Bank of England

Monetary Policy Report

Monetary Policy Committee

February 2026

Monetary policy at the Bank of England

The objectives of monetary policy

The Monetary Policy Committee (MPC) sets monetary policy to keep inflation low and stable, which supports growth and jobs. Subject to maintaining price stability, the MPC is also required to support the Government's economic policy.

The Government has set the MPC a target for the 12-month increase in the Consumer Prices Index of 2%. The 2% inflation target is symmetric and applies at all times. The MPC's **remit** recognises, however, that the actual inflation rate will depart from its target as a result of shocks and disturbances, and that attempts to keep inflation at target in these circumstances may cause undesirable volatility in output.

The Monetary Policy Report

The MPC is committed to clear, transparent communication. The Monetary Policy Report is a key part of that.

We have made some changes to the structure and content of the Report so that it reflects better the wide range of inputs that are informing monetary policy, as explained in this **Quarterly Bulletin article**. The purpose of the document is to set out the analysis that informed policy discussions.

The Report is produced quarterly by Bank staff under the guidance of the members of the MPC. It has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

The Monetary Policy Committee

- Andrew Bailey, Chair
- Sarah Breeden
- Swati Dhingra
- Megan Greene
- Clare Lombardelli
- Catherine L Mann
- Huw Pill
- Dave Ramsden
- Alan Taylor

PowerPoint™ versions of the Monetary Policy Report charts and Excel spreadsheets of the data underlying most of them are available at **www.bankofengland.co.uk/monetary-policy-report/2026/february-2026.** The 'Projections Databank' is an additional Excel spreadsheet containing a wide range of information relating to the central projection, as well as projections for the scenarios.

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Monetary Policy Summary

At its meeting ending on 4 February 2026, the Monetary Policy Committee voted by a majority of 5–4 to maintain Bank Rate at 3.75%. Four members voted to reduce Bank Rate by 0.25 percentage points, to 3.5%.

Although above the 2% target currently, CPI inflation is expected to fall back to around the target from April, owing to developments in energy prices including from Budget 2025. Reflecting the impact of monetary policy, and consistent with evidence of subdued economic growth and building slack in the labour market, pay growth and services price inflation have generally continued to ease. The risk from greater inflation persistence has continued to become less pronounced, while some risks to inflation from weaker demand and a loosening labour market remain.

Monetary policy is being set to ensure that CPI inflation not only reaches 2% but remains sustainably at that level in the medium term, which involves balancing the risks around achieving this. The restrictiveness of policy has fallen as Bank Rate has been reduced by 150 basis points since August 2024. On the basis of the current evidence, Bank Rate is likely to be reduced further. Judgements around further policy easing will become a closer call. The extent and timing of further easing in monetary policy will depend on the evolution of the outlook for inflation.

Monetary Policy Overview

The Monetary Policy Committee's (MPC's) job is to ensure that inflation continues to fall back to the 2% target and then stays there. Monetary policy has already helped to bring inflation back towards the target over the past three years. That has allowed the MPC to make monetary policy less restrictive by cutting Bank Rate six times since August 2024.

CPI inflation was 3.4% in December. Wage and price pressures have continued to moderate but remain above rates consistent with meeting the inflation target in the medium term.

Recent developments provide more confidence that inflation is on track to return close to the 2% target soon but the MPC needs to ensure that it stays at the target.

The MPC's policy decisions continue to be shaped by how two big forces play out. On the one hand, the period of high inflation could have affected the way wages and prices are determined in the economy, creating more persistent inflationary pressure. On the other hand, weaker labour demand and subdued household spending could take inflation below the target. Monetary policy is being set to balance these risks so that Bank Rate is neither too low nor too high.

The current approach to setting interest rates, including today's decision, is based on two key judgements.

Key policy judgement 1

The risk from greater inflation persistence has continued to become less pronounced, while some risks to inflation from weaker demand and a loosening labour market remain.

The recent experience of high inflation could still be affecting wages and prices. This could create more persistent inflationary pressure, requiring tighter monetary policy than otherwise. Services price inflation and wage growth still need to fall further for the MPC to be confident that inflation will return to the target and stay there (Box A: Estimates of 'target-consistent' wage growth). In addition, weak productivity growth could put upward pressure on companies' costs (Box C: The outlook for productivity growth).

However, other developments and new analysis suggest that the risk of greater inflation persistence has continued to diminish. The outlook for inflation over the next six months is notably lower than expected in November. That mainly reflects developments in energy prices, including the impact of measures announced in Budget 2025 (Box D: Budget 2025 and the impact of fiscal policy on the economy). Lower inflation in coming months should feed through into lower inflation expectations among households and businesses, reducing the risk

that high inflation becomes self-fulfilling (Box B of the **November 2025 Monetary Policy Report**). And, while wage growth may only be falling slowly, new evidence provides reassurance that structural changes in wage-setting will not keep adding to inflationary pressures (Box B: Heterogeneity in wage-setting behaviour among UK firms).

While concerns about the upside risk from greater inflation persistence continue to become less pronounced, some risks to the outlook for inflation from weaker demand and a loosening labour market remain. This could lead to a substantial margin of spare capacity, causing inflation to settle below the 2% target unless monetary policy were loosened further. Despite past reductions in Bank Rate, the household saving rate remains above historical levels. That could indicate that households are more cautious following the recent shocks to their finances, and that spending growth will remain weak (Box D of the **November 2025 Monetary Policy Report**). Labour market conditions have loosened (Section 1.2) and any further weakening in labour demand could lead to a more pronounced rise in unemployment (Box E of the **November 2025 Monetary Policy Report**).

Key policy judgement 2

On the basis of the current evidence, Bank Rate is likely to be reduced further. Judgements around further policy easing will become a closer call.

Monetary policy is being set to ensure that inflation not only reaches the 2% target but remains sustainably at the target in the medium term. Monetary policy continues to weigh on inflation and activity (Box E: Monitoring the transmission of monetary policy with interest rate-sensitive indicators). If inflationary pressures continue to ease, Bank Rate is likely to be reduced further. Judgements around further reductions will become a closer call.

As always, the extent and timing of further easing in monetary policy will depend on the evolution of the outlook for inflation. On the one hand, cutting Bank Rate too quickly or by too much could lead to inflationary pressures persisting, requiring policy to change course. On the other hand, waiting too long to ease policy could come at the cost of a sharper downturn in activity, and subsequently inflation, requiring greater policy easing later on to ensure inflation returns sustainably to the target. With uncertainty around how precisely a neutral level of Bank Rate can be estimated, slowing the pace of further easing could provide space to gain assurance about how the risks are evolving.

The central projection described in Section 3.1 provides a reasonable baseline for how the majority of the MPC judges the economy is likely to evolve if neither of the remaining risks around inflation persistence and demand weakness materialise to a meaningful degree. Section 3.2 sets out how the economy could evolve differently to the central projection,

including by updating the scenarios from the November Report. These scenarios also help the MPC to consider how well different monetary policy responses might perform in achieving the MPC's objective of low and stable inflation at the 2% target.

At this meeting, the MPC voted to maintain Bank Rate at 3.75%. More evidence is needed on how the risks to the medium-term outlook are evolving before cutting Bank Rate further.

1: Current economic conditions

1.1: Inflation

> **Headline CPI inflation was 3.4% in December, slightly lower than expected at the time of the November Report.**

CPI inflation has fallen by 0.4 percentage points from its recent peak in September (Chart 1.1) and was 0.1 percentage points below expectations at the time of the November Report. The downside news relative to November largely reflects lower food and services price inflation.

Despite the recent slowing, inflation remains above the 2% target. That in part reflects unusually large increases in administered prices such as Vehicle Excise Duty and higher water bills. These are currently estimated to be contributing around 0.5 percentage points to the inflation overshoot, based on the difference between their current and historical contributions (Chart 1.3). Food, beverage and tobacco inflation is estimated to be contributing a further 0.5 percentage points to the inflation overshoot. Elevated labour cost growth is also pushing up inflation, particularly for services which tend to be labour intensive.

Chart 1.1: CPI inflation was 3.4% in December

Contributions to CPI inflation (a)
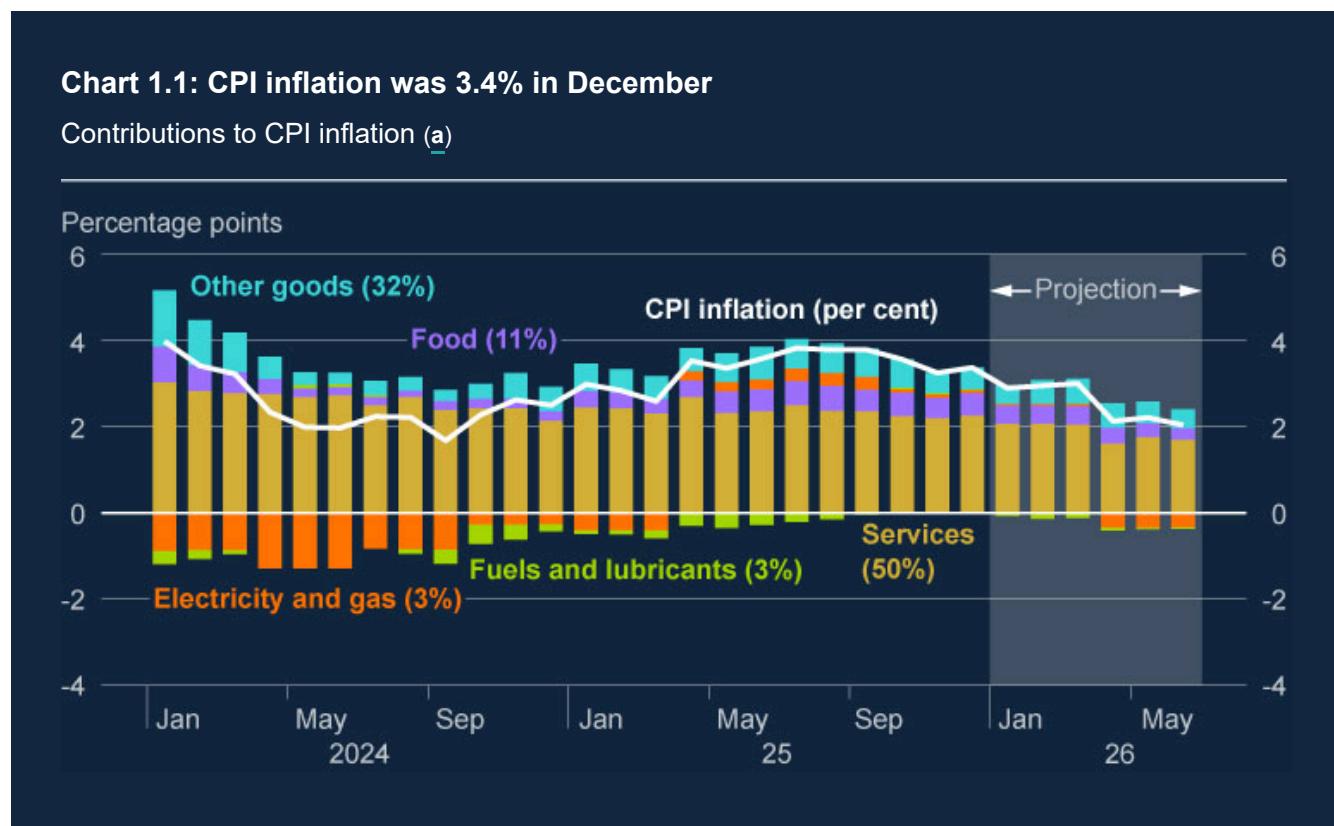
Sources: Bloomberg Finance L.P., Department for Energy Security and Net Zero (DESNZ), ONS and Bank calculations.

(a) Figures in parentheses are CPI basket weights in 2025, which do not sum to 100% due to rounding. Data are shown to December 2025. Component-level Bank staff projections are shown from January 2026 to June 2026. The projection also accounts for expected changes in CPI weights in 2026. The food component is defined as food and non-alcoholic beverages. Fuels and lubricants estimates use DESNZ petrol price data for January 2026 and are then projected based on the sterling oil futures curve.

> **Headline CPI inflation is projected to slow much more than expected in the November Report, to 2.1% in 2026 Q2, largely reflecting measures announced in Budget 2025.**

CPI inflation is expected to fall to 2.1% in 2026 Q2, a 0.7 percentage point greater fall than anticipated in the November Report (Chart 1.2). That news largely reflects the energy bills package announced in Budget 2025 (Box D), which, alongside a fall in wholesale gas prices, is expected to result in a decline in the Ofgem price cap in April to £1,616 from £1,758. That fall in the contribution of utility prices represents around one third of the overall expected decline in CPI inflation in the first six months of 2026 (Chart 1.1).

Chart 1.2: Lower household energy prices mean that CPI inflation is projected to slow much more than expected in the November Report

News to CPI inflation relative to the November 2025 projection (**a**)
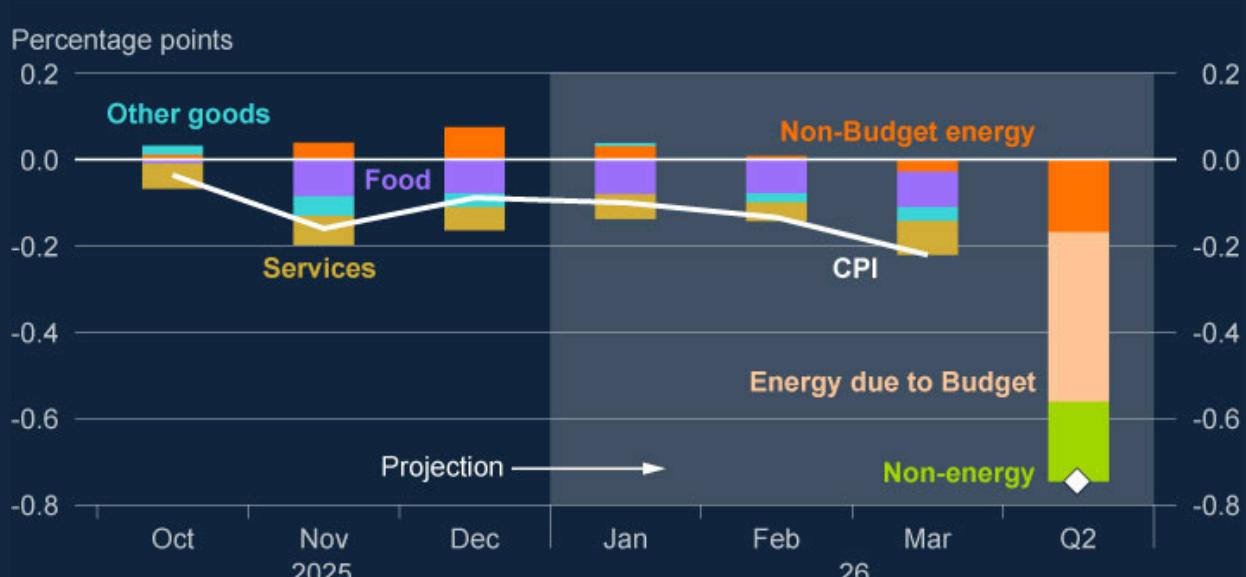
Sources: ONS and Bank calculations.

(a) Bank staff's short-term inflation forecast only extends for six months. For that reason the Q2 'Non-energy' bar represents the difference between the February Report short-term forecast shown in Chart 1.1 and the November Report medium-term central projection, excluding the effects of energy. The 'Energy due to Budget' bars represent the estimated impact of the energy bills package and the extension of the fuel duty cut. The 'Non-Budget energy' bar represents expected falls in utility price inflation due to non-Budget related factors such as falls in wholesale gas prices.

A reduction in the contribution from other changes in administered prices, regulated prices and indirect taxes (AR&T) is also expected to support the near-term disinflation process. Bank staff judge that the overall contribution of AR&T will fall to around its historical average in 2026 Q4 (Chart 1.3).

Chart 1.3: The estimated contribution of AR&T to CPI inflation is expected to be around its historical average by 2026 Q4

Estimated contributions of AR&T to CPI inflation (excluding major VAT changes) (a)

Percentage points

Estimated contribution to CPI inflation

1997–2019 average

2026 Q4 estimate
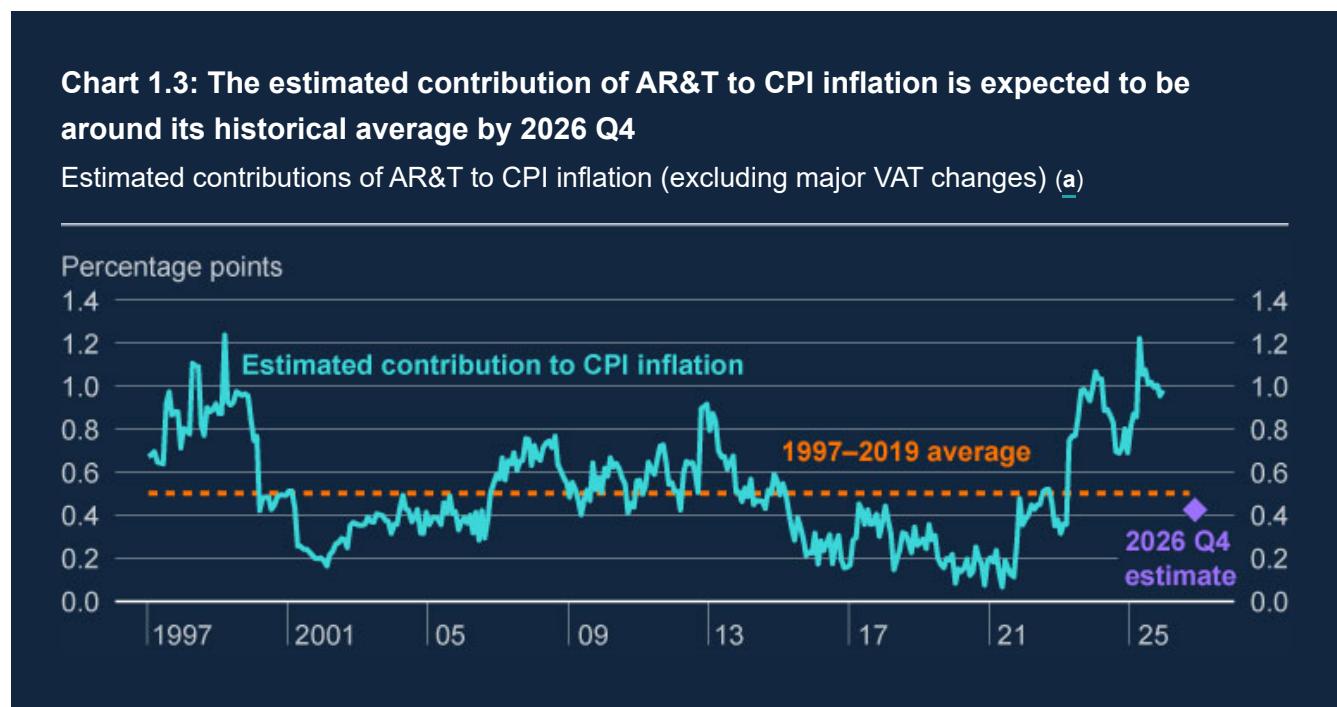
Sources: ONS and Bank calculations.

(a) These data exclude major VAT changes in 2008–11 and 2020–22, the Eat Out to Help Out scheme and the Energy Price Guarantee effective 2022–24. The diamond includes the impact of the energy bills package announced in Budget 2025 which is worth a little over 0.2 percentage points. Around 12% of the basket is estimated to be associated with AR&T changes. Given the variability of the contribution of AR&T over the past, the long-term average might not be a good guide to future trends. The latest data are for December 2025 and the diamond is for 2026 Q4.

A broad-based slowing in other components is expected to account for the remaining fall in CPI inflation over 2026 H1. That in part reflects the continued slowing in wage growth and a fading impulse from the 2025 increase in employer NICs. Continued falls in some indicators of external costs are also expected to support disinflation in the near term.

Bank staff project that core goods inflation will fall to 0.9% by June 2026, slightly above its 2012–19 average. Services and food price inflation are expected to moderate to 3.3% and 2.4% respectively, close to, but still slightly above, their 2012–19 averages.

Global price pressures remain subdued.

Indicators of global price pressures have been weak, reflecting falling energy prices, domestic demand weakness in China and the effects of higher US tariffs. Chinese export prices fell by over 2% in the year to 2025 Q3, which may be partly due to trade diversion, as well as continuing demand weakness in China. This, alongside weakness in euro-area export prices and the US dollar, has meant that aggregate UK import prices have been fairly flat over 2025 and import price inflation is expected to remain subdued.

Spot oil prices were around $66 a barrel in the 15 UK working days to 26 January, a little higher than in the period leading up to the November Report. The UK gas futures curve has fallen by around 13% on average over the same period.

Indicators of food price inflation have eased. Agricultural commodity prices for items such as cocoa and cattle had surged in 2025 (Box E of the **August 2025 Monetary Policy Report**), pushing up consumer prices, but these have since fallen from their recent peaks. Further down the supply chain, producer output prices have been flat since August. Contacts of the Bank's Agents report that food price inflation has peaked and should moderate further from here (**Agents' summary of business conditions – February 2026** (ASBC)).

| **Wage growth has continued to moderate.**

Annual private sector regular AWE growth slowed to 3.6% in the three months to November, down from 4.4% in the three months to August and 0.1 percentage points below the projection in the November Report. That fall was partly due to mechanical base effects, as strong monthly growth rates from last year dropped out of the annual comparison, but timelier measures of pay growth have also cooled. Bank staff estimates that abstract from volatile movements in AWE indicate a three-month annualised growth rate of around 3¼%. Alternative indicators generally also suggest continuing moderation, though to differing degrees. An estimate of private sector median pay based on HMRC RTI data implies pay growth of 4.6% in December 2025, down from 5.0% in September 2025.

The recent slowing in wage growth has brought it closer into line with the rate implied by its key determinants, following a period of unexplained strength. A model estimated on pre-Covid pandemic data suggests that the estimated rate of wage growth in 2025 Q4 can be largely explained by movements in inflation expectations, productivity and the margin of slack in the economy (Chart 1.4). Box B discusses reasons for the recent excess strength in wage growth shown in the gold bars and implications for the wage outlook.

Chart 1.4: Wage growth is broadly as expected based on a simple model of its key determinants

Contributions to estimated annual private sector regular pay growth (a)
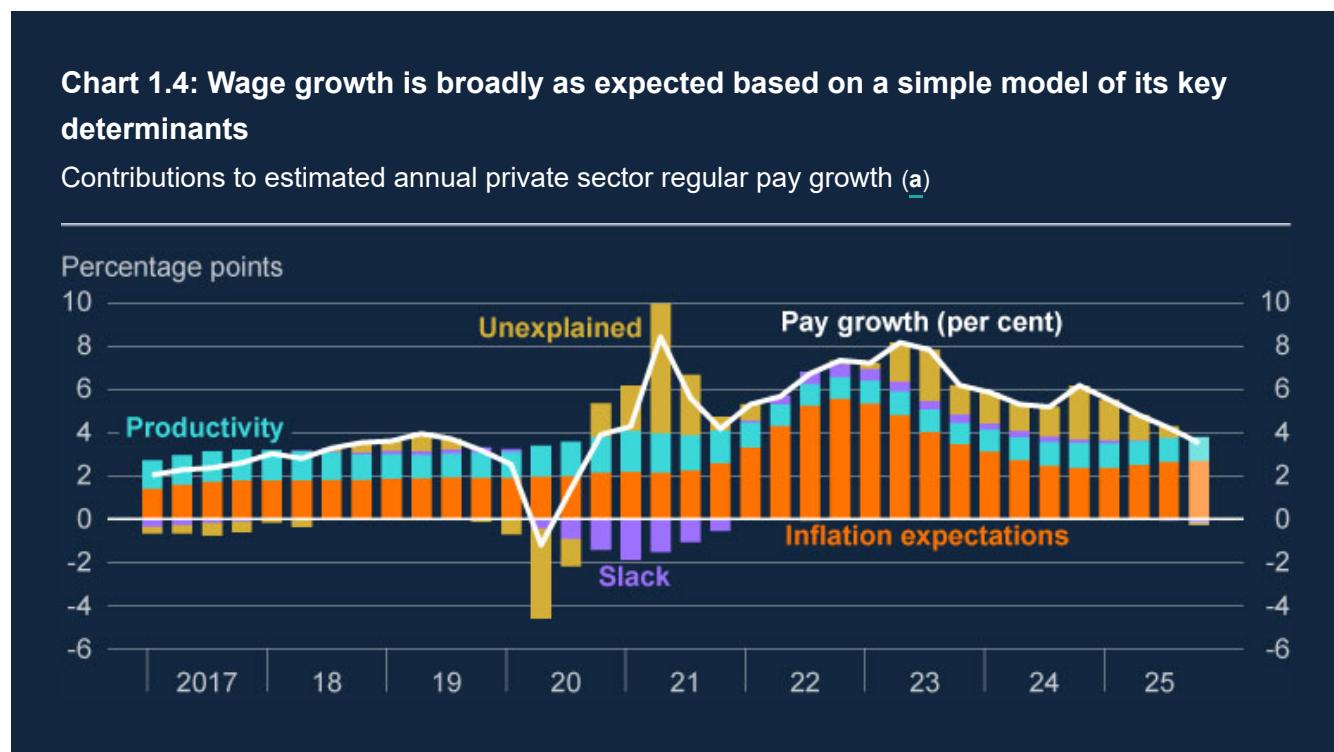
Sources: Barclays, Citi/YouGov, ONS and Bank calculations.

(a) Wage equation based on **Yellen (2017)**. Short-term inflation expectations are based on the Barclays Basix Index and the YouGov/Citigroup one-year ahead measure of household inflation expectations. Slack is based on the MPC's estimate of the unemployment gap. Productivity growth is based on market sector productivity growth per head. Values may not sum due to rounding. The unexplained component is the residual. The final data point is 2025 Q3 and the estimate for 2025 Q4 is a staff projection.

In contrast to the slowing in the private sector, public sector regular pay growth rose to 7.9% in the three months to November. That in part reflects some public sector pay rises being implemented earlier in 2025 than in 2024. The risk that high public sector pay growth spills over to the private sector is likely to be low, in part because job flows between the two sectors are currently below their pre-pandemic averages.

