INFLATION REPORT PRESS CONFERENCE

Wednesday 11 February 2004

Opening Remarks by the Governor

Over recent months growth in the United Kingdom has been strong. It is expected to remain so. Inflation, on the new CPI measure, has been below the new 2% target for some time, but was expected to move up to exceed the target at the two-year horizon as demand growth pressed on supply capacity. In response to that inflation outlook, the Monetary Policy Committee judged last week that a rise in interest rates was necessary to keep inflation on track to meet the target in the medium term.

Signs of further economic recovery are evident in most parts of the industrialised world. At home, GDP growth in the second half of last year was above its historical average. Consumer borrowing and spending have been rising faster than expected, but are likely to slow in the face of decelerating incomes and house prices. For business, the outlook for exports and investment looks brighter than for some considerable time. So a long overdue rebalancing of the economy is now in prospect.

There are already some signs of higher inflation to come. The growth rates of money and credit remain at very high levels, and there is evidence of greater cost pressures in the pipeline. Against that, sterling's effective exchange rate rose between the November and February *Reports* by just over 2%, although it is still below its average level between 2000 and the beginning of last year. The higher level of sterling will offset part of the impact on inflation of faster domestic demand growth.

In assessing inflationary pressures, the official GDP data may not be the best guide to the balance between demand and supply in the economy as a whole. GDP includes an estimate of the output of the public sector. That is extremely difficult to measure in sectors such as health and education, and the ONS has commissioned a review by Sir Tony Atkinson. But in evaluating the impact of higher public spending on inflation what matters is not the value of the services provided by the public sector but the opportunity cost of the resources that would otherwise be employed in the private sector. And such a measure of total demand for resources has risen by significantly more than official GDP in both of the past two years, with implications for the degree of spare capacity.

The Committee's latest projection for GDP growth, on the assumption that official interest rates remain constant at 4% throughout the two-year forecast period, is shown in Chart 1 (GREEN CHART) on page ii of the Report. Business investment, exports and public expenditure are all expected to help offset, at least in part, the slowdown of consumer spending. The central projection is for growth above its historical average, although slowing a little over the forecast period. This outlook is somewhat stronger than in November.

After 44 *Inflation Reports,* and, for some of you I fear, 44 press conferences, containing projections for RPIX inflation, today marks the start of a new era with the Committee's first projection for inflation on the new CPI measure. The final outturn for RPIX inflation under the old target was, appropriately enough, 2.5%. The new measure starts life at 1.3%, below the new 2% target. The Committee's projection for CPI inflation, again conditional on an official interest rate of 4%, is shown in Chart 2 (RED CHART) on page iii. The central projection rises steadily to reach the target at the two-year horizon, reflecting the growing pressure of demand on supply capacity. Chart 3, also on page iii, shows the Committee's current projection for RPIX inflation. It remains close to 2.5% for most of the forecast period because rising domestically generated inflation is offset by declining house price inflation. This profile is similar to that in the November *Report*, as can be seen from Charts 6.3 and 6.4 on page 46. The news about stronger demand pressures is broadly offset by the higher level of sterling.

Last May I said that the Committee's central view might be described as positively Panglossian. Some of you might think this is equally true of today's projection, with a central view of above-trend growth and low inflation. But it is crucial to bear in mind that, in the central projection, inflation is continuing to rise at the two-year horizon and that the risks, although broadly balanced, are nevertheless considerable in both directions. What this means for policy only time will tell. Central projections rarely materialise - as Dr. Pangloss himself discovered.