INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

The world economy remains in a deep recession and its financial system in a fragile condition. But there are more encouraging signs looking ahead. Confidence has recovered somewhat from its collapse last autumn and strains in financial markets have eased. Around the world, the policy stimulus has been extensive. At home, Bank Rate has fallen almost to zero, the MPC has announced a programme of asset purchases totalling £175 billion and further hundreds of billions of pounds have been directed to supporting the banking system. Nevertheless, nominal indicators remain weak and the adjustment of balance sheets has a long way to run.

Activity in the UK economy has continued to fall. The level of GDP is around 6% below its peak, and manufacturing output is more than 10% down on a year ago. Unemployment continues to rise. The recession appears deeper than the MPC thought likely at the time of the May *Report.* But, as the impact of de-stocking has turned round and the effects of a lower exchange rate and the policy stimulus have begun to come through, the pace of contraction has moderated. It is likely that output stabilised in the middle of this year, and business surveys and other short-run indicators suggest that growth is more likely than not to resume over the next few quarters.

Nevertheless, given the depth of the recession, to erode the margin of spare capacity that has been created will require an extended period of robust growth. And the sustainability and strength of any recovery will be affected by necessary balance sheet adjustments of the banking, household and public sectors. Recovery could be slow and protracted.

The Monetary Policy Committee has a nominal target: 2% for the CPI measure of inflation. And the nominal side of the economy has been especially weak. The growth rate of money held by companies and households has fallen from an average annual rate of about 8% in the five years before last autumn to 2 ½% now. Total money spending in the four quarters to 2009 Q1 fell by 4%. A fall of that magnitude has occurred in only two other episodes since 1900, and, if it persisted, would be inconsistent with meeting the inflation target in the medium term. That is why the MPC has been

taking action to inject extra money directly into the economy. The aim is simple: to raise the supply of money and so boost nominal spending in order to meet the 2% inflation target. In turn, that will aid recovery.

The ability to conduct asset purchases to boost the supply of money does not depend directly on the banking system's ability to lend. But constraints on the supply of lending will diminish its effectiveness in stimulating a recovery. It will take time for banks to repair their balance sheets and they face considerable challenges in replacing those sources of funding that dried up in the financial crisis and the temporary support provided by the public sector. Our continuing operations in corporate credit markets are helping to ensure that, for some companies at least, an alternative source of finance is readily available.

The financial sector is the most obvious, but not the only, sector that is likely to restructure its balance sheet. Households may save more in response to the falls in financial asset prices, or simply to create a buffer of savings to guard against uncertain times ahead. And the public sector, having cushioned the slowdown in spending, will over time need to adjust its finances to a more sustainable position. Such factors mean that the pace of recovery over the next few years is highly uncertain.

Chart 1 (GREEN CHART), on page 6 of the *Report*, represents the Committee's best collective judgement of the range of outcomes for four-quarter GDP growth, assuming that Bank Rate follows a path implied by market interest rates and that the stock of purchased assets, financed by the issuance of central bank reserves, reaches £175 billion and remains at that level throughout the forecast period. The stimulus to demand, combined with a turnaround in the stock cycle and the effects of the depreciation in sterling, is likely to drive a recovery in activity. But the likelihood of a prolonged period of balance sheet adjustment in the financial, private and public sectors means that the Committee judges that the risks are weighted towards a relatively slow recovery.

Chart 2 (RED CHART), on page 8 of the *Report*, shows the Committee's judgement about the path of CPI inflation under the same monetary policy assumptions. In the short run, inflation is likely to be volatile, at first falling quickly as the impact of last year's sharp increases in energy prices drop out of the twelve-month comparison, before rising sharply as last year's VAT cut is reversed. It is more likely

than not that later this year I will need to write a letter to the Chancellor to explain why inflation has fallen more than one percentage point below the target. In the medium term, inflation is likely to remain low as the margin of spare capacity that is likely to persist over the forecast period continues to push down on CPI inflation. That is partially offset by the upward pressure associated with the pass-through of sterling's past depreciation to consumer prices. The relative magnitude of these opposing influences on inflation is again highly uncertain, but on balance the Committee judges that, with Bank Rate following the market yield curve and a stock of asset purchases of £175 billion, inflation is more likely to be below the target than above it in the medium term.

Given that outlook for inflation, the Monetary Policy Committee last week voted to maintain Bank Rate at 0.5%, and to increase the programme of asset purchases to £175 billion in total. Those actions were taken, and were necessary, to keep inflation on track to meet the 2% target in the medium term. The Committee is very conscious that at some point this extraordinary degree of policy stimulus will need to be withdrawn. The framework within which Bank Rate was cut and asset purchases are being carried out – the inflation target – is the same framework within which at some point Bank Rate will be raised and those same assets sold. So on the "glorious twelfth", when some take to the moors to try to hit a moving target, perhaps you would allow me to remind you that central bankers take refuge in aiming at a fixed target.