

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

The overall outlook for GDP growth and inflation in this *Report* is little changed from February. The UK economy continues to perform strongly. Having increased by more than 3% in the past year output is now close to regaining its pre-crisis level, 700,000 more people are in work than a year ago, and inflation is below, but close, to the 2% target.

The economy has started to head back towards normal. The Monetary Policy Committee's (MPC) forecast sees the prospect of the economy moving:

- From a recovery supported by household spending to an expansion sustained by business investment;
- From falling to rising real wages; and
- From employment to productivity growth to support those wage increases and improve export competitiveness.

The sustained expansion that is now in prospect rests on these developments. And a sustained expansion is needed to meet the MPC's intention of absorbing spare capacity over the next few years, while keeping inflation close to the target.

There has probably been a modest narrowing in the margin of spare capacity over the past three months, as we had expected in February. Companies appear to be operating at around normal levels of capacity, but despite recent progress, significant slack remains in the labour market.

That slack is evident in the 1.4 million people who are working part-time because they are unable to find full time work, as well as in an unemployment rate of 6.8% that remains significantly above our estimate of its current equilibrium. Our slack estimate is in some respects cautious. It does not reflect that the long-term unemployed have recently been finding work at a faster rate than usual, nor does it allow for any of the unprecedented rise in

self-employment, which has accounted for over half of the increase in total employment since last summer, to represent additional 'hidden' slack.

Overall, while there is a range of views on the Committee, our best collective judgement is that the margin of spare capacity likely remains in the region of 1-1½ % of GDP.

Our central estimate is that spare capacity is likely to be used up more slowly than in the recent past, in part because output growth moderates but also because productivity growth is expected to resume. We continue to assume that productivity growth will recover only to its pre-crisis average rate by the end of the forecast period. Given the huge shortfall in productivity relative to its previous trend, this is cautious if prudent. Even with this assumption the margin of spare capacity is absorbed only by the end of the forecast period.

The time taken to absorb spare capacity is a reflection of the continued headwinds faced by the economy. The financial sector continues to heal. Public and private balance sheets continue to be repaired. Export growth faces a 10% appreciation of sterling over the past year. And growth in the world economy remains muted.

While risks around the euro area are now two-sided around a modest growth rate, there are downside risks from the consequences of the rapid growth of shadow banking in China. More broadly the MPC is alert to vulnerabilities from a reassessment of risk in financial markets, perhaps prompted by geopolitical developments or uncertainties about the normalisation of monetary policy. Despite a more complex global environment, implied volatilities in many markets are well below their long-term averages.

Heading back to normal will likely be accompanied by more normal, that is higher, levels of volatility.

The global picture is consistent with muted external inflationary pressures that, coupled with sterling's past appreciation, will moderate CPI inflation in the near term. Inflation has fallen sharply since the Autumn and is now around one percentage point lower than we had expected a year ago. We have interpreted this news largely as the result of one-off factors rather than lower underlying inflationary pressure.

Notwithstanding that cautious assumption, the outlook for inflation in the medium term remains benign. In the past three months, pay growth has edged up as expected and is likely to continue to do so as productivity growth improves and labour market slack diminishes, reaching around 2½% by the end of the year. However, unit labour cost growth of only 1% is expected over 2014, and remains consistent with meeting the inflation target in the medium term.

As time has moved on and the recovery has been sustained, the economy has edged closer to the point at which Bank Rate will need gradually to rise. The exact timing will inevitably be the subject of considerable speculation and interest. The ultimate answer will depend on the evolution of the economy, particularly the degree of slack, the prospects for its absorption, and the broader inflation outlook. The MPC will continue to monitor 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, wages and unit labour costs.

This should be kept in perspective. What matters above all is that the MPC, having confirmed that monetary policy will reflect the new guidance set out in the February *Inflation Report*, shares a common framework which has implications for the stance of monetary policy over the medium term.

- Monetary policy will be set to meet the inflation target over the forecast horizon, while using up wasteful spare capacity, particularly in the labour market;
- The actual path of Bank Rate will depend on economic developments;
- When Bank Rate does begin to rise, increases are expected to be gradual and limited, meaning that Bank Rate may need to stay at low levels for some time;
- When the time comes to begin to remove stimulus we will, as documented in a box in the *Report*, defer sales of assets at least until Bank Rate has reached a level from which it could be cut materially; and
- The MPC's flexibility to maintain extraordinary stimulus for as long as necessary is supported by close coordination with the Financial Policy Committee (FPC), which remains vigilant to any resulting risks to financial stability, including those associated with housing. Having taken initial steps in November, the FPC retains considerable flexibility over a graduated range of tools to manage those risks.

At its May meeting the MPC judged that there was scope to make further inroads into slack before the first increase in Bank Rate was necessary.

Our guidance is giving businesses and households confidence that we won't take risks with price stability, financial stability, or the incipient expansion. It will promote the recovery in business investment, productivity and real wages that a sustained expansion demands.

Amidst the excitement that output is close to regaining its pre-crisis level we should not forget that the economy has only just begun to head back towards normal.

Part of getting back to normal is to have sporting analogies in these press conferences, so let me put it like this. Securing the recovery is like making it through the qualifying rounds of the World Cup. That is an achievement, but not the ultimate goal. The real tournament is just beginning and its prize is a strong, sustained and balanced expansion. Across the Bank we are setting policy in order to help win that prize for the good of the people of the United Kingdom.