Overview

GDP growth was robust in 2014, moderating in the second half of the year. Despite the weakness in 2015 Q1, the outlook for growth remains solid. Household real incomes have been boosted by the fall in food, energy and imported goods prices. The absorption of remaining slack and a pickup in productivity growth are expected to support wage growth in the period ahead. Along with the low cost of finance, that will help maintain domestic demand growth. Activity in the United States and a number of emerging markets has slowed but momentum in the euro area appears to have strengthened over the quarter as a whole.

CPI inflation was 0.0% in March 2015 as falls in food, energy and other import prices continued to weigh on the annual rate. Inflation is likely to rise notably around the turn of the year as those factors begin to drop out. Inflation is then projected to rise further as wage and unit labour cost growth picks up and the effect of sterling's appreciation dissipates. The MPC judges that it is currently appropriate to set policy so that it is likely inflation will return to the 2% target within two years. Conditional on Bank Rate following the path currently implied by market yields — such that it rises gradually over the forecast period — that is judged likely to be achieved.

Recent economic developments

Demand and supply

The European Central Bank's (ECB's) public sector asset purchase programme, which commenced in March, has helped to boost euro asset prices, and lower the yields on most euro-area government bonds. The programme also appears to have weighed on yields in other advanced economies. Divergent economic prospects and monetary policy stances have caused significant movements in exchange rates. Since November, the euro has depreciated sharply while the US dollar has risen. In effective terms, sterling is around 2% higher than in February and 16% higher than its trough in March 2013. Sterling Brent crude oil prices have risen, but remain 40% below their mid-2014 peak.

Supported by policy measures and lower oil prices, the expansion in global activity looks to be continuing, although the news since February has been mixed. Euro-area GDP growth appears to have strengthened further in Q1. A combination of lower borrowing rates, improved household real incomes and a lower euro mean the outlook, at least in the near term, is brighter than in February. In contrast, US growth weakened sharply in Q1. In part that is likely to reflect a temporary impact from adverse weather conditions. But weak wage and productivity growth, and a stronger dollar may imply a more persistent slowing in activity. Growth also appears to have been weaker in a number of emerging markets, including China.

UK GDP grew at a little above its historical average rate in 2014 and somewhat faster than estimated potential supply, although it moderated during the course of the year. That slowing reflected both weaker net trade and domestic demand growth. Preliminary estimates of GDP suggest that growth slowed further in 2015 Q1. Activity in the housing market remains subdued. Nevertheless, surveys of household and business confidence and other indicators of consumption and business investment suggest activity has been more robust than reported in official data.

In light of recent developments, the MPC reviewed the outlook for potential supply and the likely degree of slack in the economy. Supply growth over the past two years has been concentrated in the labour force, while productivity growth has been weak. The best collective view of the MPC is that the amount of slack has narrowed over the past six months and is broadly in the region of ½% of GDP, though there is considerable uncertainty around this estimate and a wide range of views across the Committee.

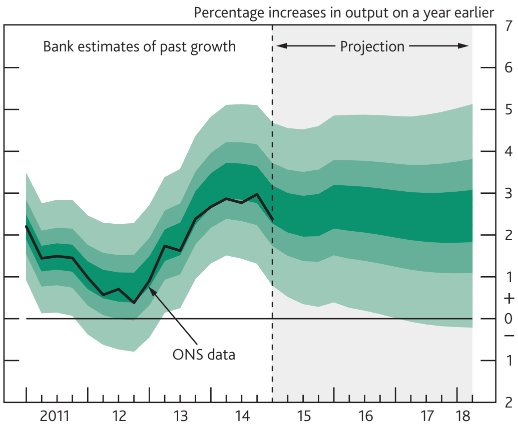
Costs and prices

CPI inflation was 0.0% in March, triggering a second successive open letter from the Governor to the Chancellor of the Exchequer. Around three quarters of the weakness in inflation relative to target, or 1.5 percentage points, was due to unusually low contributions from food, energy and other goods prices, which are judged largely to reflect non-domestic factors. The biggest single driver has been the large fall in energy prices. Falls in global agricultural prices and the appreciation of sterling have also led to lower retail prices for food and other goods. Absent further developments, these factors will continue to drag on the annual inflation rate before starting to drop out around the end of 2015.

The remaining one quarter of the weakness in inflation relative to target, or 0.5 percentage points, is judged to reflect domestic factors. Wage growth remained subdued in Q1, despite a further fall in the unemployment rate. Part of that weakness is likely to reflect the effects of slack in the labour market, although the concentration of recent employment growth in lower-skilled jobs, which tend to be less well paid, is also likely to account for part of it.

Another influence on wage and price-setting decisions is inflation expectations. Nearly all measures of inflation expectations have fallen over the past year, with household measures now below pre-crisis average levels. Surveys suggest that employees and firms expect little recovery in pay growth this year. Other measures of inflation expectations are, however, close to historical averages. The MPC judges that inflation expectations remain broadly consistent with the 2% inflation target.

Chart 1 GDP projection based on market interest rate expectations and £375 billion purchased assets



The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. To the left of the vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past; to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter green areas on 30 occasions. In any particular quarter of the forecast period, GDP growth is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP growth can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents.

The outlook for GDP and inflation

Chart 1 shows the MPC's best collective judgement for the outlook for four-quarter GDP growth under the assumptions that: Bank Rate rises gradually to 1.4% by 2018 Q2, in line with the path implied by market interest rates; and the stock of purchased assets remains at £375 billion. Growth is projected to be at or a little below its historical average rate throughout the forecast period, although remaining slack in the economy is absorbed.

