Overview

The UK recovery has gained momentum and inflation has returned to the 2% target. Reduced uncertainty, easier credit conditions and the stimulative stance of monetary policy should support continued solid economic growth, with the expansion in demand becoming more entrenched and more broadly based.

Robust growth has not so far been accompanied by a material pickup in productivity. Instead, employment gains have been exceptionally strong and unemployment has fallen much more rapidly than expected. The LFS headline unemployment rate is likely to reach the MPC's 7% threshold by the spring of this year. Even so, the Committee judges that there remains spare capacity, concentrated in the labour market.

Inflation is likely to remain close to the target over the forecast period. Given this, and with spare capacity remaining, the MPC judges that there remains scope to absorb slack further before raising Bank Rate. Moreover, the continuation of significant headwinds — both at home and from abroad — mean that Bank Rate may need to remain at low levels for some time to come.

Economic outlook

Demand and supply

The UK economy grew by 1.9% in 2013, the strongest annual growth rate for six years. Much of that expansion was driven by consumer spending, as lifting uncertainty and easing credit conditions prompted households to reduce their rate of saving. That brightening in the economic environment also prompted a revival in the housing market, with housing transactions in 2013 Q4 up more than 25% on a year earlier, accompanied by a pickup in house price inflation. This revival helped support strong growth in housing investment. In contrast, business investment has remained subdued, although surveys of investment intentions suggest that it is likely to gather pace this year. Despite stronger activity in the United Kingdom's main overseas markets, export performance continued to disappoint. The strength of domestic activity contributed to a slight firming in short-term market interest rates and a further appreciation in sterling.

The recovery in output has not yet been matched by a material pickup in productivity growth. Instead, gains in employment have been exceptionally strong: since the MPC announced its policy guidance last August, almost half a million more people have found work. As a result, the LFS headline unemployment rate has fallen much more rapidly than the Committee anticipated and is likely to reach the MPC's 7% threshold by the spring of this year.

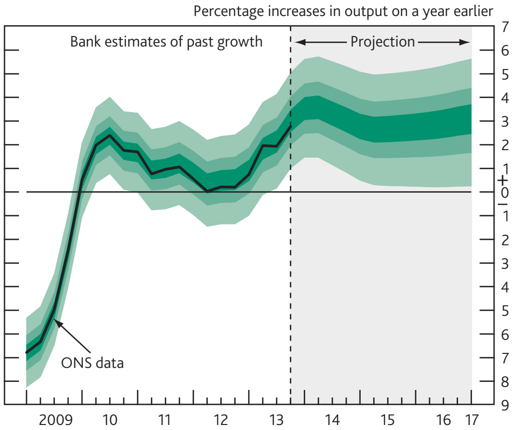
With unemployment nearing that threshold, the Committee has reviewed the current and prospective degree of spare capacity in the economy. Although such estimates are necessarily uncertain, the Committee judges that spare capacity remains, equivalent to around 1%–1½% of GDP and concentrated in the labour market. Around half of that slack reflects the difference between unemployment and an estimate of its medium-term equilibrium rate. Bank staff have revised down their estimate of the medium-term equilibrium rate reflecting the disproportionate falls in longer-term unemployment over recent months. The medium-term equilibrium rate is likely to continue to drift down over the forecast period as unemployment falls further. The remaining slack largely reflects an assessment that there is scope for companies to increase further the hours worked by their employees. In particular, despite an increase in average hours worked since last summer, the number of people indicating they would like to work longer hours has remained elevated.

The Committee continues to expect a gradual recovery in productivity growth. As demand picks up further, some businesses should be able to redeploy staff to more productive activities. Easier credit conditions and reduced uncertainty may allow capital and labour to be reallocated towards more productive companies. And a recovery in business investment should also provide support. The recent weakness in productivity growth has nevertheless caused the Committee to revise down its judgement of the likely strength of the response of productivity to higher demand. More generally, the timing and strength of the pickup in productivity remain highly uncertain.

