

INFLATION REPORT PRESS CONFERENCE

Wednesday 12 November 2003

Opening Remarks by the Governor

Since publication of the August *Inflation Report* the outlook for growth has improved. Following a weak first quarter, output in the UK has grown at around its historical average, and inflation has now been above the 2.5% target for almost a year. Inflation is expected to remain close to the target, although continuing steady growth - at home and abroad - and diminishing spare capacity are likely to mean that underlying inflationary pressures will build gradually. As a result, the Monetary Policy Committee judged last week that the first interest rate rise for almost four years was necessary to keep inflation on track to meet the target.

In the rest of the industrialised world, demand and output are, as expected, responding to the exceptionally supportive stance of monetary and fiscal policy in recent years. Even in the euro area, where output has been broadly flat for the past year, business surveys are consistent with a return to trend growth rates. And in the United States optimistic surveys and rapid growth in the third quarter have contributed to a stronger labour market with productivity continuing to grow rapidly. There are some signs of recovery in Japan, and demand remains strong in the rest of Asia. But although some regions of the world appear more buoyant than in August, the recent weakness in the euro area means that the outlook for UK export markets is, in the near term, marginally softer than in August.

In the UK, estimates of demand and output were revised up, and some of the statistical fog has dissipated. Consumer spending has decelerated markedly to growth rates averaging just over ½% a quarter for the past year from around 1% a quarter over the previous five years. But neither consumer spending nor the housing market has slowed as much as the Committee expected. Despite the fall in average real take-home pay over the past year, the first since 1995, retail sales grew rapidly in the third quarter, following a strong second quarter. And the growth rate of household borrowing has risen further. Even though the picture of indebtedness for all households taken together is by no means

as bad as some of the headlines might suggest, we need to know rather more about the current distribution of that debt among families and the Bank has commissioned a survey to improve our knowledge. There is a risk that some heavily indebted households will be badly affected by changes in economic circumstances or interest rates. Everyone needs to think carefully about the amount of debt which they can afford.

Business investment is higher than previously thought. And government spending continues to rise rapidly. Net trade, however, is likely to continue to subtract from growth in the near term, as it has for the past seven years.

Unemployment remains low. And there are signs, in the surveys and the latest employment data published this morning, that the labour market may be starting to tighten further. Earnings growth and settlements in the economy as a whole continue at moderate levels. The difference between them, “wage drift”, is unusually low at present - close to zero in fact - so that some pick-up in earnings growth would be expected even if settlements remained subdued. The Committee will be monitoring wage developments carefully over the forthcoming pay round.

The Committee’s latest projection for GDP growth, on the assumption that official interest rates remain constant at 3.75% throughout the two-year forecast horizon, is shown in Chart on page iii of the Report. The central projection is one of growth at, or a little above, its historical average throughout the forecast period. Consumer spending, business investment and public expenditure are all expected to contribute to steady growth. Overall, the outlook is somewhat stronger than in August.

The Committee's latest projection for inflation is shown in Chart 2 on page iii. Although some of the temporary factors pushing up RPIX inflation are expected to unwind in the coming months, the central projection for inflation is that it remains around the target through the forecast period, picking up at the two-year horizon as underlying inflationary pressures build.

There are considerable risks to the central projection for inflation, but, in the Committee's view, they are broadly balanced. In making its decision last week, the Committee was mindful of the increased uncertainty about the effect of a rise in interest rates on household spending, and, ultimately, on inflation and our ability to meet the target, resulting from the high levels to which household debt have risen. The Committee judged that, although inflation is expected to remain close to the target of 2.5% through much of the forecast period, the prospect of gradually increasing inflationary pressures made an increase of $\frac{1}{4}$ percentage point necessary to meet the target in the medium term.