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

16 November 2010

Mervyn King
Governor
The Bank of England
Threadneedle Street
London EC2R 8HA

Dear Mervyn,

CPI INFLATION

Thank you for your letter of 15 November on behalf of the Monetary Policy Committee (MPC) regarding today's CPI inflation figure, written under the terms of the MPC's remit.

I take note of your assessment of the factors behind the continued elevated rate of CPI inflation for October of 3.2 per cent. As you highlight, these include several temporary factors such as the restoration of the standard VAT rate in January 2010, past rises in oil prices and the continued pass through of higher import prices following sterling's depreciation since mid-2007. I agree the precise impact of these factors is difficult to calibrate.

As detailed in your letter and in the November *Inflation Report*, the MPC's near-term inflation forecast has risen since August and is expected to remain above the 2 per cent target throughout 2011. You explain this is due to the forthcoming VAT increase in January 2011 as well as recent increases in commodity and other world export prices adding to companies' costs. But the MPC's central judgement continues to be that as these effects wane, inflation is likely to fall back to target by early 2012, reflecting continuing downward pressure on wages and prices from the persistent margin of spare capacity.

As you highlight, the prospects for inflation remain highly uncertain, with substantial risks in both directions. I note also that the range of views amongst MPC members about the weight to attach to these risks is wider than usual, but overall the Committee judges that, conditional on the current policy stance, the chances of inflation being above or below target in the medium term are evenly balanced. I reemphasise here that the MPC's symmetric inflation target ensures vigilance on both upside and downside risks. In this light, I recognise the Committee's continued readiness to respond in either direction as the balance of risks evolve.

The MPC's forecast of above-target inflation in the short term, which falls back in the medium term is broadly in line with other forecasters. The Treasury's published compilation of independent forecasts in October showed the average independent forecast for CPI inflation was 2.8 per cent in the fourth quarter of 2010 and 2.5 per cent in the fourth quarter of 2011. For the medium term, the most recent publication in August of the average independent forecast is 2.0 per cent in 2012 and 2.2 per cent in 2013. The Office for Budget Responsibility's June Budget forecast was for inflation to fall back to a little under 2 per cent in early 2012 and to settle at 2 per cent in the medium term. The OBR will publish a new forecast for the economy on 29 November.

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.

Best wishes,

George

GEORGE OSBORNE