> **Some further easing in wage growth is expected in 2026 as labour market conditions continue to loosen.**

The Agents' pay survey suggests that basic private sector pay settlements will average 3.4% over 2026, broadly in line with expectations at the time of the November Report, and down from an average actual pay settlement of 4.0% in 2025 (**ASBC – February 2026**). The distribution of expected pay settlements has shifted lower, with over 70% of settlements now in the 2%–4% range (Chart 1.5). Firms reported that current and expected inflation were the most important factors pushing up pay settlements. Firms' ability to recruit and retain staff remained important, but less so than in 2025, consistent with the continued loosening in the labour market.

Chart 1.5: The distribution of expected pay settlements in the Agents' pay survey has shifted left

Fitted kernel density and median survey expectations (a)
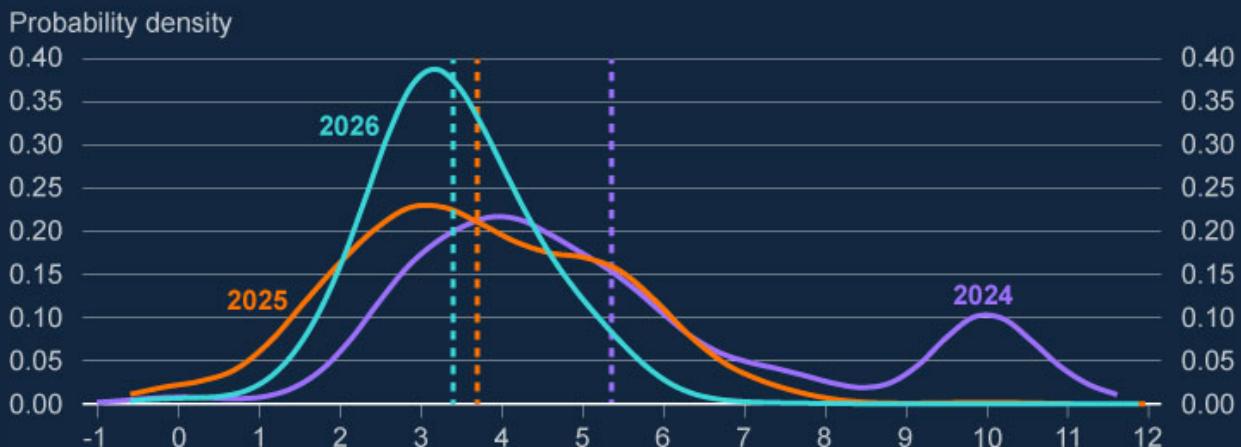
Sources: Bank of England Agents and Bank calculations.

(a) Kernel density estimates of the distribution of one year ahead expected pay settlements from the Agents' pay survey. Curves are smoothed representations of the underlying survey responses. Each line shows the distribution of responses for the year indicated. Dashed lines represent the median survey expectations for each year. The latest data are the 2026 expected pay settlements.

Other forward-looking indicators of pay growth are also consistent with some further easing. Firms responding to the DMP Survey, for example, expect wage growth to fall by 0.7 percentage points to 3.7% by 2026 Q4, and then a little further in the three months to January 2027.

A smaller increase in the NLW should help to support the disinflation process. The forthcoming increase in April 2026, of 4.1%, is expected to have a negligible impact on aggregate wage growth, in contrast to the 0.2 percentage points boost to wage growth estimated in 2025, when the NLW was increased by 6.7%. Contacts of the Bank's Agents report that lower pressure from the NLW is expected to reduce labour cost growth this year.

Bank staff's central projection is for a further slowing in AWE growth, to 3.2% by 2026 Q2 (Chart 1.6). The projection is informed by the 3.4% estimate for basic settlements from the Agents' pay survey, as well as an expectation that pay drift will weigh on AWE pay growth. Pay drift reflects the extent to which aggregate pay growth diverges from pay settlements and can be positive when firms are under pressure to raise pay to retain or attract workers. As the

labour market has loosened (Section 1.2), pay drift has turned slightly negative. Firms' average wage expectations in the DMP Survey could suggest upside risks to this projection, however.

Chart 1.6: Wage growth has fallen and is expected to moderate somewhat further
Measures of private sector wage growth and pay settlements (a)
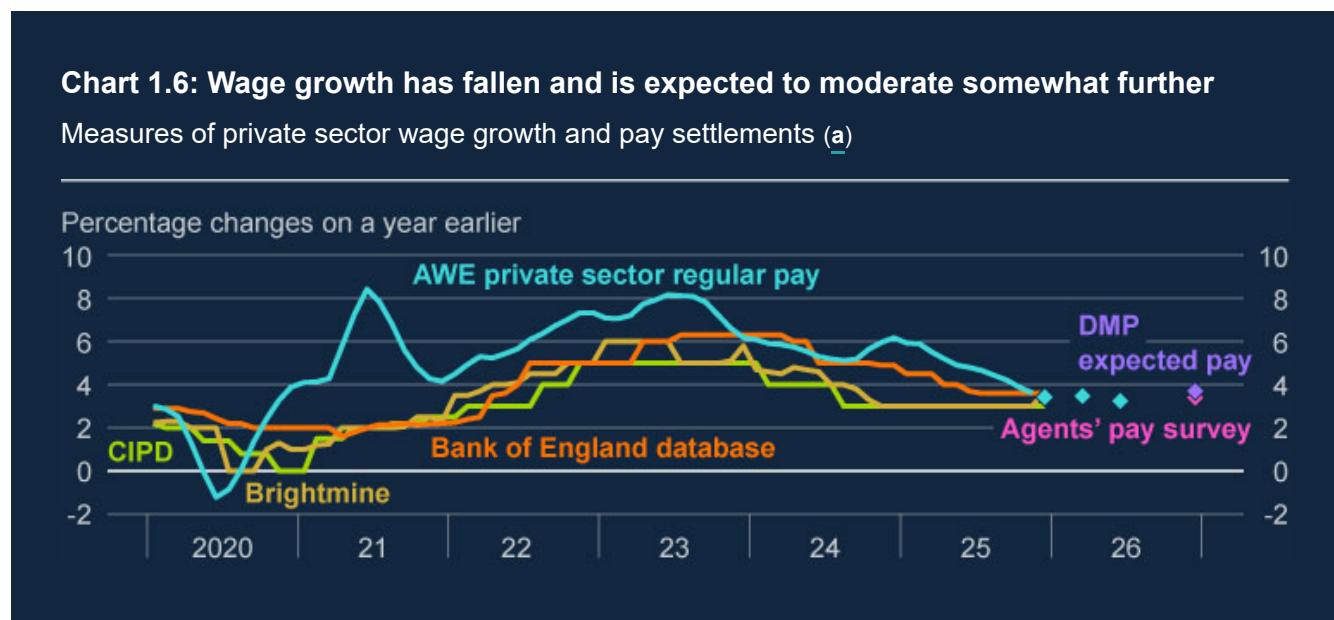
Sources: Bank of England Agents, Brightmine, CIPD, DMP Survey, Incomes Data Research, Labour Research Department, ONS and Bank calculations.

(a) AWE private sector regular pay shows the ONS measure of private sector regular AWE growth (three-month average on same three-month average a year ago). The DMP expected pay series is a three-month average, measuring pay growth for the year ahead. It measures total wage growth per worker. The other measures capture basic pay settlements which may differ from AWE growth due to pay drift. The latest AWE data are for the three months to November, while the aqua diamonds are quarterly projections for 2025 Q4–2026 Q2. The DMP expected pay growth is for the three months to December. The Agents' pay survey diamond shows respondents' expected average pay settlements in 2026, weighted by employment and sector. The Bank of England settlements database is a 12-month average to December 2025. The Brightmine and CIPD data are three-month averages to December 2025.

Measures of underlying services inflation eased over 2025 as a whole but edged up slightly in the most recent data.

Measures of underlying services inflation have eased over the past year, and monthly annualised inflation rates are currently at around 4% (Chart 1.7). These measures ticked up slightly in the most recent data, partly reflecting a pickup in restaurant and café prices which rose by an annualised rate of 5% on the quarter. In turn that is probably the consequence of lagged pass-through of last year's rise in food price inflation, which is expected to moderate in the coming months.

The decline in wage growth and a fading impact from higher employer NICs are expected to support a further easing in annual services inflation, to 3.3% by June 2026. That easing is expected to be broad-based, with the trimmed-mean measure of underlying services inflation

(Chart 1.7, orange line) expected to fall to around 3 ½% over the next few months, leaving both measures slightly above the range that is likely to be consistent with CPI inflation at target. There is a risk that pass-through from lower wage growth to services inflation is more limited if firms seek to rebuild their margins over and above their costs (Box A of the **November 2025 Monetary Policy Report**). 39% of firms responding to the DMP Survey said they expected to rebuild margins in the year ahead. But contacts of the Bank's Agents expect a limited degree of margins rebuild over the next year, mainly reflecting continuing weakness in demand (**ASBC – February 2026**).

Chart 1.7: Underlying services inflation measures have edged up slightly

Measures of three-month average monthly annualised services price inflation (a)

Sources: ONS and Bank calculations.

(a) Measures shown are three-month averages of seasonally adjusted monthly annualised inflation. The low-variance measure is calculated by weighting each component of services inflation by the inverse variance of the change in 12-month inflation of that component from 12 months previously. The maximum adjusted weight is capped at twice its original value. Details of the components that have been included/excluded from the Services excluding indexed and volatile components, rents and foreign holidays measure are included in the accompanying spreadsheet published online. The trimmed-mean measure excludes the 10% largest and 10% smallest price changes. The latest data points are for December 2025.

Inflation expectations

Households' and firms' inflation expectations remain elevated.

Short-term household inflation expectations remain above their long-term averages (Chart 1.8, aqua lines in left panel). The Citi one-year-ahead measure stood at 3.8% in January, down from 4.2% in October but around 2 standard deviations above its 2010–19 average. The equivalent measure from the Inflation Attitudes Survey fell by 0.1 percentage points to 3.5% in 2025 Q4 but is also above its historical average. Medium-term household measures remain elevated.

Household inflation expectations are above the range implied by their past relationships with other economic variables. Short-term expectations tend to be sensitive to developments in spot consumer price inflation (**Rowe (2016)**), however. Consequently, as headline inflation falls in coming months, short-term inflation expectations are expected to moderate towards their pre-pandemic averages, although there are risks around this (Section 3.2 and Box B of the **November 2025 Monetary Policy Report**).

Firms' inflation expectations also appear somewhat elevated. One-year-ahead CPI expectations of firms responding to the DMP Survey in the three months to January were 3.2% on average, down from 3.4% in the three months to October, while three-year-ahead expectations were unchanged at 2.9% (Chart 1.8, right panel). Firms' average two-year-ahead CPI expectations in the Deloitte CFO Survey for 2025 Q4 were 2.5%, a little above their 2014–19 average of 2.2%.

The own-price expectations of firms responding to the DMP Survey in the three months to January were 3.5% on average for the year ahead, compared with realised price growth of 3.7%, implying little disinflation over the coming year. But firms' own price expectations tend to respond to realised inflation and so should fall back as CPI inflation falls in coming months.

Medium-term inflation expectations implied by financial markets, such as the five-year, five-year forward inflation swap rate, have risen slightly since the November Report. The median respondent to the latest Market Participants Survey expected CPI inflation one year ahead to be 2.2%, a little lower than the 2.3% reported in the November Survey, and to be 2% at the three-year horizon.

Chart 1.8: Households' and firms' inflation expectations have eased a little but remain elevated

Survey-based measures of household (a) and business inflation expectations (b)

Sources: Citigroup, DMP Survey, YouGov and Bank calculations.

(a) Data shown are from the Citi/YouGov survey and are based on responses to the questions: 'How do you expect consumer prices of goods and services will develop in the next 12 months?', and 'And what do you think will happen to the prices of goods and services, on average, over the longer term – say five to ten years?'. Dashed lines represent the series averages over 2010–19. The latest data points are for January 2026.

(b) Data shown are from the DMP Survey and are based on three-month averages of responses to the question: 'What do you think the annual CPI inflation rate will be in the UK, one year from now and three years from now?'. The latest data points are for January 2026. The DMP Survey data have a short back-run, so no historical averages are shown.

1.2: Activity

Domestic demand

> **Underlying GDP growth remains subdued, consistent with weak growth in potential supply and a small drag from past monetary tightening and uncertainty.**

Underlying GDP is estimated to have grown by 0.1% in 2025 Q4, down from 0.2% in Q3 and slightly lower than headline GDP growth (Chart 1.9). These growth rates are a little lower than estimated potential supply growth, although that has also been subdued in recent quarters.

Market sector output growth has been even weaker than underlying growth over the past 18 months, as past monetary policy restrictiveness and uncertainty, in part relating to Budget 2025, have weighted on activity (Chart 1.10). Public sector output growth has been stronger and is expected to remain robust.

Chart 1.9: Underlying GDP growth remains subdued, but is expected to pick up slightly

Quarterly growth in headline GDP and underlying growth implied by business surveys (a)

Sources: Bank of England Agents, BCC, CBI, Lloyds Business Barometer, ONS, S&P Global and Bank calculations.

(a) The final data point for quarterly headline GDP growth is for 2025 Q3. The diamonds for 2025 Q4 and 2026 Q1 show Bank staff projections. Underlying GDP growth estimates are from a survey indicator model based on a Staggered-Combination MIDAS approach (**Moreira (2025)**). The orange diamonds to 2025 Q3 show in-sample fitted values of the survey indicator model, and diamonds for 2025 Q4 and 2026 Q1 show out-of-sample projections. The orange swathe shows the interquartile range of estimates from individual survey indicators in the model and values have been interpolated between quarters.

Underlying growth is expected to pick up slightly in 2026 Q1, to 0.2%. This is broadly consistent with the S&P Global Composite UK PMI output index, which picked up in January to around its historical average. Agents' contacts continue to expect subdued growth throughout 2026, citing weak confidence and subdued global demand (**ASBC – February 2026**).

Chart 1.10: Weakness in market sector output growth has been offset by strong growth in public sector output

Changes in sectoral GDP since December 2023 (a)

Per cent

Public sector output

Market sector output

Dec Jan | May | Sept | Jan | May | Sept
2023   24   25

Sources: ONS and Bank calculations.

(a) Public sector output includes public administration and defence, education, and human health and social work activities. Market sector output is total GDP excluding public sector output. The final data points are for November 2025.

| **Household consumption growth has been subdued but picked up in 2025 Q3.**

Past rises in interest rates have been a major driver of weak consumption growth in recent years, although Bank staff judge that these effects may be starting to wane (Box E). The household saving ratio fell to 9.7% in 2025 Q3 (Chart 1.11), reflecting lower real income growth and a pickup in consumption growth. Initial estimates of the household saving ratio are often subject to substantial revision, however.

Despite the most recent fall, the saving ratio remains higher than in the decade prior to the pandemic. A large part of that is likely to reflect past monetary policy restrictiveness. Increases in the effective interest rate on the stock of UK mortgages are continuing to reduce household cash flows, for example, which is weighing on consumption. Past rises in inflation and heightened uncertainty could also be contributing to a higher saving ratio by causing a structural shift in households' saving preferences (Box D of the **November 2025 Monetary Policy Report**). There continues to be little evidence that households are saving more for precautionary reasons, however. While evidence from the Bank of England/NMG survey points to higher economy-wide unemployment expectations, households' own perceived job-loss risk remains low on average. And, whereas a pickup in flows of liquid deposits could signal that households are saving for precautionary reasons, the mix of liquid and illiquid deposits in households' deposit flows has been similar to historical trends.

Evidence from spending indicators suggests that consumption growth will remain weak in the near term. Retail sales volumes fell overall in 2025 Q4, and GfK consumer confidence remained subdued. Contacts of the Bank's Agents expect weak consumer confidence to persist into early 2026. Real disposable incomes are expected to continue to rise, although the freeze in income tax thresholds will limit the support to household spending. While further increases in effective mortgage rates are expected to continue to weigh on spending growth, waning effects of past monetary policy restrictiveness are expected to boost consumption growth overall in coming quarters.

Chart 1.11: Despite a small decline in 2025 Q3, the household saving ratio remains elevated relative to past averages

Household saving ratio (a)
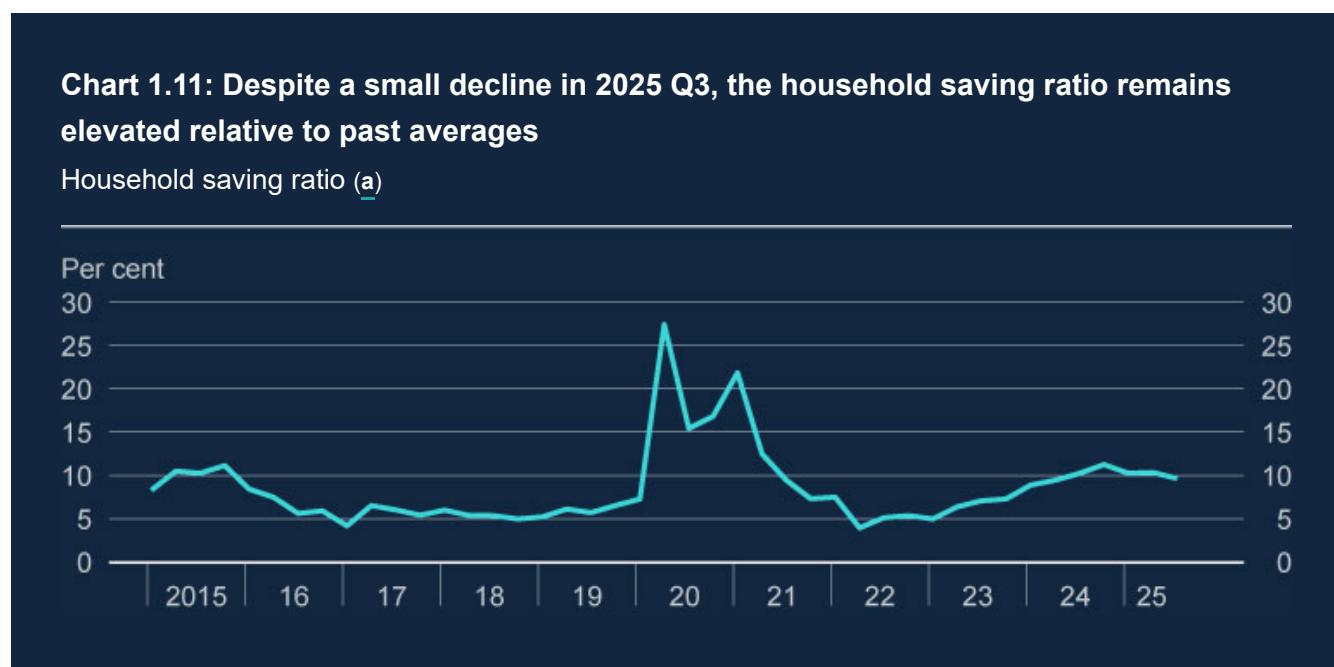
Sources: ONS and Bank calculations.

(a) Saving as a percentage of total available household resources. The ONS series is NRJS. The final data point shown is for 2025 Q3.

> **Business investment growth has been reasonably robust, although investment intentions have been weak.**

Business investment was revised up significantly as part of Blue Book 2025 and was relatively robust at 2.7% in the year to 2025 Q3 (Chart 1.12), driven by investment in information communications technology (ICT) and machinery. Recent business investment growth will have been supported by declines in firms' external financing costs (Section 1.3). And contacts of the Bank's Agents report that the cost of labour relative to capital has risen, raising incentives to invest in labour-saving technologies (Box C). As the lagged effects of past increases in interest rates continue to wane and some substitution from labour to capital continues, that is expected to support business investment growth in coming quarters.

Subdued investment intentions could pose a downside risk to the near-term outlook for business investment growth, however. Investment intentions fell sharply in 2024 Q4 and have remained weak (Chart 1.2). Contacts of the Bank's Agents note that the wider economic outlook is not conducive to investment (**ASBC – February 2026**). And while some firms are resuming delayed investment projects, these are mainly intended to increase efficiency and reduce costs.

Chart 1.12: Business investment growth has been reasonably robust, although investment intentions surveys point to weakness

Four-quarter business investment growth and range of survey indicators of investment intentions (a)
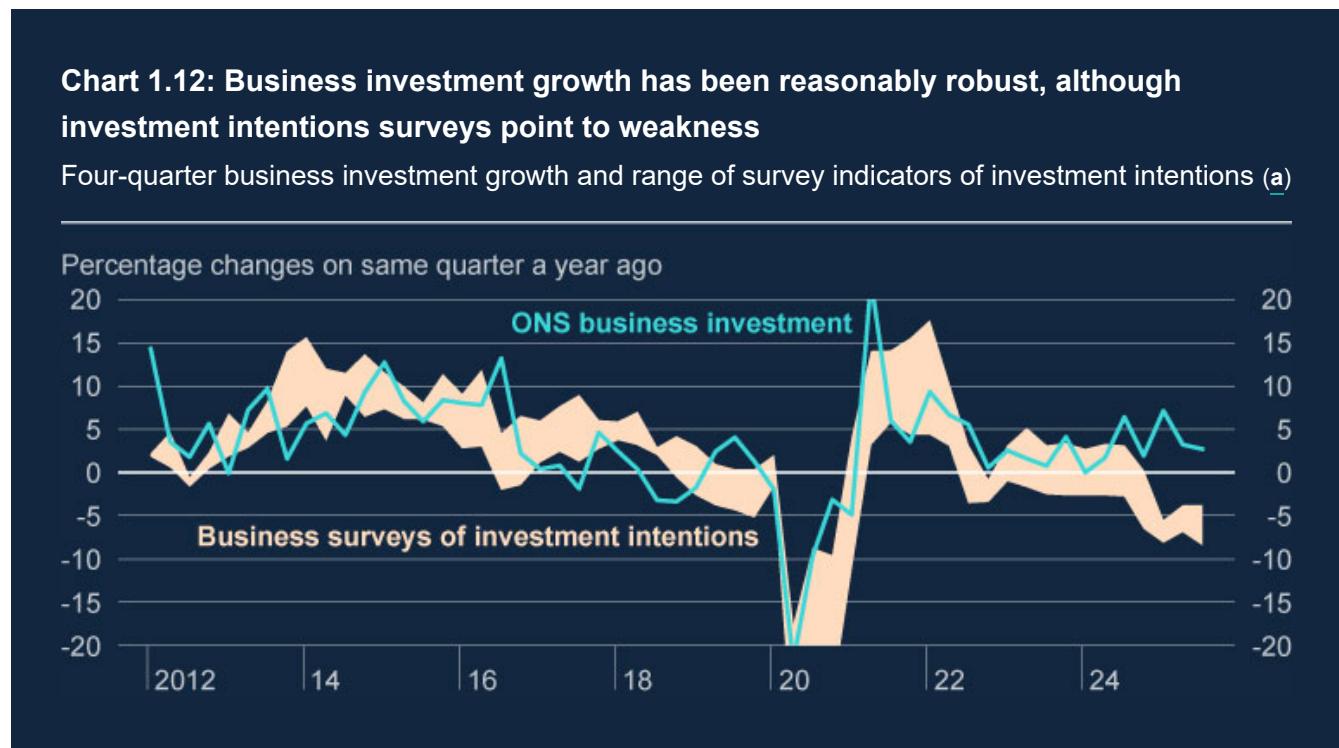
Sources: Bank of England Agents, BCC, CBI, ONS and Bank calculations.

(a) Survey measures are scaled to match the mean and variance of four-quarter business investment growth since 2000. Measures of the Bank's Agents (split by manufacturing and services), the BCC (non-services and services) and the CBI (manufacturing, distribution, financial services and business/consumer/professional services) are weighted together using shares in real business investment. The Agents' measure indicates companies' intended changes in investment over the next 12 months, with the latest available observation for each quarter shown. The BCC measure is the net percentage balance of respondents reporting that they have increased planned investment in plant and machinery and the data are not seasonally adjusted. The CBI measure is the net percentage balance of respondents reporting that they have increased planned investment in plant and machinery for the next 12 months. The final data are for 2025 Q3.

## Labour market

Underlying employment has been flat.

Underlying employment growth has been around zero over the past year (Chart 1.13, left panel). That is weaker than subdued GDP growth would have implied, due to cost pressures from higher employer NICs and the NLW. The flash December HMRC payrolls data continue to point to weak hiring momentum, and survey evidence from the DMP and S&P Global

Composite UK PMI suggests that employment growth remains subdued. Contacts of the Bank's Agents report headcount reductions in sectors most exposed to discretionary consumer spending and to the NLW and NICs increases.

LFS employment growth rose slightly to 0.2% in the three months to November (Chart 1.13, left panel). Notwithstanding the latest uptick, recent outturns have brought the official measure more in line with the subdued growth implied by alternative indicators as LFS sample sizes have risen.

Aggregate employment growth is expected to remain muted in the near term. Survey evidence from the DMP and S&P Global composite UK PMI continues to indicate subdued hiring intentions.

Chart 1.13: Underlying employment has been flat and unemployment continues to rise
Measures of underlying and LFS employment growth; unemployment rate and near-term projections (a) (b)

Sources: Bank of England Agents, DMP Survey, HMRC, KPMG/REC UK Report on Jobs, Lloyds Business Barometer, ONS, S&P Global and Bank calculations.

(a) Bank staff's indicator-based measure of underlying employment growth is constructed using a dynamic factor model following the approach of **Doz et al (2011)**. The model extracts a common component from monthly survey indicators, capturing comovements across series. The common component is scaled to align with LFS employment growth between 2000–19. The shaded area represents the 95% confidence interval. The latest data are for January 2026 for the estimate of underlying employment based on survey data and for the three months to November 2025 for the LFS.
(b) The latest data are for the three months to November 2025. The diamonds show Bank staff projections for the three months to December 2025 and March 2026 respectively. Although LFS unemployment data have been reinstated by the ONS, they are badged as official statistics in development and the LFS continues to suffer from low response rates, which can introduce volatility and potentially non-response bias (Box D of the **May 2024 Monetary Policy Report**).

| **Labour market conditions have loosened further…**

Consistent with continuing weakness in employment growth, the labour market appears to have loosened further. The unemployment rate remained at 5.1% in the three months to November (Chart 1.13, right panel) and measures of recruitment difficulties have eased. The LFS redundancy rate remains elevated relative to the last few months (Chart 1.14, orange line), although contacts of the Bank's Agents report that firms have been managing headcount mainly through natural attrition rather than widespread redundancies (**ASBC – February 2026**).