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 stays at £375 billion. Growth eases a little in the near term as the initial fillip from the release of pent-up demand fades. Thereafter, the recovery is projected to move to a firmer footing: a gradual revival in productivity underpins a modest pickup in pay growth, while stronger demand and improved corporate sentiment drive a rebound in business investment.

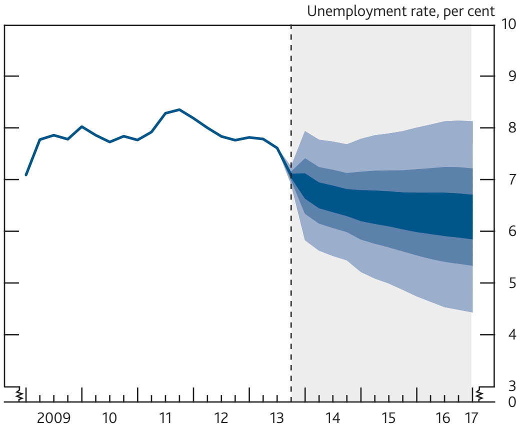
The strengthening of activity in advanced economies means that the risks around the global outlook are judged to be more balanced than of late. However, tensions in some emerging economies have resurfaced, and the need for further adjustment within the euro area continues to pose a risk to UK growth. At home, the main risks to the durability of the recovery are that sustained weakness in productivity prevents a pickup in household incomes and that companies are slow to increase their capital expenditure in response to rising demand. But the possibility of a virtuous cycle in sentiment, spending and incomes means there could be even greater near-term momentum in growth.

Chart 1 GDP projection based on market interest rate expectations and £375 billion purchased assets



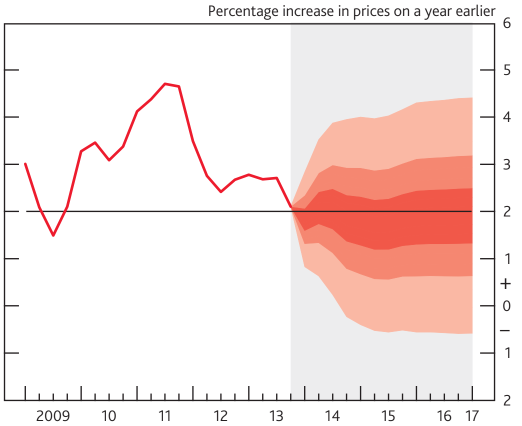
The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. To the left of the vertical dashed line, the 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. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents.

Chart 2 Unemployment projection based on market interest rate expectations and £375 billion purchased assets



The fan chart depicts the probability of various outcomes for LFS unemployment. 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 the mature estimate of unemployment 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 blue areas on 30 occasions. In any particular quarter of the forecast period, unemployment is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions unemployment can fall anywhere outside the blue area of the fan chart. Over the forecast period, this has been depicted by the light grey background. The calibration of this fan chart takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to unemployment in one quarter will continue to have some effect on unemployment in successive quarters. The fan begins in 2013 Q4, a quarter earlier than the fan for CPI inflation. That is because Q4 is a staff projection for the unemployment rate, based in part on data for October and November. The unemployment rate was 7.1% in the three months to November, and is projected to remain at 7.1% in Q4 as a whole.

Chart 3 CPI inflation projection based on market interest rate expectations and £375 billion purchased assets



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. 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.

A gradual revival in productivity growth, together with a slight easing in the pace of expansion, should lead to a marked slowing in the rate at which the degree of spare capacity is used up. As a consequence, based on the same assumptions as **Chart 1**, unemployment is expected to fall less rapidly than in the recent past (**Chart 2**), with some spare capacity likely to remain even at the forecast horizon.

But the future path of unemployment is highly uncertain. In particular, for a given growth profile, slack will be eroded more quickly if the impediments to productivity growth are more deeply rooted and take longer to rectify. Alternatively, unemployment may fall more slowly if companies have greater capacity than the MPC judges to expand output without increasing employment or if there is a period of catch-up in productivity as companies adopt a backlog of innovations and technical advances.

