BANK OF ENGLAND
LONDON EC2R 8AH

15 December 2008

The Rt Hon Alistair Darling
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Chancellor,

CPI inflation rose from 2.1% in December 2007, to a peak of 5.2% in September. Tomorrow, the Office for National Statistics (ONS) will publish data showing that CPI inflation has subsequently fallen back to 4.1% in November. That however, is more than one percentage point above the target. As a result, I am writing a further open letter to you on behalf of the Monetary Policy Committee (MPC). As requested by the National Statistician, in order to avoid conflict with the release of the official CPI statistic, the Bank of England will publish this open letter at 10:30am tomorrow.

Our remit specifies that an open letter should explain why inflation has moved away from the target, the period within which we expect inflation to return to the target, the policy action that the Committee is taking to deal with it, and how this approach meets the Government's monetary policy objectives. Since September, the medium-term outlook for inflation has shifted substantially. That reflects a marked shift in the prospects for economic activity and a reversal of many of the factors that had driven inflation higher throughout much of 2008. The change in the economic outlook has led the MPC to make large reductions in Bank Rate in the past three months.

Why has inflation moved away from the target?

In the long run, inflation is determined by monetary policy. But, in the short run, other factors both at home and abroad can have temporary implications for inflation. I described in my previous letters in June and September how most of the rise in inflation in 2008 was associated with developments in commodity markets. There were sharp increases in the global prices of food and energy through the first half of 2008. For example, oil prices rose from around $95 a barrel at the start of the year, to around $145 in July, a rise of more than 50%. The price of a basket of food commodities measured in US dollars rose by 30% between the start of the year and the summer.

The effects on UK retail prices of increases in these global prices have been augmented by movements in the sterling exchange rate. Since the start of the year, sterling has lost almost 20% of its value against the Euro, over 25% of its value against the US dollar and around 20% against a wider basket of currencies.

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. Since the summer, however, global commodity prices have fallen back sharply. For example, oil prices have fallen by two thirds to around $45 a barrel today and food commodity prices have declined by close to 40%.

The falls in global commodity prices have begun to feed through to retail prices both in the UK and abroad. This is most obvious in the UK for petrol prices. Twelve-month petrol price inflation has fallen by over 20pp since September and turned slightly negative in November. Food and electricity and gas price inflation has fallen back only slightly since September reflecting the slower feed through from global price developments to these retail prices. Nevertheless, petrol, food and electricity and gas prices collectively account for 0.9pp of the 1.1pp decline in CPI inflation since September.

In an accounting sense, therefore, the changes in food, petrol and electricity and gas prices have been responsible for most of the movements in headline CPI inflation during 2008. The corollary is that over this period, the price of other goods and services has risen at a broadly steady annual rate not far from 2%.

Over what period does the MPC expect inflation to return to the target?

The sharp movement in CPI inflation back towards target that has occurred over the past two months is likely to continue in the coming months. This reflects three major factors.

First, the feed through from lower global commodity prices to retail prices is likely to continue. For example, petrol prices are likely to fall further in the coming months. In addition, a number of major gas and electricity suppliers have signalled that, if the recent falls in wholesale gas prices are maintained, they will reduce their tariffs early in 2009.

Second, economic activity has declined in recent months. ONS data for the third quarter show that aggregate output contracted by 0.5% and unemployment rose. 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. It has been exacerbated by the further tightening in the supply of credit to households and businesses which is likely to continue to weigh on demand in coming months. Additional measures, building on the Government's package to support the banking system announced in October, will probably be required to underpin lending to households and companies. In the meantime, the weak outlook for activity will open up a significant margin of spare capacity in the economy which will restrain price and wage increases.

Third, the temporary reduction in the standard rate of Value Added Tax (VAT) that you announced in the Pre-Budget Report (PBR), and which took effect at the start of this month, is likely to reduce prices further. The direct impact of the reduction in VAT will be to lower temporarily prices of those goods and services that are subject to the standard rate. The magnitude of this direct effect will depend on the extent to which the tax reduction is passed on by retailers. The reduction in VAT will also have indirect effects on inflation by raising the level of near-term demand in the economy.

The combined effect of these factors is likely to be moderated to some degree by the recent further fall in sterling. This will continue to push up on the cost of imported goods and services and hence on domestic retail prices.

Nevertheless, taking all of these factors together, it is likely that overall CPI inflation will return to target in the first half of 2009 and then move materially below it later in the year. It is possible that I will not need to write a further open letter to you in three months time. Indeed, given the short-term outlook for inflation, 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 the target during 2009.

What policy action are we taking?

The MPC focuses on the outlook for inflation in the medium term because it takes time for monetary policy to affect the economy. As a result, there is relatively little that the MPC can do to prevent inflation moving from above target now to below target during the course of 2009.

Moreover, the profile for inflation until the end of 2010 will be heavily influenced by the temporary change in VAT announced in the PBR. In particular, the direct effects of the cut in VAT will temporarily lower inflation through much of 2009 with a corresponding increase in inflation through 2010 as the cut in VAT is reversed. As you noted in the PBR, the MPC's remit explicitly recognises that inflation will "on occasions depart from the target as a result of shocks and disturbances" and that "attempts to keep inflation at target in these circumstances may cause undesirable volatility in output." The MPC considers the direct price level effects associated with the changes in VAT to be an example of such a temporary disturbance. In setting Bank Rate, it will therefore 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 in early 2011.

Abstracting from the direct effects of the VAT change, a substantial risk has emerged over the past three months that inflation will undershoot the target in the medium term. As a result, the MPC have lowered Bank Rate very significantly at each of its past three meetings.

In the November *Inflation Report*, the Committee described how this change in the outlook for inflation arose from a sharp deterioration in the outlook for demand, coupled with the large fall in global commodity prices and measures of inflation expectations.

Since that *Report*, the immediate outlook for activity has deteriorated further. A wide range of survey evidence, both at home and abroad, points to a weaker outlook, driven by the continuing difficult conditions in global money and credit markets. That will pull down further on inflation in the medium term. This depressing effect on inflation will be augmented by the further falls in global commodity prices that have occurred since the November *Report*, particularly in the near term. And measures of inflation expectations have fallen further. Set against that, falls in market interest rates and the further depreciation in sterling since the *Report* will act to support the outlook for activity and inflation. The fiscal measures announced in the PBR will also act to cushion some of the slowing in activity next year.

At its December meeting, the MPC judged that there remained a substantial risk that inflation would undershoot the target in the medium term if Bank Rate remained at 3.0%. The MPC therefore judged that lowering Bank Rate to 2.0% was necessary. The MPC will continue to take whatever actions are required to ensure that the outlook for inflation remains in line with the Government's 2% target.

How does this approach meet the Government's monetary policy objectives?

Inflation throughout much of 2009 is likely to be below target and there is a risk that below-target inflation could persist for a while. The MPC's target for inflation is symmetrical: the Committee is just as determined to ensure that inflation does not deviate below the target as it is to ensure that inflation does not rise above it.

Price stability, as your remit to us states, is "a precondition for high and stable levels of growth and employment". By ensuring price stability in the medium term, the MPC will make its best contribution to economic performance more generally.

The Monetary Policy Committee remains determined to set monetary policy in order to bring inflation back to the 2% target in the medium term, thereby supporting growth and employment, and I welcome the opportunity to explain our thinking in this open letter. I am copying this letter to the Chairman of the Treasury Committee, through which we are accountable to Parliament, and will place it on the Bank of England's website for public dissemination.

Yours sincerely

Mervyn King