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

12 February 2015

Mark Carney
Governor
The Bank of England
Threadneedle Street
London EC2R 8HA

Dear Mark,

CPI INFLATION

Thank you for your letter of 12 February on behalf of the Monetary Policy Committee (MPC) regarding December's CPI inflation figure, written under the terms of the MPC's remit.

Inflation has fallen markedly, to 0.5% in December 2014, triggering the first open letter for inflation falling more than 1 percentage point below target.

As set out in my Royal Economic Society lecture on 14 January, I share the view that the low inflation recently experienced in the UK has mostly been driven by global factors, notably the sharp fall in oil prices and the decline in food prices. Earnings growth has recently been showing signs of strengthening, with total pay up 1.7% on the year according to the latest data, and now rising faster than inflation.

I note you say the economy is growing strongly, unemployment is falling and earnings growth has been picking up in recent months. Our economic plan is delivering stability and growth at home, in the face of rising instability around the world.

I agree with you that a few months of very low or even negative inflation, driven mainly by external factors, does not in and of itself mean that we run the risk of generalised deflation. Indeed lower energy and food prices are welcome news for Britain's households, which is why we are robust in insisting they are passed on in lower pump prices and utility bills, and we should not confuse this with the threat of persistent low inflation.

Your latest forecast supports this assessment, showing that while inflation is likely to remain low for the next year or so, this mostly reflects the recent falls in commodity and food prices, so that inflation then returns to target in two years' time.

In 2013, I updated the MPC remit to clarify the Government's expectations of the MPC in terms of the judgements it must make in setting and communicating policy. In particular, it recognised that inflation will on occasion depart from its target as a result of shocks and disturbances. Attempts to keep inflation at the target in these circumstances may cause undesirable volatility in output and could potentially create risks to financial stability. It also clarified how the MPC and the Financial Policy Committee (FPC) should interact.

Your letter provides a clear assessment of considerations and trade-offs guiding decisions from the MPC when considering the appropriate approach to, and horizon for, bringing inflation back to target, including implications for output volatility and risks of possible financial imbalances. Clear communication is particularly important at this time of heightened global uncertainty.

In the UK, our monetary framework is well equipped to deal with negative inflation shocks, just as the MPC was able to look through the surge in commodity prices in 2010 and 2011.

Monetary policy has a critical role to play in supporting the economy as the Government delivers on its commitment for necessary fiscal consolidation. The Government has ensured that monetary policy can continue to play that role fully by updating the UK's monetary policy framework and MPC remit at Budget 2013.

As set out in my remit letter to the MPC, the Government's commitment to the 2% inflation target remains absolute. This target is symmetric: deviations below the target are treated the same way as deviations above the target. Symmetric targets help to ensure that inflation expectations remain anchored and that monetary policy can play its role fully.

I therefore welcome that the MPC remains vigilant to both upside and downside risks to its forecast and stands ready to act if these risks materialise, to ensure inflation remains likely to return to target within two years.

I note the MPC's assessment that the UK's banking sector is now stronger and operating with substantially more capital, meaning that, were downside risks to materialise, there would be scope for cutting Bank Rate below its current level of 0.5%.

This approach is consistent with the Government's economic policy objective of achieving strong, sustainable and balanced growth that is more evenly shared across the country and between industries.

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

George Osborne.

GEORGE OSBORNE