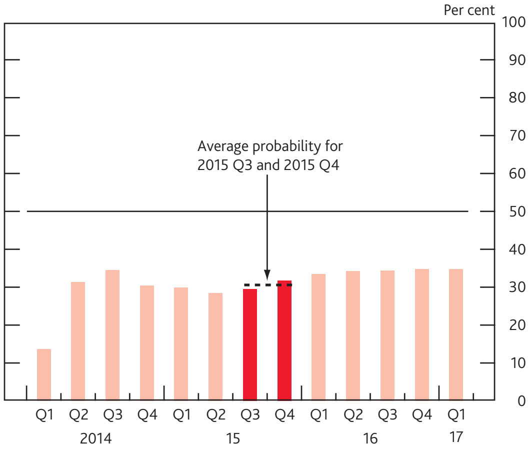
Costs and prices

CPI inflation fell to 2% in December, a fall of almost 1 percentage point since June. The vast majority of that fall appears to reflect the impact of various one-off and idiosyncratic price movements, rather than a more generalised easing in underlying cost and price pressures, which were already subdued. Oil prices have fallen by around 6% over the past year and other commodity prices have fallen by more than 10%. The further appreciation of sterling should also act to dampen import price pressures. Domestically, unit labour costs have risen less than their average historical rate, in part reflecting the drag on pay from labour market slack. The news on inflation expectations since November has, on balance, been good and most measures of medium-term expectations remain close to past averages. Overall, the MPC continues to judge that medium-term inflation expectations remain sufficiently well anchored.

Chart 3 shows the Committee's best collective judgement of the outlook for CPI inflation, on the same basis as **Chart 1**. The near-term outlook is lower than in November, reflecting unexpectedly weak inflation outturns, smaller rises in utility prices than the MPC had assumed, and the impact of sterling's recent appreciation. Inflation is expected to remain at, or slightly below, the target over the forecast period, as the waning impetus from past increases in import prices and from administered and regulated prices is offset by a diminishing drag from spare capacity. The probability of CPI inflation being at or above the 2.5% knockout 18 to 24 months ahead remains around one third (**Chart 4**).

The inflation outlook is sensitive to several factors. The path of inflation will depend on the pace at which slack is absorbed and the impact that slack has on wages and prices. It is possible that the recent unexpectedly sharp falls in inflation reflect underlying cost and price pressures that are weaker than currently judged. Inflation will also be sensitive to

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 Q3 and 2015 Q4, consistent with the 18 to 24-month period in the MPC's price stability knockout.

developments in commodity prices and the exchange rate, both of which can move sharply.

The policy decision

The UK recovery has gained momentum. Unemployment has fallen more sharply than expected; nonetheless spare capacity remains. CPI inflation has fallen back to the 2% target more quickly than anticipated and, with domestic costs well contained, is expected to remain at, or a little below, the target for the next few years.

At its February meeting, the Committee noted that the existence of spare capacity is both wasteful and increases the risk that inflation will undershoot the inflation target in the medium term. Moreover, the outlook for inflation meant that the near-term trade-off between keeping inflation close to the target and supporting output and employment was more favourable than in recent years. The MPC therefore judged that there remained scope to absorb spare capacity further before raising Bank Rate.

It seemed likely that data released over the next few months would show that the 7% threshold has been reached. The Committee agreed on further guidance for when the threshold was reached. That guidance is explained in the box 'Monetary policy as the economy recovers' on pages 8–9. Essentially, the MPC will seek to close the spare capacity in the economy over the next two to three years while keeping inflation close to the target. To that end, it judges that there is scope for the economy to recover further before Bank Rate is raised and, even when Bank Rate does rise, it is expected to do so only gradually and to a level materially below its pre-crisis average of 5%.

In the light of both the economic outlook and its policy guidance, the Committee voted to maintain Bank Rate at 0.5% and the stock of purchased assets at £375 billion.

