Overview

In the United Kingdom, recovery has finally taken hold. The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand. But significant headwinds — both at home and abroad — remain, and there is a long way to go before the aftermath of the financial crisis has cleared and economic conditions normalise. That underpins the MPC's intention to maintain the exceptionally stimulative stance of monetary policy until there has been a substantial reduction in the degree of economic slack.

The pace at which that slack is eroded, and the durability of the recovery, will depend on the extent to which productivity picks up alongside demand. Productivity growth has risen in recent quarters, although unemployment has fallen by slightly more than expected on the back of strong output growth.

CPI inflation fell to 2.2% in October. The near-term outlook for inflation is lower than expected three months ago, reflecting unexpectedly low outturns and the recent appreciation of sterling. Inflation is set to fall back to around the 2% target over the next year or so as the impetus from past increases in import prices fades and a gradual revival in productivity growth, together with a persistent margin of spare capacity, curbs domestic price pressures.

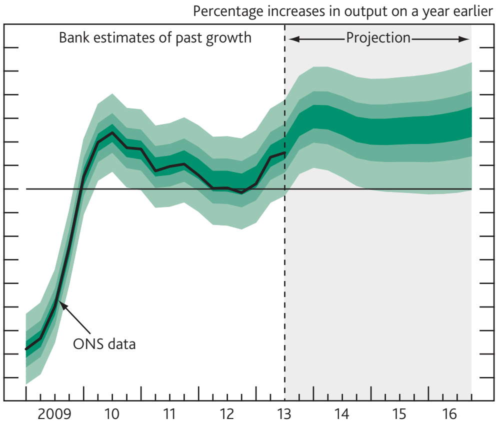
Economic outlook

Demand and supply

The UK economy expanded by 0.8% in 2013 Q3 and business surveys point to continued robust growth in Q4. The gathering pace of expansion during 2013 was supported by an increase in domestic demand. That reflects both an improvement in credit conditions — for example, rates on new loans to households have fallen significantly over the past year — and a reduction in uncertainty. The easing of these headwinds has supported consumer spending and helped to revive the housing market: housing activity and prices increased and housing investment rose robustly in the first half of this year. Leading indicators suggest that housing activity is likely to strengthen further in the near term.

Although official statistics suggest that capital expenditure is yet to increase, companies' investment intentions have also improved on the back of reduced uncertainty and improved access to credit, as well as stronger demand prospects. The prospective revival of investment may be most pronounced for large companies since, despite some improvement, access to finance for small businesses remains constrained. Companies' plans may also be bolstered by a gradual recovery in world demand, although the extent to which UK companies are able

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 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.

to capitalise on that expansion may be tempered by the rise in sterling of around 3% over the past three months.

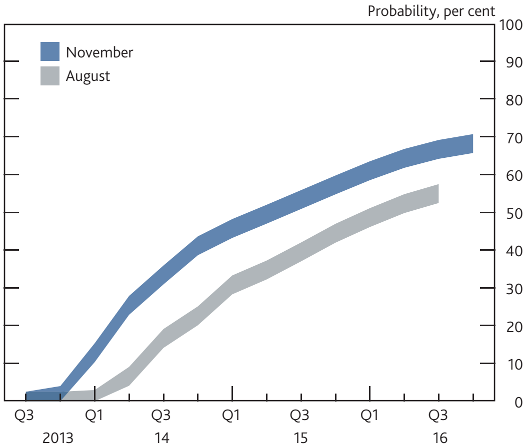
Since the August *Report*, the MPC has maintained Bank Rate at 0.5% and the size of its asset purchase programme at £375 billion. Short-term UK market interest rates have risen, partly reflecting the strength of domestic activity. The projections below are based on the assumption that Bank Rate follows a path implied by market interest rates, rather than the constant rate assumption used in August. That does not reflect the Committee's view of the most likely path of Bank Rate; it is simply a reversion to the convention of using the market curve now that financial markets have had the opportunity to absorb the policy guidance provided by the Committee in August.

