

INFLATION REPORT PRESS CONFERENCE

Thursday 7 February 2019

Opening Remarks by the Governor

The Fog of Brexit

There's a story that, a century or so ago, *The Times* ran the headline, "Fog in the channel, continent cut off". I stress that this is just a story because like much regarding the UK and Europe it's difficult to separate fact from fiction.¹

Cutting off the continent is not, of course, the intention of Brexit. The UK is leaving the European Union not leaving Europe, and it's pursuing an ambitious, broad economic and security partnership.

But the exact form of that partnership, how it will be settled, and when that settlement will take effect are all still unclear.

That Fog of Brexit is causing short-term volatility in the economic data, and, more fundamentally, it's creating a series of tensions.

Tensions for business:

- Although many companies are stepping up their contingency planning, the economy as a whole is still not yet prepared for a no deal, no transition exit. As just one example, half the businesses in the latest survey by the Bank Agents are not ready for such a possibility, and on balance respondents expect UK output, employment and investment to contract substantially if it were to occur.
- Actual business investment is likely to have fallen 3% over the past year despite the ongoing domestic expansion, strong corporate balance sheets and high business profitability. The latest indicators (including from the Bank's Decision Maker Panel of over 7000 firms) suggest more of the same.

¹ There is a running controversy about this purported example of splendid isolationism, which is oft cited but seldom sourced. Professor Niall Ferguson has called it an enduring myth – "just the sort of story that is invented by an Englishman and told by Englishmen to amuse other Englishmen", in the words of a letter to *The Times* from Moray McLaren, published on 3 November 1939. The intrepid librarians at the Bank of England have verified that the headline "Fog in the Channel" did appear in *The Times* on 9 August 1888. But while the article that followed reported that "Traffic in the Channel was much impeded", with several vessels stranded or grounded, the headline itself made no reference to the continent being cut off or otherwise isolated.

- There is increasing evidence that companies are also building stocks as part of their contingency planning. It is likely that these have a strong import component thereby limiting the net impact on aggregate demand.
- The news is not all glum. Even though companies aren't currently investing, they have been hiring, with the employment rate now the highest since records began in 1971.

The Fog of Brexit is creating tensions for households:

- Despite that strong labour market, consumer confidence took another step down in January. The gap between the relatively high confidence that households have in their personal financial situation and their more sceptical view of the general economic outlook is now extraordinarily wide.
- It is possible that such uncertainty is holding back spending on durables, including cars and housing.
- Indeed, with house prices now flat nationwide and mortgage demand soft, spending on all aspects of housing (including renovations and transactions) could be a short-term drag on growth.
- Retail sales contracted by 0.2% in Q4 and indicators suggest spending growth has been modest since the start of the year.
- Nonetheless, given the historical resilience of the UK consumer and the strong growth in household real incomes (which are likely to have risen by 2½% in the year to 2019 Q1, the strongest since the referendum), household spending is an upside risk to our forecast.

And the Fog of Brexit is creating tensions in financial markets:

- Financial markets remain sensitive to Brexit-related news, and a variety of risk premia on UK assets are elevated.
- Given the wide range of potential scenarios and the various paths to them, it would be remarkable if the current levels of sterling and other UK financial asset prices were consistent the outcome that finally emerges.

How these tensions are reconciled once the fog lifts will have consequences for the path of monetary policy in ways that cannot be predicted in advance.

To forecast the economy and set monetary policy accordingly, the MPC must make a series of judgments.

First, given the dynamics of the negotiations, we are now assuming uncertainty remains elevated for a while and that financial conditions stay tighter for longer.

Second, we have downgraded our forecast for UK weighted global GDP by 0.5 per cent. Over the past year the global economy has transitioned from robust, broad-based expansion to a widespread slowdown, with all major regions currently decelerating in the wake of tighter financial conditions and rising trade tensions.

Nevertheless, with the easier paths of monetary policy in all major economic areas implied in markets, the MPC expects global growth will stabilise later this year at around potential rates.

As usual, our projections incorporate a number of assumptions:

- Paths for oil prices (and energy prices more broadly) which are expected to push inflation below the 2% target in the near term;
- A conditioning path for the sterling exchange rate which is down 1% on November;
- Market interest rates which suggest a gently rising path for Bank Rate over the next three years;
- The path for government spending and taxation as set out in the Autumn budget, which raises GDP over the forecast period by around one third of a percent relative to the previous plans; and
- Most importantly, a smooth transition to a Brexit deal that is the average of various possibilities.

The MPC recognises that these assumptions and judgments will need to be updated once greater clarity emerges about the nature of EU withdrawal.

For now, these judgments and assumptions lead to a forecast in which:

- Business investment and economic growth soften further in the near term before picking up sharply as the fog clears. UK GDP growth is expected to rise to 2% by the end of the forecast, building excess demand in the process.
- Inflation dips below target in the near term before picking up and settling a little above the 2% target for the balance of the forecast.

While much is uncertain at present, one certainty is that the UK economy will not evolve exactly as described in this Inflation Report.

- For starters the average of a range of different outcomes is not the same as a specific deal.
- The timing of both the agreement and of its implementation could change.
- The pace of rebound in investment and the pickup in consumption could be different; and
- Whatever form Brexit takes, the world will still turn and its outlook evolve.

In the context of Brexit, uncertainty itself is one of the factors driving the outlook for growth and inflation. To illustrate these effects, the MPC has provided key sensitivities of our projections to Brexit uncertainties.

- Any persistent adjustment in sterling would likely have material consequences for inflation at the policy-relevant horizon, due to the slow speed of pass-through into consumer prices. For example, a depreciation or appreciation of 5% would leave inflation 0.3 percentage points higher or lower three years from now, all else equal.
- The outlook for growth and inflation also depends heavily on the extent to which Brexit uncertainties evolve. Uncertainty about the outcome of negotiations has intensified since November and is now weighing more heavily on activity, predominantly through lower business investment and tighter financial conditions.

- Depending on how negotiations progress (particularly regarding clarity about the ultimate form of the new economic partnership), Brexit uncertainties could dissipate sooner or intensify further than the MPC has assumed in its central projection. A more rapid decline could boost annual GDP growth by around 0.5 percentage points on average over the forecast period and raise inflation in the medium term by 0.4 percentage points. By contrast, a further rise in uncertainty and tightening in financial conditions could push demand growth below supply growth and leave inflation below the 2% target.

Implications for Monetary Policy

While uncertainty is affecting the near term performance of the economy, judging the appropriate stance of monetary policy requires focusing on the more persistent factors affecting inflation.

The fundamentals of the UK economy are sound. The financial sector is resilient. Corporate balance sheets are strong. And the labour market is tight.

Based on the MPC's smooth Brexit conditioning assumption, growth is expected to pick up to rates above the rate of growth of supply capacity, excess demand is likely to build, and inflation to settle slightly above the 2% target.

If these circumstances come to pass, the Committee judges that an ongoing tightening of monetary policy over the forecast period, at a gradual pace and to a limited extent, would be appropriate to return inflation sustainably to the 2% target at a conventional horizon.

The appropriate path of monetary policy will depend on the balance of the effects of Brexit on supply, demand and the exchange rate. The response will not be automatic and could be in either direction.

Although it isn't clear how long the fog of Brexit will last, whatever the weather, the MPC will always act to achieve the 2% inflation target, consistent with its remit.