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OPENING REMARKS BY MERVYN KING

Good morning everyone.

Growth in the first quarter was well below trend. Inflation was above target. This is the reverse of the situation during much of the past five years. Yet the central projection in today's Report remains one in which growth is expected to pick up to trend and inflation is expected to fall back and remain close to the target of 2.5%. Lest you conclude that the Monetary Policy Committee has become positively Panglossian, I should assure you that the Committee does not believe that all is for the best in the best of all possible worlds. Indeed, the risks around the central projection were crucial to the Committee's decision last week.

The world economy has grown only slowly in recent months, and, prior to the war in Iraq, business and consumer confidence fell markedly. But we have now seen a sharp fall in oil prices, a rise in equity prices, and some recovery in confidence, especially in the United States. Although consumer spending in the US has moderated in recent months, supportive monetary and fiscal policy are likely to mean a gradual recovery in output growth to around trend. Output growth in the euro area remains weak and shows little sign of recovery. And the sharp rise in the value of the euro – up 13% over the past year on the effective index – will dampen growth prospects given flat domestic demand. In Japan, however, the outlook is less bleak than in February.

At home, the preliminary estimate for GDP growth in the first quarter was only 0.2%, well below the central projection in February. And manufacturing output is now estimated to have fallen in Q1. Consumer spending decelerated sharply in the early part of the year, and house price inflation has continued to slow. Real disposable income will be hit by the fall in the exchange rate and the impact of higher National Insurance contributions and Council Tax. So the prospect is for much weaker consumption growth over the next year than for more than five years. Government spending, by contrast, is likely to continue to grow rapidly, and, in due course, a recovery in investment will also support activity. And the fall in sterling should result in net trade eventually making a positive contribution to output growth, something which has not happened for eight years. But in the short term the risks to activity are on the downside.

Since February, there have been significant changes to key asset and commodity prices. Oil prices are around $5 a barrel lower than in February. Equity prices rose around 4% between the February and May Reports. Offsetting this has been a sharper than expected slowing of house price inflation. But the single largest change has been the fall in sterling's effective exchange rate index (ERI). In today's projections the starting point for the ERI is just over 4% lower than in the February Report. And the rate has fallen further since the MPC finalised its projection. The ERI is now lower than when the MPC was set up in 1997. In making its projections, the Monetary Policy Committee has judged that the first-round effects of a depreciation of sterling on retail prices come through more slowly than the average of past experience. It has also assumed that the second-round effects of depreciation on both inflation expectations and resulting wage increases are likely to be smaller than in the past. The main impact of the fall in the exchange rate is the stimulus to net trade which pushes up activity and inflation over the forecast period and beyond. But there are upside risks to inflation from basing the central projection on these new judgments.

The labour market remains broadly stable. Unemployment on the Labour Force Survey measure remains at 5.1%, the same level as a year ago, and employment continues to increase. Underlying private sector pay growth has moderated somewhat over the past year, despite a sharp rise in tax and price inflation, although the figures published yesterday suggest that bonuses have not fallen as fast as previously anticipated.

The Committee's latest projections for output growth are shown in Chart 1 on page iii of the Report. As usual, these are conditional on constant official interest rates throughout the two-year forecast horizon. Over the past year output growth has been close to trend, although the quarterly pattern has shown marked volatility, associated in part with the Jubilee holiday. Looking ahead, growth is expected to be fairly close to its long-run average over the forecast horizon with noticeably weaker consumer spending growth offset by strong public spending, some recovery in business investment and a pick-up in net trade as the effect of the depreciation of sterling works through. Relative to the February Report, the near term outlook for output is somewhat weaker although the recovery in net trade from the fall in the exchange rate stimulates stronger growth further ahead, leading to a higher level of output at the two-year horizon.

Since February, RPIX inflation has risen further above target, and has been at 3% for the past two months. The Committee's latest projection for inflation is shown in Chart 2 on page iii of the Report. Inflation may rise a little further in the short term, but is then likely to fall back as the contribution from housing depreciation and oil prices diminishes sharply. The cumulative effect of recent below-trend growth is likely to ensure that underlying inflationary pressures are relatively weak over the next year or so. But, further ahead, sterling depreciation is likely to raise inflation.

In reaching its decision last week, the MPC, as ever, considered the balance of risks to the inflation outlook, not just the central projection. The downside risks to demand and activity in the short run imply downside risks to inflation at the forecast horizon. But there are upside risks to the inflation outlook relative to the central projection that the impact of sterling's depreciation on prices will be less than in the past. Overall the risks to inflation are broadly balanced. The Committee will be monitoring carefully developments in demand and activity, on the one hand, and in prices and wages, on the other, to assess whether there are signs of either of these two risks starting to materialise.

Finally, I would like to thank Chris Allsopp for making an invaluable contribution to our discussions, as a member both of the MPC and before that of Court. The Governor retires after our next meeting. I know I speak for all members of the MPC – past and present – when I say that Eddie's leadership of the Bank and the MPC has been vital to our success and a landmark in British monetary policy. There will be other opportunities to pay tribute to Eddie, but I did not want this occasion to pass without recording the gratitude of all those who have worked with him for his immense contribution. Although Eddie's name will no longer be on the team sheet for next season, I am delighted that Rachel Lomax and Richard Lambert will be joining the side and that Steve Nickell has signed a new contract.