Y Gwir Anrh/Rt Hon Rhodri Morgan AC/AM
Prif Weinidog Cymru/First Minister for Wales

Llywodraeth Cynulliad Cymru
Welsh Assembly Government

Ein cyf/Our ref: MB/FM/0660/08

Angela Burns AM
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Cardiff Bay
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October 2008

Dear Angela

During First Minister's Questions on 7 October I agreed to write to you regarding the relevance of inflation forecasts to budget allocations.

The 2007 Comprehensive Spending Review (CSR) assumed Consumer Price Index (CPI) inflation close to the 2% target throughout the spending period. The Welsh settlement was set for the three years 2008-9 to 2010-11 on this basis. Since the CSR, CPI inflation has risen from 2.1% in December 2007 to 3.3% in May 2008 and 4.7% in August, due to unanticipated increases in food and energy prices.

There is a high level of uncertainty about inflation prospects. The International Monetary Fund (IMF) has noted in its most recent report, published in October 2008, that inflation prospects in developed countries are highly dependent on commodity price movements, and particularly on the price of oil. Such movements, and therefore the future course of inflation, are very difficult to predict successfully.

However, it seems very unlikely that the recent high rates will be reflective of the position over the whole period covered by the budget. Indeed the Bank of England expects inflation to fall markedly from its current rate. This expectation is shared by the IMF and is reflected in the consensus of independent forecasters.

As a result of good financial management before the current economic downturn, the Assembly Government was able to release extra funds from reserves for additional investment in our key public services over the next two years. Furthermore, the Commission on Funding and Finance has now been established. The Commission will review the appropriateness and operation of the Barnett formula in determining the overall allocation of funding to Wales, and identify possible alternative funding mechanisms.

Yours
Rhodri