

## **INFLATION REPORT PRESS CONFERENCE**

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

Since the *August Report*, the economic landscape has changed. As a result, the downward revision to the inflation outlook in today's *Report* is the largest in any one quarter since the Monetary Policy Committee was set up.

It is very likely that the UK economy entered a recession in the second half of this year. The preliminary estimate of the fall in output in the third quarter was 0.5%, a little more than the fall in the Committee's central projection in August. But since then three factors have transformed the outlook.

First, the short-run indicators for activity declined markedly. Surveys and reports from the Bank's Agents suggest that in September and October there was a sharp fall off in demand, both at home and abroad. Growth in the fourth quarter is likely to be materially weaker than the Committee expected in August. And, as we saw this morning, unemployment in the UK has risen at the fastest rate for seventeen years.

Second, following the failure of Lehman Brothers, the most serious banking crisis since the outbreak of the First World War reduced the supply of credit to the real economy, and, in some cases, led to a cessation of lending altogether. Confidence has been badly affected. All this will restrain demand looking into next year.

Third, although CPI inflation did rise above 5% in September, its expected future path has fallen very significantly. Oil and other commodity prices have more than halved since their peak. In August, the projections were conditioned on a starting level for the oil price of around \$124 a barrel, whereas today's *Report* assumes a level of \$64 a barrel. In the space of a few months, we have gone from the highest rate of manufacturing input price inflation in nearly thirty years to the lowest monthly rate on record. And measures of short-run inflation expectations have fallen back sharply.

In response to those three factors, there have been significant policy actions. On 8<sup>th</sup> October, the UK authorities announced a plan to recapitalise the banks in order to repair banks' balance sheets and thereby restore confidence in the UK financial system. Other countries have taken similar measures. Central banks around the world cut interest rates in a coordinated move in early October. And the MPC cut Bank Rate again last week.

The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART) on page 7 of today's *Report*. The projection is based on the assumption that Bank Rate moves in line with market expectations prevailing prior to the Committee's November decision. Those were for Bank Rate to fall from an average of 4% in the fourth quarter of this year to a little below 3% over the next year or so, before rising back to around 4%. I will return to this assumption in a minute. The central projection is for output to decline over the next year, so that four-quarter growth falls further in the near term. That is markedly lower than the projection in August, reflecting the impact of the banking crisis on credit supply and the sharp falls in confidence in the real economy. Further ahead, domestic demand should gradually start to recover as the impact of lower interest rates, the effects of the bank recapitalisation programme on credit availability, and some recovery in real take-home pay take hold. And that, together with a pickup in exports following the fall in sterling's effective exchange rate, should support a recovery in output growth to slightly above its long-run average. The risks shown in Chart 1 are broadly balanced.

The Committee's latest projection for CPI inflation is shown in Chart 2 (RED CHART) on page 8 of the *Report*, again on the assumption that Bank Rate follows the path implied by market yields prevailing prior to the Committee's November decision. Inflation falls sharply from its current level of 5.2% as domestic energy and food price inflation declines, driven by the large falls in commodity prices. The precise speed with which overall inflation declines also depends on the extent to which the lower level of sterling is passed through into higher prices. But in the central projection, inflation reaches the 2% target in the second half of 2009 and then moves materially below the target. The weakness in inflation further out in the forecast period reflects weak demand which,

despite a material slowing in the growth rate of potential supply, opens up a margin of spare capacity and pulls down on price and wage increases. The risks shown in Chart 2 are broadly balanced.

On this occasion, the fan charts need to be interpreted with particular caution for two reasons. First, as always the projections shown are based on a number of conditioning assumptions. Notably, they assume, as I described earlier, that interest rates will follow the path consistent with market expectations prior to the MPC's decision last week. They also make no allowance for any fiscal relaxation relative to currently published tax and spending plans. As a result, the fan charts exaggerate the extent to which the Committee believes output will decline and inflation will fall below target in the medium term.

Second, there are very few historical parallels to the present set of circumstances. So the uncertainty surrounding the projections in today's *Report* is unusually large. More than ever, therefore, I urge you to focus your attention on the broad shapes of the fan charts rather than on the precise calibrations of the projections and balance of risks.

For some time, the Monetary Policy Committee has faced a balancing act between the upside risk to inflation from continuing high inflation in the near term, and the downside risk that a sharper or more prolonged slowdown could pull inflation well below the target in the medium term. Over the past two months, the three factors I described earlier have turned the prospects for inflation decisively to the downside. As a result, the Committee judged at its meeting last week that, to return inflation to the target, it was necessary to cut Bank Rate by 1 ½ percentage points to 3%.

The outlook for inflation has changed substantially. But the Committee's approach to setting monetary policy has not. It continues to set interest rates in a deliberate, forward-looking manner in order to ensure that inflation is on track to hit the inflation target in the medium term. That approach has served the UK economy well over the past eleven years. And I am confident that it will continue to do so in these exceptional and difficult times.