Overview

CPI inflation was 0.5% in December 2014, well below the 2% target. The main reason for this was the steep fall in wholesale energy prices during the second half of last year. Inflation is likely to fall further in the near term, and could temporarily turn negative, as falls in energy prices continue to be passed through. Inflation is likely to rebound around the turn of the year as these effects drop out of the annual rate.

The fall in oil prices, together with monetary policy measures taken abroad, should support global demand. Lower energy prices will also boost UK real income growth. That, along with a lower expected path for Bank Rate than in November, should help to sustain the recent robust expansion in UK domestic demand. As slack is absorbed, inflation is projected to rise back to levels consistent with the inflation target. The Committee judges that it is currently appropriate to set policy so that it is likely that inflation will return to the 2% target within two years. Under the assumption that Bank Rate rises gradually over the forecast period, that is judged likely to be achieved.

Recent economic developments

Supply, costs and prices

CPI inflation was 0.5% in December, down from 1.2% three months ago and 1½ percentage points below the Monetary Policy Committee's (MPC's) 2% target. That triggered an open letter from the Governor to the Chancellor of the Exchequer. A large part of the weakness in inflation can be accounted for by falls in energy prices. The sterling price of Brent crude oil has fallen by around 50% since mid-2014, leading to sharp decreases in petrol prices. Falls in the prices of food and other imports, in part a consequence of the past appreciation of sterling, have also weighed on inflation. Overall, the MPC judges that around two thirds of the undershoot in inflation, relative to target, can be explained by lower energy, food and other goods prices.

Weak domestic cost growth has also continued to pull down inflation. Unit labour costs grew by only 0.5% in the year to 2014 Q3, as subdued productivity growth was only just outpaced by pay growth. There are some signs pay growth may be picking up. If sustained, that should contribute to a steady rise in unit labour cost growth. The rise in pay growth probably reflects the narrowing in slack since mid-2013: the unemployment rate fell to 5.8% in the three months to November and average hours worked have risen to around pre-crisis levels. But participation in the labour market was weaker than expected in November. The central view of most MPC members is that slack has continued to narrow, and is broadly in the region of ½% of GDP.

An important influence on households' and companies' wage and price-setting behaviour is inflation expectations. Survey measures of household and company inflation expectations have fallen over the past year, at both short and longer-term horizons. More recently, financial market measures have also fallen at all horizons, but they are close to pre-crisis averages. On balance, inflation expectations remain broadly consistent with the 2% inflation target.

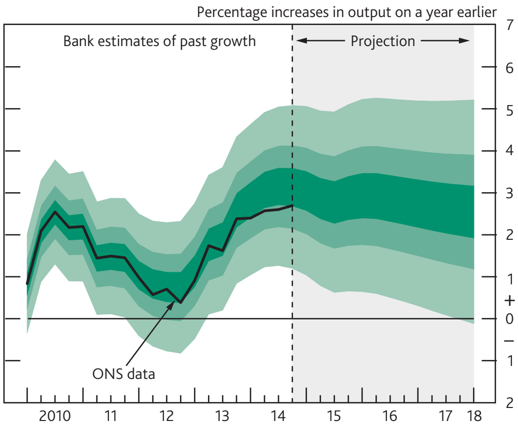
Demand

US GDP continued to grow solidly in Q4, but euro-area output growth remained sluggish. Growth has also slowed in many emerging economies, including China. The fall in oil prices seen since mid-2014 is, in part, likely to reflect a slowing in the outlook for global activity, but a larger influence appears to have been news in oil supply. That, along with a range of monetary policy easing measures taken by central banks, including the European Central Bank (ECB), is likely to support global demand.

The difference between paths for monetary policy implied by market interest rates remains large across countries: euro-area interest rates remain close to 0% over the next three years, whereas in the United States they pick up to a little under 2%. In the United Kingdom, market-implied short-term interest rates reach a little over 1% over the next three years, almost ¾ of a percentage point lower than in November. Sterling has appreciated by 1% since the November *Report*. Despite weak activity abroad, export growth picked up in Q4.

Private sector domestic demand growth has remained robust over the past year. Consumer spending grew strongly in Q3, supported by an increase in household real income growth. In the near term, the boost to real incomes from the fall in energy prices is likely to support consumption growth further. In contrast, activity in the housing market remains muted and housing investment fell in Q3. House prices continued to rise, but at a slower rate than earlier in 2014. Business investment also fell in Q3, but the data are volatile and survey indicators continue to point to robust investment growth.

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



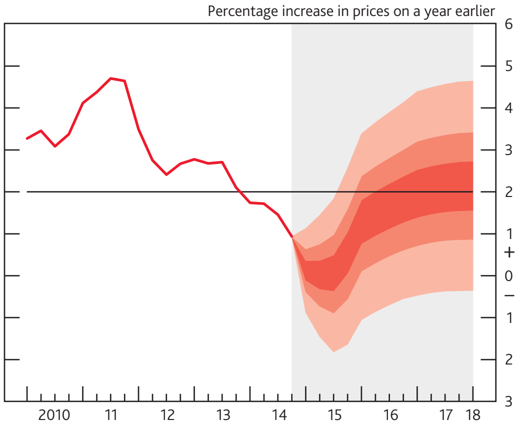
The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £375 billion throughout the forecast period. To the left of the vertical dashed line, the 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 a little above 1%, in line with the path implied by market interest rates; the stock of purchased assets remains at £375 billion; and the price of oil rises gradually to around US$70, in line with the path implied by futures prices. The path for Bank Rate is lower than in November, when Bank Rate was expected to reach just under 1¾% over the forecast period. The robust pace of growth over 2014 is projected to be sustained in the near term, before slowing to around historical average growth rates.