Vacancy levels have stabilised since mid-2025, with a small pickup in the November data. But the rise in unemployment means that the vacancy to unemployment (V/U) ratio, one measure of labour market slack, has fallen further below its estimated equilibrium level. And net additional hours desired by workers as a proportion of average hours worked, a measure of under-employment, fell but remain elevated relative to their historical average (Chart 1.14, aqua line).

The composition of the rise in unemployment is also consistent with labour market slack having increased. Bank staff analysis indicates that short-term unemployment has accounted for nearly half of the recent increase in LFS unemployment since its trough in 2022 Q3. Short-term unemployed workers typically move back into work more quickly, so a greater share of short-term unemployment suggests a larger pool of workers that can be absorbed back into employment relatively easily. Consistent with that, Bank staff estimates suggest that the medium-term equilibrium unemployment rate has increased only slightly, although there are risks around this (Section 3.2).

…and some further loosening is expected in the near term.

The unemployment rate is expected to rise further to 5.3% by mid-2026, a little higher than the central expectation in the November Report. That is consistent with the latest uptick in forward-looking indicators for redundancies, such as HR1 notifications and Google searches for redundancies.

The margin of slack in the economy is judged to have widened slightly further as demand growth has remained subdued.

Consistent with the rise in labour market slack, recent evidence points to a gradual widening in aggregate spare capacity. Survey evidence on capacity utilisation and intelligence from the Bank's Agents' contacts suggests that spare capacity within firms has increased further in recent months. And model-based estimates suggest that the economy-wide output gap has widened modestly (Section 3.2).

Chart 1.14: Conditions in the labour market have continued to loosen

LFS redundancy rate and net additional desired hours as a percentage of average weekly hours (a)

Sources: ONS and Bank calculations.

(a) The orange line is the ratio of the redundancy level for the given quarter to the seasonally adjusted number of employees in the previous quarter, multiplied by 1,000. Latest redundancies data are for the three months to November 2025. The aqua line is the number of net additional desired hours that the currently employed report they would like to work, on average, per week, expressed as a share of average weekly hours. Latest data are to 2025 Q3.

1.3: Global and financial conditions

Global economic activity

| **Global activity has been more resilient than expected.**

Bank staff estimate that the global effective tariff rate on imports into the US is around 17%, 1 percentage point lower than at the time of the November Report. The estimated effective US tariff rate on imports from the UK remains around 9%. Uncertainty over US trade policy has persisted (Section 3.2).

Global activity has been more resilient than expected at the time of the November Report. Bank staff judge that uncertainty associated with past trade policy measures has been smaller than previously assumed. Easier global financial conditions have also supported global activity, while AI-related investment has boosted activity growth in some regions.

UK-weighted world GDP growth is expected to have been 0.4% in 2025 Q4 (Chart 1.15) and is projected to pick up a little over the coming quarters as the expected drag from the impact of tariffs and trade policy uncertainty is offset by a boost from global financial conditions.

Table 1.15: World GDP growth has been more resilient than expected to trade policy developments

UK-weighted world GDP growth and GDP growth in selected countries (a)
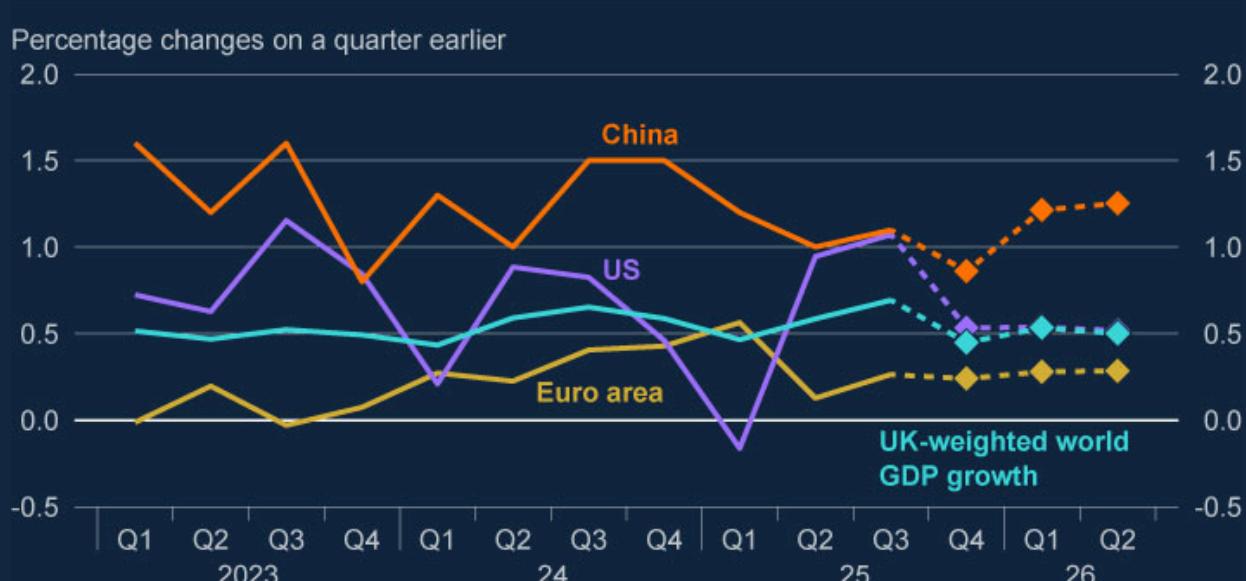
Sources: LSEG Workspace and Bank calculations.

(a) The diamonds show Bank staff projections for UK-weighted world quarterly GDP growth, and for quarterly GDP growth in China, the US and the euro area. The projections are for 2025 Q4 to 2026 Q2 for all of the areas. The preliminary flash estimate for 2025 Q4 euro-area GDP was published after the cut-off for incorporation into the forecast so the data point for that quarter is a projection. UK-weighted world GDP growth is constructed using real GDP growth rates of 188 countries weighted according to their shares in UK exports.

Financial conditions

The market-implied path for Bank Rate was a little lower relative to the lead up to the November Report.

Based on the 15-day average of forward interest rates to 26 January, the market curve implied that Bank Rate would fall to around 3.3% in 2026 H2 (Chart 1.16). The market curve slopes upwards beyond 2026 and reaches 3.7% in early 2029. The median respondent to the Market Participants Survey expected Bank Rate to fall to 3.25% and stay there.

The market-implied paths for US and euro-area policy rates were around 20 basis points higher, on average, over the next three years than in the period leading up to the November Report.

Chart 1.16: The market-implied path for policy rates was a little lower relative to the November Report in the UK

Policy rates and instantaneous forward curves for the UK, US and euro area (a)

Per cent

Solid lines: February 2026
Dashed lines: November 2025

Federal funds rate

Bank Rate

ECB deposit rate

UK

US

Euro area

2020 21 22 23 24 25 26 27 28 29

Sources: Bloomberg Finance L.P. and Bank calculations.

(a) All data are as of 26 January 2026. The February 2026 curves are estimated based on the 15 UK working days to 26 January 2026. The November 2025 curves are estimated based on the 15 UK working days to 28 October 2025. The federal funds rate is the upper bound of the announced target range. The market-implied path for US policy rates is the expected effective federal funds rate. The ECB deposit rate is based on the date from which changes in policy rates are effective. The final data points are forward rates for March 2029.

| **Overall financial conditions have eased slightly since the November Report.**

A **financial conditions index** constructed by Bank staff suggests that conditions have eased slightly compared with those at the time of the November Report. The sterling ERI appreciated somewhat in the run-up to the February Report. Sterling rose by nearly 1% against the US dollar and around 0.3% against the euro. UK and global equities have generally risen despite volatility linked to global technology company valuations and geopolitical developments.

Since the November Report, 10-year UK government bond yields have fallen a little and are below the peaks observed last year. **Recent Bank staff analysis** indicates that much of the rise in long-term yields over 2025 was driven by higher term premia. That in turn reflected global geopolitical uncertainty and concerns about fiscal sustainability, with UK-specific evolving gilt-market demand dynamics also having played a role.

Domestic credit conditions

| **Lending rates have generally fallen following the reductions in Bank Rate and earlier falls in term reference rates, which will support borrowing volumes.**

Since their peaks, falls in Bank Rate and term OIS rates have generally passed through to the rates faced by households and corporates in line with historical experience. Rates on new corporate loans have fallen from their peaks, broadly tracking changes in Bank Rate (Chart 1.17, right panel). Mortgage rates have declined further since the November Report, with some products now at their lowest levels for several years (left panel). Quoted personal loan rates have eased slightly, while credit card rates remain close to recent highs, consistent with their historically slower adjustment and an unwind in spreads which had narrowed during the tightening phase. Pass-through to sight deposits remains low and gradual.

Bank lending volumes have continued to pick up, supported by lower lending rates and improved credit supply. Net lending growth to households has continued to increase since November, across both secured lending and consumer credit, although real lending growth remains slightly below its pre-pandemic average. Bank lending to corporates has strengthened, particularly among large firms. And credit availability for both households and corporates has improved over the past year, according to responses to the **Bank's Credit Conditions Survey – 2025 Q4** (CCS). For secured lending, this is consistent with a variety of developments including lenders' responses to the Financial Conduct Authority's (FCA) statement on mortgage stress rates in March and the **FPC's update** to its Loan to Income (LTI) flow limit Recommendation in 2025 Q2. More generally, the **FPC's decision** to lower the system-wide benchmark for Tier 1 capital should provide banks with greater confidence in using their existing capital to support lending.

As the main source of money creation, the recovery in net lending has supported growth in broad money, which reached 5% in the year to December 2025. Stronger growth in money balances could signal upside risks for nominal spending and the inflation outlook, although that signal tends to be strongest over longer windows of time (Box D of the **May 2025 Monetary Policy Report**).

Chart 1.17: Most household and corporate interest rates continue to track reductions in reference rates

Household and corporate interest rates and their corresponding reference rates (a)
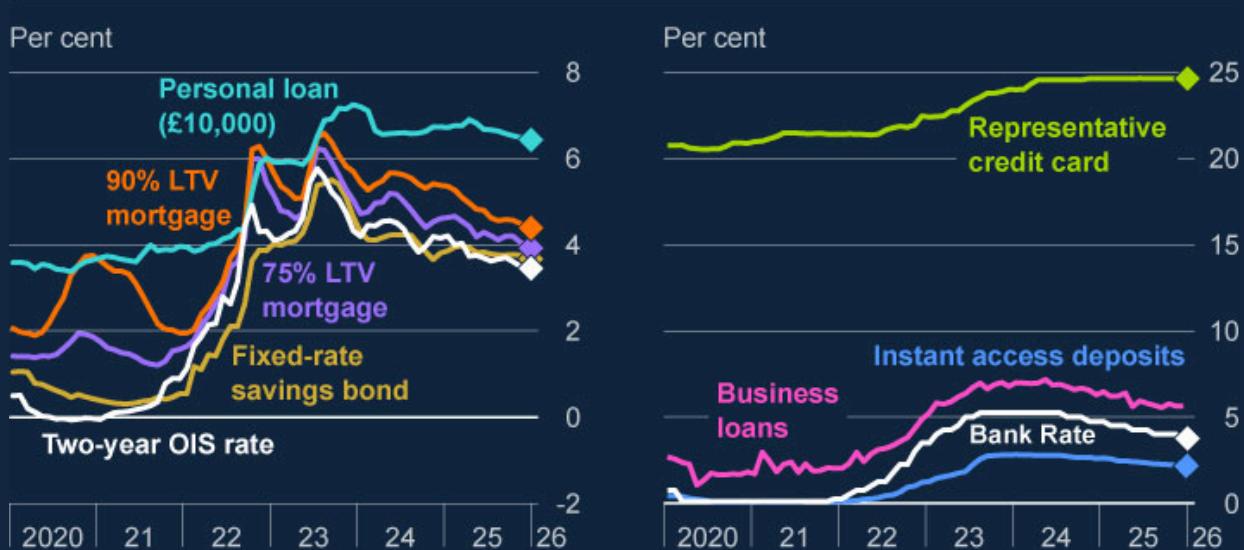
Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

(a) Household loan and deposit rates are based on average quoted rates and business loan rates are based on average effective rates on new lending. The Bank's quoted rates series are weighted monthly average rates advertised by all UK banks and building societies with products meeting the specific criteria. **Introduction of new Quoted Rates data** provides more information. The 75% and 90% LTV mortgage rates are for two-year fixed-rate products. The reference rate for these and fixed-rate savings bonds is the two-year OIS rate. The reference rate for £10,000 personal loan rates is the five-year OIS rate but this is not shown. The two-year OIS rate shows monthly averages, while Bank Rate shows month-end numbers. The provisional January 2026 data are shown as diamonds. For quoted rate series and the two-year OIS rate, these are based on average values to 26 January 2026. The provisional data point for Bank Rate is the rate as of 26 January 2026. The final business loan rate data are for December 2025.

2: Topical policy issues

The boxes in this section highlight some of the key pieces of analysis that informed the MPC's discussions.

Box A: Estimates of 'target-consistent' wage growth

Wage growth is an important determinant of inflationary pressures. But other determinants of inflation – including labour productivity, import prices and firms' margins – will also influence whether inflation settles sustainably at target. This box describes an estimate of wage growth that, for plausible long-run growth rates of these other determinants, should be consistent with keeping inflation at 2%. It also provides a cross-check of that estimate based on historical correlations between wages and prices. The results suggest that target-consistent wage growth is likely to be around 3¼%, but there are risks in either direction. A higher estimate for target-consistent wage growth could mean that additional easing in monetary policy is required, while a lower estimate could mean that less easing is required, all else equal.

What rate of wage growth would be consistent with meeting the 2% inflation target?

Wage growth is an important determinant of inflation, with labour costs making up around two-fifths of consumer prices. But other determinants, including productivity growth, import prices and margins, will also affect inflationary pressures. These can be interlinked, for example higher productivity growth will ultimately feed through to wages, although that adjustment can take time. And inflation outturns can influence inflation expectations and subsequently wage growth.

Looking at how the main determinants of inflation are likely to behave in the long run can help assess the rate of wage growth that would keep inflation sustainably at the target. These determinants fit into a simple formula that breaks inflation into imported costs and domestically generated pressures:

CPI inflation = import share x imported inflation + (1- import share) x domestically generated inflation

CPI inflation reflects changes in the prices of imports as well as of domestically produced goods and services, with a lower rate of import price inflation meaning that the prices of domestic goods and services can grow at a faster rate while keeping inflation at target. Domestically generated inflation largely depends on how fast labour costs are growing relative to productivity (known as unit labour costs). And while firms tend to pass on wage costs directly to prices, pass-through is not always one-for-one and so domestically generated inflation also depends on how margins, the share of profits in total revenue, change over time.

Assumptions about how each of these other determinants of inflation will grow in the long run implies an estimate for target-consistent wage growth of around 3¼% (Table A.A). Underlying this, long-run import price growth is assumed to be 1%, a little above its average since the late 1990s. Combined with an import share of 25%, based on **ONS estimates**, this implies that domestically generated inflation would need to be around 2¼% to be consistent with the inflation target. Within that, margins are assumed to be constant in the long run, consistent with a stable long-run profit share. And long-run labour productivity growth is assumed to be around 1% (Box C).

Table A.A: Key assumptions underpinning Bank staff's long-run estimate of target-consistent wage growth (a)

Determinant of CPI inflation	1998–19 average	2024–25 Q3 average	Long-run assumption
Import price inflation	1.2%	-0.7%	1.0%
Import intensity	n.a.	23%	25%
Margins contribution	-0.2%	-0.1%	0.0%
Labour productivity growth	1.0%	0.0%	1.0%
Target-consistent wage growth			3¼%

Sources: ONS and Bank calculations.

(a) Import intensity data are not readily available on a historical basis, but a simple calculation based on the import share of GDP suggests that the import share was probably lower in the past. The import share of GDP has risen from around 20% in 1998 to around 24% in 2025. This analysis does not assume that the law of one price holds, so other than import prices, no other foreign price directly influences domestic prices. For simplicity, in the long run, capital costs are assumed to grow in line with labour costs, therefore the labour share of income and margins are assumed to be stable over time. Labour productivity refers to measured productivity per worker. Other factors such as taxes may also be important, but in the long run these are assumed to be immaterial.

There is uncertainty around each of the assumptions contained in Table A.A, and some of these determinants may evolve differently over the next three years. This would mean that the rate of wage growth that is consistent with the 2% target could be higher or lower than 3¼%.

One possibility is that something other than identified supply shocks such as the global financial crisis and Brexit has been weighing on productivity growth over the past two decades, and that this persists such that productivity growth remains below 1% (Box C). This could occur alongside structurally higher imported inflation due to rising global trade fragmentation and geopolitical tensions (**Dhingra (2025)**). To the extent that trade openness is associated with higher productivity, these factors could interact, such that a less open economy results in weaker productivity growth. These developments would raise inflation and require wage growth to fall further to be consistent with inflation at target, all else equal limiting the extent to which monetary policy might be eased further.

In another state of the world, potential productivity growth could recover faster than anticipated, for example due to rising AI adoption (Box C). While that should be matched in the long term by stronger demand, and hence wages, that adjustment will not happen immediately. If this also occurred alongside persistent weakness in imported inflation due to subdued global demand and trade diversion (Section 3.2), that could mean wage growth would need to settle at a higher rate to be consistent with inflation remaining sustainably at target. That could support additional easing in monetary policy.

What do empirical estimates imply for target-consistent wage growth?

Another way to estimate target-consistent wage growth is to look at which rates of wage growth have been consistent with CPI inflation at 2% in the past. It can be difficult to find a clear and stable link between wages and inflation because of the varying contribution to CPI of energy, import prices and other external costs. Bank staff have therefore estimated the historical relationship between wages and CPI excluding energy and CPI services, while separately accounting for drivers of external costs and productivity.

This empirical approach suggests that target-consistent wage growth is around 3.1%–3.2%, with an interquartile range of 2.9% to 3.4% (Chart A.1). That is broadly consistent with the estimate presented in Table A.A, although the uncertainty around the empirical estimate shown in Chart A.1 is very large.

Chart A.1: There is a large degree of uncertainty around empirical estimates of target-consistent wage growth

Fitted kernel density (a)

Probability density of target-consistent wage growth estimates
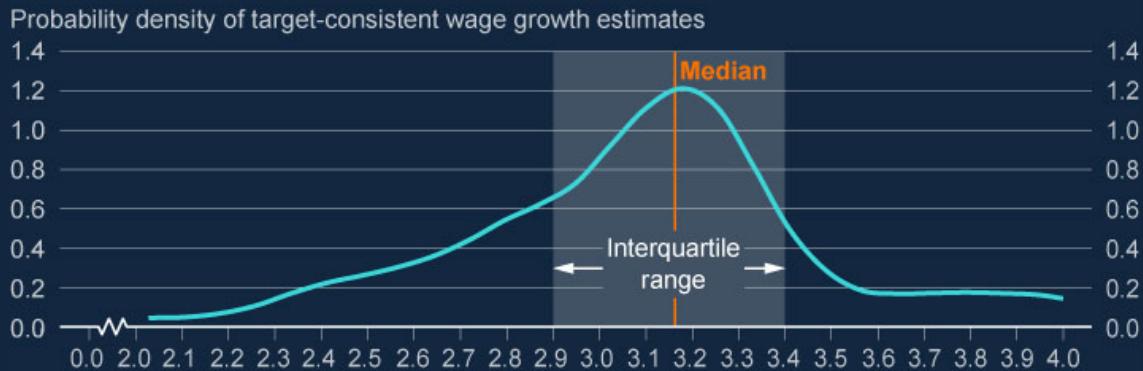
Sources: ONS and Bank calculations.

(a) The chart shows a kernel density of around 280 reduced-form estimates derived from regressions linking labour costs to CPI inflation excluding energy and to CPI services. Each estimate corresponds to the implied wage growth consistent with 2% inflation, conditional on import price growth of 1%. The various specifications result from modelling both CPI excluding energy and CPI services using different measures of labour costs, such as AWE pay growth and unit labour costs, as well as a mixture of autoregressive distributed lag and error correction models. The models are mostly estimated over 1988–2025.

Box B: Heterogeneity in wage-setting behaviour among UK firms

One possible explanation for the recent strength in wage growth is a structural change in wage-setting behaviour. A machine-learning approach, which identifies heterogeneity in wage-setting across firms and over time, finds little evidence for this hypothesis. Some of the recent unusual strength in wage growth can instead be explained by the lagged response to labour market conditions of firms whose wage-setting resembles collective bargaining behaviour. This type of wage-setting behaviour appears to be much more prevalent than implied by official data on the share of workers covered by collective wage agreements. Given the recent fall in inflation and continued loosening in the labour market, wage inflation among this type of firm is likely to slow in due course, all else equal allowing for a looser monetary policy stance.

How do UK firms set wages?

At a macroeconomic level, the key drivers of wage growth are productivity growth, inflation and inflation expectations, and labour market tightness. Many of these drivers are captured in standard models of pay growth including the **Yellen (2017)** equation (Section 1.1). Statutory policies such as the National Living Wage (NLW) can also affect pay growth.

But wage-setting practices vary substantially across firms. According to intelligence from the Bank's Agents, some firms respond strongly to specific labour market conditions in their sectors and regions, while others are mainly affected by national developments including changes in the NLW. Firms also differ in the degree to which collective bargaining agreements are in place, and in the extent to which they make use of performance-related pay.

Explicitly accounting for heterogeneity in wage-setting behaviour can help to improve our understanding of the determinants of wage growth. For example, some firms tend to adjust wages more quickly than others in response to changes in inflation. When the economy is relatively stable, a model that assumes the same lag between underlying determinants and wages across all firms may account for the evolution of wages reasonably well. But when there are large shocks, differences in how firms respond to underlying drivers may become more important in explaining aggregate wage dynamics.

To explore the heterogeneity in wage-setting behaviour across UK firms, Bank staff are developing a new machine-learning model, following an approach similar in spirit to **Gregory et al (2025)**. This analysis is based on the Annual Survey of Hours and Earnings (ASHE), which contains detailed information on employer and employee characteristics, hours and pay for over 1.3 million workers employed by 190,000 private sector firms starting in 2004. Bank staff have analysed this dataset using a clustering algorithm, which sorts data into groups by minimising the within-group variation and maximising the between-group variation. The algorithm considers a wide range of firm-level data to identify distinct types of wage-setting behaviour among UK firms.

Results based on this modelling approach suggest that firms in the UK fall into four main categories of wage-setting behaviour. Drawing on intelligence from the Bank's Agents, these four clusters can be interpreted as 'reputational employers' and 'incentive payers', each accounting for around 10% of private sector workers, and 'cost minimisers' and 'bargaining employers', each employing around 40% of the private sector workforce.

The identified wage-setting clusters differ with respect to some key characteristics. Reputational employers offer higher pay than firms in other clusters, even after controlling for workers' qualifications and experience. This may be both a recruitment and retention strategy to deal with skill shortages and to bolster their overall reputation. Reputational employers tend to raise wages quickly when inflation expectations increase. This type of wage-setting behaviour is common in the financial and IT sectors (Chart B.1).

Incentive payers rely on performance bonuses more than firms in other clusters, and their wage-setting decisions are particularly sensitive to their own staff turnover. Firms in the agricultural and mining sectors are somewhat more likely to follow this model than firms in other sectors (Chart B.1).

Cost minimisers employ a large share of workers at or close to the NLW. They tend to set wages partly in relation to changes in the NLW and partly based on labour market tightness in their industries and regions. Many firms in the accommodation and hospitality sector fall into this wage-setting cluster (Chart B.1).

