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

15 November 2011

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

Dear Mervyn

CPI INFLATION

Thank you for your letter of 14 November on behalf of the Monetary Policy Committee (MPC) regarding the CPI inflation rate of 5.0 per cent in October, 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, import and global energy prices, including recent domestic utility price rises.

The Committee's best collective judgement is that inflation will fall back sharply in the next six months or so, to around the target rate of 2.0 per cent by the end of next year. I recognise that there remain significant uncertainties around the precise pace and the extent of the drop in inflation.

I understand that the balance of risks around the medium-term outlook for UK inflation has changed as a result of world growth slowing and the increased uncertainty about the prospects for the global economy, and in particular the Eurozone. I recognise that these developments are likely to have weakened the outlook for overall activity in the UK economy and so will probably lead to a greater and more persistent margin of spare capacity than previously thought. As a result, at its meeting in October, the MPC voted to increase the size of its asset purchase programme by £75 billion in response to increasing risks that inflation would undershoot the 2 per cent target in the medium term. At its November meeting the MPC voted to maintain both the Bank rate at 0.5 per cent and the stock of purchased assets financed by the issuance of Central Bank reserves at £275 billion, in order to balance the risks to the inflation outlook, relative to the target, in the medium term.

I continue to welcome the MPC's ongoing 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 made clear, monetary policy has a critical role in supporting the economy as the Government delivers on its commitment to necessary fiscal consolidation. The forecast of the independent Office for Budget Responsibility including the outlook for inflation, to be published on 29 November, will reflect the action taken by the MPC to meet the inflation target.

I agree with you that the main risk facing the UK economy continues to come from the uncertain global economic outlook. This is why in my response to your open letter in August I said that a crisis of confidence in the global economy demanded a global response. The meetings of Eurozone Heads of State and informal European Council on 26 October took some steps towards a resolution. At Cannes, the G20 urged leaders in the Eurozone to stand behind their currency and deal with their problems. But the challenge of implementation remains, and it is vital for the details to be finalised. The threat to the UK economy from the crisis in the Eurozone is very serious. The Eurozone has the financial capacity to restore stability. So the institutions and leaders of the Eurozone need to act without delay. Resolving the Eurozone crisis would provide the single biggest boost to global confidence, including for the UK economy.

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

Yours sincerely,

GEORGE OSBORNE