

## **INFLATION REPORT PRESS CONFERENCE**

**Wednesday 16 May 2007**

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

Inflation rose to 3.1% in March, thus triggering an open letter from me to the Chancellor. As you saw yesterday, CPI inflation fell back to 2.8% in April, as the substantial increases in household gas and electricity prices that occurred a year ago started to drop out of the twelve-month rate and the falls in this year's prices started to take effect. CPI inflation is likely to fall back further over the next few months as those effects continue. But the crucial question for monetary policy is where inflation is likely to be once energy prices have settled down. At that point inflation will reflect the balance between money spending and supply capacity in the economy as a whole. And it is the Committee's view of that outlook which has been behind its decisions to raise Bank Rate four times since last August.

Output growth is estimated to have been at or above its long-run average rate for five quarters and that strong growth appears to be continuing into the second quarter of this year. Asset prices, and money and credit growth, remain remarkably high. Although consumer spending has been volatile, the underlying trend is of recovery from the slowdown in 2005. Real take-home pay is expected to increase more rapidly than in the recent past after a period of slower growth reflecting rising taxes and energy costs. That will help to offset the drag from higher interest rates and rising debt. Business investment has been stronger than the Committee expected in February and surveys of investment intentions suggest continuing growth. And despite slower growth in the United States, robust growth in the euro area and in Asia is supporting a strong world economy.

The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART) on page 6 of today's *Report*. That projection is based on the assumption that official interest rates move in line with market expectations over the

forecast period. The path of interest rates assumed in this projection anticipates a further rise in Bank Rate, as shown in the table in the box on page 41. The central projection is for GDP to continue to grow at around its recent rate before slowing a little towards the end of the forecast period. That is very similar to the February projection. In the Committee's view, the risks to output growth around the central projection are broadly balanced, as indeed they were in February.

The Committee's projection for CPI inflation is shown in Chart 2 (RED CHART) on page 8 of the *Report*, again on the assumption that official interest rates follow market expectations. CPI inflation falls back to, and a little below, the 2% target over the next six to twelve months, before picking up again as the effects of this year's cuts in gas and electricity prices drop out of the twelve-month inflation rate. Looking to the medium term, the central projection is for inflation to settle around the target. Against a background of rapid money and credit growth, the outlook for money spending appears strong. Supply capacity, however, also seems resilient with the supply of labour, including further inward migration, continuing to expand allowing earnings growth to remain subdued.

There are substantial risks around that central projection. In the medium term, the main downside risk is that there could be more slack in the labour market which would slow pay growth further. On the upside, a number of measures of inflation expectations have drifted up, and, with a limited degree of spare capacity and firm demand growth, the main risk is that businesses become more confident of their ability to raise prices and in turn pay higher wages.

Overall, the balance of risks to inflation around the central projection two years or so ahead is, in the Committee's judgment, on the upside. The Committee will monitor those risks carefully over the coming months. Indicators of pricing pressure are particularly important at present. If they remain elevated, that would be consistent with the possibility that inflation expectations had moved more persistently upwards or margins were being raised more aggressively, and that the upside risks were crystallising. If,

however, wage pressures were to diminish, that would suggest that the upside risks had receded.

Given the outlook for inflation, and the balance of risks around the central projection, the Committee judged that a rise of 25 basis points in Bank Rate was necessary at last week's meeting. The Committee will look through the short-run volatility to the outlook in the medium term. It is determined to meet the 2% target, and will take whatever further action may be required to do that.