

INFLATION REPORT PRESS CONFERENCE

Thursday 3rd August 2017

Opening Remarks by the Governor

Good afternoon.

The UK economy is beginning the process of adjusting to a new, as yet uncertain, economic relationship with the European Union. Monetary policy cannot prevent the weaker real incomes likely to accompany the move to new trading arrangements with the EU, but it can influence how this hit to incomes is distributed between job losses and price rises. And it can support UK households and businesses as they adjust to such profound change.

The MPC has long emphasised that the effects on inflation of the Brexit process would be the product of its impact on demand, supply and the exchange rate. And it has consistently stressed that as a result, the implications for monetary policy would not be automatic.

The August *Inflation Report*, released today, updates on how these and other dynamics are affecting the economic outlook.

Since the referendum was called, UK households, businesses and financial markets have reacted at different speeds and to varying degrees to the prospects for the UK's departure from the EU.

- Financial markets, particularly sterling, marked down the UK's relative prospects quickly and sharply.
- Households looked through Brexit-related uncertainties initially. But more recently, as the consequences of sterling's fall have shown up in the shops and squeezed their real incomes, they have cut back on spending, slowing the economy.

- Businesses have been somewhere in between. But since the referendum, they have invested much less aggressively than usual in response to an otherwise very favourable environment.

The MPC's projections continue to be conditioned on a smooth transition to an average of possible outcomes for the UK's post-Brexit trading arrangements. To be clear, assuming a smooth transition doesn't mean that the MPC thinks UK households and businesses know the end result of negotiations that have just started. Indeed, in the MPC forecast, uncertainty about the eventual shape of the UK's economic relationship with the EU weighs on the decisions of businesses and households and pulls down on both demand and supply growth.

Rather, the assumption of a smooth Brexit means that UK households and businesses act on the expectation that the UK will forge a new relationship with Europe without material disruptions to trading conditions or financial stability. This simplifying assumption has broadly fit the behaviour of the real economy over the past year.

GDP

In the MPC's central projection, GDP growth remains sluggish in the near term as the squeeze on households' real incomes continues to weigh on consumption. Growth then picks up to just above its reduced – or modest – potential rate as net trade and business investment firm up and consumption growth gradually recovers in line with modestly rising household incomes.

The outlook for net trade is bolstered by strong global growth and the past depreciation of sterling. Global growth has firmed in line with the MPC's expectations, and it is now broad based across advanced and emerging economies. Global trade is growing at its strongest rate since 2011. And there are encouraging signs that the composition of advanced economy

growth is rotating towards investment, supporting the sustainability of the expansion and potentially raising the equilibrium rate of interest.

This strong external environment, businesses' high rates of profitability, their low cost of capital and the limited spare capacity in the economy are all expected to support investment by UK firms over the forecast period. However, while on balance these incentives more than offset the drag from the continued uncertainties around Brexit, business investment is still likely to grow below historic average rates with adverse consequences for productivity, capacity and wages.

CPI inflation

CPI inflation fell back to 2.6% in June, in line with the projection in May. The MPC expects inflation to peak around 3% in October and to remain around 2¾% until early next year.

Conditional on the current market curve, which implies that Bank Rate will rise by ½ percentage point over the next three years, inflation is projected to remain a little above the target at the end of the forecast period – an overshoot that reflects entirely the effects of the referendum-related fall in sterling.

As the effect of rising import prices gradually diminishes, domestic inflationary pressures gradually pick up over the forecast period. With the unemployment rate expected to remain around 40-year lows, wage growth is projected to recover as the remaining slack in the economy is absorbed. In addition, margins in the consumer sector, having been squeezed by the pickup in import prices, are expected to be rebuilt. Consequently inflation is projected to remain at a level slightly above the two percent target by the end of the forecast.

Policy decision

As the Brexit negotiations proceed, the assumption of a smooth transition to a new economic relationship with the EU will be tested. If UK households and businesses look through the flurry of headlines, then the economy can be expected to pick up from its current period of sluggishness.

Given the outlook for supply in the economy, even a limited pickup in growth is likely to have consequences for the stance of monetary policy.

That's because, as the MPC has previously emphasised, the process of leaving the EU is beginning to affect potential supply in the UK. Brexit-related uncertainties are causing some companies to delay decisions about building capacity and entering new markets. The UK's eventual new trading arrangements will require a period of reallocation as some sectors of the economy expand and others contract. Moreover, prolonged low investment will restrain growth in the capital stock and increases in productivity. Indeed, if the MPC's current forecast comes to pass, the level of investment in 2020 is expected to be 20% below the level which the MPC had projected just before the referendum.

As a result of these factors, the supply capacity of the economy is likely to expand at only modest rates throughout the forecast period. That means that only a modest uptick in demand growth from current sluggish rates will be sufficient to reduce and eventually eliminate slack.

The MPC's remit specifies that, in exceptional circumstances, the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity.

Through most of the forecast period, the economy operates with a small degree of spare capacity and CPI inflation is well above target. But by the end of the forecast, that trade-off is eliminated, spare capacity is fully absorbed, and inflation remains above the 2% target.

The Committee judges that, given the assumptions underlying its projections, including the closure of drawdown period of the TFS and the recent prudential decisions of the FPC and PRA, some tightening of monetary policy would be required in order to achieve a sustainable return of inflation to target.

Specifically, if the economy follows a path broadly consistent with the August central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the path implied by the yield curve underlying those projections. Any increases in Bank Rate would be expected to be at a gradual pace and to a limited extent.

The Committee will continue to monitor closely the incoming evidence, and it stands ready to respond to changes in the economic outlook as they unfold to ensure a sustainable return of inflation to the 2% target.