

HM Treasury, I Horse Guards Road, London, SWIA 2HQ

4 August 2016

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

Dear Mark,

CPI INFLATION

Thank you for your letter of 4 August on behalf of the Monetary Policy Committee (MPC) regarding June's CPI inflation figure, written under the terms of the MPC remit.

As you expected at the time of your May letter, inflation has remained below 1 per cent in the past few months. I agree with your assessment that falling commodity prices and the past appreciation of sterling explain most of the deviation from target.

You make clear that in its August Inflation Report the MPC expects the vote to leave the European Union (EU) will lead to a materially lower path for growth and a somewhat higher path for inflation than set out in May. I agree with you that the UK economy is highly flexible and dynamic which will help it move to a new equilibrium. The UK economy is also fundamentally strong — employment is at a record high, there are almost a million new businesses since 2010 and the budget deficit has been reduced by almost two-thirds as a share of GDP.

The vote to leave the EU has created a period of uncertainty, which will be followed by a period of adjustment as the shape of our new relationship with the EU becomes clear and the economy responds. The strength of the economy as we enter this period means we are well-placed to deal with both the short term volatility and the longer term adjustment.

In line with the requirements in the MPC remit, 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. I note that the MPC judges it likely that without monetary policy action output would be lower, unemployment would be higher and slack greater.

You make clear the MPC's judgement that fully offsetting the persistent effects of sterling's depreciation would lead to an undesirable loss in output and employment and would be less likely to generate a sustainable return of inflation to the target beyond the three-year forecast horizon. The MPC has therefore set policy such that inflation settles at its target

over a longer period than usual to mitigate some of the adverse effects of the shock to growth.

Alongside the actions the Bank is taking, I am prepared to take any necessary steps to support the economy and promote confidence. I am clear that the UK starts from a position of strength to take advantage of the opportunities that we will have as we forge a new relationship with the EU. The government will set out its fiscal plans at Autumn Statement in the normal way, once the Office for Budget Responsibility has produced a new forecast.

As set out in the MPC's remit, active monetary policy has a critical role to play in supporting the economy. In these uncertain times clarity about our macroeconomic framework is vital. I confirm that the government's commitment to the current regime of flexible inflation targeting, with an operational target of 2% CPI inflation, remains absolute. The 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 also 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 in a timely fashion.

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

PHILIP HAMMOND