Overview

In the United Kingdom, CPI inflation rose further above the 2% target while output fell. Output was, however, temporarily affected by the heavy snowfall at the end of 2010 and growth appears likely to resume. The world economy grew further, although vulnerabilities remain. Expansionary monetary policy, combined with further growth in global demand and the past depreciation of sterling, should ensure that the recovery in the United Kingdom is maintained. But the continuing fiscal consolidation and squeeze on households' purchasing power are likely to act as a brake. After some near-term weakness, GDP growth is judged to be about as likely to be above as below its historical average rate. Even so, the depth of the recession means that some spare capacity is likely to persist over the forecast period.

CPI inflation is likely to pick up to between 4% and 5% in the near term and to remain well above the 2% target over the next year or so, reflecting in part the recent increase in VAT. The near-term profile is markedly higher than in November, largely reflecting further rises in commodity and import prices since then. Further ahead, inflation is likely to fall back, as those effects diminish and downward pressure from spare capacity persists. But both the timing and extent of that decline in inflation are uncertain. Under the assumptions that Bank Rate moves in line with market interest rates and the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion, the chances of inflation being either above or below the target in the medium term are judged to be broadly balanced.

Financial and credit markets

Since the November *Report*, the MPC has maintained Bank Rate at 0.5% and its stock of purchased assets at £200 billion. Market participants revised up their expectations of the near-term path of Bank Rate. The sterling effective exchange rate has been broadly stable over the past two years, and remains around 25% below its mid-2007 level. UK banks made further progress in refinancing maturing funding, but significant challenges remain. Credit conditions for smaller companies and households continued to be tight. Annual growth of both bank lending and broad money remained weak, as did indicators of housing market activity.

Demand

The solid recovery in global demand continued, driven largely by emerging economies. GDP in the United States expanded further in Q4, supported by strong consumption growth although significant headwinds remained. Within the euro area, Germany grew robustly in Q3, but activity remained weak in some parts of the euro-area periphery. UK exports have grown briskly over the past year and surveys pointed to further healthy growth in the near term.

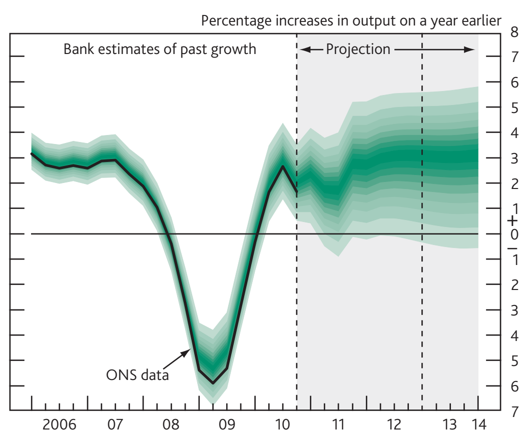
At home, private domestic demand grew robustly in the first three quarters of 2010, driven in part by a temporary boost from an end to the period of de-stocking. But fixed investment also increased strongly, partly financed from companies' substantial positive cash flows. And, abstracting from quarterly volatility, households' consumption grew at a moderate pace, despite stagnant real incomes. The impact of this strength in domestic demand on UK output was partly offset by rapid growth of imports.

A significant fiscal consolidation is in train. The Committee's projections are conditioned on the plans set out in the June *Budget* and the October *Spending Review*.

The outlook for GDP growth

GDP was provisionally estimated to have fallen by 0.5% in 2010 Q4. The ONS estimated that, without the disruption caused by heavy snow, output would have been broadly flat. Growth in 2011 Q1 is likely to be boosted as activity rebounds. But abstracting from the effects of snow, growth around the turn of the year appears likely to be somewhat weaker than expected in the November *Report*.

Chart 1 GDP projection based on market interest rate expectations and £200 billion asset purchases



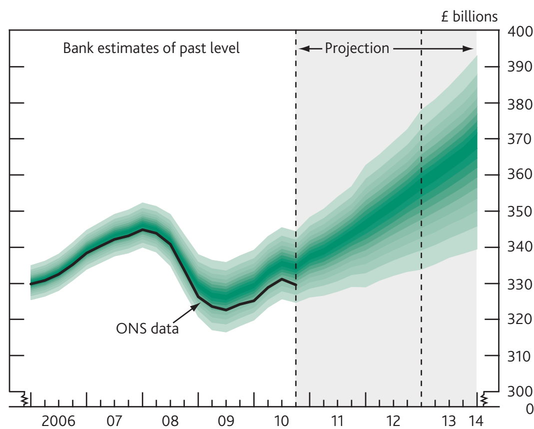
The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. To the left of the first vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past; to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter green areas on 10 occasions. In any particular quarter of the forecast period, GDP is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP growth can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. In any quarter of the forecast period, the probability mass in each pair of identically coloured bands sums to 10%. The distribution of that 10% between the bands below and above the central projection varies according to the skew at each quarter, with the distribution given by the ratio of the width of the bands below the central projection to the bands above it. In **Chart 1**, the ratios of the probabilities in the lower bands to those in the upper bands are approximately 6:4 at Years 2 and 3; the downward skew is somewhat smaller at Year 1. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents. The second dashed line is drawn at the two-year point of the projection.

