BANK OF ENGLAND
LONDON EC2R 8AH

15 September 2008

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

Dear Chancellor,

In June I wrote an open letter to you when CPI inflation moved more that one percentage point above the 2% target. In that letter, I noted that inflation was likely to rise further and remain well above the target for a period of about a year or so. As a result, I expected to write a sequence of open letters to you - at three monthly intervals - as specified in the terms of the remit you have given to the Monetary Policy Committee.

Inflation has now risen further. The Office for National Statistics will publish data tomorrow showing that CPI inflation was 4.7% in August. I am, therefore, sending this further open letter to you today on behalf of the Monetary Policy Committee. 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.

Why has inflation moved away from the target?

Inflation has risen sharply this year, from 2.1% in December, to 4.7% in August.
Inflation is ultimately determined by the pressure of money spending on capacity, which is controlled by monetary policy. But, other factors both here and in the rest of the world can have temporary implications for inflation. As I highlighted in my letter in June, over the past year, there have been sharp, largely unanticipated, increases in the price of energy and food, reflecting

developments in the global balance of demand and supply for these commodities. In the year to August:

- world agricultural prices increased by 40%
- oil prices rose by 60% to average around $110 a barrel
- wholesale gas prices increased by 90%.

These price rises have led to sharp increases in headline inflation rates around the world. HICP inflation in the euro area recently peaked at 4.0% and in the US CPI inflation has reached 5.6%. Here in the United Kingdom they have led to large increases in the retail prices of food, petrol, gas and electricity. In the year to August:

- food prices in the shops rose by 13%,
- petrol prices rose by around 20% and
- retail gas and electricity prices rose by around 25%.

Despite having a share of less than 20% in the overall basket of goods and services used to calculate the CPI, these components alone account for 2.1 percentage points of the 2.6 percentage points increase in the overall CPI inflation rate since last December.

Adding to these global price developments is the wider effect of the depreciation of sterling. Sterling has now depreciated by 15% since its peak last July, and by around 4% since my previous letter to you in June. The fall in the value of sterling pushes up on import price inflation, which, in the latest data for the second quarter of 2008 was around 12% - its fastest rate of growth in over twenty years. Import price inflation is likely to remain high as the effects of the exchange rate continue to pass through.

Although the factors accounting for the rise in inflation are the same as I described in June, the expected peak in inflation later this year is now likely to be significantly higher than anticipated in June: the Committee now expects inflation to peak soon at around 5%. This is mainly because import prices are likely to be stronger than anticipated three months ago, although the recent falls in oil prices will act to moderate the peak in inflation. As I stressed in my previous letter, there are considerable uncertainties, in both directions, around the precise profile for inflation in the coming months.

The pickup in commodity, energy and other import prices reflects a change in these prices *relative* to the prices of other goods and services. This is not the same as a generalised rise in prices and wages caused by rapid growth in the amount of money spent in the economy. In the year to 2008 Q2, money spending in the economy rose by 4½%, somewhat below its average rate of increase since 1997 – a period in which inflation was low and stable. Although rising commodity, energy and import prices clearly raise the price level, they cannot, by themselves, generate sustained inflation in the United Kingdom unless we allow other prices and costs, including pay, to rise at a faster rate. The MPC is committed to ensuring that this does not happen, so that the period of above-target inflation we are presently experiencing indeed proves to be temporary.

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

In the absence of further unexpected increases in energy and commodity prices, inflation should peak soon. Nevertheless, each monthly change in food, energy and import prices will, by altering the overall price level, affect the official twelve-month measure of inflation for a year. So CPI

inflation is likely to remain markedly above the target until well into 2009, particularly if the recent depreciation of sterling is sustained. I continue to expect, therefore, that I will be writing further open letters to you over the next year.

Our remit recognises that actual inflation will depart from the target as a result of unpredictable shocks and disturbances. It also recognises that attempts to bring inflation back to the target quickly in these circumstances may lead to undesirable volatility in output. The Committee judges that the rise in energy and food prices is an example of such a shock and is focussed on bringing inflation back to the target in the medium term. The current medium-term outlook for inflation is dominated by two key influences.

