INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

A series of transitions are underway that will affect the outlook for the UK economy and the stance of monetary policy.

First, global financial conditions have begun to tighten and trade growth is slowing. As a consequence, while the global economy continues to grow at above-potential rates, growth is becoming more uneven and is expected to decelerate towards its potential over the next few years.

Second, UK fiscal policy is shifting from a restrictive to a more accommodative stance.

Third, and most importantly, the UK economy is in the process of adjusting to a new, and as yet uncertain, economic relationship with the European Union.

As has been the case since the referendum, the MPC's forecasts are conditioned on the assumption of a smooth transition to the average of a range of potential Brexit outcomes.

As the deadline for concluding the Withdrawal Agreement approaches, the expectations of households and businesses are diverging somewhat from this base case assumption. In general, households are more sanguine, while businesses are more wary. These shifting expectations could lead to some greater-than-usual short-term volatility in the data.

Momentum in household consumption appears to be greater than previously thought. UK households remain resilient to a Brexit that has not yet happened. Consumer spending is being supported by a tight labour market, with the employment rate and vacancies at record highs and the unemployment rate close to record lows. Regular pay growth has been stronger than the MPC had expected, rising to over 3%.

In contrast, business investment has been weaker than previously anticipated. The level of investment fell by more than 1% in the first half of the year and is now almost 15% lower than the MPC had projected just before the vote. As the Brexit deadline looms, UK companies are now understandably postponing investment until they have greater clarity over the UK's future trading relationship with the EU.

Financial markets are hedging their bets against Brexit downsides, with sterling risk reversals building, despite sterling being already being some 15% below its pre-referendum peak.

In the Committee's central projections, GDP growth averages around 1¾% over the forecast period. Consumption grows modestly relative to historical rates, rising broadly in line with the subdued pace of real income growth. Growth in business investment is expected to stay subdued in the near term, before rebounding as the current Brexit-related uncertainty wanes. Net trade is also expected to contribute positively to growth, supported by solid global growth, the lower level of sterling, and (the assumed) significant access to EU markets over the next few years.

The MPC's projections were finalised before the Budget had been announced. The Committee will assess the implications of the Budget measures at its next meeting.

Although modest by historical standards, the projected pace of UK GDP growth is slightly faster than the diminished rate of supply growth, which averages around 1½% per year. The MPC judges that demand and supply are currently broadly in balance.

As a consequence, over the forecast, a margin of excess demand emerges as demand growth exceeds potential supply growth. That supports a further firming of domestic inflationary pressures. Whole economy regular pay growth has risen from around 1¾% per year on average between 2010 and 2015, to 2½% in 2016 and 3.1% in Q3 of this year. With productivity growth remaining below rates typically seen before the crisis, pay growth doesn't need to be as high as its pre-crisis average for unit labour cost growth to be consistent with meeting the inflation target.

Inflation is currently above the MPC's 2% target, boosted by the effects of higher energy costs and the rise in import prices associated with sterling's past depreciation. The contribution from these external factors is projected to fade over the forecast period.

Taking waxing domestic and waning external influences on inflation together, CPI inflation is projected to remain above the target for most of the forecast period before reaching 2% by the end of the third year.

At its meeting yesterday, the MPC judged that the current stance of monetary policy remains appropriate. The Committee also judges that, were the economy to continue to develop broadly in line with the November Inflation Report projections, an ongoing tightening of monetary policy over the forecast period would be necessary to return inflation sustainably to the 2% target at a conventional horizon. Any future increases in Bank Rate are likely to be at a gradual pace and to a limited extent.

The economic outlook depends significantly on the nature of EU withdrawal, in particular: the form of new trading arrangements between the EU and UK; whether the transition to them is abrupt or smooth; and how households, businesses and financial markets respond.

Whatever happens, monetary policy will act to ensure price stability, and subject to that, provide support for the economy during the transition.

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As the MPC has repeatedly stressed, the implications of Brexit for the appropriate path of monetary policy will depend on the balance of its effects on demand, supply and the exchange rate.

Demand

Withdrawal from the EU will affect demand for goods and services produced in the UK because of changes to the ease with which UK companies can trade with the EU, levels of uncertainty about the future relationship and earnings prospects and financial conditions. These effects over the MPC's policy horizon are likely to be more negative the greater the disruption to the economic relationship between the EU and UK, and more positive if there is less disruption.

Supply

The extent to which changes in demand affect inflationary pressures will depend on how the supply capacity of the economy evolves. As trading relationships change, reductions in openness are likely to reduce the economy's productive capacity for a period of time. Shifts in production across sectors will be neither seamless nor costless, as resources in different

sectors, including labour, are often highly specialised. This will drag on supply as the adjustment process unfolds.

As changes in supply are usually gradual, they normally have less bearing on monetary policy in the short term than changes in demand. If the future economic relationship between the EU and UK changes only gradually, supply losses would emerge relatively slowly.

In some Brexit scenarios, however, it is possible that the UK's supply capacity could fall sharply. For example, an abrupt and disorderly withdrawal could result in delays at borders, disruptions to supply chains, and more rapid and costly shifts in patterns of production, severely impairing the productive capacity of some UK businesses.

The exchange rate

The prospects for inflation will also depend on how the exchange rate reacts and on any tariffs that result from the new trading arrangements. In the case of a smooth transition to a relationship judged to have a relatively small long-term economic impact, financial market participants might expect a smaller hit to UK real incomes than they currently anticipate, causing the pound to appreciate.

In contrast, a disruptive withdrawal from the EU could result in a more pessimistic view of future income and some further depreciation.

Implications for monetary policy

Since the nature of EU withdrawal is not known at present, and its impact on the balance of demand, supply and the exchange rate cannot be determined in advance, the monetary policy response will not be automatic and could be in either direction.

In the case of a smooth transition to a relatively close economic relationship, the extent to which domestic inflationary pressures increase would depend on the balance between an expected rebound in demand as uncertainty fades, any further impacts on supply over the MPC's policy horizon, and the scale of the likely appreciation of sterling.

In contrast, a disruptive withdrawal from the EU would probably result in a further decline in the exchange rate and a large, immediate reduction in supply. Tariffs might also be extended. Each of these developments would tend to increase inflation. Set against that, it is likely that demand would weaken as a consequence of lost trade access, heightened uncertainty, and tighter financial conditions. The overall extent of inflationary pressures would depend on the balance of these forces, as well as the evolution of inflation expectations.

Three other considerations will be important to the conduct of monetary policy.

First, the current situation differs materially from that on the eve of the referendum. The economy is now broadly in balance, rather than in being material excess supply as it was then. Inflation is notably above target, not significantly below. And if Brexit is disorderly, any disruption to supply capacity will be immediate and material rather than distant and speculative.

Second, there is little that monetary policy can do to offset large, negative supply shocks, which occur relatively rarely in advanced economies.

Third, in exceptional circumstances, the MPC's remit allows the Committee to extend the horizon over which it returns inflation to the target in support of its objectives for growth and employment. Given the economy's starting position, this flexibility would only become relevant if the shock to demand were greater than that to supply. In that event, the Committee would explain clearly its approach to managing any trade-off between inflation and output variability, including the horizon over which it is seeking to return inflation to the target.

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However the Brexit process unfolds, monetary policy will remain guided by the constancy of the inflation target. The MPC will respond to any material change in the outlook, adjusting policy in either direction, as required to bring inflation sustainably back to the 2% target while supporting jobs and activity during this most important transition for the people of the United Kingdom.