

# INFLATION REPORT PRESS CONFERENCE

Thursday 2 May 2019

## Opening Remarks by the Governor

### Introduction

Back in February, the MPC observed that the Fog of Brexit was creating a series of tensions for UK businesses, households and financial markets, and that this was occurring against a backdrop of considerable trade and financial pressures in the global economy.

At that time, the short-term outlook for the UK economy was subdued, and the data were expected to be unusually volatile and potentially less informative than normal. But provided clarity emerged about the future relationship with the EU and the worst of the global risks were avoided, the MPC expected that UK growth would pick up to above potential rates, domestic inflationary pressures would build gradually and a modest ongoing withdrawal of monetary stimulus would be required to keep inflation sustainably at target over the policy horizon.

So what has changed since then?

### Global Outlook

In recent months, global tensions have eased.

In particular, there has been a further marked easing in global financial conditions triggered by revisions to the monetary policy outlooks in major economies. In tandem, global risk sentiment has recovered. This has spilled over to lower yields and to ease financial conditions in the UK.

There have also been signs that global trade is stabilising and trade tensions, for now at least, have abated somewhat.

Partly as a result, activity appears to be stabilising in the major economies. The hard data now suggest that global growth troughed towards the end of last year, and the survey data bottomed out shortly thereafter. Recent developments are consistent with the MPC's expectations for a modest pickup in global growth over the course of this year to around potential rates.

## **UK Economy: Past as Prologue?**

In contrast to this more benign global backdrop, domestic tensions remain.

To get a sense of their consequences, it is helpful to review the how the UK economy has performed relative to MPC's forecast from February last year.

Overall GDP growth appears bang in line with our forecast. However, its expenditure components are substantially different, with the expected rotation from consumption towards business investment and net exports failing to materialise.

Instead, higher employment and stronger wage growth meant that household consumption was stronger than anticipated, growing by 2% versus 1½% expected.

Offsetting that positive news, business investment fell by more than 2% rather than growing by 4%. And net trade subtracted ½ a percentage point from the expansion instead of contributing ¾ of a percentage point to growth.

### **Businesses**

This pattern looks set to continue in the near term.

The latest business investment intentions surveys point to further declines over the next few quarters, which would mark the longest run of falling investment in the post-war era.

Falling investment is weighing on productivity growth, boosting unit labour costs, and supporting domestically generated inflation.

Unable to plan for their long-term future, UK businesses have focused on short-term Brexit contingency plans.

Concerned about disruptions to trade given the potential 29<sup>th</sup> March cliff edge, companies on both sides of the Channel brought forward production, pushing UK goods imports and exports with the EU to decade highs in the three months to February despite the doldrums in both economies.

According to our Agents' surveys, the proportion of UK firms with contingency plans in place has risen from around one half in February to over three quarters at present.

Stock building has been central to the plans of over two-fifths of survey respondents, boosting GDP in the first quarter.

Nevertheless, it remains the case that companies are only as ready as they can be, and they expect a marked decline in the rate of growth, investment and employment in the event of a hard Brexit. In recent surveys, firms expected their output would fall by 3½% in the event of a no deal no transition Brexit.

Faced with a high option value of waiting for news about Brexit, companies in aggregate appear to have favoured hiring relative to capital investment.

As a result, the UK labour market has outperformed expectations over the past year, with employment and wage growth both surprising on the upside. The resulting strength in real income growth has supported consumption, which in turn has driven domestic demand.

### **Households**

Four-quarter real income growth picked up further in the first quarter, and surveys of consumer confidence indicate that households remain relatively optimistic about their own financial prospects, despite being pessimistic about the overall economic situation.

That divergence may be the reason why the only area of household spending discernibly restrained by Brexit is the housing market, where transactions are currently subdued and prices stagnating.

In aggregate, Q1 GDP growth is projected to come in 0.3pp stronger than expected in the February Report.

Around half of that upside surprise could be due to the boost from Brexit-related stock building. Consistent with reports from the Bank's Agents, the MPC expects a corresponding drag to growth in Q2.

Smoothing through this volatility, the underlying pace of growth is a touch stronger than the MPC had previously assessed, though it is still a little below potential, meaning that the current margin of slack in the economy is expected to widen a little in coming quarters.

## **Financial markets**

While UK financial markets remain sensitive to Brexit-related news, global developments appear to have driven down the market curve for Bank Rate that underlies the MPC's projections.

Expectations of policy rates in the US and euro area have fallen significantly since the February *Report* and market expectations for the path of Bank Rate have followed. That path currently implies that Bank Rate will rise to around 1% by the end of the forecast period, around 15 basis points lower than in the February *Report*.

As the MPC's inflation forecast suggests, this new market curve introduces an additional financial market tension to the one already existing between the current level of sterling and the level that would be consistent with whatever Brexit outcome that ultimately comes to pass.

## **The economic outlook**

At some point, the tensions between households, companies and financial markets will be reconciled.

In the MPC's projections, that resolution comes through our assumption of a smooth Brexit, resulting in a forecast of two phases.

In the first phase over the next year:

- Growth remains modest, reflecting the continued drag from Brexit uncertainties and below-potential global growth.
- Near-term inflation is expected to pop above 2% in April and then fall back below target, in large part reflecting movements in household energy prices and still modest core services inflation.

In the second phase over the balance of the forecast, as global growth stabilises around potential rates and Brexit uncertainties wane:

- Business investment growth recovers, the housing market improves, consumption continues to grow broadly in line with incomes, and aggregate demand picks up to above potential rates.

- Excess demand rises slightly above 1% by the end of the forecast period, notably higher than in February, with the unemployment rate projected to decline to 3½%.

The emergence of excess demand leads to a strengthening of domestic inflationary pressures, more than offsetting the fading contribution from import and energy prices, such that inflation rises above target in two years' time and continues rising through the end of the three-year forecast period.

### **Implications for Policy**

At its meeting yesterday, the MPC agreed that the current stance of policy remained appropriate.

The Committee emphasised that the right path for monetary policy will depend on how the current tensions between businesses, households and financial markets are resolved. The response of monetary policy to Brexit will depend on the balance of its effects on supply, demand and the exchange rate.

The MPC's latest projections imply that the current market curve used as the conditioning assumption for our forecast is unequal to the task of achieving the MPC's remit.

Based on the MPC's conditioning assumption of a smooth Brexit, the Committee continues to judge 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.