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OPENING REMARKS BY MERVYN KING

Good morning everyone.

Since August, the pattern of steady growth and inflation close to target has continued. In the second and third quarters GDP grew by 0.6% and 0.7%, respectively, around the average rate over the past forty years. Inflation on the RPIX measure is 2.3%, very close to the target. But the Monetary Policy Committee does not take a Panglossian view of this picture. Beneath the surface of overall stability lies a remarkable imbalance between a buoyant consumer and housing sector, on the one hand, and weak external demand, on the other. The tension between these two components of demand creates risks to the outlook. And the Committee spent a considerable amount of time discussing those risks.

Many of those risks concern the world economy. Recovery remains fragile. Although growth in the United States was higher than expected in the third quarter, it appears that over two years the US economy has moved from a sweet spot to a soft spot. Falls in consumer confidence raise the possibility of further weakness in demand, although the action by the Federal Reserve last week means that both monetary and fiscal policy remain very accommodating. In the euro area domestic demand is below its level of a year ago, and GDP has risen only moderately. Output in Japan now shows some signs of a pickup, as evident in the data released this morning. Overall there are downside risks to the central view of a continuing global recovery.

Equity prices have again proved volatile over the past quarter in all the major markets. But, following the recovery of prices over the past month, the net change on the quarter has been rather small, in sharp contrast to the three months before the August Report. Exchange rates have also been broadly stable. The sterling effective exchange rate index is up only slightly from its level in August. The most significant change in asset prices has been the rise in the prices of government securities, reflecting a fall of around 25 to 50 basis points in market interest rates along the yield curve, which in itself will help to stimulate demand.

So far this year, consumer spending in the UK appears to have risen at an annualised rate of around 3%, below the 4% or so growth of the previous four years. But the quarterly growth rates have moved erratically making it difficult to be confident that household spending is slowing. And on the latest data consumption remained 4% above its level of a year ago. Consumer confidence remains high, household borrowing has been accelerating, and the remarkable strength of the housing market suggests that the outlook is for spending to remain quite buoyant in the near term. Government spending too has been rising quickly. Business investment, by contrast, remains weak.

The strength of the housing market has exceeded the Committee's expectations. This matters because mortgage equity withdrawal – now some 6% or so of disposable income – is supporting consumption growth, and hence the imbalance I referred to earlier. House price to average earnings ratios have risen to previous peaks. The Committee continues to believe that house price inflation is likely to slow soon, with prices becoming broadly stable by the end of the forecast horizon. The longer the slowdown in house price inflation is deferred, the greater that slowdown is likely to prove. Although the Committee's central projection is that consumption growth is likely to moderate, there are, of course, significant risks. In the short-term these come from the momentum of household spending, and, looking further ahead, from the growing risk of a sharp correction to house prices and consumer spending.

There has been little change since August in the pattern of employment, unemployment and earnings growth. In the Labour Force Survey published this morning employment fell and unemployment rose. But the overall picture remains one of broad stability. The Committee remains of the view that there are upside risks to the inflation outlook from the upcoming pay round as a result of increases in public spending and higher National Insurance Contributions from next spring.

The Committee's latest projections for output growth are shown in Chart 1 (GREEN CHART) on page iii of the Report. As usual, these are conditional on the official interest rate remaining at 4% throughout the two-year forecast horizon. In the central projection, output growth picks up to a little above trend over the first year, led by private consumption and public spending. It then falls back to around its long-term average as consumer spending decelerates, despite some recovery in external demand and business investment. This profile is broadly similar to that shown in the August projection.

Inflation outturns in recent months have been a little higher than expected. The new projection for (RED CHART) inflation – chart 6.2 on page 58 of the Report shown alongside the August projection in chart 6.3 – reveals some differences from that in August. Then, inflation was expected to lie below the target for much of the forecast horizon, rising above the target at the two year horizon. Now, inflation is expected to be above the 2.5% target for the first four quarters of the projection, as sharp falls in petrol prices a year ago drop out of the index and the contribution of housing depreciation to the index increases further. The immediate impact of rapidly rising house prices is to raise RPIX inflation because the index contains an allowance for housing depreciation which is related to lagged increases in house prices. The contribution of this housing depreciation component is expected to rise from about ½ percentage point in Q3 to around 1 percentage point by the end of the year. The central projection for inflation falls to just below the target in the second year, rising somewhat at the two year horizon. It is important not to exaggerate the policy significance of near-term deviations of inflation from target that are thought to be temporary.

Given the new projection for inflation, the Committee decided at its meeting last week to leave official interest rates at 4%. But the Committee remains mindful of the current uncertainties which underlie the three main risks identified in today's Report – to the world economy, to consumer spending, and from pay pressures. The Committee stands ready to respond should any of those risks materialise.