BANK OF ENGLAND
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16 August 2010

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

Dear Chancellor,

Tomorrow the Office for National Statistics (ONS) will publish data showing that CPI inflation fell to 3.1% in July. That is, however, more than one percentage point above the target. Under the terms of our remit, I am therefore writing a further open letter to you on behalf of the MPC. In line with our normal convention, the Bank of England will publish this open letter at 10:30am tomorrow.

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.

Why has inflation moved away from the target?

Inflation has been volatile over the past two years or so. In that time, it has moved above 5%, then fallen to 1.1%, risen again to 3.7%, and has since started to fall back once more. But on average over that period, inflation has been above the target. And the recent strength of inflation has surprised the MPC.

The MPC's assessment is that much of the current high level of inflation can be attributed to the increase in VAT in January 2010, past rises in oil prices and the continued pass-through of higher import prices following the depreciation of sterling since mid-2007. The MPC's central judgement remains that these effects will prove to have a temporary impact on inflation, and are masking the downward pressure on inflation from spare capacity within companies and the labour market. But, as explained in our August *Inflation Report*, it is hard to be precise about the quantitative impact that each of these factors has had on inflation. Small differences in the assumptions about the impact of different factors can lead to noticeably different interpretations of why inflation has behaved in the way that it has.

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

As set out in the August *Inflation Report*, following the announcement in the Budget of a further increase in VAT, inflation is now expected to remain above the 2% target until the end of 2011 – about a year longer than projected in May. There remains a significant probability that I will need to write further open letters to you in the coming months.

As the effects of higher VAT, energy price rises and import price increases drop out of the twelve-month comparison, inflation should fall back, probably to below the target, reflecting the influence of spare capacity in the economy. That influence of spare capacity is one of the factors driving the current weakness in wages – regular pay growth has been less than 2%, markedly lower than the average growth rate of pay in the five years prior to the crisis. The MPC's central view remains that inflation in the medium term is likely to be close to, or a little below, the target. That is consistent with the current low rate of pay increases, little growth in broad money and credit, generally stable inflation expectations and the most likely prospect being a muted recovery in demand that is insufficient to eliminate the margin of spare capacity in the economy. But how fast and how far inflation will fall are both difficult to judge, with substantial risks in both directions relative to the MPC's central view.

What policy action are we taking?

In my previous letter to you, I explained the unprecedented action the Committee has taken to ensure that the outlook for inflation in the medium term remains consistent with the 2% target. At its August meeting, the Committee judged that it was appropriate to maintain Bank Rate at 0.5% and the stock of purchased assets financed by the issuance of central bank reserves at £200 billion in order to balance the risks to the inflation outlook, relative to the target, in the medium term.

The MPC is very conscious of the risks to the outlook. On the downside, there is a risk that growth could be weaker than the Committee expects. As a result the substantial and persistent margin of spare capacity could exert greater than expected downward pressure on inflation. But on the upside, if the current period of above-target inflation were to become engrained in inflation expectations and this affected wages and prices, it would be costly to bring inflation back down again.

The MPC will continue to set policy in order to balance these risks to the outlook for inflation. We stand ready either to expand or to reduce the extent of monetary stimulus as the outlook demands.

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

By keeping inflation close to the 2% target in the medium term, the Monetary Policy Committee will make its most effective contribution to economic performance in the United Kingdom. We know from our experience in the 1970s and 1980s how destructive high inflation can be. Price stability, as the remit for the MPC states, is "a precondition for... high and stable levels of growth and employment". The Committee accordingly remains determined to keep inflation on track to meet the target in the medium term.

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