Bank of England

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Governor

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Dear Jeremy

On 20 March 2024, the Office for National Statistics (ONS) published data showing that twelve-month inflation in the Consumer Prices Index (CPI) was 3.4% in February.

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.

Inflation has continued to fall as expected. Cost pressures have eased, and the restrictive stance of monetary policy is working to bring inflation down. But we need to be sure that inflation will return all the way to our 2% target sustainably. So today, the MPC has voted to keep Bank Rate at 5.25%.

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 2022, mainly reflected a sharp rise in external cost pressures originating from the pandemic and Russia's invasion of Ukraine. In addition, steep rises in import prices in 2021 and 2022, and their effect on real incomes, led to elevated domestic inflationary pressures 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 over the past year. It has fallen by a further 1.2 percentage points since my previous letter in December, from 4.6% in October to 3.4% in the data for February 2024. This decline continues to be driven predominantly by an easing in external cost pressures, reflected in lower energy, food and core goods price inflation. Services price inflation, which is more directly linked to domestic costs, has also started to decline although it remains elevated.

Turning to the external cost pressures first, energy prices continue to pull down on CPI inflation overall, despite the 5% increase in Ofgem's energy price cap in January, and nonenergy goods price inflation has continued to ease. Annual inflation for food and non-alcoholic beverages fell to 5.0% in February, roughly halving since October. The annual rate of inflation in the prices of core goods has also fallen from 4.3% in October to 1.9% in February. Inflation in the prices of core goods, which are mostly tradable, tends to be driven by price developments in global markets. And as previous supply chain pressures have abated and producer price inflation has fallen significantly, consumer goods price inflation has gradually eased too. Material risks remain, however, notably from developments in the Middle East including disruption to shipping through the Red Sea.

While these external cost pressures have lessened, domestic inflation pressures have remained more persistent. Services price inflation has fallen from 6.6% in October to 6.1% in February. This is in line with expectations in the MPC's February Monetary Policy Report but above levels consistent with meeting the MPC's 2% target sustainably in the medium term. However, higher-frequency measures of core services inflation are pointing to some moderation.

There remain increased uncertainties around the ONS's official labour market activity data based on the Labour Force Survey. The MPC continues to take a collective steer from a wide range of labour market indicators. The labour market has continued to loosen but remains tight by historical standards. Private sector regular average weekly earnings growth was 6.1% in the three months to January, 1.1 percentage points lower than in the three months to October, and broadly in line with the February Report.

The outlook for inflation

In the MPC's February Monetary Policy Report projections, CPI inflation was expected to fall temporarily to the 2% target in the second quarter of 2024. It was then expected to increase slightly again over the second half of the year, accounted for by the direct energy price contribution to 12-month inflation.

In the near term, energy prices are expected to continue to contribute negatively to the annual CPI inflation rate. Household energy bills will fall as Ofgem's price cap will be reduced by 12% in April. And the Government's recent announcement of a freeze in fuel duty and cancellation of this year's RPI-linked increase is expected to provide a further marginal reduction in inflation from the second quarter of the year, relative to expectations in the February Report.

Food price inflation is expected to continue to fall as producer input costs are projected to be broadly flat or falling over the forecast period. Core goods price inflation is similarly expected to decline as changes in prices are expected to follow the moderation in producer price inflation.

Services price inflation is expected to fall back gradually over the course of 2024, albeit more slowly than other components of CPI. Inflationary pressures for service-sector firms are moderating owing to lower non-labour input costs. Moderation in wage growth will also ease these pressures.

Looking further ahead, the restrictive stance of monetary policy is expected to reduce further domestic inflationary pressures and return inflation to the 2% target gradually. In the MPC's latest February Report projection, conditioned on the market interest rates prevailing at that time, CPI inflation was projected to be 2.3% in two years' time and 1.9% in three years. Compared with previous Reports, the Committee judged that the risks from domestic price and wage pressures were more evenly balanced.

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.

At the March meeting, the Committee voted to maintain Bank Rate at 5.25%. Headline CPI inflation has continued to fall back relatively sharply in part owing to external effects from energy and goods prices. The restrictive stance of monetary policy is weighing on activity in the real economy, is leading to a looser labour market and is bearing down on inflationary pressures. Nonetheless, key indicators of inflation persistence remain elevated.

Monetary policy will need to remain restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term in line with the MPC's remit. The Committee has judged since last autumn that monetary policy needs to be restrictive for an extended period of time until the risk of inflation becoming embedded above the 2% target dissipates.

The MPC remains prepared to adjust monetary policy as warranted by economic data to return inflation to the 2% target sustainably. It will therefore 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. On that basis, the Committee will keep under review for how long Bank Rate should be maintained at its current level.

Yours sincerely,

Andrew Bailey

cc: Harriett Baldwin MP, Chair of the Treasury Committee