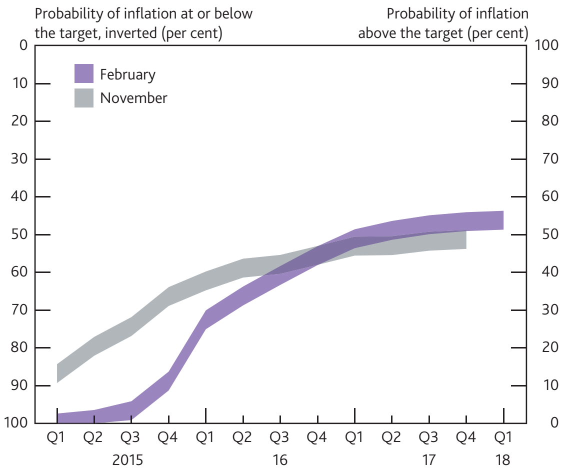
The projection assumes that world GDP growth gradually recovers over the forecast period, supported by the fall in oil prices. There are downside risks from euro-area activity being more persistently weak, from potential market disruption as and

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 February and November 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.

when US interest rates rise, and from the economic challenges faced by major commodity exporters. On the upside, the recent policy actions by the ECB may provide greater stimulus to growth than is incorporated in the central projection and the drop in oil prices may boost demand in oil-importing countries by more than expected.

Domestically, the projection is for solid consumption growth as the fall in energy prices and rising wage growth supports growth in households' real incomes. Business investment grows at a similar rate to that projected in November, reflecting the past easing in credit conditions and the recovery in demand. There is a risk that further falls in household interest rates stimulate spending by more than anticipated, balanced against which is the risk that households do not spend the windfall from lower energy prices. Further out, growth is underpinned by a gradual revival in productivity growth. But there remains considerable uncertainty around that judgement.

Chart 2 shows the Committee's best collective judgement for the outlook for CPI inflation on the same basis as in **Chart 1**. Inflation is projected to fall further in the near term, as the recent falls in energy prices continue to be passed through to petrol prices and utility bills. Inflation begins to rise in the second half of 2015, as those effects and the recent fall in food and other goods prices drop out of the twelve-month comparison. As the remaining margin of domestic slack continues to be absorbed, inflation is projected to return to target at the two-year point before rising a little further.

The MPC judges there to be a risk that the temporary period of low inflation may persist for longer — if, for example, wages react by more than expected to the recent weakness in inflation. There are, however, also upside risks — for example, if labour market tightness leads to greater-than-expected pressure on wages. Furthermore, inflation will be sensitive to large movements in either direction in energy and other commodity prices, as well as in the exchange rate.

In the near term, the MPC considers that on balance these factors point to downside risks to the inflation outlook, relative to the central path. But by the two-year point, the MPC judges that inflation is as likely to be above as below the target (**Chart 3**).

The policy decision

The UK expansion has continued, but inflation has fallen to 0.5%, well below the MPC's 2% target. The MPC judges that around two thirds of the undershoot in inflation reflects unusually low contributions from energy, food and other goods prices, which will continue to bear down on annual inflation for the next year or so. The remainder is accounted for by weak domestic cost growth: although it has been diminishing, there remains a degree of slack in the economy.

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. Given the nature of the shocks affecting inflation, the MPC judges it appropriate to set policy so that it is likely that inflation will return to the 2% target within two years. Inflation is below the target while unemployment is above its long-run sustainable rate. There is therefore no immediate trade-off between returning inflation to the target and supporting economic activity. In fact, to return inflation to the target it is necessary to eliminate the remaining degree of economic slack. It is therefore appropriate to aim to return inflation to the target as quickly as possible after the effects of energy and food price movements have abated.

At its meeting on 5 February, the MPC noted that conditional on interest rates following the path currently implied by market yields, it was likely that slack in the economy would be absorbed and inflation would return to the 2% target within two years.

As set out in this *Report*, there are risks to the inflation outlook in both directions. Were downside risks to materialise, market expectations of the future path of interest rates could adjust to reflect an even more gradual and limited path for Bank Rate increases than is currently priced. The Committee could also decide to expand the Asset Purchase Facility or to cut Bank Rate further towards zero from its current level of 0.5%. The scope for prospective downward adjustments in Bank Rate reflects, in part, the fact that the United Kingdom's banking sector is operating with substantially more capital now than it did in the immediate aftermath of the crisis. Reductions in Bank Rate are therefore less likely to have undesirable effects on the supply of credit to the UK economy than previously judged by the MPC. Were upside risks to materialise, it would be appropriate for Bank Rate to increase more quickly than embodied in current market yields but the likelihood is that those increases would still be more gradual and limited than in previous tightening cycles.

The MPC stands ready to take whatever action is needed, as events unfold, to ensure inflation remains likely to return to target in a timely fashion. Under the central case, the MPC judges it more likely than not that Bank Rate will increase over the forecast period.

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.