INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

Since May, global trade tensions have intensified, global activity has remained soft, and the perceived likelihood of a no-deal Brexit has increased significantly. These developments have led to substantial declines in market interest rates and a marked depreciation of sterling.

UK financial conditions have loosened materially as a result. They can be expected to remain volatile as the prospects for Brexit, and therefore the UK economy, develop.

The UK economic outlook will continue to hinge on the nature of EU withdrawal, and the appropriate path of monetary policy will depend on the balance of its effects on demand, supply and the exchange rate. As a consequence, the monetary policy response to Brexit will not be automatic and could be in either direction. The Committee will always act to achieve the 2% inflation target in a sustainable manner.

Global Developments and Financial Conditions

With the ink barely dry on the MPC's May *Inflation Report*, the US-China trade dispute deepened. More generally, the rationales for trade actions have broadened, increasing the risk that protectionism could prove more pervasive, persistent and damaging than previously expected.

There are already signs that trade actions are having larger effects than previously anticipated on global business confidence and investment spending. For example, the global manufacturing PMI fell to its lowest level since October 2012.

The latest indicators suggest global growth is holding steady rather than picking up as the MPC had expected three months ago. The quality of that growth has also deteriorated with the growth rate of business investment in the G7 being cut almost in half since its peak in late 2017.

Global price pressures remain subdued, with headline and core inflation below target in all major advanced economies.

In response to the softer outlooks for global demand and inflation, the expected paths of policy interest rates in advanced economies have shifted sharply lower, most notably in the US, where the FOMC cut rates by 25 basis points yesterday.

Expectations of easier monetary policy are supporting global financial conditions. US 10-year yields are near two-year lows, 10-year gilt yields are their lowest in three years, and German 10-year bund yields are their lowest ever. Around $14 trillion of global investment-grade debt is now trading at negative yields.

In the MPC's latest projections, these more accommodative financial conditions offset the drag from trade headwinds, although global growth is now expected to return to potential rates more slowly than in May.

UK financial conditions have also loosened since May, in response to both global developments and the growing weight financial market participants are placing on the possibility of No Deal. Sterling is now 6% lower than at the time of the May *Report*, UK-focused equity prices have fallen about 5%, and gilt yields have dropped by half a percentage point. The market yield curve underlying the MPC's latest projection falls to 0.5% over the coming year, and ends the forecast period at 0.6%, around 40 basis points lower than in the May 2019 Report.

The UK Outlook

As well as their impact on financial markets, Brexit developments are making UK GDP growth more volatile than usual owing to stock building and plant shutdowns.

Looking through these temporary factors, the underlying pace of growth has slowed to below-potential rates as a result of weaker global demand and more entrenched uncertainty about Brexit amongst UK companies.

Only one in six respondents to the Decision Maker Panel[1] now expect the future relationship with the EU to be resolved this year, down from almost one half in January. One third of our Agents' business contacts report being more uncertain about the economic outlook now than they were ahead of the extension of Article 50 in April, while only one in ten have become more certain.

This has already led to marked weakness in UK business investment since the referendum. Investment intentions point to further contractions in Q2 and Q3, and the MPC now expects business investment to pick up more slowly over the next year.

By contrast, the labour market remains tight, with employment at record highs and unemployment at a 44-year low, and pay growth has strengthened as a result.

Supported by the resilient labour market, households' confidence in their personal financial situations is holding up, with spending rising broadly in line with real incomes.

To be clear, households are acting prudently. This is no debt-fuelled consumption boom, and their concerns about the general economic situation continue to restrain housing market activity.

Overall, the MPC expects underlying UK GDP growth to remain subdued over the coming year, with Brexit-related uncertainties and the softer external environment weighing on spending. As a consequence, a margin of excess supply persists over the next year.

UK inflation is currently bang on our 2% target. Domestic inflationary pressures have strengthened as wage growth has picked up, with growth in unit labour costs currently around target-consistent rates, though core services inflation remains somewhat subdued.

