Overview

The prospects for the UK economy have worsened. Global demand slowed. And concerns about the solvency of several euro-area governments intensified, increasing strains in banking and some sovereign funding markets. Household and business confidence fell, both at home and abroad. These factors, along with the fiscal consolidation and squeeze on households' real incomes, are likely to weigh heavily on UK growth in the near term. Thereafter, the recovery should gain traction, supported by continued monetary stimulus and a gentle recovery in real incomes. Implementation of a credible and effective policy response in the euro area would help to reduce uncertainty and so support UK growth, but its absence poses the single biggest risk to the domestic recovery.

CPI inflation rose to 5.2% in September. Inflation is likely to fall back sharply through 2012 as the contributions of VAT, energy and import prices decline, and downward pressure from slack in the labour market persists. But how far and how fast inflation will fall are uncertain. Under the assumption that Bank Rate moves in line with market interest rates and the size of the asset purchase programme remains at £275 billion, inflation is judged more likely to be below than above the 2% target at the forecast horizon.

Financial and credit markets

Since the August *Report*, the MPC increased the size of its asset purchase programme by £75 billion, to a total of £275 billion. The MPC maintained Bank Rate at 0.5% and market interest rates suggested that the expected timing of the next rise in Bank Rate had been pushed out. Prices of risky assets fell sharply, and volatility in financial markets increased, as concerns about the euro area intensified. Conditions in bank funding markets deteriorated, increasing the risk of a renewed tightening in credit conditions. Euro-area leaders announced a package of measures on 27 October but substantial details were still to be agreed. UK broad money and credit growth remained weak.

Demand

The pace of global expansion slowed and the outlook worsened. Euro-area growth fell markedly in 2011 Q2, as growth in both Germany and France faltered. Euro-area growth is likely to weaken further in the near term, weighed down by fragile confidence, tight credit conditions and fiscal austerity. US GDP growth picked up in Q3 but prospects remain subdued given continued high unemployment and the prospective tightening in fiscal policy. The pace of expansion in some emerging markets cooled against a backdrop of tighter domestic policy and softening external demand. UK exports fell in 2011 Q2 and business surveys suggested that they would remain weak in the near term.

At home, domestic demand grew only modestly in 2011 Q2, having contracted sharply in the previous two quarters. Households' consumption fell for the fourth consecutive quarter, as the squeeze on real incomes continued. Revisions to spending and income data since the August *Report* suggested that the household savings ratio had been materially higher over the past two years than previously estimated. Business investment rebounded following an erratic fall in Q1, but four-quarter growth remained weak.

GDP was provisionally estimated to have increased by 0.5% in 2011 Q3, boosted by the unwinding of various one-off factors. Abstracting from such factors, underlying demand over the preceding year had grown at a rate well below its historical average. And business surveys pointed to even weaker growth in the near term, with output indicated to be broadly flat in Q4.

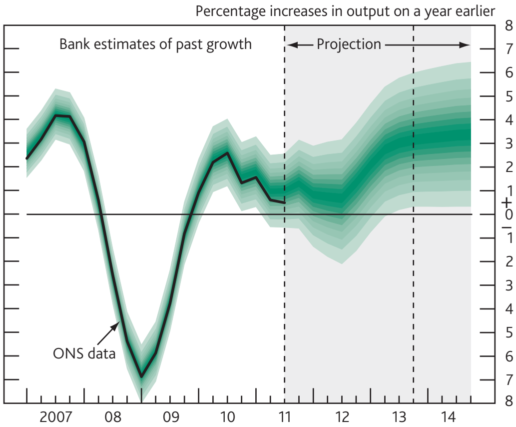
The Committee's projections are conditioned on the tax and spending plans set out in the March *Budget*. Those plans imply that the reduction in the cyclically adjusted primary deficit in 2011/12 will be similar to that observed in 2010/11.

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 asset purchase programme remains at £275 billion. The marked deterioration in the external environment, together with the domestic headwinds stemming from the fiscal consolidation and squeeze on households' real incomes, means that growth looks set to be weak in the near term. The recovery is likely to gather pace over the second and third years of the forecast as private demand picks up, supported by continuing stimulus from monetary policy and a gentle recovery in real incomes.

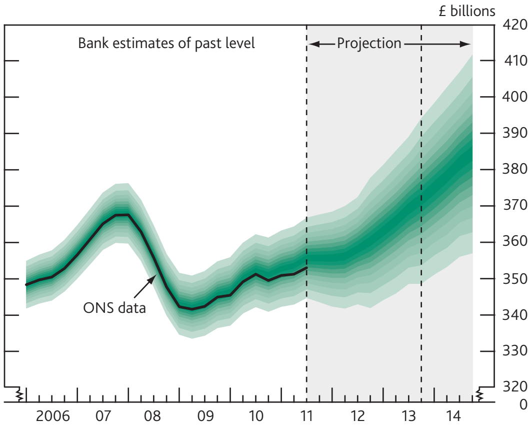
The outlook for output growth is unusually uncertain. That reflects in particular the exposure of the UK economy to developments in the euro area. The euro area faces substantial challenges as several members seek to ensure the sustainability of their public and external debt and maintain financial stability. Implementation of a credible and effective policy response in the euro area would diminish uncertainty and so support the UK recovery. Even in this case, however, the scale of the imbalances means that there is likely to be a prolonged period of subdued growth within the euro area. But a failure to meet these challenges would almost certainly have significant implications for the UK economy. To the extent that such a possibility is already reflected in asset prices, bank funding costs and confidence, it is captured in the MPC's projections. But the MPC sees no meaningful way to quantify the most extreme outcomes associated with developments in the euro area and, as was the case in the August *Report*, they are therefore excluded from the fan charts.

