Overview

In the United Kingdom, a recovery appears to be taking hold. 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 rose to 2.9% in June and looks set to remain around that rate in the near term.

Against that backdrop, the Committee has provided some explicit guidance regarding the future conduct of monetary policy. The MPC intends at a minimum to maintain the present highly stimulative stance of monetary policy until economic slack has been substantially reduced, provided this does not entail material risks to price stability or financial stability.

In the Committee's view, a sustained recovery in both demand and supply appears likely. The outlook for growth is stronger than in May, mainly reflecting a marked improvement in business and consumer sentiment. This stronger demand is assumed to be largely matched by an increase in effective supply capacity, such that the outlook for inflation is similar to May, with inflation expected to fall back to around the 2% target over the forecast period.

Trade-offs and forward guidance

A recovery appears to be taking hold. Early estimates suggest that GDP increased by almost 1% in the first half of 2013. That is below the pace of growth needed to make material in-roads into the margin of slack in the economy, but is nonetheless welcome after over a year of almost no growth. Moreover, business surveys and reports from the Bank's Agents point to a stronger near-term outlook than expected in May.

Although a recovery now looks to be under way, the prospects for the UK economy continue to be affected by past developments that have led to a sustained period of depressed demand and above-target inflation. Those developments have been accompanied by exceptional weakness in productivity, which has fallen back to 2005 levels. That weakness may be a direct consequence of weak demand, and so may unwind as the economy recovers. But it may also reflect other restraining forces, such as the need for resources to be reallocated across different parts of the economy, which may lessen only gradually as output increases. The responsiveness of effective supply capacity to a pickup in demand is a key uncertainty facing the MPC.

CPI inflation was 2.9% in June. The elevated rate of inflation reflects, in particular, pass-through from higher import costs and an unusually high contribution from administered and regulated prices. The MPC's remit makes clear that its primary objective is price stability, as defined by the 2% target for

CPI inflation. The remit also recognises that, in situations such as now, when inflation is above the target but demand is weak, the Committee faces a trade-off between the speed with which it attempts to return inflation to the target and the support it is able to provide to activity.

The scale of recent shocks, and the difficulty in knowing how effective supply capacity will respond as demand picks up, means that this trade-off is, at present, unusually uncertain. And misjudging that trade-off could give rise to significant costs in the medium term. Attempting to return inflation to the target too quickly risks prolonging the period over which the nation's resources are underutilised. That, in turn, might also erode the longer-term supply capacity of the UK economy. But returning inflation to the target too slowly might cause people to question the MPC's commitment to keep inflation close to the target and lead medium-term expectations of inflation to be less well anchored. Such a loss of credibility would make it more costly to keep inflation close to target.

The MPC's explicit policy guidance (see the box on page 7) provides greater clarity on how it views this trade-off and about the future path of monetary policy as the economy recovers. It also provides a robust framework within which the MPC can explore the scope for economic expansion without putting price stability and financial stability at risk.

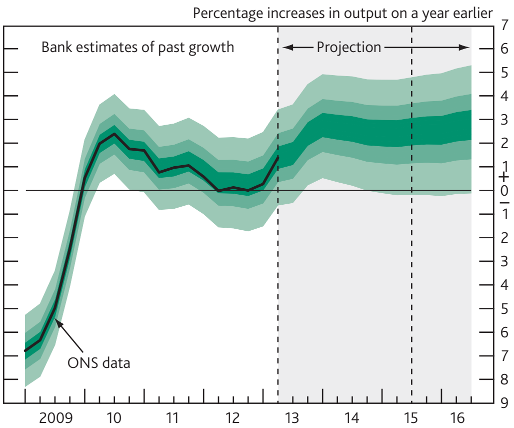
Economic outlook

Short-term market interest rates have risen since May and, in the Committee's best collective judgement, imply a faster withdrawal of monetary stimulus than appears likely given the current economic outlook. The projections below are based on the assumption that Bank Rate remains at 0.5% over the forecast period, rather than the usual market curve assumption. That does not reflect the Committee's view of the most likely path of Bank Rate. Rather it provides a convenient reference point against which to assess the economic outlook.

