

Overview

The world economy remained in deep recession: output contracted further and international trade fell precipitously. The global banking and financial system remained fragile despite further significant intervention by the authorities. In the United Kingdom, GDP fell sharply in the first quarter of 2009. But there were promising signs, both in the United Kingdom and globally, that the pace of decline had begun to moderate. The outlook for domestic economic activity continues to be dominated by opposing forces. Weak global demand, combined with the process of adjustment under way in the UK economy, as private saving rises and banks restructure their balance sheets, will continue to act as a significant drag on economic activity. But pushing in the opposite direction, there is considerable economic stimulus stemming from the easing in monetary and fiscal policy at home and abroad, the substantial depreciation in sterling, past falls in commodity prices, and actions by the authorities internationally to improve the availability of credit. Over the forecast period, that stimulus should lead to a recovery in economic growth, but the timing and strength of that recovery is highly uncertain.

CPI inflation remained close to 3%, significantly higher than the 2% inflation target. Past falls in sterling continued to put upwards pressure on inflation. But the degree of spare capacity in the economy increased further and the loosening in the labour market contributed to a sharp easing in pay pressures. CPI inflation is likely to drop below the 2% target later this year. Under the assumptions that Bank Rate moves in line with market rates and the stock of purchased assets financed by the issuance of central bank reserves reaches £125 billion, it is more likely than not that CPI inflation will be below the 2% inflation target in the medium term. But there are significant risks to the inflation outlook in each direction. The assessment of these risks is key to MPC decisions.

Financial and credit markets

Since the February *Report*, the MPC has cut Bank Rate to 0.5%, and announced a programme of asset purchases totalling £125 billion, including an extension by a further £50 billion announced on 7 May, in order to boost the growth of money and credit and of nominal demand. Over the past three months, yields on gilts eligible for purchase fell, as did those on non-financial corporate debt. Money growth remained weak but did not yet reflect the full impact of the asset purchase programme. Growth in bank lending to companies and households remained sluggish, but the Government's Asset Protection Scheme should improve the resilience of some banks to further losses. There were also signs that companies were making increasing recourse to the capital markets. Equity prices rallied over the past month or so but were little changed from the time of the February *Report*. The sterling effective exchange rate remained around a quarter below its 2007 peak.

Global activity

The sharp and synchronised fall in global economic activity continued in the early months of 2009. Spending on consumer durables and capital goods fell further, reflecting weak consumer and business sentiment and tight credit conditions. The considerable macroeconomic stimulus implemented by governments and central banks should help to ameliorate the global downturn and business surveys pointed to a moderation in the pace of contraction.

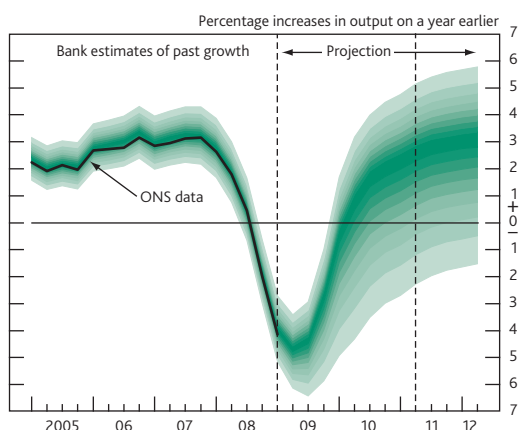
The fall in world activity was accompanied by a sharp contraction in international trade flows. That decline was probably associated with a marked reduction in both inventory holdings and in the demand for capital and consumer durable goods. The substantial depreciation of sterling should continue to encourage both domestic and overseas spending to switch towards UK-produced goods and services.

Domestic demand

Falls in business spending accounted for most of the overall decline in domestic demand in the fourth quarter of 2008. Weak and uncertain demand prospects, together with tight credit conditions, led to a further scaling back of capital expenditure. And companies ran down their stock levels very sharply, significantly amplifying the decline in economic activity.

Consumer spending fell by 1% in 2008 Q4, as households saved a higher proportion of their income. It is likely that households' spending continued to fall in the first quarter of 2009, weighed down by concerns about job prospects and a desire to strengthen their finances.

Chart 1 GDP projection based on market interest rate expectations and £125 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 £125 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 outcomes 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. 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.

The Committee's projections are based on the fiscal plans set out in the 2009 Budget. Those plans included some additional discretionary measures which should help to support demand in the near term. But the projection for public sector net borrowing was revised up substantially and this may pull down on spending if households and companies expect the increased level of borrowing to lead to higher taxes in the future.

The outlook for GDP growth

GDP was estimated to have fallen by 1.9% in 2009 Q1, a larger decline than anticipated at the time of the *February Report*. But there were signs from surveys that the rate at which output was contracting had begun to moderate.

Chart 1 shows the Committee's best collective judgement for four-quarter GDP growth, assuming that Bank Rate follows a path implied by market rates and the stock of purchased assets financed by the issuance of central bank reserves reaches £125 billion and remains at that level throughout the forecast period. The outlook for economic growth is unusually uncertain. The sharp downturn in global economic activity,

combined with the process of adjustment under way in the UK economy, as private saving rises and banks restructure their balance sheets, continues to act as a significant drag on UK growth. But that is counteracted by the considerable stimulus stemming from the easing in monetary and fiscal policy at home and abroad, the substantial depreciation in sterling, past falls in commodity prices, and actions taken by authorities internationally to bolster the availability of credit. This stimulus, when combined with a turnaround in the stock cycle, should lead to a recovery in economic growth over the forecast period.

