INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

Good afternoon.

The biggest determinants of the UK's medium-term prosperity will be the country's new relationship with the EU and the reforms that it catalyses.

These processes will also have a significant bearing on inflation over the next few years. Market participants' views regarding this economy's future growth potential will influence asset prices, particularly the exchange rate. Firms' assessments of the outlook for demand and the ease of future trade will affect their investments. Households' confidence in their economic situation will help determine their spending. And, with time, the UK economy's supply will be affected by a new set of trading arrangements with the EU and other countries.

The MPC has long emphasised that the effects of the process of leaving the EU on inflation 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.

During these exceptional circumstances, the MPC is required by its remit to balance a period of above-target inflation with a period of weaker growth. The primary objective of monetary policy remains inflation control, however, which means any overshoot of inflation above the target can only be temporary in nature and limited in scope. As such, the MPC has been clear that its tolerance for above-target inflation is limited.

Today's decision reflects the Committee's updated assessment of those forces and those limits. The Committee has unanimously confirmed that the current monetary stance remains

appropriate. But it has also made important revisions to its forecast and highlighted some of the key judgements underlying it.

1. Demand developments and outlook

Growth has remained resilient since the referendum, with the UK posting the fastest rate in the G7 last year.

The MPC expects growth to be stronger over the forecast period than in November, with the economy now projected to expand by 2.0% in 2017 and around 1¾% thereafter. This upgrade will leave the level of UK output around 1% higher over the next three years than expected in November.

This stronger outlook is the product of four factors, in descending order of importance.

First, the Chancellor's Autumn Statement eased fiscal policy over the coming years. This explains about half of our forecast upgrade.

Second, the outlook for the global economy is firmer, reflecting an easing of fiscal policy in other major economies together with improvements in financial conditions and business confidence, particularly in the United States. This explains more than a quarter of the upgrade.

Third, financial conditions in the UK remain supportive, underpinned by low risk-free rates, the 18% fall in sterling since its November 2015 peak, and lower credit spreads. Moreover, domestic credit conditions are accommodative, reinforced by strong competition in consumer credit markets and historically low mortgage rates. In part this reflects Bank of England policy actions, which have also helped lower the impact of uncertainty on activity.

Fourth, as was the case in November, there are few signs that households are cutting back spending ahead of the coming squeeze in their real incomes. With the savings rate falling towards pre-crisis lows and household debt picking up, how households adjust their spending and their expectations of future income will be important determinants of the outlook.

This stronger projection doesn't mean the referendum is without consequence.

Uncertainty over future arrangements is weighing on business investment, which has been flat since the end of 2015. Business investment is expected to be around a quarter lower in three years' time than projected prior to the referendum, with material consequences for productivity, wages and incomes.

More broadly, the level of GDP is still expected to be 1½% lower in two years' time than projected in May, despite the substantial easing of monetary, macroprudential and fiscal policies.

Financial markets are already pricing in a material adjustment to the UK's economic prospects, as evidenced by the sharp fall in the value of sterling. Markets are valuing today what they expect to be necessary tomorrow: an adjustment to real incomes as the UK moves towards its new trading arrangements. The MPC expects the tension between current consumer strength and relative financial market pessimism to begin to be resolved over the course of this year.

2. Inflation outlook

Having risen markedly from around zero in 2015, the MPC still expects CPI inflation to be back to around 2% in the data for February. This largely reflects external factors – in particular, past falls in energy, food and other imported goods prices dropping out of the annual comparison.

Beyond that, inflation is expected to increase further, peaking around 2.8% at the start of 2018, before falling gradually back to 2.4% in three years' time. This overshoot is entirely because of sterling's fall, which itself is the product of the market's view of the consequences of Brexit.

Consistent with this, longer-term measures of inflation expectations have risen over the past year from very low levels to stabilise around historical average levels, and remain well anchored.

3. Supply outlook

The outlook for inflation depends importantly on the path for supply, which is why the MPC undertakes regular, detailed assessments of these prospects. It has incorporated the latest results in today's projections.

Following a long period of consistently overestimating wage growth, the MPC has updated its view of the natural rate of unemployment. Specifically, the MPC now judges that the rate of unemployment the economy can achieve while being consistent with sustainable rates of wage growth to be around 4½%, down from around 5% previously.

As a result, the stronger outlook for demand is in large part matched by an increase in the economy's estimated supply capacity, and the net impact of these two factors on the inflation projection is broadly neutral.

As a consequence, when taken together with the 3% appreciation of sterling since our last forecast and the gently rising path for interest rates implied by market yields, the projections for inflation – and the trade-off that the Committee faces – are little changed relative to November.

4. Policy decision

Monetary policy cannot prevent either any structural adjustments that are necessary as the UK moves to new trading arrangements or any consequences of those adjustments for real incomes. In the shorter run specifically, attempting to offset fully the effect of weaker sterling on inflation would be achievable only at the cost of higher unemployment and even weaker income growth.

In such exceptional circumstances, the MPC's remit specifies that it must balance the speed with which it intends to return inflation to the target with the support that monetary policy provides to jobs and activity. At its February meeting, the MPC unanimously judged that it remained appropriate to seek to return inflation to the target over a somewhat longer period than usual, and that the current stance of monetary policy remained appropriate to balance the demands of the Committee's remit.

As the Committee has previously noted, however, there are limits to the extent that above-target inflation can be tolerated. The projections described in the February *Inflation Report*, and the continuing suitability of the current policy stance, depend crucially on three judgements:

- that the lower level of sterling continues to boost consumer prices broadly as expected, and without adverse consequences for inflation expectations further ahead;
- that regular pay growth does indeed remain modest, consistent with the Committee's updated assessment of the degree of slack in the labour market; and
- that the hitherto resilient rates of household spending growth slow as real income gains weaken.

In judging the appropriate policy stance, the Committee will be monitoring closely the incoming evidence regarding these and other factors. For instance, if spending growth slows more abruptly than expected, there is scope for monetary policy to be loosened. If, on the other hand, pay growth picks up by more than anticipated, monetary policy may need to be tightened to a greater degree than implied by current market yields.

More generally, monetary policy can respond, in either direction, to changes to the economic outlook as they unfold to ensure a sustainable return of inflation to the 2% target.

5. Conclusion

Following the referendum, the Bank eased macroprudential and monetary policies in order to support households and businesses during a period of initial uncertainty and eventual adjustment to the country's new relationship with the EU. That stimulus is working. The cost of borrowing is down, availability of credit is up, and some of the impact of uncertainty on households and businesses has been mitigated.

The Brexit journey is really just beginning. While the direction of travel is clear, there will be twists and turns along the way. Whatever happens, monetary policy will be set to return inflation sustainably to target while supporting the necessary adjustments in the economy. At this week's meeting, the MPC maintained its policy stance. If circumstances warrant a change in policy, we will act consistent with our remit.