INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

A renewed recovery is now underway in the United Kingdom, and it appears to be broadening. While that is certainly welcome, the legacy of the financial crisis means that the recovery remains weak by historical standards, and there is still a significant margin of spare capacity in the economy. This is most clearly evident in the high rate of unemployment.

It is now more important than ever for the Monetary Policy Committee (MPC) to be clear and transparent about how it will set monetary policy in order to avoid an unwarranted tightening in interest rate expectations as the recovery gathers strength. That is why the MPC is today announcing explicit state-contingent forward guidance. Our aim is to help secure the recovery, while ensuring that risks to price stability and financial stability are well contained.

There are clear signs that economic activity has strengthened this year. Recent positive indicators have led the MPC to revise up its growth projection significantly in this *Inflation Report*. Nevertheless, even under the assumption that the current exceptionally stimulative monetary stance is maintained throughout the projection horizon, the MPC expects annual growth to be only 2.4% in two years' time – a rate still a little below its historical average. Moreover, the level of GDP is not expected to regain its pre-crisis peak until a year from now. This is the slowest recovery in output on record.

While job growth has been a relative positive in recent years, unemployment is still high. There are one million more people unemployed today than before the financial crisis; and many who have jobs would like to work more than they currently can. The weakness in activity has also been accompanied by exceptionally weak productivity. It is for these reasons that the MPC judges there to be a significant margin of slack in the economy, even though the extent of that slack, particularly the scope for a productivity rebound, is very uncertain.

What is clear is that, even under conservative assumptions about the scope for a productivity rebound, the elimination of the margin of spare capacity will require a sustained period of robust growth. The MPC can help to deliver that, but only if it is consistent with our primary objective to maintain price stability.

CPI inflation was 2.9% in June, and is likely to remain around that level in the near term, as it continues to be pushed up by past increases in import prices and an unusually large contribution from administered and regulated prices. Nevertheless, underlying domestic inflationary pressures remain subdued. That is why, as shown in Chart 3 on page 8 of the *Report*, even on the assumption that Bank Rate remains at its current level and a sustained period of growth is delivered, inflation is expected to fall back to the 2% target only a little after the 2-year horizon. For that reason, the MPC's judgement is that the path of market interest rates implies a faster withdrawal of monetary stimulus than appears likely given the current economic outlook.

Above-target inflation, coupled with a depressed level of output, make for an exceptionally challenging environment in which to set monetary policy. The uncertainty over the degree of slack in the economy, and the responsiveness of productivity to the emerging recovery, makes the MPC's task harder still. In these unprecedented circumstances, the MPC has to decide how quickly to return inflation to target and how much support it is able to provide to activity. The second document we are publishing today describes these trade-offs inherent in setting monetary policy, and how we are responding to them.

It was in this context that the MPC agreed at its meeting last week to adopt forward guidance. The MPC intends, at a minimum, to maintain the currently exceptionally accommodative stance of monetary policy until economic slack has been substantially reduced, provided that this does not put at risk either price stability or financial stability.

In practice, that means the MPC intends not to raise Bank Rate above its current level of 0.5% at least until the Labour Force Survey headline measure of unemployment has fallen to a threshold of 7%. While the unemployment rate remains above 7%, the MPC stands ready to undertake further asset purchases if further stimulus is warranted. But until the unemployment threshold is reached the MPC intends not to reduce the stock of asset purchases from the current £375 billion.

The Bank of England's unwavering commitment to price stability and financial stability is such that this threshold guidance will cease to apply if material risks to either are judged to have arisen. In that event, the unemployment threshold would be 'knocked out'. The guidance will remain in place only if, in the MPC's view, CPI inflation 18 to 24 months ahead is more likely than not to be below 2.5%, medium-term inflation expectations remain sufficiently well anchored, and the FPC has not judged that the stance of monetary policy poses a significant threat to financial stability that cannot otherwise be contained through the considerable supervisory and regulatory policy tools of the various authorities. The two inflation knockouts ensure that the guidance remains fully consistent with our primary objective of price stability. The financial stability knockout takes full advantage of the new institutional structure at the Bank of England, ensuring that monetary and macroprudential policies coordinate to support a sustainable recovery. The knock-outs would not necessarily trigger an increase in Bank Rate – they would instead be a prompt for the MPC to reconsider the appropriate stance of policy.

Similarly, it is important to be clear that Bank Rate will not automatically be increased when the unemployment threshold is reached. Nor is 7% a target for unemployment. The rate of unemployment consistent with medium-term price stability – a rate that monetary policy can do little to affect – is likely to be lower than this. So 7% is merely a 'way station' at which the MPC will reassess the state of the economy, the progress of the economic recovery, and, in that context, the appropriate stance of monetary policy.

The threshold guidance we are announcing today makes the current exceptionally stimulative monetary stance more effective in three ways:

- it reduces uncertainty about the future path of monetary policy, in particular helping to avoid the risk that market interest rates rise prematurely as the recovery gains traction;
- it provides greater clarity regarding the MPC's view of the appropriate trade-off between the horizon over which inflation is returned to the target and the speed with which growth and employment recover; and
- it gives monetary policy greater scope to explore the potential sustainable level of employment and output without putting price and financial stability at risk.

Today's *Inflation Report* contains for the first time, in Chart 5.10 on page 47, the MPC's projection for unemployment. It shows that, with Bank Rate remaining constant at 0.5% throughout the 3-year forecast period, the MPC's best collective judgement is that the median unemployment rate at the end of the projection period is 7.3%. Chart 5.11 on page 48, also new in this *Report*, shows that unemployment is judged by the MPC to be as likely to reach the 7% threshold beyond the three year forecast horizon as before.

It is important to stress that forward guidance does not mean the MPC is promising to keep interest rates low for a particular period of time. The path of Bank Rate and asset purchases will, as always, depend on economic conditions. What is new is that the MPC, given current exceptional circumstances, is today setting out the conditions that will need to be met before we consider increasing Bank Rate or reducing our stock of asset purchases. We are introducing forward guidance as part of a mixed strategy that also includes Bank Rate at a historic low, asset purchases and the Funding for Lending Scheme. That strategy is complemented by the use of the Bank's other policy tools – in particular, recent actions to increase the resilience of the UK banking sector.

There is understandable relief that the UK economy has begun growing again. But there should be little satisfaction. Much is at stake as we seek to secure this recovery and return inflation to the target. A fall in unemployment from 7.8% now to the 7% threshold would, given the normal growth of the labour force, mean well over three quarters of a million new jobs over the three-year forecast period. A recovery in productivity driven by a recovery in demand would mean faster growth of real incomes. Such outcomes would represent real improvements in the lives of people across the nation. That is why the MPC has made clear its intention, while remaining committed to price and financial stability, to conduct monetary policy to secure the recovery.