Overview

Robust, broadly based, growth over the past year has taken output to above its pre-crisis peak and unemployment has fallen sharply. Spending should continue to be supported by reduced uncertainty and improved credit availability. Over time, a sustained revival in productivity and real household incomes is expected to underpin the expansion.

Inflation is close to the MPC's 2% target and is projected to remain close to the target in the period ahead. As slack has been absorbed, financial market expectations of the date of the first Bank Rate rise have moved forward. But when Bank Rate does begin to rise, the pace of rate increases is expected to be gradual, with rates probably remaining below average historical levels for some time.

Recent economic developments

Demand

The global recovery appears set to continue, despite stalling slightly during the first part of 2014.

In the euro area, growth continued to disappoint, net lending has been falling and inflation has stayed low. In response, the European Central Bank announced a package of measures to support activity and raise inflation. In the United States, GDP growth was volatile in 2014 H1, but lower on average than expected three months ago. Growth in the rest of the world has been largely as expected.

Financial market volatility has remained low, with continuing evidence of a search for yield across asset classes. Sterling has appreciated by around 14% from its March 2013 trough, reflecting in part the strength of UK demand relative to the rest of the world over the past year or so. The UK net trade balance improved slightly in 2014 Q1, despite this appreciation and weaker global growth in that quarter.

The domestic recovery has continued to broaden, with robust spending by businesses and households, supported by lower uncertainty and continuing improvements in credit conditions. Four-quarter growth in business investment reached 11% in 2014 Q1 and business surveys point to strength continuing. Household consumption has also remained strong, with consumer confidence high despite continued weakness in real wages.

House prices have risen by just under 1% a month on average since the May *Report*, although recent indicators have weakened somewhat. That follows signs of a moderation in housing activity since the start of the year. The implementation of the Mortgage Market Review has placed strains on banks' lending capacity.

Weaker housing activity may also have reflected fewer properties coming onto the market earlier in the year. More recently, secondary market supply has picked up while new buyer enquiries have softened, suggesting a closer alignment of supply and demand.

Supply, costs and prices

The domestic recovery continues to be accompanied by a strengthening labour market. In the three months to May, employment rose by around 250,000, average hours worked rose strongly by 0.6%, and the headline LFS unemployment rate fell to 6.5%. That suggests that labour market slack is being used up at a faster pace than expected three months ago.

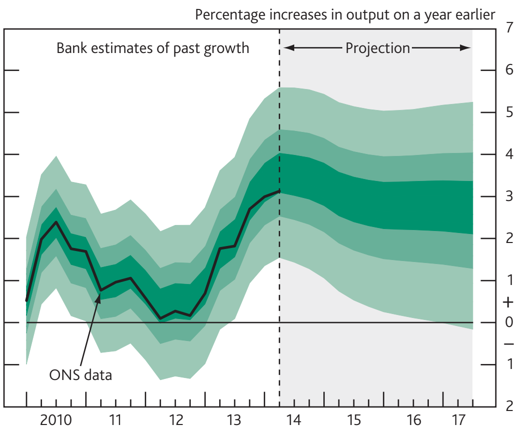
The strength in labour market quantities contrasts with continuing weakness in wage growth. Annual private sector regular pay growth probably rose by around 1% in Q2. Weakness in wages in part reflects productivity growth remaining very subdued. It is also possible that stronger quantities are taking time to feed through to wage growth: surveys suggest that the wages employers are paying to hire new recruits are rising faster than average pay. These could be reflected in average pay if more people start moving jobs and as new wage settlements are completed.

But the weakness in wages is also consistent with there having been higher labour supply, and hence more labour market slack, than previously thought. Reflecting that, the Committee has revised up its estimate of medium-term equilibrium labour force participation and revised down that for unemployment.

Not surprisingly, there is a wide range of views on the Committee about the likely degree of slack. Uncertainty about how much slack there is has increased in recent months, in part reflecting labour market outturns. In the Committee's best collective judgement, however, the degree of slack has narrowed somewhat, and the central estimate is now broadly in the region of 1% of GDP.

CPI inflation was a touch below the 2% target in June. The fall in inflation over the past year or so in part reflects lower contributions from food and energy prices. In the light of sterling's recent appreciation, import prices, which have been pushing up inflation in recent years, are now falling.

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 growth and inflation

Chart 1 shows the Committee's best collective judgement for the outlook for four-quarter GDP growth, assuming that Bank Rate rises gradually in line with the path implied by market interest rates and the stock of purchased assets stays at £375 billion. The final estimate of four-quarter growth, taking into account expected future revisions, is projected to ease back from around 3½% in 2014 to around its pre-crisis historical average rate. The risks around that central projection are skewed a little to the downside. Improved sentiment and credit conditions continue to support spending, while a gradual revival in productivity growth underpins strengthening real household incomes. Housing and business investment support growth, albeit to a lesser extent than judged likely three months ago.

