February 2021. The prices of electricity, gas and other fuels have subtracted a further ¼ percentage point from CPI inflation since April 2020. Lower energy prices will also have affected inflation indirectly by reducing input costs in other sectors of the economy.

The pandemic has led to a significant change in the use of capacity in the UK economy, evident for example in the sharp drop in hours worked and rising unemployment. There have been differences in the impacts of the pandemic on demand and supply in different sectors of the economy. Sectors in which demand has been much lower than usual have experienced weaker inflationary pressures. For example, clothing and footwear goods prices were particularly weak in February 2021 and around 6% lower than a year earlier. Services inflation fell to 1.5%, 1 percentage point below its 2019 average, reflecting fairly broad-based weakness in its components. Since August 2020, a number of services components have also been affected by the temporary cut in VAT for hospitality, holiday accommodation and attractions that will now remain in place in its current form until the end of September 2021.

Twelve-month CPI inflation rose to 0.7% in March 2021. Annual fuel price inflation turned positive for the first time in over a year, reflecting increases on the month and past weakness dropping out of the twelve-month comparison. In addition, clothing and footwear goods prices recovered the falls seen in February, but remained 4% lower than a year earlier.

**The outlook for inflation**

The outlook for the economy, and particularly the relative movement in demand and supply during the recovery from the pandemic, remains uncertain. It continues to depend on the evolution of the pandemic, measures taken to protect public health, and how households, businesses and financial markets respond to these developments.

As has been the case in recent MPC forecasts, CPI inflation is projected to rise to close to the target in the near term, as earlier falls in energy prices continue to drop out of the annual comparison and more recent increases in wholesale energy prices are passed on to consumer prices. In the central projection in the May *Monetary Policy Report*, the contribution from energy prices increases further, such that CPI inflation rises temporarily above the 2% target towards the end of 2021. These transitory developments should have few direct implications for inflation over the medium term, however.

Broader global increases in producers' input costs associated with temporary disruptions to supply chains and changes in demand patterns related to the pandemic and associated restrictions, may also put upward pressure on prices, although contacts of the Bank's Agents have so far reported little pass through to consumer prices.

GDP is expected to recover strongly to pre-Covid levels over the remainder of this year in the absence of most restrictions on domestic economic activity. Demand growth is further boosted by a decline in health risks and a fall in uncertainty, as well as fiscal and monetary stimulus. Consumer spending is also supported by households running down over the next three years around 10% of their additional accumulated savings. After 2021, the pace of GDP growth is expected to slow as the boost from some of those factors wanes. The level of activity is higher in each quarter of the forecast than in the February projections.

The fall in activity over the past year has reflected a decline in both demand and supply. The LFS unemployment rate fell slightly to 4.9% in the three months to February, but it is likely that labour market slack has remained higher than implied by this measure. Overall, there is judged to be spare capacity in the economy at present. The extension of the Government's employment support schemes in *Budget 2021* is expected to limit significantly the near-term rise in the LFS unemployment rate. Spare capacity is eliminated as activity picks up during 2021, and there is a temporary period of excess demand, before demand and supply return broadly to balance.

In the central projection, conditioned on the market path for interest rates, inflation returns to around 2% in the medium term.

The MPC is continuing to monitor closely developments in indicators of inflation expectations, including those of households, businesses and financial markets. Overall, the Committee judges that inflation expectations remain well anchored and consistent with inflation close to the 2% target.

**What policy action is the Committee 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.

Since the onset of the Covid-19 shock, the MPC has, consistent with the responses of other parts of the Bank of England and the UK Government, taken a number of actions to fulfil its mandate. The Committee has reduced Bank Rate to 0.1%; has introduced a Term Funding scheme with additional incentives for Small and Medium-sized Enterprises (TFSME); and has announced a £450 billion increase in the stock of UK government bond and sterling non-financial investment-grade corporate bond purchases.

In the current unprecedented circumstances, the economy has been subject to very large shocks, some of which could persist over an extended period. Unemployment has risen over the past year and is likely to remain above pre-pandemic rates for some time, while CPI inflation is below the 2% target. The Committee's approach is to set monetary policy so that inflation returns sustainably to its target at a conventional horizon of around two years.

In the central projections of the MPC's May *Monetary Policy Report*, the economy experiences a temporary period of strong GDP growth and a temporary period of modestly above-target CPI inflation, after which growth and inflation fall back, with inflation close to the target two and three years ahead. In judging the appropriate stance of monetary policy, the Committee will, consistent with its policy guidance and as always, focus on the medium-term prospects for inflation, including the balance between demand and supply, rather than factors that are likely to be more transient.

The MPC will continue to monitor the situation closely and will take whatever action is necessary to achieve its remit. The Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

At its May meeting, the Committee judged that the existing stance of monetary policy remained appropriate.

**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 the current circumstances, and consistent with the MPC's remit and meeting the inflation target in the medium term, monetary policy is aimed at supporting businesses and households through the crisis, and limiting any lasting damage to the economy. The MPC's contribution has been reinforced by the actions taken by the Financial Policy and Prudential Regulation Committees. In these ways, the Bank of England is promoting strong, sustainable, balanced growth and therefore making its most effective contribution to the United Kingdom's economic performance.

Yours sincerely,

Andrew Bailey

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