World GDP growth is projected to pick up slightly over the forecast period, broadly unchanged from the February *Inflation Report*. While ECB policy actions should support euro-area growth, the possibility of a disorderly resolution of Greek debt negotiations is considered to pose a downside risk to the world and UK growth outlook. Globally, a normalisation in US monetary policy could be associated with volatility in financial markets and a knock-on impact on global activity.

Domestically, the projection is for solid demand growth. The boost to household spending from lower energy and food prices is sustained by a pickup in wage growth. Business investment growth remains robust, reflecting the low cost of finance and the broader recovery in demand. Supply growth is supported by a gradual pickup in productivity growth. There remain considerable uncertainties around the timing and extent of that pickup.

Chart 2 shows the Committee's best collective judgement for the outlook for CPI inflation on the same basis as **Chart 1**. In the very near term, inflation is projected to remain close to zero, as the past falls in food, energy and other goods prices continue to drag on the annual rate. Towards the end of 2015, inflation rises notably, as those effects begin to drop out. As the drag from domestic slack continues to fade, inflation is projected to return to target within two years and to move slightly above the target in the third year of the forecast period.

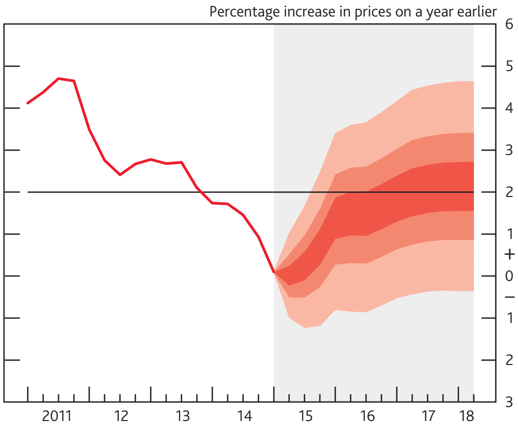
The path for inflation depends crucially on the outlook for domestic cost pressures. A tightening of the labour market and an increase in productivity should underpin wage growth in the period ahead. There is a risk that the temporary period of low inflation may persist for longer — for example, if it affects wage settlements. Alternatively, wages could pick up faster as labour market competition intensifies, which could pose an upside risk to inflation. Inflation will also remain sensitive to further movements in energy and other commodity prices, and the exchange rate.

The MPC considers that on balance these factors point to downside risks to the inflation outlook in the first half of the projection, relative to the central path. Inflation is judged as likely to be above as below the 2% target by early 2017, with the likelihood of inflation being above the target then rising a little further (**Chart 3**).

The policy decision

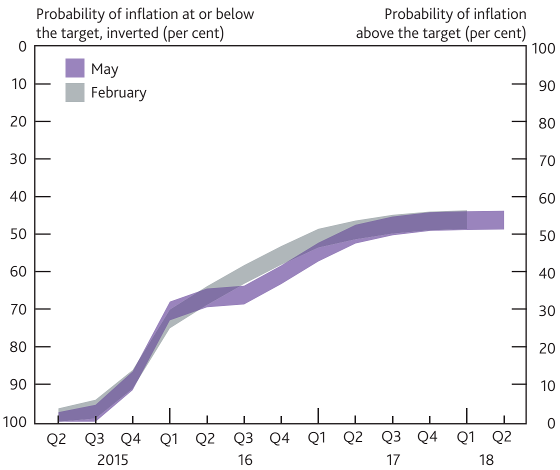
The UK expansion has continued, but inflation has fallen to 0.0%, well below the MPC's 2% target. The MPC judges that around three quarters of the undershoot in inflation reflects unusually low contributions from energy, food and other goods prices,

Chart 2 CPI inflation projection based on market interest rate expectations and £375 billion purchased assets



The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

Chart 3 Inflation probabilities relative to the target



The May and February swathes in this chart are derived from the same distributions as **Charts 5.1** and **5.2** respectively. They indicate the assessed probability of inflation relative to the target in each quarter of the forecast period. The 5 percentage points width of the swathes reflects the fact that there is uncertainty about the precise probability in any given quarter, but they should not be interpreted as confidence intervals.

which will continue to bear down on annual inflation for much of this year. The remainder is accounted for by weak domestic cost growth: although it has been diminishing, slack remains.

The MPC's inflation target is symmetric: deviations of inflation below the target are to be treated with the same importance as deviations above it. As was the case three months ago, inflation is currently below the target with unemployment somewhat above its long-run sustainable rate. Eliminating that remaining economic slack, and so returning output to its sustainable level, should also reduce the drag on domestic costs and prices, helping to return inflation to the target. It therefore remains appropriate to set policy so as to return inflation to the target relatively quickly, once the effects of energy and food price movements have abated. The MPC continues to judge it appropriate to set policy so that it is likely that inflation will return to the 2% target within two years.

In the February 2014 *Inflation Report*, the MPC said that, given the likely persistence of headwinds weighing on the economy, when Bank Rate did begin to rise, it was expected to do so more gradually than in previous cycles. Moreover, the persistence of those headwinds, together with the legacy of the financial crisis, meant that Bank Rate was expected to remain below average historical levels for some time to come.

At its meeting on 8 May, the MPC noted that while those headwinds had begun to ease, a path that implied only gradual rises in Bank Rate over the next few years, broadly in line with the current market path, remained consistent with absorbing slack and returning inflation to the target within two years.

The MPC also noted, however, that, as set out in the February 2014 *Report*, the interest rate required to keep the economy operating at normal levels of capacity and inflation at the target was likely to continue to rise as the effects of the financial crisis faded further. Despite this, beyond the three-year forecast horizon the yield curve had flattened further over the past year. There was uncertainty about the reasons for this. Given that uncertainty, there was a risk that longer-term yields would move back up over time, for example, in response to a tightening of US monetary policy.

In the light of the economic outlook, the Committee voted to maintain Bank Rate at 0.5% and the stock of purchased assets at £375 billion.