INFLATION REPORT PRESS CONFERENCE

Thursday 4th February 2016

Opening remarks by the Governor

Good afternoon.

At its meeting yesterday, the Monetary Policy Committee (MPC) voted 9-0 to maintain Bank Rate at 0.5% and the stock of purchased assets at £375 billion.

When Bank Rate first reached this level almost seven years ago, the global economy had stalled, financial markets had plummeted, the UK banking system was in crisis, and its private domestic demand was collapsing.

Yesterday's decision was taken amid sluggish global growth, turbulent financial markets, but the ongoing *resilience* of the UK financial system and its private domestic demand.

Those distinctions explain the difference between the outlook then for a recession and now for a continued, solid expansion.

Global outlook

Global growth has slowed again over the past few months, as emerging economies decelerated further and the US economy grew less than expected. It is now expected to remain around 1 percentage point below past averages this year, despite the boost to real incomes in advanced economies from lower oil prices and the slight easing of fiscal policy in the US and euro area.

Further ahead, growth in the UK's main trading partners is expected to remain well below past averages, reflecting the balance of steady growth in advanced economies and an eventual slow, modest recovery in emerging markets.

For some time, the MPC has identified downside risks to global growth from deteriorating prospects in emerging market economies. These include:

- the ongoing challenges of economic rebalancing in China;
- the impact of sharply lower export prices for commodity producers; and
- a reversal of capital flows and a marked tightening of financial conditions.

As these risks have begun to materialise, global financial conditions have deteriorated notably, including widespread falls in advanced economy equities, rises in corporate bond spreads, and notable increases in market volatility.

Domestic outlook

These developments pose downside risks to growth in the UK via trade, financial and confidence channels.

The outlook for trade is particularly challenging, with net exports expected to drag on UK growth over the forecast period.

However, there are three domestic offsets to the tightening of global financial conditions.

- First, sterling has fallen 3½% since November, the largest decline between *Inflation Reports* since the crisis.
- Second, the gilt yield curve has fallen further, with UK ten-year rates down 25 basis points since November.
- And third, the UK financial system is now resilient.

In this last regard, it is important to recall that major UK banks are well capitalised taking into account the results of the Bank of England's 2015 stress test, which focussed on a much more severe shock to Chinese and emerging market growth, sharply higher spikes in financial market volatility and steeper falls in risky asset prices. This means that banks are much less likely to amplify such stresses and are likely to be much more able to continue lending to the real economy, even if global conditions were to deteriorate further.

The resilience of the UK financial sector is matched by the resilience of UK private domestic demand. Despite the slight slowing in the pace of UK growth last year and the prospects for a referendum this year on the UK's membership of the EU, indicators of household and business confidence currently remain robust.

After seven lean years, real incomes picked up sharply last year — supported by both record-high employment and lower food and energy prices — and they are expected to grow solidly going forward.

Business investment growth has been well above its pre-crisis average, with firms investing to meet rising demand while benefiting from favourable credit conditions. With the understandable exception of the oil and gas sector, such strong growth is expected to continue; given high returns on capital and limited spare capacity.

Overall, given global weakness, somewhat more modest wage growth and accelerating fiscal consolidation, the overall pace of growth in the UK is expected to dip below past averages this year, before returning to around 2½% thereafter, as a tighter labour market and rising productivity support real incomes and consumption, and spur business investment.

This more modest profile for demand compared with our last *Report* is matched by a lower, but still solid, path for supply growth.

Developments on the supply side reflect an economy that's moving from a period of exceptionally rapid employment growth and unusually slow productivity growth to one where growth in both reverts to more normal and sustainable rates.

With 1 ½ million jobs created over the past three years, unemployment has fallen 3 percentage points to around 5%. Job vacancies relative to unemployment are now back at pre-crisis levels, and people are moving between jobs more frequently.

Given the resilience of the labour market, the MPC now expects the average hours that people work to resume their pre-crisis downward trend, reflecting the higher job security and a further normalisation of working patterns.

As labour supply growth has slowed, productivity growth has picked up, with last year's hourly productivity growth probably the fastest in four years. The MPC expects potential supply growth to rise steadily over the forecast as this pickup in structural productivity growth largely offsets the reversion of labour supply growth to normal rates.

What does this all mean for inflation?

Inflation outlook

As set out in my open letter to the Chancellor today, by far the most important reason for low inflation remains the sharp falls in commodity prices globally. Since our November *Report*, oil is down by another third.

The scale of the most recent commodity price falls means that CPI inflation is likely to remain low for much of this year. However, with momentum from private demand expected to eliminate the economy's margin of spare capacity this year, domestic cost growth should rise. As the drag from external factors wanes, increasing domestic cost pressures are expected to be more than sufficient to return inflation to the 2% target by the start of 2018.

In the near term, the MPC judges the risks to inflation to lie to the downside. That reflects the possibility that wage pressure takes a little longer to build following a period of low headline inflation. However, the mechanical return to higher rates of inflation as past falls in energy prices drop from the annual comparison should in time reduce this risk. Moreover, the MPC judges that inflation expectations remain well anchored, though it is watchful for signs that low inflation is having more persistent second-round effects on wages.

Policy outlook

Returning inflation to target requires balancing the protracted drags from sterling's past appreciation and lower commodity prices with expected increases in domestic cost growth.

Fully offsetting the drag on inflation from external factors over the short run would involve too rapid an acceleration in domestic costs – one that would risk being unsustainable and would generate undesirable volatility in output and employment.

Given these considerations, the MPC is setting policy to return inflation to the target in around two years and keep it there in the absence of further shocks.

In the central case we set out today, one that is conditioned on a market path for Bank Rate that was around 20 basis points higher on average than last night's close, CPI inflation is likely to exceed the 2% target slightly at the two-year point and then rise further above it.

As a consequence, the MPC judges that it is more likely than not that Bank Rate will need to rise over our forecast period.

As always, there are both upside and downside risks to inflation. It could be higher if the recent weakness in wage growth reflects temporary factors obscuring the underlying tightness of the labour market. Equally, inflation could be lower if global risks crystallise more abruptly or if weak external price pressures further contribute to weaker wage growth.

In any event, the MPC stands ready to act to ensure inflation remains likely to return to the target in a sustainable fashion. We will do the right thing at the right time on Bank Rate.

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As one of the most open economies in the world, the UK cannot help but be affected by an unforgiving global environment and sustained financial market turbulence.

However, our prospects for a continued solid expansion are underpinned by the resilience built over the past seven years:

- a labour market with record-high employment;
- strong private domestic demand reflecting improved private sector balance sheets, rising productivity and robust confidence; and
- a financial system capitalised for severe emerging market stress so that it can continue to serve the real economy.

We look forward to your questions.