Overview

Output had barely grown for a year and a half and was estimated to have contracted slightly in the past two quarters. The euro-area economy remained weak, but global activity overall continued to expand at a moderate pace. A number of one-off factors are likely to affect the pattern of quarterly growth of domestic output during 2012. Looking through those effects, underlying demand growth is likely to remain subdued in the near term, before a gentle increase in households' real incomes and consumption helps the recovery to gain traction. Stimulus from monetary policy should continue to support demand, although headwinds from the external environment, tight credit conditions and the fiscal consolidation are likely to persist. The possibility that the substantial challenges within the euro area will lead to significant economic and financial disruption continues to pose the greatest threat to the UK recovery.

CPI inflation stood at 3.5% in March 2012, down from a peak of 5.2% in September 2011. That fall reflected the effects of earlier increases in energy prices and VAT dropping out of the twelve-month inflation rate. The prospects for inflation are uncertain. The near-term outlook is judged to be somewhat higher than expected three months ago, with inflation now likely to remain above the 2% target for the next year or so. But a gradual easing in the impact of external price pressures, together with a continuing drag from economic slack, should lead inflation to fall back to around the target. Under the assumptions that Bank Rate moves in line with market interest rates and the size of the asset purchase programme remains at £325 billion, the risks of inflation being above or below the target by the end of the forecast period are judged to be broadly balanced.

Financial and credit markets

Since the February *Inflation Report*, the MPC has maintained Bank Rate at 0.5% and the size of its asset purchase programme at £325 billion. The European Central Bank's longer-term refinancing operations were associated with an initial improvement in bank funding conditions, although some indicators of unsecured funding costs subsequently picked up. Spreads on some euro-area countries' government debt remained elevated. UK banks raised significant funds from debt markets in 2012 Q1. They continued to pass through earlier rises in their funding costs to mortgage rates. Money growth picked up in Q1; credit growth remained weak. Sterling has appreciated by 3% since the February *Report*.

Demand

Global growth remained uneven across different regions. Output in the euro area — the United Kingdom's most important trading partner — contracted in 2011 Q4 and business surveys pointed to a further fall in 2012 Q1. In contrast, the US economy recorded solid increases, supported by household spending. Activity in the emerging economies expanded steadily, albeit more slowly than at the beginning of last year. UK exports grew modestly in 2011, underpinned by solid export growth to non-EU countries.

At home, GDP growth was weak during 2011. That weakness was concentrated within domestic demand. Consumption fell, as the squeeze on real incomes continued and households saved more. And business investment remained significantly below its pre-crisis level, held back by weak demand, heightened uncertainty and tight credit conditions.

Output was provisionally estimated to have fallen by 0.2% in 2012 Q1, the second consecutive quarter of contraction. That fall was driven by a large decline in measured construction output. Growth in the rest of the economy was also estimated to be weak, with manufacturing and services output both broadly flat. But business surveys, labour market developments and reports from the Bank's Agents all pointed to somewhat stronger activity in the first quarter, suggesting that the underlying picture was less weak.

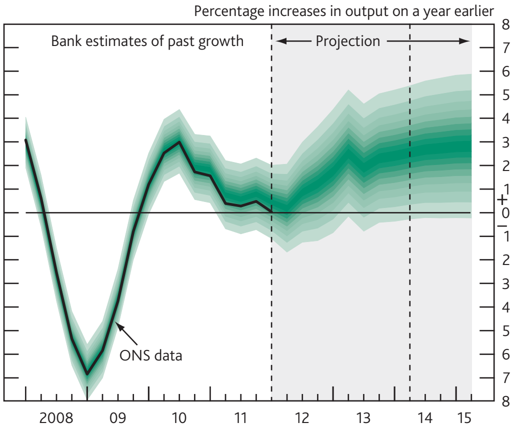
The Committee's projections are conditioned on the tax and spending plans set out in the March *Budget*. Those plans suggest that the reduction in the fiscal deficit as a proportion of nominal GDP is likely to be a little slower in 2012/13 than in the previous two years.

