Overview

The global economy has suffered a sharp and synchronised downturn. Business and household sentiment in many countries has deteriorated markedly, and the global banking and financial system has remained fragile. In the United Kingdom, an adjustment process is under way, as private saving rises and banks restructure their balance sheets. Reflecting both this and the deteriorating global picture, GDP contracted sharply in the fourth quarter of 2008. Business surveys pointed to a similar reduction in output in early 2009. Under the assumption that Bank Rate moves in line with market yields, the MPC's central projection is for output to contract further in the near term. Activity then recovers, reflecting the building stimulus from easing monetary and fiscal policy, the substantial depreciation of sterling, past falls in commodity prices, and actions by authorities at home and abroad to improve the availability of credit. The risks surrounding the central projection for GDP growth are judged to be weighted heavily to the downside.

CPI inflation fell to 3.1% in December. In the central projection, CPI inflation falls well below the 2% target in the medium term, as the drag from a substantial margin of spare capacity more than outweighs the waning impact on import and consumer prices from the lower level of sterling. The near-term path of inflation is uneven. That reflects two further factors: first, the marked fall in energy prices, which drags down sharply on inflation during 2009; and, second, the direct impact of the temporary cut in VAT, which pulls down inflation during 2009 but briefly pushes it back towards the target in early 2010. The balance of risks around the central projection for inflation is judged to be slightly on the downside.

Financial markets

The deteriorating global economic outlook exacerbated strains within financial and credit markets. Banks continued to restructure their balance sheets and remained reluctant to lend. On 19 January, the UK Government announced a further range of measures to improve conditions in the financial system and support lending growth. That package included the establishment of an Asset Purchase Facility (APF) operated by the Bank of England, aimed at increasing the availability of corporate credit. The APF also provides a framework for the MPC to purchase assets for monetary policy purposes should the Committee judge that to be useful to meet the inflation target.

Sterling has depreciated by 13% since the November *Report* and by more than a quarter since mid-2007. Part of that depreciation stems from the deepening cyclical downturn, with investors reducing their near-term expectations for Bank Rate relative to policy rates in other countries. It is also likely to reflect an increase in the perceived riskiness of sterling assets, as well as being associated with the prospective rebalancing of the UK economy.

Many overseas central banks lowered official interest rates significantly. In the United Kingdom, the MPC has reduced Bank Rate by 3.5 percentage points since the beginning of November to 1%. Prior to the Committee's February decision, market participants expected Bank Rate to trough at around ¾% in mid-2009, substantially lower than envisaged at the time of the previous *Report*.

Global activity

The synchronised downturn in global demand and output has intensified since the previous *Report*. Official data and surveys suggest output in the advanced economies contracted markedly in the fourth quarter of 2008 and is likely to fall further in the first quarter. Emerging market economies slowed sharply, as world trade contracted abruptly and the availability of external financing tightened. Looking ahead, the outlook for global demand has worsened materially since November. This deterioration is likely to pull down on UK export growth in coming quarters, despite the substantially lower value of sterling.

Domestic activity

Mirroring the downturn in the world economy, the near-term outlook for UK activity worsened. Credit conditions tightened further, demand prospects became more uncertain and sentiment deteriorated. Businesses responded by cutting output, running down inventories, scaling back investment plans and shedding labour.

Consumer spending appears to have contracted sharply in 2008 Q4. Falling employment, lower financial wealth and tight credit conditions are likely to continue to bear down on consumers' expenditure in the near term. And households' desire to reduce indebtedness and increase savings will probably also weigh on consumption. In coming quarters, those factors are likely to more than offset the boost to households' spending power from past falls in commodity prices, the low level of Bank Rate and the temporary reduction in VAT.

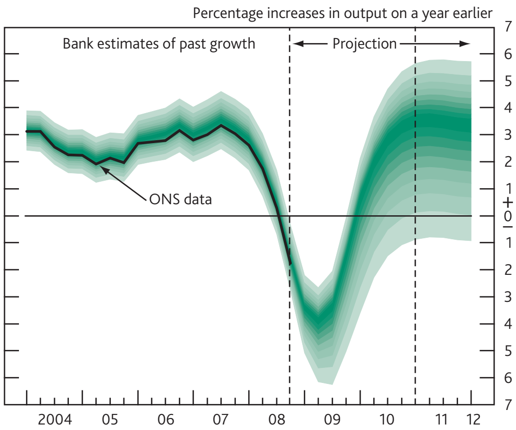
The Committee's central projection is based on the tax and spending plans published in the Government's *Pre-Budget Report 2008*. Those plans, including the temporary reduction in VAT and the acceleration of capital projects, should help to support near-term demand.

The outlook for GDP growth

GDP was estimated to have fallen by 1.5% in 2008 Q4, a substantially larger decline than envisaged at the time of the November *Report*. Subsequent industrial production data suggest that this estimate could be revised down. Evidence from business surveys and from the Bank's regional Agents point to a broadly similar contraction in the first quarter of 2009.

