Overview

The expansion in UK domestic demand has continued. But the outlook for global growth has weakened. Some asset and commodity prices have fallen, as have market interest rate expectations. Growth is projected to be a little weaker than in August. It slows slightly in the near term, settling back to around historical average rates, underpinned by a gradual pickup in demand abroad and a revival in productivity and real household income growth at home.

Inflation has fallen further below the MPC's 2% target, reflecting the impact of lower food, energy and import prices and some continued drag from domestic slack. Inflation is expected to remain below the target in the near term, and is more likely than not to fall temporarily below 1% at some point over the next six months. It then rises gradually back to the target as external pressures fade and unit labour cost growth picks up. The MPC's guidance on the expected path for Bank Rate continues to apply. When Bank Rate does begin to rise, the pace of rate increases is expected to be gradual, with rates probably remaining below average historical levels for some time.

Recent economic developments

Demand and supply

The global outlook has weakened since August. In the euro area, the United Kingdom's largest trading partner, output grew only modestly in the first half of 2014. More timely survey indicators of activity and consumer and business confidence are consistent with continuing subdued growth. Growth has also slowed in some emerging economies, including China. Although US GDP grew solidly in Q3, household consumption growth remained subdued. Partly reflecting weaker external demand, UK exports fell in Q2 and surveys of export orders paint a less positive picture of the near-term outlook than three months ago.

Disappointing news on global activity was associated with some declines in risky asset prices, with financial markets exhibiting pronounced volatility during October. The FTSE All-Share is around 5% lower than in August and spreads on riskier corporate bonds have risen by 70 basis points on average. It is also possible that investors are now demanding greater compensation for holding some riskier assets. Market participants' expectations for interest rates in three years' time have also fallen notably since August in some advanced economies — for example, by around 60 basis points in the United Kingdom and around 40 basis points in the United States. In the United Kingdom, rates are now expected to remain below 2% over the next three years.

Against this backdrop of slower global activity, UK domestic demand growth has so far remained robust, supported by easier credit conditions and past rises in confidence. Consumer spending growth strengthened in 2014 H1, despite weak wage growth.

Surveys suggest a continuation of strong business investment in the near term. Revisions in the *Blue Book* suggest that the UK recovery has been better balanced than previously estimated, with business investment playing a greater role.

Although housing investment rose markedly in Q2, housing market activity has moderated further. Mortgage approvals were broadly flat in Q3, weaker than expected in August, and house price inflation has also slowed. This may in part reflect some restriction in the availability of mortgage credit, but an easing in demand for housing finance may also have been a factor. The near-term outlook for housing market activity is softer than in August.

The unemployment rate continued to fall, reaching 6.0% in the three months to August. The most recent decline largely reflects fewer people participating in the labour market, with employment rising more slowly than earlier in the year. Private sector productivity growth has picked up a little, but still remains weak. The margin of spare capacity has probably narrowed a little over the past six months. But the central view of most MPC members is that slack remains broadly in the region of 1% of GDP. There is, however, considerable uncertainty around that central estimate, with a wide range of views on the Committee.

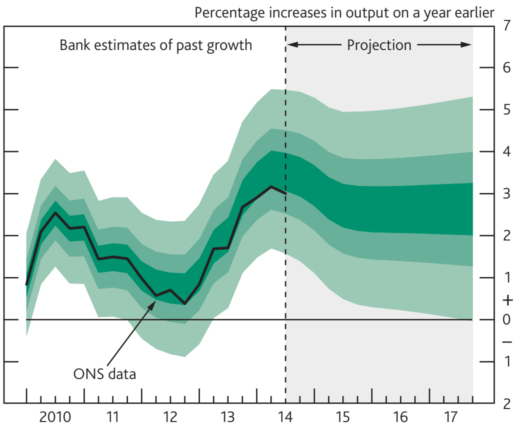
Costs and prices

CPI inflation was 1.2% in September, down from 1.9% three months ago, and much weaker than projected in August. Low CPI inflation partly reflects a decline in food and energy prices which, after pushing up CPI inflation for most of the past decade, are now weighing on the headline rate. These lower prices reflect falls in global commodity prices, which in turn reflect both the slowdown in global demand and positive news about supply. Prices of other imported goods and services are also lower. Although sterling has depreciated slightly since August, its rise over the previous year or so is pushing down import prices. Inflation in the euro area, a key source of UK imports, also remains low.

Cost pressures from the labour market remain subdued. Unit labour costs fell over the four quarters to Q2. While that fall was largely driven by the volatile non-wage component of labour costs, wage growth remains low relative to historical averages. That reflects both slack in the labour market and subdued productivity growth. The composition of employment gains has probably weighed on productivity and pay: much of the most recent rise in employment has been concentrated in lower-skilled occupations.

