

## **INFLATION REPORT PRESS CONFERENCE**

**Wednesday 8 August 2007**

### **Opening Remarks by the Governor**

Inflation has fallen back quite sharply, from 3.1% in March to 2.4% in June, as household gas and electricity prices started to decline. It's likely to fall back further over the next few months but could remain volatile in the short run, reflecting the unpredictability of energy prices and the British weather.

Output growth is estimated by the ONS to have been at or above its long-run average rate for six successive quarters. Business surveys have been even more upbeat than official estimates. Activity in the world economy has remained buoyant. And against a background of rapid growth of money and credit, business investment has been strong and consumer spending has remained firm despite only modest growth of real incomes and a higher level of Bank Rate. Nevertheless, there are tentative signs of a slowing of household spending.

In the past few weeks there have been falls in equity prices and credit spreads have widened, especially on riskier debt. We don't know whether these tremors in financial markets signal a more disruptive movement to come, or constitute a gradual release of pressure on spreads that had built up over some time. So it's impossible at this stage to judge how large and how persistent this tightening of credit conditions is likely to be. The Committee will monitor carefully data on both the price and quantity of credit.

Strong demand growth has put pressure on the supply capacity of the economy. The MPC judges that a slowing of the growth rate of total demand will be needed to keep inflation close to the 2% target. And today's projections are indeed for a slowing of demand growth.

The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART 1) on page 7 of today's *Report*. That projection is based on the assumption that official interest rates move in line with market expectations over the forecast period. On this occasion the Committee has chosen to condition its projections on the average value of asset prices over a five-day rather than a fifteen-day window prior to last week's meeting to take into account significant price movements in the run up to that meeting. In the central projection, growth falls over the forecast period, reflecting a slowing in both consumer spending and business investment. That is a little weaker than in May, but, as then, the risks to growth are judged to be evenly balanced.

There is uncertainty about the path of output over the past year, and the MPC's judgement is that growth may have been stronger, and hence spare capacity less, than suggested by the current official estimates. Chart 5.2 (GREEN CHART 5.2), on page 36, shows the central estimate of GDP growth in the recent past implied by the pattern of past revisions to official data and business surveys. It also shows projections for four-quarter growth over the forecast period given by those estimates of past output. Chart 5.2 displays a more noticeable slowing in growth than Chart 1, reflecting a higher starting point.

The Committee's projection for CPI inflation is shown in Chart 2 (RED CHART) on page 8 of the *Report*, again on the assumption that official interest rates follow market expectations. The central projection is for CPI inflation to fall back to around the target over the next month or so, before settling close to the target for the remainder of the forecast period. Oil prices have risen sharply over the past three months, so in the near term the projection is a little higher than in May. Further out, the projection is a little lower, reflecting the more pronounced slowdown in demand growth.

The Committee judges that there continues to be greater-than-usual uncertainty about the outlook for inflation. Overall, the balance of risks to inflation around the central projection two years or so ahead is, in the Committee's judgement, a little on the upside.

In the medium term, there are risks to inflation in both directions from demand. Activity in the world economy – particularly in Asia and the euro area – may be stronger than in the central projection, posing upside risks to inflation. But downside risks stem from the possibility that consumption and domestic demand overall might slow more quickly than in the central projection, particularly against a background of tightening credit conditions. There is uncertainty too about the labour market where employment growth has been modest and pay growth has been steady. But it's not clear that pay pressures have been sufficiently muted to maintain employment following significant increases in energy and non-wage costs.

The main upside risk to inflation is that, with a limited degree of spare capacity, businesses may be more confident about raising prices than assumed in the central projection. And continued strong growth of the world economy may put further upward pressure on commodity and other import prices.

Given the outlook for inflation, and the balance of risks around the central projection, the Committee judged that leaving interest rates unchanged was the appropriate policy response at last week's meeting. Over the coming months, indicators of consumer spending, business investment and credit growth will show whether demand growth is slowing in line with the central projection. And indicators of pricing and capacity pressures remain particularly important. If they do not fall back, that would be consistent with the upside risks to inflation crystallising. The Committee will monitor developments carefully to judge what action may be required to keep inflation on track to meet the 2% target.