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Report to the Treasury Committee
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To be submitted for the February 2021 TSC hearing.

Background

Since much of this report covers the pandemic period from an economic point of view, I should like at the outset to say that the pandemic is first and foremost a public health crisis and I wish to join my other MPC colleagues in repeating my thanks to the scientists and health care professionals who have been at the forefront of dealing with this crisis and my sympathies to those who have lost loved ones. I wish also to record my thanks to Bank of England staff who have worked so tirelessly under difficult circumstances.

Economy and voting record

The economic landscape has changed dramatically since my previous annual report in August 2019. Due to the global coronavirus pandemic the UK has just registered the largest decline (-9.9%) in its annual output since 1709 and as of January 1st 2021 we have started a new trading relationship with the European Union (EU) having ended the transition period we entered on the 31st January 2020.

Prior to the global pandemic I had become concerned that the UK outlook had weakened materially and in large part due to uncertainty surrounding the timing and nature of our exit from the EU. By the final quarter of 2019 the UK economy was barely growing (0% in 2019 Q4), a general election was on the horizon and multiple forms of Brexit (including no deal) were of non-negligible probability. After subsequent downward revisions to our economic forecast over 2019, and with below-target inflation forecast in the first year of the November 2019 *Monetary Policy Report* (*MPR*), I considered the appropriate course of action at the November 2019 meeting was to begin to lower Bank Rate from 0.75% to 0.50% **–** a view I maintained at the December 2019 and January 2020 meetings. At the time, I felt the real economy required stimulus and argued that with Bank Rate close to a perceived effective lower bound, risk-management considerations dictated that policy should lean strongly against downside risk to the outlook.[1]

When I voiced my concerns about downside risks to our economic forecast in 2019 and early 2020, I had in mind further and prolonged Brexit uncertainty and greater escalation of US-China trade tensions. Such uncertainty, for example, was, in my view, weighing particularly on investment, with consequences for not only current aggregate demand but future aggregate supply. However, by February 2020, the focus had shifted to the coronavirus and its potential economic impact. I first viewed this through the lens of temporary lower global growth due to economic disruption in China and South-East Asia. By early March, as we witnessed coronavirus take hold in Europe, it was clear it was going to be much more than that.

[1] A risk-management approach proposes that the possibility of running out of monetary headroom warrants looser monetary policy in advance of it occurring. See Evans et al (2015) and Adam and Billi (2007).

On the 10th March 2020 I voted with my colleagues to reduce Bank Rate by 50 basis points to 0.25% and to introduce a funding scheme (TFSME) in order to assist with the transmission of the interest-rate cut to the real economy, and provide additional incentives for lending to small businesses. At this point, nominal government bond yields had already reached all-time lows, commodity prices had fallen sharply and it was clear the UK economy was going to be disrupted significantly by the spread of the virus throughout Europe. Indeed, by this point the majority of Bank of England staff were already working from home. By the following week market conditions had further deteriorated and what had started as a 'flight to safety' had now become a 'dash for cash'[2] with a number of closely watched measures of gilt market efficacy flashing red. I agreed on the 19th March further easing of monetary conditions was necessary and voted for a further 15bp cut to Bank Rate and to begin to expand the Bank's stock of assets through the purchase of £200 billion in UK government bonds and sterling non-financial investment-grade corporate bonds. The effect of these purchases and the pace at which they were carried out helped restore order to financial markets, which we rely on to transmit monetary policy effectively to meet our inflation target.

As we moved past the financial upheaval in March, the economic implications of what it takes to control the virus became apparent. In the second quarter of 2020 the hospitality sector almost completely shut down and at times many sectors were operating at only half capacity. This resulted in a staggering 20 percent fall in output relative to the last quarter of 2019. The government's furlough schemes were able to shield 12 million employees or around 1/3 of the workforce against the risk of unemployment and loss of income. Considerable support was offered to businesses via tax relief and newly created lines of credit e.g. the Bounce Back Loan Scheme. These schemes likely explain the relatively low levels of company insolvencies reported in 2020 relative to 2019 and the small change in the official unemployment rate. As well as these policy "shock absorbers", we had a technological one: namely that a significant portion of the active workforce was able to shift to working from home – 49% at its peak in 2020 Q2. The 21st century development of our telecommunications infrastructure and its adoption by firms has therefore served to increase our economic resilience in ways many of us could not have predicted.

The fragility of the economic situation was at the forefront of my mind when the Committee met in May 2020. While the MPC can do little about the supply element of the pandemic-induced economic contraction, I believed we still had an important role to play in insuring against further risk aversion and any unwarranted tightening in financial conditions. And with CPI inflation forecast to fall below 1 percent in Q2, there seemed little cost to announcing further asset purchases at the May policy meeting, which is what I voted for in the minority. This became the majority position at the June meeting, when the MPC announced the expansion of its stock of government bond purchases by a further £100bn.

