Overview

CPI inflation remained well above the 2% target but the recent weakness in underlying output growth persisted. The recovery in the world economy was maintained and is expected to support growth in the United Kingdom, as should the considerable stimulus from monetary policy and the current level of sterling. But the continuing squeeze on households' real incomes is likely to weigh on demand, especially over the next year or so. Further ahead, the chances of four-quarter GDP growth being either above or below its historical average rate are judged to be roughly balanced.

CPI inflation is likely to rise further this year and is more likely than not to remain above the target throughout 2012. The near-term profile is markedly higher than in February, largely reflecting renewed increases in energy prices. Inflation is likely to fall through 2012 into 2013 as the impact of external price pressures and the increase in VAT dissipates and some downward pressure from a margin of spare capacity persists. But the timing and extent of that decline in inflation are both highly uncertain. Under the assumptions that Bank Rate moves in line with market interest rates and the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion, the chances of inflation being above or below the target in the medium term are judged to be about the same.

Financial and credit markets

Since the February *Report*, the MPC has maintained Bank Rate at 0.5% and its stock of purchased assets at £200 billion. Financial markets were relatively resilient in the face of the Japanese earthquake and tsunami and the political unrest in the Middle East and North Africa. Market participants lowered their expectations of the near-term path of Bank Rate. The sterling effective exchange rate fell slightly, but remained within its range of the past two years. UK banks continued to make steady progress in replacing maturing funding. Bank lending to businesses declined again, and the availability of bank credit to households and smaller businesses remained tight. Money growth was weak.

Demand

The world economy continued to grow at a solid pace, but some recent indicators were more mixed and risks remain. The recovery in the euro area was maintained, although market concerns about the fiscal sustainability of some euro-area periphery countries intensified. US unemployment declined, but GDP growth slowed in 2011 Q1 and significant headwinds persist. Activity in emerging economies grew robustly, although several tightened policy in response to heightened inflationary pressures and growth is likely to slow modestly as a consequence. UK exports have grown briskly over the past year and business surveys pointed to continued strong growth.

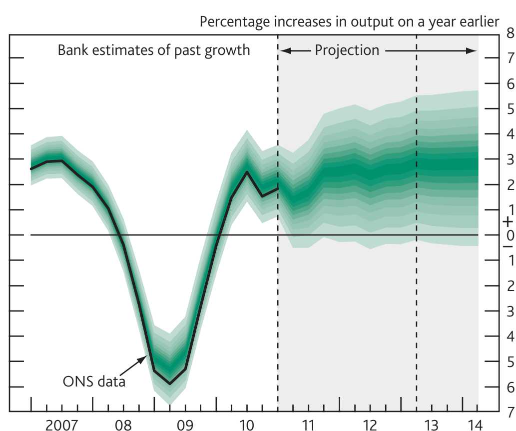
At home, private domestic demand growth slowed sharply in 2010 Q4, in part disrupted by heavy snow. During 2010, private domestic spending grew moderately, largely driven by higher corporate spending, including a material boost from stockbuilding. In contrast, consumer spending stagnated as real incomes fell, reflecting subdued wage growth and the impact of the lower level of sterling and higher commodity prices on import prices. The contrasting fortunes of the household and corporate sectors continued into 2011: households' purchasing power is likely to have fallen further, and surveys suggest that households' confidence was somewhat weaker than that of businesses. Imports grew rapidly during 2010, despite the rise in import prices relative to domestic prices.

The fiscal consolidation continued. The Committee's projections are conditioned on the tax and spending plans set out in the March *Budget*, which were little changed relative to the previous plans.

The outlook for GDP growth

Despite the rebound in activity following the heavy snow at the end of last year, GDP was provisionally estimated by the ONS to have risen by only 0.5% in 2011 Q1. That was a weaker outturn than expected in the February *Report*, accounted for by a reported large fall in construction output. Business surveys and the growth in employment over recent months suggest that underlying activity may have been stronger than indicated by official output data.

