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

16 August 2011

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

Dear Mervyn,

CPI INFLATION

Thank you for your letter of 15 August on behalf of the Monetary Policy Committee (MPC) regarding the CPI inflation rate of 4.4 per cent in July, written under the terms of the MPC's remit.

I note the explanation in your letter that the current elevated rate of inflation continues to be driven by the temporary impact of past rises in VAT, global energy prices and import prices.

As set out in the August *Inflation Report*, the MPC expects that inflation is likely to rise to around 5 per cent later this year, boosted by utility prices. The MPC's forecast for the medium term continues to be that inflation is likely to fall back through 2012 and into 2013 as the effects of these temporary factors wane and drop out of the 12-month comparison, and as the downward pressure from slack in the labour market persists.

I also note that recent independent forecasts, which are compiled and published by HM Treasury every month, continue to expect inflation to fall back in the medium term.

I understand there remain very significant uncertainties around the outlook for inflation, including the timing and the extent of the decline in inflation as outlined in the August *Inflation Report* and your letter, but that the MPC continues to judge there are broadly equal chances of inflation being above or below target in the medium term.

I continue to welcome the MPC's commitment and determination to respond flexibly to the economic outlook and to set monetary policy to balance the upside and downside risks in order to meet the inflation target in the medium term.

As I have highlighted in my previous letters, for its part, the Government's commitment to delivering its fiscal consolidation plan continues to provide the MPC with the space it needs to target low inflation. In the current context, stepping back from the Government's commitment to fiscal consolidation would, other things equal, risk prompting an offsetting monetary tightening such that overall there would be little, if any, net support to economic activity even in the short term.

I agree with you that the big risks currently facing the UK economy come from the rest of the world. Your letter refers to the risks of further stress and dislocation in financial markets. As I have said, the UK economy is not immune to these external events taking place in our major trading partners. Abandoning our deficit reduction plan in these circumstances would be disastrous, so the Government remains totally committed to delivering on its fiscal plans. We will also go further with supply-side reforms to improve the competitiveness of the UK economy and help create jobs.

A crisis of confidence in the global economy demands a global response. Credible fiscal consolidation in countries with large deficits must be matched by a rebalancing of global demand in order to support growth. The Eurozone needs to demonstrate commitment to greater fiscal integration and governance arrangements that avoid moral hazard and entrench fiscal responsibility. Banking systems must be strengthened and financial regulation coordinated at a global level. And structural reforms to improve economic performance in developed economies must be accompanied by progress on global trade negotiations. There is evidence of increasing support for this agenda among some other G7 and G20 countries. Now we need to demonstrate real progress in putting it into practice at the international meetings planned for this autumn.

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.

Yours sincerely,

George

GEORGE OSBORNE