The timing and strength of that recovery is, however, highly uncertain. The pace of the recovery may be slowed by a number of factors: the contraction in world demand and trade may be protracted; households may save more; and the availability of credit to companies and households may improve only gradually. That said, the substantial scale of the stimulus in train may prompt a rapid rebound in activity. In particular, the impact of monetary policy on nominal spending is more difficult to judge than normal given the use of unconventional measures. The risks are more than usually interdependent given the importance of credit supply and conditions in the banking system. On balance, the Committee judged that these factors point to a relatively slow recovery in economic activity. The projected distribution for GDP growth is weaker than in the February *Report*, reflecting lower-than-expected activity in the first quarter of 2009, both at home and abroad, and a judgement that it is likely to take longer for bank lending to return to normal than assumed in February.

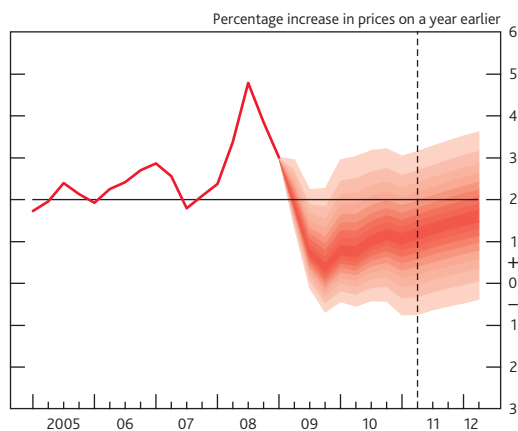
Costs and prices

CPI inflation was 2.9% in March, significantly higher than the 2% inflation target. Measures of households' inflation expectations changed little and appeared broadly consistent with inflation returning to target in the medium term.

Inflation is likely to fall back to below the 2% target later this year, driven in part by diminishing contributions from food and energy prices. The growing margin of spare capacity will also act to depress wage and price increases. The labour market has loosened substantially and pay pressures have eased markedly.

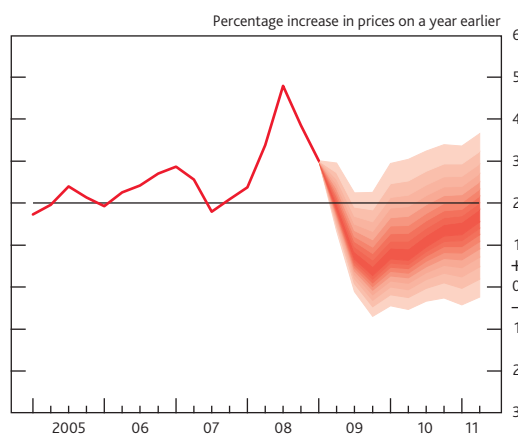
The significant depreciation of sterling has, however, raised companies' import costs. The continued elevation in CPI inflation in the first few months of 2009 probably owed much to the upward pressure from higher import costs. The extent to which the adjustment to sterling's depreciation will come through higher prices rather than lower wages is a key uncertainty surrounding the inflation outlook.

Chart 2 CPI inflation projection based on market interest rate expectations and £125 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 £125 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. 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.

Chart 3 CPI inflation projection based on constant nominal interest rates at 0.5% and £125 billion asset purchases



See footnote to Chart 2.

The outlook for inflation

Chart 2 shows the Committee's best collective judgement for the outlook for CPI inflation, assuming that Bank Rate follows a path implied by market rates and the stock of purchased assets financed by the issuance of central bank reserves reaches £125 billion. The outlook for inflation remains extremely uncertain. The margin of spare capacity that is likely to persist over the forecast period bears down on CPI inflation. That force is partially offset by the upward pressure associated with the pass-through of sterling's depreciation to consumer prices and by the judgement that inflation expectations remain anchored around the inflation target.

The relative magnitude of these opposing influences on inflation is highly uncertain, and there is a range of views on the relative strength of these forces among Committee members. The downward pressure from the margin of spare capacity will depend on the timing and strength of the recovery, as well as on the impact of the slowdown on the growth of productive supply and on the sensitivity of inflation to the degree of slack in the economy. The pass-through from the lower level of sterling will depend critically on the behaviour of the labour market and the extent to which companies adjust to higher import costs by lowering wages. The balance of these factors suggest that, conditioned on the monetary policy assumptions described above, it is more likely than not that CPI inflation will be below the 2% inflation target in the medium term. The projected distribution for inflation in the medium term is higher than in the February *Report*.

Chart 3 shows the projection for CPI inflation conditioned on the assumptions that Bank Rate is held constant at 0.5% and the stock of purchased assets increase to £125 billion. This suggests that, on those assumptions, the risks of inflation being above or below the 2% target become more evenly balanced towards the two-year horizon.

The policy decision

At its May meeting, the Committee noted that the immediate prospect was for CPI inflation to fall substantially below the 2% target, while output continued to contract. But a substantial stimulus was in train which should lead to a recovery in output growth. There were significant uncertainties regarding the inflation outlook relating to the timing and strength of that recovery and the extent of the pass-through from sterling's depreciation. In the light of that outlook, the Committee judged that maintaining Bank Rate at 0.5% and increasing the size of the programme of asset purchases financed by the issuance of central bank reserves by £50 billion to a total of £125 billion was, on balance, most likely to keep CPI inflation on track to meet the 2% inflation target over the medium term.