

Overview

In the United Kingdom, output growth eased in the second quarter and surveys pointed to further slowing in the third. Consumer spending appeared to decelerate as households' real incomes were squeezed. Residential and business investment prospects deteriorated. Global economic activity was a little firmer than expected, but the near-term outlook for the advanced economies remained subdued. Under the assumption that Bank Rate moves in line with market yields, the Committee's central projection is for output to be broadly flat over the next year or so, after which growth gradually recovers. But there is a risk that the slowdown may be more pronounced.

CPI inflation rose markedly. Energy and import cost pressures increased. Some measures of household inflation expectations rose. Earnings growth remained moderate. In the central projection, higher energy, food and import prices push inflation substantially higher over the next few months. Inflation then falls back sharply to a little below the 2% target in the medium term, as the contribution from energy, food and import prices wanes and the margin of spare capacity increases. But considerable uncertainty surrounds this outlook. The main risks to inflation — from a more pronounced slowdown in demand on the downside, and from the possible impact of a prolonged period of elevated inflation on pay pressures and inflation expectations on the upside — have both increased since the *May Report*. Overall, the balance of risks to inflation is judged to be on the upside.

Financial markets

Financial market participants' expectations of the near-term paths of policy rates in the advanced economies rose as the prospects for inflation deteriorated, and international equity prices fell. Credit conditions tightened further. In the United Kingdom, lenders' concerns over credit quality increased against a backdrop of softening demand and falling property prices. Access to funding markets remained tight and the process through which UK banks raised new capital proved difficult. Banks and other financial institutions continued to restrain the growth of their balance sheets, pushing down on money and credit growth.

Domestic demand

Household spending appeared to slow in the first half of this year. But the extent of the moderation is uncertain, with surveys of retailers suggesting an earlier and sharper slowdown than implied by official estimates. The picture painted by the surveys seems more consistent with the pronounced squeeze on real take-home pay and the reduced availability of credit.

Increases in domestic energy and import prices are likely to erode households' purchasing power further over the next year or so. Tight credit conditions, accompanied by marked weakness in the housing market, are also likely to weigh on household spending. A period of muted consumption growth is therefore in prospect.

The outlook for investment deteriorated. Investment in dwellings declined in 2008 Q1, as the housing market weakened sharply and house builders scaled back construction. Pronounced falls in a range of activity indicators suggest that dwellings investment is likely to exert a sizable drag on GDP growth in the near term. Business investment plans have also been scaled back, reflecting the weaker and more uncertain outlook for demand and the tightening of credit conditions.

Government spending made another firm contribution to nominal domestic demand growth in early 2008. Conditioned on the fiscal plans set out in *Budget 2008*, the public sector's contribution to nominal demand growth is assumed to decline over the forecast period.

Overseas trade

The expansion of global economic activity in the first half of 2008 was somewhat stronger than expected. But the near-term prospects for activity in the advanced economies remained fragile. Rapid output growth in the euro area in the first quarter looks set to be followed by a period of subdued economic activity. In the United States, GDP advanced at a moderate rate in the second quarter, but weakness in housing and labour markets persisted. By contrast, output growth in Asia and commodity-exporting economies remained robust.

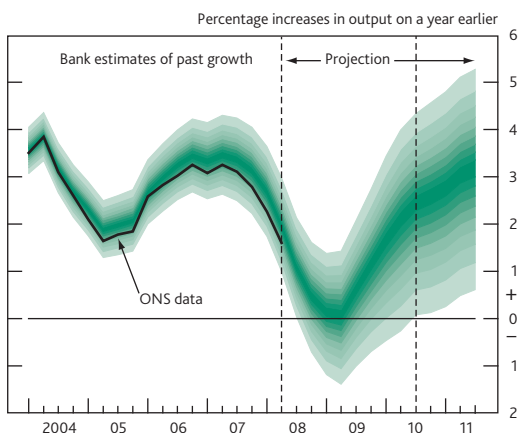
The United Kingdom's main overseas markets seem likely to slow, bearing down on the demand for UK exports. But the improvement in competitiveness associated with the depreciation of sterling over the past year should help to support export volumes and slow import growth.

The outlook for GDP growth

According to the ONS's preliminary estimate, quarterly GDP growth eased to 0.2% in 2008 Q2. Subsequent data on industrial production suggested that growth in the second quarter may have been weaker than provisionally estimated, and business surveys and reports from the Bank's regional Agents point to broadly flat output in the third quarter.