On that basis, and assuming that the size of the asset purchase programme stays at £375 billion, the incipient recovery is likely to gather pace over the forecast period (**Chart 1**). This pickup in growth is supported by: a moderate but persistent expansion in global demand; the sustained stimulus from monetary policy; a further easing in credit conditions aided by the Funding for Lending Scheme and steps to increase the resilience of UK banks and building societies; and a gradual fading of the impact of the financial crisis on household and business spending. Even so, the legacy of adjustments left by the financial crisis means that the recovery is likely to remain weak by historical standards.

The outlook for growth is stronger than in May. That largely reflects the unexpectedly strong tone of recent domestic data, including the marked improvement in business and consumer sentiment. It also reflects the judgement that the forward guidance announced by the Committee may make its current

Chart 1 GDP projection based on constant nominal interest rates at 0.5% 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 MPC's policy guidance

The Committee intends at a minimum to maintain the current highly stimulative stance of monetary policy until economic slack has been substantially reduced, provided this does not entail material risks to either price stability or to financial stability.

In particular, the MPC intends not to raise Bank Rate from its current level of 0.5% at least until the Labour Force Survey headline measure of the unemployment rate has fallen to a threshold of 7%, subject to the conditions below.

The MPC stands ready to undertake further asset purchases while the unemployment rate remains above 7% if it judges that additional monetary stimulus is warranted. But until the unemployment threshold is reached, and subject to the conditions below, the MPC intends not to reduce the stock of asset purchases financed by the issuance of central bank reserves and, consistent with that, intends to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility.

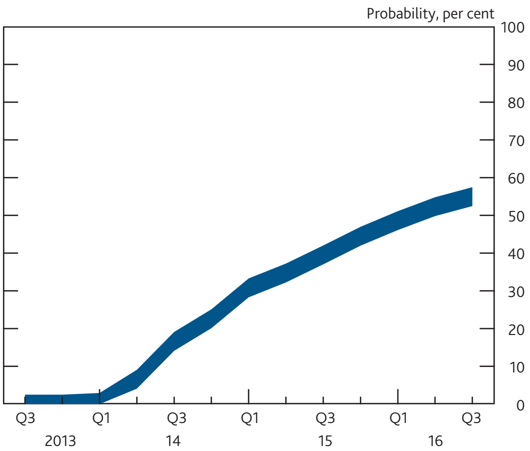
The guidance linking Bank Rate and asset sales to the unemployment threshold would cease to hold if any of the following three 'knockouts' were breached:

- in the MPC's view, it is more likely than not, that CPI inflation 18 to 24 months ahead will be 0.5 percentage points or more above the 2% target;
- medium-term inflation expectations no longer remain sufficiently well anchored;
- the Financial Policy Committee (FPC) judges that the stance of monetary policy poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

The Committee will continue to set the level of Bank Rate and the size of the asset purchase programme each month, taking these criteria into account. The action taken by the MPC if any of these knockouts were breached would depend upon its assessment at the time as to the appropriate setting of monetary policy in order to fulfil its remit to deliver price stability. There is therefore no presumption that breaching any of these knockouts would lead to an immediate increase in Bank Rate or sale of assets.

monetary stimulus more effective, in part by providing greater clarity about the conditions under which the highly stimulative stance of policy will be maintained.

Chart 2 Cumulative probability of unemployment having fallen below the 7% threshold



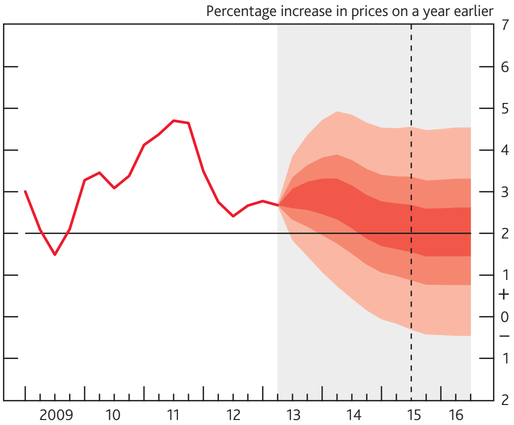
The swathe in this chart is derived from the same distribution as **Chart 5.10**. The swathe shows the probability that unemployment has fallen below 7% by each quarter of the forecast period. The 5 percentage points width of the swathe reflects the fact that there is uncertainty about the precise probability in any given quarter, but it should not be interpreted as a confidence interval.

