Overview

In the United Kingdom, the economic recovery remains weak and uneven. Domestic demand increased moderately during 2012, but this was largely offset by a pronounced fall in exports. Employment continued to grow strongly. The weakness of productivity suggests that the financial crisis may still be weighing on the current effective supply capacity of the economy as well as on demand.

The MPC judges that the growth of both demand and effective supply are likely to pick up gradually over the next year or so, supported by past asset purchases, an easing in credit conditions aided by the Funding for Lending Scheme, and a continuing improvement in the global environment. But the legacy of adjustment and repair left by the financial crisis means that the recovery is likely to remain weak by historical standards.

CPI inflation remains above the 2% target and is set to edge higher over coming months. Inflation is likely to stay above the target for much of the next two years, bolstered by external price pressures and administered and regulated prices. But inflation is expected to fall back to around 2% in the latter part of the forecast period, as external price pressures fade and a gradual revival in productivity growth curbs increases in domestic costs.

Financial and credit markets

Since the February *Inflation Report*, the MPC has maintained the size of its asset purchase programme at £375 billion. Bank Rate remains at 0.5% and the timing of the first increase in Bank Rate implied by market interest rates has moved out to late 2016. The improvement of sentiment in global financial markets seen since the autumn of last year has persisted. Medium-term gilt yields have fallen by around 40 basis points over the past three months.

Banks' funding costs remain low and the rates on many household and corporate loans have continued to fall, although by less for smaller businesses. The recent extension of the Funding for Lending Scheme (FLS) should give lenders confidence that they will be able to access low-cost funding until the start of 2015. It also sharpens the incentives for banks to lend, in particular to smaller businesses and also to financial companies providing credit to the real economy. The general improvement in funding conditions, together with the extension to the FLS, should help to support lending growth. Net lending to the real economy remained moribund in the second half of 2012, but is likely to strengthen gradually over this year and next.

Demand and supply

Domestic demand increased moderately during 2012, as the firming of households' real incomes supported a modest increase in consumer spending, and robust capital expenditure by energy companies outweighed falling investment in other sectors. But this expansion in domestic demand was largely offset by a marked fall in exports, as the growth in world demand slowed and the United Kingdom's share of that demand declined further. GDP is estimated to have increased by 0.3% in 2013 Q1 and quarterly GDP growth is likely to strengthen a little over the course of this year.

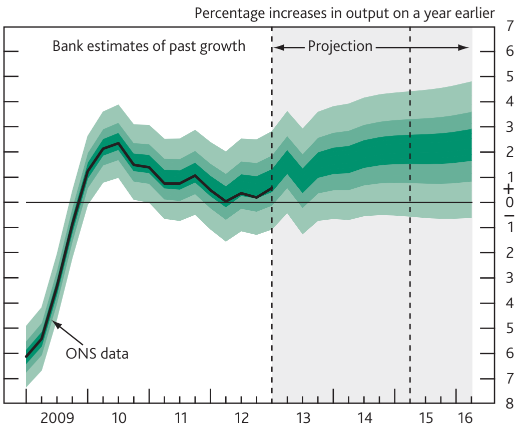
Employment growth eased back in the three months to February. But its pace over the past two years has far exceeded that of output, such that labour productivity has fallen back to levels last seen in 2005. This suggests that the effective capacity of the economy to supply goods and services today may have been impaired. That may be related to the weakness of demand and so may lessen as the economy recovers. But it may also reflect other factors, such as a damaged banking sector, which persist even as output recovers.

The MPC's projections are conditioned on the tax and spending plans set out in the March 2013 *Budget*. They also take account of the recommendations of the interim Financial Policy Committee (FPC), including the recommendation at its March meeting that some banks needed to improve their capital positions.

The outlook for GDP growth

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 size of the asset purchase programme stays at £375 billion. Both demand and effective supply look set to pick up gradually over the next year or so, supported by past asset purchases, a further easing in credit conditions helped by the FLS extension, and a gradual fading of the impact of the financial crisis on household and business spending. But the hangover of adjustments and rebalancing prompted by the financial crisis means that the recovery is likely to remain weak by historical standards, with GDP more likely than not to remain below its pre-crisis level for another year or so (**Chart 2**).

