INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

In January, CPI inflation reached 4.0% – well above the 2% target – thus triggering a further exchange of open letters. But monetary policy has to be forward looking and so the real question relates not to its current level but to the outlook for inflation in the medium term.

Inflation is likely to remain high over the next year, and higher than the Committee expected three months ago. That mainly reflects further sharp increases in commodity and import prices in the past three months – gas and oil prices have risen by over 15% and food prices by about 20%. Taken together with the increase in VAT last month, those factors mean that prices are likely to rise sharply in the first half of this year. But unless food, energy and other commodity prices continue to rise at the same rate, CPI inflation will then fall back. And because inflation is measured as the increase in prices over the previous twelve months, the anticipated fall back in the official measure will lag the fall in actual inflationary pressures.

In the light of futures prices for energy, food and other commodities, the Committee judges that a reasonable central view is that measured inflation will begin to fall back next year. But the extent to which it will do so is uncertain, and there are large risks in both directions. On the one hand, if businesses and households come to expect inflation will remain elevated for longer, that may lead them to start to push up prices and wages more quickly than is consistent with the inflation target. On the other hand, as the effects of higher VAT and imported inflation diminish, there is also a risk that weak growth and persistent spare capacity will push inflation well below the target. And broad money growth remains low. Of course, if either risk were to materialise, the Committee would respond.

Chart 3, on page 7 of the *Report*, shows the Committee's best collective judgement of the range of outcomes for CPI inflation. It is based on the assumption that Bank Rate follows a path implied by market interest rates and that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. Inflation is likely to remain high throughout 2011, before falling back thereafter. In the medium term, the best collective judgement of the Committee is that the chances of inflation being above or below the target are broadly equal. But there are real differences of view among the Committee about the likely path of inflation in the medium term.

A key factor shaping the outlook for inflation is the extent to which spare capacity will persist over the forecast period. Around half of the shortfall in productivity, relative to its pre-crisis trend, is judged likely to persist for a considerable period. And other factors – such as low investment – will also have eroded supply capacity relative to previous trends. Nevertheless, there is evidence of a significant margin of spare capacity in the economy, not least from this morning's labour market data which show that unemployment remains at almost 8%. That is restraining inflationary pressure, even though its influence is masked by the temporary effects of higher VAT and imported inflation, and is likely to continue to do so. Earnings growth remains weak at around 2%.

The recovery is unlikely to be smooth. Output growth was weaker than expected in the final quarter of last year, and not only because of the effects of the snow. There will be ups and downs in quarter-to-quarter growth rates. But had it not been for snow in December, GDP growth over the course of last year would have been above 2%. And the rebalancing of the economy – necessary to ensure that the recovery is sustainable – is underway. Spending has begun to shift away from consumption – both private and public – towards exports. While consumption is being restrained by the effects of the fiscal consolidation and the squeeze on real incomes, exports are beginning to show the effects of the past depreciation of sterling as well as continuing robust growth in world demand. And investment is beginning to recover from low levels, supported by the strong cash balances in many companies.

That rebalancing is expected to continue over the forecast period. But there are particular uncertainties about the likely path of household saving and over the size and timing of the boost from net trade. Chart 1, on page 6 of the *Report*, shows the Committee's best collective judgement about the range of different outcomes for four-quarter GDP growth, under the same monetary policy assumptions used for Chart 3. The projection for four-quarter growth is weaker than in November for much of 2011, following the weak data around the turn of the year. But thereafter, the projection is similar to that set out in November, with broadly equal chances of growth being above or below its past average rate.

When setting policy it is important to distinguish between the reasons for the current overshoot of the inflation target and their implications for inflation in the medium term. On the first, only a very much deeper recession could have prevented the price-level shocks which the UK has experienced from pushing inflation above the target. It is the second issue which is relevant to monetary policy today, and there is plenty of room for differing views about the outlook for inflation two to three years ahead. The experience of above-target inflation may materially push up longer-term inflation expectations. Or it may not. Only time will tell. The judgements are difficult. I can only repeat that the MPC will continue to set policy to balance the upside and downside risks to inflation in order to meet our target in the medium term.