



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

17 June 2008

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

Dear Mervyn,

CPI Inflation

Thank you for your letter of 16 June 2008 regarding today'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.

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.

3. In your letter, you state that, "Inflation has risen sharply this year, from 2.1% in December to 3.3% in May. That rise can be accounted for by large and, until recently, unanticipated increases in the prices of food, fuel, gas and electricity. These components alone account for 1.1 percentage points of the 1.2 percentage points increase in the CPI inflation rate since last December".

4. I agree with this assessment of why inflation has temporarily exceeded the upper range of the 1 percentage point band around the 2 per cent target.

5. I also agree with you that those "sharp price changes reflect developments in the global balance of demand and supply for food and energy". This is in line with the analysis in the Treasury document '*Global Commodities: a long term vision for stable, secure and sustainable global markets*', published last week.

6. As you highlight, "In the year to May:

- world agricultural prices increased by 60% and UK retail food prices by 8%
- oil prices rose by more than 80% to average \$123 a barrel and UK retail fuel prices increased by 20%.
- Wholesale gas prices increased by 160% and UK household electricity and gas bills by around 10%".



7. In May, inflation rose to 3.7 per cent in the euro area and 4.2 per cent in the US. In the communiqué from their meeting last weekend, G8 finance ministers agreed on the global nature of the rise in inflation. And the Prime Minister and I are working across a range of international fora to help deliver a co-ordinated and genuinely global response to the large increases in oil and food prices that you point out. As the Treasury has set out action is needed to improve the functioning of markets, taking a principled approach to enhance the balance between supply and demand at the regional, national and international levels.

8. Faced with the recent sustained commodity price shocks in oil and food, the rise in inflation has been extremely moderate compared with the behaviour of the economy in the 1970s and the 1980s.

9. I agree with your assessment that pay growth has remained moderate. Average earnings growth, excluding bonuses, in the year to April was 3.9 per cent, a little below its average since May 1997. Continued restraint on pay is required from both the public and private sector and that is why the Government has agreed a number of multi-year pay deals covering 1.5 million public sector employees. To return now to inflationary pay settlements would undermine rather than raise people's living standards with a damaging circle of wage increases eroded by steadily rising prices.

10. You emphasise the likelihood that, while the pick-up in inflation should be temporary, inflation will remain markedly above the target until well into 2009. In the latest Treasury compiled Comparison of Independent Forecasts, published tomorrow, inflation averages 3.2 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. Consistent with the remit, the next open letter will not be required until September if the August inflation figure is above 3 per cent.

11. The Government will continue to support the MPC in the forward-looking decisions it takes, consistent with the Government's monetary policy objectives as set out in the remit, namely to maintain price stability and, subject to that, to support the economic policy of the Government, including its objectives for growth and employment.

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.

*Yours sincerely
A D*

ALISTAIR DARLING