INFLATION REPORT PRESS CONFERENCE

Thursday 3rd November 2016

Opening remarks by the Governor

1. Introduction

Good afternoon.

The biggest determinants of the UK's medium-term prosperity will be the country's new relationship with the EU and the reforms that it catalyses.

Those processes will also have a significant bearing on inflation over the next few years through several channels. First, the perceptions of market participants regarding this economy's future growth potential will influence asset prices, particularly the exchange rate. Firms' assessments of the outlook for demand and the ease of future trade will affect their investments. And the cost of borrowing and the return to saving faced by households, as well as their confidence in the economic situation, will determine their spending. Finally, by the end of the MPC's forecast period, the UK economy's supply could be affected by a new set of trading arrangements with Europe and potentially other countries.

In light of these realities, the MPC indicated in the spring that the effects of a vote to leave the EU on inflation would be the product of its impact on demand, supply and the exchange rate. And it stressed then that the implications for monetary policy would not be automatic.

2. August assessment

In August, the balance of these demand, supply, and exchange rate effects was consistent with the need for additional monetary policy stimulus then, and the prospect of more soon.

In pursuit of its remit, the MPC delivered a timely, coherent and comprehensive package of easing measures that was calibrated to balance the trade-off it faced between ensuring a sustainable return of inflation to target and supporting jobs and growth.

3. Developments since August

Since August, demand growth has been materially better than expected, and the MPC now projects the level of GDP to be 0.7 percentage points higher by the end of this year. What did we miss? And what have we learned about the adjustment to Brexit?

The MPC had expected consumption to continue to grow solidly throughout the remainder of 2016. But consumption has been even stronger, with households appearing to entirely look through Brexit-related uncertainties. For households, the signs of an economic slowdown are notable by their absence. Perceptions of job security remain strong. Wages are growing at around the same modest pace as at the start of the year. Credit is available and competitive. Confidence is solid.

This positive consumer sentiment has supported the housing market, which has also been more resilient than we expected, as housing activity behaves more like consumption than investment.

Both consumption and housing have benefitted from a smaller drag from uncertainty and very supportive financial conditions. These positives are neither solely due, nor totally unrelated, to the actions the MPC took in August.

These measures are working. Variable mortgage rates have fallen by the full ¼% and new fixed-term mortgage rates are down by more. Rates on floating loans to businesses are down by around 15 basis points and sterling corporate bond issuance has picked up strongly. For those looking to borrow, credit is widely available. For those with debts, the cost is cheaper.

Business investment appears to have been somewhat less soft than we had expected, in part because of these easier financial conditions, and in part because domestic demand and uncertainty appear to have exerted a bit less of a drag than expected.

In contrast to developments in the real economy, financial markets have taken a less sanguine view of Brexit prospects. Sterling is now around one-fifth lower than its peak a year ago. The latest sharp move appears to reflect market expectations of an even less open set of trading arrangements than anticipated in the immediate aftermath of the referendum. Partly reflecting sterling's depreciation, measures of inflation expectations have picked up notably and gilt yields have risen back towards their pre-referendum levels.

While the Committee now expects stronger growth through the balance of this year, it is the fall in sterling that will have the more significant implications for the path for inflation at the monetary policy horizon.

It is early days in the adjustment process. Households, firms, financial markets, and the MPC will continue to learn as they go and they will adjust their expectations accordingly. The limited post-referendum data we have so far suggest households could behave more adaptively, reacting to changes in jobs and incomes they actually experience, rather than those in prospect. Firms are in various stages of preparation to take action. And financial markets will likely continue to anticipate and adjust rapidly as their perceptions of the UK's longer run arrangements with Europe evolve.

4. The path ahead

Ultimately, the tension between consumer strength on the one hand and the more pessimistic expectations of markets on the other will be resolved.

In the MPC's November projections, this resolution is expected to occur as imported inflation begins to weigh on people's real incomes, slowing consumption growth. This moderation in household spending reinforces the cumulative effects of a pick-up in uncertainty on investment, which is expected to lower the economy's capital stock and dampen productivity growth. As a consequence, although stronger in the near term, growth is expected to be weaker in the medium term compared to the Committee's August projections.

Despite that more modest medium-term growth outlook, CPI inflation is expected to be higher throughout the three-year forecast period than in the Committee's August projections. This is largely the result of the renewed depreciation of sterling. In our central projection, inflation rises from its current level of 1% to around 2¾% in mid-2018 before beginning to fall back gradually thereafter.

The balance of stronger near-term consumer demand, a modest supply outlook, and a lower sterling exchange rate, implies a more challenging trade-off between returning inflation sustainably to the target on the one hand and supporting real activity on the other.

To be clear, modest supply growth ultimately means lower real income growth. The only question is how this comes about. It can happen either through a compression of nominal wage growth and higher unemployment, or through faster growth in consumer prices and a smaller rise in joblessness.

5. Implications for policy

The MPC's remit requires it to explain how it is balancing that trade-off, including the horizon over which it aims to return inflation to target.

The direct impact of sterling's depreciation on CPI inflation will ultimately prove temporary. In the MPC's judgement, attempting to offset it fully with tighter monetary policy would be excessively costly in terms of foregone output and employment growth. The MPC is choosing a period of somewhat higher consumer price inflation in exchange for a more modest increase in unemployment. However, there are limits to the extent to which above-target inflation can be tolerated.

Those limits depend on the cause of the inflation overshoot, the extent of second-round effects on inflation expectations and domestic costs, and the scale of the shortfall in economic activity below potential. In the MPC's November forecast, the inflation overshoot is the product of a perceived shock to future supply, which has caused the exchange rate to fall, alongside a modest projected shortfall of activity. Inflation expectations have picked up to around their past average levels and domestic costs have remained contained. Given the projected rise in unemployment, the risks around activity and inflation, and the potential for further volatility in asset prices, the MPC judges it appropriate to accommodate a period of above-target inflation. That notwithstanding, the MPC is now monitoring closely the evolution of inflation expectations.

In light of these developments, the MPC at its November meeting agreed unanimously that Bank Rate should be maintained at its current level. It also agreed unanimously to continue the previously announced asset purchase programmes.

It remains the case that the path for monetary policy will depend on the evolution of the prospects for demand, supply, the exchange rate, and therefore inflation. Monetary policy can respond, in either direction, to changes to the economic outlook as they unfold to ensure a sustainable return of inflation to the target.

6. Conclusion

The UK is a highly flexible, dynamic economy. These characteristics will help it to move to a new equilibrium as its future relationship with the European Union becomes clearer and new opportunities with the rest of the world open up. Many of the adjustments needed to move to that new equilibrium are real in nature, and are not in the gift of monetary policymakers.

Monetary policy cannot construct the edifice of lasting prosperity. But it will help build the foundations by achieving the inflation target in a sustainable fashion and in a way that helps to smooth real adjustment in the economy, to stabilise growth, and to support jobs in the wake of much larger forces. This is the best contribution the MPC can make to the good of the people of the United Kingdom.