

INFLATION REPORT PRESS CONFERENCE
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OPENING REMARKS BY MERVYN KING

Good morning everyone, and a warm welcome to all our new viewers on the Internet where the Press Conference is broadcast live for the first time.

Since the February Report, the Monetary Policy Committee has reduced interest rates by 50 basis points in two steps, in April and again last week. This was judged necessary to keep inflation on track to meet the target of 2½% looking ahead two years or so.

Over the past quarter, much of the focus of the MPC's discussion has been on prospects for the US economy and the implications of those prospects for the rest of the world, in general, and the United Kingdom, in particular. It is still too early to be at all sure about how prolonged and how deep the US downturn will prove to be. An inventory correction is well underway as shown by the fall in inventories and imports in the first quarter. The slowdown has spread to investment in fixed capital too with sharp falls in orders for capital goods, especially in the high-tech sector. The duration of this pause in investment is highly uncertain, not least because it depends on the outlook for productivity growth. In recent years higher investment, especially in the ICT sector, has raised productivity through capital deepening which, in turn, has stimulated further investment. What will happen to productivity growth now investment has slowed is a question to which the answer should become apparent over the next year or so.

But the key factor will be the behaviour of consumption. Some slowdown is very likely, especially with rising unemployment, lower equity prices and high debt-income ratios. So far, however, consumption has held up and the housing market remains strong. The Federal Reserve has cut interest rates by a total of 2½ percentage points since the turn of the year, and the impact of that easing on the real economy has yet to be seen. Fiscal policy is also likely to be supportive of a recovery.

Elsewhere, the euro area has seen some decline in business confidence, although consumer confidence remains high, and in Japan the prospect for domestic demand growth appears weak.

Overall, the MPC has revised down its estimate of growth of the world economy, and, in turn, net trade is likely to make a further significant negative contribution to growth of UK GDP. World trade – weighted by UK trade shares – rose by almost 11% last year, the fastest growth for 25 years. The central projection is for this growth in world trade to halve in 2001.

At home, over the past year the UK economy has grown at 2.5%, close to trend, and inflation has been just below the 2½% target. In recent months, however, the data have moved rather erratically, affected by adverse weather, travel disruption and foot and mouth disease. The first estimate of GDP growth for Q1 was, at 0.3%, lower than expected, and followed a weak figure for Q4 of 0.4%. Against that, consumer demand has remained remarkably buoyant: retail sales were up 1.5% in the first quarter, car registrations were high, and the housing market has picked up. Figures for business investment have been revised up significantly since the February Report and the many explanations that were provided for the apparent weakness of investment growth have proved redundant. Government spending is planned to rise rapidly. And annual money and credit growth, at around 8% and 12% respectively, remain high.

So the imbalance between strong domestic demand and weak net trade has continued. Hence the contrasting fortunes of the internationally exposed sector, on the one hand, and those producing primarily to meet final domestic demand, on the other.

The labour market has become, if anything, even tighter over the past three months. The figures published this morning show that the unemployment rate fell to 3.2% in April on the claimant count, and to 5.1% on the LFS measure in the three months to March. Employment continues to grow at slightly above the trend rate of increase of the labour force but there are some indications that the labour market is reaching a turning point.

Pay pressures have remained subdued. The sharp rise in average earnings in February was reversed in March according to the numbers published this morning; the “blip” reflected a shift to February of bonus payments normally paid in March. Wage settlements continue to drift up slightly. We shall be monitoring this area carefully.

Chart 1 on page iv shows the assessment of the outlook for GDP growth on the assumption that the official interest rate remains at 5.25% over the forecast period. In the central projection, temporary factors, such as foot and mouth disease, depress the annual growth rate in the first half of this year before a return to growth at around trend. Domestic demand growth is expected to moderate towards the end of the forecast period. The fall in equity prices and slower growth in household incomes are expected to reduce consumption growth. The Committee judges that the risks to output growth are on the downside in the first year and evenly balanced in the second.

The inflation outlook is shown in Chart 2 on page iv. The central projection stays at around 2% through the first year of the projection, before picking up gently towards the target rate as the effects of the earlier exchange rate appreciation wear off. The weaker world outlook is largely responsible for the somewhat softer inflation outlook than anticipated in February. Risks in both years are on the downside.

Some commentators have argued that, since its inception, the MPC has not really been tested. What do they have in mind? We have faced ups and downs in the world economy accompanied by financial crises in several large economies, a 30% sustained rise in the effective exchange rate, a new currency on our doorstep, the challenge of assessing the significance of the “new economy”, structural reforms in the UK, and a tripling of oil prices. Indeed, only one element appears to have been stable throughout this period – the predictably boring response of the Monetary Policy Committee to all these events was to move interest rates to keep inflation on track to meet the target, so playing our part in delivering economic stability.

Finally, I would like to thank DeAnne Julius for everything that she has contributed to the Committee since she joined in September 1997, and to welcome Kate Barker, who will bring a wealth of experience when she joins us next month.