

Overview

The world economy showed signs of recovery, although global activity remained significantly below pre-crisis levels. In the United Kingdom, output had fallen by about 6% over six quarters, but a number of indicators suggested that economic activity had begun to stabilise. A recovery in output is likely, driven by the considerable stimulus from the past easing in monetary and fiscal policy and the depreciation of sterling. But constraints on the supply of bank credit and concerns over balance sheets will weigh on spending. A degree of economic slack is likely to persist over the forecast period, although its extent will depend on the strength of the recovery and on developments in supply, both of which remain highly uncertain.

CPI inflation fell to 1.1% in September, but is likely to rise sharply to above the 2% target in the near term. Earnings growth remained subdued. 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 reaches and stays at £200 billion, downward pressure from the margin of spare capacity bears down on inflation for much of the forecast period, although this gradually fades as the economy recovers. The risks of inflation being above or below target are broadly balanced by the end of the forecast period. But there are significant risks to the inflation outlook in each direction.

Financial and credit markets

The MPC maintained Bank Rate at 0.5% and continued its programme of asset purchases financed by the issuance of central bank reserves. Expectations of future levels of Bank Rate fell, as did gilt yields. Broad money growth weakened, although it was stronger than it would have been in the absence of the Bank's asset purchases. Equity and corporate bond prices rose markedly, buoyed by the asset purchase programme and perceptions that the risk of a more severe downturn had receded. The sterling exchange rate fell back, and was around a quarter below its mid-2007 peak.

Businesses with access to bond and equity markets continued to utilise them as a source of finance, and some used the proceeds to repay bank debt. There was a further improvement in banks' own funding conditions. But the need for banks to repair their balance sheets remained and the supply of bank credit to most companies and households continued to be restricted.

Demand

The world economy showed signs of recovery, with a number of emerging economies experiencing a robust rebound in growth. The US economy grew strongly in Q3, reflecting

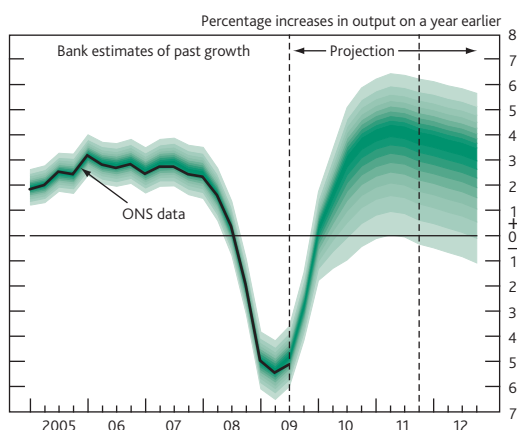
increased household spending. Growth in the euro area is also likely to have been positive in Q3. But global activity and trade remained well below pre-crisis levels and some of the turnaround in world demand has been associated with transitory factors. Even so, the emerging recovery in global demand and the substantial depreciation of sterling should support a continued improvement in the United Kingdom's net trade position.

Households have reduced their consumption substantially over the past year or so. Weakness in current and expected post-tax income and a desire to strengthen their balance sheets in a more uncertain economic environment are likely to have contributed to this contraction in household spending. Indicators of retail spending and consumer confidence picked up in Q3, which may herald some stabilisation in consumption in coming quarters.

Businesses continued to make sharp cutbacks to spending in the face of weak demand, uncertain growth prospects and tight credit conditions. Capital spending was estimated to have fallen by more than 10% in 2009 Q2, and de-stocking continued. Business investment is likely to fall further in coming quarters, although a reduction in the pace of de-stocking should boost output.

The Committee's projections are conditioned on the fiscal plans set out in the 2009 Budget. Those plans implied a marked rise in the ratio of public sector debt to GDP. Stabilising that ratio will require some combination of a reduction in government spending and a rise in taxation as a share of GDP.

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



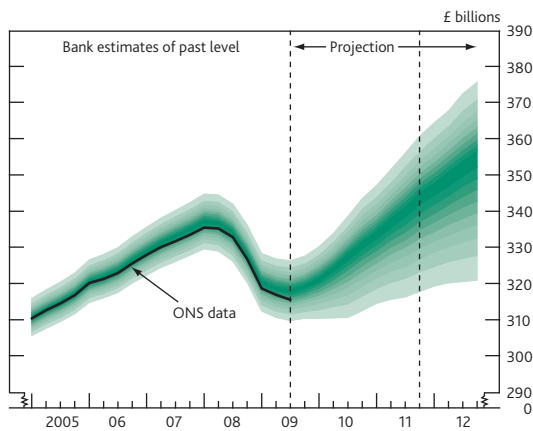
The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves reaches £200 billion and remains there throughout the forecast period. To the left of the first vertical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

According to the provisional estimate, GDP fell by 0.4% in 2009 Q3, a significantly weaker outcome than anticipated at the time of the *August Report*. Initial estimates of GDP growth are prone to revision as more data become available. Evidence from business surveys, and the pattern of past revisions, suggests that this estimate is likely to be revised up a little in due course.