Bargaining firms may use collective agreements to set pay. However, this cluster also includes many firms that show bargaining-like behaviour without having formal collective agreements in place. The bargaining firms identified by the machine-learning analysis employ almost 40% of UK workers, which is significantly higher than official estimates of the share of private sector employees covered by explicit collective agreements (around 15%). Pay dispersion within these firms is relatively low, and

wage growth tends to respond to both inflation and labour market conditions with longer lags than in other clusters. Bargaining firms are most common in industries with high shares of public sector employment, such as education, health, utilities and transport (Chart B.1).
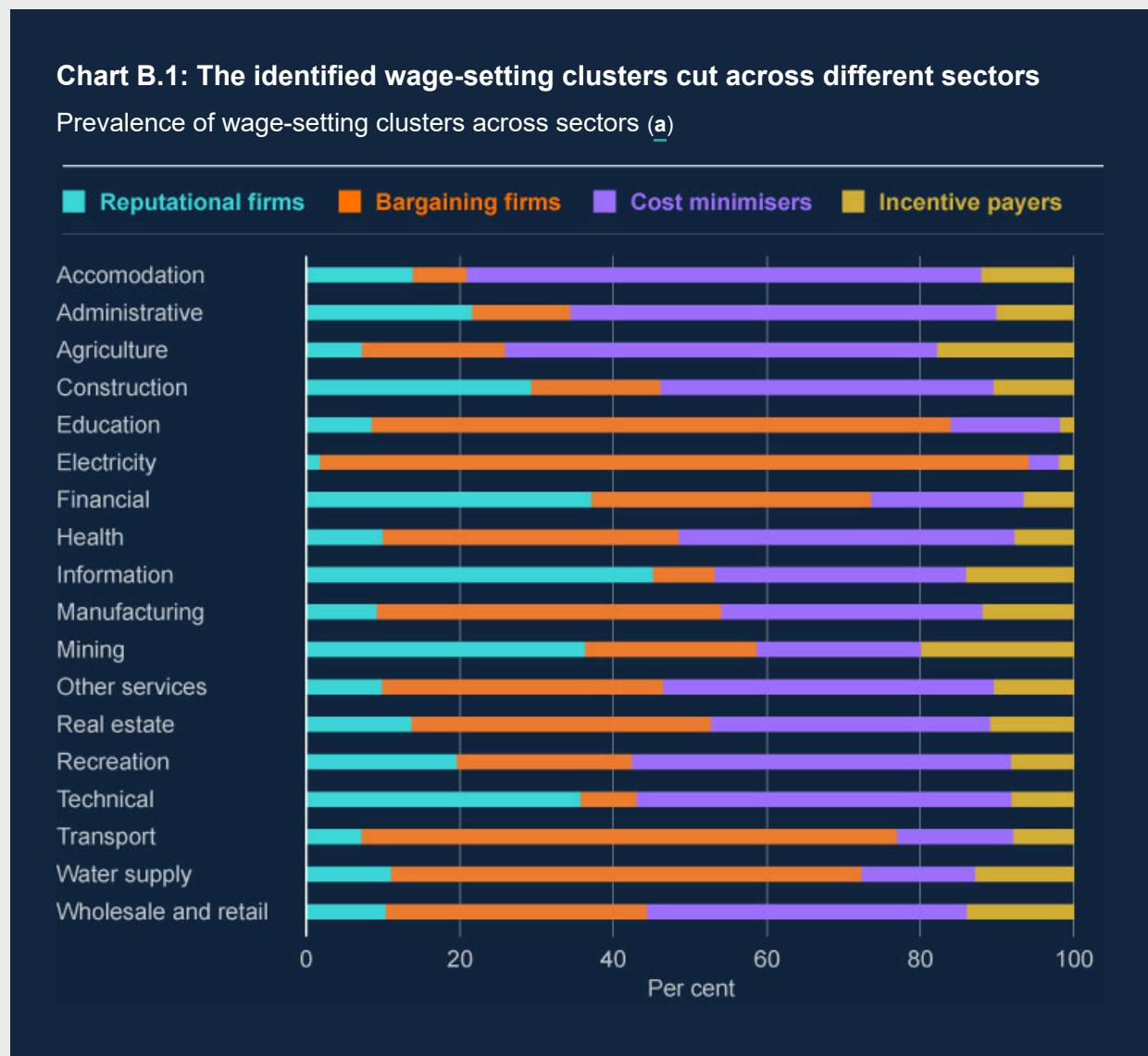
Chart B.1: The identified wage-setting clusters cut across different sectors

Prevalence of wage-setting clusters across sectors (a)

Sources: ASHE and Bank calculations.

(a) This work was undertaken in the ONS Secure Research Service using data from ONS and other owners and does not imply the endorsement of the ONS or other data owners. The clusters are identified using an unsupervised machine-learning algorithm (K-means clustering), which groups the firm-level observations to minimise the differences within the clusters and maximise the differences between clusters. The chart shows the percentage of workers in each cluster by sector.

Is there evidence for structural change in how UK firms set wages?

Based on the specific machine-learning model developed by Bank staff, there is little evidence for structural change in the characteristics or size of wage-setting clusters in the UK economy. Reclustering the data over subperiods from 2004–09, 2010–19 and 2021–25 finds that the four distinct groups of wage-setters have been broadly stable (Chart B.2). This suggests that the pandemic and the subsequent period of high inflation have not induced many UK firms to fundamentally change their approach to wage-setting, and that the identified clusters tend to reflect approaches to wage-setting that do not vary materially across the business cycle. However, because the analysis focuses on identifying differences between employers, this finding cannot rule out potential economy-wide changes in wage-setting that could impact all clusters equally.
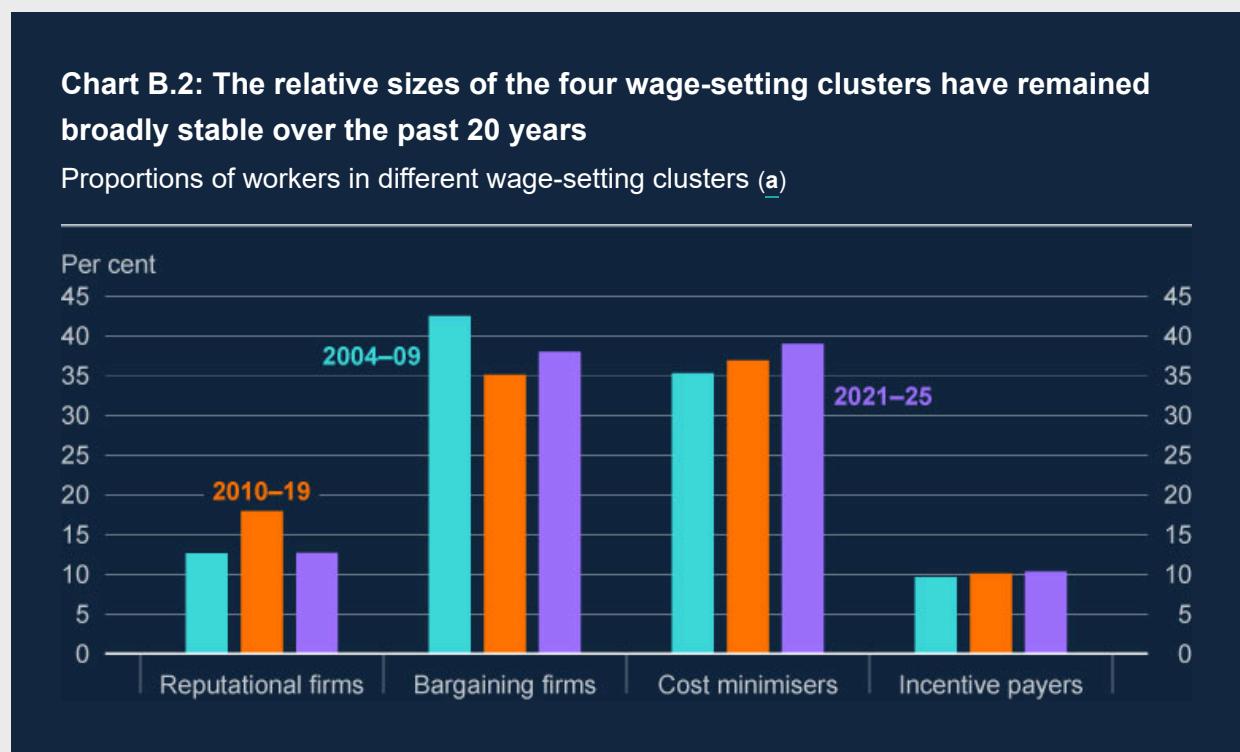
Chart B.2: The relative sizes of the four wage-setting clusters have remained broadly stable over the past 20 years

Proportions of workers in different wage-setting clusters (a)

Sources: ASHE and Bank calculations.

(a) This work was undertaken in the ONS Secure Research Service using data from ONS and other owners and does not imply the endorsement of the ONS or other data owners.

Can accounting for heterogeneity help explain persistence in wage growth?

Aggregate wage growth has been higher than the Bank's standard macroeconomic models can account for in recent years (**Forecast Evaluation Report – January 2026**). For example, the aggregate Yellen equation that accounts for wage growth based on measures of productivity growth, inflation expectations and labour-market slack showed material unexplained bars for most of the 2023–25 period (Chart 1.4). Aggregate models may not have revealed the full extent of persistence, however, as the correct lag structure is difficult to identify in the absence of a sufficient number of

large shocks. Heterogeneous approaches tend to capture such relationships better by drawing on more granular data and allowing for different dynamics for separate groups.

Across all four identified wage-setting clusters, wage growth has been high since 2022 (Chart B.3). In the most recent available ASHE data from April 2025, wage growth has fallen back significantly for reputational firms (aqua line) and incentive payers (gold line). But it remains elevated for cost minimisers (purple line) and bargaining employers (orange line). For the former, that can at least partly be explained by cost minimisers' large exposure to the NLW, which has increased materially in recent years. For the latter, it probably reflects longer lags in bargaining employers' responses to macroeconomic conditions in the face of large shocks.

Accounting for heterogeneity by estimating separate Yellen equations for the four clusters and recombining into an aggregate wage equation can explain a greater proportion of wage growth. This is mainly due to accounting for a higher degree of bargaining behaviour in the economy and allowing the wage growth of these bargaining-type employers to react to all variables with a one-year lag, in contrast to the contemporaneous relationships estimated in the annual data for all other clusters. While the disaggregated data are only available at an annual frequency, this approach could plausibly reduce the degree of unexplained wage growth between 2023 and 2025 in Chart 1.4 by about a third.

Given the continuing disinflation process and the recent loosening in the labour market, wage growth among bargaining firms is likely to slow. This would be consistent with evidence from the DMP Survey, which suggests that sectors with a relatively higher presence of bargaining firms do not have elevated year-ahead wage growth expectations compared with other sectors. Lower wage growth among bargaining firms should subsequently feed through to lower inflationary pressures.

Chart B.3: Wage growth has fallen back more slowly in the bargaining and cost minimising clusters

Median annual pay growth across wage-setting clusters (a)

Sources: ASHE and Bank calculations.

(a) This work was undertaken in the ONS Secure Research Service using data from ONS and other owners and does not imply the endorsement of the ONS or other data owners. The chart shows median annual growth of regular pay for workers in each cluster. The final data points are for April 2025.

Box C: The outlook for productivity growth

Potential output growth matters for monetary policy because it affects the speed at which the economy can grow without generating excess inflationary pressures. A key determinant of potential output is the evolution of potential productivity. While measured productivity has been exceptionally weak in recent years, adjusting for possible mismeasurement and cyclicality suggests that potential productivity has been somewhat stronger. Potential productivity growth is projected to pick up to a little below its assumed long-run trend rate of 1% over the forecast period, but there are risks in both directions. Stronger productivity growth, for example due to larger-than-expected benefits from AI, could put temporary downward pressure on firms' unit labour costs and require a looser policy stance, all else equal, while weaker productivity growth could require a tighter stance.

How has productivity growth evolved over recent years?

Measured productivity growth has been exceptionally weak on average since 2023. Gross value added per hour worked fell by 0.7% overall between 2022 Q4 and 2025 Q3, although that masks a more pronounced fall to 2024 Q3 and a subsequent pickup (Chart C.1, aqua line in left panel).

Adjusting the official measure of productivity growth for erratic and volatile components of GDP and possible mismeasurement in LFS data suggests a flatter path for productivity growth over recent years. The orange line in the left panel of Chart C.1 adjusts headline productivity growth using Bank staff's measure of underlying GDP (Chart 1.9). It also accounts for **possible measurement error in LFS total hours worked**, by combining Bank staff's estimate of underlying employment growth (Chart 1.13) with an estimate of underlying hours worked, which better accounts for estimates of temporary and structural biases in existing measures. This indicator suggests a less pronounced slowdown in measured productivity growth over 2023–24 than in the official data.

Part of the recent weakness in productivity also appears to have been cyclical. Bank staff's central estimate of potential productivity growth, which is informed by a range of measures that account for capacity utilisation, suggests that potential productivity growth has been stronger over recent years than measured productivity growth (Chart C.1, purple line in left panel). Nevertheless, it has been subdued relative to its assumed long-run trend growth rate of 1%, averaging ½% per year since 2024.

Chart C.1: Part of the weakness in measured productivity growth appears to have been cyclical; potential productivity growth is expected to pick up towards 1% per year over the forecast period

Measures of annual productivity growth (a) and projected contributions to potential productivity growth (b)
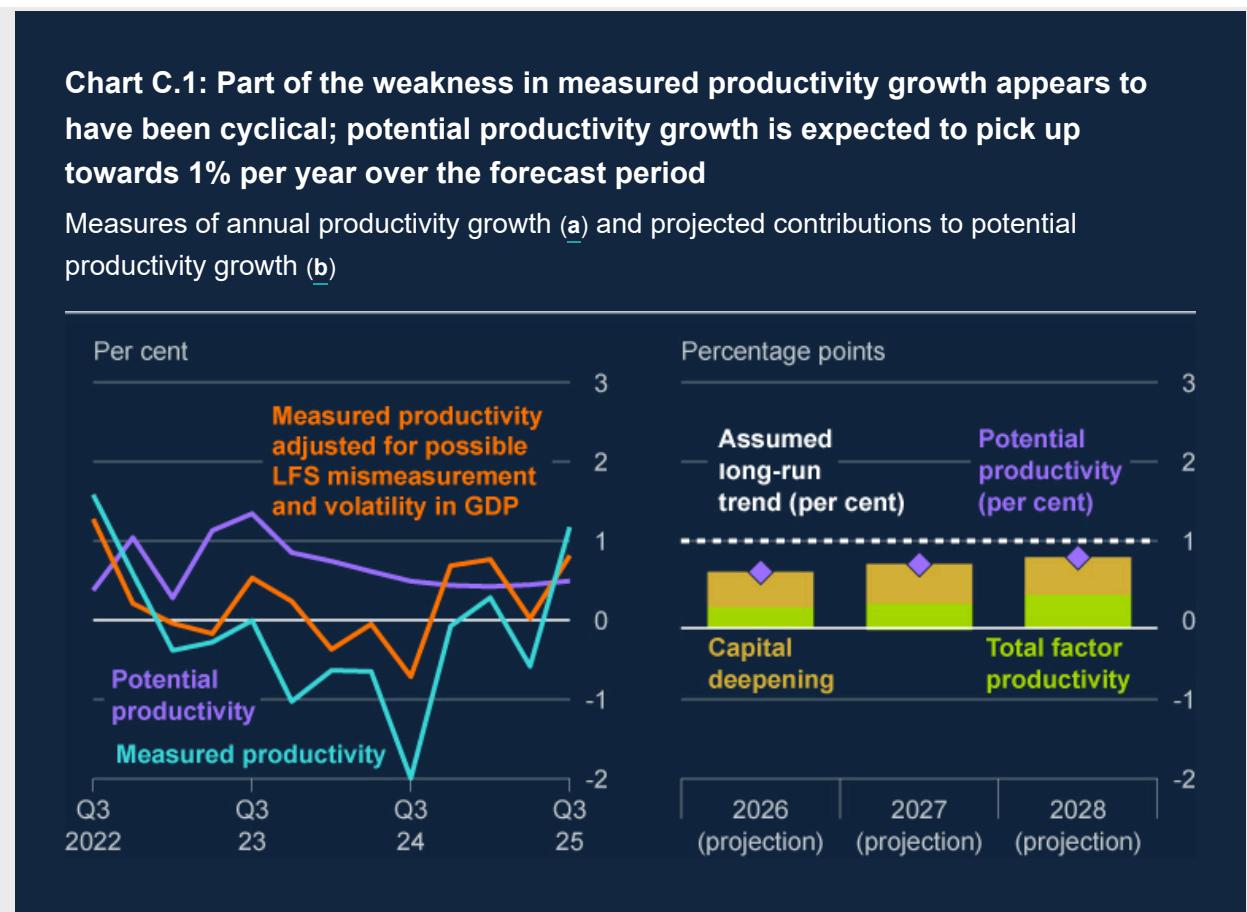
Sources: ONS and Bank calculations.

(a) The measures of productivity shown are based on output per hour worked. The adjustments in the orange line are based on the indicator-based models from Charts 1.9 and 1.13 for underlying GDP and underlying employment, respectively. Hours worked are further adjusted for estimates of possible biases in LFS data that are used in official productivity measures, associated with the decline and subsequent recovery in response rates across different survey waves in recent years. The estimate of potential productivity growth is consistent with the central projection for potential output growth and is informed by a range of measures, such as filter models and an indicator that further adjusts the orange line for a measure of capacity utilisation constructed with a range of cyclical data across industries. The final data points are for 2025 Q3.
(b) The decomposition of potential productivity growth is based on a growth-accounting framework using a constant returns to scale Cobb-Douglas production function, with the elasticity of output with respect to capital set to one third. The contribution from total factor productivity is a residual.

What is the outlook for potential productivity growth?

Potential productivity growth is projected to pick up modestly over the forecast period to a little below its assumed long-run trend rate (Chart C.1, purple diamonds in right panel). That is broadly in line with the **OBR's latest assessment** of productivity growth.

Potential productivity growth can be split into contributions from capital deepening (the available capital services per worker) and total factor productivity (TFP). Growth in capital deepening (Chart C.1, gold bars in right panel) is expected to be supported by

relatively robust business investment over the forecast period. That is consistent with further falls in monetary policy restrictiveness, as well as reports from contacts of the Bank's Agents who have noted that they intend to respond to future rises in demand by investing in automation and AI, rather than by raising headcount (**ASBC – February 2026**).

In the central projection, the effects of Brexit are assumed to leave the level of potential productivity 3¼% lower than otherwise by end-2028 (Box E of the **February 2025 Monetary Policy Report**). Bank staff judge that this effect can explain almost all of the difference between the current estimated level of potential productivity and its assumed long-run trend level. The remaining effects of Brexit on potential productivity growth are expected to fade gradually over the forecast period, consistent with a modest pickup in TFP growth (Chart C.1, green bars in right panel). Nevertheless, potential productivity growth is projected to remain a little below its assumed long-run trend rate over that horizon (purple diamonds).

A larger remaining drag from Brexit could mean that TFP growth remains weaker than expected over coming years. Recent empirical evidence suggests that Brexit may already have had a larger-than-expected impact on trade volumes, through disruption to trade in services (**Bhalotia et al (2025)**) as well as to trade in goods. It is possible that any additional knock-on effects on productivity growth will be slow to come through.

It is also possible that the assumed 1% long-run trend rate of potential productivity growth is too high. That assumption is informed by long-run filter model estimates of productivity growth and was first described in the **February 2019 Inflation Report** following outturns for productivity growth that had been consistently weaker than expected over the previous decade. Measured productivity growth has averaged about ½% per year over the past two decades but is estimated to have been depressed relative to its long-run trend by various shocks including the 2008–09 global financial crisis, Brexit and the Covid pandemic. However, it is possible that estimates have overstated the degree to which slow growth in measured productivity has been due to those identified shocks rather than other factors, which could mean that the weakness in productivity growth persists.

There are also upside risks to the productivity outlook, particularly if benefits from AI are larger than expected. While cross-country comparisons are difficult due to differences in data sources and survey questions, **firm-level survey data** suggest that UK businesses may be some of the biggest adopters of AI so far. And AI adoption may accelerate over coming years if it follows the pattern of previous technological innovations, where slower initial uptake has tended to be followed by a period of much

quicker technological diffusion (**Rogers (1983)**). That said, the uptake of other technologies linked to AI, such as robotics, does not appear to have picked up much over recent years (**Acemoglu and Restrepo (2020)**).

There is a high degree of uncertainty around the possible impact of AI on productivity growth. The range of estimates focused on the US economy is wide (for example, **Acemoglu (2024)**, **Aghion and Bunel (2024)** and **Filippucci et al (2024)**), although the literature generally points towards a positive impact on productivity over a long period. Respondents to the latest DMP Survey expected AI to increase their firms' productivity by around 0.6% per year on average over the next three years. The MPC will continue to monitor the potential macroeconomic impacts of AI, including on employment and productivity.

The strength of productivity growth has implications for firms' unit labour costs and hence inflationary pressures. If productivity growth is lower than expected, that could put further upward pressure on firms' unit labour costs, absent a full and fast adjustment in wages and demand (Box A). In turn that could require a tighter monetary policy stance, all else equal. The opposite would be true if productivity growth were to be higher than expected.

What is the outlook for overall potential output growth?

Although estimated potential productivity growth has averaged below its assumed long-run trend rate since 2024, that has been more than offset by strong population growth, and hence potential labour supply (Table C.A). Overall, growth in potential output is estimated to have exceeded growth in demand, such that a negative output gap has opened up (Section 1.2).

Annual potential output growth is expected to be a little below its assumed long-run trend rate of 1.5% on average over the forecast period (Table C.A). A greater share of that growth than in recent years is expected to be accounted for by growth in potential productivity. Most of the remainder reflects continued strength in population growth. Potential labour force participation and the non-accelerating inflation rate of unemployment are expected to be broadly unchanged over the forecast period (Box F of the **November 2025 Monetary Policy Report**).

Table C.A: Potential output is expected to grow at a little below its assumed long-run trend rate of 1.5% per year on average over the forecast period

Estimated contributions to potential output growth

	Potential output growth (a)	Of which: potential labour supply (b)	Of which: potential productivity (b)
2019–23	0.6	0.0	0.5
2024–25	1.9	1.3	0.5
2026 (projection)	1.3	0.7	0.6
2027 (projection)	1.3	0.6	0.7
2028 (projection)	1.4	0.6	0.8

Sources: ONS and Bank calculations.

(a) The data are percentage growth rates. The data for period averages are compound annual averages from the first year to the last year in the range.
(b) The data are percentage point contributions to potential output growth. The data for period averages are compound annual averages from the first year to the last year in the range. The contributions may not sum to potential output growth due to rounding.

Box D: Budget 2025 and the impact of fiscal policy on the economy

Measures announced in Budget 2025 are expected to weigh on inflation in the short term, reducing the risk of second-round effects from the most recent period of higher inflation. The Budget measures are also expected to boost demand slightly over the forecast period. But that effect is small relative to the overall planned fiscal consolidation, which is projected to weigh on the output gap.

What will be the impact of the policy measures announced in Budget 2025 on inflation and demand?

The Government set out its tax and spending plans in Budget 2025, published on 26 November 2025. The fiscal measures announced in the Budget have been incorporated into the central projection (Section 3.1).

The combined effect of the announced measures directly reduces CPI inflation by 0.5 percentage points at its peak in 2026 Q2 (Chart D.1, green line in left panel), leaving CPI inflation close to the 2% target in that quarter (Section 1.1). Around half of that impact reflects the energy bills package, which takes effect from April 2026 and is expected to reduce the typical household gas and electricity bill by £134 (orange bars). The delay to the rise in fuel duty rates until September 2026 is projected to weigh on headline inflation by a further 0.2 percentage points in 2026 Q2 (purple bars). And the freeze in rail fares from March 2026, together with the slightly more generous allowance for Vehicle Excise Duty on electric cars, provides a small further drag on CPI inflation in the near term (gold and aqua bars).

The faster near-term fall in inflation following the measures announced in the Budget has not changed the judgement on the scale of remaining second-round inflation effects in the central projection (Section 3.1). That is consistent with the most recent period of higher inflation having not been expected to lead to additional second-round effects in previous Reports. Nevertheless, the risk of greater inflation persistence is judged to have continued to diminish, in part due to the lower near-term outlook for inflation (Section 3.2).

The negative effect on inflation of the measures announced in Budget 2025 is expected to unwind from 2027 Q2, pushing up CPI inflation by 0.1 percentage points, on average, between 2027 Q2 and 2029 Q1 (Chart D.1, green line in left panel). The

introduction of mileage-based charges for electric vehicles in 2028 Q2 is provisionally expected to raise inflation slightly in the final year of the forecast (aqua bars) but there is considerable uncertainty surrounding this estimate.

The combined effect of the measures announced in Budget 2025 is expected to be expansionary over the MPC's forecast period, raising the level of real GDP by 0.2% at its peak in the 2027–28 fiscal year (Chart D.1, white line in right panel). Beyond the three-year forecast horizon, new tax increases are projected to dominate (red bars), such that the combined effect of the measures is expected to weigh on real GDP (dashed white line).

Chart D.1: The policies announced in Budget 2025 are expected to weigh directly on inflation in the near term and are slightly expansionary over the MPC's forecast period

Estimated marginal impacts of Budget 2025 on projections for CPI inflation (a) and the level of real GDP (b)
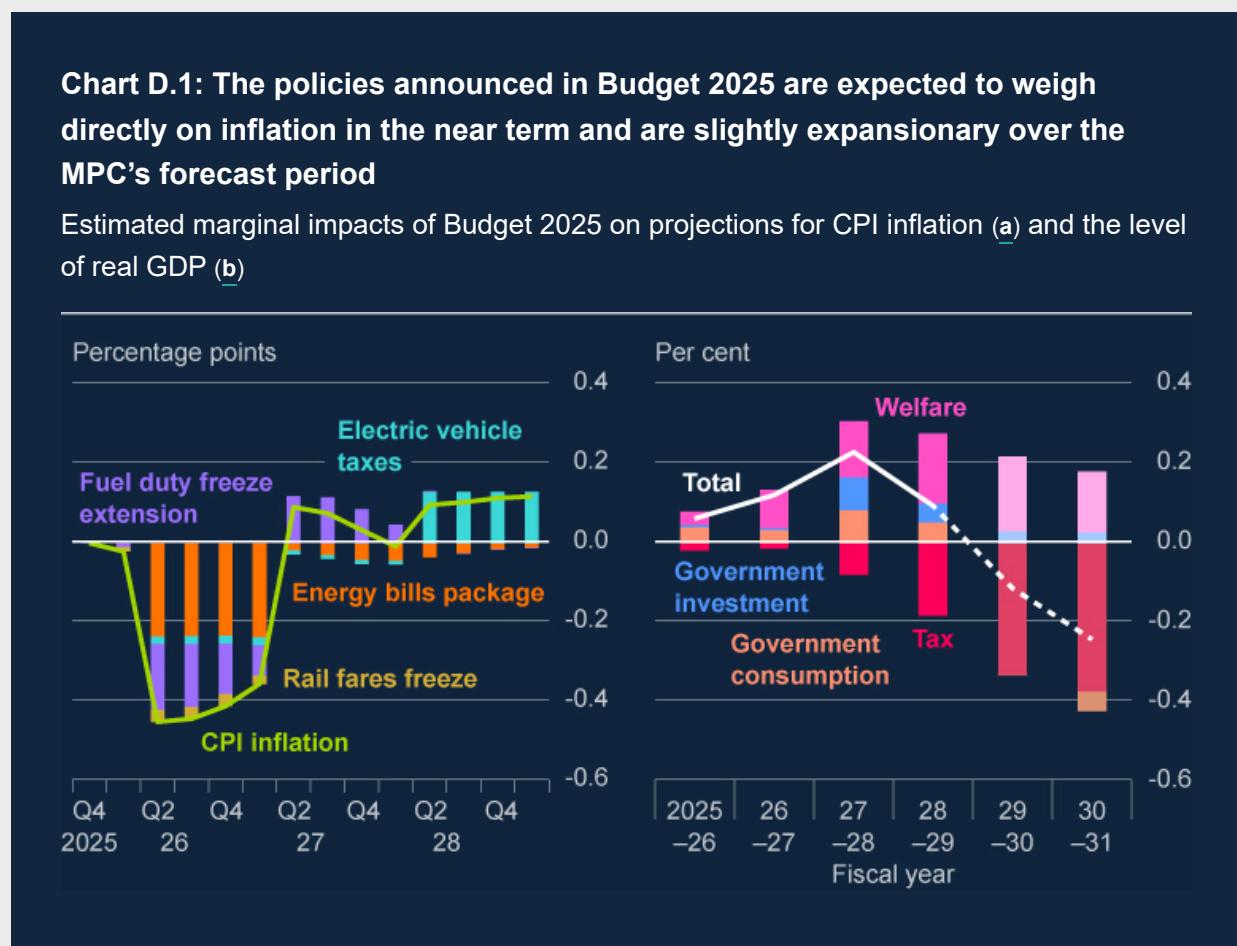
Sources: Office for Budget Responsibility (OBR), ONS and Bank calculations.

