INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

The UK economy has continued to bump along the bottom, but a gradual recovery in output may now be in prospect. There are signs that many economies are on the mend, although much uncertainty remains about the likelihood of a sustained rise in real final demand in the world economy as a whole. At home, the tailwinds of an enormous policy stimulus and the depreciation of sterling are meeting the headwinds created by the balance sheet adjustment of the damaged banking system. Spare capacity will press down on inflation in the medium term. But the near-term outlook is for inflation to rise further as the restoration of the standard rate of VAT to 17 ½% and higher petrol prices impact on the CPI measure of inflation.

While the banking system reduces its leverage, there will continue to be downward pressure on the supply of credit to households and businesses and on monetary growth. The twelve-month growth rate of broad money, excluding intermediate financial companies, slowed further to around 1%. But, because asset purchases injected additional money into the economy, money growth is stronger than it would otherwise have been, and asset prices have picked up. Since their troughs last year, equity prices have risen 50% and both commercial and residential property prices have increased by around 10%. It is also reassuring that total money spending has begun to grow again after the sharp falls at the beginning of last year.

Inflation has risen sharply, as expected, from its trough of 1.1% in September last year to 2.9% in December, reflecting higher petrol price inflation and last year's temporary reduction in VAT dropping out of the twelve-month comparison. Although the exchange rate has been broadly stable over the past year, the sharp fall in sterling since the middle of 2007 is also still feeding through to consumer prices. The January figure for CPI inflation is likely to have exceeded 3%, as the effects of the restoration of VAT to 17 ½% fed through. This would be the third episode when inflation has temporarily moved above the target by more than one percentage point, requiring me to write an open letter to the Chancellor. On both previous occasions the MPC said that inflation would come back down. On both previous occasions it did. And the Committee expects that to be the case this time too.

Monetary policy can do little to affect these short-run movements in inflation. Rather it affects the path of nominal spending. And that, relative to the supply capacity of the economy, determines inflation in the medium term. The strength of both the headwinds and the tailwinds affecting spending is uncertain, so it is hard to be sure how strong or sustained the recovery in spending will prove to be. And it is perhaps even harder to judge the impact of the financial crisis and last year's downturn on the supply capacity of the UK economy – both in terms of magnitude and persistence. Nevertheless, it seems clear that at present there is significant spare capacity in the economy that will act to dampen inflation.

Chart 1 (GREEN CHART 1), 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, remains at £200 billion throughout the forecast period. The considerable stimulus from monetary policy and the depreciation of sterling should underpin a recovery in economic activity. But that will need to work against the headwinds from the banking system and the need to strengthen the public sector finances. Overall, the outlook for GDP growth is similar to that in the November *Report*. Within that big picture, the pace of recovery is somewhat less strong than three months ago, but the Committee believes that the downside risks are, on balance, now less pronounced.

Chart 2 (GREEN CHART 2), on page 7 of the *Report*, shows a fan chart for the level of GDP, which is derived from the growth projection shown in Chart 1. It shows that despite the recovery in economic growth, output is unlikely to return to a level consistent with a continuation of its pre-crisis trend for a considerable period. That is in large part because the impact of the downturn on the supply capacity of the economy is expected to persist. But output is also judged likely to remain below capacity throughout the forecast period.

Chart 3 (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. After rising sharply in the near term, inflation is likely to fall back to below the target, as the impact of the past depreciation of sterling fades, and as the margin of spare capacity pushes down on CPI inflation. The outlook for inflation is highly uncertain, but the Committee judges that inflation is, on balance, more likely to be below the target than above it for much of the forecast period, though by the end the risks are broadly balanced.

It was at this press conference one year ago that I explained the asset purchase programme to you. That was at a time of sharply falling output and collapsing confidence. Since then, the position has improved considerably. Output has stabilised and confidence has recovered. The additional money created by the asset programme will continue to boost the economy for some time to come. But the nature of the headwinds means that the recovery is likely to be slow. And there is much uncertainty – about both the outlook for the world economy and the strength of domestic spending. Although the MPC last week announced a pause in its programme of asset purchases, it is far too soon to conclude that no more purchases will be needed. So the Committee will keep its options open, and further purchases will be made if they prove necessary to keep inflation on track to meet the target in the medium term.