INFLATION REPORT PRESS CONFERENCE

Thursday 11th May 2017

Opening Remarks by the Governor

Good afternoon.

The outlook for UK growth and inflation will continue to be influenced by the response of households, companies and financial markets to the prospects for the UK's departure from the EU. 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.

For some time, the responses of financial markets and households to the UK's decision to leave the EU have diverged. In its February projections, the MPC expected that this tension between consumer strength and relative financial market pessimism would be reduced over the course of this year.

That process has now begun. With wage growth moderating and inflation picking up, both household spending and GDP growth have slowed markedly. In contrast, sterling has appreciated, possibly reflecting market expectations of a more orderly Brexit process.

On balance, the Committee judges that consumption growth will be slower in the near term than previously anticipated before recovering in the latter part of the forecast period as real incomes pick up.

The Committee's latest projections

In the MPC's central forecast, quarterly growth is forecast to stabilise around its current rate, resulting in growth of 1.9% in 2017 and around 1¾% in each of the next two years. This is broadly as the Committee had expected in February.

The global outlook has improved further since February, with stronger business surveys and generally better financial conditions. The latest indicators, including trade growth and capital goods orders, suggest broad-based strength. And signs of more robust global demand have also been reflected in global asset prices, with equity prices rising further in recent months. The MPC's projection for world GDP growth remains near the top of the range of external forecasts.

The combination of the stronger global outlook and sterling's past depreciation is likely to support UK net trade. And together with somewhat lower uncertainty, stronger global growth is also likely to encourage investment as exporters renew and increase capacity.

Turning to inflation, CPI inflation has risen above the MPC's 2% target as sterling's past depreciation has begun to feed through to consumer prices. This impact has been offset to some extent by continued subdued growth in domestic costs, with wage growth notably weaker than expected.

The MPC expects inflation to rise further above the target in the coming months, peaking a little below 3% in the fourth quarter. Conditioned on the market yield curve, inflation is projected to remain above the MPC's target throughout the forecast period. The yield curve has steepened slightly and sterling has rallied somewhat since the forecast was closed.

The projected inflation overshoot entirely reflects the effects on import prices of the fall in sterling since late November 2015—a depreciation caused by market expectations of a material adjustment to the UK's medium term prospects as it leaves the EU.

The contribution to inflation of higher import prices is likely to fade gradually throughout the forecast period. The extent to which domestic cost pressures pick up will determine where CPI inflation settles towards the end of the forecast.

Wage growth has been soft in recent years despite strong employment growth. Weakness in productivity growth and a continuing drag from slack have contributed to this softness, but they cannot explain its full extent. Uncertainty of companies about the outlook may also have made them unwilling to raise wages at a faster pace until they have more clarity about future costs and market access.

The MPC judges that the factors currently weighing on wage growth are unlikely to persist, and it projects that wages will rise significantly as the output gap narrows throughout the forecast period and closes by the end.

As a result, inflation is projected to rise in the third year of the forecast even as the impact of imported price pressures diminishes.

Policy decision

Monetary policy cannot prevent either the necessary real adjustment as the UK moves towards its new international trading arrangements or the weaker real income growth that is likely to accompany that adjustment over the next few years. Attempting to offset fully the effect of weaker sterling on inflation would be achievable only at the cost of higher unemployment and, in all likelihood, even weaker income growth. For this reason, the MPC's remit specifies that, in such exceptional circumstances, the Committee must balance any trade-off between the speed with which it intends to return inflation to the target and the support that monetary policy provides to jobs and activity.

At its May meeting, the MPC decided that the current stance of monetary policy remained appropriate to balance the demands of its remit. The actual and prospective overshoot of inflation relative to target is entirely due to the effects of sterling's depreciation, which itself reflects fundamental factors that monetary policy could not affect. In such exceptional circumstances, the MPC’s remit requires it to pay close consideration to the trade-off between inflation and slack. For most of the forecast period, the economy is expected to operate with a degree of spare capacity, justifying that some degree of above-target inflation could be tolerated. The output gap is projected to close by the end of the forecast, however, reducing the Committee’s tolerance for above-target inflation at that point.

The MPC’s forecast relies on, amongst other things:

- a significant pick-up in wage growth;
- no further slowing in aggregate demand;
- the lower level of sterling continuing to boost consumer prices broadly as projected, without adverse consequences for inflation expectations further ahead; and
- the adjustment to the UK’s new relationship with the EU being smooth.

As these conditions make clear, while Brexit will play an important role, other factors will also influence the outlook for the economy and inflation. In judging the appropriateness of the monetary stance, the Committee will monitor closely incoming evidence regarding a range of factors.

Monetary policy will respond in either direction to changes in the economic outlook as they unfold to ensure a sustainable return of inflation to target, while supporting the necessary real adjustments in the economy.

On the whole, the Committee judges that, if the economy follows a path broadly consistent with its central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast horizon than the very gently rising path implied by the market yield curve at the time of the forecast.