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

16 February 2010

Mervyn King
Governor
The Bank of England
Threadneedle Street
London
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Dear Mervyn

CPI INFLATION

Thank you for your letter of 15 February on behalf on the Monetary Policy Committee (MPC) regarding today's CPI inflation figure, written under the terms of the remit I set out in my letter to you of 22 April 2009.

As you point out in your letter, inflation over the medium term is determined by the balance of spending and supply capacity in the economy, but in the short run, temporary factors can cause measured inflation to move around. Such short-run factors have caused inflation to rise to 3.5 per cent in January. These include: the reversal of the temporary VAT rate reduction; oil price rises of around 70 per cent over the past year which have pushed up petrol prices; and the effects of sterling's depreciation continuing to feed through to consumer prices.

I note the Committee's view that the rise in inflation will be temporary, as has been the case on previous occasions when inflation has exceeded 3 per cent. As you say, it was made clear in the February *Inflation Report* that, although inflation is likely to remain high over the next few months, the rise should be temporary.

The MPC's remit allows it to look through short-term movements in inflation. Although inflation is temporarily above the target, the February *Inflation Report* suggests that the underlying pressures to inflation are to the downside. The Committee expects that the pressure from the margin of spare capacity in the economy will cause inflation to fall back to below the target and that it is more likely than not that inflation will remain below target for a period. By the end of the Bank's three-year forecast horizon, the Committee has judged that the risks to the inflation outlook relative to the target will be broadly balanced.

The Committee's outlook for inflation is similar to that set out in December's Pre-Budget Report. After the temporary upward pressures have passed, the PBR forecast was for inflation to fall to 1¾ per cent in the final quarter of 2010 and to 1½ per cent towards the end of 2011. Inflation was then forecast to rise back to the target rate of 2 per cent by the end of 2012. In the latest Treasury compiled Comparison of Independent Forecasts, inflation is also expected to fall in the second half of the year, with the CPI inflation forecasts averaging 1.9 per cent in the fourth quarter of 2010.

I strongly support the Committee's determination to ensure that the outlook for inflation remains in line with the 2 per cent target. With the world economy emerging from the deepest downturn in modern times, the inflation outlook, remains subject to some uncertainty. But prospects for the UK and the global economy are better than 12 months ago as governments across the world have stepped in to support their economies. As forecast in the Pre-Budget Report, UK GDP growth returned at the end of 2009, supported by measures to stabilise the financial system, substantial macroeconomic stimulus and targeted help for businesses and individuals. I expect growth to pick up through 2010 and 2011.

Over the medium term, setting a credible consolidation path to ensure sound public finances is a key element of the Government's macroeconomic strategy, and it is essential for economic stability and the long-term health of the economy. The focus of the Government's fiscal policy shifts towards consolidation in 2011-12 and the 2009 Pre-Budget Report set out plans to more than halve government borrowing over four years. The Fiscal Responsibility Act enshrines these plans as binding targets in legislation.

The Government will continue to support the MPC in the forward-looking decisions it takes, consistent with the monetary policy objectives set out in the remit, namely to maintain price stability and subject to that, to support the economic policy of the Government. The MPC's approach has been a cornerstone of economic policy since 1997. Since its introduction in 1997 the framework has successfully delivered a sustained period of low and stable inflation with CPI inflation averaging 1.8 per cent since 1997.

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

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ALISTAIR DARLING

APPROVED BY THE CHANCELLOR AND SIGNED IN HIS ABSENCE