BANK OF ENGLAND
LONDON EC2R 8AH

17 February 2009

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

Dear Chancellor,

As I informed you on 5 February, the Monetary Policy Committee (MPC) agreed at its February policy meeting that it would like to be able to use the Asset Purchase Facility for monetary policy purposes. To the extent that the facility could be used to buy gilts on the secondary market financed by central bank money, this would be similar to the current implementation of monetary policy, except that the instrument of policy would shift towards the quantity of money provided rather than its price.

In these highly uncertain times, there are merits to stimulating the economy through a variety of different channels. Accordingly, it would be beneficial if the facility could also use central bank money to purchase high-quality private sector assets to improve liquidity in credit markets that are currently not functioning normally, building on the facility we have already put in place financed by the issuance of Treasury bills.

In your letter of 29 January, you requested that, if the MPC were to conclude that it might be useful to use asset purchases for monetary policy purposes, I should write to you setting out the Committee's reasons. At its February meeting, the Committee discussed its latest forecasts for GDP growth and CPI inflation. Those forecasts pointed to a substantial risk that inflation would undershoot the target in the medium term. That was a materially worse outlook than the Committee's previous central view. As a result, the MPC lowered Bank Rate by 0.5 percentage points to 1.0%. The Committee judged it likely that further reductions in Bank Rate alone might not be enough to bring inflation in line with the target in the medium term. As a result, the Committee unanimously concluded that it might be necessary to use asset purchases at future meetings in order to meet the 2% target for CPI inflation, and accordingly asked that I write to you.

If the Committee were to use the facility for monetary policy purposes, purchases of assets would be financed through central bank money, rather than by the issuance of Treasury bills. As I set out in my speech on 20 January, this would provide scope for the monetary base to be expanded. This would act to boost the supply of broad money and credit and increase the liquidity of private sector portfolios, thereby raising nominal spending.

In order to facilitate an expansion of the monetary base through the Asset Purchase Facility, the MPC proposes that gilt-edged securities be added to the list of eligible assets set out in your letter of 29 January. I suggest that the MPC be authorised to use the facility to purchase eligible assets financed by central bank money up to a maximum of £150 billion but that, in line with the current arrangements and in recognition of the importance of supporting the flow of corporate credit, up to £50 billion of that should be used to purchase private sector assets. Within those limits, the speed and scale of purchases would be for the Committee to decide.

If the facility were to be used to purchase gilts, it would be important that the Government's debt management policy remain consistent with the aims of monetary policy. It should not alter its issuance strategy as a result of the transactions that are undertaken through the Asset Purchase Facility for monetary policy purposes. I should be grateful if you could confirm that this will be the case.

The Bank of England remains committed to improving liquidity in credit markets that are currently not functioning normally. Therefore, I envisage that purchases of private sector assets will continue as planned and that the scale of purchases will not be affected by the extension of the Asset Purchase Facility. The option of issuing Treasury bills to finance such asset purchases will remain open. If and when the MPC decides that private sector purchases should be financed by the creation of central bank money, the Bank executive will apply the same criteria in selecting those assets as if the purchases were financed by the issuance of Treasury bills. And in that case, I would expect that the need to finance purchases using Treasury bills would cease, at least initially.

If the facility were to be used for monetary policy purposes, I envisage that the Committee would vote each month on a resolution concerning the asset purchases it deemed necessary to meet the inflation target. The Committee would continue to vote on the appropriate level of Bank Rate. Those decisions and the minutes relating to them would be published in accordance with the stipulations of the Bank of England Act 1998. The Committee would be accountable for its use of the Asset Purchase Facility in the same way that it is for its decisions on the level of Bank Rate. It would continue to explain its monetary policy decisions through the Inflation Report and its evidence to the Treasury Committee.

As with the operations to set the level of Bank Rate, the implementation of the MPC's decisions on asset purchases would be delegated to the Bank executive. The Bank will set out in Market Notices the detailed arrangements for using the Asset Purchase Facility to purchase gilts and the implications for the Sterling Monetary Framework in due course.

With the exception of the changes set out above, the facility could continue to operate in an identical way to that described in our exchange of letters on 29 January. The same Bank of England subsidiary would undertake the purchases, with the benefit of the indemnity already provided by the Government. The risk control framework agreed between the Bank and the Treasury would remain in place, amended to take into account the changes outlined above.

Similarly, the Bank would continue to provide Treasury officials with the information necessary for them to monitor the operation and financial performance of the facility. The Bank would continue to operate the Asset Purchase Facility in an open and transparent manner, including publishing a quarterly report of the transactions undertaken and, where appropriate, information on specific transactions and operations. To aid transparency, purchases financed by central bank money would be identified separately from previous purchases financed by Treasury bills.

At some future date, I would expect that the MPC would wish to exit from the strategy of buying assets and would wish to reduce the amount of assets held under the Asset Purchase Facility. This could be achieved in part as existing assets mature, but could also require sales. If sales are required, the Committee would consider the appropriate mechanisms for selling assets, having due regard for the impact of those sales on the Government's debt management operations, but subject to taking the action necessary to meet its policy objectives.

I should be grateful if you would confirm whether you are willing to authorise the Monetary Policy Committee to use the Asset Purchase Facility for monetary policy purposes in line with the proposals described here.

I am copying this letter to The Rt Hon John McFall MP.

Yours sincerely