(a) The orange bars in the left panel capture the estimated impact of the reduction in costs levied on household electricity and gas from April 2026. The purple bars capture the estimated impacts of the measures taken to stagger and delay the reversal of the temporary 5p cut to fuel duty until September 2026, and to cancel this year's uprating of fuel duty by RPI. Bank staff have estimated the CPI impact of these measures over 2026 and 2027 and have used OBR estimates over the remainder of the forecast period. OBR estimates have been used over the entire forecast period for the other measures on the chart.
(b) The estimated impacts of Budget 2025 measures on the level of real GDP are based on the OBR's costings and Bank staff's fiscal multiplier estimates. The estimates for 2029–30 onwards fall beyond the MPC's forecast period and are shown as lighter coloured bars and a dashed line.

| **How has public sector net borrowing evolved?**

The OBR expects public sector net borrowing over 2025–26 to be £21 billion higher than projected in its forecast at the time of Spring Statement 2025. That follows similar upward revisions in several years since the Covid pandemic. Those revisions have partly reflected the discretionary policy decisions made by the current and previous governments. But **underlying revisions to the OBR's forecast**, in part due to economic conditions having evolved differently to expectations, have also played a role. For example, the OBR has made significant upward revisions to expected welfare spending since the pandemic, due to higher inflation and higher health-related caseloads. Underlying upward revisions to the OBR's forecasts for tax receipts have been much smaller than for spending over this period.

| **What impact will the overall planned fiscal consolidation have on the output gap?**

Government plans imply a significant fiscal consolidation over the next five years (Chart D.2, white line in left panel), such that the OBR forecasts public sector net borrowing will fall from 4.5% of GDP in the current fiscal year to 1.9% of GDP in 2030–31. That consolidation is expected to be largely delivered through higher taxation (gold, green and pink bars). In the MPC's central projection, the fiscal stance weighs on the output gap by around one percentage point by the end of the three-year forecast period (Chart D.2, yellow line in right panel). But that projection is sensitive to the assumed impact of changes in taxation on demand.

While top-down cross-checks of the fiscal stance broadly support the MPC's central projection, some bottom-up estimates suggest that the impact of the fiscal consolidation may be larger. The cyclically adjusted primary balance, a top-down measure that adjusts the government's budget (excluding interest) for the position of the economic cycle using an estimate of the output gap, suggests a similar impact on demand from fiscal policy to the yellow line in the right panel of Chart D.2. It is possible that the tax multiplier used by Bank staff to translate a given change in tax policy into an impact on real GDP is too low, however. The range of tax multiplier estimates in the empirical literature is wide, but the multiplier used in the central projection is towards the lower end of that range. Applying a larger tax multiplier would generate a wider output gap over the forecast period (peach line).

The timing of the effects of tax changes on demand is also uncertain, with a range of estimates in the empirical literature. Tax increases weigh on demand indirectly by reducing disposable income, meaning that they may take longer to impact economic activity than an increase in government spending. Sensitivity analysis suggests that a more gradual reduction in demand from tax increases would imply a larger drag on the output gap from fiscal policy towards the end of the forecast period than in the central

projection (Chart D.2, red line in right panel). Conversely, anticipation of future planned tax increases could result in a more front-loaded reduction in demand (azure line). Households may choose to reduce consumption today if they expect planned tax changes to reduce their real incomes.

Chart D.2: Tax receipts are expected to increase significantly over coming years, reducing public sector net borrowing and weighing on the output gap

OBR projections for cumulative changes in public sector net borrowing as a percentage of real GDP since 2024–25 (a) and estimates of the contribution of the fiscal stance to the level of the output gap (b)
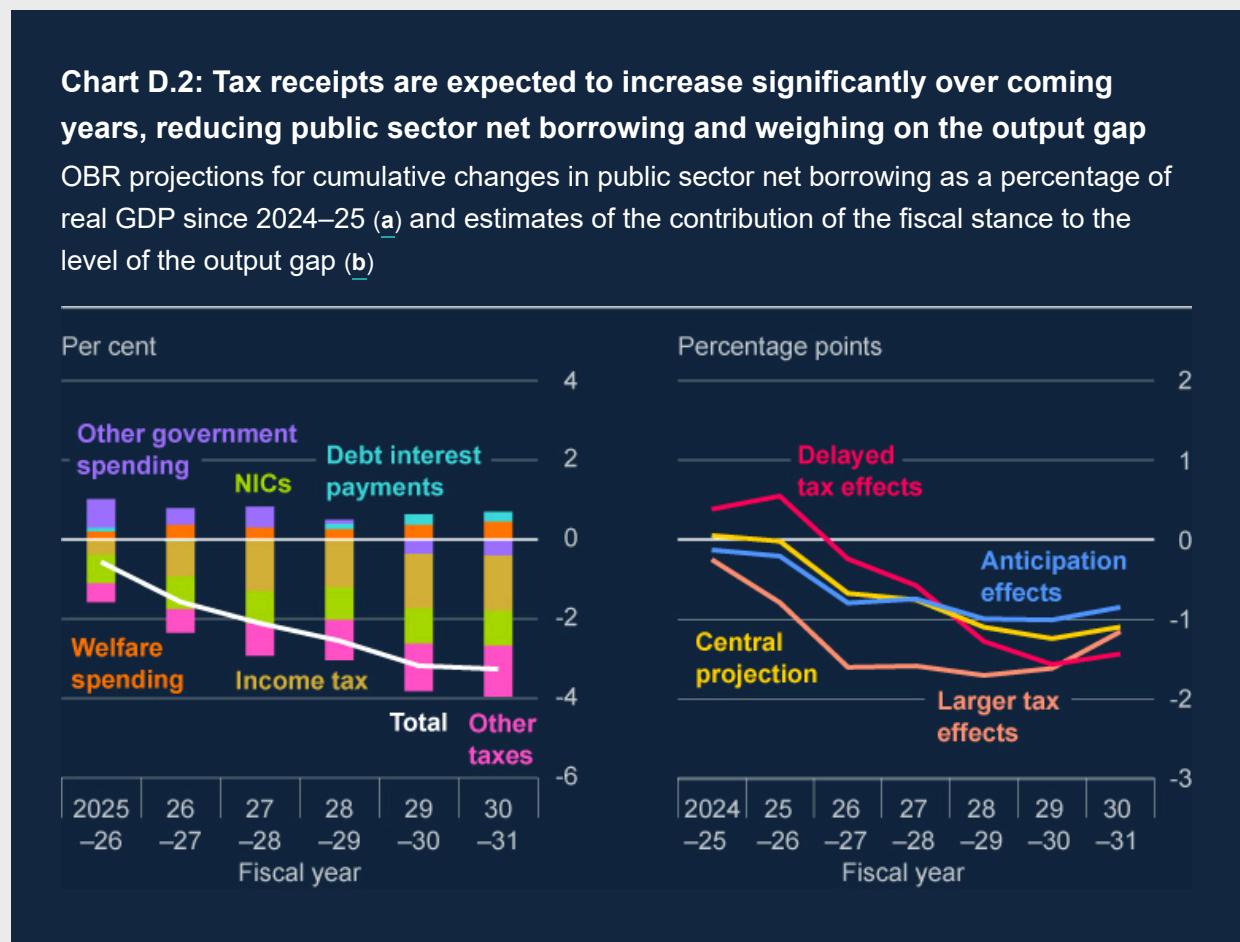
Sources: OBR, ONS and Bank calculations.

(a) The estimates are based on the OBR's November 2025 forecast. Other government spending includes OBR forecasts for government investment (capital departmental expenditure limit) and government consumption (resource departmental expenditure limit). Other taxes include OBR forecasts for VAT, corporation tax and property taxes. Negative values indicate a fall in expected public sector net borrowing. The estimates for 2029–30 onwards fall beyond the MPC's forecast period.

(b) After each fiscal event, Bank staff estimate the effects of discretionary policy changes on the level of real GDP by applying separate demand multipliers to changes in tax and different types of spending from their implementation dates. These effects are then converted into changes in the output gap by using an impulse response function that accounts for endogenous supply effects from changes in demand, for example through capital deepening. In the peach line, the tax multiplier is assumed to be double that in the central projection. The azure line assumes that discretionary changes in taxes have effects prior to their implementation. To illustrate those effects, in the azure line Bank staff assume that 20% of the impact of a change in taxes occurs up to four years prior to implementation and builds to its maximum estimated impact in the year of implementation. In the red line, tax increases are expected to take longer to impact demand but are scaled to have the same peak effect as in the central projection. The estimates for 2029–30 onwards fall beyond the MPC's forecast period.

Box E: Monitoring the transmission of monetary policy with interest rate-sensitive indicators

Restrictive monetary policy has contributed to the disinflation process in recent years. But as Bank Rate has been gradually reduced, a key question is the extent to which interest rates are still weighing on activity and inflation. Tentative evidence from indicators of consumption, business investment and prices that are particularly sensitive to interest rates suggests that lagged effects of past monetary policy tightness continue to weigh on activity and inflation, but that those effects are gradually fading. Further policy easing will in part depend on the speed at which remaining inflationary pressures are expected to dissipate.

How can we assess the impact of monetary policy on the economy?

Tighter monetary policy reduces activity and inflation through a range of channels (**Burr and Willems (2024)**). One way of identifying the impact of changes in Bank Rate is to compare the evolution of more and less interest rate-sensitive components of demand and inflation. A fall in more interest rate-sensitive relative to less interest rate-sensitive parts of consumption, for example, could suggest that the degree of monetary policy restrictiveness is increasing.

Bank staff monitor a range of indicators that are more sensitive to changes in monetary policy than aggregate measures of demand and inflation. To estimate interest rate sensitivities, staff have run local projections (**Jordà (2005)**) of various subcomponents of economic activity on the UK monetary policy shocks identified in **Braun et al (2025)**. These projections, together with DMP Survey responses on the adjustment of sales and investment to a rise in interest rates across sectors, have been used to classify subcomponents based on the strength and speed of their estimated response to monetary policy. The subcomponents have then been recombined into more and less interest rate-sensitive measures of consumption, investment and inflation.

A comparison of more and less interest rate-sensitive components of activity and inflation can only be suggestive of monetary policy effects, however. A wide variety of shocks and confounders could pollute these measures if they happen to affect more interest rate-sensitive and less interest-rate sensitive components differently. In addition, the approach will not fully capture general equilibrium effects of monetary policy on demand, for example through the labour market. These will tend to affect both more and less interest rate-sensitive components and come through with long

lags, which makes them harder to discern. The indicators presented in this box can therefore only provide tentative evidence of the extent to which monetary policy is weighing on demand and inflation.

What can we learn from the evolution of more and less interest rate-sensitive parts of consumption and investment?

Bank staff have identified subcomponents accounting for around 40% of household consumption and around 50% of investment as particularly sensitive to monetary policy. A significant part of the components classified as interest rate-sensitive consumption are durable goods that are frequently purchased with credit. Meanwhile, investment tends to be more sensitive for firms that operate with higher leverage.

Interest rate-sensitive components of consumption have, on average, grown at a materially slower pace than implied by their pre-Covid pandemic trend in recent years (Chart E.1, orange lines in left panel). Interest rate-sensitive consumption was particularly weak in 2023, following material rises in Bank Rate from December 2021. Since the beginning of 2024, interest rate-sensitive consumption has increased again, though at a pace that is slightly weaker than the 2010–19 average growth rate. By contrast, less interest-rate sensitive parts of consumption have fallen only a little below their trend since 2021 (aqua lines). That would be consistent with monetary policy having had a more limited effect on this component of consumption.

Chart E.1: High interest rates still appear to be weighing on more interest rate-sensitive parts of consumption and investment
Investment and consumption components that are more and less sensitive to interest rates (a)
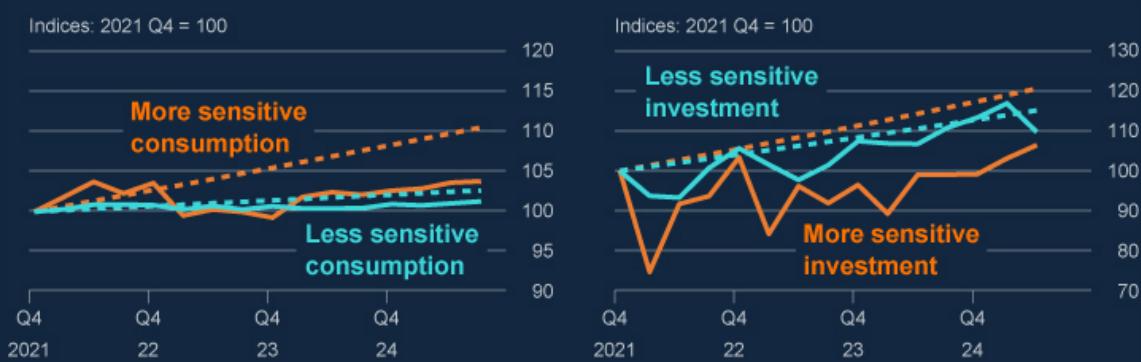
Sources: **Braun et al (2025)**, ONS and Bank calculations.

(a) The analysis is based on quarterly ONS consumer trends data at the COICOP class level and quarterly ONS industry level investment data. The dashed lines show a hypothetical trend based on 2010–19 average growth rates. The latest data are for 2025 Q3 for consumption and 2025 Q2 for investment.

Subcomponents of investment that have historically been sensitive to interest rates have grown more slowly than less sensitive subcomponents since the beginning of the tightening cycle (Chart E.1, right panel). This may partly reflect the effects of tight monetary policy via a cost of capital channel, which tend to come through quickly. More recently, interest rate-sensitive investment has picked up, which could in part be due to the reductions in Bank Rate since the summer of 2024. Meanwhile, less interest rate-sensitive investment has been only slightly weaker than its pre-Covid trend in recent years.

Other drivers of spending, such as elevated uncertainty following past inflationary episodes (Box D of the **November 2025 Monetary Policy Report**), could also be contributing to the divergence between the more and less interest rate-sensitive components shown in Chart E.1. This type of precautionary behaviour is likely to affect durables consumption to a greater degree than non-durables.

Nevertheless, the measures in Chart E.1 are consistent with monetary policy having weighed on the economy in recent years. But the gradual pickup in interest rate-sensitive parts of consumption and investment since 2024 could suggest that monetary policy restrictiveness has started to fade and its overall impact on the level of demand may now be around its peak.

What can we learn from more and less interest rate-sensitive components of the CPI inflation basket?

Higher interest rates tend to weigh more on some items in the CPI basket than others, consistent with differential exposures to the various channels of the monetary policy transmission mechanism. For example, the prices of durable and discretionary goods and services may be more responsive to monetary policy because consumers adjust their demand for them more strongly and more quickly in response to changes in interest rates.

Broadly following the methodology of **Arnaut and Bengali (2024)**, local projections of individual CPI components on identified monetary policy shocks indicate that around 35% of the UK CPI basket can be categorised as particularly sensitive to monetary policy. This is comparable to estimates of policy sensitivity of the HICP basket in the euro area (**Allayioti et al (2024)**). Items that are classified as less sensitive to monetary policy include, for example, pharmaceutical products, while more sensitive CPI components include jewellery and watches. The analysis focuses on core inflation because energy and food prices are driven to a large extent by developments in international markets.

Both the more and less interest rate-sensitive parts of the CPI basket made significant contributions to the elevated rates of core inflation in 2022 and 2023 (Chart E.2). From the summer of 2023, inflation in interest rate-sensitive components has fallen back. Their contribution to core inflation has been close to its historical average since the beginning of 2025, though there has been limited progress since. Meanwhile, inflation in less interest rate-sensitive components has also fallen back significantly but continues to make an elevated contribution to core inflation.

Chart E.2: Inflation for CPI items that are sensitive to monetary policy has fallen and is close to its pre-Covid average

Contributions to core inflation from more and less interest rate-sensitive CPI components (a)

Percentage points

Less sensitive CPI components

More sensitive CPI components

2020   21   22   23   24   25
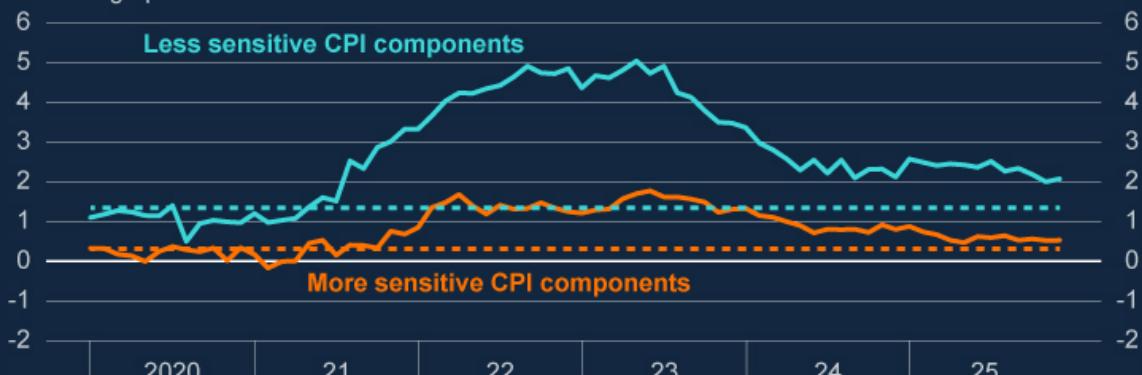
Sources: **Braun et al (2025)**, ONS and Bank calculations.

(a) Individual CPI components, at COICOP-4 (class) level, are split into more and less interest rate-sensitive components, broadly following **Arnaut and Bengali (2024)** and **Allayioti et al (2024)**. The dashed lines show the average contributions to core inflation over 2012–19. The latest data are for December 2025. The chart excludes components with a large share of administered and regulated prices.

The analysis is consistent with monetary policy having contributed to the disinflation process by returning the inflation rate of interest rate-sensitive components of the CPI basket to its historical average. Much of the remaining strength in the inflation rates of less sensitive components is likely to reflect elevated wage growth. Despite their classification as less sensitive to interest rates, monetary policy can still affect these parts of the CPI basket through a range of channels including the labour market, although with long lags.

The recent loosening in the labour market is expected to continue to reduce wage growth over the MPC's forecast period. But if progress on disinflation in less interest rate-sensitive items continued to stall, additional restrictiveness could allow the inflation target to be reached more quickly by temporarily pushing the interest rate-sensitive contribution to CPI inflation below its historical average. The case for further policy easing thus depends in part on the speed at which remaining inflationary pressures are expected to dissipate.

3: Outlook and risks

3.1: Central projection

The central projection is based on a staff proposal, which the majority of the MPC agrees is a reasonable baseline. It provides an important input into the MPC's discussions and policy decision. This projection is, as always, uncertain and the key risks are set out in Section 3.2.

Conditioning assumptions

The February central projection, summarised in Table 3.A and detailed more fully in Annex 1, is conditioned on a range of assumptions (set out in the Report's **Projections Databank**). That includes a market-implied path for Bank Rate which falls to around 3¼% by the final quarter of 2026, before rising towards the end of the forecast period, and the Government's fiscal plans as set out in Budget 2025.

Table 3.A: Forecast summary (a) (b)

	2026 Q1	2027 Q1	2028 Q1	2029 Q1
CPI inflation (c)	3.0 (3.1)	1.7 (2.2)	1.8 (2.1)	2.0
GDP (d)	0.8 (1.1)	1.2 (1.5)	1.9 (1.8)	1.8
Unemployment rate (e)	5.2 (5.0)	5.3 (5.0)	5.1 (4.9)	4.9
Excess supply/**Excess demand** (f)	-0.9 (-0.8)	-0.9 (-0.6)	-0.5 (-0.3)	-0.2
Bank Rate (g)	3.7 (3.8)	3.3 (3.5)	3.5 (3.6)	3.7

(a) Figures in parentheses show the corresponding central projections in the November 2025 Monetary Policy Report.
(b) The numbers shown in this table are conditioned on the assumptions described in the Report's **Projections Databank**.
(c) Four-quarter inflation rate.
(d) Four-quarter growth in real GDP.
(e) International Labour Organization (ILO) definition of unemployment.
(f) Per cent of potential GDP. A negative figure implies output is below potential and a positive that it is above.
(g) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on OIS rates.

Chart 3.1: CPI inflation is expected to return to the 2% target this year and remain around that rate in the medium term. GDP growth is projected to rise modestly in the medium term, while the unemployment rate is expected to peak later this year

Annual CPI inflation, GDP growth and the unemployment rate (a)
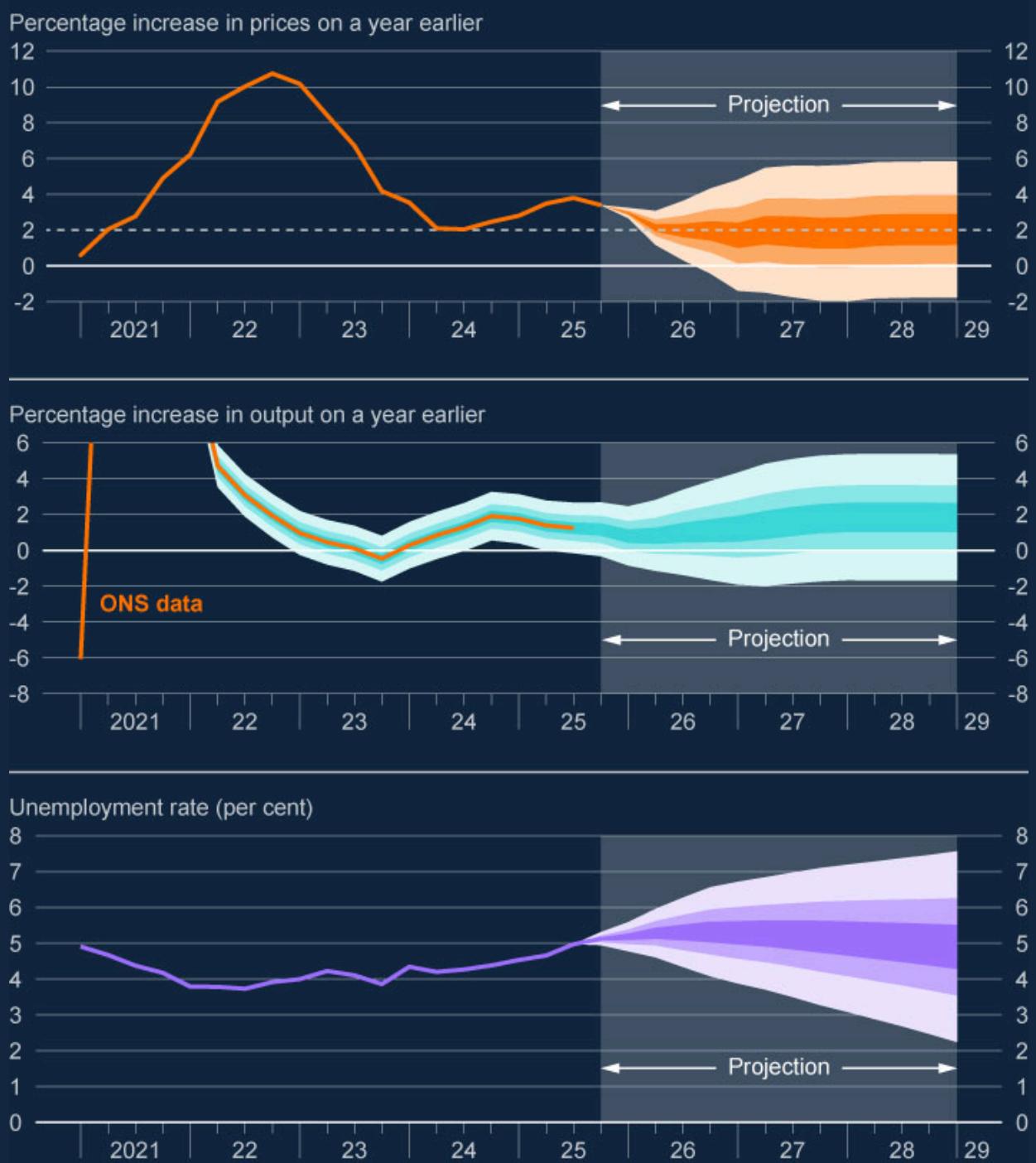
(a) The fan charts depict the probability of various outcomes for GDP growth, the ILO definition of unemployment, and CPI inflation. The uncertainty parameters determining the width of the fan charts have been calibrated to match the historical forecast errors since 2004 and up to 2025 Q2 for each variable at different horizons but exclude errors during the pandemic given its exceptional nature. The fan charts are constructed so that outturns are expected to lie within each pair of lighter areas on 30 occasions, with outturns expected to lie within the fan on 90 out of 100 occasions. On the remaining 10 out of

100 occasions, outturns can fall outside the respective aqua, orange or purple areas of the fan chart, depicted by the grey background. For GDP growth, the distribution reflects uncertainty around past data revisions and future evolution, so that the mature estimate would lie within the darkest central band on only 30 out of 100 occasions. The Committee no longer uses the calibration of the fan chart skew to reflect judgements on the balance of risks to the central projection.

Inflation

CPI inflation was 3.4% in 2025 Q4. It is projected to return to around the 2% target in 2026 Q2 and to remain close to that level over the forecast period. The near-term projection for CPI inflation is significantly lower than in the November Report, largely reflecting lower energy prices including from Budget 2025 (Box D).

