

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

A year ago inflation was rising and heading towards 5%. It has now fallen to within touching distance of the 2% target. The big picture in today's *Report* is of a further decline in inflation, as external influences fade and domestic cost pressures ease, and a gradual recovery in output. Nevertheless we are navigating rough waters and storm clouds continue to roll in from the euro area.

Output has contracted in each of the past three quarters, but the underlying picture is probably not as weak as the headline data suggest. The extra bank holiday in June is likely to have reduced output in Q2 by around ½%, an effect that should unwind in Q3. And a large fall in construction output in the first half of the year, which seems at odds with survey data, is unlikely to be repeated. Even looking through these erratic factors, though, the underlying picture is that output has been at best broadly flat over the past two years, and has continually disappointed expectations of a recovery.

In contrast, the labour market has remained surprisingly resilient in recent months. Private sector employment has grown robustly and unemployment has edged downwards. Although welcome news in its own right, the resilience of employment, combined with the weakness of output, means that productivity growth has been unusually low. That continues a recent pattern of both weak output and productivity growth that is difficult to explain. We cannot be sure how persistent that weakness will be, and that is one reason why the Committee has lowered its forecast for growth.

A major concern for the Committee in recent months has been the rise in bank funding costs, related to the euro-area crisis, which has fed through into higher rates for domestic borrowers. The new Funding for Lending Scheme, a joint Bank of England and Treasury initiative, was

designed to reduce those pressures. The Scheme provides incentives to banks and building societies to lend more to UK households and businesses. The design takes into account that, before the Scheme, a number of large banks planned to reduce their lending to the real economy. The Funding for Lending Scheme is bigger and bolder than any initiative so far tried to get the banks lending again. Although its overall impact is uncertain, the early indications are positive, with some banks cutting their loan rates. By the time of our next *Report* in November, I hope it will be possible to say more about the initial effects of the Scheme.

The economy will continue to face headwinds over the forecast period, from the fiscal consolidation and tight credit conditions at home, as well as from the difficulties in the euro area and a broader slowing in the world economy. The recession in the euro area is damaging demand for our exports; a black cloud of uncertainty is hanging over investment; and the weakening euro is a further obstacle to the adjustment we need to make in our net trade position. Our efforts to bring about a rebalancing of the UK economy will require patience.

The Committee's overall judgement about the outlook for four-quarter GDP growth is summarised in Chart 1 on page 6 of the *Report*. As usual, it is based on the assumptions that Bank Rate follows a path implied by market interest rates, and that the size of the asset purchase programme remains at £375 billion. In the near term growth is subdued, but further out the recovery gradually strengthens as some of the recent headwinds to growth abate and the policy stimulus announced since May takes effect. Consumption is supported by a gentle recovery in real take-home pay, as external price pressures fade, and the FLS helps to ease credit conditions. The overall outlook for growth is weaker than in May reflecting downside news in the near term and, in the medium term, the possibility that the weakness in output and productivity growth that we have seen since the financial crisis persists. GDP growth is more likely than not to be below its historical average rate in the second half of the forecast period.

CPI inflation has continued to fall from its high of 5.2% last September, reaching 2.4% in June, and is expected to fall further this year. Twice in the past four years inflation has risen above 5% as a result of external price pressures. On both occasions the Committee said that inflation would fall back, and on both occasions it has. Over the past three months, commodity prices

have fallen, and, as a result, the outlook for near-term inflation is lower than in May. The Committee's best collective judgement of the outlook for CPI inflation is summarised in Chart 3, on page 8 of the *Report*. It is based on the same assumptions about monetary policy as Chart 1. Inflation is likely to fall further from its current level to be around or a little below target for much of the forecast period, as the impact of external price pressures eases, and domestic cost pressures remain subdued. At the forecast horizon, the risks to inflation around the 2% target are broadly balanced.

Unlike the Olympians who have thrilled us over the past fortnight, our economy has not yet reached full fitness. But it is slowly healing. Many of the conditions necessary for a recovery are in place, and the MPC will continue to do all it can to bring about that recovery. As I have said many times, the recovery and rebalancing of our economy will be a long, slow process. It is to our Olympic team that we should look for inspiration. They have shown us the importance of total commitment when trying to achieve a goal that may lie some years ahead.