BANK OF ENGLAND
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14 November 2011

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 will publish data tomorrow showing that CPI inflation was 5.0% in October. In August 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 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 2% 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 November *Inflation Report* on Wednesday 16 November.

Why has inflation moved away from the target?

CPI inflation fell back to 5.0% in October. But it remains well above the 2% target. As described in previous letters and *Inflation Reports*, the current high level of inflation reflects the increase in the standard rate of VAT earlier this year, and previous steep increases in import and energy prices, including recent domestic utility price rises. In the absence of those temporary factors, it is likely that inflation would have been below the 2% target.

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

As the impetus from external price pressures dissipates, and the increase in VAT drops out of the annual comparison early next year, the Committee's best collective judgement is that inflation will fall back sharply in the next six months or so, and continue falling thereafter to around target by the end of next year.

While we can be confident about the direction of change of inflation over the coming months, we remain uncertain about the precise pace and extent of the drop in inflation. It could fall back more slowly if companies attempt to restore profit margins by raising their prices, there is significant further pass through from previous increases in import prices, or the sustained period of above-target inflation becomes embedded in wage and price-setting behaviour. But it is also possible that inflation could fall back more sharply given the existing margin of spare capacity in the economy, the substantial risks around the global economic recovery and the implications of a further slowdown in the world economy for the United Kingdom.

What policy action are we taking?

The key consideration for monetary policy is the outlook for inflation in the medium term, and the balance of risks around it, rather than the current rate of inflation. Since my previous letter, world growth has slowed and uncertainty about the prospects for the global economy, and in particular the euro area, has increased. Those developments, and accompanying falls in household and business confidence in the United Kingdom, 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. That made it more likely that inflation would undershoot the 2% target in the medium term, and is why, at its October meeting, the MPC voted unanimously to maintain Bank Rate at 0.5%, and to increase the size of its asset purchase programme by £75 billion. At its November meeting, the MPC judged that 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 £275 billion in order to balance the risks to the inflation outlook, relative to the target, in the medium term. Further details of the MPC's latest projections will be set out in the November *Inflation Report* to be published later this week.

In evaluating the outlook for inflation, the Committee will continue to monitor closely wage growth, credit conditions, measures of inflation expectations, indicators of spare capacity, and overseas developments. The MPC stands ready to respond accordingly to changes in the balance of risks to the inflation outlook.

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

The main risk facing the UK economy continues to come from the uncertain global economic outlook, and the extent to which weaker global economic conditions threaten the recovery, and to postpone the necessary rebalancing of the UK economy. The MPC can use Bank Rate or asset purchases to help ease the adjustment of the UK economy to these shocks, but there is a limit to what it can achieve when real adjustments are necessary. 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 in the medium term. 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