On the one hand, the high current rates of overall CPI inflation may lead households and companies to expect higher inflation in the medium term. If this happens, companies will have greater confidence in their ability to pass on cost increases to their final prices without losing market share. And in turn they will resist less strongly increases in their costs, most obviously in terms of higher wages for their employees. Similarly, if employees start to expect the current high rates of inflation will persist into the medium term, they will push more strongly for higher wage increases from their employers. There continues to be evidence from surveys and financial markets that higher inflation has raised expectations of inflation, at least in the near term.

On the other hand, activity in the economy has slowed sharply. The Office for National Statistics estimates that the level of output was unchanged in the second quarter of 2008 compared to the first quarter. The near-term outlook is for activity growth to remain muted: at the time of the August *Inflation Report,* the Committee judged that overall output will be broadly flat for the year ahead, before gradually recovering thereafter. That is a noticeably weaker outlook than expected when I wrote to you in June. The erosion of real incomes associated with higher inflation, together with the pronounced monetary squeeze evident in the money and credit data, is likely to restrain spending. Partly offsetting these effects, the depreciation of sterling will act to support output by stimulating net trade in goods and services. But the weakness in overall activity – by creating a margin of spare capacity – will dampen the pressures on prices and wages.

The MPC is aiming to balance these two influences. If we are successful, then overall CPI inflation will return to the 2% target when the present sharp rises in energy, food and import prices drop out of the annual CPI inflation rate. As a result, the MPC still expects inflation to fall sharply in 2009 and to fall back to target thereafter.

What policy action are we taking?

The extent of the slowdown necessary to balance these influences and return inflation to the 2% target – and the stance of policy that will deliver that – is inevitably uncertain. The impact of continuing high inflation on price and wage pressures may be larger than currently envisaged by the MPC. That could result in a sustained period of significantly above target inflation, which, if left unchecked, would become embedded in medium-term inflation expectations. Painful experience in the past has shown that if we allow an increase in inflation to become embedded in expectations then a prolonged period of depressed activity and high unemployment is ultimately required to get inflation back down. And because the peak in CPI inflation is expected to be higher than three months ago, the risk that it may have an effect on other prices and costs is now greater. For that reason, the Committee has become firmer in its belief that a period of muted economic growth is necessary to dampen pressures on prices and wages and return inflation to the target in

the medium term. But it is also aware that the slowdown in activity that is already in train could, if severe, result in inflation falling below the target in the medium term.

Each month, the MPC sets Bank Rate on the basis of a fresh assessment of the balance of risks to CPI inflation around the target, using all of the available information. To date, the assessment has been that the risks around the target remain finely balanced, which explains why the MPC has maintained Bank Rate at 5% at each of its meetings since my previous letter to you. But the MPC will examine the latest developments, including those in financial markets, and assess how the balance of risks is evolving at its next and subsequent meetings.

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

Over the past decade, inflation has been low and stable. Volatility in commodity, energy and import prices may mean that inflation will be less stable in the future but it does not mean that inflation will persist at a higher rate. The actions of the Committee will ensure that the present rise in inflation is temporary and that it returns to the 2% target.

In the short term, this commitment should give those setting prices and wages confidence that inflation will be close to the target in the future. That will minimise the slowdown in economic activity that will be necessary to ensure that inflation does indeed fall back to the target.

In the longer term, price stability, as your remit to us states, is "a precondition for high and stable levels of growth and employment". The prolonged periods of subdued economic growth and high unemployment, needed in the past to reduce inflation from persistently high levels, deterred investment and contributed to poor economic performance over a longer period. The MPC can contribute to the country's prosperity most effectively by ensuring price stability in the medium term.

The Monetary Policy Committee remains determined to set Bank Rate at the level required to bring inflation back to the 2% target, 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.