Chart 1 GDP projection based on market interest rate expectations and £275 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 reaches £275 billion and remains there 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 Year 1, but they are the same at Years 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 2 Projection of the level of GDP based on market interest rate expectations and £275 billion asset purchases



Chained-volume measure (reference year 2008). 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.

Domestically, the strength of the recovery will depend on how much further households have to adjust to past falls in real incomes and to the more uncertain economic environment. The outlook for both household and business spending also depends on the extent to which the cost and availability of bank credit are affected by the renewed strains in bank funding markets and for how long those strains persist. The impact that the further round of asset purchases will have on nominal spending is also inevitably uncertain.

There remains a range of views among Committee members about the likely strength of the recovery. On the same assumptions as above, the Committee's best collective judgement is that by the second and third years of the forecast, growth is somewhat more likely to be above its historical average rate than below it.

Chart 2 shows that output is likely to remain significantly below the level associated with a continuation of its pre-recession trend. The Committee judges that a substantial part of that discrepancy reflects a shortfall in the level of potential supply. Nonetheless, a margin of spare capacity, concentrated in the labour market, is likely to endure throughout the forecast.

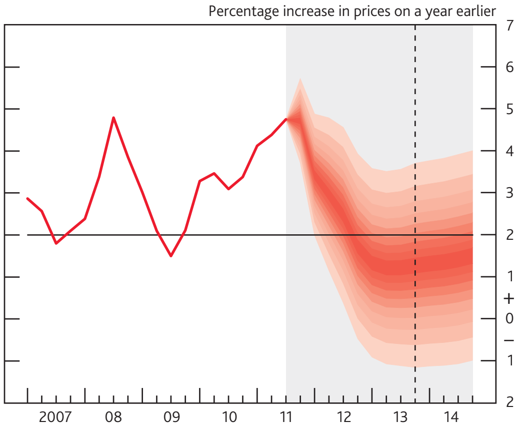
Costs and prices

CPI inflation rose to 5.2% in September. The strength of inflation continued to reflect the effects of the past increase in the standard rate of VAT to 20% and in the prices of energy and other imported goods and services. Oil and gas prices had fallen only modestly since August despite the marked deterioration in the global outlook.

Indicators of long-run inflation expectations were mixed. Professional forecasters' longer-term expectations and measures derived from financial markets were stable around average levels. In contrast, measures of households' longer-term expectations had increased over the past year or so, and in 2011 Q3 were above their series averages. And there was also some evidence that households expected inflation to be more persistent than envisaged in the Committee's central case.

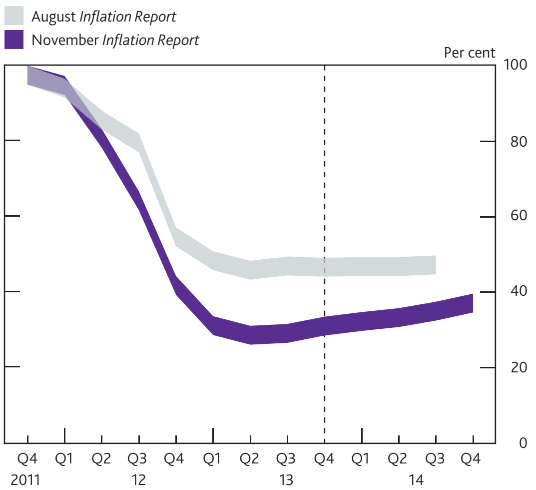
Labour productivity growth remained weak: the level of private sector productivity in 2011 Q2 was still below its level in 2007. Survey measures of capacity utilisation and strong private sector hiring in the year to 2011 Q2 continued to suggest that there was little margin of slack within companies. But employment fell during the summer, as gains in private sector employment slowed and the pace of public sector job losses quickened. The Labour Force Survey measure of unemployment rose to above 8%. Earnings growth edged up further, but remained well below its pre-recession average, reflecting both considerable slack in the labour market and weak productivity.

Chart 3 CPI inflation projection based on market interest rate expectations and £275 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 reaches £275 billion and remains there 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 the same as those in the upper 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.

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



The November and August swathes in this chart are derived from the same distributions as **Chart 3** and **Chart 5.7** on page 42 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 November projection. The two-year point of the August projection was one quarter earlier.

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**. Inflation is likely to fall sharply over 2012 as the contributions of VAT, energy and import prices decline, and downward pressure from slack in the labour market persists.

How far and how fast inflation is likely to fall remain uncertain. The extent to which inflation slows in the near term depends on the extent to which the sustained period of high inflation leads to upward pressure on pay and on whether companies attempt to restore their profit margins by raising prices. The evolution of inflation also depends on the extent to which the prospective period of weak demand leads to a widening margin of slack in the economy and the impact that has on costs and prices. The degree of slack and its impact on inflation will depend on: the path of output; the degree to which the recent weakness in productivity growth persists; the extent to which the unemployed are able to compete effectively for jobs; and the sensitivity of wages to labour market slack. Developments in inflation will also be sensitive to movements in commodity and other import prices.

There remains a range of views among Committee members regarding the relative strength of the factors affecting the outlook for inflation. On balance, the Committee's best collective judgement, based on the conditioning assumptions described above, is that inflation is more likely to be below than above the 2% target at the forecast horizon (**Chart 4**).

The policy decision

At its November meeting, the Committee judged that GDP growth was likely to be weak in the near term before gathering pace in 2013 and 2014. Inflation was thought to be around its peak and was set to fall back sharply through 2012. The outlook for both growth and inflation was unusually uncertain given its sensitivity to developments in the euro area. The Committee judged it appropriate at that meeting to maintain Bank Rate at 0.5% and the size of the asset purchase programme at £275 billion, in order to meet the 2% CPI inflation target over the medium term.