

INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

Following a weak first quarter, economic activity in the United Kingdom is reported to have picked up over the course of the year. Inflation rose from 1.1% in September 2004 to 2.5% in September this year. Over the next year, inflation is likely to fall back as higher energy prices drop out of the twelve-month comparison. We saw yesterday what may be the first signs of that in the CPI figures for October. But there are substantial risks to the outlook – in both directions.

Since August further revisions to the official output data suggest that the economy slowed more sharply over the preceding year than previously estimated. But business surveys and the continued growth of employment, apparent again in this morning's figures, paint a less subdued picture. Excluding energy extraction, which was erratically weak in the third quarter, it now appears that output growth has recovered gently from a low point at the start of 2005. In assessing the balance between demand and supply in the economy, there is considerable uncertainty not only about past growth rates of demand but also about the extent to which higher oil prices and future flows of migrant workers may reduce supply capacity.

Domestic demand, led by consumer spending, has been weaker than expected over the past year, in part because real post-tax employment income has grown much less quickly than for some time. But there has probably been some recovery in consumer spending during the year. And there have been signs of a strengthening of activity in the housing market with house prices remaining broadly stable. Business investment has been relatively subdued over recent years, although strong profitability and cash flow, and the lowest level of long-term real interest rates for a generation, imply that there is scope for a recovery. The softness of business investment, given the path of output, is not unique to the UK and has been evident in a number of industrialised countries. The world

economy continues to expand and at some point foreign trade is likely to make a positive contribution to annual GDP growth for the first time since 1995.

The Monetary Policy Committee's projection for GDP growth is shown in Chart 1 (GREEN CHART) on page ii of today's *Report*. That projection is based on the assumption that official interest rates move in line with market expectations of a broadly flat profile over the forecast period. The central projection is for annual GDP growth to rise, reflecting a recovery of domestic demand and foreign trade. Consumer spending picks up modestly, but continues to grow at below average rates. The Committee expects some further rebalancing of the economy away from household consumption towards foreign trade and business investment over the forecast period.

The Committee's projection for inflation is shown in Chart 2 (RED CHART) on page iv of the *Report*, again on the assumption that official interest rates follow market expectations of a flat profile over the forecast period. The sharp rise in energy prices over the past two years contributed to the recent pickup of CPI inflation, although the relative contributions of energy prices and domestically generated inflation are difficult to disentangle. The central projection is for CPI inflation to fall back to below the 2% target over the next year before gradually rising back to and then a little above the target two years and more ahead, reflecting growing demand pressures and rising import prices. It is too early to be sure that the recent pickup in inflation will not lead to further "second-round" increases in pay and prices, although the Committee draws comfort from the observation that so far neither inflation expectations nor earnings growth have risen. The Committee will be monitoring developments in those areas carefully.

As I said last month in Gateshead, "it is likely that in future the shocks to both demand and potential output will be more challenging for monetary policy than during the Great Stability". One source of uncertainty about the inflation outlook concerns the impact of higher oil prices and flows of migrant workers on potential supply, and, more generally, about how the balance between demand and potential supply in the economy has changed and will evolve. Moreover, we do not know where oil prices will move, nor the extent to

which the recent rise in inflation can be attributed to higher energy prices. So there are risks to inflation in both directions. In the Committee's judgment those risks are evenly balanced, although the degree of uncertainty is larger than usual. Given the outlook for inflation, and the balanced nature of the risks, the Committee decided last week to leave interest rates at their present level. But it remains committed to doing whatever is necessary to keep inflation on track to meet the target in the medium term.