CHANCELLOR OF THE EXCHEQUER

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

24 March 2009

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

Dear Mervyn

CPI INFLATION

Thank you for your letter of 23 March, written under the terms of the remit I set out in my letter to you of 11 March 2008. In keeping with the remit stipulating a three-month break between open letters, this is your fourth letter since inflation rose above 3 per cent in May 2008.

As your letter points out, inflation volatility over the last two years has increased relative to the previous decade, largely as a result of developments in commodity prices. Sterling has fallen since 2007 as a result of a number of factors.

Turning to the February CPI inflation figure, you note that at 3.2 per cent it is higher than had been expected. In considering the reasons for this, you suggest that it "could reflect pass-through of exchange rate depreciation to consumer prices since much of the strength in outturn appears to be concentrated in components where a large share of goods is imported." You also said that inflation still looks set to fall in the coming months, continuing the declines seen since CPI inflation peaked at 5.2 per cent in September. In the latest Treasury compiled Comparison of Independent Forecasts, published on 11 March 2009, CPI inflation averages 0.4 per cent in 2009Q4 rising to 1.6 per cent in 2010Q4.

In discussing the factors pushing down on inflation, you note the effect of lower gas and electricity prices. You also comment that the output contraction being experienced in the UK will pull down inflation and "mirrors the pattern of demand in other countries", with output having fallen in 54 out of the 57 countries for which data is available in the final quarter of 2008. For 32 of these countries, the fall in output was larger than in the UK. The G20 Finance

Ministers and Central Bank Governors noted the implications for policy of these significant downside risks to inflation in the Communiqué published on 14 March: "G20 central banks will maintain expansionary policies as long as needed, using the full range of monetary policy instruments, including unconventional policy instruments, consistent with price stability."

I welcome the MPC's intention to look through the temporary effects on inflation, and to set monetary policy in order to meet the 2 per cent inflation target in the medium term. I note that you say that, although inflation is above 3 per cent in February, it is likely to moderate significantly in the coming months, and may move below target as the effects of slower growth and falling global energy prices, where a number of UK suppliers have signaled a reduction in tariffs, feed through to consumer prices.

The Government will continue to support the MPC in the 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.

For its part, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and growth. I will update my economic and fiscal forecasts in the Budget on 22 April.

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

Yours sincerely

ALISTAIR DARLING