Inflation Report Press Conference

Thursday 4th August 2016

Opening Remarks by the Governor

Good afternoon.

The decision to leave the European Union marks a regime change. In the coming years, the UK will redefine its openness to the movement of goods, services, people and capital.

Some of the adjustments to this new reality may prove difficult and many will take time. But the UK can handle change. It has one of the most flexible economies in the world. It benefits from a deep reservoir of human capital, world-class infrastructure and the rule of law. Its people are admired the world over for their strength under adversity.

To be clear, the future potential of this economy and its implications for jobs, real wages and wealth are not the gifts of monetary policymakers. We cannot immediately or fully offset the economic impacts of a large structural shock.

However, monetary policy can support the necessary adjustments of the UK economy during a period of heightened uncertainty.

That's why, at its meeting yesterday, the MPC agreed an exceptional package of measures comprising:

- a 25 basis point reduction in Bank Rate to 0.25%;
- a new Term Funding Scheme (TFS) to reinforce the pass-through of the cut in Bank Rate to the borrowing rates actually faced by households and firms;
- a new programme of private sector asset purchases with up to £10 billion of UK corporate bonds; and
- a £60 billion expansion of gilt purchases.

Economic outlook

We took these steps because the economic outlook has changed markedly, with the largest revision to our GDP forecast since the MPC was formed almost two decades ago.

Early indicators are consistent with the risks the MPC identified before the vote. And we now face a trade-off between the degree of support we give to the economy on the one hand and how fast we return inflation sustainably to the target on the other.

By acting early and comprehensively, the MPC can reduce uncertainty, bolster confidence, blunt the slowdown, and support the necessary adjustments in the UK economy.

The degree and composition of stimulus is largely determined by the effects of the vote to leave the EU on demand, supply and the exchange rate.

Demand

Beginning with demand, the 9% depreciation of sterling since the referendum will boost exports and weigh on imports. However, even though the MPC expects the current account deficit to halve over the next three years, improvements in the external sector are not expected to offset fully the drag from substantially weaker private domestic demand.

The MPC expects several factors to weigh on investment in the near term and on employment and consumer spending over time. These include a protracted period of heightened uncertainty, weaker activity in residential and commercial real estate markets, and a higher cost of capital for UK-focused firms.

Some of these effects are beginning to manifest in surveys of investment intentions, business activity, and the housing market. These indicators have fallen sharply, in most cases to levels last seen in the wake of the financial crisis, and in some cases to all-time lows.

The MPC has been conservative in its interpretation of these data, producing a forecast that is stronger than historical relationships would imply. Nonetheless, we expect aggregate demand to grow only a little for the next few quarters before picking up to rates that remain below those projected in May.

Supply

The extent to which this lower path for aggregate demand is likely to be accompanied by a lower path for aggregate supply is a key determinant of the inflation outlook.

The weakness in demand will itself weigh on supply as a period of low investment restrains growth in the capital stock and productivity.

There could also be more direct implications for supply from the decision to leave the European Union. The UK's trading relationships are likely to change, but precisely how will be unclear for some time. If companies are uncertain about the future impact of this on their businesses, they could delay decisions about building supply capacity or entering new markets. In addition, in anticipation of the UK's new trading arrangements, a period of resource reallocation could be necessary as some sectors of the economy expand and others contract.

As a result of these factors, the MPC expects supply growth to remain well below past average rates throughout the forecast period.

The combination of these demand and supply factors means that cumulative GDP growth is expected to be around 2½% lower by the end of the forecast period than was the case in May. On balance, even after stimulus, a margin of spare capacity is expected to open up and the unemployment rate expected to rise from its current level of 4.9% to around 5½% over the next two years.

Exchange rate

The fall in sterling will push up on import and consumer prices notably over the next three years. Indeed, despite the much weaker outlook for activity, CPI inflation in two years' time is projected to be higher than expected in May, reaching 2.4% at both the two and three year points of our forecast.

Policy trade-off

The MPC's Remit recognises that when the effects of shocks persist over an extended period, the MPC is likely to face an exceptional trade-off between returning inflation to target promptly and stabilising output.

When this is the case, the Remit requires the MPC to explain how it has balanced that trade-off, including the horizon over which it aims to return inflation to target.

Fully offsetting the persistent effects of sterling's depreciation on inflation would require exerting further downward pressure on domestic costs. And that would mean even more lost output and a total disregard for higher unemployment.

In the Committee's judgement, such outcomes would be undesirable in themselves and, moreover, would be unlikely to generate a sustainable return of inflation to the target beyond its three-year forecast period.

As a result, in order to mitigate some of the adverse effects of the shock on growth, the MPC is setting policy so that inflation settles at its target over a longer period than the usual 18-24 months.