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 size of the asset purchase programme stays at £325 billion. The pattern of quarterly growth in 2012 is likely to be affected by a number of one-off factors, including the Queen's Diamond Jubilee and the Olympics. Looking through those effects, underlying growth is likely to remain subdued in the near term before a gentle increase in households' real incomes and consumption helps the recovery to gain traction. Stimulus from monetary policy should help to support activity, but continued strains within the euro area, tight credit conditions and the fiscal consolidation are all likely to temper the pace of expansion.

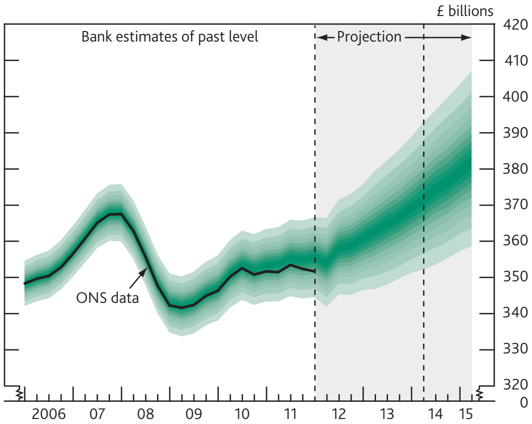
The prospects for UK growth remain unusually uncertain. The single biggest threat to the recovery stems from the challenges within the euro area, in particular the need to reduce the indebtedness and improve the competitiveness of some member countries. Even if a credible and effective set of policies is successfully implemented, the scale of the necessary adjustments suggests that a prolonged period of sluggish growth and heightened uncertainty is likely. A failure to implement such policies could have severe implications for the UK economy. As was the case in past *Reports*, the MPC sees no meaningful way to quantify the size and likelihood of the most extreme possibilities associated with developments in the euro area, and they are therefore excluded from the fan charts. But the threat of these more extreme outcomes is

Chart 1 GDP projection based on market interest rate expectations and £325 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 £325 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 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. 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 the same as 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 2 Projection of the level of GDP based on market interest rate expectations and £325 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.

likely to affect economic activity over the forecast period, for example through its effect on asset prices, including the exchange rate, bank funding costs, and confidence; such effects are captured in the MPC's projections.

Domestically, the strength of the recovery will depend on whether households have further to adjust to the erosion in their purchasing power and to the more uncertain economic environment. The path of domestic spending will also depend on: the pace of productivity growth and how that affects households' and companies' earnings; the extent to which the availability of bank credit improves; and the effects on growth of both fiscal and monetary policy.

There remains a range of views among Committee members about the outlook for GDP growth. On the same assumptions as above, the Committee's best collective judgement is that growth is likely to remain subdued in the near term, but that by the third year of the forecast, the chances of GDP growth being above or below its historical average are broadly balanced. The projected distribution for growth is lower than in the February *Inflation Report*, reflecting weaker growth around the start of this year, a higher near-term outlook for inflation and a more gradual pickup in productivity growth.

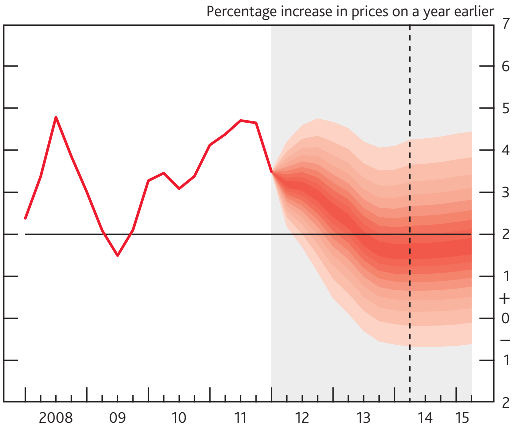
Recent growth has been weak by historical standards. **Chart 2** shows that output has been broadly flat since the middle of 2010 and is not likely to surpass its pre-crisis level before 2014. The weakness appears to have been associated with unusually slow growth in potential supply. Even so, the Committee judges that there exists a sizable margin of spare capacity, largely concentrated in the labour market. That should diminish towards the end of the forecast period, but is unlikely to close completely.

