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

18 May 2010

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

Dear Mervyn,

CPI INFLATION

Thank you for your letter of 17 May on behalf of the Monetary Policy Committee (MPC) regarding today's CPI inflation figure, written under the terms of the MPC's remit.

I am grateful for your explanation of the current elevated rate of inflation, at 3.7 per cent for April. A number of temporary factors have contributed to this elevated rate of inflation, including the VAT rate rise in January 2010 and high fuel prices. Clothing and footwear prices and duty increases for fuel, alcohol and tobacco have also contributed to the increase in inflation between March and April this year. The MPC's remit allows it to look through short-term movements in inflation and I note the Committee's view that the current elevated rate of inflation is expected to be temporary. I am sure that you will remain vigilant towards any upside risks to inflation, including the risks to inflation expectations, of any prolonged period of above target inflation.

I note that the MPC expects CPI inflation will fall back to target within a year. Thereafter, your letter states that downward pressure from the persistent margin of spare capacity will probably cause inflation to fall below the target for a period. The latest Treasury-compiled Comparison of Independent Forecasts is broadly in line with this view and shows the average forecast for CPI inflation at 2.1 per cent in the fourth quarter of 2010 and 1.7 in the fourth quarter of 2011.

I welcome this opportunity in our exchange of letters to state clearly the Government's absolute commitment to maintaining price stability, and as Chancellor I will support the MPC's decisions and actions to meet the 2 per cent inflation target as measured by the 12-month increase in the Consumer Prices Index (CPI).

As we have discussed, over the longer term I would welcome your views on how we might accelerate the process of including housing costs in the CPI inflation target.

For its part, the Government sees the reduction of the fiscal deficit and ensuring economic recovery as the most urgent issues facing the UK. It will be a priority for the Government to deliver a significantly accelerated reduction in the structural deficit over the course of this Parliament.

The Government has announced that it is committed to making savings of £6 billion in non-front line services in 2010-11. As I announced yesterday, the great majority of these savings will be used to reduce the record deficit. I am grateful for your positive assessment of the advisability of these plans, which you provided at the *Inflation Report* press conference.

Yesterday, I announced that Sir Alan Budd will chair a new Office for Budget Responsibility (OBR), established on an interim basis, to make an independent assessment of prospects for the public finances and the economy before the emergency Budget due on Tuesday 22nd June. The Government's new macroeconomic framework will therefore combine the independent and transparent approach to monetary policy with a similarly independent and transparent assessment of the fiscal position.

By establishing fiscal credibility through an improved fiscal framework and early action to tackle the deficit, the Government's fiscal policy will therefore support the recovery and the goal of price stability. My aim is that fiscal policy will allow monetary conditions to remain supportive while maintaining low and stable inflation.

I am depositing this letter immediately in the libraries of both Houses and on the Treasury website.

Best wishes.
George

GEORGE OSBORNE