Overview

Over the past year, there has been considerable volatility in quarterly output growth. Looking through the influence of temporary factors, overall output appears to have been broadly flat. In large part that reflects sharp falls in particular sectors of the economy that are unlikely to be repeated in 2013. In contrast, the combined output of the manufacturing and services sectors has grown modestly. The weakness in overall output sits in sharp contrast to continued strong employment growth, suggesting that the financial crisis may have had some impact on the effective supply capacity of the economy.

The MPC continues to judge that the UK economy is set for a slow but sustained recovery in both demand and effective supply, aided by a further easing in credit conditions — supported by the Bank's programme of asset purchases and the Funding for Lending Scheme — and some improvement in the global environment. But the risks are weighted to the downside, not least because of the challenges facing the euro area.

Inflation has remained stubbornly above the 2% target. Despite subdued pay growth, weak productivity has meant no corresponding fall in domestic cost pressures. And increases in university tuition fees and domestic energy bills have added to inflation more recently. CPI inflation is likely to rise further in the near term and may remain above the 2% target for the next two years. But inflation is expected to fall back to around the target thereafter, as a gradual revival in productivity growth dampens increases in domestic costs and external price pressures fade.

Financial and credit markets

Since the November *Inflation Report*, the MPC has maintained the size of its asset purchase programme at £375 billion and the level of Bank Rate at 0.5%. Policy initiatives in a number of countries since last summer have led to a marked easing of financial market stresses. Investors' perceptions of near-term risks have diminished and their willingness to hold risky assets has increased: yields on vulnerable euro-area countries' sovereign debt have continued to fall; and global equity prices have risen significantly, most notably for banks. Sterling has depreciated by more than 3% in effective terms.

UK banks' funding costs have fallen further, aided by the improved financial environment and the Funding for Lending Scheme (FLS). And there is growing evidence that this is feeding into private sector credit conditions: many loan rates to households and companies have fallen and some measures of credit availability have improved. But it is still too early to know the extent to which this improvement in funding conditions will lead to an increase in net lending to the real economy, which remains flat.

Demand and supply

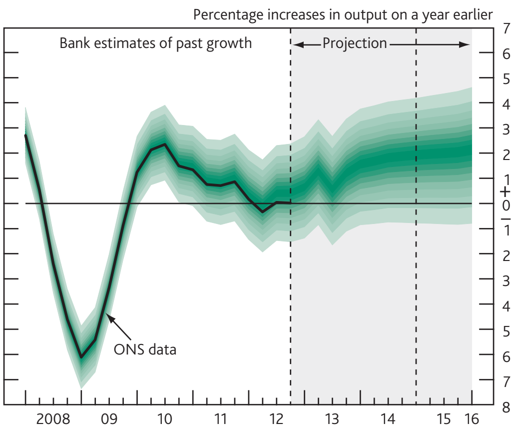
In the first three quarters of 2012, UK export markets expanded moderately as persistent weakness in the euro area was offset by solid growth in other advanced trading partners. Despite that, falls in services exports dragged down total UK exports.

At home, GDP is estimated to have contracted by 0.3% in 2012 Q4. That fall largely reflected an unwinding of the temporary boost from the Olympics. Over 2012 as a whole, total output was broadly flat, held back by sharp falls in construction output and in oil and gas extraction. The combined output of the manufacturing and services sectors grew modestly.

The flatness of total output contrasts with robust increases in private sector employment. Indeed, 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 may have been impaired. That may be a consequence of the sustained weakness in demand and so prove to be temporary. But it may also reflect other factors, such as banking sector difficulties, which may persist even as demand recovers.

The Committee's projections are conditioned on the tax and spending plans set out in the 2012 March *Budget*, updated for the 2012 Autumn Statement. They also take account of the Government's decision to use the cash flows generated by the Asset Purchase Facility to pay down government debt, which has an effect similar to the MPC purchasing gilts of the same value.

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 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 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 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.

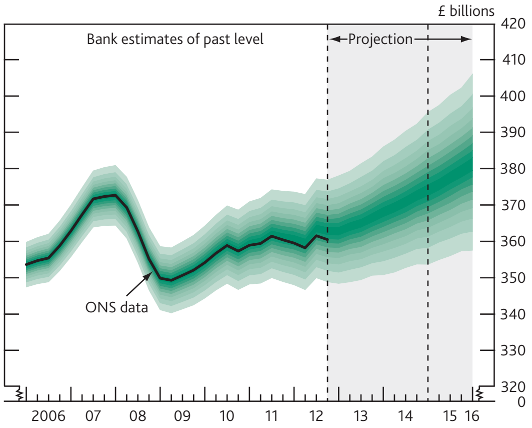
The outlook for GDP growth

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. Growth is likely to remain weak in the near term. But further out, a continued easing in domestic credit conditions — supported by the Bank's asset purchase programme and the FLS — together with a stronger global backdrop, underpin a slow recovery in both demand and effective supply.

