

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

When we met in August, the mood in markets had taken a turn for the worse. Since then, concerns about the sustainability of the euro area have intensified, and continue to affect market sentiment, asset prices and bond yields. Official meetings come and go, but the underlying global problems of trade imbalances, unsustainable levels of external and internal indebtedness and loss of competitiveness remain. Sovereign and bank funding concerns are symptoms of these underlying problems. The journey to a more balanced world economy will be long and arduous.

The immediate impact of the decline in sentiment is that the outlook for growth of the world economy has worsened since August. That is also true here in the United Kingdom, where activity could be broadly flat until around the middle of next year. We continue to face a difficult economic environment.

The Committee's judgement about the outlook for four-quarter GDP growth is summarised in Chart 1, on page 6 of the *Report*. 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 increases over the next three months to £275 billion, remaining constant thereafter. Despite the easier monetary stance, growth over the next few quarters is likely to be markedly weaker than in the August projection. This reflects the impact on the United Kingdom of the deterioration in prospects internationally, working through weaker net trade, higher credit spreads and the likelihood that elevated uncertainty will cause businesses to postpone investment and households to spend less. And, as in August, the Committee has judged that there is no meaningful way to quantify the most extreme outcomes associated with developments in the euro area, and they are therefore excluded from the fan charts.

Inflation fell back in October to 5.0%. Looking ahead, we can be reasonably confident that inflation will fall sharply at the start of next year as the contributions of VAT, energy and import prices decline. The extent and pace of the fall, however, remain uncertain.

Real take-home pay should gradually begin to recover after a period in which prices have grown faster than wages. It would be wrong, though, to think that monetary policy was the reason for the sharp squeeze in real take-home pay. Instead the squeeze was an unavoidable consequence of movements in world energy and other commodity prices, the need to rebalance the UK economy, and the cost of the financial crisis in terms of lower productivity. Indeed, lower inflation would have been possible only with lower nominal pay growth and higher unemployment.

Chart 3, on page 8 of the *Report*, shows the Committee's best collective judgement of the outlook for CPI inflation. It is based on the same assumptions about monetary policy as underlie Chart 1. The big picture is that we think inflation will slow sharply through 2012 to at or around the inflation target thereafter. The Committee judges that in 2013 and 2014 inflation is more likely to be below the target than above. But the scale of the difference in the balance of risks around the target is dwarfed by the uncertainty around the path for inflation as it falls from its recent high levels.

A key uncertainty surrounding the outlook for inflation concerns the impact of the financial crisis on the level of potential output in the UK economy, and for how long any adverse impact might persist. Measured productivity is around 10% lower than would have been the case had it risen on its pre-crisis trend. The truth is that we cannot know with any real precision how much of the observed reduction in demand is matched by a shortfall in supply, and how much is associated with an increase in spare capacity. And that inevitably means a great deal of uncertainty about the outlook for inflation in the medium term.

The UK economy is in a position now where rebalancing and recovery could go hand-in-hand, provided the world economy and financial system were to stabilise. External factors are providing an unwelcome drag on growth in our economy, adding to the headwinds that we already face in the process of rebalancing towards a sustainable path of recovery. Unfortunately the prospect of a lasting improvement to the position overseas seems remote until the external debt position and loss of competitiveness of countries in difficulty is tackled, and creditor countries play their part in a rebalancing of spending globally.

The outlook for inflation is particularly uncertain. Much of that uncertainty stems from events beyond our shores and over which the Monetary Policy Committee has little influence. In such circumstances, there are limits to what domestic monetary policy can achieve. But, as I said earlier, the big picture from today's *Report* is that the MPC believes that inflation will fall back sharply next year, and towards the 2% target.