

Overview

The world economy continued to recover, although global activity remained well below pre-crisis trends. After falling substantially, output in the United Kingdom stabilised in the second half of 2009 and a period of gradual expansion is in prospect. The outlook for growth is underpinned by the considerable stimulus from the easing in monetary policy, and supported by global growth and the past depreciation of sterling. But it is likely that credit conditions will remain restrictive for some time and that the need to strengthen public and private sector finances will weigh on spending. A degree of spare capacity is likely to persist over the forecast period, although its extent will depend on the strength of the recovery and on the evolution of supply, both of which remain highly uncertain.

CPI inflation rose sharply to well above the 2% target in December and is likely to have risen further in January. The pickup in inflation largely reflects the impact of one-off adjustments to the level of prices which should have only a temporary effect on inflation. Downward pressure from the persistent margin of spare capacity is likely to cause inflation to fall back to below the target for a period as these temporary effects wane. 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 remains at £200 billion, it is more likely than not that inflation will be below the target for much of the forecast period, but the risks are broadly balanced by the end. The prospects for inflation remain unusually uncertain and there are significant risks to the inflation outlook in each direction.

Financial and credit markets

Since the November *Report*, the MPC has held Bank Rate at 0.5% and continued its announced programme of asset purchases. Market participants' expectations of the near-term path of Bank Rate were marked down. Gilt yields rose. Corporate bond yields fell a little and equity prices firmed slightly. The sterling exchange rate was little changed. Broad money growth remained weak, although the growth of non-financial companies' deposits picked up further.

Some of the weakness in money growth reflected further steps taken by UK banks to repair their balance sheets, although significant challenges regarding their capital adequacy and funding persisted. Credit conditions remained tight. In aggregate, companies continued to raise funds in capital markets while repaying bank debt. Mortgage approvals picked up and house prices rose again.

Demand

The world economy continued to recover, with a sharp rebound in manufacturing output and trade. Activity increased

in the United Kingdom's main trading partners but global activity and trade remained well below pre-crisis trends. The gradual expansion in foreign demand and the past substantial depreciation of sterling should support UK net trade over coming quarters.

Households' consumption was estimated to have stopped falling in 2009 Q3, having declined substantially over the previous year. And the household saving ratio picked up sharply. The past contraction in households' spending is likely to have been driven by weakness in actual and expected labour incomes, a desire to strengthen their balance sheets, and reduced availability of credit. Some indicators of consumption are consistent with an increase in spending in Q4, although this may partly reflect the impact of temporary factors.

The retrenchment in business spending eased. Capital expenditure was broadly flat in 2009 Q3, having fallen by almost 20% in the first half of the year. And the pace at which companies ran down inventories slowed further. But the substantial degree of spare capacity and the continuing tightness in credit conditions are likely to dampen any recovery in business investment.

A significant fiscal consolidation is in prospect. The precise nature and pace of that correction are uncertain. The Committee's projections are conditioned on the plans set out in the December 2009 *Pre-Budget Report*. That consolidation is likely to put downward pressure on spending and inflation over the forecast period.

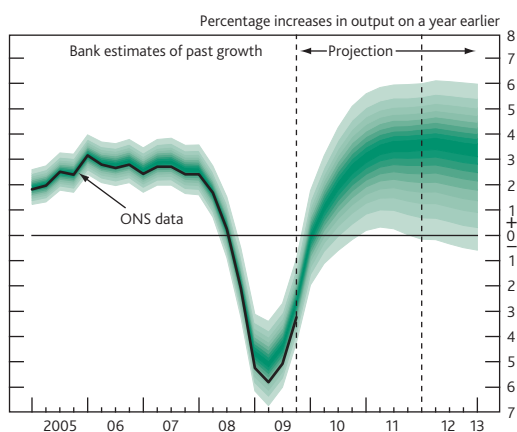
The outlook for GDP growth

GDP was provisionally estimated to have risen by 0.1% in 2009 Q4. Early estimates of GDP growth are prone to revision as more data become available. The Committee judges that it is more likely than not that estimates of GDP during the recession will be revised up a little over time. Business surveys pointed to continued growth in the first quarter of this year.

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 purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. The considerable stimulus from the easing in monetary policy and the past depreciation of sterling, combined with an expansion in world demand, should underpin a recovery in economic activity. But that recovery will be dampened by a number of forces. Credit conditions are likely to remain restrictive for some time and may become more binding as companies seek to expand. And the need to strengthen public and private sector finances is likely to weigh on spending.