The weakness in economic activity reflects not only the sharp downturn in global economic activity, but also a fundamental adjustment within the domestic economy as private saving rises and banks restructure their balance sheets. But there is a significant economic stimulus in train that will buttress economic activity. That stimulus reflects: the easing in monetary and fiscal policy; the substantial depreciation in sterling; past falls in commodity prices; and the actions taken by the authorities at home and abroad to stabilise the global banking system and increase the availability of credit.

Chart 1 GDP projection based on market interest rate expectations



The fan chart depicts the probability of various outcomes for GDP growth. 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 ten occasions. Consequently, GDP growth is expected to lie somewhere within the entire fan on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. 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 yields. The central view is that the authorities here and abroad will be successful in stabilising the global banking system, and that financial and credit markets will gradually return to more normal conditions. In the central projection, output continues to contract in the near term, as the weakening labour market and increased uncertainty weigh on consumption, businesses run down inventories and reduce investment, and the weakness in world demand inhibits export growth. The near-term contraction in GDP in the central projection is substantially deeper than envisaged in the November *Report*. Further out, GDP growth recovers as the impact of the sizable policy stimulus both at home and abroad is increasingly felt, the contribution from stockbuilding rises, and the lower value of sterling shifts both domestic and overseas expenditure towards UK suppliers. Nonetheless, a significant margin of spare capacity remains in the economy at the end of the forecast period.

The prospects for economic growth remain unusually uncertain, reflecting the exceptional economic and financial factors affecting the outlook. The risks around the central projection are judged to be weighted heavily to the downside. This in large part reflects the possibility that, over the forecast period, the authorities at home and abroad are only partially successful in improving the availability of credit and restoring business and consumer confidence.

Costs and prices

CPI inflation fell to 3.1% in December, driven by sharp falls in energy prices and the temporary reduction in VAT. And measures of households' near-term inflation expectations continued to fall back from their recent peaks.

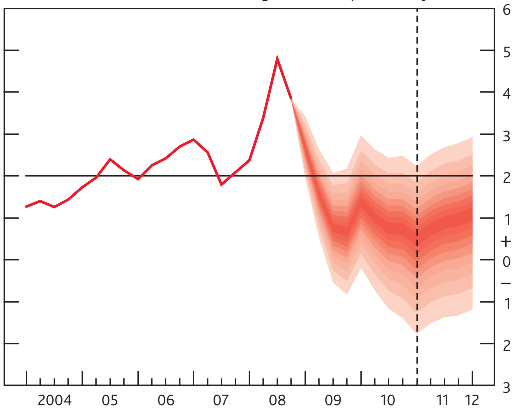
Looking ahead, the weaker demand environment should act to moderate increases in prices and wages. Survey measures of pricing intentions have fallen sharply since the November *Report*. And the loosening in the labour market has been accompanied by a reduction in earnings growth. But the impact of the current slowdown on inflation is likely to be dampened over the forecast period by weaker growth in the supply potential of the economy.

The outlook for inflation is also affected by the substantial depreciation in sterling over the past 18 months, which has significantly raised companies' import costs. In the short term, the weakness in demand means that businesses are likely to be forced to absorb some of the increased costs in lower profit margins and wages in order to support sales. Even so, higher import prices will probably continue to put upward pressure on consumer prices for some time. The speed and extent of this pass-through represent key uncertainties surrounding the inflation outlook.

The outlook for inflation

Chart 2 shows the Committee's best collective judgement of the outlook for CPI inflation, assuming that Bank Rate follows market yields. In the central projection, CPI inflation falls well below the 2% target in the medium term, as a substantial margin of spare capacity more than outweighs the waning impact on import and consumer prices from the lower level of sterling. The near-term path of inflation is uneven. That reflects two further factors: first, the marked fall in energy prices, which drags down sharply on inflation during 2009; and, second, the direct impact of the temporary cut in VAT, which pulls down on inflation during 2009 but pushes it back towards the target in early 2010. The central projection is more volatile than in the November *Report* in the near term, and a little weaker in the medium term.

Chart 2 CPI inflation projection based on market interest rate expectations



The fan chart depicts the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years 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. Consequently, inflation is expected to lie somewhere within the entire fan chart on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. 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.

The prospects for inflation, as for economic growth, remain unusually uncertain. There are significant risks on both sides of the inflation projection. On the downside, the main risk is that the recession may be more pronounced than in the central case, putting further downward pressure on inflation. On the upside, the main risk concerns the implications of sterling's depreciation for consumer prices. Overall, the balance of risks around the central projection for inflation is judged to be slightly on the downside. There is a range of views among the Committee on both the central projection and the balance of risks.

The policy decision

At its February meeting, the Committee noted that the recent easing in monetary and fiscal policy, the substantial depreciation in sterling, the falls in commodity prices and the UK authorities' actions to support lending would together provide a considerable stimulus to activity as the year progressed. Nevertheless, the Committee judged that there remained a substantial risk of undershooting the 2% CPI inflation target in the medium term at the existing level of Bank Rate. A further easing in monetary policy was therefore likely to be needed. At its February meeting, the Committee decided that an immediate reduction in Bank Rate of 0.5 percentage points to 1% was warranted.