BANK OF ENGLAND

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Governor

The Rt Hon Rishi Sunak
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Dear Rishi

On 15 September 2021, the Office for National Statistics (ONS) published data showing that twelve-month inflation on the Consumer Prices Index (CPI) was 3.2% in August. 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 September 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?

The economic effects of the pandemic have been uneven, with significant changes in both demand and supply, and therefore price pressures, over time. CPI inflation has been below the MPC's target for much of the past two years. The effects of Covid-19 (Covid) were associated with inflation at or below 1% over much of the crisis period. Indeed, as recently as March 2021, CPI inflation was as low as 0.7%. As set out in recent *Monetary Policy Reports* and the minutes of MPC meetings, CPI inflation has been expected to rise back towards and then above the MPC's target in the near term, including a period above 3%. This has now occurred, with CPI inflation rising above target in May and reaching 3.2% in the August data that has triggered this letter. Core CPI inflation, excluding energy, food, alcoholic beverages and tobacco, has also risen, to 3.1%, its highest rate since November 2011.

Inflation has been affected by global developments, particularly the economic recovery from the worst of the pandemic, and supply constraints in certain sectors.

The recent pickup in CPI inflation has been partly due to base effects. Recent consumer price data have measured the change in prices relative to spring and summer 2020, when prices were particularly low, reflecting the impact of Covid. These base effects are widespread, affecting items in the CPI such as road fuels, clothing and footwear, and catering services. Catering services inflation rose to 7.9% in August, its highest rate on record. This partly reflects the base effects from last year's Eat Out to Help Out scheme, which reduced prices in August last year, and also reflects the temporarily reduced VAT rate for hospitality, holiday accommodation and attractions dropping out of the twelve-month inflation calculation.

In addition to the impact of base effects, energy prices in the CPI have also risen from April as previous increases in wholesale electricity and gas prices have been passed on to household energy bills. Overall, the collapse in these prices last spring and their subsequent rebound has pushed up energy's contribution to CPI inflation by almost 1 percentage point between 2021 Q1 and August.

Global price and input cost pressures have risen. Goods prices, in particular, have increased around the world. Commodity prices have risen sharply since their troughs in 2020, accounting for some of that increase. Higher goods prices have also reflected the global shift in demand to goods and away from services during the pandemic.

Alongside these developments, constraints on supply have been increasing. Some supply bottlenecks have appeared, which have raised global shipping costs, for example. Building global cost pressures have been passed through directly to some consumer goods prices in the United Kingdom. Supply shortages of specific goods, such as semiconductors, appear also to have affected some UK consumer goods prices indirectly. For example, continuing semiconductor shortages have disrupted new car production, which has led to an increase in demand in the used car market. Twelve-month used car price inflation rose to 18.3% in August.

To a lesser degree, the reopening of the economy has led to a pickup in some consumer services prices.

The outlook for inflation

CPI inflation is expected to rise further in the near term, to slightly above 4% in 2021 Q4. Around half of the projected above-target inflation is accounted for by elevated energy price inflation. From October, the contribution of energy prices to inflation will reflect a base effect as well as Ofgem's most recent announced increases in the standard variable tariff caps on retail gas and electricity prices. The material rise in spot and forward wholesale gas prices since the August *Report* represents an upside risk to the MPC's inflation projection from April 2022, when Ofgem are next due to update the retail energy price caps based on the relevant forward contracts. That means that CPI inflation could remain above 4% into 2022 Q2, all else equal.

Core goods inflation is expected to remain above its pre-Covid average, accounting for the majority of the remainder of the projected above-target inflation. In contrast to much of the pandemic period, services inflation is expected to rise slightly, to rates close to pre-Covid averages, in part reflecting a continuing recovery of activity in consumer-facing services, as well as the tapered rise in VAT on hospitality, holiday accommodation and attractions from October.

Most indicators of cost pressures have remained elevated. The Bank Agents' contacts have reported that there have been greater signs of cost pass-through in the manufacturing and construction sectors recently. They have also reported some signs of companies passing on some labour cost increases in labour-intensive sectors. That said, it appears that supply conditions in the global semiconductors sector have improved slightly, although it will take some time for previous order backlogs to clear.

The Labour Force Survey unemployment rate fell to 4.6% in the three months to July, slightly below the expectations in the August *Report*. The number of full and part-time furloughed jobs has continued to decline, but, on the basis of the most recent reported number of 1.7 million in July, to a materially lesser degree than estimated in the August *Report*. There have been few signs of any increase in redundancies, and the stock of vacancies has increased further, as have indicators of recruitment difficulties. Bank staff's estimate of underlying pay growth has picked up, to above its pre-pandemic rate.

Uncertainty around the outlook for the labour market has therefore increased. Key questions include how the economy will adjust to the closure of the furlough scheme at the end of September; the extent, impact and duration of any change in unemployment; as well as the degree and persistence of any difficulties in matching available jobs with workers. In the August *Report*, the economy was projected to have a margin of excess demand for a period, before demand and supply were expected to return broadly to balance, as demand growth was expected to slow and constraints on supply were expected to ease. The Committee will review these, along with other, developments as part of its forthcoming forecast round ahead of the November *Monetary Policy Report*, which will also include its periodic assessment of the supply side of the economy.

In the August *Report* projections, the MPC judged that above-target inflation would be transitory as commodity prices were assumed to stabilise, supply shortages were assumed to ease and global demand was expected to rebalance away from goods and back towards services. In the central projection, conditioned on the market path for interest rates, inflation returned to around 2% in the medium term. The Committee's central expectation continues to be that current elevated global cost pressures will prove transitory.

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.

In the recent unprecedented circumstances, the economy has been subject to some of the largest shocks it has faced in centuries and economic activity has been exceptionally volatile.

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.

Given the lag between changes in monetary policy and their effects on inflation, the Committee, in judging the appropriate policy stance, will as always focus on the medium-term prospects for inflation rather than factors that are likely to be transient.

At its previous meeting, the Committee judged that, should the economy evolve broadly in line with the central projections in the August *Monetary Policy Report*, some modest tightening of monetary policy over the forecast period was likely to be necessary to be consistent with meeting the inflation target sustainably in the medium term. Some developments during the intervening period appear to have strengthened that case, although considerable uncertainties remain. The Committee will be monitoring closely the incoming evidence regarding developments in the labour market, and particularly unemployment, wider measures of slack, and underlying pay pressures; the extent to which businesses pass on wage and other cost increases, as well as medium-term inflation expectations.

At its September 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 all parts of the United Kingdom and sectors of the economy.

Consistent with the MPC’s remit, the Committee sets monetary policy to meet the inflation target sustainably in the medium term. An essential part of the MPC’s strategy is a consistent and transparent approach to achieving monetary stability, which is vital in responding to the very large shocks that the economy has faced recently, and is reflected in this exchange of letters. 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