INFLATION REPORT PRESS CONFERENCE

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Opening remarks by the Governor

Sometimes predictions do come true.

For example, as the MPC predicted three months ago, today I have had to write the second in what is likely to be a sequence of open letters to the Chancellor. That's because, as expected, inflation fell to zero in March, two percentage points below the target and the lowest since official CPI data began.

As was the case in February, the single most important reason for below-target inflation has been the sharp drop in energy prices. In March, oil was around 40% cheaper than in the middle of last year and the price of petrol at the pump has fallen by more than a tenth. Food prices have also dropped, and sterling's appreciation over the past two years has continued to depress import prices.

Taken together, these factors explain around three quarters of the shortfall in inflation from target, with the remainder reflecting subdued growth in domestic costs, particularly wages.

The MPC expects the impact of past falls in commodity prices to be relatively short lived and will therefore look through them in setting policy. Although it could temporarily turn negative in the near term, inflation is expected to pick up notably towards the end of the year as the past falls in prices drop out of the annual comparison.

Recent developments support the MPC's view that a temporary period of falling prices, driven by a few components of the CPI, should not be mistaken for the potentially damaging process of widespread and persistent deflation. The proportion of the CPI's components showing positive inflation is much the same as it was during the decade prior to the crisis. More fundamentally, the economy is growing, unemployment is falling, earnings growth is improving and there is no evidence of household spending being delayed.

Given that inflation expectations remain broadly consistent with the 2% target, the more enduring influences on UK inflation will be the evolution of domestic costs, particularly wages relative to productivity, and the likely persistent drag from the strength of sterling, which has risen around 6% in the past year and 18% since its trough.

These influences are currently weighing on core inflation, which fell to 1 per cent in March, and is expected to remain subdued for most of the year.

The MPC's strategy for returning inflation to target remains the same as in February: namely, to set policy to support the rise in domestic costs needed to return inflation to target within two years.

The appropriate path for Bank Rate will hinge crucially on the outlook for supply. The composition of supply growth is expected to shift notably over the forecast horizon as slack in the labour market is eliminated and productivity finally begins to pick up.

After a comprehensive review, the MPC judges that current slack in the economy is around ½ per cent of GDP. The MPC expects that remaining spare capacity to be absorbed within the next year.

In recent years labour supply has expanded significantly owing to higher participation rates among older workers, a greater willingness to work longer hours and strong population growth, partly driven by higher net migration. These positive labour supply shocks have contained wage growth in the face of robust employment growth. Wages have grown by around 2% in the past year – less than half the average rate before the global financial crisis – and a key risk is that these subdued growth rates continue.

Such strong growth in labour supply is unlikely to be sustained. Going forward, growth in the UK economy's potential will increasingly depend on productivity.

In the medium term, productivity growth – doing more with less – is the key determinant of income growth. Our shared prosperity depends on it.

Productivity, though, is not something that monetary policy determines, and among the many uncertainties we face, the timing and extent of any prospective pick-up in productivity growth remains our most difficult judgement.

One insight from our review of supply is that over the past year, some of the weakness in measured productivity reflects so-called compositional effects: there has been disproportionate growth in relatively low productivity jobs, partly reversing what occurred when unemployment rose sharply.

But there has also been underlying weakness. And in light of that, we have become even more conservative in our forecast for renewed productivity growth. Productivity is projected to grow only modestly in the year ahead, before returning towards, but remaining below, past average growth rates. That recovery reflects a combination of factors. They include the lessening of compositional effects, a pick-up in the reallocation of resources to new and more dynamic firms, and the effects of the investment recovery coming through.

On the demand side, the expansion is set to reaccelerate following a slightly softer than expected first quarter.

Consumer confidence is strongest in over a decade. Household spending should continue to be supported this year by the boost to real take-home pay from lower food and energy prices. Over the balance of the forecast, wage growth is expected to accelerate as compositional effects fade and the pick-up in productivity supports higher labour compensation.

Higher demand, accommodative financial conditions and emerging capacity constraints should encourage continued investment growth outside the extraction sector.

The MPC expects the global economy to expand at a steady not spectacular rate, with the principal risks to growth rotating from advanced to emerging economies. The most significant development in recent months has been the increased momentum in our main trading partner, the euro area. European activity should be supported by the ECB's Quantitative Easing, which the MPC judges to be net positive for UK growth. ECB action, improvements in euro area fundamentals, and very limited UK exposure, mean that any intensification of the Greek crisis would likely have only a modest downward impact on UK GDP.

Overall, despite a moderately weaker outlook for demand growth relative to our February *Inflation Report*, a similarly weaker outlook for supply means we continue to expect a sufficient firming in inflationary pressures to return to target within two years. Beyond that, and conditional on the gently rising path for Bank Rate implied by market yields, inflation is expected to rise a little above the target.

With the closing of the output gap in sight, the question of the level of the equilibrium interest rate – the rate required to keep the economy operating at capacity and inflation at the target – comes into sharper focus. Perhaps the most important legacies of the financial crisis are the persistent headwinds which continue to weigh on the UK economy from weaker global demand, sustained fiscal consolidation, ongoing private deleveraging and, with time, higher financial intermediation costs. The MPC has long expected that these headwinds will likely merit not only a more gradual rate of increase in Bank Rate than in previous cycles, but also require levels of Bank Rate to remain below average historical levels for some time to come.

There are, however, limits to these effects. At our most recent meeting the MPC noted that it was uncertain why the yield curve had flattened further over the past year beyond our three-year forecast horizon. In this context, the direction of recent moves in advanced economy bond markets are not particularly surprising.

Last week, we were reminded of the difficulties in forecasting the outcomes of complex, interacting systems. Today, the MPC is setting out our latest best collective judgement for the outlook for the economy. As illustrated by the fan charts around it and my comments this morning, this forecast is subject to considerable uncertainties and will inevitably be buffeted by domestic and international shocks.

That's why the MPC votes frequently so that we can respond to events and act to deliver the price stability upon which British households and firms depend. This provides the best environment for the ingenuity and creativity of the British people to flourish and drive the sustained rise in living standards to which we all aspire.