Policy response

To achieve this balance, the MPC is today implementing a timely, coherent and comprehensive package of measures.

First, the response is <u>timely</u> because the combination of the markedly weaker outlook for the economy and the lags in the transmission of monetary policy dictates the need for stimulus now. For example, cutting Bank Rate will immediately ease financing conditions for households and firms, thereby supporting activity. Around half of mortgagors have floating rate contracts and more than four-fifths of bank loans held by firms are at floating rates; lower interest rates will be felt immediately in the economy.

Second, the package of measures is <u>coherent</u>.

The MPC recognises the risk that, when interest rates are very low, Bank Rate cuts might not be fully passed on to the interest rates actually faced by households and firms. There have been examples overseas of interest rates on loans *increasing* when official policy rates have been reduced from very low levels.

The MPC is determined that the stimulus the economy needs does not get diluted as it passes through the financial system.

That's why it has launched a new Term Funding Scheme. The TFS will reinforce the transmission of cuts in Bank Rate to the interest rates actually faced by households and firms.

Compared to the old Funding for Lending Scheme, the TFS is a pure monetary policy instrument that is likely to be more stimulative pound-for-pound. Specifically, it

- reinforces Bank Rate cuts,
- reduces the effective lower bound of Bank Rate to close to but a little above zero,
- charges a penalty rate if banks don't lend,
- covers all types of lending, and
- is funded by central bank reserves.

UK banks and building societies could borrow up to £100 billion over the next year at rates that neutralise the effects that could otherwise cause them not to pass on the new lower Bank Rate to end borrowers.

The coherence of today's stimulus package is further enhanced by:

- The FPC's decision today to amend the leverage ratio framework for UK banks by excluding central bank reserves. This gets a regulatory constraint out of the way of monetary policy operations without compromising financial stability;
- The FPC's earlier action to increase the availability of credit by up to £150 billion by cutting the counter-cyclical capital buffer rate to zero and emphasising that banks' liquidity reserves are usable; and

- The PRA Board's decision to use regulatory flexibilities to smooth insurers' transition to new regulatory standards in a very low interest rate environment.

Third, the package is comprehensive. The cut in Bank Rate, the new Term Funding Scheme, the new corporate bond purchases and the expansion of gilt purchases work through multiple channels, are mutually reinforcing, and more powerful as a result.

In the absence of these actions, output would have been lower, unemployment higher, and slack greater over the forecast period, and the return of inflation to the target would have been less sustainable.

The purchase of up to £10 billion of UK corporate bonds will support the real economy by directly affecting financing conditions for companies that make a material contribution to UK economic activity. By supporting investment, this action should improve the monetary policy trade-off with inflation. By acting in capital markets, it will be complementary to the TFS which reinforces the bank lending channel. And by lowering credit and liquidity premia, corporate bond purchases are an efficient means of providing stimulus.

Expanding the stock of gilts held in the Asset Purchase Facility by £60 billion will reinforce the transmission of lower Bank Rate to longer-term market interest rates. In addition, by triggering a process of portfolio rebalancing among sellers of long-dated gilts, gilt purchases will transmit to other risky asset prices, easing financial conditions and providing additional stimulus directly.

Conclusion

The MPC has worked closely with the Bank's other committees to understand how conventional and unconventional monetary measures interact with the financial system. We have tailored our approach to avoid unintended consequences. This joined-up approach, using multiple channels, will ensure that stimulus will have maximum impact on the real economy.

By acting now, the MPC is supporting the necessary adjustments in the UK economy and ensuring a more sustainable return of inflation to the target in the medium term.

This is a timely, coherent and comprehensive package of measures. It is appropriately sized given the scale of the shock, uncertainties about the degree of the adjustment, and relatively limited data.

All of the elements in this package have scope to be increased. The MPC can lower Bank Rate, increase the size of the TFS, and expand the scale or variety of assets held in the Asset Purchase Facility.

Indeed, if the incoming data prove broadly consistent with the August *Inflation Report* forecast, a majority of MPC members would anticipate a further cut in Bank Rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of this year.

Today's announcement is the latest element of the Bank's joined-up policy response to the referendum.

A plan that was based on months of extensive analysis of the risks, detailed planning and appropriate public communication before the vote.

A plan that delivered a broad range of contingency measures to contain the immediate impact on the financial system of the result.

A plan that has already expanded the amount of credit available to the economy.

And now a plan that delivers a timely, coherent and comprehensive monetary policy response that lowers the cost of credit and improves financial conditions for households and businesses across a wide range of channels.

The Bank continues to stand ready to take whatever action is needed to achieve its objectives for monetary and financial stability as the UK adjusts to new realities, and moves forward to seize new opportunities, outside the EU.