

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

The UK economy slowed in the first half of the year, and output in 2005 is likely to be around 2% higher than in 2004. That is well below consensus forecasts made earlier in the year. But the recent slowdown has been modest by the standards of the past – notwithstanding some of the more dramatic headlines for which I know you are not personally responsible. CPI inflation, however, has continued to rise. It is now 2.0% and is expected to rise further in the short run as the effects of the recent increases in oil prices feed through to retail prices.

Following revisions to the official data, it now appears that output decelerated in the second half of last year, and that output growth over the past year was below its long-run average. That picture is consistent with signs of a slight softening in the labour market. But recent indicators point to a pickup in consumer spending, following a flat first quarter. And the prospects for UK exports look firmer than they did a quarter ago. Since May, equity prices have risen by almost 10%, sterling's effective exchange rate has fallen by 3 ½% and market interest rates have fallen sharply. Those changes provide a significant stimulus, which is reflected in the profile of demand in today's projections.

The Monetary Policy Committee's projection for GDP growth is shown in (GREEN CHART on page iii of today's *Report*). That projection is based on the assumption that the official repo rate moves in line with market expectations prior to last week's meeting, which were for further cuts. The central projection is for GDP growth to be rather subdued in the near term, a rather weaker profile than in the May projection, and the Committee judges that there are also downside risks to consumer spending and hence total demand in the next quarter or two. Further ahead, the central projection for growth picks up, and is a little stronger than in May, as the impact of the recent changes in asset prices and lower interest rates implied by the market yield curve feed through.

CPI inflation was 2.0% on the latest reading, exactly at target. But it has risen by around one percentage point over the past nine months. Part of that increase can be accounted for by the effects of higher oil prices, and part by the pressure of demand on supply. Inflation will probably rise a little further in the next few months. But it is then expected to fall back as the effects of the higher level of oil prices drop out of the twelve-month comparison. Further ahead, the pressure of demand on supply capacity pushes up the central projection for inflation.

As usual, the *Report* contains two projections for inflation. In the first, conditioned on the market expectation of official interest rates (RED CHART on page iii of the *Report*), the central projection is for inflation two years ahead to be above the target and rising, reflecting growing demand pressures and rising import prices, although with the risks slightly on the downside. In the second projection, conditioned on the assumption that the official repo rate remains constant at 4.5% (Chart 3 on page iv), the central projection for inflation is close to the target two years ahead.

Given those two new projections for inflation – corresponding to market and constant interest rates – and the risks surrounding the central outlook, the MPC last week decided that a reduction in the repo rate to 4.5% was necessary to keep inflation on track to meet the target in the medium term.

As you know, that meeting was the 100th for the MPC. In true cricketing tradition, we acknowledge our century and then, provided the management does not instruct us to declare, get our heads down to make another hundred. Last Thursday night some market commentators were confident that interest rates would fall much further. Last Thursday night some sports commentators were also confident that England would beat Australia after Flintoff and his team-mates had smashed their way to such a large total on the first day of the Second Ashes Test. But, as we saw at Edgbaston on Sunday, nothing is that certain. So, as ever, the MPC will play each ball on its merits and not decide in advance where interest rates will go next.