INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

The recovery has gained momentum. Output is growing at the fastest rate since 2007, jobs are being created at the quickest pace since records began, and after four years above target the inflation rate is back at 2%.

The recovery to date has been underpinned by a revival in confidence, a reduction in uncertainty, and an easing in credit conditions. This has led households to save less and spend more, and has prompted a strengthening in the housing market. While business investment has so far been subdued, recent data and surveys suggest that it is likely to gather pace this year.

The first phase of the MPC's forward guidance was put in place last summer when, following fears of a "triple dip" recession, the UK economy was just emerging from a long period of stagnation, persistent above-target inflation and subdued business and household confidence. Its principal aim was to help secure the nascent recovery by reassuring households and businesses across the UK that the Bank wouldn't raise interest rates until jobs, income and spending were really growing. Specifically, the MPC set a 7% unemployment rate as a threshold for even beginning to consider whether Bank Rate should be raised. That was a relatively easy call because the considerable slack in the economy at the time ensured that the MPC was not taking undue risks with inflation as monetary policy encouraged faster output and employment growth.

Forward guidance is working. Expected interest rates have remained low even as the economy has recovered strongly. Uncertainty about interest rates has fallen. Most importantly, UK businesses have understood the message. Surveys (described in this *Inflation Report* in a box on page 12) confirm what MPC members have heard as we travel the country: virtually all businesses understand guidance, and almost three-quarters of them say it has boosted their confidence in UK economic prospects. In many cases guidance is encouraging businesses to hire and spend. It has also helped to anchor inflation expectations. Finally, the forward guidance framework has highlighted a clear division of responsibilities between monetary and macro-prudential policy, freeing monetary policy to focus on achieving the inflation target in a manner that grows jobs and output, without being burdened by multiple, other objectives that are best addressed by more targeted measures.

As a result of exceptionally strong jobs growth – almost half a million more people have found work since August – the unemployment rate has fallen much faster than anticipated to 7.1%, and is likely to reach the 7% threshold by the spring. The MPC said last August that, once unemployment had reached the threshold, we would assess the state of the economy more broadly, drawing on a wide array of indicators. That assessment is provided in today's *Report.*

So what have we learned?

First, productivity growth has been disappointing.

There remain good reasons to expect an eventual revival in productivity but, given recent outturns, the MPC has taken a cautious approach. Productivity growth is expected to return to its pre-crisis average rate only around the end of the forecast (as described in the table on page 41 of the *Report*).

Second, there is greater slack in the labour market than we would have expected, given the strong jobs growth. In part that is because a substantial share of the fall in unemployment has been driven by a fall in the number of long-term unemployed. That means a lower level of unemployment is consistent with stable inflation. In addition, the share of people working part-time because they can't find a full-time job remains close to a record high, and almost half of the recent increase in employment has been driven by self-employment, which is now at a record level.

The Committee's overall assessment is that spare capacity of 1 – 1½ % of GDP remains concentrated in the labour market. The effect of this slack is evident in low wage inflation, which is at around 1% so that, even with weak productivity, unit labour costs are rising at an annualised rate of just 0.5%.

Third, the inflation environment is more benign than we had anticipated. In particular, inflation has fallen from 5% in 2011 back to the target for the first time since 2009. Global inflation is subdued, with core inflation in both the euro area and US close to 1%; commodity prices have fallen, and sterling has appreciated by 10% since its March trough. All of these developments will hold back imported inflation pressures that have to a great extent explained the above-target inflation over the past five years. In addition, administered and regulated prices now appear likely to put less upward pressure on inflation over the forecast period.

Fourth, we've learned that as yet the recovery is neither balanced nor sustainable. A few quarters of above trend growth driven by household spending are a good start but they aren't sufficient for sustained momentum. Activity is still below its pre-crisis level. Wage growth remains weak, and the household savings rate is likely to fall further. The pick-up in business investment is still in its earliest stages. The global outlook, though improved in the advanced world, entails growing downside risks in emerging markets.

So what's next?

The MPC has today outlined the next phase of guidance, setting out the factors that will guide its decisions and how Bank Rate is likely to evolve once the 7% unemployment threshold is reached. That guidance (which is summarised in the box on pages 8 and 9 of the *Report*) has five elements.

First, the MPC is for the first time today providing guidance that it is seeking to absorb all the spare capacity in the economy over the next two to three years. That recognises that spare capacity is both wasteful and increases the risk that inflation will undershoot the target in the medium term.

Second, the MPC is giving guidance that it judges that there remains scope to absorb spare capacity further before raising Bank Rate.

Third, the MPC is giving guidance that, if and when the time comes that the economy can sustain higher interest rates, Bank Rate is expected to rise only gradually. For a sustained and balanced recovery, the degree of stimulus will need to remain exceptional for some time.

The timing and pace of any increase in Bank Rate will reflect the degree of spare capacity and the pace with which it is being absorbed. The MPC will be monitoring a broad range of indicators including unemployment, participation in the labour market, average hours worked and the extent of involuntary part-time working, surveys of spare capacity in companies, labour productivity, and wages.

To allow others to monitor how the economy is evolving relative to our projections, today we are publishing for the first time forecasts of 18 more economic indicators. One thing we can guarantee is that the future outturns will differ from these forecasts, but publishing them should help others understand our key judgements and anticipate how monetary policy will respond to the evolution of the economy.

Fourth, the MPC is giving guidance that any increases in Bank Rate should be limited. This recognises that many of the headwinds holding back the economy will remain for some time yet. Public and private balance sheets continue to be repaired. Weak world demand and the appreciation of sterling will hold back the expansion of net exports. And there remain strains in the financial system despite good progress on post-crisis repair.

These persistent headwinds mean that, even in the medium term, the level of interest rates necessary to sustain low unemployment and price stability will be materially lower than before the crisis. While it is hard to be precise, one illustration of the possible level of Bank Rate in the medium term can be derived from the latest forecast based on a market curve which approaches only 2% three years from now. In this forecast, inflation is near but a little below target and the spare capacity gap narrows but does not quite close.

Finally, the MPC intends to maintain the stock of asset purchases until the first rise in Bank Rate.

The first phase of guidance was about the conditions that would have to be met before we would even begin to think about raising Bank Rate. Now we are outlining:

- *what* we intend to do: close the spare capacity gap over the next few years;
- *why* we intend to do it: to keep inflation at target and avoid wasteful spare capacity, particularly in the labour market; and

- *how* we intend to do it: first by waiting to raise Bank Rate until spare capacity has been absorbed further and then eventually through gradual and limited rate increases. Bank Rate may need to stay at low levels for some time to come.

The first phase of guidance gave businesses confidence that Bank Rate would not be raised at least until jobs, incomes and spending were growing at sustainable rates. As guidance evolves, that remains the case: the MPC will not take risks with the recovery.