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 assets purchased through the issuance of central bank reserves reaches and stays at £200 billion. The considerable stimulus from the past easing of policy, including asset purchases, and the depreciation of sterling should lead to a recovery in economic activity. Output in the near term will be further boosted as the inventory adjustment is completed. But there are a number of headwinds that are likely to impede the recovery. The supply of bank credit will probably remain constrained for a protracted period. The desire to strengthen private sector balance sheets and the recognition that a

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



Chained-volume measure. 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.

significant fiscal consolidation is required are likely to weigh on spending.

Chart 2 shows the Committee's best collective judgement for the level of GDP, corresponding to the distribution of GDP growth shown in **Chart 1**. Despite the recovery in economic growth, output is very unlikely to return to a level consistent with a continuation of its pre-crisis trend for a considerable period. That reflects in large part the substantial impact of the downturn on the supply capacity of the economy, but also the sustained weakness of demand relative to that capacity.

The strength of the recovery remains highly uncertain and depends on the opposing forces affecting the outlook. The Bank's asset purchases have injected money into the economy, raising the prices of a range of assets and improving companies' access to capital markets. Nevertheless, spending growth remains weak. It is likely to take a considerable period for banks to repair their balance sheets; the impact of this protracted adjustment on spending will depend on the extent to which households and businesses can access alternative sources of finance. High levels of debt and increased uncertainty about the future may lead households to save more, although the low level of Bank Rate should dampen this tendency. The extent to which the United Kingdom is able to move towards a sustainable position of internal and external balance will depend in part on the strength of world growth.

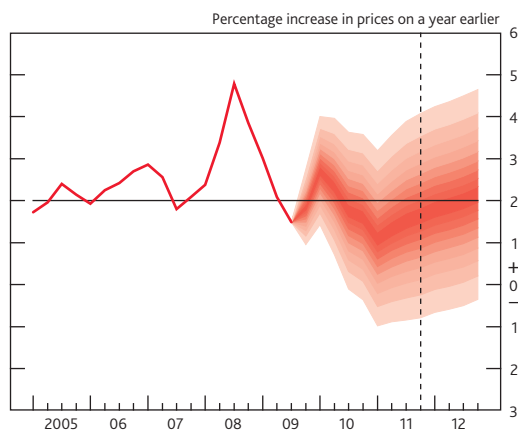
On balance, the Committee continues to judge that the interaction of these factors points to a slow recovery in the level of economic activity. The projected distribution for GDP growth is somewhat stronger than in the *August Report*, reflecting increased asset purchases, the lower interest rate path implied by market yields, the lower level of the exchange rate and a stronger outlook for world demand.

Costs and prices

CPI inflation fell back to 1.1% in September, having been 5.2% a year earlier. Inflation is likely to rise sharply to above the 2% target in the near term, reflecting higher petrol price inflation and the reversal of last year's reduction in VAT. Measures of households' inflation expectations for the medium term remained stable at levels that appeared broadly consistent with inflation at target.

Earnings growth has slowed markedly over the past year, driven in part by the weakness in demand. But that may also be due to increased wage flexibility which could have contributed to the relative resilience of employment over this period. It may also reflect companies adjusting to the substantial rise in import costs associated with sterling's depreciation by pushing down on their other costs.

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 reaches £200 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.

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. Inflation is likely to rise sharply in the near term, primarily reflecting the reversal of the VAT reduction, while sterling's past depreciation continues to push up on inflation. Thereafter, downward pressure from the persistent margin of spare capacity is the dominant force. This pressure acts to bear down on CPI inflation, although it gradually fades as the economy recovers.

The extent to which CPI inflation will deviate from the 2% target is highly uncertain and depends on a number of factors. The degree of downward pressure from the weak demand environment will depend on the timing and strength of the recovery, the impact of the downturn on the supply capacity of the economy, and on the sensitivity of inflation to the degree of economic slack. The profile for inflation will also depend on the extent to which companies need to adjust further to the higher import costs associated with sterling's depreciation and on whether there are further substantial movements in energy and commodity prices. There is a range of views among Committee members about the relative strength of these factors. On balance, the Committee judges that, conditioned on the monetary policy assumptions described above, the risks of inflation being above or below the target are broadly balanced by the end of the forecast period. The outlook for inflation in the medium term is somewhat higher than in August, reflecting the stronger projected distribution for GDP growth.

The policy decision

At its November meeting, the Committee noted that the substantial stimulus from the past easing in monetary and fiscal policy and the depreciation of sterling should lead to a slow recovery in the level of economic activity. CPI inflation looked set to rise sharply in the near term. Further out, downward pressure from the persistent margin of spare capacity was likely to bear down on inflation for some time to come. The Committee noted that a further expansion of the asset purchase programme should reduce that margin of spare capacity and bring inflation back to target more quickly. In light of the outlook, the Committee judged that maintaining Bank Rate at 0.5% and increasing the size of its asset purchase programme by £25 billion to a total of £200 billion was appropriate to keep CPI inflation on track to meet the 2% inflation target over the medium term.