INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

The near-term outlook for inflation has deteriorated markedly over the past three months. CPI inflation was 3% in April, and rising energy and import prices will almost certainly push inflation up further, possibly significantly, in the coming months. As those price increases feed through to household bills, they will lead to a squeeze on real take-home pay which will slow consumer spending and output growth, perhaps sharply. So the balancing act faced by the Monetary Policy Committee is even more challenging than it was in February.

Financial market conditions have stabilised since the introduction of the Special Liquidity Scheme, but they remain fragile. Banks continue to adjust their balance sheets – by raising new capital and lowering the supply of credit to the rest of the economy. The impact of tighter credit conditions is most clear in property markets. Commercial property prices have fallen by 16% since the summer and house prices are now falling too.

In these circumstances, the household saving rate is likely to rise. This is part of a rebalancing of the UK economy, away from spending and importing, towards saving and exporting – a change that will be supported by the depreciation of sterling, which is now 12% below where it was in August.

The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART) on page 7 of today's *Report*. The projection is based on the assumption that Bank Rate moves in line with market expectations, which, when the *Report* was finalised, were for a modest further fall in Bank Rate over the next year. The central projection is for growth to slow sharply in the near term, reflecting the squeeze on real incomes, before recovering as credit conditions begin to ease and the depreciation of sterling boosts exports and reduces imports. The Committee judges that the possibility of more

prolonged restrictions to the supply of credit means that the balance of risks to the outlook for growth is to the downside in the medium-term.

The Committee's latest projection for CPI inflation is shown in Chart 2 (RED CHART) on page 8 of the *Report*, again on the assumption that Bank Rate follows the path implied by market yields. In the central projection, higher prices for domestic energy, food and imports push inflation markedly above the target this year. If, as futures markets anticipate, energy prices stabilise, inflation should start to decline around the end of this year and settle around the 2% target in the medium term. There is considerable uncertainty over that profile because it rests on assumptions about the magnitude and timing of further rises in domestic gas and electricity prices which are extremely difficult to anticipate accurately. Nevertheless, it is likely that, with inflation above 3% for several quarters, I will be required to write a number of open letters to the Chancellor over the next year.

The unexpected rises in energy prices will, over the coming months, push up the overall price level and will remain in the official measure of inflation for 12 months thereafter. To try to bring CPI inflation back to the target within this period would result in an undesirable degree of volatility in output, so the MPC is aiming to bring inflation back to target over a somewhat longer horizon. That does not, however, mean it is ignoring the near-term rise in inflation. The extent of the deviation from target this year is likely to affect the behaviour of those setting prices and wages. For that reason, the Committee judges that a slowing of demand growth this year, reducing pressure on capacity, will be necessary to ensure that inflation settles around the target in the medium term.

As I described to you in February, the challenge facing the MPC is to balance two conflicting risks to the outlook for inflation in the medium term. On the downside, a sharper than expected slowing in activity could pull inflation below the target. On the upside, inflation, after a significant period above target, could have a greater tendency to persist. In the Committee's judgement, the balance of these risks around the central projection is to the upside.

The Monetary Policy Committee is facing its most difficult challenge yet. For the time being, at least, the 'nice' decade is behind us. The credit cycle has turned. Commodity prices are rising. We are travelling along a bumpy road as the economy rebalances. Monetary policy cannot, and should not try to, prevent that adjustment. The Monetary Policy Committee must focus on bringing inflation back to the 2% target in the medium term. As our remit states, "the real stability upon which economic prosperity is founded requires that inflation remain low and stable for a long period of time." Inflation will return to the target and growth will eventually recover to a sustainable rate. But we will need to be patient.