Overview

CPI inflation remained well above the 2% target and output grew sluggishly. The recovery in global activity continued, although the pace of growth slowed and vulnerabilities, especially within the euro area, increased. In the United Kingdom, the squeeze in households' real incomes is likely to continue to weigh on domestic demand, especially over the next year or so. But expansionary monetary policy, prospective growth in global demand and the current level of sterling should mean that, after some near-term weakness, GDP growth gradually picks up.

CPI inflation is set to rise further in 2011, boosted by increases in utility prices. Inflation is likely to fall back through 2012 and into 2013 as the impact of the factors temporarily raising inflation diminishes and downward pressure from slack in the labour market persists. But the precise timing and extent of that fall are highly 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 above or below the 2% target in the medium term are judged to be roughly equal.

Financial and credit markets

Since the May *Report*, the MPC has maintained Bank Rate at 0.5% and its stock of purchased assets at £200 billion. Strains within financial markets intensified amid heightened concerns about the fiscal positions of several euro-area countries. These strains initially eased somewhat following the announcement of the support package agreed by eurozone leaders on 21 July, but subsequently re-emerged. In the United Kingdom, banks raised significantly less wholesale term funding, and credit conditions for households and smaller businesses remained tight. Weakness in broad money and credit growth persisted. Partly reflecting these developments in the United Kingdom and elsewhere, expectations of the near-term path of Bank Rate were lowered and ten-year government bond yields fell to record lows.

Demand

The recovery in global demand continued, although the pace of expansion slowed. Disruption to global supply chains following the Japanese earthquake and tsunami, and the squeeze on spending from past oil price rises, are likely to have depressed output growth temporarily. But some of the slowdown in growth appears likely to be more persistent. Substantial divergences across euro-area countries remained and indicators pointed to a slowing in aggregate growth in Q2. The pace of recovery in the United States is likely to be hindered by continued weakness in labour and housing markets. And policy tightened in a number of emerging economies. Trade data and business surveys suggested that the growth of UK exports may have slowed along with world demand in 2011 Q2.

At home, private domestic demand fell sharply in 2011 Q1. Households' consumption fell for the third consecutive quarter, driven by a further sharp squeeze in real incomes. And the support previously provided by business spending was absent, with companies cutting back on both stockbuilding and investment. The impact of the fall in private domestic demand on UK output was partly offset by a contraction in imports.

GDP was provisionally estimated to have increased by 0.2% in 2011 Q2. The increase in output was probably moderated by a number of one-off effects. But even abstracting from such effects, underlying output over the past year appears to have grown at a rate below its historical average.

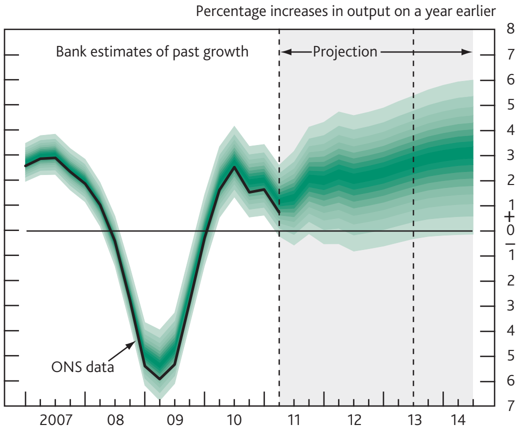
The Committee's projections are conditioned on the tax and spending plans set out in the March *Budget*. Those plans imply that the contraction in the cyclically adjusted primary deficit in 2011/12 will be similar to that observed in 2010/11.

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 stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion. Growth is likely to remain sluggish in the near term, reflecting the continuing squeeze on households' real incomes. Thereafter, GDP growth gently picks up, underpinned by a steady recovery in business investment and a gradual rebalancing of the economy towards external demand. Although the fiscal consolidation is likely to dampen activity throughout the forecast period, consumer spending growth should slowly increase as the drag on real income growth from high inflation dissipates.

The outlook for output growth remains highly uncertain. The greatest risks to the prospects for global demand come from the euro area and the substantial challenges faced by several member countries as they seek to ensure the sustainability of their fiscal positions and to preserve the stability of their banking systems. Were they to crystallise, the risks emanating from the euro area have the potential to have a significant impact on the UK economy. To the extent that such risks are already reflected in asset prices, bank funding costs and confidence, they will be captured in the MPC's projections. But beyond that, the MPC sees no meaningful way to quantify such risks and they are therefore excluded from its fan charts.(1)

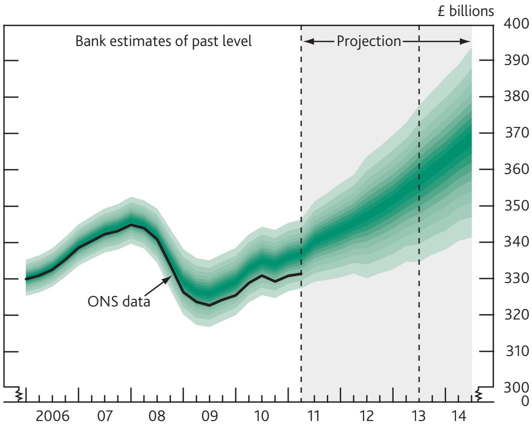
Chart 1 GDP projection based on market interest rate expectations and £200 billion asset purchases



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 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.

(1) See the box on page 38.

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.

