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

13 May 2015

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

Dear Mark,

CPI INFLATION

Thank you for your letter of 13 May on behalf of the Monetary Policy Committee (MPC) regarding March's CPI inflation figure, written under the terms of the MPC remit.

As expected at the time of your first open letter in February 2015, inflation has continued to decline, reaching 0.0% in March 2015 and triggering a second open letter for inflation falling more than 1 percentage point below target.

I agree that the underlying causes of below target inflation remain broadly the same as those described in February, as falls in the prices of food and energy and some other imported goods continue to explain most of the deviation from target.

I also agree with your assessment that a temporary period of falling prices driven mainly by one-off external factors does not in and of itself mean that we run the risk of generalised deflation.

Temporary negative inflation rates driven by falls in commodity prices actually boost households' real take-home pay and support growth in real disposable income, which is welcome news for Britain's households. Indeed, as set out in your letter, real disposable income is expected to rise more strongly in 2015 than in any year since 2007. The Office for Budget Responsibility expects real household disposable income to be higher this year than ever before.

This is why we have been robust in insisting that lower energy prices were passed on in lower pump prices and utility bills – resulting, as noted in your letter, in a 14% decline in the average price of unleaded petrol in the year to March and a 4% decline in the retail price of gas in the first quarter of the year.

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.

Today I want to re-affirm that the Government's commitment to the current regime of flexible inflation targeting, with an operational target of 2% CPI inflation, remains absolute.

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.

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 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 in a timely fashion.

Ultimately, the credibility of our economic policy rests on the strength of our public finances. This new Government now has a clear mandate to take the steps needed to return them to surplus and ensure continued economic security.

I am depositing this letter immediately in the libraries of both Houses and on the Treasury website.

GEORGE OSBORNE