

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

Output growth recovered towards the end of last year after a soft patch in the third quarter. Inflation has picked up since November. The Monetary Policy Committee's new central projection is for continuing steady growth with low inflation. Over the next two years inflation is expected to rise gradually, to slightly above the target of 2%. But the balance of risks to that central projection is judged to be a little on the downside. Since the future is highly unlikely to turn out exactly as in the central projection, attention should be focussed on the forecast as a whole – both the central projection and the risks.

The provisional estimate of output growth in the fourth quarter of last year is 0.7%, higher than the upwardly revised estimate of 0.5% in the third quarter and close to the rate of expansion for much of the previous year. Business surveys suggest that there is more momentum in output growth than the Committee had expected in November, especially in services. Manufacturing output is estimated to have risen at the end of 2004 and the figures for earlier months were revised up, reducing the discrepancy between the official estimates of output and the picture painted by business surveys and reports from the Bank's Agents.

The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART) on page ii of the Report. As in November, the projection is based on the assumption that official interest rates over the forecast period will move in line with market expectations which, at present, are broadly flat. Today's central projection is for growth to be robust – a somewhat stronger near-term outlook than envisaged in November – and not far from its historical average.

A key downside risk to this outlook is the path of consumer spending. The Committee's central projection is that consumer spending will increase at around its average growth

rate over the past three years. Income growth remains strong, financial wealth has risen, and money and credit continue to grow rapidly. But in the fourth quarter of last year consumer spending appears to have slowed. Retail sales fell in December and reports from individual retailers and business surveys indicate weakness. So the outlook is highly uncertain. As I said last month in Manchester, drawing strong conclusions about spending over the Christmas period is something we should all give up for Lent.

As in November, the impact of demand pressure on inflation over the next two years is difficult to judge. Unemployment is stable at its lowest level for thirty years and all indications point to a tight labour market with potential upward pressure on earnings. But the growth of both employment and regular pay in the private sector has been subdued of late. Whether labour costs remain subdued is another key risk to the forecast.

Recent outturns for CPI inflation have been higher than expected, although still below the 2% target. Inflation has returned to 1.6% where it was at the time of the August Report. The Committee's projection for CPI inflation, again conditional on the market expectation of official interest rates, is shown in Chart 2 (RED CHART) on page iii of the Report. The central projection is for demand pressures and higher import prices to push up inflation to slightly above the 2% target two years ahead, rising modestly thereafter. That projection is a little higher than in November. As far as risks are concerned, the extent to which higher cost pressures may be offset by the effects of intense competition in distribution – which has compressed profit margins and raised productivity – is particularly uncertain. Moreover, in recent years falls in import prices have offset rises in the prices of domestically produced goods, although that has been less true in recent months. There is inevitably great uncertainty over the future course of import prices.

As ever, the risks are at least as important as the central projection itself. The main downside risk to inflation stems from uncertainty about the near-term momentum to consumer spending. The principal upside risk to inflation is uncertainty about earnings growth in such a tight labour market. Import prices imply risks in both directions.

Overall, the Committee judges that the balance of risks is somewhat to the downside, though there is a range of views among members.

Given both the central projection and the balance of risks, the Committee decided at its meeting last week that it was appropriate to leave the official interest rate unchanged.