Monetary policy as the economy recovers

This box provides further guidance on the setting of monetary policy once the unemployment threshold has been reached.

- **The MPC sets policy to achieve the 2% inflation target, and, subject to that, to support the Government's economic policies, including those for growth and employment.**
- **Despite the sharp fall in unemployment, there remains scope to absorb spare capacity further before raising Bank Rate.**
- **When Bank Rate does begin to rise, the appropriate path so as to eliminate slack over the next two to three years and keep inflation close to the target is expected to be gradual.**
- **The actual path of Bank Rate over the next few years will, however, depend on economic developments.**
- **Even when the economy has returned to normal levels of capacity and inflation is close to the target, the appropriate level of Bank Rate is likely to be materially below the 5% level set on average by the Committee prior to the financial crisis.**
- **The MPC intends to maintain the stock of purchased assets at least until the first rise in Bank Rate.**
- **Monetary policy may have a role to play in mitigating risks to financial stability, but only as a last line of defence if those risks cannot be contained by the substantial range of policy actions available to the Financial Policy Committee and other regulatory authorities.**

Monetary policy since the financial crisis

The objective of monetary policy is to achieve the inflation target, and, subject to that, to support the Government's economic policies, including those for growth and employment. The stance of policy to achieve the inflation target will vary over time depending on the economic circumstances. Following the global financial crisis, the MPC reduced Bank Rate to its historically low level of 0.5% and purchased assets amounting to £375 billion. Last August, as the economy showed early signs of recovery but the degree of spare capacity remained large, the Committee provided guidance on the future stance of monetary policy, stating its intention to maintain (at a minimum) the current degree of exceptional monetary stimulus at least until the unemployment rate reached 7%, subject to maintaining price and financial stability.

Unemployment has since fallen sharply as the recovery has gained momentum, and it seems likely that data released in the next few months will show that the 7% threshold has been reached. This box provides further guidance on the setting of policy once the unemployment threshold has been reached.

Scope remains to absorb spare capacity further

With inflation expectations well anchored, and in the absence of external price pressures, the MPC can consistently achieve the 2% inflation target in the medium term only if the economy is operating close to capacity. When inflation is at target but the economy is operating below potential levels of activity, the MPC will, in the absence of other influences, set policy to stimulate demand to eliminate that spare capacity.

Spare capacity comprises slack within the labour market — one component of which is the gap between the actual unemployment rate and its medium-term equilibrium rate — and slack within companies. Last August, given its assessment that there was substantial slack in the economy, the MPC specified the unemployment rate as the threshold for its policy guidance. Although the Committee recognised that unemployment was not a comprehensive measure of economic slack, it chose the unemployment rate because it is less volatile than some alternative measures of slack, is not prone to substantial revisions, and is widely understood.

At the time it provided its policy guidance, the MPC stated that once unemployment had fallen to the 7% threshold, it would assess the state of the economy more broadly, drawing on a wide array of indicators. Given that the threshold is likely to be reached in the next few months, that assessment is provided in this *Inflation Report*. The MPC's view is that the economy currently has spare capacity equivalent to about 1%–1½% of GDP, concentrated in the labour market. Around half of that slack reflects the difference between the current unemployment rate of 7.1% and an estimate of its medium-term equilibrium rate of 6%–6½%. The remaining slack largely reflects a judgement that employees would like to work more hours than is currently the case. Companies appear to be operating at close to normal levels of capacity, although this is subject to some uncertainty.

The existence of spare capacity in the economy is both wasteful and increases the risk that inflation will undershoot the target in the medium term. Moreover, recent developments in inflation mean that the near-term trade-off between keeping inflation close to the target and supporting output and employment is more favourable than at the time the MPC announced its guidance last August: CPI inflation has fallen back to the 2% target more quickly than anticipated and, with domestic costs well contained, is expected to remain at, or a little below, the target for the next few years. The MPC therefore judges that there remains scope to absorb spare capacity further before raising Bank Rate.

