Bank of England

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The Governor

Mervyn King

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The Rt Hon Gordon Brown MP
H M Treasury
1 Horse Guards Road
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Dear Chancellor,

The CPI inflation rate for March, to be published at 9:30 am tomorrow by the Office for National Statistics, is 3.1%. That is more than one percentage point above our target of 2%. Under the terms of the remit you have given us, I am, therefore, writing an open letter to you today, on behalf of the Monetary Policy Committee, to explain why inflation has risen above target and what we propose to do about it. As requested by the National Statistician, in order to avoid conflict with the release of an official statistic, in this case the CPI, the Bank of England is publishing this open letter at 10:30 am.

Before coming to the inflation figures, let me recall the background to this letter. The 1998 Bank of England Act sets out the objectives of the Monetary Policy Committee. They are to maintain price stability and, subject to that, to support the economic policy of the Government, including its objectives for growth and employment. When you wrote to me on 21 March this year, you confirmed that the remit for the Monetary Policy

Committee would remain unchanged and that the price stability objective remained a target for inflation, as measured by the twelve-month increase in the Consumer Price Index, of 2%, which the Committee should seek to meet at all times. But your letter also made clear that it is not, in practice, always possible to keep inflation at the target. The remit for the Monetary Policy Committee states that:

> "The framework takes into account that any economy at some point can suffer from external events or temporary difficulties, often beyond its control. The framework is based on the recognition that the actual inflation rate will on occasions depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the inflation target in these circumstances may cause undesirable volatility in output".

Consequently, if inflation moves away from the target by more than one percentage point in either direction, you have asked me to send you an open letter setting out the reasons why inflation has moved away from the target, the policy action that the Committee is taking to deal with it, the period within which we expect inflation to return to the target, and how this approach meets the Government's monetary policy objectives. As the remit for the Monetary Policy Committee makes clear, the thresholds for writing an open letter do **not** define a target range. The target is 2% at all times and is not a range. The purpose of the thresholds is to define when inflation should trigger an explanatory letter.

Let me turn to the reasons for the rise in CPI inflation to 3.1% from 1.8% a year ago. As discussed in our February *Inflation Report*, part of that rise reflects an unexpectedly sharp increase in domestic energy prices during the second half of last year, more than offsetting a fall in petrol prices. Part reflects a rise in food prices caused by a weather-induced global reduction in supply. But, taken together, those factors account for only around one half of the pick up in CPI inflation over the past year.

It appears that some of the risks identified by the Monetary Policy Committee over the past year have started to materialise. Spending in the UK economy, associated with continuing rapid growth of money and credit, has recovered from the slowdown in 2005, leading to five consecutive quarters of robust growth. Capacity pressures have increased. Against that background, businesses have become more confident that they could raise prices to rebuild profit margins, which had previously been squeezed by the doubling in world oil prices since 2004. Over recent months, official data for output prices and responses to business surveys confirm that the pricing climate in which businesses operate has become somewhat easier.

CPI inflation has recently been rather volatile from month to month, increasing the chance that at some point a letter would be triggered. Last August I said at the *Inflation Report* press conference that there was an evens chance of an open letter being triggered over the winter. That volatility had been anticipated by the Committee when it widened the fan chart for inflation in its projections published in August and thereafter. Indeed, in the February *Inflation Report*, the Committee explained that it felt uncertainty surrounding the near-term outlook for inflation had risen further.

Why did CPI inflation exceed 3% in March when it was 2.8% in February? Since February sterling oil prices have risen by around 25%, reversing part of the fall in prices seen in the second half of last year. Higher petrol prices contributed significantly to the pick up of inflation in March. Some of the falls in food prices a year ago, especially of milk, were not repeated in March this year. And the prices of furniture and furnishings rose by almost 10% in March – a record rise – as retailers put up prices, according to the Office for National Statistics, "in the lead up to Easter special offers". Some of these factors may turn out to be temporary – though that remains to be seen.

What does the Monetary Policy Committee propose to do about the rise in inflation? Because there are long lags between changes in interest rates and their impact on inflation, the Committee will continue to look through the short-term volatility in inflation over the next year or so resulting from fluctuations in domestic energy prices and set Bank Rate to keep inflation on track to meet the 2% target in the medium term. As some of the upside risks to inflation began to materialise last year, the Monetary Policy Committee acted. Since August, it has raised Bank Rate by a total of 75 basis points to 5.25%. At its May meeting, the Committee will have an opportunity to assess more fully the news contained in the latest inflation figures, as well as the full range of economic data, before reaching its next decision on Bank Rate.

Over what horizon does the Monetary Policy Committee expect inflation to return to target? The Committee will present a full analysis of the inflation data – which, in line with pre-release arrangements, were available to the Committee only today – in our next *Inflation Report* to be published on 16 May and in the minutes of the May meeting published a week later. But, at first sight, the news seems unlikely to alter the broad picture painted in the February *Report*. As the substantial increases in household gas and electricity prices that occurred a year ago drop out of the annual comparison, and the falls in those prices which have already been announced take effect, CPI inflation is likely to fall back within a matter of months. At the time of the February *Report*, the Committee judged that, assuming Bank Rate followed the market yield curve, the central outlook was for inflation to fall to a little below the target by the end of this year, before settling at around the target during the following year. Output growth in the central projection was thought likely to remain robust at around its long-run average over the next two years or so.

Of course, there are many risks to this outlook. One of the risks identified at the February meeting – to pay growth – has, at least so far, not yet materialised. Although it is still too early to be confident, wage settlements are not far above last year's levels and in the public sector are modest. But the Committee will consider very carefully at its next meeting whether the inflation data for March mean that some of the other upside risks to the outlook for inflation are materialising. The Committee must ensure that inflation expectations are anchored on the 2% target. It is important to prevent that anchor from dragging.

How does the Committee's approach meet the Government's monetary policy objectives? By keeping inflation on track to meet the 2% target in the medium term, thus ensuring price stability, the Committee is providing a platform of macroeconomic stability which is the best contribution that monetary policy can make to promote the Government's objectives of high and stable levels of economic growth and employment.

Letter writing is a key part of the accountability provisions of the monetary policy framework. As I explained in the Mais Lecture in May 2005, "When the time comes for me to write an open letter to the Chancellor … I will welcome the opportunity to explain how we expect to bring inflation back to target and over what horizon. Such letters are an integral part of the policy framework, not an indication of its failure". I am surprised that it has taken ten years and 120 meetings of the Monetary Policy Committee before a deviation of inflation from target sufficient to trigger a letter has arisen. When the Monetary Policy Committee was set up in 1997, the chances of going almost ten years without an open letter being triggered seemed negligible.

The Monetary Policy Committee remains determined to set interest rates at the level required to bring inflation back to the 2% target, and I welcome the opportunity to explain our thinking in this first open letter.

I am copying this letter to the Chairman of the Treasury Select Committee, through which we are accountable to Parliament, and placing it on the Bank of England's website for public dissemination.

Yours sincerely

Mervyn King