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OPENING REMARKS BY MERVYN KING**

Good morning everyone.

When we met in May, I presented a central projection for inflation which, at the two-year forecast horizon, was above the target and rising, with the risks on the upside. Over the past three months the picture has changed, literally so in the case of our fan chart. Today's projection is shown in Chart 6.2 on page 50 of the Report. As anticipated in May, erratic changes in the prices of seasonal foods have led to a fall in RPIX inflation. Those effects are expected to unwind over the next few months. Inflation is expected to rise to above 2% by the end of this year, and then to drift up to the 2.5% target. At the forecast horizon, the new projection is both lower, and rising less steeply, than that in May. The most important explanation of this change in the outlook is the fall in share prices, both at home and abroad.

Abroad, the main share price indices have fallen by around 20% since May, and the prospects for growth appear weaker in all the major economies. The initial jolt to confidence in equity values was heightened concern in the United States over the reliability of company accounts, and corporate governance more generally. But the questioning of equity values which this prompted has led to falls in all major markets, as the decline in prices since the peak in 2000 spread beyond the hi-tech sector. This is likely to dampen the speed of recovery in private final demand in the industrialised world and was reflected in falls in business and consumer confidence in July. In the euro area, domestic demand has fallen over the past year, and remains particularly weak in Germany. Recent surveys and data for industrial production in the euro area suggest some faltering of the recovery in output seen in the first quarter. In Japan, GDP is actually lower than it was five years ago.

Nevertheless, the MPC expect a gradual recovery of the world economy, albeit at a somewhat slower rate than in May. Monetary and fiscal policy continue to support

recovery, and expectations of future short-term interest rates over the next two years have fallen back by around half a percentage point since May in the US and euro area.

At home, equity prices fell in line with those abroad, with the FTSE All-Share index down 19% between the May and August MPC meetings. It is down by over a third from its peak in 2000. In contrast, house prices continued to rise rapidly, and both the Halifax and Nationwide indices now show increases over the past year of more than 20%, compared with around 15% at the time of the May Report. But there are some signs that these unsustainably high rates of increase may be starting to moderate.

Since May there have also been some significant movements in exchange rates. In particular, the dollar has declined by around 7½ % against the euro and somewhat less against other currencies. Sterling rose by 7% against the dollar and fell by around 1% against the euro, leaving the effective exchange rate index broadly unchanged from its level in May, despite a sharp fall and subsequent recovery during the quarter.

For some time, the MPC has been concerned that the rapid growth of household consumption, and the associated higher debt levels, could, if allowed to continue unchecked, pose the risk of an abrupt adjustment to a more sustainable path. Data revisions mean that for the recent past consumption has been revised up and is likely to have risen to above trend growth in Q2. There are, however, mixed signals about its future pace. Business investment was revised down, and was 9% below its level of a year ago in Q1. It may remain subdued for a while. Government spending continues to rise rapidly.

Output growth strengthened in the second quarter, but the pace of the recovery has been clouded by the industrial production data for June. It is simply impossible to know how far the 5.3% fall in manufacturing output resulted from a one-off reduction in working time, as the two Bank Holidays and World Cup fever reduced hours worked. These problems of interpretation affect data not only for output, but also for retail sales and the housing market. Only when data for July and August are available will it be possible to see how far the underlying level of output has been affected.

The labour market continues to show a remarkable degree of stability. Employment, unemployment and underlying earnings growth are broadly flat. Little has changed since May. The prospective impact of the Budget announcements on public spending and of higher National Insurance contributions next year pose upside risks to pay growth and inflation over the next year or so, as we discussed in the May Report.

The Committee's latest projections for output growth are shown in Chart 6.1 on page 47 of the Report. These are, as usual, conditional on the official interest rate remaining at 4% over the two-year forecast horizon. In the central projection, output growth picks up over the next year or so to around its historical average and remains close to that rate. The continued stimulus from both monetary and fiscal policy helps to counteract the impact of falls in equity values. But prospects for growth are weaker than in May.

Considerable uncertainties surround the central projections. These revolve around the impact of declines in equity prices on consumption and investment, both in the UK and overseas, and the difficulties of interpreting recent spending and activity data. Overall, at the forecast horizon, the risks to activity are, in the MPC's judgment, marginally on the downside and to inflation on the upside. Although there are some differences among the Committee concerning the overall balance of risks, the range of opinion is relatively narrow. And in this Report we have not felt it necessary to include a table quantifying differences of opinion about the central projection - Table 6.B - as in some previous reports.

The forecast published by the MPC in May implied that, if the economy were to evolve precisely according to the central projection, then a rise in interest rates would be necessary at some point to meet the target. Since then, the falls in equity prices and other developments have brought the forecast more into line with the target. The central projection in this Report is for growth close to trend and inflation close to the target. But the very great uncertainties, both about the outlook and the difficulty of interpreting recent data, mean that the Committee will remain alert to the need to respond to any further change in the outlook. It remains ready to take whatever action is necessary, in either direction, to meet the inflation target.

Finally I would like to thank David Clementi for his contribution both to the Bank and the MPC over the past 5 years. We have worked very closely together, and I am sorry to see him leave. I look forward to welcoming his successor.