



BANK OF ENGLAND

Mark Carney
Governor

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
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13 May 2015

Dear Chancellor,

In February I wrote to you when CPI inflation moved more than one percentage point below the 2% target. Three months later, as expected, that remains the case: on 14 April, the Office for National Statistics (ONS) published data showing that twelve-month CPI inflation was 0.0% in March. In line with the remit of the Monetary Policy Committee (MPC),¹ I am writing another open letter, to be published alongside the *May 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 March twelve-month CPI inflation stood at 0.0%. As in February, this remains the lowest figure since the official CPI data began and 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: falls in prices of commodities and some other imported goods and, to a lesser degree, below-average growth of domestic unit wage costs. As anticipated, the drag from the first set of factors has grown in the past three months. That is why inflation has fallen further.

Table 1, a version of which was included in my last letter, helps to illustrate the point. It compares the arithmetic contributions to CPI inflation over the year to March 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/chancellorletter150114.pdf>

² This comparison is instructive because, adjusted for measurement changes, CPI inflation in that earlier period averaged close to the 2% target rate. 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, according to Bank staff estimates, by close to 0.4 percentage points. Consequently, the configuration of price increases that brought about an average CPI 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 March 2015 CPI inflation relative to their pre-crisis averages

<i>Percentage points</i>	1997-2007 average	March 2015	Difference
Energy, food and other goods ^(a)	0.4	-1.1	-1.5
Services	1.6	1.1	-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 44% lower in March than in the middle of 2014. The average price of a litre of unleaded petrol fell by 14% in the year to March, from £1.29 to £1.11. Wholesale gas prices have also declined and most of the major utility companies reduced the retail price of gas by an average of 4% in the first quarter of this year. Overall, the energy component of the CPI contributed -0.6 percentage points to headline inflation in March, compared to a pre-crisis average of +0.3 percentage points, so dragging by around 0.9 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 March, by 3%. As in February, this was the lowest inflation rate for food prices since estimates of the official CPI series began, in 1989.⁴ It 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 drag is around ½ percentage point higher than when I last wrote to you, in February.

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 wages.

In the three months to February average weekly earnings were 1.7% higher than a year earlier, but significantly 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. Recently, this may owe something to a shift in the composition of employment growth towards jobs that attract a below-average wage. Nevertheless growth in unit labour costs has been subdued, growing by only 0.9% in the year to the fourth quarter of 2014.⁵

That weakness in unit labour cost growth is likely to reflect past levels of slack in the economy and elevated unemployment in particular. Its effect is evident in the contribution of services prices to annual CPI inflation which, in March, 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

The fall in annual CPI inflation over the past three months was in line with the MPC's central forecast in the February *Inflation Report*. Its updated forecasts are published today in the May *Inflation Report*. In the view of the MPC, inflation is likely to remain close to its current rate over the next few months, with a negative outturn likely at some point over that period. It is therefore very likely that I will need to write further open letters to you in the coming months.

⁴ The official annual CPI inflation series began in 1997 but the ONS produces an estimate going back to 1989.

⁵ 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 ($0.4 \times (2.0 - 0.9) = 0.4$ percentage points).

In the absence of further falls in commodity prices, however, inflation rates close to zero are unlikely to endure for very long. CPI inflation should pick up notably once earlier declines in commodity prices start to drop out of the annual comparison, towards the end of this year.

A temporary period of falling prices, driven by large one-off adjustments in a few specific components of the CPI, should not be mistaken for the potentially damaging process of 'deflation'. As I noted in my last letter, deflation is characterised by persistent and generalised declines in prices, and often nominal wages. Excluding food and energy, however, the proportion of the CPI's components showing positive inflation is much the same as it was during the decade between 1997-2007 (62% compared with 67%).⁶ Inflation expectations remain broadly consistent with the 2% target. The economy is growing, unemployment is falling and earnings growth has improved since the middle of last year. Indeed, temporarily negative inflation rates driven by falls in commodity prices actually boost households' real take-home pay. In 2015 real disposable 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 abate within twelve months. Attempting to return inflation to 2% within the coming year might 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 somewhat above its long-run sustainable rate. In the absence of further shocks, to return inflation to the target it is necessary to eliminate the remaining degree of economic slack. 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.

Given the nature of the shocks affecting inflation, the MPC continues to judge it appropriate to set policy so that it is likely that inflation will return to the 2% 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. Bank Rate has been at a historically low level of 0.5% for more than six years. From 2009 to 2012, the MPC purchased £375 billion of assets financed by the issuance of central bank reserves, and the Committee continues to reinvest the

⁶ This computation uses four-digit COICOP categories.

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.

As set out in its *Inflation Report* today, the MPC judges it likely that, conditional on interest rates following the path currently implied by market yields, slack in the economy will be absorbed and inflation will return to the 2% target within two years.

There are uncertainties around these judgements and risks in both directions. To the downside, the fall in near-term inflation could be more persistent than the Committee currently expects. Global activity could continue to disappoint. If low inflation were to depress inflation expectations, it could become self-reinforcing.

Were these downside risks to materialise, the MPC would need to provide more support to return inflation to the target over the appropriate horizon. That support could be provided in a number of ways. 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 May *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, although the likelihood is that those increases would still be more gradual and limited than in previous tightening cycles.

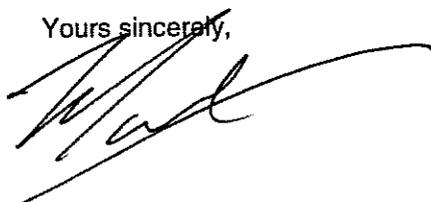
The MPC stands ready to take whatever action is needed, as events unfold, to ensure inflation remains likely to return to target in a timely fashion. Under the central case as set out in today's *Inflation Report* the MPC judges it more likely than not that Bank Rate will increase from its current level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

A handwritten signature in black ink, appearing to be 'M. C. D.', written over a horizontal line.