Chart 1 GDP projection based on market interest rate expectations and £375 billion asset purchases

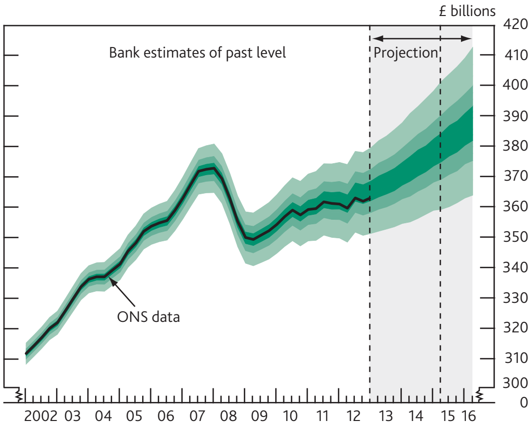


The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. To the left of the first vertical dashed line, 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 30 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 30 occasions. In any particular quarter of the forecast period, GDP growth 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 30%. The distribution of that 30% 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 probabilities in the lower bands are slightly larger than those in the upper bands at Years 1, 2 and 3. 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.

The main risks to the recovery continue to emanate from abroad. Although financial tensions have abated since last summer, there remains a risk that the required adjustments to indebtedness and competitiveness within the euro area occur in a disorderly manner. Although the Committee's fan charts exclude these more extreme outcomes, they embody the assumption that those adjustments will nevertheless be associated with a prolonged period of weak growth and heightened uncertainty.

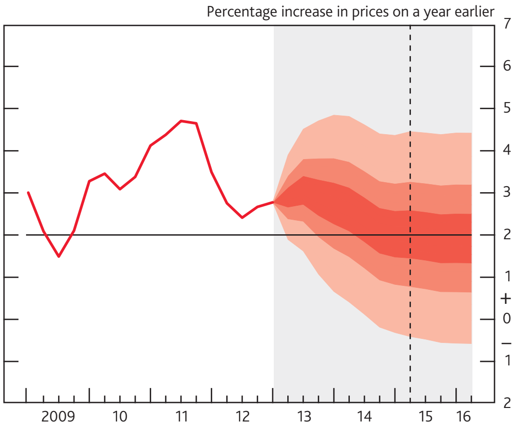
The pace and durability of the UK recovery will also depend upon: the extent to which the legacy of the financial crisis

Chart 2 Projection of the level of GDP based on market interest rate expectations and £375 billion asset purchases



Chained-volume measure (reference year 2009). 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 £375 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 £375 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 30 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 30 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 30%. The distribution of that 30% 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 probabilities in the upper bands are the same as those in the lower bands at Years 1, 2 and 3. 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.

continues to weigh on household and company spending; the degree to which productivity and expectations of future output pick up alongside demand; the impact of the fiscal consolidation; and whether credit conditions ease further and prompt higher lending to the real economy. An improvement in banks' capital positions on the back of the FPC's recommendation should help to support lending growth.

Taking those risks into account, the Committee's best collective judgement is that the economy is likely to see a modest and sustained recovery over the next three years.

Costs and prices

CPI inflation was 2.8% in March. Administered and regulated prices, which are largely determined by regulatory factors, rather than the balance of domestic demand and supply, continued to contribute around 1 percentage point to CPI inflation. Most measures of long-run inflation expectations remain close to their series averages.

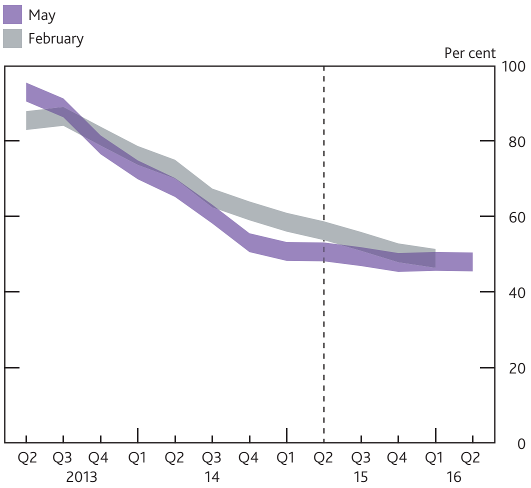
In contrast to previous downturns, labour market participation has been surprisingly resilient since the financial crisis. By bolstering the supply of labour, this resilience has helped to contain pay growth, which was especially weak in the second half of last year. But in terms of unit labour cost growth, that weakness was broadly offset by the weakness of productivity growth.