The projection assumes that global growth remains steady in the face of continuing economic and financial challenges. In the euro area there are downside risks, associated with a prolonged period of weak inflation and low growth in the periphery, which could re-awaken concerns about debt sustainability. Globally, marked rises in financial market volatility and corrections in asset prices, perhaps associated with a normalisation in US monetary policy, pose significant downside risks.

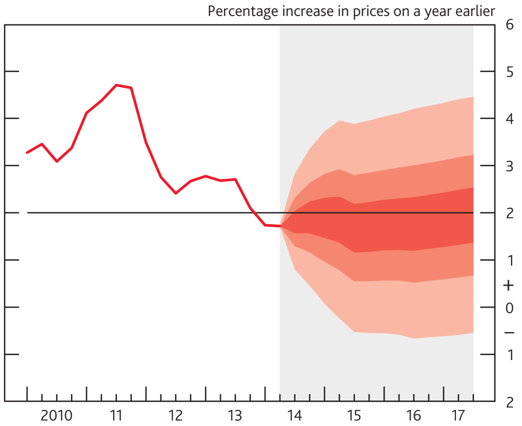
Domestically, output is sensitive to the assumption that a gradual revival in productivity and real household incomes help to underpin a sustained expansion. Productivity growth has shown few signs yet of a recovery and is now projected to pick up more slowly than anticipated in May. Actions taken by the Bank's Financial Policy Committee in June have reduced the risks related to household indebtedness from the housing market. But there is more uncertainty about the path for the housing market in the near term than three months ago. The outlook will also depend on how easily households and businesses are able to absorb the gradual rises in interest rates embodied in the market interest rate path.

As output growth moderates and productivity growth recovers, the rate at which unemployment falls slows. Remaining labour market slack is absorbed gradually, and is eliminated by the end of the forecast period. But conflicting indicators from the labour market mean that uncertainties about the level of slack, and its future path, are considerable. In recent years, increases in the number of people who are willing and able to compete for jobs, and in the desired hours of those in employment, have boosted labour supply and employment. These positive supply-side trends could continue. Equally, there is a risk that they could abate as real pay recovers.

Chart 2 summarises the MPC's best collective judgement of the outlook for CPI inflation on the same basis as **Chart 1**. In the central case, inflation falls back a little in the near term as the appreciation of sterling bears down on import prices and, in turn, prices in the shops. By the end of the forecast horizon, the drag from slack has lessened and the associated recovery in wage growth is consistent with inflation being at the target.

There are risks on either side of this projection, in particular stemming from labour costs. As labour market slack diminishes and productivity growth picks up, wage growth is expected to rise slowly. But wage growth could pick up more sharply than expected, particularly if recruitment pressures broaden and intensify. Against that, it is also possible that wage pressures could remain weaker for longer if labour supply growth remains strong.

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.

The experience of recent years has shown that inflation can also be pushed materially away from the target by external cost shocks. Global energy prices remain a key risk, especially if they become more sensitive to geopolitical events. The outlook for import prices more generally depends on the evolution of the exchange rate. Its impact on inflation will be lower if companies do not fully pass lower import prices through to customers and instead take the opportunity to expand margins.

The policy decision

Robust growth over the past year has taken output to above its pre-crisis peak. Strong output growth has yet to be matched by a material pickup in productivity, however. Instead employment gains have been exceptionally strong and unemployment has fallen sharply. The strength in labour market quantities has contrasted with the weakness of wage growth, increasing the uncertainty about the current degree of spare capacity. It seems likely that slack over the past year or two has been greater than previously thought; it also seems likely that slack is being used up at a faster rate than expected. In light of the heightened uncertainty about the current degree of slack, the Committee noted the importance of monitoring the expected path of costs, particularly wages, in assessing inflationary pressures.

At its August meeting, the Committee noted that, conditioned on the path of Bank Rate implied by market yields, four-quarter output growth was expected to be close to its historical average rates for the next few years. The pace at which slack was being absorbed was projected to slow, reflecting a gentle expansion of supply, thereby limiting the build-up of domestic inflationary pressures. Import prices were likely to weigh on inflation. Overall, CPI inflation was thought likely to remain close to, or a little below, 2%, before reaching the target at the end of the forecast period.

The Committee sets monetary policy to meet the 2% target in the medium term and in a way that helps to sustain growth and employment. The Committee gave guidance in its February *Report* on how it would seek to achieve the inflation target over the policy horizon. At its August meeting, the Committee noted that the central message of that guidance remained relevant: given the likely persistence of the headwinds weighing on the economy, when Bank Rate did begin to rise, it was expected to do so only gradually. Together with the legacy of the financial crisis and broader global forces, this meant that Bank Rate was expected to remain below average historical levels for some time to come. It remained the case, however, that the actual path for monetary policy, even after the first rise in Bank Rate, would remain dependent on economic conditions. In other words, the Committee's guidance on the likely pace and extent of interest rate rises was an expectation, not a promise.

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