Chart 1 GDP projection based on market interest rate expectations and £200 billion asset purchases

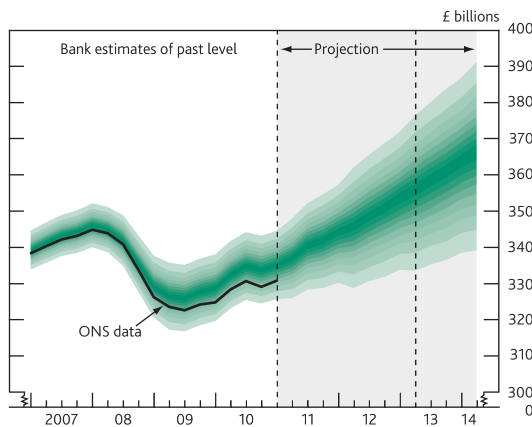


The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. To the left of the first vertical dashed line, 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 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.

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 financed by the issuance of central bank reserves remains at £200 billion. The projection during the first half of the forecast period is weaker than in February, reflecting the dampening effects of both further increases in energy prices and recent disappointing outturns for productivity on households' future real labour incomes and hence consumption. Fiscal consolidation is likely to continue to weigh on activity throughout the forecast period. But the considerable stimulus from monetary policy, together with strong growth in global demand and the current level of sterling, should support recovery by shoring up private sector spending and encouraging a rebalancing of the economy towards exports and away from imports.

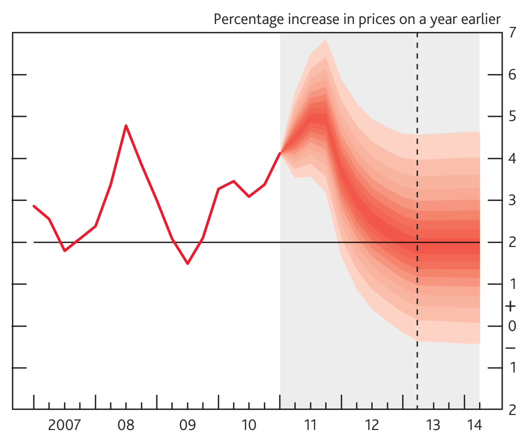
There are some key uncertainties surrounding the likely strength of the recovery. Private domestic demand growth could be boosted if more of the historically large corporate financial surpluses were spent on capital investment or transferred to households in the form of higher wages or dividends. But there are significant downside risks to consumers' expenditure. In particular, some households may cut their spending further if they are still adjusting to past falls

Chart 2 Projection of the level of GDP based on market interest rate expectations and £200 billion asset purchases



Chained-volume measure (reference year 2006). 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 £200 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 £200 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 lower bands are slightly smaller than those in the upper bands at Years 1, 2 and 3, albeit that the upward skew in Year 1 is smaller than those at Years 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.

in their real incomes or to the uncertain economic outlook. That uncertainty may be especially pronounced for those households most exposed to the effects of the fiscal consolidation. The extent to which net trade improves will depend on the durability of the expansion in world demand and on the degree and pace of rebalancing prompted by sterling's past depreciation.

There remains a wider than usual range of views among Committee members about the outlook for growth. The Committee judges that relative to the most likely path — contained within the darkest band in **Chart 1** — the risks to growth are skewed to the downside. Taking into account that skew, the Committee's best collective judgement is that GDP growth is likely to be below its historical average rate over the next year or so. Thereafter, growth is about as likely to be above its historical average rate as below it.

Chart 2 shows the distribution for the level of GDP corresponding to the Committee's growth projection, which is somewhat lower than in February. The Committee continues to judge it likely that some margin of spare capacity, although diminishing, will persist throughout the forecast period.

Costs and prices

CPI inflation was 4.0% in March. That elevated rate of inflation reflects the temporary impacts of three factors: the increase in VAT to 20%; higher energy prices; and higher import prices. Recent increases in the prices of energy and other commodities are likely to put further upward pressure on inflation as they work through the supply chain. These cost pressures were evident in manufacturers' output prices.

Some measures of households' near-term and longer-term inflation expectations increased further, although the increases in near-term expectations over the past year were less than the upward revision to the MPC's own view of near-term inflation. In contrast, longer-term inflation expectations of professional forecasters and those implied by financial market prices were stable.

