BANK OF ENGLAND
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15 November 2010

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

Dear Chancellor,

In August I wrote an open letter to you because CPI inflation had remained more than one percentage point above the 2% target. In that letter, I explained that inflation was likely to remain above target until the end of 2011. As a result, I said that there was a significant probability that I would need to write further open letters to you in the coming months as specified in the terms of the remit given to the Monetary Policy Committee.

The Office for National Statistics (ONS) will publish data tomorrow showing that CPI inflation was 3.2% in October. As that is more than one percentage point above the 2% 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 is 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 I described in my August letter, the MPC's assessment is that the current elevated rate of inflation largely reflects a number of temporary influences, including the restoration of the standard rate of VAT to 17.5% in January, past rises in oil prices and the continued pass through of higher import prices following the depreciation of sterling since mid-2007. But, as discussed in the November *Inflation Report,* the impact of these factors on inflation is hard to calibrate, and small differences in assumptions can affect the explanation for the strength in inflation. The MPC's central judgement continues to be that the temporary impact of those factors has offset the downward pressure on inflation from spare capacity – pressure which can, in part, be seen in the labour market, where wage growth has been subdued at around 2% – but considerable uncertainty remains about that impact.

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

The MPC expects that the prospective increase in the standard rate of VAT in January to 20% will mean that inflation is likely to remain elevated throughout 2011. In addition, commodity and other world export prices have increased recently, adding to companies' costs and so to inflationary pressure in the near term. As a result, CPI inflation is expected to remain above target, and at a somewhat higher level than expected three months ago, for a period of a year or so. Indeed, over the next few months the inflation rate might rise further.

But, as explained in the November *Inflation Report,* the MPC believes that the factors driving the current high level of inflation are very different from those that are likely to be important in the medium term. The MPC's central view remains that spare capacity within companies and in the labour market will continue to put downward pressure on inflation. As the temporary effects of VAT increases and higher import prices dissipate, inflation is expected to fall back towards the target. That view is consistent with the current low rate of pay increases, low growth in broad money and credit and generally stable inflation expectations. In addition, although the recovery in demand is likely to continue, the depth of the recession means that a margin of spare capacity is likely to persist for some while.

But the outlook for inflation remains highly uncertain, with substantial risks in both directions. The near-term strength in inflation may be more pronounced if the prices of commodity and other imported goods and services increase further. And that would exacerbate the risk that the prolonged period of above-target inflation may cause inflation expectations to rise, making it more costly to bring inflation down. But if the weakness in wage growth continues, once the temporary effects of VAT increases and higher import prices wane, then inflation could move significantly below the target. The range of views amongst Committee members about the weight to attach to each of these risks is wider than usual. Overall, however, the Committee judges that, conditional on the current stance of policy, the chances of inflation being above or below the target in the medium term are evenly balanced.

What policy action are we taking?

Inflation is likely to remain above the target for the next year or so. But monetary policy affects consumer prices with a lag. That is why the MPC needs to set policy in a forward-looking fashion, balancing the opposing risks to inflation in the medium term. The Committee's latest analysis was set out in the November *Inflation Report*, published last week.

At its November meeting, the MPC judged that it was appropriate to maintain the stance of policy that it has adopted for the past year, that is to keep Bank Rate at 0.5% and maintain the stock of purchased assets financed by the issuance of central bank reserves at £200 billion. But the Committee is ready to adjust policy – in either direction – in order to ensure that the risks to the outlook for inflation in the medium term remain evenly balanced around the 2% target.

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

The Government's monetary policy objectives are described in the remit given to the MPC. That remit sets out the Government's commitment to consistently low inflation in the long term. And it recognises that price stability is "a precondition for...high and stable levels of growth and employment". The Committee remains determined to keep inflation on track to meet the target in the medium term, increasing or decreasing the degree of monetary stimulus as required by the inflation outlook.

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