INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

It may still – just – be summer, but there is a feeling of chill in the economic air. The British economy is going through a difficult and painful adjustment – to higher energy and commodity prices, and in banking, credit and housing markets. This adjustment to our economy cannot be avoided. And, as a result, inflation is rising and growth is slowing.

Rising food and energy prices have pushed up CPI inflation to 4.4% in July. Recent announcements of rises in retail gas and electricity prices mean that inflation is likely to rise further this year and to peak at around 5% in the coming months.

Increases in food and energy bills will intensify the squeeze on real take-home pay, which, for many households, is unlikely to grow this year. These are circumstances in which both consumer spending and house prices are likely to weaken together.

In addition, the continued adjustment of banks' balance sheets has resulted in a monetary squeeze and tighter credit conditions, as shown by the sharp contraction of underlying broad money and credit growth. The impact of this is very clear in residential and commercial property markets where activity has slowed as prices have fallen. Indicators of housing investment point to a substantial slowdown. And surveys suggest that companies have scaled back their plans for capital investment.

The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART) on page 6 of today's *Report*. The projection is based on the assumption that Bank Rate moves in line with market expectations, which are for Bank Rate to be roughly constant over the forecast period. The central projection is for output to be broadly flat over the next year, so that four-quarter growth slows sharply in the near term. That is markedly lower than the projection in May, reflecting a weaker prospect for both consumer and investment spending. But further ahead, as food and domestic energy prices stabilise, the growth rate of real take home pay should recover. And that, together with some easing in credit supply conditions and a pickup in exports following the fall in sterling's effective exchange rate, should support a recovery in output. Nevertheless, the possibility of a more prolonged adjustment in the financial sector means that, in the Committee's judgement, the balance of risks around this central projection is on the downside.

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. In the central projection, higher prices for domestic energy, food and imports push inflation further above the target this year. These price increases will continue to enter the measure of CPI inflation for 12 months, so inflation is likely to remain markedly above the target until well into next year. But the impact of these increases in commodity prices will diminish during 2009. They cannot by themselves generate sustained inflation unless other prices begin to rise at a faster rate. And it is the task of the MPC to ensure that they do not. So the current period of above-target inflation, although very marked, will be temporary and inflation will return to the 2% target.

To deliver that, the MPC must judge the appropriate stance of monetary policy. The near-term outlook for inflation has deteriorated since May, reflecting the news about food and energy prices. The Committee judges that a more pronounced slowdown in activity is likely to be necessary to contain wage and price pressures and ensure inflation expectations are anchored in the medium term. In the central projection, the slowdown opens up a sufficient margin of spare capacity for inflation to fall back. And, towards the end of the forecast period, it falls a little below the 2% target. But there are serious upside risks around that central projection, which stem from the possible impact of continuing high inflation in the near term on pay growth and on inflation expectations.

The Monetary Policy Committee continues to face a balancing act between these upside risks and the downside risk that a sharper or more prolonged slowdown could pull inflation well below the target in the medium term. It was in the light of these risks that the Committee judged at its meeting last week that, to return inflation to the target, it was appropriate to maintain Bank Rate at 5%.

The adjustment of the UK economy to higher commodity prices and a more realistic pricing of credit will be painful. The next year will be a difficult one, with inflation high and output broadly flat. But with monetary policy focused on its task of bringing inflation back to the target, we will come through the adjustment. And we will return, if not to the *nice* decade, then at least to one that, as central bankers say, is not so bad.