Report to the Treasury Select Committee

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Overview

Over the last year, economic outcomes and prospects in the UK have been driven by the path of the Covid-19 pandemic; by government measures to control its spread; and by the response of firms and households to both health outcomes and government restrictions.

At the outset of the pandemic, the uncertainty around each of these three factors was extraordinarily high. With no precedent in recent history, it was not appropriate to formulate a central outlook or to attach meaningful probabilities to various scenarios. As a result, we published a plausible illustrative scenario – rather than a forecast of a central path for the economy - in the May 2020 Monetary Policy Report (MPR).

Over time, we learnt more about the evolution of the pandemic; the government's reaction function; and the exchange rate between those two things and economic activity. This made it possible for the MPC to return to formulating its central projections from August, albeit with uncertainty bands around those projections that remained very wide.

As the crisis has unfolded, my approach to monetary policy has been influenced by what economists term "risk management" and "robust control" considerations. The former emphasises that, when nominal interest rates are close to the effective lower bound, it is optimal to act early and aggressively in the face of downside risks, because it is easier for policy to respond were upside risks to emerge than downside ones. The latter is a heuristic for decision-making under extreme uncertainty about the economic outlook. It suggests that, when it is impossible to assign probabilities to different outcomes, the policymaker should target policy to minimise the impact of the worst-case scenario. This has meant being particularly alert to the possibility of particularly severe scenarios for the evolution of the pandemic.

Both of these considerations have driven me to support loosening policy at different points over the past year. But over time, as vaccination programmes have progressed, uncertainty reduced, and downside risks lessened, they have weighed less on my approach to policy. The section below sets out in more detail the evolution of the economy and my thinking on policy over the past year or so.

Economy and Voting record

The path of the economy over the past year has been dominated by the Covid-19 pandemic; measures imposed to control its spread; and the responses of households and firms to these. Last year, we saw the sharpest contraction in economic activity since the 18th century, with GDP troughing at around 25% below its pre-pandemic levels in April 2020 and falling by around 10% for the year as a whole. As of the first quarter of this year, the economic output is still around 9% below its pre-pandemic level. Inflation has been below the 2% target for the past 12 months, reflecting the underlying weakness of demand, as well as falls in commodity prices and the recent cut in VAT.

The MPC has taken extraordinary action to support the economy through the pandemic, in pursuit of its statutory remit.

In two successive meetings in March 2020, as the scale of the covid crisis and its impact on financial markets and on the transmission of monetary policy became apparent, the MPC took swift action. We cut Bank Rate to 0.1%; launched a Term Funding Scheme with additional incentives for SMEs (TFSME) to reinforce the transmission of rate cuts to the real economy; and announced a £200 billion increase in our target stock of asset purchases, with the purchases to be completed as quickly as operationally possible. Our action on asset purchases in particular was taken in response to indications of financial market dysfunction, as a “flight to safety” by investors rationally re-pricing assets quickly turned into a “dash for cash” liquidity shock.

My – and the Committee’s – primary motivation for the timing, pace and scale of these purchases was to counteract an unwarranted tightening in financial market conditions at a time when it was likely that the equilibrium interest rate had fallen.

Our actions, combined with those of other central banks internationally, restored the functioning of core financial markets, even as implications of the spread of covid-19, and government measures to control it, on the real economy started to become apparent.

In June, I supported the MPC's decision to further increase the stock of government bond purchases by a further £100bn. For me, the rationale for this action differed from the asset purchases announced in March. My main concern at that point was the risk of a second wave of the virus, and another subsequent major lockdown. As the extreme uncertainties of the period were such that it was impossible to meaningfully attach a probability to this possibility, I was influenced by "robust control" considerations, seeking to target policy to minimise the impact of a worst case scenario. Risk management considerations also played a role in my approach to policy at that point. These considerations drove me to support further stimulus – not to alleviate market dysfunction primarily through supporting market liquidity as in March – but rather for the broader and more balanced rationale of supporting demand through a range of transmission channels.

Over the course of the summer, the public health and economic picture improved considerably and faster than had been set out in the May illustrative scenario, with infection rates falling and parts of the economy reopening as the UK emerged from the first lockdown. Despite the upside news, however, there remained material downside risks to our forecast – particularly around a second wave. I was therefore keen that the MPC communicate through its guidance that that we would not be withdrawing support for the economy until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

One commentator at the outset of the epidemic described the health policy response as "the hammer and the dance": the hammer of a total lockdown to get the virus under control, followed by a more nimble dance of localised, targeted measures to contain its spread as restrictions are eased. By November, it was clear that the dance phase was proving ineffective, and that some of the downside risks to our forecast were beginning to materialise. The targeted, localised measures were struggling to push infection rates down sufficiently, and we were now facing another nation-wide lockdown.

I therefore voted, alongside the rest of the MPC, to announce a further £150bn in asset purchases in November. My view was that – alongside the substantial ongoing fiscal support to protect employment through the furlough scheme and maintain the flow of credit to the real economy through the government-guaranteed lending schemes – further monetary stimulus could play a supportive role by helping to keep risk-free rates at their current low levels, preventing an unwarranted tightening in monetary conditions.

By February, economic prospects had improved and uncertainty fallen. Most importantly, the vaccination programme had commenced and was proceeding on track, and the economic impact of the third lockdown appeared to be less severe than we had forecast. In addition, a trade deal had been agreed with the European Union.