Over the course of the summer the economic and public health situation improved considerably from the depths of the lockdown in April 2020. The seven-day moving average of daily reported cases fell below 600 in July, the hospitality sector reopened and overall output grew by 16.2% in the third quarter. This was welcome news but it is worth remembering that this sharp rebound was to be expected given the nature of the lockdown, and that throughout 2020 the level of measured economic activity remained more than 5% below its 2019 peak. The UK's economic recovery also lagged that of its peers. This relative underperformance in part reflected measurement differences

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[2] See Hauser (2020). *Seven Moments in Spring: Covid-19, financial markets and the Bank of England's balance sheet operations.*

concerning public-sector output, but was primarily driven by a shortfall in consumption owing to a longer period of lockdown[3] and a slower rebound in mobility that reflected more sustained working from home and perhaps greater caution concerning the virus.

As the third quarter came to an end, I considered us to be in a holding pattern because it remained unclear as to how we would eventually come to control or live with the virus. That pattern was broken in the final quarter of 2020 as the second wave of coronavirus started to take hold and the government sought to control its spread through non-pharmaceutical interventions (NPIs). Consistent with the logic I outlined in May and June, at the November 2020 meeting I supported the Committee's decision to expand our stock of assets by a further £150bn. This policy announcement, on November 5th, was followed by the welcome reporting by Pfizer-BioNTech on November 9th of the 90% effectiveness of their vaccine. This and subsequent vaccine announcements provided a path out of the stop-and-go cycle of NPIs I had become concerned about, but also called for a more cautious approach to managing the virus and the economy in the near term.

At the February 2021 meeting, the Committee judged that the existing stance of monetary policy remained appropriate, with the positive news related to the vaccine rollout offset by the near-term deterioration of the public-health outlook and stringent lockdown measures. The decision to leave policy unchanged was consistent with our guidance not to tighten monetary policy at least until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target sustainably. As explained below, the excess demand that emerges in the central projection over the forecast, and the attendant increase in inflation slightly above 2%, are temporary, fading by the end of the forecast.

Following the successful completion of the PRA's initial consultation with regulated firms regarding the setting of zero or negative Bank Rate, I supported the decision alongside my colleagues to request that the PRA further engage with firms to ensure they start preparations to be ready to implement a negative Bank Rate at any point after six months. I think it would be prudent for banks to start preparations regardless of the desired policy stance, for that is what it means for a negative Bank Rate to be in the MPC's monetary policy toolkit. I also supported the MPC's decision to request that Bank staff start technical preparations to deliver the option of a tiered system of reserve remuneration that could be ready to be implemented alongside a negative Bank Rate, should it be necessary in the future.

Economic outlook

In the February *MPR*, the MPC's central forecast is for UK activity to fall by 4% in 2021 Q1 – to about 12% below its 2019 Q4 level – reflecting Covid-related government restrictions and firms' initial adjustment to the new UK-EU trading relationship. As the vaccination programme is rolled out, restrictions are assumed to ease from 2021 Q1, and households' health concerns and uncertainty about the outlook gradually recede, leading to a material pickup in consumer spending and GDP during 2021. Against the backdrop of supportive monetary policy, activity is also forecast to be boosted materially by the substantial additional spending measures announced by the government in the Spending Review 2020, with an estimated peak impact of around 1% of the level of GDP in 2021 Q2. GDP is projected to reach its 2019 Q4 level by 2022 Q1. In the forecast, business

[3] The UK lockdown exceeded Germany's by 41 days, France's by 14 days and Spain's by 13 days.

investment also recovers as sales improve and uncertainty dissipates, but more gradually than consumption, not exceeding its 2019 Q4 level until 2022 Q4.

In the medium term, the supply capacity of the economy is affected by some persistent scarring effects of Covid-19 as well as the UK's withdrawal from the EU.

In the MPC's central projection, Covid-related effects are projected to lower the supply capacity of the economy by about 1¾% by the end of the forecast, relative to what it would have been absent the pandemic. These include the effect of weak investment weighing on the productive capacity of the economy, as well as frictions in the reallocation of labour and capital across different sectors. This is a level effect on GDP by the end of the forecast.

The new trading arrangements between the UK and the EU also weigh on GDP in the longer run. The higher trade barriers are projected to reduce trade by about 10½%, which is expected to lower investment, productivity and GDP. As a result, the MPC projects GDP to be about 3¼% lower in the long run, with about two thirds of that decline assumed to occur by the end of the forecast.

The sharper decline of demand relative to supply means there is currently a material amount of spare capacity in the economy. The unemployment rate is projected to rise further, peaking at 7¾% in mid-2021, as the government's job support scheme unwinds, before declining gradually over the forecast. The sharp pickup of spending over 2021 translates into some excess demand emerging by the end of the year, but that excess demand then gradually fades over the forecast, as the boosts to the growth in demand from receding health risks, declining uncertainty and government spending diminish. By the end of the forecast, demand and supply are in balance, and spare capacity eliminated.

Looking through the base effects from previous energy price falls and the VAT cut that cause inflation to rise sharply in the near-term from 0.5% in 2020 Q4, inflation continues to pick up towards the target as spare capacity is eliminated and excess demand emerges, reaching 2.1% in 2022 and 2023. It then falls back to target by the end of the forecast as excess demand is eroded.