Domestically, the strength of the recovery will depend on the extent to which households have further to adjust to past falls in their real incomes or to the uncertainty associated with the financial crisis and the fiscal consolidation now in train. It will also depend on whether the desire of companies to initiate deferred projects or to increase capacity in those sectors benefiting from the rebalancing of the economy is sufficient to support a recovery in business investment, against a general backdrop of only modest economic expansion. The outlook for both household and business spending will also depend on the extent to which the availability of bank credit improves and the cost falls.

There remains a range of views among Committee members about the outlook for growth. Based on the conditioning assumptions described above, the Committee's best collective judgement is that, following some near-term weakness, GDP growth is likely to pick up gradually, so that by 2014, it is a little more likely to be above its historical average than below it.

Chart 2 shows that output is likely to remain significantly below the level associated with a continuation of its pre-recession trend. The Committee judges that a majority of this shortfall reflects weakness in the level of underlying productivity. Even so, some margin of slack, particularly in the labour market, is likely to persist throughout the forecast period.

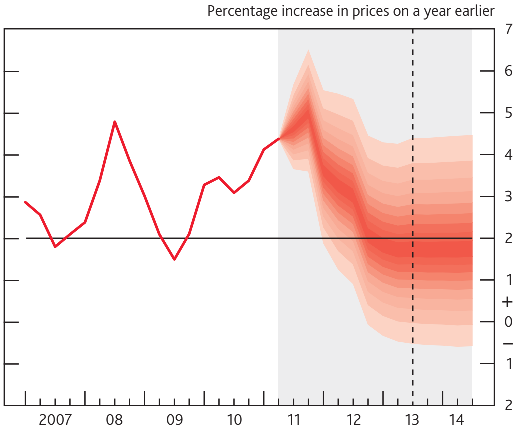
Costs and prices

CPI inflation was 4.2% in June. The strength of inflation continued to reflect the effects of past increases in both the standard rate of VAT to 20% and the prices of energy and other imported goods and services. Sterling oil and gas prices have been broadly unchanged since May, although both remained significantly higher than a year ago. Non-energy commodity prices have fallen slightly since May.

Indicators of inflation expectations were mixed. Most measures of companies' and households' one year ahead inflation expectations fell back in 2011 Q2, reversing some of their increases over the past year. Although some measures of longer-term inflation expectations had increased a little since the beginning of 2011, most were close to their series averages.

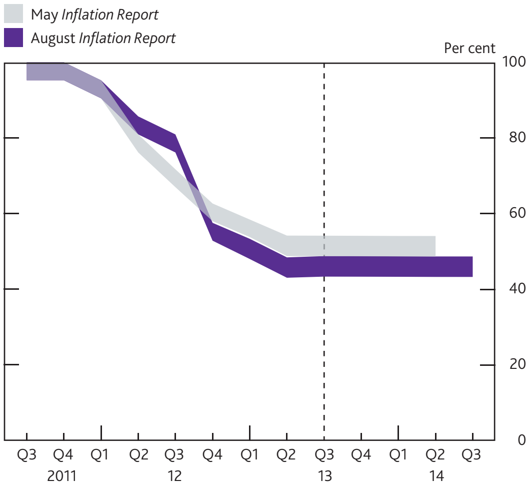
Labour productivity remained weak. Despite modest output growth, the Labour Force Survey indicated that private sector employment had increased by over half a million in the past year. Labour productivity remained well below the level associated with a continuation of its pre-crisis trend, perhaps indicating a substantial amount of underutilised capacity within companies. That contrasted with survey measures of capacity utilisation, however, which pointed to there being only a small margin of spare capacity. Unemployment was broadly unchanged, but remained elevated. Private sector pay

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 probabilities in the lower bands are slightly smaller than those in the upper bands at Years 1, 2 and 3, albeit that the upward skew in Year 1 is smaller than those at Years 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.

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



The August and May swathes in this chart are derived from the same distributions as **Chart 3** and **Chart 5.7** on page 39 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 August projection. The two-year point of the May projection was one quarter earlier.

growth stayed subdued, at around 2.5%, probably reflecting both continuing slack in the labour market and weak productivity.

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**. There is a good chance that inflation will reach 5% later this year, boosted by utility price rises, and reflecting the continuing impact from past increases in VAT and in oil and other import prices. Inflation is likely to fall back through 2012 and into 2013 as those effects wane and downward pressure from slack in the labour market persists. The extent of that fall is likely to be mitigated by some upward pressure on nominal wages stemming from the response of companies and households to the sustained period of high inflation.

The timing and extent of the likely decline in inflation are highly uncertain. Labour productivity is still a little lower than it was three years ago. The extent to which that weakness in productivity persists as the economy recovers will affect the degree of inflationary pressure associated with any given path of demand. The downward pressure on wages from the elevated rate of unemployment will depend on the extent to which those who have become unemployed retain their attachment to the labour market and on the sensitivity of wages to labour market slack. The magnitude of both the squeeze in real wages and the overshoot of the inflation target are exceptional, so it is hard to be sure how this will affect wage and price-setting. And the prospects for import prices, especially commodity prices, will depend, in part, on the strength of global demand.

There remains a range of views among Committee members regarding the relative strength of the factors affecting the outlook for inflation. On balance, the Committee's best collective judgement, based on the conditioning assumptions described above, is that inflation is about as likely to be below as above target in the medium term (**Chart 4**).

The policy decision

At its August meeting, the Committee judged that the outlook for the global economy had deteriorated and that GDP growth in the United Kingdom would pick up only gradually. Inflation looked set to increase in the near term, boosted by higher utility prices. But under the assumption that Bank Rate moved in line with market yields, inflation was likely to fall back in the medium term, as the impact of the factors raising inflation diminished and some downward pressure from a degree of slack in the labour market persisted. 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.