INFLATION REPORT PRESS CONFERENCE
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OPENING REMARKS BY MERVYN KING

Good morning everyone, and welcome to the tenth birthday of the Inflation Report. It is rather frightening to think that I, and some of you, have been meeting like this for ten years. When I introduced the Inflation Report to you ten years ago, I said that its aim was two-fold. First, "to provide an objective and independent assessment of inflation in the UK. In fact, everything you wanted to know about inflation but were afraid to ask". Second, "to stimulate an informed public debate on inflation, and, in that process, earn a reputation for the Bank as the authority on inflation." The first Inflation Report was even made available in good bookshops around the country from 5.30pm that night. As the Bank's fortunes waxed, the enthusiasm of Waterstone's and others to sell the Report waned, and our main distribution outlet now is via the internet. The Report too has changed its role from being a <u>commentary</u> on the consequences of decisions taken by Government to an <u>explanation</u> of decisions taken by the Monetary Policy Committee.

In its latest report, the Monetary Policy Committee has revised downwards its outlook for growth in the UK economy over the next two years. A weaker prospect for the world economy, especially the euro area, and further falls in equity prices and business investment are the main factors behind this revision. Although inflation has picked up since November, the factors behind that rise are expected to be temporary. Hence the Committee was faced with an outlook in which, looking two years or so ahead, the odds were that, in the absence of a reduction in interest rates, inflation would have fallen below the 2.5% target. That is the explanation of last week's decision.

The world economy continues to recover slowly, although growth seems to have faltered in the fourth quarter of last year. In the euro area, domestic demand is virtually unchanged on a year ago. In the US, growth in Q4 was lower than expected. And the further falls in equity prices in recent weeks have weakened the outlook for consumption and investment around the world. Uncertainty surrounding military action in Iraq hangs heavily over the short-run outlook for the world economy, and may have affected business and consumer confidence.

Exchange rates too have moved over the past quarter. The dollar has depreciated against the euro by around 10%, and against sterling by around 5%. The resulting fall in sterling against the euro has led to a fall in its effective exchange rate of 2% or so since November. And the oil price is around $32 compared with around $26 in November, although the futures price two years ahead is little changed.

At home, estimates of GDP have been revised upwards, and the lowest quarterly growth rate during the recent slowdown is now estimated to have been only 0.2%. Output growth over the past year, at 2.2%, has been close to trend. Business investment has continued to fall and, given the decline in equity prices and present uncertainties, the Committee judges that the recovery in investment will be slower than expected in November. There are signs that household consumption growth, which has remained at around 4% a year over the past five years, may now be about to ease. Narrow money growth, correlated with current consumer spending, has fallen. Consumer confidence has fallen markedly in recent months. And real disposable incomes are likely to grow more slowly in the future. House price inflation seems to have passed its peak, and in due course that will reduce the stimulus to spending from mortgage equity withdrawal. In the Committee's central projection, consumption growth falls from well above to well below its trend rate over the forecast horizon, and, over the same period, house price inflation slows from 25% a year to zero.

There has been little change to the picture of broadly stable employment and unemployment as shown by the figures published this morning. Employment continues to rise and unemployment, on the Labour Force Survey measure, has fallen back to 5.1%. Earnings growth remains subdued, although it is still too early to be confident of the impact of higher National Insurance contributions – on both employers and employees – in a tight labour market. The risks to inflation from this direction remain on the upside.

The Committee's latest projections for output growth are shown in **(GREEN CHART)** Chart 1 on page iii of the Report. As usual, these are conditional on interest rates remaining at their new level throughout the two-year forecasting horizon. In the central projection, output growth remains around trend rates over the first year of the forecast, but slows a little thereafter as consumer spending decelerates. This profile is noticeably weaker than in the November projection, reflecting primarily a softer world outlook, a more muted recovery in business investment, and a sharper slowdown in consumer spending.

Inflation has been marginally above target now for two months and in December was 2.7%. This was anticipated in the November Report. It reflects rises in petrol prices and the housing depreciation component of RPIX. As I explained at the November press conference, the contribution of the housing depreciation component to inflation was expected to rise, and indeed has risen, to around one percentage point. The Committee's latest projection for inflation is shown in **(RED CHART)** Chart 2 on page iii of the Report. Inflation may well rise further above target in the

short-run as oil prices and the housing depreciation component add to inflation. But, as I stressed in November, it is important not to exaggerate the policy significance of short-run deviations of inflation from target which, for good reasons, are believed to be temporary. And with oil prices expected to drop in line with the futures price, and house price inflation expected to slow sharply, RPIX inflation is expected to fall back to around the target by the end of the two year forecast horizon.

Looking further ahead, the Committee judged that growth was likely to slow, reducing inflationary pressures. In the absence of an interest rate reduction, inflation was more likely to be below the target than above. Of course, the Committee recognised that the arguments for leaving interest rates unchanged and for lowering them were finely balanced. The Committee was conscious that a reduction in rates might lead some observers to conclude that the MPC shared the "doom and gloom" of some recent comment. Yet the central projection remains one of growth close to trend and inflation close to target. The Committee also considered the risk that a reduction in rates might encourage more household borrowing and stimulate consumer spending to the point where a subsequent correction might lead to a much sharper downturn. But with signs of more weakness in the world economy than expected in November, with a more gradual recovery in business investment, and with signs that the peak of house price inflation is now past, the Committee judged that, without an adjustment in policy, inflation would fall below the target at and beyond the two-year forecast horizon. So, on balance, the Committee felt that it was important to act in a pre-emptive fashion, and take the action necessary to keep inflation on track to meet the target in the medium term.

Perhaps the conclusion of my opening remarks ten years ago might serve as an appropriate comment on the intervening period – "so far so good", but "progress must be continued". And the price of the Inflation Report over ten years? It has fallen from £4 a copy to £3.