



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

16 December 2008

Mervyn King
Governor
Bank of England
Threadneedle Street
LONDON EC2R 8AH

Dear Mervyn,

CPI Inflation

Thank you for your letter of 15 December regarding November'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. In keeping with the remit stipulating a three-month break between open letters, this is your third letter since inflation rose above 3 per cent in May 2008.

I agree with your assessment of why inflation has temporarily exceeded the upper range of the 1 per cent band around the 2 per cent target, set by the remit at all times. As you set out in your letter, "there were sharp increases in the global prices of food and energy through the first half of 2008". You also state that "the effects on UK retail prices of increases in these global prices have been augmented by movements in the sterling exchange rate" and explain that "Together, these developments led to large movements in retail food, petrol and electricity and gas inflation, contributing 3.3 percentage points (pp) to overall CPI inflation when it peaked in September, markedly higher than the 0.9pp they collectively contributed in December 2007".

I note that the Committee expects inflation to fall back sharply and may fall below 3 per cent in the next few months. You state that "the falls in global commodity prices have begun to feed through to retail prices both in the UK and abroad". You also note "it is quite possible that I will next need to write to you to explain why inflation has deviated by more than one percentage point below that target during 2009". This is consistent with the projections that I presented in my Pre-Budget Report of 24 November. In the latest Treasury compiled Comparison of Independent Forecasts, published on Wednesday, CPI inflation averages 4.0 per cent in 2008Q4 falling to 0.8 per cent in 2009Q4. The Pre-Budget Report also noted that "inflation is forecast to move a little above the 2 per cent inflation target following the reversal of the VAT rate cut and as the lagged effects of sterling depreciation on import prices continue to feed through, before returning to target in 2011 as the still negative output gap exerts downward pressure".



This is a difficult time for the global economy and the UK, like many other countries, is being affected. As you say in your letter: “Business surveys and other information point to a sharper contraction in output in the fourth quarter. In large part this weakness is being driven by the sharp falls in business and consumer confidence that have been evident worldwide since the intensification of the turmoil in global financial markets, triggered by the failure of Lehman Brothers in September”.

In light of these challenges, the Pre-Budget Report announced measures to support the economy, businesses and households through these uncertain times while delivering the Government’s long-term goals. These include:

- temporarily reducing the Value Added Tax (VAT) rate to 15 per cent with effect from 1 December 2008 to 31 December 2009;
- bringing forward £3 billion of capital spending from 2010-11 including introducing a green stimulus supporting low carbon growth and jobs;
- making permanent the £600 increase in the income tax personal allowance announced in May 2008 with a further increase of £130;
- measures to help small and medium-sized enterprises facing credit constraints, including a new Small Business Finance Scheme and a £1 billion guarantee facility to support bank lending to small exporters; and
- more generous tax relief for businesses now making losses.

Over the medium term, the Government’s fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.

As your letter sets out, the Pre-Budget Report measures have significant effects on the short-term inflation outlook. In particular, the effect of the temporary reduction in VAT will reduce prices, both directly through lower, temporary prices and indirectly by raising the level of near-term demand in the economy. The remit for the MPC states that there is a “recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output”. I welcome the MPC’s intention – as set out in your letter – to look through the temporary effects on inflation and focus on ensuring that inflation remains on track to meet the 2% target once the direct effects of the VAT change drop out of the annual inflation measure.



On financial stability, in the Pre-Budget Report, the Government also announced the creation of a new lending panel which will monitor lending to both businesses and households and we are now meeting regularly to discuss how the tripartite authorities and the banks can continue lending to credit worthy borrowers.

On Monday, the Government announced proposals for changes to the Credit Guarantee Scheme. These changes are designed to enhance the effectiveness of the Scheme in supporting stability in the financial sector and maximise its impact on wider economic stability through supporting lending to the economy. They draw on experience gathered over recent weeks of operating the scheme and follow discussions with participating banks. The Government will keep this and other measures designed to support lending under review.

The Government remains committed to the objective of allowing fiscal policy to support monetary policy and 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.

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.

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.

Yours sincerely

Ad

ALISTAIR DARLING