BANK OF ENGLAND
LONDON EC2R 8AH

15 February 2010

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

Dear Chancellor,

Tomorrow, the Office for National Statistics (ONS) will publish data showing that CPI inflation rose to 3.5% in January. That is more than one percentage point above the target. As a result, I am writing an open letter to you on behalf of the 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 we 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.

Why has inflation moved away from the target?

In the medium term, inflation is determined by the balance of money spending and the supply capacity in the economy. Money spending, in turn, is influenced by monetary policy, allowing the MPC to meet the inflation target. But in the short run, other factors, which cannot immediately be offset by monetary policy, can cause measured inflation to move around. Over the past three years inflation has been much more volatile than in the preceding ten years, reflecting an increase in size and frequency of these short-run factors.

Three such short-run factors have driven the current measured rate of inflation up. First, the restoration of the standard rate of VAT to 17½% is raising prices relative to a year ago. Second, over the past year, oil prices have risen by around 70%. That is pushing up petrol-price inflation significantly, which, in turn, is raising overall CPI inflation. Third, although the exchange rate has been broadly stable over the past year, the effects of the sharp depreciation of sterling in 2007 and 2008 are continuing to feed through to consumer prices.

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

This is the third episode when inflation has moved above the target by more than one percentage point. As was the case on previous occasions, the Committee expects this to be a temporary deviation of inflation from the target, as was made clear in last week's *Inflation Report*.

The direct effect of the short-run factors on inflation should be only temporary. Thereafter, inflation will be determined by the growth rate of nominal spending relative to the supply capacity of the economy. Nominal spending fell significantly during much of the previous year, although it bounced back somewhat in the third quarter. That weakness in spending has created a substantial margin of spare capacity within the economy. The Committee expects that will bear down on inflationary pressures over time. The effects are already evident to some degree in the labour market, where pay growth has been weak – the average weekly earnings measure of pay has increased by around 1% over the past year. And intelligence from the Bank's Agents suggests that pay growth in the non-financial sector is likely to remain subdued in the period ahead.

The MPC's latest projections, published last week in the February *Inflation Report*, suggest that, although it is likely to remain high over the next few months, inflation is more likely than not to fall back to the target in the second half of this year, as the short-run factors wane and the influence of spare capacity builds. Thereafter, on the assumption that Bank Rate follows a path implied by market interest rates and that the stock of purchased assets, financed by the issuance of central bank reserves, remains at £200 billion throughout the forecast period, the Committee judged that inflation was more likely than not to move below the 2% target for a period. By the end of the three-year forecast horizon, on that same monetary policy assumption, the Committee judged that the risks to the inflation outlook relative to the target were broadly balanced.

What policy action are we taking?

Although inflation is temporarily above the target, the latest *Inflation Report* forecast suggests that the underlying pressures are to the downside. The Committee has taken unprecedented action to offset these downside pressures, ensuring that the medium-term outlook for inflation remains consistent with the 2% target. Bank Rate has been cut to 0.5% and the Committee has embarked on a £200 billion asset purchase programme to inject extra money into the economy, thereby raising asset prices and boosting nominal spending. At its February meeting, the Committee judged that it was appropriate to leave the stance of monetary policy unchanged. It is important to emphasise that the effects of the money-financed asset purchases will persist. That, together with the low level of Bank Rate, will continue to provide a substantial boost to nominal spending for some time to come.

The Committee is committed to taking whatever actions are necessary to ensure that the outlook is for inflation to remain in line with the 2% target. It will continue to monitor the appropriate scale of the asset purchase programme and further purchases would be made should the outlook warrant them.

Equally, if at some point in the future, the medium-term outlook for inflation threatened to rise above the 2% target, the Committee would tighten monetary policy.

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

The Monetary Policy Committee remains determined to set monetary policy in order to keep inflation close to the 2% target in the medium term, thereby supporting growth and employment. 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 most effective contribution to economic performance more generally.

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