On that basis, and assuming that the size of the asset purchase programme is maintained at £375 billion, the recent recovery is likely to be sustained (**Chart 1**). Reduced uncertainty, especially regarding the risks to euro-area activity, and a continued easing in domestic credit conditions should help to release pent-up demand from households and companies. And the strengthening of the housing market should support increased investment in the housing stock and higher demand for housing-related goods and services. The pace of growth is likely to ease back a little in the second and third years of the forecast, as some of the initial boost provided by the lifting of uncertainty and easing of credit conditions moderates. The rise in Bank Rate implied by the market curve also acts to dampen growth over the forecast period. Despite growth becoming entrenched, the legacy of adjustment and repair left by the financial crisis means that the recovery is likely to be subdued by historical standards.

The external environment continues to pose the greatest threat to the recovery; in particular, the necessary adjustments to indebtedness and competitiveness within the euro area may yet prove to be a much greater drag on growth. At home, the continuing need for adjustment and balance sheet repair in both public and private sectors may mean that the recent boost to growth from the lifting of uncertainty proves short-lived. In contrast, domestic demand may revive more quickly than anticipated if improvements in sentiment and spending feed off each other and so impart further momentum to growth.

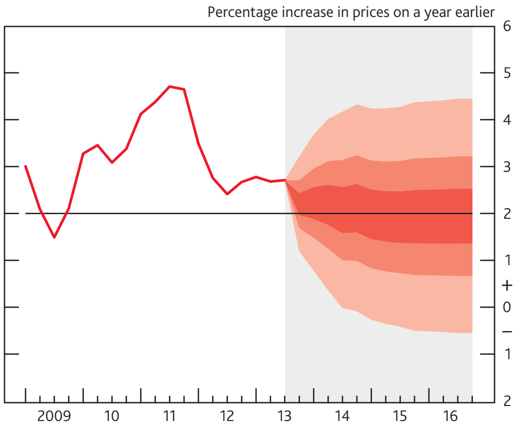
The scope for economic expansion depends critically on the extent to which the unprecedented weakness in labour productivity seen over recent years unwinds as demand recovers. The stronger the revival in productivity, the slower will be the absorption of spare capacity and so the greater the scope for the economy to grow without generating inflationary pressure. Labour productivity growth picked up in the first half of 2013, suggesting that stronger demand is likely to elicit some response in productivity. The recent increase in demand has, however, also led to a narrowing of spare capacity within companies and to a further edging down in the unemployment rate. The headline Labour Force Survey (LFS) unemployment rate fell to 7.7% in August, a touch lower than expected three months ago.

Chart 2 Cumulative probability of unemployment having reached the 7% threshold



The November swathe in this chart is derived from the same distribution as **Chart 5.8** and is conditioned on market interest rate expectations; the August swathe is that shown in Chart 5.11 of the August *Report* and is conditioned on constant interest rates. The swathes show the probability that unemployment has reached 7% by 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 it should not be interpreted as a confidence interval.

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. 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.

There remains a range of views on the Committee about the factors that led to the recent weakness in productivity and about the extent to which productivity will rise as demand increases. But there is little in the recent data to alter those views materially and the MPC's best collective judgement remains that productivity is likely to increase as the economy recovers, such that slack is eroded only gradually. As a result, despite the sustained recovery in activity, and based on the same assumptions as **Chart 1**, the MPC attaches only around a two-in-five chance to the LFS unemployment rate having reached the 7% threshold by the end of 2014. The corresponding figures for the end of 2015 and 2016 are around three in five and two in three respectively (**Chart 2**). These probabilities are higher than in August, reflecting the stronger outlook for near-term demand.