Chart 3.2 illustrates the underlying determinants of CPI inflation in the MPC's central projection over the medium term. The contributions shown in this chart are based on the standard relationships and assumptions used in the Bank's forecast models, the direct effects of certain tax policy measures, and judgements to capture relevant factors that are missing from the standard modelling toolkit such as the MPC's previous judgements on inflation persistence (Box F). This approach attributes changes in past and projected inflation to broad economic influences, such as economic slack, that may affect multiple components of inflation.

The expected near-term fall in CPI inflation reflects a lower contribution from energy prices, reflecting the energy bills package introduced in the Budget and lower wholesale gas prices (Chart 3.2, orange bars and Section 1.1). The contributions from administered prices and the pass-through of NICs-related costs are also assumed to dissipate in 2026 Q2 (azure bars and Section 1.1). The contribution from import prices declines over the course of the year (aqua bars) in part due to the expected effects of trade diversion weighing on world export prices (Sections 1.1 and 3.2). In the medium term, these factors make little contribution to the deviation of inflation from the 2% target, although the introduction of mileage-based charges for electric vehicles is provisionally expected to raise inflation slightly in the final year of the forecast (azure bars).

Chart 3.2: Inflation is expected to slow sharply in 2026 Q2 and to be close to the target over the remainder of the forecast

Percentage point deviation from the 2% inflation target (a)

Legend:
- Import prices
- Energy excluding budget measures
- Energy budget measures
- MPC persistence judgements
- Administered prices, NICs and EV mileage charge
- Slack
- Other
- — CPI inflation deviation from target

Percentage points

Projection

2025   26   27   28   29
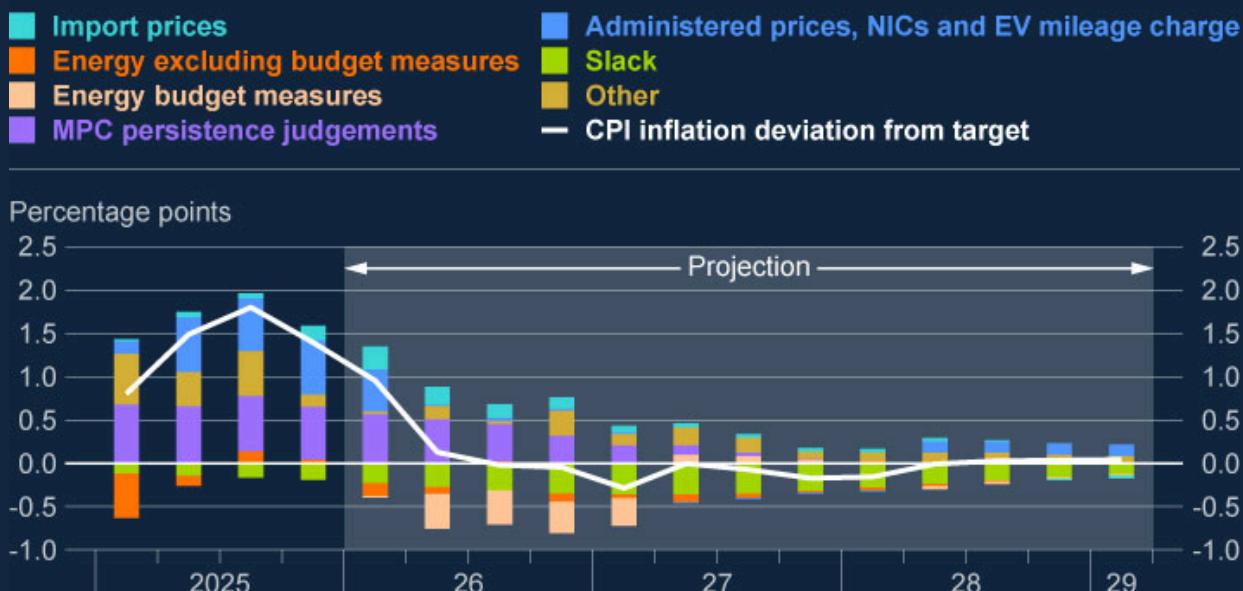
Sources: ONS and Bank calculations.

(a) 'Administered prices, NICs, and electric vehicle (EV) mileage charge' includes the estimated direct effects of changes to Vehicle Excise Duty, bus fares, VAT on school fees, and water charges. The NICs component represents Bank staff's allowance for the effects of the recent increase in employers NICs on CPI inflation. The EV mileage charge component relates to the mileage-based charge on electric vehicles announced in Budget 2025. The 'Energy budget measures' bars represent the estimated direct effects of the energy bills package and the extension of the fuel duty freeze. The 'Import prices' bars includes an MPC judgement on the price of tradables (**May 2024 Monetary Policy Report**) which has little effect on the profile beyond 2026. The 'Other' bars represent other deviations of inflation not attributable to the listed influences including the estimated effects of changes to tobacco and vaping products duties.

The restrictive stance of monetary policy, both currently and over recent years, is helping to bring inflation back to target. This policy stance has contributed to the economy operating with a margin of spare capacity, which over time weighs on domestic inflationary pressures (Chart 3.2, green bars).

Monetary policy is acting against second-round effects in wage- and price-setting related to the 2022 peak in inflation. To capture these effects, whereby elevated CPI inflation at that time contributed to higher inflation expectations and in turn higher wage growth and inflationary pressures, the MPC introduced a judgement that estimated the extent of these additional effects (Chart 3.2, purple bars), including an assumption that they would unwind more slowly than they emerged (Section 5.3 of the **Forecast Evaluation Report – January 2026**).

Over the forecast period, the impact of restrictive monetary policy is projected to continue acting against the remaining second-round effects in price- and wage-setting, such that these effects fade and then dissipate by end-2027 (Chart 3.2, purple bars). The margin of slack widens a little further in the near term, which, together with a fall in inflation expectations alongside headline inflation, supports a normalisation in wage-setting. Wage growth is projected to be slightly above its fundamental drivers over much of the first half of the forecast, based on the expected outlook for productivity (Box C), short-term inflation expectations and economic slack (Chart 3.3). The wage growth projection takes some signal from the Agents' pay survey, which points to wage growth a little above what these fundamentals would imply in 2026 (Section 1.1). Over the second half of the forecast, pay growth is projected to move broadly in line with fundamentals and averages a little under 3%. Wage growth is close to estimated target-consistent levels throughout the forecast (Box A).

Chart 3.3: Wage growth continues to moderate over the forecast

Projections for private sector regular average weekly earnings four-quarter growth (a)
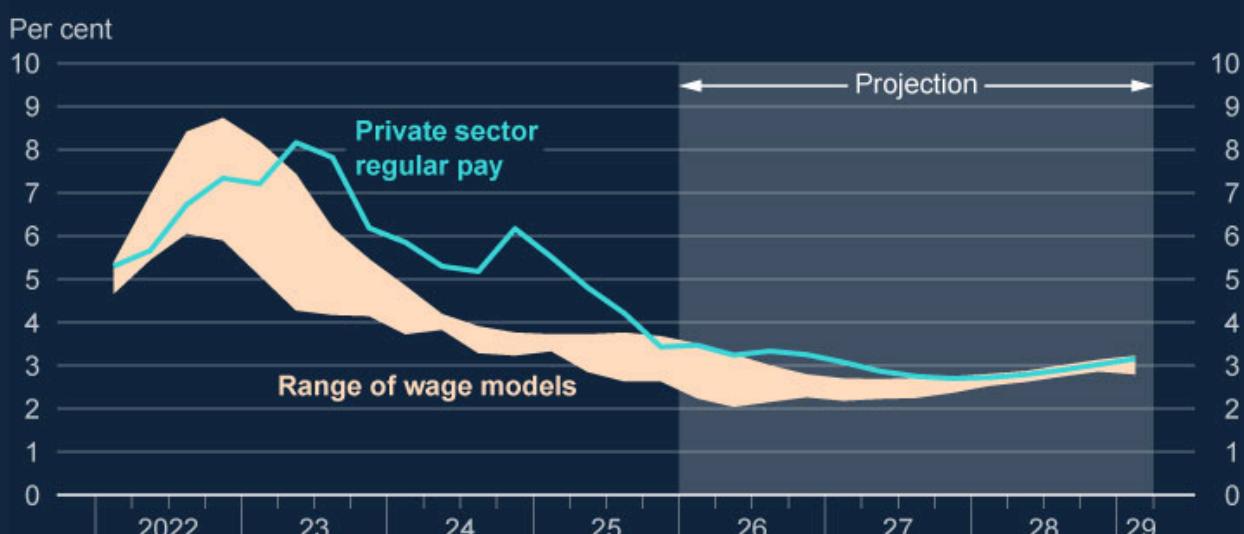
Sources: Bloomberg Finance L.P., Citigroup, ONS, YouGov and Bank calculations.

(a) The shaded area represents a range of projections from three statistical models of nominal private sector regular average weekly earnings growth, including a wage equation based on **Yellen (2017)**, a wage equation based on **Haldane (2018)** and a simple error-correction model based on productivity, inflation expectations and slack in the labour market as embodied in the difference between the actual unemployment rate and the estimated medium-term equilibrium rate. The projections are dynamic, multi-step ahead forecasts beginning at a point within the models' estimation periods and are sensitive to data revisions, which can lead to changes in the range over the past as well as over the forecast period.

Activity

Four-quarter UK GDP growth is projected to strengthen over the forecast period, to around 1.9% by the final year of the forecast. This partly reflects the gradual easing of monetary policy restrictiveness to date, as well as the further easing implied by the market path for interest rates.

The pickup in GDP growth is accounted for primarily by a recovery in annual household consumption growth to a little over 2% by the end of the forecast period. Underpinning this is an expected fall in the saving ratio from just under 10% in 2025 Q4 to around 7½%. Accommodative financial conditions and increasing support from the housing market are also expected to support activity over the forecast period. Housing investment is expected to grow relatively strongly in 2027 and 2028, in part reflecting a positive impact from planning reforms (Section 1 of the **May 2025 Monetary Policy Report**).

Global growth has been resilient over 2025, and is expected to continue at a steady pace over the forecast. Supportive global financial conditions and a waning impact on growth from tariffs and trade policy uncertainty is expected to support demand for UK exports.

These factors more than offset an increasing drag on demand from fiscal policy over the forecast (Box D). Government spending growth is nonetheless expected to increase somewhat before easing back in 2028.

The degree of slack present in the economy, which is currently estimated to be around 1% of GDP, widens a little further over the course of 2026, before starting to narrow as GDP growth outpaces supply growth (Box C). A small margin of spare capacity is projected to remain at the end of the forecast period. Compared with the November Report, there is a slightly greater degree of spare capacity throughout the forecast period. This in part reflects a judgement to take a signal from recent weaker-than-expected readings on the labour market and on capacity utilisation.

The labour market has continued to loosen as subdued growth in output has fed through to weaker labour demand (Section 1.2). The unemployment rate is projected to peak in the second half of 2026, at around 5¼%, before declining gradually. Unemployment remains above Bank staff's assumed medium-term equilibrium rate by the end of the forecast period, though there is uncertainty surrounding this estimate (Section 3.2).

3.2: Risks and sensitivities

This section explores the risks to the economic outlook, including the possibility that a higher or lower future path for Bank Rate may be required for inflation to remain at the 2% target sustainably. The section contains an updated assessment of the two scenarios included in the

November 2025 Report and sensitivity analysis of the implications for inflation of risks around the current size of the output gap, with the related illustrative policy simulations set out in Annex 2.

Risks around structural change in the economy

There remains a risk that structural changes in the labour market will keep wage growth above target-consistent rates.

Wage growth has continued to moderate over the past year and is expected to fall further as the labour market loosens and headline inflation falls (Section 1). But forward-looking wage indicators including the DMP and Agents' pay surveys suggest wage growth could remain more elevated. There is a risk that recent years' large supply shocks have led to lasting changes in wage and price-setting behaviour, resulting in increased real wage resistance and a higher medium-term equilibrium unemployment rate, also known as the non-accelerating inflation rate of unemployment (NAIRU), which in the central projection is expected to be around 4¾% in three years. If the NAIRU is higher, wage growth may fall more slowly than expected in the central projection.

Evidence from clustering analysis of the ways that firms set wages suggests that firms' wage-setting behaviour has been little changed over recent years (Box B). The analysis also finds that the share of workers whose wages are set in a way that is consistent with collective bargaining-type behaviour appears to be around twice the share of workers who are members of a union. Incorporating this finding into models helps explain why wage growth has typically been higher than expected over recent years and suggests that there is less risk that there has been an unidentified structural change in the labour market.

However, last year's increase in employer NICs could have resulted in a reduction in effective labour supply (Box F of the **November 2025 Monetary Policy Report**). The flow of workers leaving payrolled employment has been relatively larger for sectors that are more exposed to the rise in NICs, consistent with a large negative impact on employment in the DMP Survey. There is also a risk that other factors may have led to structural changes in the labour market, including changes in the incidence of long-term sickness, changes in the National Living Wage and developments in public sector wages.

The rate of wage growth that is consistent with inflation at target could be higher or lower depending on the outlook for productivity growth.

The inflation target-consistent rate of wage growth depends on a range of factors including import price inflation, productivity growth and firms' average margins (Box A). There is uncertainty around how these factors will evolve. In particular, there are risks in both directions around future productivity growth (Box C). On one side, new technology, particularly AI, could boost productivity growth as it is adopted by businesses. In that case, wages could

rise more quickly without preventing inflation settling sustainably at the target. On the other side, it is possible that something other than previously identified supply shocks such as the global financial crisis and Brexit has been slowing productivity growth over the past two decades, and that this persists such that the longer-term trend in productivity growth remains weak. All else equal then, wages would need to rise more slowly for inflation to return to target sustainably.

Risks from inflation expectations

Elevated inflation expectations continue to pose a risk that inflationary pressures will remain more persistent, but as inflation is now expected to fall back to around the 2% target in coming months that risk may be receding.

Inflation expectations have remained elevated recently (Section 1.1). And past evidence has highlighted the importance of elevated inflation expectations for wage and price-setting (Box B of the **November 2025 Monetary Policy Report**).

A scenario in the November 2025 Report explored how past high inflation could continue to affect wage and price-setting in the medium term through inflation expectations. Bank staff have updated that scenario to incorporate data published since then and the new central projection. In this updated scenario, inflation settles above the 2% target under the latest market curve, as it did in the November Report (Annex 2). This is because inflation expectations have remained elevated and could be suggesting additional upward pressure on wages and prices.

The projected fall in inflation in coming months should lead inflation expectations to fall back, which in turn should help lessen the risks highlighted in the scenario. Inflation expectations, particularly for households, tend to move in line with inflation outturns over time. This is particularly likely to be the case as the inflation rate of salient products such as energy and food are expected to fall. In addition, the lower near-term inflation outlook should reduce the risk of threshold effects in inflation dynamics (Box C of the **November 2025 Monetary Policy Report**). Inflation returning to around the target may therefore lessen the risks incorporated in the scenario.

Nonetheless, developments in inflation expectations are uncertain. Households' and firms' recent experience of high inflation may make them less responsive to falling inflation outturns than might be expected based on historical relationships. In this case inflation expectations could remain elevated, as they do in the scenario.

As was the case in the November Report, the set of mechanical policy rules under this scenario generally suggests that Bank Rate would need to be somewhat higher than in the equivalent rules under the central projection (Annex 2). The specific response from those policy rules results from the need to manage a trade-off between persistently above-target

inflation and excess spare capacity in the economy. As was the case in November, the MPC would be likely to need to implement an even more restrictive monetary policy response than suggested by these rules to prevent an extended period of above-target inflation. As outlined in Annex 2, each policy rule uses different macroeconomic indicators and weights, leading to a range of different implied future paths for Bank Rate.

Risks from consumption and labour demand

There is a risk that household consumption growth will be slower than anticipated.

The household saving ratio fell by 0.7 percentage points in 2025 Q3, driven by a fall in real household disposable income while real consumption grew modestly. But the saving ratio nevertheless remains above previous averages (Section 1.2). There is a risk that households' consumption and saving behaviour has changed such that the saving ratio remains elevated, which means consumption could contribute less to demand.

The November 2025 Report explored one potential manifestation of this risk using a scenario calibrated to assume a higher level of household risk aversion, accounting for around one third of the rise in the household saving ratio since 2022. An updated version of this scenario incorporating data developments since November and the new central projection results in inflation falling swiftly and remaining below target throughout the next three years under the market path for interest rates (Annex 2). These results are similar to those shown in the November Report, with the saving ratio staying broadly constant over the next few years rather than declining steadily, consumption growth being slower than in the central projection and the output gap widening by more.

The set of mechanical policy rules under this scenario, with the exception of the forward-looking first-difference rule, suggests that Bank Rate would need to be reduced from its current level (Annex 2). An overall looser stance than implied by the market curve would probably be required to prevent inflation falling persistently below target.

There is a risk that labour demand will be weaker than anticipated and lead to higher unemployment.

Labour demand has remained weak over recent quarters and there is a risk that unemployment continues to rise beyond the near-term peak currently expected. There are some indications that redundancies are rising (Section 1.2). Intelligence from the Bank's Agents suggests that businesses have grown more cautious about new hiring. And the recent rise in unemployment has been concentrated among the youngest age groups. Employment downturns have historically tended to emerge first among younger cohorts, meaning that these developments could be signalling a greater-than-anticipated weakening in labour demand.

Weaker-than-expected labour demand may have greater consequences for unemployment when the economy is operating on a flat section of the Beveridge curve, as is currently the case. This means that changes to labour demand will tend to be associated with larger movements in unemployment (Box E of the **November 2025 Monetary Policy Report**). Furthermore, historically there have been relatively few periods in which unemployment has risen slowly. Instead, it tends to be the case that there are turning points where unemployment rises quickly.

Risks around the current level of spare capacity

There is uncertainty over the current level of spare capacity in the economy, which would mean current inflationary pressures are stronger or weaker than embodied in the central projection.

Some of the risks highlighted above would be associated with a different amount of spare capacity in the economy than is currently estimated in the central projection. For example, if there have been structural changes in the labour market such that labour supply is lower than assumed, that would mean that there is less spare capacity in the labour market. In contrast, if potential productivity growth has already been faster as a result of AI technology, there may be more spare capacity in the economy.

There is a range of signals on the level of the output gap from different macroeconomic indicators. Persistently high domestic inflationary pressure and wage growth could be consistent with there being little spare capacity in the economy, but measures of capacity utilisation within firms and rising unemployment suggest that there could be significant spare capacity.

The left panel of Chart 3.4 shows model-based estimates of the current level of the output gap, as well as the output gap in the central projection which synthesises evidence from these models and bottom-up analysis. These models are consistent with current spare capacity in the economy being within a range of around 0.5 percentage points around the central projection of around 1% of potential GDP.

The right panel of Chart 3.4 uses a sensitivity analysis drawing on the relationships underlying the Bank's **COMPASS** model to illustrate how uncertainty about the output gap generates uncertainty about the medium-term inflation outlook. If there were 0.5 percentage points more or less spare capacity over the forecast period, then inflation would tend to be around 0.2 percentage points lower or higher each year, holding interest rates in line with the market path of interest rates. These sensitivities are calculated based on a simple change in the output gap and use the model's Phillips curve estimate, rather than separately modelled changes in components of supply and demand. Nevertheless, the results are similar to alternative estimates based on such changes, for example if there were a different level of the NAIRU.

Chart 3.4: The range of output gap estimates is consistent with differences in the inflation outlook

Output gap estimates, per cent of potential GDP (left panel) and estimated sensitivity of future inflation to a persistent change in the output gap level (right panel) (**a**)
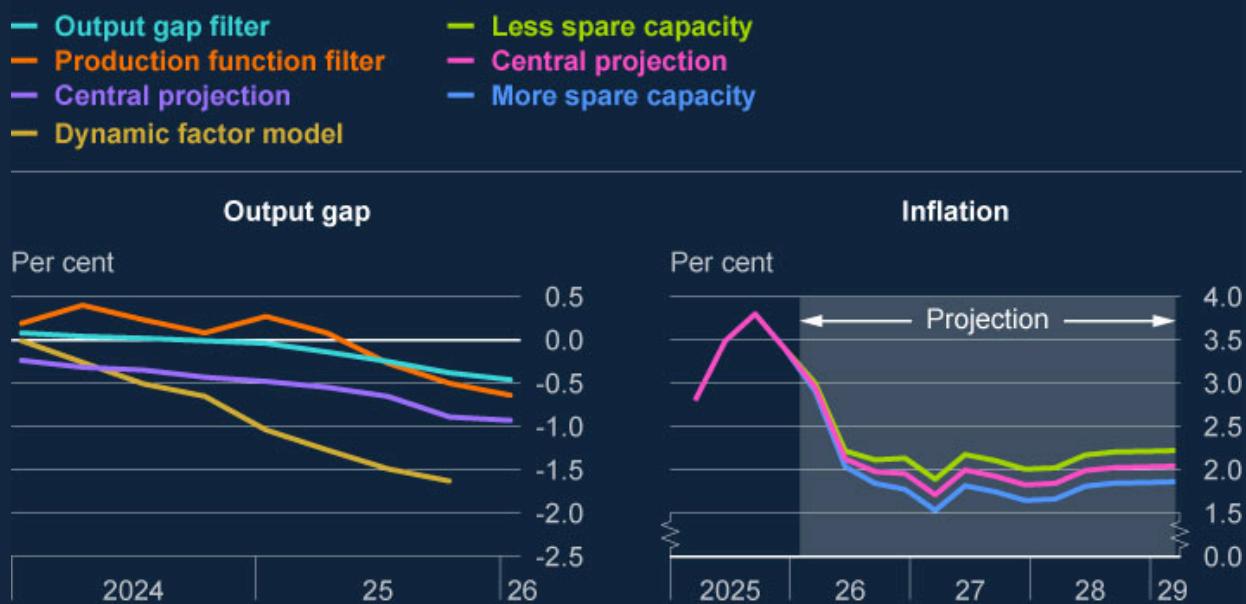
Sources: ONS and Bank calculations.

(a) The production function filter is an unobserved components model which integrates a multivariate filter approach with a Cobb-Douglas production function, following **Toth (2021)**. The output gap filter is a dynamic factor model-based estimate of the common cyclical component of GDP (including select GDP expenditure components), labour market indicators, capacity utilisation, wage growth, and inflation, following **Jarociński and Lenza (2018)**. The dynamic factor model is a data driven model that is less reliant on economic assumptions; it is based on 13 cyclical indicators covering labour market tightness, capacity utilisation, wages and inflation.

In the sensitivity with more spare capacity, mechanical policy rules generally suggest that Bank Rate would need to be reduced from its current level and by more so than in the central projection (Chart 3.5, left panel). This is because greater spare capacity also pushes down on inflation.

In contrast, when there is less spare capacity, the policy rules generally suggest Bank Rate would be closer to the market curve used in the central projection, albeit slightly higher (Chart 3.5, right panel). This is because a higher path for Bank Rate would be required to dampen the inflationary pressures generated by the smaller degree of spare capacity.

Chart 3.5: A greater degree of spare capacity would imply a lower path for Bank Rate, while a smaller degree of spare capacity would imply a slightly higher path for Bank Rate, based on mechanical policy rules

Bank Rate levels implied by select monetary policy rules under the central projection and assuming alternative paths for the output gap (a)

— Forward-looking first-difference rule
— Optimal policy projection
— Forward-looking Taylor-type rule
— Contemporaneous Taylor-type rule
-- Memo: market path

More spare capacity

Per cent

Baseline projection

Per cent

Less spare capacity

Per cent
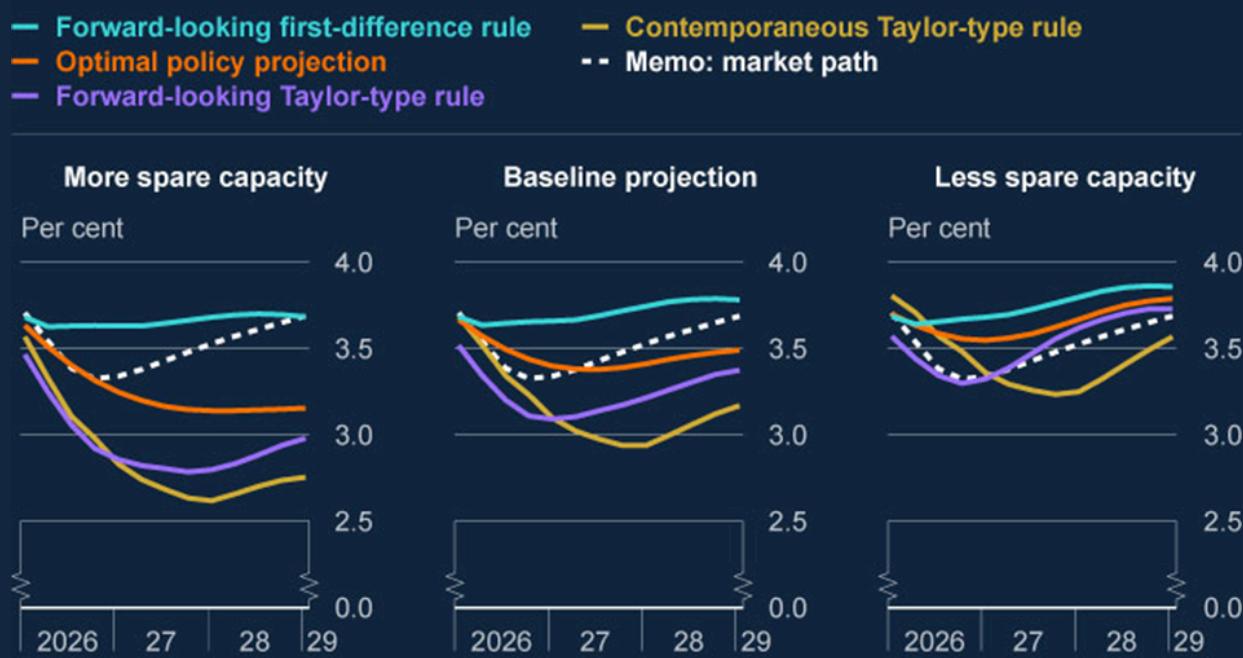
Source: Bank of England.

