Bank of England

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Governor

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Dear Jeremy

On 15 November 2023, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 4.6% in October.

This letter sets out the outlook for inflation and the policy action the Monetary Policy Committee (MPC) is taking to return inflation to the 2% target, along with other considerations required by the MPC's remit when inflation moves away from the 2% target by more than 1 percentage point.

We have come a long way this year. Cost pressures have eased and the restrictive stance of monetary policy is working to bring inflation down. So today, the MPC has voted to maintain Bank Rate at 5.25%. But we still have some way to go. We will watch the data carefully and keep interest rates high enough for long enough to ensure that inflation falls all the way back to the 2% target. Low and stable inflation is the foundation of a healthy economy.

Why has inflation moved away from the 2% target?

As I have described in previous letters, the increase in consumer price inflation, to a peak rate of 11.1% in October last year, 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.

Consumer price inflation has fallen significantly throughout the past year. Since my last letter in September, CPI inflation has fallen by 2.1 percentage points, from 6.7% in August to 4.6% in the data for October 2023. This further marked decline has been driven in large part by a continued easing of external cost pressures, reflected in declines in energy, food and core goods price inflation. Services price inflation has remained elevated, however.

The decrease in Ofgem's energy price cap in October materially reduced the typical household energy bill compared to a year ago, and consumer fuel prices also remained lower in October this year than a year earlier. Consumer energy prices thus contribute negatively to annual CPI inflation.

Food price inflation is also continuing to slow. Annual inflation for food and non-alcoholic beverages eased to 10.1% in October, down 3.5 percentage points since August. Food prices were driven up by rising global agricultural prices in combination with high costs in the food sector, especially from energy. Consistent with an easing in these costs, food industry contacts of the Bank's Agents report that ingredient costs are now stabilising or falling.

The annual rate of inflation in the prices of core consumer goods has fallen from 5.2% in August to 4.3% in October. As core goods are mostly tradable, core goods inflation tends to be driven by price developments in global markets. Pressures on core goods prices have lessened substantially since a year ago, when disruptions to global supply chains and a sharp rise in raw materials and shipping costs were pushing up the prices of core goods. As these supply chain pressures have abated and producer price inflation has fallen, consumer goods price inflation has gradually eased too.

While these external cost pressures have lessened, domestic inflation pressures remain elevated. Services price inflation, which is more directly linked to domestic costs, has fallen from its peak rate of 7.4% earlier in the year, to 6.6% in the latest October data. This is somewhat lower than expected in the MPC's most recent Monetary Policy Report from November. However, the downside news can be accounted for by components of services inflation that are not typically reliable indicators of trends in inflationary persistence as a whole, such as non-private rents, accommodation and airfares. Services price inflation that excludes these elements has been more stable at continued high rates. So while the moderate fall in services price inflation points to some easing of domestic inflationary pressures, it is too early to conclude that services inflation is on a firmly downward path.

On labour market developments, the MPC continues to take a collective steer from a broad range of indicators to inform its view. These indicators suggest that a tight labour market continues to contribute to domestic inflationary pressures, but also that the labour market is loosening. Employment growth has eased, and private sector regular pay growth was 7.3% in the three months to October, 0.8 percentage points lower than in the three months to July, and lower than expected in the November Report. The vacancies-to-unemployment ratio also continues to decline, although it is high by historical standards. And a number of surveys and reports from the Bank's Agents point to a continuing easing of recruitment difficulties.

The outlook for inflation

CPI inflation is expected remain near to its current level around the turn of the year, before continuing to fall towards the 2% target.

In the near term, energy prices can be expected to continue to contribute negatively to the annual CPI inflation rate. Household energy bills will remain lower in January than they were a year earlier despite a 5.1% increase in Ofgem's price cap, and oil and wholesale gas futures prices have fallen. There are, however, upside risks to inflation from energy prices following the recent tragic events in the Middle East. Food price inflation is also expected to continue to fall as easing cost pressures work their way through the food supply chain. Similarly, core goods CPI inflation is likely to ease further over the coming months as lower production costs and easing global traded goods inflation are reflected in the prices paid by UK consumers.

Services inflation is likely to remain elevated in the near term, however, and may cause a small uptick in headline CPI inflation in January 2024. On the month in January 2023, there was volatility in a number of services components, such as airfares, which dropped quite sharply, before reversing again in the subsequent months. In the calculation of the annual inflation rate, the level of services prices in January next year will therefore be compared with a relatively low level of services prices in January this year. This so-called base effect will push the annual inflation rate up in January. But services inflation is expected to fall back gradually thereafter as price pressures for services firms are likely to decline with a moderation in wage growth and lower non-labour input costs.

Looking further ahead, the restrictive stance of monetary policy is expected to further reduce domestic inflationary pressures and gradually return inflation to the 2% target. In the MPC's latest most likely or *modal projection* from its November Report, conditioned on market interest rates prevailing at the time, CPI inflation was expected to reach the 2% target by the end of 2025. It was forecast to fall below the target thereafter as an increasing degree of economic slack was expected to emerge. The Committee judged that the risks around this modal inflation forecast were skewed to the upside, reflecting the possibility of more persistence in domestic wage and price-setting, and also the increasing upside risk to inflation from energy prices. Mean CPI inflation in the November Report, which incorporated these risks, was 2.2% and 1.9% at the two and three-year horizons respectively.

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. In forming a view on its policy stance, and the horizon within which inflation returns to target, the Committee considers a number of factors including the nature and persistence of any shocks, the speed of Bank Rate transmission through to the real economy, the structure of the economy and the inflation expectations of agents in the economy.

Since the MPC's previous decision, CPI inflation has fallen back broadly as expected, while there has been some downside news in private sector regular AWE growth. However, key indicators of UK inflation persistence remain elevated. As anticipated, tighter monetary policy is leading to a looser labour market and is weighing on activity 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 this 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 a range of measures of the underlying tightness of labour market conditions, 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. As illustrated by the November Monetary Policy Report projections, the Committee continues to judge that monetary policy is likely to need to be restrictive for an extended period of time. Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures.

Yours sincerely,

Andrew Bailey

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