

BANK OF ENGLAND
LONDON EC2R 8AH

17 May 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 rose to 3.7% in April. That is more than one percentage point above the target. Under the terms of our remit, I am therefore writing an open letter to you on behalf of the MPC. As requested by the National Statistician, in order to avoid conflict with the release of the official CPI statistic, the Bank of England will publish this open letter at 10:30am tomorrow.

Our remit specifies that we should explain 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 risen from 1.1% in September 2009 to 3.7% in April. The MPC's assessment is that that rise is largely accounted for by three factors: first, the impact of higher oil prices, which on average in April were nearly 80% higher than at the beginning of 2009, pushing up on petrol price inflation; second, the restoration at the beginning of January of the standard rate of VAT to 17½%; and third the continuing effects on inflation of the sharp depreciation of sterling in 2007-8. The MPC judges that together these factors more than account for the deviation of CPI inflation from target and that the temporary effects of these factors are masking the downward pressure on inflation from the substantial margin of spare capacity in the economy.

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

The change in VAT and higher petrol prices will continue to be reflected in the overall price level. But, unless they increase further, that should affect the twelve-month CPI measure of inflation for no more than a year. Moreover, the continuing impact of the past depreciation of sterling is still pushing up on consumer prices, but likewise the effects on inflation can be expected to wane over time. As this happens, the MPC expects that inflation will fall back. Nevertheless, inflation has been somewhat higher than expected over the past year and the Committee is conscious that the pace and extent of the prospective fall in inflation are highly uncertain. It will monitor developments closely.

Money growth and nominal spending growth show signs of recovering, at least in part as a result of the Bank's asset purchases. Output growth has also picked up and the projections outlined in the May *Inflation Report* show that its pace is likely to increase. The May projections also suggest that, absent further price level surprises, it is likely that inflation will fall back to target within a year. Thereafter, as discussed in the *Report*, the MPC expects that the effects of the persistent margin of spare capacity in the economy – built up during the recession – will continue to pull down on inflation, probably bringing it below target for a period. But if the recovery continues as expected, that will gradually erode the slack in the economy, bringing inflation back to target.

What policy action are we taking?

In my letter to your predecessor three months ago, I explained the unprecedented action the Committee took in response to a large contraction in demand to ensure that the outlook for inflation in the medium term remained consistent with the 2% target. At its May meeting, the Committee judged that it was appropriate to maintain the current stimulatory stance of monetary policy. The low level of Bank Rate, together with the continued effects of money-financed asset purchases, are providing a significant boost to nominal spending which should continue for some time. That will help to keep inflation on track to meet the target in the medium term. But the MPC is very conscious that there are risks to inflation in both directions. On the downside, there is a risk that inflation will turn out to be weaker, perhaps because the influence of spare capacity in the economy could be more significant than assumed. On the upside, there is a risk that inflation may be raised by further commodity price increases or other price level surprises. And if the current period of above-target inflation causes inflation expectations to move up that may lead to some persistence in the current high level of inflation.

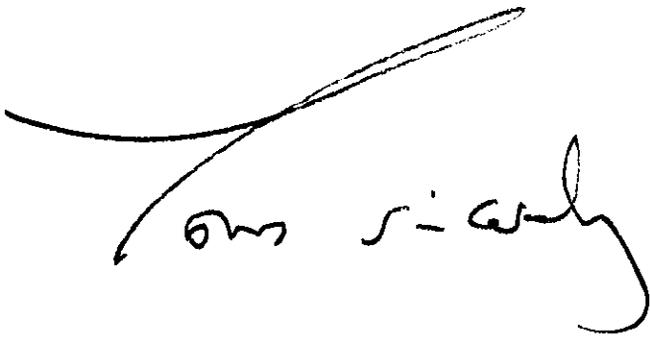
The MPC will continue to set policy to keep inflation on track to meet the inflation target in the medium term, taking into account the balance of risks. We stand ready either to expand or reduce the extent of monetary stimulus as needed.

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. Price stability, as the remit to us states, is "a precondition for... high and stable levels of growth and employment". And so, by keeping inflation low, we will thereby support growth and employment. The events of the

past few years and the heightened degree of uncertainty have made clear that -- now more than ever -- the importance of a stable and transparent monetary policy framework is paramount.

I will place this letter on the Bank of England's website for public dissemination.



Tom Sisk



Andrew King