It was now possible to see upside as well as downside risk to activity and inflation from the second quarter of 2021 onwards. These upside risks centred on the government being able to ease restrictions faster than anticipated; demand recovering more quickly and more powerfully than expected; and the extension of fiscal support to avoid a cliff-edge. At the same time, short and longer-term supply side constraints in the face of rising demand could push up on inflationary pressures.

But it was also possible to tell a very different – and much more pessimistic – downside story. The risk of new variants could lead to a longer period of restrictions despite the vaccine rollout; unemployment could rise significantly in the second half of the year if the Coronavirus Job Retention Scheme (JRS) ended as it was then slated to by end-April; and firms and households could exhibit more cautious behaviour than anticipated, both for health reasons and as a precautionary response to rising unemployment.

Given the speed of developments, my view was that there was a strong case for waiting to see which world we would find ourselves in.

If downside risks materialised, I was prepared to consider further policy support, which could take the form of QE and/or a negative Bank Rate. I was clear that the latter would not be without risks. The experience of other countries was not a reliable guide to the impact of a negative Bank Rate in the UK at a time of great stress, and there was a risk of a procyclical impact if negative rates impaired the ability of banks to continue lending to the real economy through the pandemic. Ultimately, given the balance of risks and the uncertainty around the economic impact of negative rates, I judged that any pre-emptive, risk-management consideration was not sufficient to justify a policy change at that point.

Over the past few months, the economic news has come in largely to the upside. Data suggests the impact of the more recent restrictions on economic activity continued to be more benign than anticipated, suggesting households and firms are learning to adapt to restrictions. The vaccination rollout has proceeded quickly, and infection and hospitalisation rates have fallen. As a result, the Government's roadmap for exiting lockdown has advanced more quickly than the MPC had expected in February. Moreover, the Budget has provided more significant support for the UK economy over the near-term, while fiscal stimulus abroad – particularly in the US – has helped to boost world demand, with positive spillovers to the UK.

The outlook

In the May MPR forecast, GDP is expected to rise sharply in the second quarter of this year as restrictions on economic activity are lifted. Activity continues to recover to pre-covid levels over the course of this year, boosted by a decline in health risks, a fall in uncertainty, and monetary and fiscal stimulus. Unemployment does not rise materially from its current level, thanks to extension of the JRS, which will now end in the Autumn, when the recovery in demand is forecast to be well under way.

From next year, growth slows as the boost from these factors wanes. But there is nevertheless a temporary period of excess demand and slightly above-target inflation – primarily reflecting the impact of energy prices - before growth falls back, the output gap returns to balance, and inflation returns to the 2% target. The MPC continues to judge that inflation expectations remain well anchored.

Given the temporary period of modest excess demand and above-target inflation, it is important to emphasise the MPC's guidance that we will not tighten policy until we have clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

For me, the important evidence will be on the impact on unemployment when the JRS is removed in the Autumn; the scale of corporate insolvencies as we emerge from the pandemic; the strength of household and firms' behavioural response when restrictions are lifted, and relatedly, any signs of the emergence of recessionary dynamics. I would also want to see how pay and other price pressures - which have risen recently, but are difficult to interpret owing to distortions from the furlough scheme and compositional effects - respond to normalisation of economic activity.

Finally, some thoughts on risks around our central outlook. My view is that they are two-sided. On the one hand, a number of risks we had been worried about for some time have not crystallised, and may not do so. The UK's vaccine rollout is on track; early evidence suggests vaccines have been effective in reducing hospitalisations and deaths and mutant strains of the virus have not established themselves in the UK. All these factors may support a stronger bounceback in demand than pencilled into the MPR, and less damage to supply.

However, material downside risks also remain. These include a third wave of infections later on this winter, more cautious behaviour by households when restrictions are lifted, and worse scarring to the productive capacity of the economy as government support is withdrawn.

Explaining monetary policy

Over the past twelve months or so, I have given 6 on-the-record speeches (listed below). I will also be delivering a speech focused on the housing market ahead of my appearance before you next week.

In addition, I have given over 20 off-the-record remarks on monetary policy and financial stability.

Since the outbreak of the pandemic, I have virtually "visited" two regions – the North West and Greater London - to explain the MPC's views of the economic and financial outlook and to listen to local businesses' experiences through the pandemic. I also hosted a Community Forum with charitable groups in East Lancashire as part of my visit to the North West, to hear about the impact of covid-19 on the voluntary sector, and the communities they serve. I will be virtually visiting the South East and East Anglia next week.

I have had regular meetings with other central bankers and policymakers, including participating in fora such as the Bank for International Settlements (where I chair the Committee on Payments and Market Infrastructures), the Financial Stability Board, the G7 and G20 Finance Ministers and Central Bank Deputies meetings, and the World Bank and IMF annual meetings. I have also maintained extensive contacts with the business and financial communities both here and internationally.

<u>Speeches</u>

14 Oct 2019 *Financial stability and low for long*

11 Feb 2020 *Governance of financial globalisation*

28 Feb 2020 *It's time to talk about money*

09 Jun 2020 *Financial system resilience: Lessons from a real stress*

12 Nov 2020 *The impact of leveraged investors on market liquidity and financial stability*

13 May 2021 *Do we need "public money"?*

20 May 2021 *Forthcoming speech on the housing market, title TBC*