

13 February 2012

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 3.6% in January. In November 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 the rate of inflation is more than one percentage point above the target, I am writing a further open letter on behalf of the Monetary Policy Committee.

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. The Committee's latest judgements on the outlook for output and inflation will be published in the February *Inflation Report* on Wednesday 15 February.

Why has inflation moved away from the target?

CPI inflation has been above the 2% target since the end of 2009, prompting a series of open letters. As described in those previous letters, and in the Bank's quarterly *Inflation Reports*, inflation was pushed up over that period by increases in VAT, import prices and energy prices that were largely unexpected. In contrast domestically generated inflation has been subdued.

The effect of the factors that temporarily pushed up inflation is now waning. CPI inflation peaked in September 2011 at 5.2% and has fallen back in each month since then, to 3.6% in January. As expected, the sharp decline in the latest CPI figure largely reflected the impact of the increase in VAT in January 2011 dropping out of the twelve-month comparison. Since September, the contributions of petrol and food prices have also fallen back. Nevertheless CPI inflation remains well above the 2% target.

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

The Committee's best collective judgement is that CPI inflation will continue to fall back to around the target by the end of 2012. In coming months, that further moderation is likely to reflect the declining contributions from petrol prices and any remaining VAT impact, together with recently announced cuts to domestic energy prices. The upward pressure from past rises in energy and import prices should dissipate further over 2012, and the margin of spare capacity that has built up in the economy is likely to continue to bear down on wages and prices beyond that.

But the pace and extent of the fall in inflation remain highly uncertain. Key factors include the degree to which slack in the labour market restrains wages, and the rate at which firms rebuild their profit margins. Any further external price shocks, precipitated for example by heightened tensions in oil exporting countries, could also have a material impact on the inflation outlook.

The MPC's February *Inflation Report* will set out the Committee's latest projections in more detail.

What policy action are we taking?

Monetary policy affects inflation only with a lag. The key consideration when setting monetary policy is, therefore, the medium-term outlook for inflation, and the balance of risks around it, rather than its current rate. With external price pressures diminishing, and the underlying weakness in domestically generated inflation likely to persist, the Committee's assessment of the inflation outlook at its February meeting was that, in the absence of further policy action, the balance of risks around the inflation target in the medium term lay to the downside. That is why we judged that it was appropriate to increase the size of the asset purchase programme, financed by the issuance of central bank reserves, by £50 billion to a total of £325 billion, while maintaining Bank Rate at 0.5%.

Although the Committee expects that programme of asset purchases to take three months to complete, we will re-evaluate the outlook for inflation and our policy stance every month. In the coming months, we will pay particular attention to prospects for the euro area and their implications for the banking system and credit conditions; the degree of spare capacity in the economy and its impact on domestically generated inflation; and measures of inflation expectations and their effect on pay and prices. The MPC stands ready to react as necessary to changes in the balance of risks to the inflation outlook.

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

The unwelcome combination of sluggish growth and high inflation over the past two years is a reflection of the need for the economy to rebalance following the financial crisis and associated deep recession, together with rises in the costs of energy and imports. Although inflation is now falling broadly as expected, the process of rebalancing still has a long way to go. Growth remains weak and unemployment is high. While the MPC can use Bank Rate or asset purchases to help

ease the transition, there is a limit to what monetary policy can achieve when real adjustments are required. The best contribution that monetary policy can make to high and stable levels of growth and employment is to respond flexibly and transparently to bring inflation back to target. The Committee remains determined to set policy to ensure that inflation is 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
Mark King