INFLATION REPORT PRESS CONFERENCE

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Opening Remarks by the Governor

If a week is a long time in politics, two years is an eternity in monetary policy.

Two years ago, at a time of heightened uncertainty, the MPC instituted a comprehensive package of easing measures, including cutting Bank Rate to a historic low of ¼% and purchasing an additional £70 billion of assets.

Today, the MPC is raising Bank Rate by ¼ percent points to ¾%.

Two years ago, the UK economy had substantial spare capacity and domestically generated inflation was low. Business confidence had fallen sharply to levels last seen in the wake of the financial crisis. Inflation was expected to overshoot its target, entirely because of the sharp drop in sterling, which itself reflected the view of financial markets that Brexit would bring a large negative real shock to UK relative incomes. In these exceptional circumstances, the MPC rightly chose to support jobs and activity while it extended the horizon over which it returned inflation to target.

That strategy has worked. Today, employment is at a record high, there is very limited spare capacity, real wages are picking up and external price pressures are declining.

With domestically generated inflation building and the prospect of excess demand emerging, a modest tightening of monetary policy is now appropriate to return inflation to the 2% target and keep it there.

Activity

UK growth in the second quarter is estimated to have rebounded as expected, consistent with the MPC's judgment that the slowdown in the first quarter primarily reflected the weather not the economic climate.

Construction output rose in May at its strongest rate in two years. Retail sales grew at their fastest pace in three years. And broader survey indicators of output growth have been in line with the Committee's expectations.

In the MPC's latest projections, conditioned on the gently rising path for interest rates implied by the market yield curve, UK demand is expected to continue to grow around its current pace.

Household consumption is expected to grow at a modest rate, broadly in line with real incomes.

With continued support from external demand, limited spare capacity, the relatively high rates of return on capital and the low cost of finance, business investment is projected to expand at an annual rate of around 3½% over the forecast period – a subdued pace relative to past recoveries reflecting the drag from Brexit-related uncertainties.

Although trade tensions have increased and growth has become more uneven, global growth is projected to remain above-trend, supporting UK activity over the next few years. UK exporters remain in a sweet spot, with sterling down 17% in anticipation of a Brexit that has not yet happened.

Overall, demand growth is likely to average around 1¾% over the forecast, just above the new, subdued rate of supply growth. That is more than sufficient to absorb the very limited

degree of spare capacity that currently remains in the economy and move the economy into excess demand by late 2019.

Inflation

CPI inflation has fallen back towards the MPC's 2% target since the start of 2018, reaching 2.4% in June. Above-target inflation continues to reflect the effects of sterling's past depreciation as well as higher energy prices.

The Committee's latest inflation projection is a little higher than in May, reflecting the effect of the recent rises in energy prices and the 2½% depreciation of sterling. Such external factors could inject some volatility into the path for inflation in the near term.

The bigger picture, however, remains one of external cost pressures easing, with the peak impact on inflation from the referendum-related fall in sterling now behind us, and domestic inflationary pressures continuing to build as slack is absorbed.

The labour market is strong. Unemployment is at a 42 year low and is projected to fall a little further below the MPC's estimate of its equilibrium rate. Both the employment rate and number of vacancies are at record highs, and job-to-job flows are back around pre-crisis levels.

Pay growth has picked up in recent years, as the labour market has tightened and companies have found it harder to recruit and retain staff. Across the economy as a whole, growth in average wages excluding bonuses has risen from around 1¾% a year during 2010-15 to around 2½% in 2016, and wage growth is expected to have picked up a little further to around 2¾% around the middle of this year.

The picture of strengthening pay is corroborated by a range of indicators. The median pay settlement recorded in the Bank's settlements database has risen to around 2.5% this year, having been steady at around 2.0% for the past three years. Survey evidence from the Agents suggests that pay settlements will rise further this year. And the REC pay indices remain well above their historical averages for both permanent and temporary employees.

Although current rates of pay growth are lower than pre-crisis averages, this largely reflects weak productivity growth. As a result, domestic inflationary pressures are rising, with (whole economy) unit labour cost growth increasing from ½% on average during 2010 -15 to 1¾% in 2016, and to above 2% most recently. Unit labour cost growth is projected to average around 2¼% over the forecast, a rate consistent with inflation at target.

The Outlook for Monetary Policy

In this environment, an ongoing, limited and gradual tightening in monetary policy is likely to be required in order to return inflation sustainably to the target at a conventional horizon.

