

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

In August I said that it was impossible to be confident of where the future path of output, inflation and hence interest rates would lie. Developments since then have borne out that view. Market expectations of interest rates over the next year have fallen by more than 50 basis points since August. So I hope that everyone will recognise the uncertainty that inevitably surrounds the outlook for inflation, and hence interest rates.

The UK economy ran into a softer patch in the third quarter. The official estimate of output growth in Q3 was 0.4%, substantially below the rate expected in August, and manufacturing output was reported by the ONS to have fallen by 1%. Business surveys paint a more positive picture and are not easy to reconcile with falls in output. Nevertheless, it appears that the economy lost some momentum through the autumn. The labour market has been a little softer in recent months – employment growth has slowed. House prices have on average stopped rising – they have been broadly flat over the past two months – and a slowdown in the housing market is evident in virtually all the indicators.

But the Monetary Policy Committee has had to balance the impact of weaker activity and house prices, on the one hand, against indications of stronger future cost pressures, on the other. Oil prices have risen further. Data released on Monday suggest that factory gate prices are increasing at their fastest rate for nine years. The exchange rate has fallen by some 4% since the *August Report*. And money and credit continue to expand rapidly. Taking all these developments into account, the Committee's central projection for the UK economy remains one of steady growth with low inflation, but with many uncertainties.

Over the past year, the growth of domestic demand has moderated, and consumption growth has slowed from its earlier rapid pace in the five years after 1997. In contrast, investment spending has accelerated, and the Committee judges that the recent softer patch will probably prove temporary. The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART) on page iii of the Report. As in August, the projection is based on the assumption that official interest rates over the forecast period will move in line with market expectations. Today's central projection is for growth to be close to its historical average over the forecast period, somewhat weaker in the short run and stronger further out than in August.

How far this pressure of demand on supply capacity will lead to a pickup of inflation over the next two years is difficult to judge, and is one of the key issues facing the Committee. For several years now the link between estimates of spare capacity in the economy and inflation has been surprisingly weak. In assessing inflationary pressures the Committee has had to set this consideration against the likely impact of the fall in the exchange rate since August, the rise in oil prices and the signs of higher prices of domestically produced output. Earnings growth continues at moderate rates, although there has been a steady pickup in the rate of increase of private sector regular pay.

The Committee's projection for CPI inflation, again conditional on the market expectation of official interest rates, is shown in Chart 2 (RED CHART) on page iv of the Report. Despite recent rises in petrol prices, CPI inflation has been lower than expected, and below the 2% target. Inflation was 1.6% when we last met; now it is 1.1%, reflecting both continued downward pressure on the prices of imported food and clothing and competition in the distribution sector. The Committee's central projection is for inflation to pick up over the next year, as demand presses on supply capacity and the fall in the exchange rate affects retail prices, to reach the target around two years from now, rising modestly thereafter. That is similar to the August projection.

The risks around the central projection are significant but, in the Committee's judgement, somewhat on the downside. There is a risk that the link between inflation and estimates of the degree of pressure of demand on supply capacity will be weaker than has typically been the case in the past. Another downside risk is that the housing market, and with it consumer spending, slows more markedly than in the central projection. But there are also significant risks on the upside. In particular, the absence of spare capacity in the economy apparent in surveys and a tight labour market suggests upside risks to the central projection for earnings and inflation over the forecast period.

These risks mean we cannot be confident of where the future path of output, inflation and hence interest rates will lie. When we say that, we mean it. Where interest rates will go will depend on the economic data as they emerge over the coming months.