Labour productivity has been broadly unchanged since the middle of 2010, some way below its historical trend path. That might suggest that the degree of spare capacity within companies has increased and that there is considerable scope for rapid productivity growth in the future. In contrast, survey evidence points to a more limited amount of spare capacity within companies. Unemployment remained broadly unchanged at an elevated level. Private sector regular pay growth was muted, at close to 2%, reflecting both weak productivity growth and continuing slack in the labour market.

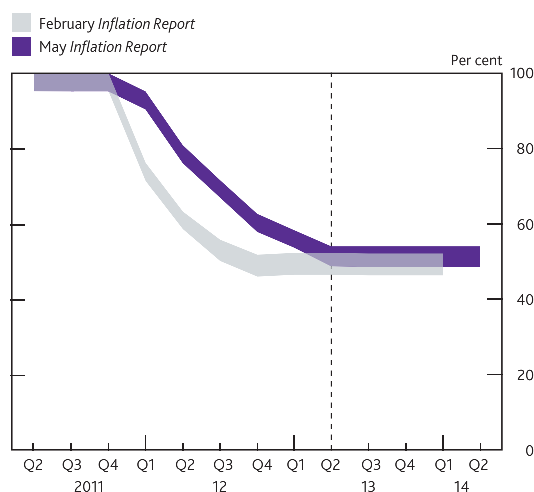
The outlook for inflation

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

as **Chart 1**. There is a good chance that inflation will reach 5% later this year and it is more likely than not to remain above the 2% target throughout 2012, boosted by the increase in VAT, higher energy and import prices, and some rebuilding of companies' margins. The projection over that period is markedly higher than in February, mainly reflecting the recent increases in energy prices, including the likelihood that they will lead to higher utility bills. Inflation is likely to fall back through 2012 and into 2013 as the temporary impact of those factors raising inflation wanes and some downward pressure from spare capacity persists. The extent of that fall is likely to be moderated by upward pressure on nominal wages, as the continuing squeeze in real wages is resisted and inflation expectations drift up further.

The prospects for inflation remain highly uncertain. Domestically, the degree of spare capacity and its dampening impact on inflation will depend on: the strength of demand; the growth of productivity; the performance of the labour market; and the sensitivity of wages to labour market slack. There is also considerable uncertainty about the strength of the forces opposing the impact of spare capacity. The magnitude of both the squeeze on real wages and the overshoot of the inflation target are exceptional, so it is hard to be sure how households and companies will respond. Externally, continued strong global growth may increase the upward pressure on import prices, particularly those of commodities. And plausible alternative paths for domestic utility prices would have significant implications for the inflation outlook.

Chart 4 An indicator of the probability inflation will be above the target



The May and February swathes in this chart are derived from the same distributions as **Chart 3** and **Chart 5.4** on page 39 respectively. They indicate the assessed probability of inflation being above target in each quarter of the forecast period. The width of the swathe at each point in time corresponds to the width of the band of the fan chart in which the target falls in that quarter, or, if the target falls outside the coloured area of the fan chart, the width of the band closest to the target. The bands in the fan chart illustrate the MPC's best collective judgement that inflation will fall within a given range. The swathes in **Chart 4** show the probability within the entire band of the corresponding fan chart of inflation being close to target; the swathes should not therefore be interpreted as a confidence interval. The dashed line is drawn at the two-year point of the May projection. The two-year point of the February projection was one quarter earlier.

The range of views among Committee members over the outlook for inflation is wider than usual. In the current uncertain environment, modest differences in judgements regarding the factors above can have a material impact on the outlook. On balance, the Committee's best collective judgement, based on the monetary policy assumptions described above, is that the chances of inflation being either above or below the 2% inflation target in the medium term are roughly equal (**Chart 4**).

The policy decision

At its May meeting, the Committee judged that the pace of recovery was more likely than not to pick up from its recent soft patch. The near-term outlook for inflation had worsened further, primarily reflecting renewed increases in energy prices. But under the assumption that Bank Rate rose in line with market yields, inflation was still likely to fall back in the medium term, as the temporary impacts of the factors currently raising inflation diminished and some downward pressure from a margin of spare capacity persisted. In the light of that outlook, the Committee judged it appropriate at that meeting to maintain Bank Rate at 0.5% and the stock of purchased assets at £200 billion, in order to meet the 2% CPI inflation target over the medium term.