Costs and prices

CPI inflation stood at 3.5% in March 2012, down from 5.2% in September 2011. That fall reflected the effects of earlier increases in energy prices and VAT dropping out of the twelve-month comparison. The elevated rate of inflation in March largely reflected the effects of past increases in import and energy prices. In contrast, there had not been strong growth in domestic costs: companies' unit labour costs had increased at around their average historical rate over the past year. Most indicators of longer-term inflation expectations remained relatively close to their series averages.

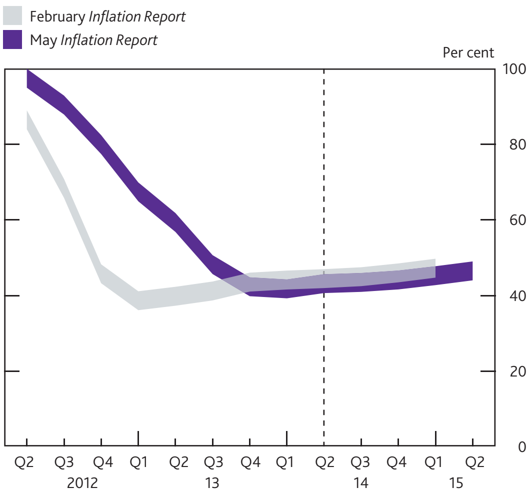
Private sector employment has increased substantially since the middle of 2010, despite weak output growth. The Labour Force Survey measure of unemployment edged lower in the three months to February. Even so, there remained a wide margin of slack in the labour market and this, along with weak productivity growth, continued to bear down on earnings growth, which declined further in early 2012.

Chart 3 CPI inflation projection based on market interest rate expectations and £325 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 £325 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 upper bands are the same as those in the lower bands at Year 1 but they are slightly larger 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.

Chart 4 An indicator of the probability that 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 5.7** on page 41 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 May projection. The two-year point of the February projection was one quarter earlier.

The outlook for inflation

Chart 3 shows the Committee's best collective judgement of the outlook for CPI inflation, based on the same assumptions as **Chart 1**. The near-term outlook is higher than in the February *Report*, with inflation likely to remain above the 2% target for the next year or so. This upward revision reflects both the impact of higher energy prices and indirect taxes, and also a judgement that cost pressures from past rises in commodity prices and weak productivity are likely to have a greater impact on inflation in the near term than expected three months ago. But a gradual easing in the impact of external price pressures and a continuing drag from economic slack should cause inflation to fall back to around the target in the second half of the forecast period.

The prospects for inflation remain uncertain, not least because it is difficult to gauge with any precision the current strength of underlying inflationary pressure. The extent to which inflation slows in the near term depends on the pace at which external price pressures ease, and hence on developments in commodity and other import prices. The path of inflation will also depend on the growth in companies' domestic costs, which will be heavily affected by the pace of productivity growth and the extent to which slack in the labour market limits wage growth. The degree to which companies seek to restore their profit margins by raising prices will also have an important bearing on inflation.

The difficulty of predicting the precise impact of these influences means that the Committee places more weight on the broad shape of the inflation outlook than its exact calibration. And there remains a range of views among Committee members regarding the relative strength of different factors. On balance, however, the Committee's best collective judgement, based on the conditioning assumptions described above, is that by the end of the forecast period, the risks of inflation being above or below the 2% target are broadly balanced (**Chart 4**).

The policy decision

At its May meeting, the Committee noted that, despite the changes in the near-term outlook, the fundamental policy challenges following the financial crisis and subsequent recession remained the same. GDP growth was likely to remain weak in the near term and to strengthen gradually thereafter. Developments in the euro area continued to pose a significant threat to that outlook. Inflation had declined sharply since last autumn, broadly as the Committee had expected. And although inflation was likely to remain above 2% for the next year or so, it was nevertheless likely to fall back gradually to around the target. The Committee therefore decided that it was appropriate to maintain Bank Rate at 0.5% and the size of the asset purchase programme at £325 billion in order to meet the 2% CPI inflation target over the medium term.