

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

Today's *Inflation Report* headlines are relatively straightforward.

Inflation is at its lowest level since the introduction of Inflation Targeting two decades ago.

It will likely fall further, potentially turn negative in the spring, and be close to zero for the remainder of the year.

As a consequence, I have written the first open letter from a Governor to the Chancellor explaining why inflation is so low and what the MPC is going to do about it.

And I will likely write a few more before the year is out.

But as unusual as that is, it arguably isn't the main story.

The headlines today mask stronger underlying dynamics which will determine UK output and inflation tomorrow.

Growth in the global economy was a touch stronger last year than we had expected in November. And the outlook for the UK's trading partners is virtually unchanged since our last forecast.

Despite renewed headwinds from geopolitics and deleveraging, modest global growth is expected to continue, reflecting three factors.

First, oil prices have halved since six months ago. As these falls are more likely to reflect changes to the actual and potential supply of crude than reductions in demand for it, this development is unambiguously positive for the global economy.

Second, central banks around the world have provided additional stimulus. Most notably, recent ECB actions should provide much needed support to activity in our largest trading partner.

Third, partly as a consequence, global real interest rates have fallen further. And, notwithstanding increases in market volatility, financial conditions have improved on balance.

In the United Kingdom, output growth remains solid and domestic demand growth robust.

Unemployment has continued to fall, reaching its lowest level for more than six years, with half a million new jobs created in the past year. The margin of slack in the economy has narrowed further as expected. And as the labour market has tightened, growth rates of wages and unit labour costs are beginning to pick up.

The combination of rising wages and falling energy and food prices will help household finances and boost the growth of real take home pay this year to its fastest rate in a decade. This will support solid growth in consumer spending.

As demonstrated by the recent Bank of England stress tests, the core of our financial system is increasingly resilient and functioning well. Access to credit continues to improve and many borrowing rates are at or near historical lows.

Against that backdrop, surveys point to robust investment growth.

The result of these underlying dynamics is that today's projection for GDP growth is stronger than in November.

With that context, let me now turn to the open letter, starting with why is inflation so low.

The MPC estimates that two-thirds of the gap between the current inflation rate and the target is explained by sharp falls in food and energy prices. As I have explained, this is generally good news for British households.

Commodity prices do not, however, wholly explain why inflation is so low. The balance of the gap from target is the result of subdued generalised inflationary pressures. Core inflation is running at around 1.3%. This reflects a long period in which unemployment has been high and wage growth muted as well as the remaining degree of slack in the economy, currently judged to be in the region of ½ per cent.

The MPC's job is to provide clarity on the horizon over which it is aiming to bring inflation back to the target and then take the necessary actions to achieve it.

Our inflation target is symmetric. We care as much about inflation below target as above.

Our remit is clear that the inflation target applies at all times but it recognises that there will be occasions when inflation will deviate from the target.

It takes time for monetary policy to affect the economy – its peak effect is generally estimated between 18 and 24 months – so the MPC can do little to offset the effects of recent falls in energy and food prices on headline inflation.

With the effects of these large, one-off falls in prices likely to dissipate in around a year, we will look through them.

With inflation below target and unemployment above its long-run sustainable rate, there is no immediate trade-off between returning inflation to target and supporting economic activity. In fact, to return inflation to target it is necessary to eliminate the remaining degree of economic slack.

This makes it appropriate to return inflation to the target as quickly as possible after the effects of energy and food price movements have abated. In the MPC's judgment, the appropriate time horizon to do that is within the next two years.

This can be accomplished by adjusting the pace and degree of Bank Rate increases in coming years. Indeed, reflecting a broad understanding of our reaction function and the forces affecting inflation in the UK, market expectations of Bank Rate increases have fallen notably since November.

The inflation forecast in today's *Report* shows inflation coming back to the target within two years and then rising a little further.

That forecast assumes Bank Rate follows the path implied by market yields: gradual and limited increases over the forecast horizon.

That a gently rising path of Bank Rate delivers inflation to the target reflects the underlying dynamics of the economy.

With sustained growth, supported by robust real income growth and a subdued, but steady, global recovery, unemployment continues to fall to its pre-crisis rate of around 5%. The remaining slack in the economy is eliminated by the middle of the forecast period.

There are, as usual, risks on either side.

On the upside, the MPC is alert to the risk that lower oil prices provide a greater-than-assumed stimulus to real incomes and to demand, or that slack in the economy is absorbed faster than in the central case.

If these risks were to materialise, it could be appropriate for Bank Rate to rise more quickly than implied by current market yields.

On the downside, the MPC is vigilant to the risks of disappointing global growth or any signs that low inflation begins to affect inflation expectations and wage growth, and therefore becomes self-reinforcing.

Were these downside risks to materialise, the Committee could adjust the pace and degree of Bank Rate increases, expand the Asset Purchase Facility, or cut Bank Rate further towards zero.

The MPC judges the risks to today's forecast to be broadly balanced.

Whatever transpires, the Bank has the means, the will and the responsibility to set monetary policy to achieve the target over an appropriate horizon.

British workers and employers can count on that as they make important decisions about wages, hiring and investment.

The prospect of limited and gradual rate increases may not make the headlines, but they will likely be consistent with the continued normalisation of the UK economy and with meeting the 2% inflation target.