INFLATION REPORT PRESS CONFERENCE

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Opening remarks by the Governor

Since we last met, indicators across much of the advanced and emerging world have been moribund.

A spectre is now haunting Europe – the spectre of economic stagnation, with growth disappointing again and confidence falling back.

The US has been unique amongst our major trading partners in maintaining economic momentum.

In October, financial markets took fright. Prices of risky assets fell sharply and, for a period, there was a pronounced rise in volatility.

It is important to keep these developments in perspective when assessing the prospects for the UK. Economic conditions here continue to normalise.

Although the world outlook is undoubtedly softer than in August, the MPC's growth forecast for the UK is only slightly weaker.

That is because expectations for the stance of global monetary policy over the medium term have eased significantly, including for the UK.

Markets still expect Bank Rate to increase, but to a more limited extent and at a more gradual pace than they did in August. Real five-year, five-year forward rates are around ½ percentage point lower than in August.

With an increasingly well-functioning banking system, that change in market expectations is being passed through to the interest rates faced by British households and businesses. As one example, fixed mortgage rates have fallen to record lows.

In this *Report* we project growth of 3.5% this year, 2.9% next year, and 2.6% for each of the following two years.

Three factors explain why the UK can continue to grow at above-trend rates in the face of subdued world demand.

First, real take home pay growth is in prospect. 700,000 new jobs have been created in the last year and confidence is returning to the labour market. We are seeing the first tentative signs of the long-awaited pickup in wage growth. Real incomes will be further supported by lower energy, food and other import prices. Oil prices are now 20% lower than a year ago and food price inflation is at a 12-year low. The MPC expects annual real pay growth to pick up from around zero now to around 2% by the end of next year.

Second, despite developments abroad and a larger-than-anticipated slowing in the housing market, consumer confidence is being supported by the combination of lower effective interest rates, a strong labour market and improved pay prospects. During the transition to higher incomes, we expect the household saving rate to continue to drift down to relatively low levels, supporting the growth of demand.

Third, investment growth is strong. Although the Committee expects the support to the expansion from investment to be a little less pronounced than in August, investment is expected to continue growing at well above its historical average rate. That reflects expanding demand, improved credit conditions and the clarity that interest rate increases are likely to be gradual and limited.

Above-trend growth through the forecast period means that the economy will continue on its path towards normalisation. We expect unemployment to fall to pre-crisis levels and the output gap to continue to close.

There is a wide range of views on the Committee about the likely degree of spare capacity in the economy. Overall, the MPC's best collective judgement remains that slack is currently broadly in the region of 1% of GDP.

The main change to the MPC's projections is that the near-term outlook for inflation is materially lower than we had expected in August.

The near-term weakness means that it is more likely than not that I will have to write an open letter to the Chancellor in the next six months on account of the inflation rate falling below 1%.

The recent softness in inflation reflects a range of factors:

- the sharp fall in global commodity prices;
- more broadly, weaker inflationary pressures in our main trading partners;

- the past appreciation of sterling, and its continuing effect on imported inflation, which has subtracted around ¾ percentage point from CPI inflation over the past year; and,
- weak domestic inflationary pressures, reflecting the margin of spare capacity that has been present in the economy for some time. Unit labour costs have been flat, despite subdued productivity growth, as a result of the pronounced weakness of wage growth.

The best collective judgment of the Committee is that inflation is likely to remain close to 1% over the next year. Inflation then begins to return slowly towards the 2% target as:

- the pass-through from sterling eases;
- commodity prices stabilise;
- wages and unit labour cost growth pick up to rates consistent with achieving the inflation target; and,
- inflation expectations remain well-anchored.

We do not expect a rapid return of inflation to the target. Although they are not permanent, the forces subduing inflation today are likely to persist for some time. In today's projections, inflation returns to 2% only by the very end of the forecast period.

The risks to the outlook are now judged to be broadly balanced. The MPC judges that developments in the world economy mean some of the downside risks to growth in earlier projections have crystallised. The risks to inflation are also judged to be balanced, in part because the Committee has taken an even more conservative view of productivity and marked down its central expectation of the path for productivity growth.

Nevertheless, clear risks remain and the path for Bank Rate will depend on how those risks evolve. The last few months have shown that markets understand that our setting of Bank Rate is data-dependent. It is appropriate that, while a tightening in monetary policy remains in prospect, markets now expect somewhat easier monetary conditions over the forecast period than was the case three months ago.

That should not be taken as validating any particular date for the first rate increase. We have highlighted repeatedly that what really matters is the broad shape of monetary tightening over the medium term, rather than estimates of precisely when the process of normalisation will begin. The latter will continue to move around as the outlook evolves.

In that light, the central message of the Committee’s guidance remains relevant. When Bank Rate does begin to rise, it is expected to do so only gradually and to remain below average historical levels for some time to come.

While that is an expectation not a promise, its clarity is helping businesses to plan, invest and hire despite a challenging global environment. And it is helping businesses and households to focus on their day’s work, building the economic expansion, without being overly troubled by foreign nightmares.