

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

As I am sure you all know, this is the 20th birthday edition of the *Inflation Report*. The *Report* was born in challenging times. When I sat in front of you in 1993, unemployment had just reached its peak of 3 million. But, although we did not know it at the time, a recovery was underway. Twenty years later, after a financial crisis and deep recession, unemployment is again much too high, and output is still below its level 5 years ago. Yet there is cause for optimism. Today too, a recovery is in sight.

Although output has been broadly flat for the past two years, that masks a more encouraging underlying picture. The bulk of the economy – primarily the services and manufacturing sectors together – actually grew at the steady, if unspectacular, rate of 1.2% over 2012. That is similar to the headline growth rate of 1.5% seen in the US, and considerably stronger than the consensus expectations for growth in Japan and the euro area. The weakness in overall output in large part reflects sharp falls in construction that are unlikely to be repeated in 2013.

The UK economy is therefore set for a recovery. That is not to say that the road ahead will be smooth. This hasn't been a normal recession, and it won't be a normal recovery. Our economy faces big challenges stemming from an abrupt and substantial reassessment of future economic prospects triggered by the financial crisis. Downward revisions to households' and businesses' expectations of future incomes, and an increase in uncertainty, have reduced private demand at home. Heightened uncertainty about the solvency of banks has led to a reduction in the supply of credit. And the same factors acting abroad have resulted in a fall in demand for our exports. Those are the forces that have shaped the economic landscape since 2008, and continue to shape the outlook in this *Inflation Report*.

The Committee's overall judgement about the outlook for four-quarter GDP growth is summarised in Chart 1 on page 6 of the *Report*. As usual, it is based on the assumptions that

Bank Rate follows a path implied by market interest rates, and that the size of the Bank's asset purchase programme remains at £375 billion. Growth is likely to be weak in the near term. But further out, a continued easing in domestic credit conditions – supported by the Bank's asset purchase programme and the Funding for Lending Scheme – together with a stronger global backdrop, underpin a slow recovery in output.

Inflation has remained stubbornly above the 2% target, and was unchanged in January at 2.7%. Increases in university tuition fees and domestic energy bills, largely resulting from administrative decisions rather than market forces, have added to inflation recently. These and other administered and regulated prices contributed around 1 percentage point to inflation at the end of last year, more than double the historical average. They are likely to push up on inflation over much of the forecast period, making the challenge of bringing inflation back to 2% more difficult.

The Committee's best collective judgement of the outlook for CPI inflation is summarised in Chart 3, on page 7 of the *Report*. It is based on the same assumptions about monetary policy as Chart 1. Inflation is likely to rise further in the near term and may remain above the 2% target for the next two years, reflecting sterling's recent depreciation and the persistent contribution from administered and regulated prices. That persistent contribution is increasingly offset by a gentle moderation in domestic cost growth, and an easing in external price pressures, such that inflation is likely to fall back to around the target by the end of the forecast period. The outlook for inflation over much of the forecast period is higher than in the November *Report*, reflecting the impacts of administered prices and the lower exchange rate.

You might be tempted to think that an above-target inflation forecast justifies a tighter monetary policy. Certainly, ensuring that inflation returns to target in the medium term is our primary responsibility and objective. But the MPC's remit is to deliver price stability in the medium term in a way that avoids undesirable volatility in output in the short run. The prospect of a further prolonged period of above-target inflation must therefore be considered alongside the weakness of the real economy. Attempting to bring inflation back to target sooner would risk derailing the recovery and undershooting the target in the medium term. So long as domestic cost and price

pressures remain subdued, we will continue to look through the temporary, albeit protracted, period of above-target inflation in order to support the recovery in growth and employment.

That policy stance is already exceptionally supportive of output. Interest rates are close to zero and the Bank's balance sheet has expanded by a factor of five since before the financial crisis. Expressed as a share of GDP, the increase in our balance sheet since 2007 is greater than that in the United States, Japan or the euro area. But, if necessary, we will do more. At its meeting last week, the Committee agreed that it stood ready to provide additional monetary stimulus if warranted by the outlook for growth and inflation.

We must recognise, however, that there are limits to what can be achieved via general monetary stimulus – in any form – on its own. Monetary policy works, at least in part, by providing incentives to households and businesses to bring forward spending from the future to the present. But that reduces spending plans tomorrow. And when tomorrow arrives, an even larger stimulus is required to bring forward yet more spending from the future. As time passes, larger and larger doses of stimulus are required.

Other more targeted policy measures are an essential complement to monetary policy if we are to help the economy along the road to recovery. For example, we must ensure that the banking sector is in a position to support the economy. That is why the Financial Policy Committee, working closely with the embryonic Prudential Regulation Authority, is trying to ensure that banks either restructure their balance sheets or raise an appropriate amount of new capital. And it is why, in the interim, we have put in place the Funding for Lending Scheme, which has helped to ease credit conditions – especially in the mortgage market – at a time when banks' funding costs are high compared to policy rates.

When there are limits to how much we can boost domestic demand through general monetary stimulus, we must focus our efforts in two areas. The first is to put in place measures aimed at boosting the supply capacity of our economy. Supply reforms can, by raising expected future incomes, increase the rate of return on new investment and encourage spending, both investment and consumption, today. There has never been a better time for such supply

reforms. The second is to find ways of boosting overseas demand for our products in order to bring about the rebalancing that the UK economy needs to see. In the end the rate at which we can grow will depend on world demand.

If we are to see a return to growth and stability over the next 20 years, not only the UK economy, but the world economy as a whole, must find a way to a new equilibrium in which there is a rebalancing of world demand. Those are not challenges that can be resolved by monetary policy alone, nor can they be resolved by any one country alone.

Today's *Report*, and the eighty that have preceded it, have documented the ups and downs of the UK economy over two periods that could hardly have been more different – a 'Great Stability' and a 'Great Recession'. When I introduced the first *Report* the turmoil of our exit from the Exchange Rate Mechanism was only just beginning to fade. Our subsequent recovery from the 1990s recession was aided by strong global growth, and monetary policy delivered fifteen years of stability. The experience of the past five years has shown us that UK monetary policy alone cannot guarantee a stable path for our economy, especially after a banking crisis. The challenge of rebalancing the world economy means that our road to recovery will be harder than in 1993. But recover we will.