Chart 1 shows the Committee's best collective judgement for four-quarter GDP growth, assuming that Bank Rate follows a path implied by market interest rates and the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion. The projection for four-quarter growth is weaker than in November for much of 2011, following the weak data around the turn of the year. The considerable stimulus from monetary policy, together with a further expansion in world demand and the past depreciation of sterling, should support recovery by encouraging private sector spending and some rebalancing of the economy towards net trade. But the strength of the recovery is likely to be dampened by the fiscal consolidation and a continuing squeeze on households' purchasing power from the effects of higher commodity prices and a persistent impact of the recession on productivity and hence wages.

The outlook for growth remains highly uncertain. Private domestic demand could grow rapidly, for example if some businesses choose to use some of their cash balances to increase investment. But there are significant downside risks to private demand, especially to household spending. In particular, uncertainty about the impact of the fiscal consolidation and restrictions on the availability of credit might cause consumption to grow more slowly than real disposable incomes. The improvement in net trade will depend on the vigour of the global recovery and the degree of rebalancing prompted by sterling's past depreciation.

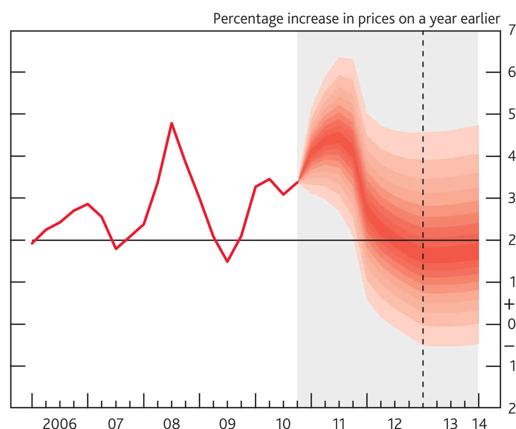
There remains a wider than usual range of views among Committee members about the outlook for growth. The Committee continues to judge that relative to the most likely

Chart 2 Projection of the level of GDP based on market interest rate expectations and £200 billion asset purchases



Chained-volume measure (reference year 2006). See the footnote to **Chart 1** for details of the assumptions underlying the projection for GDP growth. The width of this fan over the past has been calibrated to be consistent with the four-quarter growth fan chart, under the assumption that revisions to quarterly growth are independent of the revisions to previous quarters. Over the forecast, the mean and modal paths for the level of GDP are consistent with **Chart 1**. So the skews for the level fan chart have been constructed from the skews in the four-quarter growth fan chart at the one, two and three-year horizons. This calibration also takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to GDP growth in one quarter will continue to have some effect on GDP growth in successive quarters. This assumption of path dependency serves to widen the fan chart.

Chart 3 CPI inflation projection based on market interest rate expectations and £200 billion asset purchases



The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. In any quarter of the forecast period, the probability mass in each pair of identically coloured bands sums to 10%. The distribution of that 10% between the bands below and above the central projection varies according to the skew at each quarter, with the distribution given by the ratio of the width of the bands below the central projection to the bands above it. In **Chart 3**, the ratios of the probabilities in the lower bands to those in the upper bands are approximately 4:6 at Years 2 and 3. The upward skew at Year 1 is smaller. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents. The dashed line is drawn at the two-year point.

path — which lies within the darkest band in **Chart 1** — the risks to growth are skewed to the downside. Taking that skew into account, the Committee's best collective judgement is that GDP growth is about as likely to be above its historical average rate as below it in the medium term.

Chart 2 shows the distribution for the level of GDP corresponding to the Committee's growth projection. It is likely that some spare capacity will persist throughout the forecast period. The distribution for the level of GDP is somewhat lower than in November, reflecting the weakness of output around the turn of the year and the higher assumed path for Bank Rate.

Costs and prices

CPI inflation rose to 3.7% in December. That elevated level of inflation reflects the temporary impacts of three factors: increases in the standard rate of VAT; higher energy prices; and higher import prices. The degree of pass-through of the January 2011 VAT change is likely to be greater than in 2010, implying a further boost to CPI inflation. Energy and other commodity prices are also likely to raise inflation in the near term, as the effects of large price increases over the past six months or so work through the supply chain.

