

## **INFLATION REPORT PRESS CONFERENCE**

**Wednesday 11 November 2009**

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

The past year has been extremely painful for most economies around the world. World output and trade are well below the levels reached in the summer of 2008. In the United Kingdom, the cumulative fall in output has been almost 6%, and as a result unemployment has risen sharply. Although the ONS estimate that output fell further in the third quarter, a variety of other indicators point to a more buoyant picture looking ahead. That is encouraging. But small movements in quarterly growth rates will not alter the extent of the challenges now facing the economy, such is the scale of the fall in output over the past eighteen months.

The UK economy is facing a prolonged period of balance sheet adjustment. That will not be achieved in a few quarters. The banking system is reducing its leverage from extraordinarily high levels. Until that has taken place the supply of credit to households and businesses will be impeded. Those same households and businesses are re-evaluating their own financial positions – looking to build up their savings in the face of uncertain incomes and profits. That, when combined with impaired access to credit, will continue to restrain spending. And the need for a credible plan to ensure a substantial reduction in the fiscal deficit is now clear to everyone. This process of balance sheet adjustment implies the need for the UK economy to rebalance away from private and public consumption towards higher net exports. The fall in the exchange rate over the past two years will help to smooth that process.

The role of the MPC is to set monetary policy to keep overall money spending on a path consistent with meeting the 2% target in the medium term. After the introduction of inflation targeting in the UK, annual growth of money spending was always close to 5%. But over the past year it has fallen by almost 5%, meaning that it is around 10% below its previous trend. That is a measure of the monetary squeeze on the economy, and it has opened up a margin of spare capacity that will continue to bear down on inflation looking ahead. In response, the MPC cut Bank Rate almost to zero and initiated an unprecedented programme of asset purchases, which was further extended last week. Those purchases are aimed at injecting

additional money directly into the economy. Investors will look to use some of this money to diversify into assets that have a higher return. And that in turn will boost the prices of those assets, reducing yields and the cost to companies of raising funds in financial markets. Ultimately, that will help stimulate spending, smooth the necessary rebalancing of the economy, and keep inflation close to the target.

Inflation has been unusually volatile recently. It is currently 1.1%, having been 5.2% only a year ago. Such volatility is likely to continue in the short run. Inflation is likely to rise sharply over the next few months, to above the target, reflecting higher petrol price inflation and the reversal of last year's temporary reduction in VAT. Monetary policy can do very little to affect these short-run movements in inflation. So the MPC must look to the medium term when inflation is determined by the path of nominal spending relative to the supply capacity of the economy. To do that the MPC must restore the level of money spending to a path consistent with eliminating the margin of spare capacity, and ensuring that the outlook for inflation is in line with the 2% target.

Chart 1 (GREEN CHART 1), on page 6 of the *Report*, represents the Committee's best collective judgement of the range of outcomes for four-quarter GDP growth, assuming that Bank Rate follows a path implied by market interest rates and that the stock of purchased assets, financed by the issuance of central bank reserves, reaches £200 billion and remains at that level throughout the forecast period. The considerable stimulus from the past easing of monetary and fiscal policy and the depreciation of sterling should lead to a recovery in economic activity. Chart 2 (GREEN CHART 2), on page 7 of the *Report*, shows a fan chart for the level of GDP, which is derived from the growth projection shown in Chart 1. It shows the big picture. Despite a recovery in economic growth, output is unlikely, at least for a considerable period, to return to a level consistent with a continuation of its pre-crisis trend. That is in large part because the impact of the downturn on the supply capacity of the economy is expected to persist. But it is also because there is likely to be sustained weakness of demand relative to that capacity.

Chart 3 (RED CHART), on page 8 of the *Report*, shows the Committee's judgement about the

path of CPI inflation under the same monetary policy assumptions. After rising sharply in the near term, inflation is likely to fall back to below the target, as the impact of the past depreciation of sterling fades, and as the margin of spare capacity pushes down on CPI inflation. The outlook for inflation is again highly uncertain, with risks in either direction. Under the same monetary policy assumptions as in the fan charts for GDP, the Committee judges that inflation is, on balance, more likely to be below the target than above it for most of the forecast period, though by the end the risks are broadly balanced.

When we met last November, the full ramifications of the financial crisis were just starting to become clear. The banking system was in near meltdown. Output, orders and confidence had “fallen off a cliff”, to use the phrase that we heard so often from around the world. We have come a long way since then, helped in part by the extraordinary policy actions that have been implemented. We have, however, only just started along the road to recovery and the adjustment to balance sheets still has much further to run. Monetary policy cannot – and should not seek to – prevent that adjustment. But by acting to keep inflation on track to meet the 2% target, monetary policy can facilitate a smoother path of adjustment towards the rebalancing of the UK economy. And it was for that reason that the Committee extended last week its programme of asset purchases.