BANK OF ENGLAND
LONDON EC2R 8AH

15 August 2011

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

Dear Chancellor,

The Office for National Statistics will publish data tomorrow showing that CPI inflation was 4.4% in July. As it is three months since I last wrote an open letter to you, and CPI inflation remains more than one percentage point above the target, 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 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?

Inflation was above the 2% target throughout 2010 and has risen further this year. The current elevated rate of inflation continues to reflect the temporary impact of the factors described in recent *Inflation Reports* and my previous letters: the increase in the standard rate of VAT to 20%, and past increases in global energy prices and import prices. Although it is impossible to identify the effects of those factors with precision, it is likely that inflation would be below target in their absence.

Over what period do we expect inflation to return to the target?

As set out in the August *Inflation Report*, it is likely that inflation will rise to around 5% in the coming months, boosted by increases in utility prices, and reflecting the continuing effects of the temporary factors described above.

Inflation should then fall back through 2012, as those effects dissipate and downward pressure from slack in the labour market persists, although the precise timing and extent of that fall are highly uncertain. At the time of its August meeting, the Committee judged that, based on the conditioning assumptions that Bank Rate follows a path implied by market interest rates and the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion, the chances of inflation being above or below the target were roughly equal in the medium term. There have been significant movements in financial asset and energy prices since the time of that meeting. The Committee will continue to monitor those developments closely and will consider their implications for the inflation outlook at its meeting in September.

What policy action are we taking?

Although the Committee's central view is that inflation is likely to fall back in 2012, very significant uncertainties and risks around the outlook for inflation remain. The Committee seeks to balance these risks to the inflation outlook, relative to the target, when making its policy decisions.

On the upside, the key risk remains that the sustained period of above-target CPI inflation may push up on inflation expectations, or lead to some resistance to the erosion of real take-home pay, putting upward pressure on wages and prices. Inflation will continue to be sensitive to fluctuations in global commodity and trade prices, but recent evidence of a moderation in global growth suggests that the risk of significant increases in those prices has diminished somewhat.

On the downside, the key risk is that demand growth will not be sufficiently strong to soak up the pool of spare capacity in the economy, leading inflation to fall materially below target in the medium term. Recent developments in world stock markets and in the euro area are of particular concern. Several member countries face substantial challenges in ensuring the sustainability of their fiscal positions and preserving the stability of their banking systems. There is a risk that this could lead to further severe stress and dislocation in financial markets and, were this risk to crystallise, it would have a significant impact on the UK economy.

The upside and downside risks are discussed more fully in the August *Inflation Report*. There is a range of views among Committee members over the balance of risks around the inflation outlook. But every member is determined to adjust the degree of monetary stimulus as required in order to return inflation to the target in the medium term, mindful of the risk of generating undesirable volatility in output by attempting to bring inflation back to the 2% target too quickly. At the August meeting, the Committee judged it was appropriate to maintain Bank Rate at 0.5% and the stock of purchased assets financed by the issuance of central bank reserves at £200 billion.

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

The big risks currently facing the UK economy come from the rest of the world. In responding to those risks, or indeed to other risks in either direction, the MPC can use Bank Rate or asset purchases to achieve its objective. There is, however, a limit to what monetary policy can do when

large real adjustments are required. And it cannot influence inflation over the next few months. But it can ensure that the adjustment takes place against a backdrop of low inflation in the medium term. In so doing, monetary policy will make the best contribution it can to high and stable levels of growth and employment.

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