BANK OF ENGLAND
LONDON EC2R 8AH

14 February 2011

The Rt Hon George Osborne
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Chancellor,

In November, I wrote an open letter to you because CPI inflation had remained more than one percentage point above the 2% target. In it, I explained that inflation was likely to remain elevated throughout 2011. Tomorrow, the Office for National Statistics (ONS) will publish data showing that CPI inflation was 4.0% in January. As a result, I am writing a further open letter to you on behalf of the MPC.

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.

Why has inflation moved away from the target?

As I have described in previous open letters, three factors can account for the current high level of inflation: the rise in VAT relative to a year ago, the continuing consequences of the fall in sterling in late 2007 and 2008, and recent increases in commodity prices, particularly energy prices. Although one cannot be sure, prices excluding the effects of these factors would probably have increased at a rate well below the 2% inflation target.

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

There is a great deal of uncertainty about the medium-term outlook for inflation. And I do not wish to conceal that there are real differences of view within the Committee, reflecting different judgements about the risks to that outlook.

Inflation is likely to continue to pick up to somewhere between 4% and 5% over the next few months, appreciably higher than when I last wrote to you. That primarily reflects further pass through from recent increases in world commodity and energy prices. The MPC's central judgement, under the assumption that Bank Rate increases in line with market expectations, remains that, as the temporary effects of the factors listed above wane, inflation will fall back so that it is about as likely to be above the target as below it two to three years ahead. The MPC judges that attempting to bring inflation back to the target quickly risks generating undesirable volatility in output and would increase the chances of undershooting the target in the medium term.

As I noted above, members of the Committee hold differing views about the risks to inflation in the medium term. On the downside, the main risk is that the substantial margin of spare capacity will cause inflation to fall below target in the medium term. That risk could be exacerbated if growth in the economy is weaker than expected, for example if household saving is higher than expected. Opposing these downside risks, there are also significant upside risks to the medium-term outlook for inflation. The period of above-target outturns for inflation could cause inflation expectations to move up and thereby affect wage and price setting. And import price inflation could remain elevated. A fuller and more comprehensive description of the factors affecting the outlook for inflation in the medium term will be set out in the February *Inflation Report* to be published this week on Wednesday 16 February.

What policy action are we taking?

Inflation is likely to remain above the target for this year, before falling back in 2012. The key consideration for monetary policy is the balance of risks to the outlook for inflation relative to the target in the medium term. At its February meeting, the MPC judged that it was appropriate to maintain Bank Rate at 0.5% and maintain the stock of purchased assets financed by the issuance of central bank reserves at £200 billion in order to balance those risks. But every member of the Committee is conscious that there are large risks in both directions. And no one should be in any doubt that when the balance of risks requires it, every member of the Committee is determined to act to adjust policy in order to bring the risks back into balance.

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

The best contribution monetary policy can make to high and stable levels of growth and employment is to ensure price stability in the medium term. The Committee will set policy, in the light of the economic outlook, in order to return inflation to 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

Mervyn King