Headline inflation will probably dip around half a percentage point below target in coming months owing to cuts to energy bills, but core inflation should remain relatively stable at rates only a little below 2%.

[1] A survey of over 8,000 companies.

The Paths Ahead

Increasing uncertainty about the outlook suggest that the UK economy could follow a wide range of paths over the coming years depending most importantly on the nature of EU withdrawal.

Consider, as financial markets increasingly have, the prospects for No Deal.

The Bank has been working since the referendum to ensure that the financial system is ready for Brexit, whatever form it takes.

- In order to continue to serve their customers whatever happens, UK banks are now both exceptionally well capitalised and highly liquid.
- Our contingency planning with domestic and EU authorities is mitigating possible risks to disruption of cross-border financial services.
- And most fundamentally, our institutional framework is robust: the Bank has clear objectives, operational independence, all the necessary tools and the needed resolve to deliver our monetary and financial stability remits.

But financial stability is not the same as market stability. In the event of a No Deal, No Transition Brexit, sterling would likely fall, the risk premiums on UK assets would rise, and volatility would spike higher.

Similarly, preparations by government and businesses for No Deal are vital to reduce the potentially damaging transition costs to a WTO relationship, but they cannot eliminate the fundamental economic adjustments to a new trading relationship that a No Deal Brexit would entail.

In the event of No Deal, it is probable that CPI inflation would rise and GDP growth would slow. For example, our Agents' survey finds that most companies now report that they're largely ready for No Deal. However, just under a fifth described themselves as "fully ready", while three quarters of respondents said that they were "as ready as they can be." And despite greater preparedness, businesses still expect their output, employment and investment to fall by around 1 to 3% over the next year in the event of No Deal.

When setting policy in the event of No Deal, the Committee's interest rate decision would need to balance the upward pressure on inflation, from the likely fall in sterling and any reduction in supply capacity, with the downward pressure from any reduction in demand.

It is, of course, the Government's intention to achieve an agreement with the EU. As in previous *Reports* and consistent with its general approach to condition forecasts on Government policy, the MPC continues to assume a smooth transition to the average of a range of possible outcomes for the UK's eventual trading relationship with the EU.

In our latest projections, as details of the UK's future trade relationships gradually emerge, business investment recovers and household spending picks up, broadly in line with robust real income growth. Owing to the much easier financial conditions, the acceleration in growth is stronger than in May.

With potential supply growth expected to remain subdued, the pickup in GDP growth results in sharply rising excess demand, which reaches 1¾% of GDP by the end of the forecast period, materially higher than in May.

This pushes up CPI inflation such that it is well above target and still rising at the end of the forecast period.

The MPC's projections are materially affected by the inconsistency between the asset prices on which they are conditioned – which take into account the full range of Brexit outcomes, including the substantial weight market participants place on the possibility of No Deal – and the Committee's assumption of a smooth transition to a Brexit Deal.

If, as assumed, Brexit proceeds smoothly to some form of deal, market interest rates would probably rise and sterling would probably appreciate.

Consistent with the stylised sensitivities in the box in today's Report, the Committee judges that gradual and limited interest rates increases would be appropriate to return inflation sustainably to the 2% target in the case of a transition to a Brexit deal and some recovery in global growth.

At this meeting, the MPC judged that the current stance of monetary policy remains appropriate.

Profound uncertainties over the future of the global trading system and the form that Brexit will take are weighing on UK economic performance. Until they are resolved, shifting perceptions of these factors will drive volatility in market interest rates, equity prices and currencies values.

Monetary policy cannot offset the real effects of these fundamental determinants of jobs, growth and prosperity. But monetary policy can help smooth the adjustment of the economy to these shocks.

To this end, the people of the United Kingdom can be confident that the MPC will take all the appropriate measures to support jobs and activity consistent with achieving the 2% inflation target during these exceptional times.