The main risks to the domestic recovery continue to emanate from abroad. In particular, the necessary adjustments to indebtedness and competitiveness within the euro area may yet occur in a disorderly fashion. Domestically, the strength and sustainability of the recovery will rest on: whether recent improvements in sentiment and credit conditions persist; the impact of the fiscal consolidation; and the scope for supply capacity to increase in line with demand.

The pace at which unemployment will fall over the forecast period is highly uncertain, as it depends not only on demand and on labour force participation but also on productivity: the greater the revival in productivity as output increases, the less rapidly will unemployment fall and *vice versa*. There is a range of views on the MPC about the factors responsible for the recent weakness in productivity, and hence about the likely response of productivity to an increase in demand. The MPC's best collective view is that the unemployment rate is as likely to reach the 7% threshold before the forecast horizon as after it (**Chart 2**).

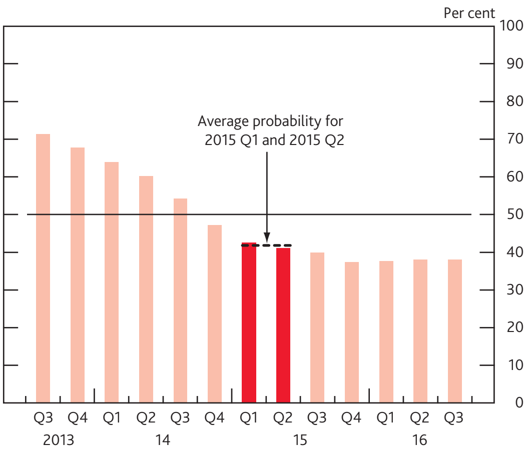
Chart 3 shows the Committee's best collective judgement of the outlook for inflation, based on the same assumptions as

Chart 3 CPI inflation projection based on constant nominal interest rates at 0.5% 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.

Chart 4 Probability that CPI inflation will be at or above the 2.5% knockout



The bars in this chart are derived from the same distribution as **Chart 3**. The bars indicate the assessed probability of inflation being at or above 2.5% in each quarter of the forecast period. The dashed line shows the average of the probabilities in 2015 Q1 and 2015 Q2, consistent with the 18 to 24-month period in the MPC's price stability knockout.

Chart 1. CPI inflation is likely to remain close to 3% in the near term, reflecting the impact of past increases in import prices and the persistent contribution from administered and regulated prices. Inflation is likely to fall back to around the 2% target over the forecast period as external price pressures fade. And a gradual moderation in domestic cost pressures, aided by a revival in productivity growth, should help to offset the sustained contribution from administered and regulated prices. The outlook for inflation is similar to May, since the stronger demand outlook is assumed to be largely matched by a faster expansion in effective supply capacity.

The outlook for inflation remains highly uncertain. The path of inflation will depend on the extent to which productivity picks up as demand accelerates, and on the degree to which companies' profit margins are restored and whether that is through higher prices rather than lower cost growth. As ever, inflation will also be sensitive to sharp movements in both the exchange rate and commodity prices. There remains a range of views among Committee members regarding the relative strength of these different factors.

The Committee's best collective judgement is that the average probability of inflation 18 to 24 months ahead being at or above the 2.5% knockout is less than 50% (**Chart 4**). By the second half of the forecast period, the risks around the 2% inflation target are judged to be broadly balanced.

The policy decision

A recovery appears to be under way, although its strength and sustainability remain unclear. Inflation remains well above the target, but seems likely to fall back to around the 2% target in the latter half of the forecast period. The exceptional weakness in productivity means that there is considerable uncertainty about the supply capacity of the economy as demand recovers. As a result, the trade-off between the horizon over which inflation returns to the target and the speed with which output and employment recover is unusually uncertain. Misjudging that trade-off could have significant costs in the medium term.

In these unprecedented circumstances, explicit policy guidance can enhance the effectiveness of monetary stimulus in three ways. It provides greater clarity regarding the MPC's view of the appropriate trade-off between the speed with which inflation is returned to the target and the support given to the recovery. It reduces uncertainty about the future path of monetary policy as the economy recovers. And it delivers a robust framework within which the MPC can explore the scope for economic expansion without putting price stability and financial stability at risk.

At its August meeting, in the light of both the economic outlook and these considerations, the MPC voted to maintain Bank Rate at 0.5% and the stock of asset purchases at £375 billion.