(a) Annex 2 provides additional detail on the definition of the policy rules shown here and the equivalent paths for the output gap and inflation. These should not be interpreted as a prescription for how policy is likely to evolve.

Risks around the restrictiveness of the monetary policy stance

The degree to which the current monetary policy stance is restrictive is uncertain.

One way to assess whether the current level of Bank Rate is restrictive is to compare it to an estimate of the neutral rate. The neutral rate, or equilibrium real interest rate, can be defined as the time-varying real interest rate that, if the economy started from a position of no output gap and inflation at target, would sustain output at potential and inflation at target. Overall, the evidence suggests that current monetary policy remains somewhat restrictive but, as Bank Rate has been reduced over recent quarters towards the neutral rate, it is becoming harder to judge exactly the extent of restrictiveness where small numbers are involved. Meanwhile, past higher levels of Bank Rate are continuing to reduce demand in the economy because of lags in transmission (Section 3.1).

Updated Bank staff models of the gap between Bank Rate and the neutral rate (Box A of the **August 2025 Monetary Policy Report**) suggest that there is currently a small positive real interest rate gap, ranging from around 0–1 percentage point (Chart 3.6, aqua and orange bars). That accords broadly with evidence from macroeconomic indicators of the monetary policy transmission mechanism (Box E).

Chart 3.6: Models generally suggest that the current stance of monetary policy remains restrictive, although this is uncertain

Average real interest rate gaps in February 2026 (**a**)
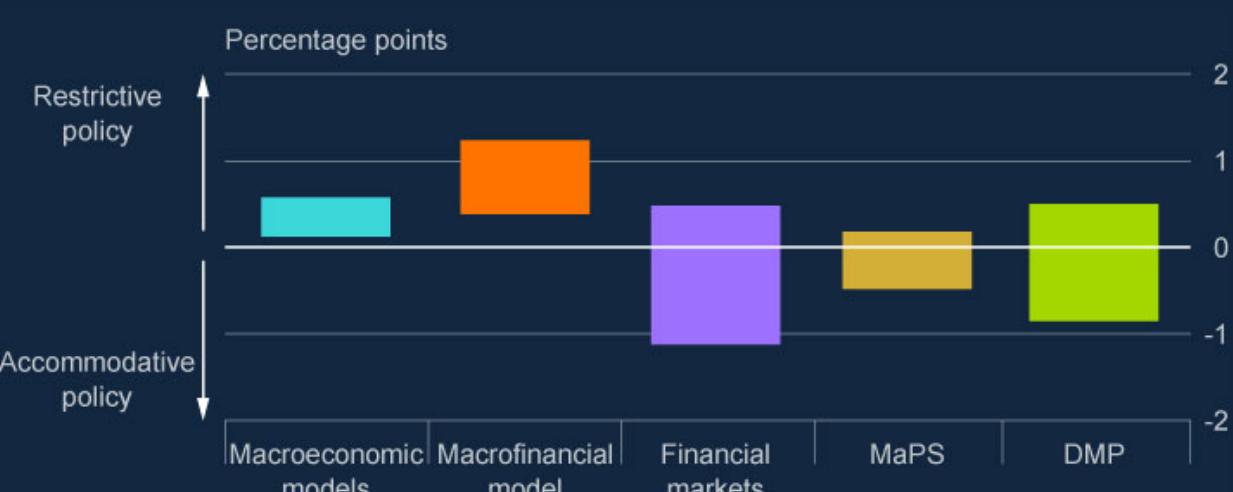
Sources: Bank of England, Bank of England/Ipsos Inflation Attitudes Survey, Bank of England Market Participants Survey (MaPS), Bloomberg Finance L.P., Consensus Economics, **Davis et al (2024)**, DMP Survey, ONS, TradeWeb FTSE Gilt Closing Data and Bank calculations.

(a) All measures of the real interest rate gap presented in this chart show the implied degree of monetary policy restrictiveness over a three-year horizon. The macroeconomic models range is produced using estimates from a dynamic semi-structural investment-saving curve model and one of the main models underlying the central projection in this Report (**Albuquerque et al (2025)**). The macrofinancial model range is estimated using the state-space model from **Davis et al (2024)**, with a 95% confidence interval applied around the central estimates of the neutral rate. The financial markets range uses estimates of the nominal neutral rate derived from five term-premia models: the benchmark and survey models in **Malik and Meldrum (2016)**, **Vlieghe (2016)**, **Andreasen and Meldrum (2015)** and **Meldrum and Roberts-Sklar (2015)**. These estimates are adjusted by average six-year to 10-year inflation expectations from half-year Consensus surveys to obtain real neutral rate estimates. The real policy rates in the financial markets ranges are calculated as the average instantaneous forward OIS curves over three-year horizons, deflated by annual Consensus survey inflation expectations over this period. These inflation expectations are linearly interpolated over the three-year horizon. The instantaneous forward OIS curves are estimated using the average paths for interest rates in the 15 UK working days to 26 January 2026, on which the baseline projections for the February Report are conditioned. The DMP range is based on the difference between DMP respondents' nominal one year ahead Bank Rate expectation relative to their three-year ahead Bank Rate expectation (which is assumed to match their perception of the neutral rate), adjusted by their expectation for CPI inflation over the same periods. The range shows the 10th–90th percentile of perceptions and the data were collected between November 2025 and January 2026.

Some alternative indicators suggest that monetary policy may no longer be restrictive. Financial market derived measures of the real interest rate gap, MaPS and the DMP Survey all provide a wide range of estimates of the real rate gap (Chart 3.6). These ranges are wide enough that it is possible that Bank Rate may be around neutral or slightly accommodative, although these results are sensitive to the definition of inflation expectations used, and financial market contacts generally consider the current level of Bank Rate to be restrictive.

Global shocks

| **Global risks remain elevated.**

One area of continued uncertainty has been around global trade policy. Bank staff analysis suggests that the impacts of past increases in US tariffs, and the associated trade policy uncertainty, on global GDP have so far been smaller than expected. There remains a risk that the US government raises some tariff rates further in the future. And there are risks that heightened trade policy uncertainty has larger effects on the UK and global economy, for example by depressing businesses' investment and via financial markets. Longer-term impacts on global productivity growth from greater global trade restrictions may also be larger, for example through less efficient allocation of activity.

There is also uncertainty over the extent to which trade policy changes are affecting global export prices and to what extent this is reflected in UK import prices. There is indicative evidence that US tariffs have led to slower growth in export prices among countries more exposed to the new tariffs, particularly China since March 2025 (**Garofalo and Prayer (2026)**). This could be consistent with these countries facing reduced demand for their exports. UK import prices moved broadly in line with global export prices over 2025. If tariffs continue to slow global export price growth, that could reduce inflationary pressure in the UK, although the magnitude of this effect remains uncertain. Geopolitical developments also continue to create substantial uncertainty around the outlook for energy prices.

| **Optimism about AI technology has boosted financial markets in recent years. If the benefits of this technology are lower than expected, this could reduce UK GDP.**

New AI technologies have increased global GDP growth, with the US particularly affected. This has been through increased investment, and by raising financial market asset prices. If the productivity and commercial benefits of AI technology are smaller than expected, that is likely to result in lower global investment, reducing global GDP. As the UK is not a main exporter of AI-related equipment, the UK impact should be limited. The UK economy would be more exposed through the effect on equity prices. If US stock markets fall after a reassessment of the value of AI, that would be likely to spillover into a fall in UK equity prices, with potential knock-on effects on other financial assets. That would lower the value of assets held by UK households and businesses, reducing consumption and investment. Given the fact that AI investment has been financed predominantly through cash and equity to date, the

FPC considers that that currently limits the likelihood of severe systemic risk implications from a market revaluation of the benefits of AI (Box C of the **December 2025 Financial Stability Report**). In general, to the extent that tail risk type events do not significantly affect the current balance of risks in the economy, it is unlikely to be effective for monetary policy to respond pre-emptively, particularly if the probability or impact of the shock occurring is unaffected by the monetary policy stance.

Box F: Insights from the Forecast Evaluation Report

Analysis of forecast performance is important to help identify strengths in, and opportunities to build on, the MPC's understanding of the economy. The recently published Forecast Evaluation Report finds that the Bank's forecasts have performed at least as well as external forecasters and model-based approaches over time. It also sets out some areas for improvement in the Bank's standard models, highlighting the importance of drawing on a wide range of models and analytical inputs when setting monetary policy.

The role of the Bank's forecasts in the MPC's policy framework has been evolving (**Bernanke (2024)** and **Dhami et al (2025)**), but they remain an important element of the wider range of inputs into the MPC's policy decisions. Evaluating how the Bank's forecasts have performed as predictors of economic outcomes is therefore important to help identify strengths and areas for improvement in the MPC's understanding of the economy.

The Bank recently published its first **Forecast Evaluation Report** (FER), with approaches underpinned by a new forecast evaluation toolkit (**Abiry et al (2026)** and **Bank of England GitHub**). The Report in part responds to **Bernanke's (2024)** recommendations for the Bank to build on its previous forecast evaluation efforts, and to do more to identify and explain its forecast errors. Drawing on some of the Report's findings, this box summarises how the economy has evolved relative to the Bank's forecasts and some takeaways for the MPC.

How has the economy evolved relative to the Bank's forecasts in recent years?

The current economic outlook is, in part, shaped by the series of significant economic shocks the UK has faced in recent years. These have made forecasting over this period particularly challenging.

The UK economy has faced a sequence of historically large shocks over the past few years (**Bailey (2023)**, **Pill (2024)**, **Mann (2025)**, **Taylor (2025)**). That sequence of shocks alongside a number of structural changes continues to be felt in current economic conditions. They have also made forecasting over this period particularly challenging, and, as noted by **Bernanke (2024)**, have meant that central banks across the world, including the Bank, have made larger forecast errors than in previous years.

Consistent with that, the FER shows that the accuracy of the Bank's forecasts, as measured by root mean squared errors, has deteriorated compared to the pre-pandemic period.

Charts F.1 and F.2 show realised data outturns compared with successive Bank forecasts since August 2021. These suggest, on average, that outturns have been higher than forecast for CPI inflation, GDP growth and wage growth, and below forecasts for the unemployment rate.

Chart F.1: CPI inflation and GDP growth outturns have tended to exceed forecasts

Forecasts and outturns for CPI inflation and GDP growth (a)
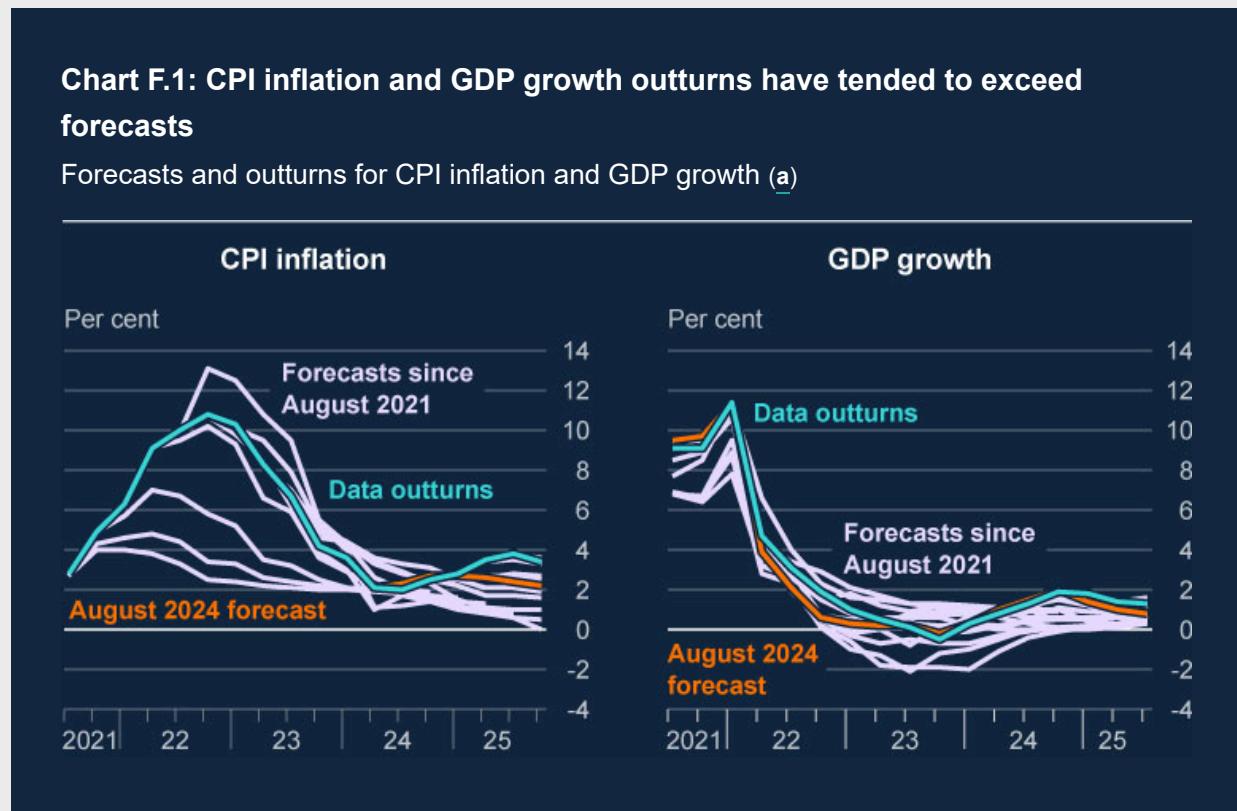
Sources: ONS and Bank calculations.

(a) Latest data points shown are for 2025 Q3, except for CPI inflation for which latest data points shown are for 2025 Q4. Lines in light purple show the successive Bank forecasts for each variable, including those published alongside the August 2021 Monetary Policy Report up to the November 2025 Monetary Policy Report. Lines in orange show forecasts as at the time of the August 2024 Monetary Policy Report, which is one year prior to the latest available data point. Forecasts shown are for four-quarter growth in GDP and CPI inflation (seasonally adjusted).

Chart F.2: Wage growth has tended to be stronger than expected over the past five years, while unemployment has been higher than projected a year ago

Forecasts and outturns for wage growth and unemployment (a)
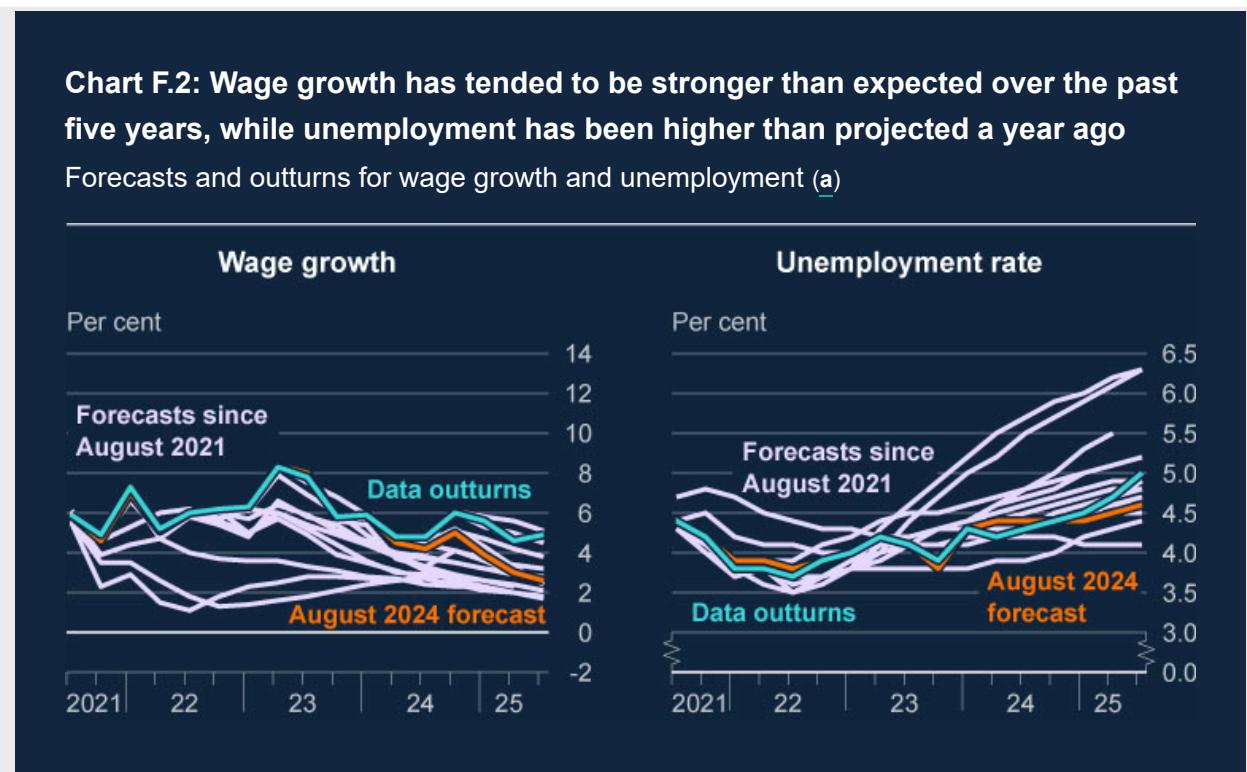
Sources: ONS and Bank calculations.

(a) Refer to Chart F.1. Forecasts shown are for four-quarter growth in whole-economy total average weekly earnings and for the level of the unemployment rate.

> **Data outturns for CPI inflation, GDP growth, wage growth and the unemployment rate have been higher than forecast in the August 2024 projections.**

These charts also highlight how data outturns have evolved relative to the projections published in the **August 2024 Monetary Policy Report** (Charts F.1 and F.2, orange lines). These suggest that errors have generally been smaller over this more recent period than on average over the past five years.

CPI inflation has been higher than projected in August 2024. That difference partly reflects particularly strong food price inflation and changes announced in Autumn Budget 2024, such as increases in a number of administered prices and employer NICs. It also partly reflects stronger-than-expected wage growth. Wage growth has fallen back over the past year, but by less than had been expected in the August 2024 Report. The Bank's models partly attribute this news to inflation expectations, which have been stronger than their historical relationships with other variables would suggest, and the increase in employer NICs. As outlined in previous Monetary Policy Reports, however, those models have struggled to explain some of the recent strength in wage growth, suggesting some role for more persistent inflationary pressures or

structural factors (Box F of the **November 2025 Monetary Policy Report**). The analysis on heterogeneity in wage-setting presented in Box B does not find evidence for the role of structural factors, however.

GDP growth has exceeded projections from August 2024, with the difference partly reflecting looser than previously announced fiscal policy alongside an easing in financial conditions. The unemployment rate has also been higher than the August 2024 expectation. This contrasts with the past five years, when outturns have tended to be lower than projected on average. The larger-than-expected rise in unemployment may reflect an increase in structural unemployment, owing in part to increases in labour costs (Section 3.2), or could reflect a cyclical reversal in the excess hiring observed after the pandemic.

Over the past five years, inflation has been stronger than expected on average, with the peak upside inflation forecast error occurring in late 2022…

Building on this overview of the performance of the most recent forecasts, the FER explores some of the drivers of the Bank's forecast errors over the past five years in greater detail. Forecast errors have generally been larger over this period.

On average, since mid-2021, inflation outturns have tended to come in stronger than the Bank's forecasts (Chart F.1, left panel). The peak one year ahead inflation forecast error was in October 2022 when CPI inflation reached 11.1%, 8 percentage points above the forecast produced in August 2021. Bank staff estimates suggest that half of that peak forecast error reflected the rise in energy prices following the Russian invasion of Ukraine in early 2022. Higher-than-expected global export prices can explain much of the remainder.

…persistence in domestic wage and price setting, which was not well captured by the Bank's standard models, explains some of the forecast errors after that peak.

The Bank's medium-term inflation forecasts were also repeatedly too low, on average, after the inflation peak in 2022. The initial shocks, which led to the sharp rises in inflation, also resulted in more persistent domestic price and wage increases, or second-round effects. Consistent with that, stronger-than-expected inflation outturns were accompanied by stronger-than-expected wage outturns. As discussed previously, it is also possible that the persistent strength in wage and price growth may have reflected structural changes in wage-setting behaviour.

The MPC applied judgements in real time to help account for these persistence effects, which were not well captured by the Bank's standard models. These persistence judgements reduced the size of the inflation forecast errors over this period. As

estimating the size and speed of those effects is challenging, those judgements have been informed by a range of other model estimates and analysis and updated over time to reflect new information. The latest version of the MPC's persistence judgements suggests second-round effects will push up on annual inflation until end-2027 (Chart 3.2 in Section 3.1).

There remain risks and uncertainty around the strengths of these mechanisms and how quickly they might fade. Exploring the risks that greater inflation persistence might present to the MPC's central projections has informed a number of recent scenarios (**May 2025 Monetary Policy Report** and **November 2025 Monetary Policy Report**).

GDP growth has been stronger than forecasts on average since mid-2021.

GDP growth has, on average, exceeded forecasts since mid-2021 (Chart F.1, right panel). During this period, growth was initially weaker than the Bank's projections due to the unanticipated surge in energy prices and higher interest rates in response to rising inflation. Growth later outperformed expectations as energy prices fell faster than anticipated, the hit to activity proved smaller, and fiscal support helped limit the impact on household incomes.

In more recent years, positive GDP surprises have also coincided with less economic slack, which also reflects estimates of potential supply growth having been judged to be slightly weaker than expected. A series of significant shocks have weighed on potential supply, such as the after-effects of the pandemic, the energy price shock and the change in trading relationships with the EU (**Bailey (2023)**).

Longer-term statistical analysis identified the Bank's labour market forecasts as an area for improvement.

The FER also includes some longer-term statistical analysis, which evaluates forecast performance over the past 10 years. This analysis pointed to the Bank's labour market forecasts as an area for improvement. The Report's findings suggest that forecast errors for wage growth have been skewed in opposite directions either side of the pandemic. And the unemployment rate has been overpredicted on average since 2015, even though it has been underpredicted in the most recent forecasts. There is also evidence that both the wage and unemployment forecasts could have made better use of information that was available at the times the forecasts were made.

What do the FER findings mean for the MPC?

The FER finds the Bank's forecasts are at least as accurate as alternative forecasts, although there is still more to do to advance the Bank's understanding of the mechanisms driving some forecast errors, particularly on

> **the labour market.**

The FER finds the Bank's forecasts have been at least as accurate as the average of external forecasters and a range of model-based alternatives over the past decade, consistent with findings from the **Bernanke Review (2024)**. While the accuracy of the Bank's forecasts has reduced since 2020, that is also true of the range of comparable benchmarks.

As noted above, the FER points to the labour market and wage-price dynamics as key areas for model improvement, with the post-2022 persistence of inflation and robust wage growth underscoring the importance of better capturing links between labour-market tightness, wage growth, CPI inflation and inflation expectations. Expanding on work in these areas would represent a further step towards the 'continuous learning' about the structure of the economy that the Bernanke Review recommends (**Lombardelli (2024)**).

> **These findings further highlight the importance of the MPC drawing on a range of inputs, alongside the central projections, to inform members' judgements and understanding of the economic outlook.**

The MPC often draws on alternative models, diverse data sources or analysis to inform the judgements layered on the forecasts (for example, the MPC persistence judgements and MPC judgements to boost demand over 2023 (Key judgement 2 in the **February 2023 Monetary Policy Report**)), or in some cases to help Committee members outline where their views on the economic outlook differ from the central projections (as set out for example in the MPC members' views section of the **February 2026 Monetary Policy Summary and Minutes**).

The FER findings further highlight the importance of the MPC continuing to draw on sources that offer alternative views on economic mechanisms, particularly those that the Bank's standard forecasts tend to capture less well.

Annexes

Annex 1: Central projection tables

This annex provides additional details on the central projection. Further forecast variables are provided in the Projections Databank, available from **Monetary Policy Report – Download chart slides and data – February 2026**.

Table A1.A: GDP (a)

	Average 1998–2007	**Average 2010–19**	**2025**	**2026**	**2027**	**2028**
World GDP (UK-weighted) (b)	3.1	2.5	2.3 (2.0)	2.2 (1.8)	2.2 (2.2)	2.2 (2.0)
UK GDP (c)	2.8	2.0	1.4 (1.5)	0.9 (1.2)	1.5 (1.6)	1.9 (1.8)
Household consumption (d)	3.2	2.1	1.0 (0.9)	1.0 (1.1)	1.4 (1.8)	2.1 (2.1)
Real post-tax labour income (e)	3.3	1.5	1.8 (2.8)	0.6 (0.7)	0.3 (0.2)	0.9 (1.0)
Household saving ratio (f)	7.4	8.2	10.1 (10.9)	9.3 (10.4)	8.6 (9.4)	7.9 (8.8)
Business investment (g)	3.4	4.2	4.6 (4.0)	1.6 (1.0)	1.2 (1.3)	2.4 (2.1)
Housing investment (h)	3.7	3.6	2.9 (2.0)	2.2 (3.5)	5.5 (6.8)	6.0 (6.5)
Government expenditure (i)	3.6	0.9	1.6 (2.2)	2.5 (2.2)	2.2 (1.6)	1.1 (1.4)
Exports (j)	4.2	3.5	2.1 (3.2)	0.9 (1.2)	2.1 (2.0)	2.3 (2.0)
Imports (k)	5.8	4.1	4.2 (4.2)	1.1 (1.1)	2.6 (2.9)	3.0 (2.9)
Excess supply/**Excess demand** (l)	0	-1.7	-0.6 (-0.6)	-1.0 (-0.8)	-0.8 (-0.5)	-0.4 (-0.1)

(a) Figures show annual growth rates (excluding 'Excess supply/**Excess demand**') and are chained volume measures. Figures in parentheses show the corresponding projections from the November 2025 Monetary Policy Report.

(b) Constructed using real GDP growth rates of 188 countries weighted according to their shares in UK exports.

(c) Based on ONS series ABMI.

(d) Includes non-profit institutions serving households. Based on ONS series ABJR+HAYO.

(e) Wages and salaries plus mixed income and general government benefits less income taxes and employees' National Insurance contributions, deflated by the consumer expenditure deflator. Based on ONS series [ROYJ+ROYH-(RPHS+AIIV-CUCT)+GZVX]/[(ABJQ+HAYE)/(ABJR+HAYO)].