Several indicators of companies' and households' near-term inflation expectations increased. But the increases in these measures since the start of 2010 are broadly in line with the upward revision to the MPC's view of near-term inflation. Measures of households' medium-term expectations also rose, but both those of professional forecasters and those implied by market prices moved by less.

Indicators of the degree of spare capacity within companies continued to give differing signals. Labour productivity remained well below the level it would have reached if it had risen in line with its pre-crisis trend, perhaps suggesting a substantial amount of underutilised capacity. But survey measures of capacity utilisation and a pickup in capital expenditure by companies during the first three quarters of 2010 pointed to a more limited amount of spare capacity. In the labour market, the elevated unemployment rate continued to suggest a sizable degree of slack. Private sector earnings growth picked up a little, but remained subdued relative to past experience. Information on settlements suggested that a further modest pickup was likely in coming months.

The outlook for inflation

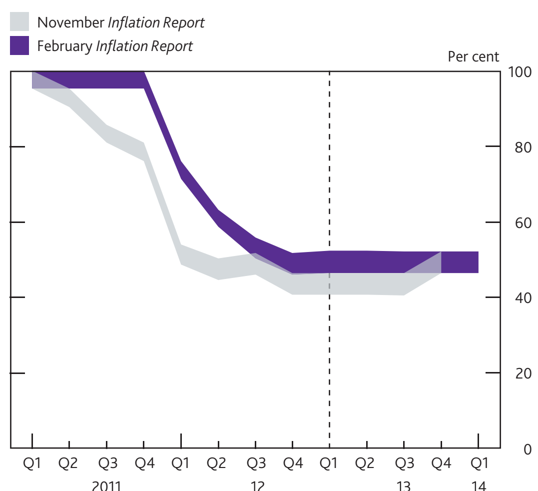
Chart 3 shows the Committee's best collective judgement for the outlook for CPI inflation, based on the same assumptions as **Chart 1**. Inflation is likely to pick up to between 4% and 5% in the near term, and to remain well above the 2% target throughout 2011, boosted by the increase in VAT, higher energy and import prices, and some rebuilding of companies'

margins. The projection over the first part of the forecast period is markedly higher than in November, due largely to the recent increases in the prices of commodities and other imported goods and services. Further ahead, inflation is likely to fall back as those effects wane and downward pressure on wages and prices from the margin of spare capacity persists. The extent of that fall is likely to be moderated by companies continuing to rebuild their margins and some upward drift in inflation expectations.

The prospects for inflation in the medium term are highly uncertain. Continued strong global growth may lead to further upward pressure on commodity and other import prices. The degree of spare capacity and its impact on inflation will depend on: the strength of demand; the impact of the recession on potential productivity; the performance of the labour market; and the sensitivity of wages to labour market slack. The profile for domestically generated inflation will also depend on the extent and pace of any rebuilding of companies' margins. And inflation will be higher, the more that elevated outturns cause expectations of inflation to rise and that feeds through into wage and price-setting.

There remains a wider than usual range of views among Committee members over the outlook for inflation. On balance, the Committee judges that, based on the monetary policy assumptions described above, the most likely outcome is that inflation will fall a little below the target in the second half of the forecast period, but the risks around that most likely outcome are skewed to the upside. Taking that skew into account, the Committee's best collective judgement is that the chances of inflation being either above or below the 2% inflation target in the medium term are broadly equal (**Chart 4**).

Chart 4 An indicator of the probability inflation will be above the target



The February and November swathes in this chart are derived from the same distributions as **Chart 3** and **Chart 5.4** on page 41 respectively. They indicate the assessed probability of inflation being above target in each quarter of the forecast period. The width of the swathe at each point in time corresponds to the width of the band of the fan chart in which the target falls in that quarter, or, if the target falls outside the coloured area of the fan chart, the width of the band closest to the target. The bands in the fan chart illustrate the MPC's best collective judgement that inflation will fall within a given range. The swathes in **Chart 4** show the probability within the entire band of the corresponding fan chart of inflation being close to target; the swathes should not therefore be interpreted as a confidence interval. The dashed line is drawn at the two-year point of the February projection. The two-year point of the November projection was one quarter earlier.

The policy decision

At its February meeting, the Committee judged it likely that growth would resume and that inflation would remain well above the target for the next year or so. Under the assumption that Bank Rate rose in line with market yields, inflation was likely to fall back to around the target in the medium term, as the temporary impact of the factors currently raising inflation waned and some downward pressure from a margin of spare capacity persisted. But both the extent and timing of that fall were uncertain. In the light of that outlook, the Committee judged it appropriate at that meeting to maintain Bank Rate at 0.5% and the stock of asset purchases at £200 billion, in order to meet the 2% CPI inflation target over the medium term.