The outlook for inflation

Chart 3 shows the Committee's best collective judgement of the outlook for CPI inflation, based on the same assumptions as **Chart 1**. Inflation is likely to edge higher in coming months and is more likely than not to remain above 2% for much of the next two years. This further sustained period of above-target inflation largely reflects the impact of the depreciation of sterling earlier this year and the judgement that the unusually large contribution from administered and regulated prices will persist. Despite that, inflation is likely to fall back to around the 2% target by the latter part of the forecast period as external price pressures fade. A gradual revival in productivity growth, combined with persistent spare capacity, should dampen domestic cost pressures sufficiently to offset the sustained elevated contribution from administered and regulated prices.

The Committee judges that demand and effective supply are likely to continue to move broadly in tandem over the forecast period, such that were demand to be stronger that would likely be accompanied by stronger supply, and *vice versa*. As a consequence, the risks surrounding the growth outlook do not automatically map into corresponding risks for spare capacity and inflation. That said, there remains uncertainty about the size and likely path of spare capacity, as well as its impact on wages and prices. In particular, it is unclear whether spare capacity will dampen domestic cost pressures sufficiently to offset the unusually large and persistent contribution from administered and regulated prices.

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



The May and February swathes in this chart are derived from the same distributions as **Chart 3** and **Chart 5.4** on page 39 respectively. They indicate the assessed probability of inflation being above target in each quarter of the forecast period. The 5 percentage points width of the swathes reflects the fact that there is uncertainty about the precise probability in any given quarter, but they should not be interpreted as confidence intervals. The dashed line is drawn at the two-year point of the May projection. The two-year point of the February projection was one quarter earlier.

There are a number of other sources of uncertainty affecting the outlook for inflation. As ever, inflation may be buffeted by movements in the exchange rate and commodity prices, both of which are prone to move sharply. It is unclear for how long inflation can remain above the target before it affects public perceptions of the MPC's determination to keep inflation close to the 2% target, with potential implications for wages and prices. The path of inflation will also depend upon the extent to which companies' profit margins are restored through higher prices, rather than through slower cost growth.

There remains a range of views among Committee members regarding the relative strength of these different factors. On balance, the Committee's best collective judgement is that inflation is more likely to be above than below the 2% target for much of the next two years, but those risks are broadly balanced in the latter part of the forecast period (**Chart 4**).

The policy decision

The nature of the shocks affecting the UK economy in recent years — which have weakened output growth, but raised inflation — have posed substantial challenges for monetary policy. In particular, such shocks mean that the Committee faces a trade-off between the speed with which inflation is returned to target and the support that monetary policy can provide to output and employment. As set out by the Chancellor in his March 2013 *Budget*, the Committee's latest remit requires that the MPC promote understanding of the short-run trade-offs inherent in the setting of monetary policy.

The Committee has always recognised such short-run trade-offs. In particular, under its remit, the Committee has the flexibility to temper the speed at which it seeks to return inflation to target in order to limit the volatility in output, subject to meeting the inflation target in the medium term. This consideration was central to the Committee's policy decision in February, for example. When judging the appropriate speed with which to return inflation to the target, the Committee has particular regard to the likely medium-term consequences of its decisions both for the long-term supply capacity of the economy, and for confidence in the achievement of the inflation target over the medium term, which allows the Committee to respond effectively to shocks in the future.

At its May meeting, the Committee agreed that a modest and sustained recovery in output was in prospect. Inflation was likely to remain above the target for much of the next two years, although the risks around the target were broadly balanced in the latter part of the forecast period. Monetary policy remained highly stimulatory. In the light of those considerations, the Committee judged that, in order to meet the 2% CPI target in the medium term while providing continuing near-term support to the economic recovery, it was appropriate to maintain the current stance of policy. It therefore voted to keep Bank Rate at 0.5% and the size of the asset purchase programme at £375 billion.