BANK OF ENGLAND
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16 May 2011

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

Dear Chancellor,

The Office for National Statistics (ONS) will publish data tomorrow showing that CPI inflation was 4.5% in April. In February I wrote an open letter to you because CPI inflation had remained more than one percentage point above the 2% target. As it is three months since I last wrote to you, and CPI inflation remains more than one percentage point above the target, I am writing a further open letter to you on behalf of the MPC.

In accordance with our remit, this letter explains 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. Following our usual procedure, the Bank of England will publish this open letter at 10.30am tomorrow.

Why has inflation moved away from the target?

As set out in my previous letter, the current high level of inflation reflects three main influences: the increase in the standard rate of VAT in January to 20%, higher energy prices and increases in import prices. Although the impact on inflation of these factors is difficult to quantify with precision, it is likely that had they not occurred, inflation would have been substantially lower and probably below the target.

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

Continuing volatility in energy and commodity prices makes it difficult to be sure when inflation will return to the target. As explained in the May *Inflation Report*, inflation is likely to rise further over the next few months, as increases in the price of energy are likely to raise petrol prices and make it more likely that there will be substantial increases in utility bills later in the year. But, under the usual conditioning assumptions that Bank Rate moves in line with market interest rates and the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion, the MPC expected inflation to fall back through 2012 and into 2013, by which time the chances of inflation being above or below the target were broadly balanced.

What policy action are we taking?

As explained above, inflation is high at present because it is being pushed up by the rise in the standard rate of VAT, higher energy prices and import prices. But unless continually repeated, the impetus from these factors should gradually diminish and, as it does, inflation is likely to moderate. The extent and timing of that decline are, however, uncertain. Over the past two weeks alone we have seen how quickly commodity prices can change. And there are both upside and downside risks to the inflation outlook.

On the upside, the continuing experience of high levels of inflation may push up on inflation expectations, or lead to some resistance to the erosion of real take-home pay. Either of these mechanisms could put upward pressure on wages and prices looking ahead, and imply that inflation would not fall back as sharply when the temporary effects of higher VAT, energy and import prices come to an end.

On the downside, however, levels of activity in the economy remain weak – the ONS estimates GDP to be about 4% below its pre-recession peak in 2008. Unemployment is high and wage growth is weak at around 2% a year. Money and credit growth are both very low. It is therefore possible that, as the temporary influence of the factors currently pushing up on inflation wanes, these downward pressures on inflation could drag inflation below the target.

The MPC is aiming to set policy in order to balance these material risks to the inflation outlook, relative to the target, in the medium term. The range of views among Committee members over the outlook for inflation is wider than usual. In the current uncertain environment, modest differences in judgements regarding the risks described above can have a material impact on the outlook. At its May meeting, the MPC judged it appropriate to maintain Bank Rate at 0.5% and the stock of asset purchases at £200 billion, in order to meet the 2% CPI inflation target over the medium term. The MPC judges that attempting to bring inflation back to the target quickly risks generating undesirable volatility in output and would increase the chances of undershooting the target in the medium term.

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

The Committee remains determined to respond flexibly to the economic outlook, and will continue to set policy by increasing or decreasing the degree of monetary stimulus as required in order to return inflation to the target in the medium term. In so doing, monetary policy will make the best contribution to high and stable levels of growth and employment.

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

Yours sincerely