INFLATION REPORT PRESS CONFERENCE

Wednesday 13 August 2014

Opening Remarks by the Governor

The expansion is on track and sustained economic momentum is looking more assured.

Robust, broadly based growth over the past year has taken output above its pre-crisis peak.

The MPC has revised up its expectation for near-term growth to 3½% this year and we now expect headline activity to slow a little later than we had previously thought.

Unemployment has fallen sharply and is now expected to drop below 6% by the end of the year and to around 5.5% by the end of the forecast period - a marked reduction relative to our expectations in May.

The MPC expects inflation to remain at, or slightly below, 2%, before reaching the target at the end of the forecast period.

As I said in Glasgow recently, as the economy normalises, Bank Rate will need to start to rise in order to achieve the inflation target.

But the MPC has no pre-set course. The path of Bank Rate will depend on how the expansion proceeds and how the inflation outlook evolves.

This expansion faces some challenges.

Geopolitical risks have intensified, and structural adjustment continues in the euro area, where growth is expected to be modest.

Financial conditions are likely to tighten as the global recovery progresses.

And sustained expansion here at home will ultimately require growth in productivity and real incomes, both of which have disappointed.

Thus far, output growth has been more than matched by record employment growth.

More than eight hundred thousand jobs have been added in the past year. Total hours worked have risen even more sharply. And the participation rate has reached its highest level in almost a quarter of a century.

All of these labour market signals tell us that slack is being used up at a faster pace than we had anticipated.

But that's not the end of the story. A range of other indicators suggest there was more slack in the first place.

In particular, pay growth has been remarkably weak, even as unemployment has fallen rapidly.

This may partly reflect lags.

But it also seems there has been an increase in labour supply at a given wage rate, especially among older age groups.

That represents not just the persistence of past trends. It might also partly stem from recent reforms to retirement and benefit rules, as well as concerns of households about the need to service debts and provide for pensions.

Whatever the causes, these developments point to the economy being able to sustain a higher level of employment and lower rate of unemployment without generating additional inflationary pressures. Indeed, continued low wage growth has enabled firms to expand their margins despite the sharp increase in employment.

Not surprisingly, there is a wide range of views on the Committee about the likely degree of spare capacity in the economy. In the Committee's best collective judgement, the degree of slack has narrowed somewhat, and our central estimate is now broadly in the region of 1% of GDP.

In light of the heightened uncertainty about the current degree of slack, the Committee will be placing particular importance on the prospective paths for wages and unit labour costs. To be clear, the MPC does not have a particular threshold for wage growth; rather we will continue to monitor a broad range of data to assess overall inflationary pressures and the timing of the first increase in Bank Rate.

The Committee's guidance remains unchanged: increases in Bank Rate, when they come, are likely to be gradual and limited.

While that is an expectation not a promise, its clarity is helping businesses to plan, invest and hire, supporting the economic momentum we see today and will need tomorrow.

The MPC's expectations for gradual and limited rate increases are shared broadly by markets. The path of Bank Rate implied by market yields, and on which this forecast is conditioned, rises by only 15 basis points per quarter and reaches only 2¼% by the end of the forecast period.

Those rate expectations stem from the persistence of the headwinds facing the economy. These include:

- muted demand in our major export markets, which is being reinforced by the persistent strength of sterling, now 14% above its trough in March of last year; and
- ongoing balance sheet repair in the public and private sectors.

Uncertainty about the sensitivity of the economy to changes in Bank Rate is another reason why gradual increases may be appropriate. Small, slow increases in Bank Rate should help mitigate the risk that higher borrowing costs trigger a sharp slowdown in domestic demand.

Even if spare capacity were to be eliminated at a stroke overnight, the appropriate level of Bank Rate would not be far from where it is today because of these headwinds.

Moreover, even when these headwinds have fully abated, the appropriate level of Bank Rate is likely to remain materially below its pre-crisis average for some time.

That's because higher capital, liquidity and other prudential requirements can be expected to lead to higher spreads between borrowing rates and Bank Rate than before the crisis.

And at the global level, the imbalance between saving and investment which drove global long-term interest rates down before the crisis appears no smaller now than it was then.

To conclude, the economy is returning to a semblance of normality.

In many respects the future will be familiar. The race against long-term unemployment is being won and unemployment can return to the low rates seen before the crisis.

However, whether tomorrow's normal rates for growth in activity and real incomes match those of the past rests ultimately on the extent to which productivity growth picks up. This remains an open question.

For its part, the MPC is committed to ensuring that normality continues to mean low, stable and predictable inflation. How we achieve that will reflect new realities. Interest rates can be expected to increase as the expansion progresses. But, given the broad forces acting on our economy, the normal interest rates of tomorrow are likely to be lower than those of yesteryear.