Chart 1 shows the Committee's best collective judgement for four-quarter GDP growth, assuming that Bank Rate follows a path implied by market yields. In the central projection, output is broadly flat in the early part of the forecast. That

Chart 1 GDP projection based on market interest rate expectations



The fan chart depicts the probability of various outcomes for GDP growth. To the left of the first vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past; to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outcomes are also expected to lie within each pair of the lighter green areas on 10 occasions. Consequently, GDP growth is expected to lie somewhere within the entire fan on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents. The second dashed line is drawn at the two-year point of the projection.

reduces pressures on resources both in the labour market and within businesses. Sluggish real income growth and constraints on the ability of households to borrow dampen consumer spending, while the weak outlook for demand and the housing market lead to falls in business and residential investment. Thereafter, economic growth gradually picks up, as the restraining effect of higher energy prices on demand and output dissipates, credit conditions ease and the lower level of sterling continues to support net trade. But the balance of risks around this central projection is judged to be on the downside, particularly in the medium term. The outlook over the first part of the projection is noticeably weaker than in the *May Report*.

Costs and prices

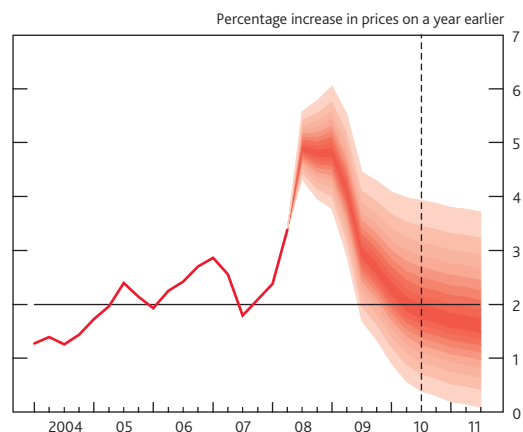
CPI inflation increased to 3.8% in June, reflecting sharp increases in food and petrol prices. Wholesale prices of oil and gas rose sharply in the period following the *May Report*, but have subsequently fallen back. Non-energy import price inflation also picked up, partly reflecting the lagged effects of sterling's substantial depreciation. CPI inflation is expected to pick up sharply over the next few months, in part reflecting the announcements already made about higher retail gas and electricity prices.

Manufacturing and service sector output prices rose, and near-term pricing intentions of businesses remained elevated, particularly in the manufacturing sector. But reports from the Bank's regional Agents indicate that some consumer-facing businesses are finding it harder to pass on price increases. Given the outlook for slowing demand, these businesses may be forced temporarily to absorb some of the increases in input costs in order to support sales.

However, in order to continue in operation, companies will over time have to pass the burden of higher non-labour costs on to households. That will occur through some combination of lower nominal wage growth, higher prices and lower employment growth, implying a reduction in the purchasing power of households' incomes. Real pay growth has already moderated and looks set to slow further, as increased non-wage costs lead businesses to put downward pressure on labour costs in a loosening labour market. But if employees resist the required adjustment in real wages, that would lead to a more pronounced slowing in output and employment.

Measures of expected inflation one year ahead rose. The rise in near-term inflation expectations is consistent with households expecting the rise in inflation to be temporary. But there is a risk that, when forming their medium and longer-term inflation expectations, households and businesses extrapolate from observed inflation outturns and that these higher inflation expectations become embedded in wage and

Chart 2 CPI inflation projection based on market interest rate expectations



The fan chart depicts the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 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 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan chart on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents. The dashed line is drawn at the two-year point.

price-setting. Movements in measures of longer-horizon inflation expectations have been mixed: some measures have remained broadly unchanged; others have moved up a little. An increase in longer-horizon expectations would be costly to reverse and would probably require a more pronounced slowdown in economic activity in order to achieve the inflation target.

The outlook for inflation

Chart 2 shows the Committee's best collective judgement of the outlook for CPI inflation, assuming that Bank Rate follows market yields. In the central projection, higher energy, food and import prices push inflation substantially further above the 2% target in coming months. Inflation then falls back sharply to a little below target in the medium term, as the contribution from energy, food and import prices wanes and the margin of spare capacity increases. The projection for inflation in the near term is markedly higher than in the *May Report*.

The inflation outlook is unusually uncertain. There are significant risks on both sides of the central projection. On the downside, the key risk is the possibility that the higher level of energy prices and the dislocation in credit markets lead to a deeper and more prolonged period of subdued demand. That would open up a larger margin of spare capacity which could cause inflation to undershoot the target. On the upside, the main risk is the possibility that the period of inflation well above target prompts an increase in medium-term inflation expectations that feeds into wage and price-setting. Both risks are judged to have increased since the *May Report*. Overall, the balance of risks around the central projection for inflation is judged to be on the upside. There is a range of views among the Committee on both the central projection and the balance of risks.

The policy decision

At its August meeting, the Committee noted that the immediate prospect was for CPI inflation to move substantially further above the 2% target, and for output to be broadly flat. The weakness of economic activity would open up a margin of spare capacity, which was likely to be necessary in order to return inflation to the target in the medium term and to ensure that longer-term inflation expectations remained close to the target. There were significant risks to the inflation outlook relating to the extent of the slowdown and to the persistence of the pickup in inflation. In the light of those risks, the Committee judged that maintaining Bank Rate at 5% at its August meeting was appropriate in order to meet the 2% target for CPI inflation over the medium term.