



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

15 September 2008

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Mervyn King
CPI Inflation

Thank you for your letter of 15 September regarding tomorrow's CPI inflation figure, on behalf of the Monetary Policy Committee, written under the terms of the remit I set out in my letter to you of 11 March. The remit requires you to explain the reasons why inflation has moved away from the target by more than 1 percentage point, the policy action which you are taking to deal with it, the period within which you expect inflation to return to the target and how this approach meets the Government's monetary policy objectives.

2. The MPC's forward-looking approach has been a cornerstone of economic policy since 1997. Your letter is an integral part of this framework that has delivered over a decade of low and stable inflation alongside sustained growth and a level of inflation that has been on average, lower than in the euro area or United States. The Government will continue to support the MPC in the forward-looking decisions it takes, consistent with the monetary policy objectives set out in the remit, namely to maintain price stability and subject to that, support the economic policy of the Government.

3. Inflation has risen sharply this year from 2.1% in December to 4.7% in August. You highlight that, "over the past year, there have been sharp, largely unanticipated, increases in the price of energy and food, reflecting developments in the global balance of demand and supply for these commodities. In the year to August:

- world agricultural prices increased by 40%
- oil prices rose by 60% to average around \$110 a barrel
- wholesale gas prices increased by 90%."

4. I agree with you that these price rises have led to sharp increases in headline inflation rates around the world. HICP inflation in the Euro area recently peaked at 4.0% and in the US CPI inflation reached 5.6%. Here in the United Kingdom they have led to large increases in the retail prices of food, petrol, gas and electricity; as you note these components alone account for 2.1 of the 2.6 percentage points increase in the overall CPI inflation rate since last December.



5. The rise in inflation in the UK has been extremely moderate compared with the behaviour of the economy during the oil shocks of the 1970s when RPI inflation peaked at 26.9 per cent in 1975 and 21.9 per cent in 1980.

6. I note that the Committee expects inflation to peak soon at around 5% and that "This is mainly because import prices are likely to be stronger than anticipated three months ago, although the recent falls in oil prices will act to moderate the peak in inflation."

7. Clearly this is a challenging time for the UK economy a result of global factors and individuals and families are feeling the effects. In recent weeks the Government has introduced a number of policy measures on housing and energy to support the most vulnerable, and those hit hardest.

8. The Prime Minister and I are working with our international partners to help deliver a co-ordinated and genuinely global response to the large increases in oil and food prices you point out.

9. While I agree that inflation will peak soon, it is likely that it will remain above target until well into 2009. In the latest Treasury compiled Comparison of Independent Forecasts, published tomorrow; CPI inflation averages 4.4 per cent in 2008Q4 falling to 2.2 per cent in 2009Q4. While I recognise the considerable uncertainties surrounding prospects, it is likely I will receive further open letters from you with the next one likely in December.

10. You state that the outlook for inflation is dominated by two key influences. First, I agree with you that it would be damaging for us to allow inflation to become entrenched as it did in the past. That is why, as I said in my speech to the TUC last week, in both the private and public sectors, pay rises must be consistent with the inflation target. Otherwise, every penny in pay rises will be swallowed up by higher prices and we will all remember the job losses that followed in the past once inflation takes a grip.

11. Second, I recognise that the MPC continues to face a difficult decision in balancing the risks to inflation and ensuring that inflation meets the target set by the Government in the medium term. I note that the Committee will examine the latest developments, including those in financial markets and assess how the balance of risks is evolving at its next and subsequent meetings.

12. I am copying this letter to the Chairman of the Treasury Select Committee and depositing this letter immediately in the libraries of both Houses and on the Treasury website.

Tom Hickey
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ALISTAIR DARLING