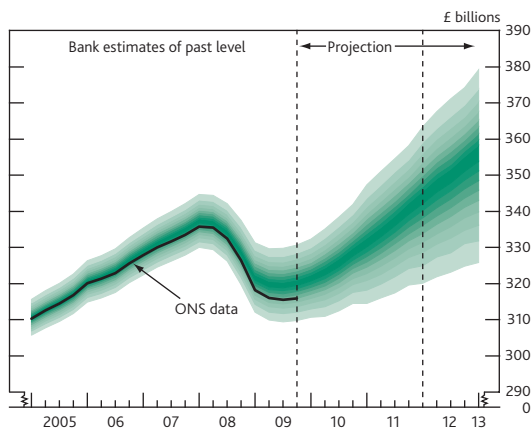
The strength of the recovery is highly uncertain. It is difficult to assess with precision the impact of the unprecedented

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 remains at £200 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 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.

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.

loosening in monetary policy when other significant and unusual forces are affecting the economy. And the extent to which net trade increases will depend on the vigour of the global recovery and on the ability of UK companies to benefit from sterling's depreciation by switching resources towards the production of tradable goods and services. There are also uncertainties about the strength of the headwinds to growth. Although it is likely to be a considerable time before banks are in a position to lend normally, it is unclear to what extent that will constrain household and company spending. The need for a significant fiscal consolidation is clear, but the nature and pace of that correction are uncertain. And it is unclear how much further households will retrench given the adjustment in their spending and saving already seen.

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 similar to that in the *November Report*.

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**. Output is unlikely to return to a level consistent with its pre-crisis trend for a considerable period. That reflects not only the impact of the downturn on the evolution of the supply capacity of the economy, but also the sustained weakness of demand relative to that capacity.

Costs and prices

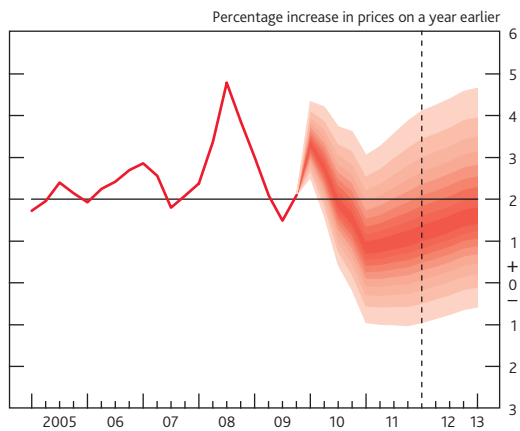
CPI inflation rose sharply to 2.9% in December, from just 1.1% three months earlier. That increase was largely accounted for by higher petrol price inflation and the effects of the reduction in the standard rate of VAT a year earlier dropping out of the twelve-month comparison. Inflation is likely to have risen further in January, reflecting the restoration of the VAT rate to 17.5%. Measures of households' medium-term inflation expectations have been broadly stable.

The substantial rise in import costs associated with sterling's depreciation has also put upwards pressure on inflation. Against a background of weak demand, companies may have attempted to offset higher import costs by pushing down other costs, such as wages. Earnings growth remained low. The weakness of earnings growth may have contributed to the resilience of employment during the downturn relative to the amount of lost output.

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 remain significantly above the 2% target in the near term, reflecting the continuing impact of sterling's depreciation and the restoration of the VAT rate to 17.5%. But these factors should have only a temporary effect

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 remains at £200 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 outcomes 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.

on inflation. As their effects wane, downward pressure from the persistent margin of spare capacity is likely to cause inflation to fall back to below the target for a period.

The extent to which CPI inflation will deviate from the 2% target in the medium term is highly uncertain. Companies' pricing decisions will depend on the timing and strength of the recovery in nominal demand. But the degree to which weakness in nominal demand exerts downward pressure on inflation will also depend on the impact of the recession on the supply capacity of the economy, and on the sensitivity of inflation to the degree of economic slack. This downward pressure on inflation may build gradually if the disruption to supply capacity is most pronounced in the near term or if companies reduce prices in response to spare capacity only with a lag. And inflation may remain higher than otherwise if the period of above-target inflation in the near term causes expectations of medium-term inflation to rise. The profile for inflation will also depend on the extent to which companies need to adjust further to the effects of sterling's depreciation and on whether there are additional substantial movements in energy and commodity prices.

There is a range of views among Committee members regarding the relative strength of these factors. On balance, the Committee judges that, conditioned on the monetary policy assumptions described above, it is more likely than not that inflation will be below the target for much of the forecast period, but the risks are broadly balanced by the end. Overall, the projected distribution for inflation in the medium term is similar to that in the November *Report*.

The policy decision

At its February meeting, the Committee noted that the immediate prospect was for CPI inflation to remain well above the 2% target, and for output to recover slowly. The downward pressure from the persistent margin of spare capacity was likely to cause inflation to fall back to below the target for a period, before gradually returning to around the target as the recovery proceeded. In the light of that outlook and in order to keep inflation on track to meet the 2% target over the medium term, the Committee judged that it was appropriate to maintain Bank Rate at 0.5% and its stock of purchased assets financed by the issuance of central bank reserves at £200 billion. The Committee noted that this stock of past purchases, together with the low level of Bank Rate, would continue to impart a substantial monetary stimulus to the economy for some time to come.