Inflation Report Press Conference

Thursday 12th May 2016

Opening remarks by the Governor

Good afternoon.

Perspective

After the worst financial crisis since the Great Depression, the United Kingdom's expansion finally took hold about three years ago.

It was driven initially by sharp declines in economic uncertainty and significant improvements in credit conditions. These helped restore confidence and unleash pent-up household demand.

The nascent recovery was reinforced by a more resilient banking system and accommodative monetary policy, with the MPC's forward guidance reassuring households and businesses that Bank Rate wasn't going to rise at the first signs of growth, thereby creating the confidence to spend, hire and invest.

The recovery was supported by a large, positive supply shock – particularly a notable increase in the labour force participation rate.

At over 3% annualised, the UK was the fastest growing economy in the G7 despite ongoing fiscal consolidation and persistent global weakness, with the growth of our trading partners running at only two-thirds of their pre-crisis average.

With time, the boost from lower uncertainty faded, pent-up demand was largely spent, and consumption growth became increasingly supported by greater hours worked, a sharp pickup in real wages (largely due to commodity price falls), and lower saving rates. Business investment rose with demand and continued improvement in financial conditions. Trade and fiscal policy continued to drag.

By early last year, growth had begun to slow to around 2½%, as the labour supply shock had largely run its course, and supply growth became more reliant on modest and somewhat erratic growth in productivity.

By the second half of last year, though still near the top of the G7, growth had moderated to around 2%, which is about the rate of potential supply growth.

Outlook

In the first quarter of this year, growth slowed further to around 1½% annualised and now appears to be decelerating again. This most recent weakness reflects in part the forthcoming referendum on the UK's membership of the European Union, which has pushed up uncertainty measures to levels not seen since the euro-area crisis.

The referendum makes describing the outlook for inflation more challenging than usual. That's because some asset prices used to condition the Committee's projections are likely to have been affected by market participants' perceptions of its consequences.

The MPC estimates that referendum effects could account for around half of the 9% fall in the sterling exchange rate since its November 2015 peak, and we have decided not to let that part of the exchange rate's fall feed through to our growth or inflation projections.

This judgement is consistent with the MPC's long-established convention to assume that government policy is followed. Specifically we have conditioned our projection on an assumed continuation of EU membership, and as a consequence the forecast also assumes that the current elevated levels of uncertainty unwind in the months that follow the referendum.

In the Committee's central case, the outlook for inflation is in most respects similar to the one we described three months ago. The MPC continues to expect CPI inflation to pick up over the next year as the impact of past falls in commodity prices fades and as the effects of the earlier appreciation of sterling wane. The recovery in inflation is likely to be further supported by the recent sharp increase in oil prices and some additional stimulus from lower market interest rates.

Moreover, if demand evolves as expected, the remaining spare capacity in the economy will likely be used up during 2016, in turn raising domestic costs. The Committee judges it likely that these factors will be sufficient to return inflation back

to 2% by mid-2018 and push it a little above the target thereafter, reflecting modest excess demand.

The central projections set out in the *Inflation Report* today are conditioned on a gentle rise in interest rates over the forecast period. Under that central case, the MPC judges it more likely than not that Bank Rate will need to be higher at the end of that period than at present in order to return inflation to target in a sustainable manner. Our now-familiar forward guidance on limited and gradual rate increases and conditions for asset sales continues to hold.

Risks to the outlook

Now turning to the elephant in the room.

The MPC judges that the most significant risks to its forecast concern the referendum.

With macroeconomic and financial indicators likely to be less informative than usual in light of the referendum, the Committee is currently reacting more cautiously to data releases than would normally be the case. There is a risk that we could be over- or under-estimating underlying momentum in the economy in the event of a vote to remain in the EU.

More profoundly, a vote to leave the EU could have material economic effects – on the exchange rate, on demand and on the economy's supply potential – that could affect the appropriate setting of monetary policy.

The recent behaviour of the foreign exchange market suggests that, were the UK to vote to leave the EU, sterling's exchange rate would fall further, perhaps sharply. This would likely be consistent with changes to some of the real fundamentals that drive sterling including the terms of trade, productivity, and risk premia. In isolation, a further fall in sterling would boost inflation over the policy horizon.

Aggregate demand would also likely fall, relative to our forecast, in the face of tighter financial conditions, lower asset prices, and greater uncertainty about the UK's trading relationships. Households could defer consumption, and firms could delay investment. Global financial conditions could also tighten, generating potential negative spillovers to foreign activity that, in turn, could dampen demand for UK

exports. All else equal, lower aggregate demand would tend to reduce inflation over the policy horizon.

However, over time, there may also be negative effects on aggregate supply, including slower capital accumulation and the need to reallocate resources across the economy in response to changing trading and investment patterns. On their own, such supply effects would tend to boost inflation over the policy horizon.

The combination of these influences on demand, supply and the exchange rate could lead to a materially lower path for growth and a notably higher path for inflation than in the central projections set out in the May *Inflation Report*.

In such circumstances, the MPC would face a challenging trade-off between stabilising inflation on the one hand, and stabilising output and employment on the other. The implications for monetary policy would not be automatic; its direction would depend on the relative magnitudes of the demand, supply and exchange-rate effects.

Whatever outlook materialises, the MPC will determine the course for monetary policy that delivers the inflation target in a sustainable and timely manner, which generally means returning inflation to target within two to three years and keeping it there.

Conclusion

The people of the United Kingdom will make a significant decision on the 23rd of June. They will do so after considering a much broader range of issues than monetary and financial stability.

Consistent with its remit, the MPC will address the consequences of that decision for growth and inflation over the monetary policy horizon.

There are limits, however, to what monetary policy can deliver. When shocks drive demand below supply, monetary policy can soften the blow. When shocks drive supply below demand, monetary policy can make the unsustainable sustainable. Over the medium run, it can deliver a level of demand consistent with the path for supply in order to meet the inflation target.

But monetary policy cannot immediately offset all the effects of a shock.

Neither is the path of supply nor the path of medium-term economic growth and its implications for jobs, wages, and wealth the gift of monetary policymakers. These will be driven by much bigger decisions.

Whatever the outcome of the referendum, the Bank of England's best contribution to promote the good of the people of the United Kingdom will be to use all our tools to support financial stability and to chart the right path for inflation back to target.