Costs and prices

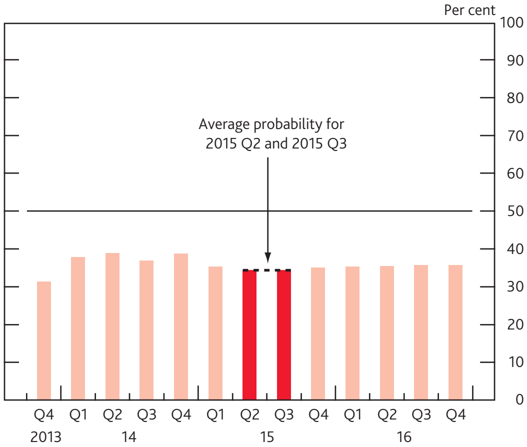
CPI inflation fell from 2.9% in June to 2.2% in October, which is much lower than expected three months ago. That unexpectedly large fall reflects both recent broad-based weakness in goods and services price inflation, together with a number of specific factors including: the impact of recent falls in oil prices on petrol prices; utility price increases occurring later than expected; and a smaller contribution from university tuition fees this year. Domestic cost pressures remain contained, with the weakness in productivity growth broadly matched by muted pay growth.

Some measures of household inflation expectations have picked up; that may have been a response to imminent utility price increases and so may prove temporary. Measures of medium-term expectations derived from financial markets and professional forecasters were little changed, although some were slightly higher than their post-crisis average. Overall, the MPC judges that medium-term inflation expectations remain sufficiently well anchored.

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 projected to fall a little further over the next year or so, as the impetus from import prices fades. This near-term projection is lower than in August, reflecting the impact of unexpectedly low outturns and sterling's recent appreciation. In consequence, the probability of CPI inflation being at or above the 2.5% knockout 18 to 24 months ahead is judged to be lower than in August, at around one third (**Chart 4**). A gradual revival in productivity growth and a persistent margin of spare capacity should contain domestic price pressures, ensuring that inflation is close to target in the medium term, despite a continuing elevated contribution from administered and regulated prices.

There are a number of sources of uncertainty affecting the inflation outlook. The path of inflation will depend on the extent to which productivity picks up as demand increases, the

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 Q2 and 2015 Q3, consistent with the 18 to 24-month period in the MPC's price stability knockout.

degree to which companies' profit margins rise, and whether that takes place through higher prices or lower costs. Inflation will also be sensitive to developments in commodity prices and the exchange rate, both of which are prone to move sharply. 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 risks around the 2% inflation target are broadly balanced in the second and third years of the forecast.

The policy decision

A recovery appears to have finally taken hold; even so, a sustained period of strong growth is likely to be needed before slack is materially eroded. To that end, the Committee indicated in August that it intended to maintain the stance of policy at least until unemployment had reached 7%, provided that it did not entail material risks to price stability or financial stability.

At its November meeting, the Committee noted that the stronger near-term outlook for demand meant that, on the assumption that Bank Rate followed a path implied by market rates, unemployment was likely to fall more quickly than anticipated in August, while CPI inflation looked set to fall back to around the 2% target over the next year or so. The pace with which unemployment fell back would, however, depend heavily on the extent to which the recovery in demand was accompanied by higher productivity. The Committee judged that neither of its price stability knockouts had been breached, and noted that the Financial Policy Committee had concluded at its latest meeting that there had been no breach of the financial stability knockout. Its guidance therefore remained in place.

The Committee reiterated that reaching the unemployment threshold would not necessarily trigger an immediate policy response. Rather the setting of policy at that point would depend on the outlook for inflation relative to the target and on the need to provide continued support to output and employment. In that regard, the Committee noted that its projections conditioned on the assumption that Bank Rate remained at 0.5% implied that no policy action was taken when the unemployment threshold was reached. These projections suggested that inflation would be only a little above the target by the end of the forecast period, while growth was projected to be stronger, and unemployment to fall more rapidly, than in the case in which Bank Rate was assumed to rise in line with the market curve.

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 asset purchases at £375 billion.