INFLATION REPORT PRESS CONFERENCE

Thursday 10th May 2018

Opening Remarks by the Governor

Three months ago, the MPC said that an ongoing tightening of monetary policy over the next few years would be appropriate to return inflation sustainably to its 2% target. That guidance was explicitly conditioned on the economy evolving broadly in line with the Committee's February *Inflation Report* projections.

In the period since then, the economy hasn't fulfilled those conditions. Growth—at 0.1% in the first quarter of this year—was much weaker, and inflation—at 2.5% in March—was notably lower than we had projected in February.

The key question is whether that softness will prove temporary or persistent. In other words, was weakness in the first quarter due to the weather or the climate?

Weather

The MPC's central assessment is that it largely reflects the former, and that the underlying pace of growth remains more resilient than the headline data suggest.

The period of adverse weather hit the construction sector particularly badly, and weighed on activity more broadly, as people struggled to work and to make it to the shops.

In contrast, the labour market has remained reassuringly strong. In the three months to February, employment rose by more than projected and the unemployment rate fell to 4.2%, the lowest rate in over 40 years and a touch below the MPC's estimate of the natural rate. Private sector wages have picked up. Adding to the positives, job-to-job flows are back to their pre-crisis average rate and there is widespread evidence in employment surveys of a tightening labour market.

Climate

The overall economic climate in the UK looks little changed thus far.

In particular, the MPC has long forecast a rotation in demand towards net trade and business investment and away from household consumption. This is what has happened, and we expect it to continue.

UK exporters remain in a sweet spot, with sterling down around 15% in anticipation of a Brexit that has not yet happened, particularly with a new draft transition agreement that extends unfettered access to EU markets until the end of 2020. Although they have eased slightly, the European and global economies are growing faster than trend and are projected to remain robust over the forecast period. As a consequence, net trade is projected to continue supporting UK growth over the next few years.

Turning to business investment, evidence from both the Bank's Decision Maker Panel (of 3700 firms) and our direct contacts across the country indicate that the drag from Brexit uncertainty, while persisting, has not intensified. With continued support from strong 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 a moderate annual rate of around 4% over the forecast period

On the consumer side, although there has been some reduction in the household savings rate since the referendum, this has been far from a debt-fuelled consumption boom. Rather, household spending has broadly tracked income and employment growth.

There is somewhat greater uncertainty about the near-term momentum in consumer spending given the recent weakness in consumer credit and the housing market, with the possibility that households could opt to save rather than spend as their real incomes recover.

On balance, with the real income squeeze coming to an end and the adverse weather behind us, consumption growth is projected to recover over the forecast to rates broadly in line with the subdued pace of real income growth. To put that recovery in context, the MPC is expecting household consumption to grow over the next few years at about only half the rate before the referendum and merely one-third of the rate before the global financial crisis.

So overall, the climate is one of modest demand growth with the combination of solid growth in net trade and moderate growth in business investment offsetting more subdued growth in household spending.

These judgments leave the MPC's latest projections broadly similar to those published three months ago. In particular, GDP growth is projected to pick up after the weak first quarter to annual rates of around 1¾% throughout the forecast period.

A critical judgment by the MPC is that such modest growth by historical standards is still likely to be sufficient to exceed the expected 1½% average annual growth in the economy's supply capacity. That diminished rate of supply growth reflects the climate of the past few years, with the shallowest investment recovery in half a century, lower growth in labour supply and modest productivity growth.

Inflation

With very little spare capacity remaining in the economy and with growth in demand outpacing that of supply, a small margin of excess demand is projected to emerge by early 2020.

As a consequence, domestic inflationary pressures are expected to continue to build gradually to rates consistent with the 2% target. That offsets a waning contribution from import prices, so that inflation falls back over this year, to settle at the 2% target by mid-2020.

Let me expand a bit. Although CPI inflation has fallen back by more than expected at the time of February *Report*, that shortfall largely reflected lower-than-expected inflation rates across a range of import-intensive CPI components.

Since sterling's depreciation, import prices have risen by less than the MPC had been expecting with pass-through from sterling world export prices currently running at around 50% rather than the anticipated 60%. In previous *Reports*, all of that gap was projected to be made up over the forecast period. But, with more signs that may not be happening, the MPC now judges that only half of the shortfall will come through.

By contrast, domestic inflationary pressures have been strengthening as anticipated. As we had projected in February, regular pay growth has risen to just under 3%, and unit labour cost growth has firmed over the past couple of quarters to rates consistent with the 2% inflation target. Other measures of domestically generated inflation have also moved closer to their target-consistent ranges.

Policy

In the exceptional circumstances prevailing since the referendum, the MPC has set policy to balance the trade-off between the speed at which inflation returns to target and the support that monetary policy provides to jobs and activity.

That policy is working. Employment is at a record high. Import price inflation is fading. Real wages are rising. And domestic inflationary pressures are gradually building to rates consistent with the inflation target.

The steady absorption of slack over the past year and the prospect of excess demand over the forecast period have reduced the degree to which it is appropriate to accommodate an extended period of inflation above the target. As a consequence, the MPC began to remove

some of the stimulus that monetary policy has been providing, raising Bank Rate to ½ per cent in November.

At its May meeting, the majority of the Committee judged that it was appropriate to maintain the current accommodative stance of monetary policy.

But if the economy evolves in line with the May *Inflation Report* projections, the MPC judges that an ongoing, modest tightening of monetary policy over the forecast period will be appropriate to return inflation sustainably to its 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 as has long been the case, the MPC expects that any future increases in Bank Rate are likely to be at a gradual pace and to a limited extent.

While the storms of February and March have given way to sunnier skies, the economic outlook for the UK remains clouded by Brexit uncertainties. Despite the welcome agreement on a transition period, the terms on which the UK will trade with the EU beyond that period remain to be determined.

As negotiations progress this year, the medium-term economic climate will become clearer. As it does, households, businesses and financial markets will adjust. The MPC will monitor these developments closely and react as appropriate to ensure that inflation returns sustainably to the 2% target consistent with its remit.