In the MPC's central projection, conditioned on the market path for Bank Rate that incorporates around three rate rises over the next three years, inflation remains above target at the conventional two-year horizon. And if Bank Rate were to remain at its new level of 0.75%, inflation would be expected to remain above the 2% target throughout the next three years.

Two issues will have a particularly important influence on the setting of policy going forward.

The first, Brexit, is on the front of the papers and the top of the news bulletins most days.

As has been the case for some time, the MPC forecast is conditioned on the assumption of a relatively smooth transition to an average of a range of outcomes. This is not a prediction but rather a simplifying assumption which broadly reflects how UK businesses and households are behaving.

The Committee recognises that the economic outlook could be influenced significantly by the response of households, businesses and financial markets to developments related to the process of EU withdrawal.

Negotiations are now entering a critical period, with the UK and EU both seeking an agreement by the end of the year.

Although the range of potential outcomes is wide, what matters for monetary policy is how people react to developments – and how these reactions affect the balance of supply, demand and the exchange rate.

Thus far, British households have been resilient – but not indifferent – to Brexit news. Consumer confidence has been little changed in recent months, below its pre-referendum levels but around its longer term average. Household spending has been increasing broadly in line with real incomes, though household borrowing for major purchases has slowed and the housing market is subdued.

Financial markets – particularly sterling – marked down the UK's relative prospects quickly and sharply. Risk premia on sterling assets have increased somewhat in recent weeks.

Since the referendum, business investment has picked up but businesses have invested much less aggressively than usual in response to an otherwise very favourable environment. There

are signs that business sentiment is softening again, with references to "uncertainty" in their conversations with the Bank's agents spiking sharply and concerns about Brexit reported in the Deloitte CFO survey at their highest level since the referendum.

The second issue – the equilibrium interest rate, or r* – is as obscure as Brexit is prominent.

The equilibrium interest rate is the interest rate that, if the economy starts from a position with no output gap and inflation at target, would sustain output at potential and inflation at target.

r* is not a direct guide to the setting of monetary policy. Rather, it provides a way to think about the forces acting on the economy, and whether policy is stimulative or contractionary. The appropriate level of Bank Rate depends not only on the level of r* but also on the need to close any output gap or whether shocks merit varying the horizon over which the MPC seeks to return inflation to target.

The MPC published today its assessment of the factors influencing the equilibrium interest rate. The key messages are:

- The level of Bank Rate consistent with output at potential and inflation at target has fallen significantly from pre-crisis levels.
- This has been caused both by structural forces – such as productivity and demographics – and shorter-term forces – such as uncertainty and private and public deleveraging – which have pushed the equilibrium interest rate down further.
- As a consequence, even though Bank Rate has been very low, the stance of monetary policy in recent years has been mildly rather than wildly accommodative.

- Indeed, the facts that today the economy is at full employment and core CPI is 1.9% tell us that the combination of historically low rates and asset purchases of two years ago was about right. Tighter policy then would have led to worse outcomes now.

The box also provides context to our long-held guidance that rate rises are expected to be limited and gradual.

Limited because we think the structural factors that have pushed down the trend equilibrium real rate are likely to persist.

And gradual because we think the domestic short-term factors (particularly headwinds from uncertainty and fiscal drag) will fade slowly.

As a result, r* can be expected to rise gradually. Policy needs to walk – not run – to stand still.

In recent years, the UK has faced a series of supply shocks and regime shifts that have created a series of difficult trade-offs for monetary policy. Brexit is the most recent and potentially the most important.

If the economy were to continue to develop broadly in line with the *Inflation Report* projections, the MPC judges that an ongoing tightening of monetary policy over the forecast period would be appropriate to return inflation sustainably to the 2% target at a conventional horizon. As was the case before, that judgment relies on the economic data being broadly consistent with the MPC's projections and on how households, businesses and financial markets respond as Brexit progresses. Any future increases in Bank Rate are likely to be at a gradual pace and to a limited extent.

The Bank is well-prepared for whatever path the economy takes, including a wide range of potential Brexit outcomes.

The UK banking system has sufficient capital to continue lending even through a disorderly, cliff-edge Brexit, however unlikely that might be. For cliff-edge Brexit risks that private financial institutions cannot self-solve, the Bank of England is working with HMT to find solutions. Where the issues are cross border, the Bank is working with the ECB to manage them.

The MPC will respond to any persistent change in the outlook to bring inflation sustainably back to 2% target while supporting jobs and activity.

That is how we set policy two years ago, it is how we are setting it today, and it is how we will do so in the future.