(f) Percentage of total available household resources. Based on ONS series NRJS.

(g) Based on ONS series GAN8.

(h) Whole-economy measure. Includes new dwellings, improvements and spending on services associated with the sale and purchase of property. Based on ONS series DFEG+L635+L637.

(i) Based on ONS series NMRY+G93X.

(j) The historical data exclude the impact of missing trader intra-community (MTIC) fraud. Since 1998 based on ONS series IKBK-OFNN/(BOKH/BQKO).

(k) The historical data exclude the impact of MTIC fraud. Since 1998 based on ONS series IKBL-OFNN/(BOKH/BQKO).

(l) Annual average level. Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.

Table A1.B: Wages and prices (a)

	Average 1998–2007	Average 2010–19	2025 Q4	2026 Q4	2027 Q4	2028 Q4
Private sector regular average weekly earnings (b)	4.1	2.2	3.4 (3.5)	3.3 (3.2)	2.7 (2.9)	3.0 (3.2)
Private sector regular pay-based unit wage costs (c)	1.9	1.6	3.9 (3.6)	3.0 (1.9)	1.6 (1.7)	1.8 (1.9)
UK import prices (d)	-0.5	1.3	2.2 (1.6)	-0.6 (0.1)	0.1 (0.6)	-0.2 (-0.1)
CPI (e)	1.6	2.2	3.4 (3.5)	2.0 (2.5)	1.8 (2.0)	2.0 (2.1)
Energy prices – direct contribution to CPI inflation (f)	0.3	0.2	0.1 (0.1)	-0.3 (0.2)	0.1 (0.1)	0.0 (0.1)

(a) Four-quarter growth in Q4 (except for Energy prices – direct contribution to CPI inflation). Figures in parentheses show the corresponding projections from the November 2025 Monetary Policy Report.
(b) Private sector average weekly earnings excluding bonuses and arrears of pay. Based on ONS series KAJ2.
(c) Private sector wage costs divided by private sector output at constant prices. Private sector wage costs are AWE (excluding bonuses) multiplied by private sector employment.
(d) Excludes fuel and the impact of MTIC fraud.
(e) Based on ONS series D7BT.
(f) Contribution of fuels and lubricants and gas and electricity prices to four-quarter CPI inflation.

Table A1.C: The labour market (a)

	Average 1998–2007	Average 2010–19	2025	2026	2027	2028
Labour productivity output per worker (b)	1.8	0.7	-0.2 (-0.2)	0.3 (0.8)	0.9 (1.1)	1.0 (1.0)
Employment (c)	1.0	1.2	1.6 (1.7)	0.6 (0.4)	0.6 (0.5)	0.8 (0.8)
Working-age (16+) population (d)	0.7	0.7	1.1 (1.1)	0.9 (0.8)	0.7 (0.7)	0.7 (0.7)
Participation rate (e)	63.0	63.5	63.8 (63.8)	63.9 (63.7)	63.8 (63.6)	63.8 (63.5)
Unemployment rate (f)	5.3	6.0	4.8 (4.8)	5.3 (5.0)	5.2 (5.0)	5.1 (4.8)
Average hours (g)	32.4	31.9	31.8 (31.8)	31.7 (31.8)	31.7 (31.8)	31.7 (31.8)

(a) Figures in parentheses show the corresponding projections from the November 2025 Monetary Policy Report.

(b) Annual average level. Real GDP divided by total 16+ employment. Based on ONS series ABMI/MGRZ.

(c) Annual average growth rate. Based on ONS series MGRZ.

(d) Annual average growth rate. LFS household population, all aged 16 and over.

(e) Annual average level. ILO definition of labour force participation as a percentage of the 16+ population. Based on ONS series MGWG.

(f) Annual average level. ILO definition of unemployment rate. Based on ONS series MGSX.

(g) Annual average level.

Annex 2: Model-based policy simulations

Endogenous policy simulations are model-based exercises that account for systematic feedback between monetary policy and economic outcomes, in both directions. As described in **Alati et al (2025)**, Bank staff regularly analyse a range of endogenous policy simulations, drawing on simple illustrative policy rules and so-called optimal policy projections (OPPs). These exercises show how alternative policy approaches affect the economic outcomes that can be achieved within a macroeconomic model and can assess how a given approach performs in alternative scenarios.

While a useful input to the monetary policy process, there is no mechanical link between endogenous policy simulations and real-world monetary policy decisions. The tools are stylised and simplified, so do not reflect the full set of information and uncertainties with which policymakers are faced.

Alternative approaches to endogenous policy

Bank staff typically consider two approaches to endogenous policy. Under simple policy rules, policy is set mechanically according to a reaction function that includes a small number of macroeconomic factors. Under OPPs, policy paths are constructed to minimise a loss function intended to capture policymakers' preferences over macroeconomic outcomes. Both approaches recognise the remit of the Bank of England. The two approaches have different merits and limitations, discussed further in **Alati et al (2025)**.

Table A2.A provides expressions for three simple policy rules, specified with Bank Rate and rates of inflation in quarterly terms. i_t denotes the quarterly nominal Bank Rate, averaged over quarter t. The right-hand side variables in the rules include: (the deviation from steady state of) year-on-year energy inflation in the current quarter (in quarterly terms), π_t^E; (the deviation from steady state of) year-on-year inflation of non-energy components in the current quarter (in quarterly terms), π_t^N; the projection for year-on-year CPI inflation three and five quarters ahead (in quarterly terms), $\pi_{t+3|t}$ and $\pi_{t+5|t}$; the output gap in the current quarter and five quarters ahead, y_t and $y_{t+5|t}$; and quarterly GDP growth three quarters ahead, $\Delta GDP_{t+3|t}$. Bank Rate and rates of inflation are incorporated in quarterly terms. For these simulations, i^* is constant and assumed to be 3% annually, consistent with a 2% annual CPI inflation objective (π^*) and an illustrative long-run trend equilibrium annual real rate of 1%.

Table A2.A: Specification and calibration of simple policy rules

Policy rule	Specification
Contemporaneous Taylor-type rule	$i_t = 0.85 i_{t-1} + 0.15(i^* + 0.375\pi_t^E + 1.5\pi_t^N + 0.5y_t)$
Forward-looking Taylor-type rule	$i_t = 0.85 i_{t-1} + 0.15\left(i^* + 1.5(\pi_{t+5|t} - \pi^*) + 0.5y_{t+5|t}\right)$
Forward-looking first-difference rule	$\Delta i_t = 0.1\left(\pi_{t+3|t} - \pi^*\right) + 0.1\Delta GDP_{t+3|t}$

The first two rules in Table A2.A are variants of the 'Taylor rule' (**Taylor (1993)** and **Taylor (1999)**). They relate the level of Bank Rate to the level of inflation (or its subcomponents) and the amount of excess supply or demand in the economy. The first rule considers energy and non-energy subcomponents of annual CPI inflation separately, as in **Albuquerque et al (2025)**. The second rule is 'forward-looking', containing five-quarter-ahead projections of macroeconomic variables on the right-hand side, as in **Batini and Haldane (1999)**. The third rule in the table is a variant of a 'first-difference' rule (**Orphanides (2003)**). It relates the change in Bank Rate to changes in demand and deviations of inflation from target.

OPPs are simulated using a loss function that weighs up deviations of inflation from target, variation in the output gap and changes in interest rates. In this Report, the OPPs are calibrated with a weight on output-gap stabilisation relative to inflation stabilisation, λ, of 0.25 and a weight on interest-rate smoothing, δ, of 60. As **Alati et al (2025)** describe, Bank staff carry out endogenous policy simulations using a variant of COMPASS, the Bank's medium-scale DSGE model described in **Albuquerque et al (2025)**.[1]

Illustrative endogenous paths for alternative projections

Section 3 of the Report discusses a subset of illustrative endogenous paths salient to the current conjuncture. Tables A2.B–F report illustrative paths for Bank Rate in the central projection, scenarios and sensitivities for the full range of endogenous policy approaches discussed in this Annex, alongside the market-implied path that underpins the central projection. Tables A2.G–K and Tables A2.L–P report corresponding illustrative projections for annual CPI inflation and the output gap respectively.

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[1] In addition to the variables entering the rules in quarterly terms, input data are transformed into 'model' variables via detrending (explained in Section 3.2 of **Albuquerque et al (2025)**), such that the rule strictly holds only for 'model' variables.

Table A2.B: Illustrative paths for Bank Rate in the central projection (per cent)

	Central projection (Bank Rate)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	3.5	3.3	3.6	3.6	3.5
2026 Q3	3.3	3.2	3.6	3.5	3.4
2026 Q4	3.2	3.1	3.7	3.4	3.3
2027 Q1	3.1	3.1	3.7	3.4	3.3
2027 Q2	3.0	3.1	3.7	3.4	3.4
2027 Q3	3.0	3.1	3.7	3.4	3.4
2027 Q4	2.9	3.2	3.7	3.4	3.5
2028 Q1	2.9	3.2	3.7	3.4	3.5
2028 Q2	3.0	3.3	3.8	3.4	3.6
2028 Q3	3.1	3.3	3.8	3.5	3.6
2028 Q4	3.1	3.4	3.8	3.5	3.7
2029 Q1	3.2	3.4	3.8	3.5	3.7

Table A2.C: Illustrative paths for Bank Rate in the updated November 2025 inflation persistence scenario (per cent)

	Inflation persistence scenario (Bank Rate)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	3.5	3.4	3.6	3.6	3.5
2026 Q3	3.4	3.2	3.6	3.5	3.4
2026 Q4	3.3	3.2	3.7	3.5	3.3
2027 Q1	3.2	3.2	3.7	3.5	3.3
2027 Q2	3.1	3.2	3.7	3.5	3.4
2027 Q3	3.1	3.2	3.7	3.5	3.4
2027 Q4	3.1	3.3	3.8	3.6	3.5
2028 Q1	3.1	3.3	3.8	3.6	3.5
2028 Q2	3.1	3.4	3.9	3.7	3.6
2028 Q3	3.2	3.4	3.9	3.7	3.6
2028 Q4	3.3	3.5	3.9	3.7	3.7
2029 Q1	3.3	3.5	3.9	3.7	3.7

Table A2.D: Illustrative paths for Bank Rate in the updated November 2025 weaker demand scenario (per cent)

	Weaker demand scenario (Bank Rate)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	3.5	3.2	3.6	3.5	3.5
2026 Q3	3.3	3.0	3.6	3.4	3.4
2026 Q4	3.1	2.9	3.6	3.3	3.3
2027 Q1	2.9	2.8	3.5	3.2	3.3
2027 Q2	2.8	2.7	3.5	3.1	3.4
2027 Q3	2.7	2.7	3.5	3.1	3.4
2027 Q4	2.6	2.7	3.6	3.0	3.5
2028 Q1	2.6	2.8	3.6	3.0	3.5
2028 Q2	2.6	2.8	3.6	3.0	3.6
2028 Q3	2.7	2.9	3.6	3.0	3.6
2028 Q4	2.7	2.9	3.6	3.0	3.7
2029 Q1	2.7	3.0	3.6	3.0	3.7

Table A2.E: Illustrative paths for Bank Rate in the sensitivity with more spare capacity in the economy (per cent)

	More spare capacity sensitivity (Bank Rate)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	3.3	3.2	3.6	3.5	3.5
2026 Q3	3.1	3.1	3.6	3.4	3.4
2026 Q4	3.0	2.9	3.6	3.3	3.3
2027 Q1	2.8	2.9	3.6	3.2	3.3
2027 Q2	2.7	2.8	3.6	3.2	3.4
2027 Q3	2.7	2.8	3.6	3.2	3.4
2027 Q4	2.6	2.8	3.7	3.1	3.5
2028 Q1	2.6	2.8	3.7	3.1	3.5
2028 Q2	2.7	2.8	3.7	3.1	3.6
2028 Q3	2.7	2.9	3.7	3.1	3.6
2028 Q4	2.7	2.9	3.7	3.1	3.7
2029 Q1	2.8	3.0	3.7	3.2	3.7

Table A2.F: Illustrative paths for Bank Rate in the sensitivity with less spare capacity in the economy (per cent)

	Less spare capacity sensitivity (Bank Rate)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	3.7	3.4	3.6	3.6	3.5
2026 Q3	3.6	3.3	3.7	3.6	3.4
2026 Q4	3.5	3.3	3.7	3.6	3.3
2027 Q1	3.4	3.3	3.7	3.5	3.3
2027 Q2	3.3	3.4	3.7	3.6	3.4
2027 Q3	3.3	3.5	3.7	3.6	3.4
2027 Q4	3.2	3.6	3.8	3.6	3.5
2028 Q1	3.2	3.6	3.8	3.7	3.5
2028 Q2	3.3	3.7	3.8	3.7	3.6
2028 Q3	3.4	3.7	3.9	3.8	3.6
2028 Q4	3.5	3.7	3.9	3.8	3.7
2029 Q1	3.6	3.7	3.9	3.8	3.7

Table A2.G: Illustrative paths for four-quarter CPI inflation in the central projection (per cent)

	Central projection (CPI inflation)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	2.3	2.3	2.0	2.2	2.1
2026 Q3	2.3	2.2	1.8	2.1	2.0
2026 Q4	2.3	2.3	1.7	2.1	2.0
2027 Q1	2.1	2.0	1.5	1.8	1.7
2027 Q2	2.3	2.3	1.8	2.1	2.0
2027 Q3	2.2	2.2	1.8	2.0	1.9
2027 Q4	2.1	2.1	1.7	1.9	1.8
2028 Q1	2.1	2.1	1.7	1.9	1.8
2028 Q2	2.2	2.2	1.9	2.1	2.0
2028 Q3	2.2	2.2	1.9	2.1	2.0
2028 Q4	2.2	2.2	1.9	2.1	2.0
2029 Q1	2.2	2.2	1.9	2.1	2.0

Table A2.H: Illustrative paths for four-quarter CPI inflation in the updated November 2025 inflation persistence scenario (per cent)

	Inflation persistence scenario (CPI inflation)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	2.3	2.3	2.0	2.1	2.2
2026 Q3	2.3	2.3	1.8	2.0	2.1
2026 Q4	2.4	2.4	1.7	2.0	2.1
2027 Q1	2.2	2.1	1.6	1.8	1.9
2027 Q2	2.5	2.4	1.9	2.2	2.3
2027 Q3	2.4	2.4	1.9	2.1	2.2
2027 Q4	2.3	2.3	1.8	2.0	2.1
2028 Q1	2.3	2.3	1.9	2.1	2.2
2028 Q2	2.5	2.4	2.0	2.2	2.3
2028 Q3	2.5	2.5	2.1	2.3	2.3
2028 Q4	2.5	2.5	2.1	2.3	2.3
2029 Q1	2.4	2.5	2.1	2.3	2.3

Table A2.I: Illustrative paths for four-quarter CPI inflation in the updated November 2025 weaker demand scenario (per cent)

	Weaker demand scenario (CPI inflation)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	2.3	2.3	1.9	2.2	1.9
2026 Q3	2.3	2.2	1.8	2.1	1.8
2026 Q4	2.4	2.3	1.7	2.2	1.7
2027 Q1	2.1	2.0	1.4	1.9	1.4
2027 Q2	2.3	2.2	1.7	2.1	1.7
2027 Q3	2.1	2.1	1.6	2.0	1.6
2027 Q4	2.0	1.9	1.5	1.9	1.5
2028 Q1	2.0	1.9	1.5	1.9	1.5
2028 Q2	2.0	2.0	1.7	2.0	1.6
2028 Q3	2.0	2.0	1.7	2.0	1.7
2028 Q4	2.0	2.0	1.7	2.0	1.7
2029 Q1	2.0	1.9	1.8	2.0	1.7

Table A2.J: Illustrative paths for four-quarter CPI inflation in the sensitivity with more spare capacity in the economy (per cent)

	More spare capacity sensitivity (CPI inflation)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	2.4	2.3	2.0	2.2	2.0
2026 Q3	2.4	2.3	1.7	2.1	1.8
2026 Q4	2.5	2.4	1.7	2.1	1.8
2027 Q1	2.2	2.1	1.4	1.9	1.5
2027 Q2	2.4	2.3	1.7	2.2	1.8
2027 Q3	2.3	2.2	1.7	2.1	1.7
2027 Q4	2.2	2.1	1.6	2.0	1.6
2028 Q1	2.1	2.1	1.6	2.0	1.7
2028 Q2	2.2	2.2	1.8	2.1	1.8
2028 Q3	2.2	2.2	1.8	2.1	1.8
2028 Q4	2.2	2.1	1.8	2.1	1.9
2029 Q1	2.1	2.1	1.8	2.1	1.9

Table A2.K: Illustrative paths for four-quarter CPI inflation in the sensitivity with less spare capacity in the economy (per cent)

	Less spare capacity sensitivity (CPI inflation)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	2.2	2.2	2.0	2.1	2.2
2026 Q3	2.2	2.1	1.9	2.0	2.1
2026 Q4	2.2	2.1	1.8	2.0	2.1
2027 Q1	2.0	1.9	1.6	1.7	1.9
2027 Q2	2.2	2.2	1.9	2.0	2.2
2027 Q3	2.2	2.1	1.8	2.0	2.1
2027 Q4	2.1	2.0	1.8	1.9	2.0
2028 Q1	2.1	2.0	1.8	1.9	2.0
2028 Q2	2.2	2.2	1.9	2.1	2.2
2028 Q3	2.2	2.2	2.0	2.1	2.2
2028 Q4	2.2	2.2	2.0	2.1	2.2
2029 Q1	2.2	2.2	2.0	2.1	2.2

Table A2.L: Illustrative paths for the output gap in the central projection (per cent)

	Central projection (output gap)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	-0.8	-0.8	-1.1	-1.0	-1.0
2026 Q3	-0.8	-0.8	-1.2	-1.0	-1.0
2026 Q4	-0.7	-0.8	-1.2	-1.0	-1.0
2027 Q1	-0.6	-0.7	-1.1	-0.9	-0.9
2027 Q2	-0.5	-0.6	-1.0	-0.8	-0.8
2027 Q3	-0.3	-0.4	-0.9	-0.6	-0.7
2027 Q4	-0.2	-0.3	-0.8	-0.5	-0.6
2028 Q1	-0.1	-0.2	-0.7	-0.4	-0.5
2028 Q2	-0.1	-0.1	-0.6	-0.3	-0.4
2028 Q3	0.0	-0.1	-0.5	-0.2	-0.3
2028 Q4	0.1	0.0	-0.4	-0.1	-0.2
2029 Q1	0.1	0.0	-0.3	-0.1	-0.2

Table A2.M: Illustrative paths for the output gap in the updated November 2025 inflation persistence scenario (per cent)

	Inflation persistence scenario (output gap)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	-0.9	-0.9	-1.2	-1.1	-1.0
2026 Q3	-0.9	-0.9	-1.3	-1.1	-1.1
2026 Q4	-0.9	-0.9	-1.4	-1.1	-1.1
2027 Q1	-0.7	-0.8	-1.3	-1.1	-1.0
2027 Q2	-0.6	-0.7	-1.2	-1.0	-0.9
2027 Q3	-0.5	-0.6	-1.1	-0.8	-0.7
2027 Q4	-0.4	-0.5	-1.0	-0.7	-0.6
2028 Q1	-0.3	-0.4	-0.9	-0.6	-0.5
2028 Q2	-0.2	-0.3	-0.8	-0.5	-0.4
2028 Q3	-0.1	-0.2	-0.7	-0.4	-0.4
2028 Q4	-0.1	-0.1	-0.6	-0.3	-0.3
2029 Q1	0.0	-0.1	-0.6	-0.3	-0.2

Table A2.N: Illustrative paths for the output gap in the updated November 2025 weaker demand scenario (per cent)

	Weaker demand scenario (output gap)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	-0.9	-0.9	-1.2	-1.0	-1.2
2026 Q3	-0.9	-0.9	-1.4	-1.1	-1.3
2026 Q4	-0.9	-0.9	-1.4	-1.1	-1.4
2027 Q1	-0.8	-0.8	-1.4	-1.0	-1.4
2027 Q2	-0.7	-0.7	-1.3	-0.9	-1.3
2027 Q3	-0.5	-0.6	-1.1	-0.7	-1.1
2027 Q4	-0.4	-0.5	-1.0	-0.6	-1.0
2028 Q1	-0.3	-0.4	-0.9	-0.5	-0.9
2028 Q2	-0.2	-0.3	-0.8	-0.3	-0.8
2028 Q3	-0.1	-0.2	-0.7	-0.2	-0.7
2028 Q4	0.0	-0.1	-0.5	-0.1	-0.6
2029 Q1	0.0	-0.1	-0.5	-0.1	-0.5

Table A2.O: Illustrative paths for the output gap in the sensitivity with more spare capacity in the economy (per cent)

	More spare capacity sensitivity (output gap)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	-1.2	-1.2	-1.6	-1.3	-1.5
2026 Q3	-1.1	-1.1	-1.6	-1.3	-1.5
2026 Q4	-1.0	-1.1	-1.6	-1.3	-1.5
2027 Q1	-0.9	-0.9	-1.6	-1.1	-1.4
2027 Q2	-0.7	-0.8	-1.5	-1.0	-1.3
2027 Q3	-0.6	-0.7	-1.3	-0.9	-1.2
2027 Q4	-0.5	-0.6	-1.2	-0.7	-1.1
2028 Q1	-0.4	-0.5	-1.1	-0.6	-1.0
2028 Q2	-0.3	-0.4	-1.0	-0.5	-0.9
2028 Q3	-0.2	-0.3	-0.9	-0.4	-0.8
2028 Q4	-0.2	-0.2	-0.8	-0.4	-0.7
2029 Q1	-0.2	-0.2	-0.7	-0.3	-0.7

Table A2.P: Illustrative paths for the output gap in the sensitivity with less spare capacity in the economy (per cent)

	Less spare capacity sensitivity (output gap)				
	Contemporaneous Taylor-type rule	Forward-looking Taylor-type rule	Forward-looking first-difference rule	Optimal policy projection	Memo: under market path
2026 Q2	-0.5	-0.5	-0.7	-0.6	-0.5
2026 Q3	-0.5	-0.5	-0.8	-0.7	-0.5
2026 Q4	-0.5	-0.5	-0.8	-0.7	-0.5
2027 Q1	-0.4	-0.4	-0.7	-0.6	-0.4
2027 Q2	-0.3	-0.3	-0.6	-0.5	-0.3
2027 Q3	-0.1	-0.2	-0.5	-0.3	-0.2
2027 Q4	0.0	-0.1	-0.4	-0.2	-0.1
2028 Q1	0.1	0.0	-0.3	-0.1	0.0
2028 Q2	0.2	0.1	-0.2	0.0	0.1
2028 Q3	0.2	0.2	-0.1	0.1	0.2
2028 Q4	0.3	0.3	0.0	0.1	0.3
2029 Q1	0.3	0.3	0.0	0.2	0.3

Annex 3: Monetary policy since the November 2025 Report

At its meeting ending on 17 December 2025, the Monetary Policy Committee voted by a majority of 5–4 to reduce Bank Rate by 0.25 percentage points, to 3.75%. Four members voted to maintain Bank Rate at 4%.

CPI inflation had fallen since the previous meeting, to 3.2%. Although above the 2% target, it was now expected to fall back towards target more quickly in the near term. Reflecting restrictive monetary policy, and consistent with evidence of subdued economic growth and building slack in the labour market, pay growth and services price inflation had continued to ease.

Monetary policy was being set to ensure CPI inflation settled sustainably at 2% in the medium term, which involved balancing the risks around achieving this. The risk from greater inflation persistence had become somewhat less pronounced since the November meeting, while the risk to medium-term inflation from weaker demand remained.

The extent of further easing in monetary policy would depend on the evolution of the outlook for inflation. The restrictiveness of policy had fallen as Bank Rate had been reduced by 150 basis points since August 2024. On the basis of the evidence, Bank Rate was likely to continue on a gradual downward path. But judgements around further policy easing would become a closer call.

Glossary and other information

Glossary of selected data and instruments

ASBC – Agents' summary of business conditions.

ASHE – Annual Survey of Hours and Earnings.

AWE – average weekly earnings.

CCS – Credit Conditions Survey.

COMPASS – Central Organising Model for Projection Analysis and Scenario Simulation.

CPI – consumer prices index.

CPI inflation – inflation measured by the consumer prices index.

DMP – Decision Maker Panel.

ERI – excess reportable income.

GDP – gross domestic product.

HICP – harmonised index of consumer prices.

LFS – Labour Force Survey.

MaPS – Market Participants Survey.

OIS – overnight index swap.

RPI – retail prices index.

Abbreviations

AI – artificial intelligence.

BCC – British Chambers of Commerce.

CBI – Confederation of British Industry.

CIPD – Chartered Institute of Personnel and Development.

COICOP – Classification of Individual Consumption by Purpose.

DESNZ – Department for Energy Security and Net Zero.

ECB – European Central Bank.

EU – European Union.

EV – electric vehicle.

FCA – Financial Conduct Authority.

FER – Forecast Evaluation Report.

FPC – Financial Policy Committee.

FTSE – Financial Times Stock Exchange.

GfK – Gesellschaft für Konsumforschung, Great Britain Ltd.

HMRC – His Majesty's Revenue and Customs.

ICT – information communications technology.

ILO – International Labour Organization.

LSEG – London Stock Exchange Group.

LTI – loan to income.

LTV – loan to value.

MIDAS – mixed-data sampling.

MPC – Monetary Policy Committee.

MTIC – missing trader intra-community.

NAIRU – non-accelerating inflation rate of unemployment.

NICs – National Insurance contributions.

NLW – National Living Wage.

OBR – Office for Budget Responsibility.

Ofgem – Office of Gas and Electricity Markets.

ONS – Office for National Statistics.

OPP – optimal policy projection.

REC – Recruitment and Employment Confederation.

RTI – Real-Time Information.

S&P – Standard & Poor's.

TFP – total factor productivity.

VAT – Value Added Tax.

V/U – vacancies to unemployment.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Bank of England or the Office for National Statistics (ONS) and all data, apart from financial markets data and results from the Decision Maker Panel (DMP) Survey, are seasonally adjusted.

n.a. = not available.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.