There are substantial risks to the *MPR* forecast for activity, which the MPC judges to be skewed to the downside in the near term, fading thereafter. The GDP fan chart also remains wider than usual, reflecting the unusually high level of uncertainty.

The *MPR* mentions a number of upside risks. Chief amongst them is a stronger recovery in consumer spending as households make up for the expenses foregone during the lockdowns, having in aggregate accumulated additional savings involuntarily. The central projection assumes that households spend about 5% of these additional accumulated savings over the forecast, but that share could be higher.

Another upside risk to the consumption recovery might arise if health concerns receded more rapidly as the vaccination campaign is rolled out. Relatedly, a faster vaccine rollout than the government's announced plans, in my view, would also represent an upside risk.

Business investment could pick up more strongly, for example if the heightened levels of uncertainty over the past year declined more rapidly as vaccinations are rolled out.

To me the downside risks to the February central projection are much more prevalent. The *MPR* enumerates a number of them.

First, the recovery of business investment could be slower than projected, if firms that have borrowed substantially over the past year delayed capital outlays to enable them to repay outstanding loans. To me, firms' ability to repay their debts and avoid insolvency represents a sizeable downside risk to growth as government support for businesses is withdrawn.

Second, I'm also concerned about the dampening effects of high uncertainty regarding the UK's future trade relations with the EU, including for trade in services, which was not part of the Trade and Co-operation Agreement signed on 24 December 2020. The Deloitte CFO survey suggests that uncertainty amongst UK firms remains relatively high compared to the years just before the EU referendum, despite a sharp fall since the autumn. I should note that another trade-related risk is the current spike in shipping costs due to a shortage of containers: the Committee continues to keep an eye on this via the Bank's regional Agents, but this would seem to be a short-run risk.

Third, there are also substantial downside risks to consumer spending. The recovery in consumption might be weaker if people remain cautious in their social interactions until vaccinations are more widespread and Covid-19 cases markedly lower, even as restrictions are gradually lifted.

Fourth, the downside risk that worries me the most is the emergence of highly transmissible variants of the virus, of the kind that necessitated a reimposition of lockdowns here and abroad earlier this year. The time needed to redesign vaccines that can deal with novel resistant strains would likely mean renewed restrictions and voluntary social distancing as health risks worsened, weighing on growth in the UK and globally.

The fifth downside risk that concerns me comes from the public health distinction between vaccine efficacy and vaccine effectiveness (sometimes called implementation). Vaccine efficacy, that is, how well the vaccine works in a laboratory setting on screened participants, is very high – a tribute to the scientific community. Less is known about vaccine effectiveness, that is, how well the vaccine works in the field, which depends also on production, logistics and public health policies. The vaccine manufacturing and distribution processes are vulnerable to small disturbances at any point along the production and distribution chains. So it is possible to have high vaccine efficacy, but, due to vaccine effectiveness, an economy facing a substantial downside risk.

While for me, risks to activity remain very much to the downside, I view risks to the supply outlook as balanced, as laid out in the *MPR*. There is a downside risk from more persistent changes to the composition of spending in the economy requiring a greater degree of resource reallocation between sectors, and leading to more capital scrapping, which would likely weigh on supply growth. But there is also an upside risk from greater investment in intangible assets and digital technologies to support new business models, which could lift productivity growth. That said, as pointed out in a number of speeches, I am less convinced about any aggregate productivity benefits from increased homeworking. The vast majority of firms, according to ONS surveys, does not intend to make homeworking a permanent feature of their business models.

With downside risks to the outlook and taking risk management into consideration, as I have done previously, I remain open to the possibility that the economy might need further support to return inflation to target sustainably.

Explaining monetary policy

Since my last report in August 2019, I have undertaken a number of activities:

- given evidence in front of the Treasury Committee for the May 2020 *MPR*
- given eleven talks on the economic outlook to business groups and financial market participants
- given nine talks to schools and at universities including an on-the-record speech on monetary policy in the intangible economy at the University of Nottingham
- given another three on-the-record speeches or remarks on the UK outlook and monetary policy at the Resolution Foundation, Covid-19 and monetary policy at the Brighton Chamber of Commerce, and the economic effects of Covid-10 at the Imperial Future Matters Online Webinar
- made five regional visits to meet with businesses and schools in:
    - North East
    - Scotland
    - Northern Ireland
    - South East & East Anglia
    - Greater London
- given five off-the-record interviews, to the Usbek & Rica Business Review, Bloomberg, the Brunswick Podcast, The Times, and the Press Association.
- Continued with duties and responsibilities as a non-Executive Director at the UK Statistics Authority.
- Continued pursuing academic research on productivity, investment and innovation with a view to better understanding how it affects the economy, monetary policy and the transmission mechanism. To that effect, I attended several workshops and conferences at the ONS, HMT, IFS, BEIS, ESWG, NIESR, CEPR, Royal Economics Society, the European Central Bank and the European Commission First European Conference.