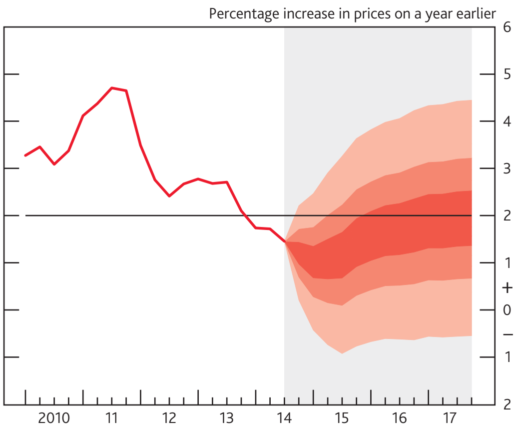
Most measures of medium-term inflation expectations have changed little since August and remain consistent with the 2% inflation target. However, some measures of short-term inflation expectations have fallen somewhat.

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 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.

The outlook for GDP growth and inflation

Chart 1 shows the Committee's best collective judgement for the outlook for four-quarter GDP growth, assuming Bank Rate rises gradually from late 2015, in line with the path implied by market interest rates, and the stock of purchased assets stays at £375 billion. Four-quarter growth is projected to fall back towards its historical average rate, somewhat above estimated potential supply growth. That central path is a little weaker than in August, reflecting the weaker global outlook and a softer profile for private sector domestic demand, the latter despite a lower implied path for Bank Rate. The risks around that central path are judged to be balanced, rather than skewed to the downside as in August.

The projection assumes that overseas growth is slower than in August, particularly in the euro area. The main downside risk stems from weaker euro-area activity, which would weigh on UK exports and could be associated with a further rise in financial market volatility. But there are also risks to the upside — for example, greater momentum in US growth or larger impacts than expected from European Central Bank or Bank of Japan policy actions.

Domestically, the projection is for solid consumption growth as households reduce their saving rate further, particularly in the near term. The weakness in the housing market bears down on housing investment. Business investment grows strongly, but at a slower rate than projected in August, reflecting the weaker and more uncertain global backdrop. There remains a risk that households may not be willing to cut back saving, particularly if concerns around the economic outlook build. Further out, the medium-term outlook for growth is underpinned by a gradual revival in productivity growth. But there remains considerable uncertainty around that judgement.

Chart 2 summarises the MPC's best collective judgement for the outlook for CPI inflation on the same basis as **Chart 1**. In the central case, inflation remains around its current level in the near term as the drags from food, energy and other imported goods and services prices, and slack in the domestic economy, persist. There is a significant probability that inflation could temporarily fall below 1% in the near term. Inflation then rises back to the target by the end of the forecast period as external pressures fade and growth in unit labour costs gradually picks up.

There are significant risks either side of this inflation projection. Global commodity prices could be higher if adverse geopolitical developments or a tightening in supply push up the price of oil, or lower if abundant supply or weaker demand for commodities proves persistent. Consumer prices will also continue to be affected by the pass-through from sterling's appreciation over the past year and any further movements in the exchange rate.

Domestic risks to inflation centre on unit labour costs. Wages need to grow more strongly than productivity to return inflation to the 2% target, absent external price pressures. Wage growth could remain subdued if slack is greater than estimated or if households' and companies' inflation expectations were to fall. Alternatively, it could pick up more sharply than anticipated if there were less slack, if it were absorbed more quickly than assumed, or if confidence in the recovery meant that pay pressures, evident in some survey indicators, started to feed through more sharply than expected into wages.

The policy decision

UK domestic demand growth remained robust in the first half of 2014. But the global backdrop has weakened, particularly in the euro area. CPI inflation fell to 1.2% in September, well below the 1.7% expected at the time of the August *Report*. Low inflation in large part reflects downward pressure from food, energy and the prices of other imported goods and services, which were previously pushing inflation above the 2% target. But domestic price pressures are also weaker than previously thought.

At its November meeting, the Committee noted that market participants had revised down their expectations for the path of Bank Rate, by around 0.5 percentage points on average over the next three years, since the time of the August *Report*. This was probably in response to the weaker global outlook. The outlook for domestic demand also appeared softer. Taking those together, the central outlook for four-quarter output growth was a little weaker than expected three months ago. Growth was expected to fall back to around its historical average rate and slack to be absorbed over the next three years. That absorption in slack was associated with inflation returning to the 2% target by the three-year forecast horizon. But the near-term profile for inflation was markedly different from that in August, with inflation likely to remain close to 1% over the next twelve months.

The Committee sets monetary policy to meet the 2% target in the medium term and in a way that helps to sustain growth and employment. The Committee gave guidance in its February *Report* on how it would seek to achieve the inflation target over the policy horizon. At its November meeting, the Committee noted that the central message of that guidance remained relevant: given the likely persistence of the headwinds weighing on the economy, when Bank Rate did begin to rise, it was expected to do so only gradually and to remain below average historical levels for some time to come. The actual path for monetary policy would remain dependent on economic conditions. In other words, the Committee's guidance on the likely pace and extent of interest rate rises was an expectation, not a promise.

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