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OPENING REMARKS BY MERVYN KING

Good morning everyone.

1. Following six months of near-zero growth, the UK economy looks set to recover. Business surveys have risen sharply in recent months. Once again, inflation has remained close to target. There are many risks to the economic outlook ahead – in both directions – but it looks increasingly clear that the trough of the recent slowdown was towards the end of last year.

2. Since February, signs of a revival of the world economy have become more widespread. There is now greater confidence that growth in the United States reached its low point in the second half of last year. Activity rebounded strongly in the first quarter, reflecting the ending of the sharp inventory correction. Business confidence has improved in most parts of the world, and policy remains supportive of future demand growth. Whether the global recovery will be sustained depends in large part on how quickly final demand growth picks up. One of the causes of the slowdown in the world economy was the contraction of the ICT sector, and it is encouraging that semiconductor sales have picked up almost everywhere, and especially in non-Japan Asia which often leads the IT cycle. Overall, the Committee's view of the medium-term outlook for the world economy is little changed from that in February.

3. In the UK, output has been broadly flat over the past six months. The annual growth rate has slowed to 1.0%. But total consumption has remained buoyant – rising by around 4% during 2001. The strength of private consumption and house prices over the past year is explained in part by the fact that real household disposable incomes rose by over 5% in 2001 and that monetary policy was eased. Although total money and credit have decelerated, household credit has continued to accelerate. Output growth last year was low because of a fall in business investment and yet another large negative contribution from net trade. Business investment fell by 7½% during 2001, the largest fall for ten years, and there are,

as yet, few signs of a recovery. Non-financial companies actually repaid debt in the first quarter. But in sharp contrast with the rather weak backward-looking output data, the forward-looking surveys have strengthened markedly since February.

4. In preparing today's report, the Committee spent some time analysing the Budget. That increased planned public spending by 1% of GDP in 2003/4, rising over the following two years to around 2% of GDP. This extra spending will be financed largely by higher taxes and National Insurance contributions. Nevertheless, total demand is likely to be modestly higher reflecting some "balanced budget stimulus" from the tax-financed rise in spending. You may have a hazy recollection of the balanced budget multiplier from years gone by. The argument is simply that higher public expenditure on goods and services will add to demand in the short run by more than the extra taxes will reduce demand, because some of the reduction in disposable incomes will result in lower saving.

5. The Committee also considered the possible impact on prices and wages of the one percentage point increase in the rate of both employers' and employees' National Insurance contributions. If employment is to be maintained, then in the long run, the impact of higher NICs must fall on real take home pay. That would imply a temporarily lower growth of real take home pay, freeing resources to move from private to public consumption. The way in which the adjustment to this outcome takes place is less clear, as is the timing of the adjustment. It could come through either lower wage increases or higher prices. The pre-announcement of the increases in contributions, and the fact that inflation expectations seem to be anchored around 2.5%, have encouraged the Committee to judge that much of the adjustment will come through smaller rises in wages. But if there are signs that the increases are being passed on in higher prices, then the Committee would take action to ensure that the inflation target was met, and the resulting slowdown would bring about the necessary moderation in nominal wage increases. Overall, the impact of the Budget on the central projection for inflation over the forecast horizon is small, although it may be larger further ahead. This will be more of an issue for future Reports.

6. Despite continuing falls in manufacturing employment, unemployment in the economy as a whole has been broadly constant over the past year, although this morning's data show that the claimant count increased marginally in March and April. Earnings growth has fallen sharply, largely because of lower bonuses this year compared with last. But there were significant upward revisions in the figures for bonuses published this morning. Regular pay growth, by contrast, has been more stable at around 4 ½% a year.

7. The Committee's latest projections for output growth and inflation are shown in Charts 1 and 2 on page iii of the Report. These are, as usual, conditional on the official interest rate remaining at 4% over the two-year forecast horizon. The central projection is for output growth to recover to above-trend rates. Household consumption is expected to moderate, despite recent rises in house prices, as the anticipation and then the payment of higher National Insurance contributions slows the growth of disposable incomes. But this is likely to be outweighed by the impact of higher exports, reflecting recovery in the world economy, and higher public spending. The outlook is somewhat stronger than in the February projection.

8. The judgment of the Committee about the outlook for inflation is shown in Chart 6.2 on page 47 where it can be compared with the February outlook shown in Chart 6.3. It is possible that inflation could fall back over the next few months, as the impact of recent erratic changes in the prices of seasonal foods and utilities unwinds. But, in the central projection, inflation then moves up to slightly above the target two years ahead. This profile is a little higher than in the February Report, and the differences are more marked at the forecast horizon where inflation is rising more steeply in today's projection.

9. There are considerable uncertainties surrounding the central projection for both growth and inflation. First, the sustainability of recovery is not yet assured, and weakness in final domestic demand, especially in the United States and at home, remains a risk. Second, and associated with a potential faltering in final demand is the possibility of changes in exchange rates, including a fall in sterling. Third, the central projection assumes that the higher National Insurance contributions

affect, in the first instance, wages more than prices. But if more of the higher contributions were passed through to higher prices then inflation would be above the central projection. At the forecast horizon the overall risks to inflation are moderately on the upside.

10. Since February, signs of recovery, especially in the forward-looking surveys, have become more visible. But they have not yet been reflected in the data for either net exports or business investment. In contrast, household consumption shows, as yet, few signs of a sustained slowdown. An anticipated recovery in final demand, bolstered by higher public spending, implies a more buoyant outlook for growth over the next two years or so than was the case in February. As a result, the Committee has raised its projection for inflation, although the central projection still remains below the 2.5% target for much of the forecast horizon. Given that projection, the Committee judged last week that it was appropriate to leave official interest rates at 4%. But it stands ready to counter building inflationary pressures as and when they emerge.

11. Finally, I would like to pay tribute to my two colleagues who are retiring from the Committee. Sushil Wadhwani has made an enormous contribution during his three years at the Bank. Ian Plenderleith was one of the original members of the MPC, has attended every one of its 61 meetings so far, and retires from the Bank after an extremely distinguished career of 36 years. Looking ahead, as we always do, I look forward to welcoming Marian Bell and Paul Tucker to the Committee.