Some of the biggest risks to the growth outlook stem from overseas. Although recent euro-area policy initiatives have probably lessened the chance that the necessary adjustments to indebtedness and competitiveness will occur in a disorderly manner, this threat remains. As in previous *Reports*, the Committee's fan charts exclude these more extreme outcomes, but they assume that the adjustments are likely to be associated with a prolonged period of sluggish euro-area growth. More generally, the extent to which recent improvements in financial market conditions will persist and spur a strengthening in global demand is uncertain, as is the degree to which UK exporters will be able to capitalise on any such strengthening.

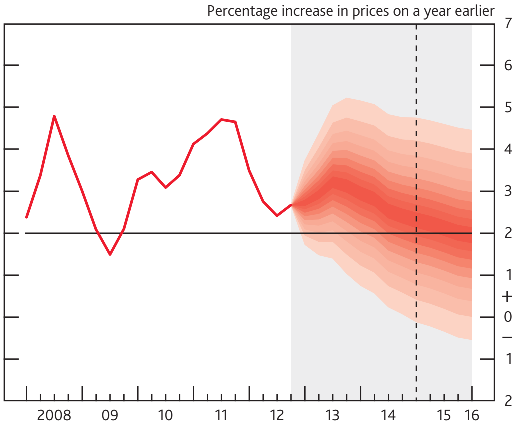
Domestically, the strength and sustainability of the recovery will rest on: the extent to which households and companies have

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 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 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.

already adjusted to the impact of the financial crisis; the degree to which productivity and expectations of future supply pick up alongside demand; the impact of fiscal consolidation; and on whether the recent easing in credit conditions continues and prompts higher lending to the real economy.

Taking those risks into account, the Committee's best collective judgement is that the economy is likely to see a slow but sustained recovery over the next three years. The expansion is expected to be weak by historical standards, mirroring the relatively subdued prospects for both global demand and the supply capacity of the domestic economy. GDP is likely to remain below its pre-crisis level until 2015 (**Chart 2**).

Costs and prices

CPI inflation was 2.7% in December, up from 2.2% in September. That rise primarily reflected increases in university tuition fees and retail energy bills. Oil prices are slightly higher than three months ago. Most measures of households' longer-term inflation expectations remain close to their series averages.

The prices of some goods and services are particularly sensitive to regulatory factors and less so to the balance of domestic demand and supply. Regulatory decisions directly affect the prices charged for some items, such as university tuition fees, and are a key determinant of the costs faced by some companies, such as the distribution fees charged to domestic energy suppliers. The contribution to inflation of such administered and regulated prices rose to around 1 percentage point at the end of 2012. That was more than its recent average and the contribution is likely to remain around that level over much of the forecast period.

Unemployment has edged lower, although it is still elevated. Labour market slack continues to bear down on pay growth, which remains unusually weak. Nonetheless, weak productivity growth means that companies' unit labour costs have continued to rise faster than their average historical rate.

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 rise further in the near term and may remain above the 2% target for the next two years, reflecting sterling's recent depreciation and the persistent contribution from administered and regulated prices. That persistent contribution is increasingly offset by a gentle moderation in domestic cost growth, aided by a gradual revival in productivity growth, and an easing in external price pressures, such that inflation is likely to fall back to around the target by the end of the forecast period. The outlook for inflation over much of the forecast period is higher than in the November *Report*, reflecting the impacts of administered prices and the lower exchange rate.

Chart 4 An indicator of the probability that 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 40 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 February projection. The two-year point of the November projection was one quarter earlier.

The Committee judges that demand and effective supply are likely to continue to move reasonably closely together. This implies that some of the uncertainties around the outlook for GDP growth should have only limited implications for spare capacity and hence inflation. Even so, the evolution of spare capacity in the economy and the extent to which it affects wage and price-setting behaviour are still likely to have an important bearing on inflation.

There are a number of other sources of uncertainty affecting the inflation outlook. The extent to which changes in relative prices — including administered and regulated prices — affect the overall inflation rate is hard to predict. Inflation is sensitive to commodity prices and the exchange rate, both of which are prone to move sharply. And the outturn for inflation will depend on the extent to which companies' profit margins are restored through them raising prices rather than reducing costs.

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 forecast period, but those risks are broadly balanced by the end (**Chart 4**).

The policy decision

At its February meeting, the Committee noted that a slow recovery in GDP growth was likely, although there was a risk that growth could continue to disappoint on the downside. Inflation was set to rise further in the near term and could remain above the target for the next two years. But it was likely to fall back to around the target by the end of 2015.

The Committee discussed the appropriate policy response to the combination of the weakness in the economy and the prospect of a further prolonged period of above-target inflation. It agreed that, as long as domestic cost and price pressures remained consistent with inflation returning to the target in the medium term, it was appropriate to look through the temporary, albeit protracted, period of above-target inflation. Attempting to bring inflation back to the target sooner by removing the current policy stimulus more quickly than currently anticipated by financial markets would risk derailing the recovery and undershooting the inflation target in the medium term. The MPC's remit is to deliver price stability, but to do so in a way that avoids undesirable volatility in output. The Committee judged that its policy stance was fully consistent with that remit. The Committee agreed that it stood ready to provide additional monetary stimulus if warranted by the outlook for growth and inflation.

In light of those considerations, the Committee decided that it was appropriate to maintain Bank Rate at 0.5% and the size of the asset purchase programme at £375 billion in order to meet the 2% CPI inflation target over the medium term.