Factors determining the timing and pace of tightening

The legacy of the financial crisis and the persistence of economic headwinds mean that interest rates may need to remain at low levels for some time to come. As discussed in the box on page 40, even when the economy has returned to normal levels of capacity and inflation is close to the target, the appropriate level of Bank Rate is likely to be materially below the 5% level set on average by the Committee prior to the crisis.

Given that the headwinds weighing on the recovery are likely to persist for some time, when Bank Rate does increase, it is expected to do so only gradually. Raising Bank Rate gradually would also guard against the risk that, after a prolonged period of exceptionally low interest rates, increases in Bank Rate have a bigger impact than expected on output and spending.

The actual path Bank Rate will follow over the next few years is, however, uncertain and will depend on economic circumstances. Bank Rate may rise more slowly than expected, and increases in Bank Rate may be reversed, if economic headwinds intensify or the recovery falters. Similarly, Bank Rate may be increased more rapidly than anticipated if economic developments raise the outlook for inflation significantly.

The MPC's assessment of the timing and extent of future policy action will be centred on the following factors:

- **The sustainability of the recovery.** The MPC's central expectation is that the recovery will become more entrenched and more broadly based. Rising productivity should improve the outlook for pay and households' real incomes, and so support the durability of the pickup in consumer spending that is already in train. Moreover, the stronger demand outlook should encourage a rise in business investment, supported by further improvements in the cost and availability of credit. A more broadly based improvement in activity should provide reassurance that the recovery will not be threatened by a gradual removal of monetary stimulus.

- **The extent to which supply responds to demand.** An important part of the MPC's assessment is the judgement that productivity growth will gradually increase, slowing the pace at which spare capacity is used up relative to the recent past. Stronger demand, easier credit conditions and reduced uncertainty should facilitate movements of capital and labour to more productive uses, both within and across companies. But the recent weakness in productivity growth has caused the Committee to revise down its assessment of the likely strength of the response of productivity growth to higher demand. More generally, the precise timing and extent of the recovery in productivity is highly uncertain, and this uncertainty inevitably carries over into the outlook for policy. If the recovery in productivity is more (less) rapid than expected, Bank Rate could rise more (less) slowly.

- **The evolution of cost and price pressures.** Wage growth has remained muted, so that even with weak productivity growth, unit labour cost growth has been contained. Although pay growth is likely to pick up over the forecast period, this rise is expected to be modest by historical standards and largely to reflect a pickup in productivity growth. Import price pressures also appear subdued, while the moderate pace of demand growth is likely to limit the extent to which profit margins are rebuilt. The MPC judges that inflation expectations remain sufficiently well anchored and will continue to monitor them closely. A continuation of these benign trends in costs and prices would tend to make the case for removing monetary stimulus less pressing.

Asset purchases and the Bank's reinvestment policy

A final factor affecting the path of Bank Rate is the timing, extent and speed at which the MPC chooses to unwind its asset purchases. Last August, the MPC stated its intention not to reduce the stock of purchased assets at least until the 7% unemployment rate threshold was reached, and, consistent with that, to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility (APF). Updating this guidance, the MPC intends to maintain the stock of purchased assets, including reinvesting the cash flows associated with all maturing gilts held in the APF, at least until Bank Rate has been raised from its current level of 0.5%.

Monetary policy and risks to financial stability

Financial instability can have lasting effects on the economy, damaging growth and endangering price stability. The Committee remains mindful that a prolonged period of low rates could lead to risks to financial stability. The financial stability knockout recognises that, in some circumstances, monetary policy has an important role to play in mitigating financial stability risks, but only as a last line of defence; that is, if the risks cannot be contained by the substantial range of mitigating policy actions available to the Financial Policy Committee, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

This division of responsibilities between regulatory policy and monetary policy will continue once the 7% unemployment threshold is reached and the financial stability knockout no longer applies. This will allow monetary policy to remain focused on its primary objective of maintaining price stability while supporting a sustained recovery.