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OPENING REMARKS BY THE GOVERNOR

In the first half of the year growth was sluggish. Inflation, by contrast, has been above target for nine successive months. Today's *Report* concludes that growth is likely to pick up and inflation to fall back. Once again, the central projection is for growth to be close to trend and inflation close to the target. But there are real risks - on both sides of the central projection.

The world economy has recovered more slowly than expected. Output in the euro area has risen by less than 1% over the past year. Since the spring of last year the effective exchange rate of the euro has risen by around 15%. As a result, net trade is now subtracting from growth, and final domestic demand remains flat. Nevertheless, the monetary easing of the past year should lead to a gradual pickup in domestic demand, and, in the central projection, output growth is expected to recover to around trend over the next year or so. In the US, signs of recovery are more apparent, with particularly sharp rises in business confidence and an increase in investment. But weakness in the labour market and the volatility of bond markets point to the uncertain speed of recovery. That uncertainty is compounded by the size of the US current account deficit, which has now risen to over 5% of GDP. The fall in the dollar's trade-weighted index of about 15% over the past year or so should help to reduce this deficit. But the continuing weakness of domestic demand in both Japan and the euro area is impeding the reduction of current account imbalances.

At home, the preliminary estimate for GDP growth in the second quarter was 0.3%, above that in the first quarter but below the central projection in May. Over the first half of the year, consumer spending decelerated markedly. But, following the recovery in consumer confidence, and the recent resilience of house price inflation and household borrowing, the Committee believes that the short-run outlook for spending is somewhat stronger than in May. The growth of consumption is, however, expected to remain lower than the growth rates of the past five years. The slowing of real disposable income growth means that the central projection is for consumer spending to grow at below trend rates for some time to come.

For several years members of the Committee have discussed the significance of the accumulation of debt by households. High and rising debt burdens increase the vulnerability of households to adverse shocks – to incomes, for example – and raise the risk of a subsequent sharp correction to house prices and consumer spending. But this must be balanced against the fact that a rise in owner occupation and higher house prices, leading households to choose to take on bigger mortgages, would lead naturally to a rise in the aggregate debt to income ratio. The Committee will continue to monitor carefully developments in debt.

Government spending continues to increase rapidly. Business investment remains broadly flat, although reports by the Bank's regional Agents suggest that some improvement may not be far off. The pattern of trade is harder to discern. In fact, the fog of war has been replaced by the mists of the trade statistics. Since May there have been significant upward revisions to the level of imports since 1999 as a result of evidence of fraud related to evasion of VAT. These revisions have increased the estimated trade deficit by no less than 1% of GDP. But the ONS has said that estimates of total GDP are unlikely to be revised materially as a result. So the new trade data imply that the imbalance between strong domestic demand and weak net trade in recent years was even greater than previously thought.

Employment has continued to rise, although total hours worked have, if anything, fallen a little over the past year. Unemployment remains stable – at 5.0% on the Labour Force Survey measure released today. Earnings growth in the economy as a whole remained subdued.

The Committee's latest projections for output growth are shown in chart 1 (GREEN CHART) on page iii of the *Report*. As usual, these are conditional on constant official interest rates at 3.5% throughout the two-year forecast horizon. In the central projection, output growth picks up in the coming quarters to a little above trend, easing somewhat thereafter. Subdued consumer spending is offset by continuing rapid growth of public expenditure, a slow but steady improvement in the contribution of net trade, and a mild pickup in business investment. Over the forecast horizon, the outlook for output growth is broadly similar to that in May.

The Committee's latest projection for inflation is shown in chart 2 (RED CHART) on page iii of the *Report*. Following a prolonged period in which RPIX inflation has been above the 2.5% target, the central projection is for inflation to fall back to a little below target around the turn of the year, as the contribution of the housing depreciation component of measured inflation diminishes, and then edge up to around target as the impact of sterling's depreciation earlier this year adds to domestic cost pressures.

The sluggish nature of the world recovery, and the resilience of consumer spending and house price inflation at home, point to real risks on both sides of the central projection. The unwinding of the imbalances, both at home and abroad, creates uncertainty about the prospects for output and inflation. Overall, the Committee's judgment is that the risks to activity are somewhat on the downside, less so for inflation. In July, the Committee felt that, given weaker output and inflation pressures, it needed to reduce official interest rates modestly as a precautionary measure. This month, given the central projection for inflation, and the risks around it, the Committee concluded that it was appropriate to leave interest rates unchanged in order to meet the inflation target looking two years or so ahead.