Report to the Treasury Committee

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Economy and voting record

Since my previous annual report in February 2019, the UK economy has been primarily affected by three major forces: the uncertainty surrounding the UK's future trading relationship with the EU and the rest of the world; the global trade and geopolitical conflict between the US and China, and, more recently, the global coronavirus pandemic.

Over the course of 2019, domestic and global uncertainty weighed on UK growth, which was below the average of prior years at only 1.1%. Unemployment, which had been falling in previous years, stopped falling in 2019. Inflationary pressure remained subdued, with pay growth no longer picking up, and core CPI inflation remaining below target-consistent rates.

I ascribed this, at the time, to a combination of domestic and global headwinds. Domestically, political uncertainty was high in the UK, and firms and households were not able to form clear expectations of what the UK's future trading relationships with the rest of the world would look like. This weighed on business investment, employment and consumption growth.

Globally, the escalation of the trade conflict between the US and China, and the risk that tariff or other trade barriers would be erected in other countries as well, weighed on global business investment. From late 2016 to early 2018, strong global growth had provided a boost to the UK economy, which, due to its openness, tends to be highly influenced by the global economic cycle.

But over the course of 2018 and 2019, the escalation of the US-China trade and geopolitical conflict increasingly weighed on global business investment. Capital goods orders in advanced economies slowed and even contracted in some areas. Employment slowed, and commodity prices fell. This led to a meaningful adjustment in actual and expected global monetary policy. This global slowdown provided an additional headwind to the UK economy, over and above the domestic headwind from political and trade uncertainty.

I voted, along with the majority of the MPC, to keep monetary policy unchanged during 2019. But my communications changed. Initially, I thought the slowdown would result in a pause in the slow rate hiking cycle that had started in the UK in 2017. But over the course of the year, I pointed out that the UK economy had gone from growing a little above potential to slowing somewhat below potential, and that it looked increasingly likely that further monetary stimulus would at some point become appropriate.

By January 2020, the only factor that was giving me pause before voting for renewed monetary stimulus, as I mentioned in an interview to the FT at the time, was the fact that some of the political uncertainty was resolved following the general election result in December 2019. I wanted to wait briefly to gauge the extent of the rebound in private sector spending, which was difficult to infer from the data at the time, with several economic indicators having dropped sharply towards the end of 2019, but then rebounding sharply at the start of 2020.

By early February, the MPC's and my focus shifted to the emerging coronavirus outbreak. Initially, this outbreak seemed to be confined to China, with relatively little sign of spread to other countries. Even then, the economic impact on China was already judged to be of sufficient magnitude that it would materially affect global growth, and therefore economic conditions in the UK.

By mid to late February, it became clear that the coronavirus was spreading to a wide range of countries including the UK, and that we would have to start thinking about a direct economic impact in many countries simultaneously, which would be far larger than what was initially expected when it was thought the virus spread might be limited.

In early March, even before any lockdown measures were imposed in the UK, data from other countries that had experienced the spread of the virus some weeks ahead of the UK, showed that the pandemic was likely to have a dramatic economic impact, with demand falling sharply and an associated risk of sharp rises in unemployment. In a speech in April, I judged that the UK economy was already experiencing a contraction that was faster and deeper than anything we had experienced in the past century or longer.

It is important not to think of the economic impact of the pandemic as a simple supply shock, in the sense of an unavoidable temporary contraction that we just have to live with. It is far more complex than that, and consequently there is far more scope for active policy responses. Some people cannot get to work, either because their travel to work has been restricted, because they are ill, because they are caring for others who are ill, or for children who are home due to school closures. That is indeed a supply shock. But there has also been a dramatic reduction in demand, and the net effect is that the pandemic is likely to be disinflationary. Social distancing, in part voluntary and in part imposed, means that demand for a wide range of consumption activities has been cut back. In turn, the weakness of demand in particular sectors, as well as uncertainty about when that demand will return, is weighing sharply on business investment and employment demand.

Fiscal and monetary policy are being deployed to minimise the duration and severity of the economic impact of the pandemic. Fiscal policy is best placed to target the most affected sectors, and the government has rapidly launched a wide range of programmes to help both firms and households who have been directly affected. While fiscal policy is doing the heavy lifting, monetary policy has an important role to play as well in easing cash flow constraints, improving the availability and cost of credit, and boosting confidence. Reductions in interest rates, expanded borrowing facilities for banks and nonfinancial businesses, and asset purchases help ensure that borrowing costs are reduced, that financial markets are functioning smoothly, and that credit supply is available. The Bank of England's balance sheet is being deployed to help meet the monetary policy remit.

The ultimate aim of monetary policy, as it always is, is to meet the inflation target, by ensuring that aggregate demand grows sustainably in line with the economy's potential. The economy's potential is severely disrupted at the moment but, once the pandemic is over, and other things equal, in principle it should return approximately to the pre-virus trajectory. A persistent undershoot of the economy relative to its pre-virus trajectory is, in my view, most likely to be disinflationary. So the current priority for monetary policy, with a lot of help from fiscal policy, is to return the economy to that pre-virus trajectory as soon as possible.

In light of these economic and financial developments, I voted for an emergency 50bp cut in Bank Rate on 10 March, followed by a further 15bp rate cut on 19 March. At the 19 March meeting, I also voted for £200bn of asset purchases, to act against the financial market dysfunction in mid-March that was leading to a tightening in financial conditions which, if it had persisted, would have reduced demand in the economy even more sharply, leading to even stronger disinflationary pressure than we are already experiencing.

Around mid-March, global financial markets experienced a so-called “fire-sale” of securities: investors or financial intermediaries needed to adjust the risk of their portfolio rapidly, and sell securities sufficiently rapidly that the price fell by more than the economic fundamentals warranted. This process can feed back on itself, and on the economic outlook. Faster selling results in more price falls, which requires faster selling. And the associated rise in borrowing cost hurts the economy even more. Unusually, the disorderly selling also took place in advanced economy government bonds and other assets generally considered to be at the safe end of the investment risk spectrum. The central bank can play an important role in breaking the feedback loop between market stress and the economic outlook by offering to buy some of the assets that are being sold in distressed conditions and increasing the level of aggregate liquidity, i.e. reserves.

Over the course of April, following a number of liquidity measures put in place in March by central banks across the world, including the Bank of England, market functioning was restored, and financial conditions eased to levels that were more consistent with returning inflation to target in the medium term. However, the balance of risks to the inflation outlook remain skewed to the downside, and when the asset purchase programme announced in March was completed in June, I voted for a further £100bn in asset purchases at the June meeting, to be accumulated at a markedly lower pace than the previous £200bn. This latest round of purchases is expected to be completed around the turn of the year.

Economic outlook

One of the important lessons we have learned from the different pandemic experiences across the world is that it is not just the economic lockdown that suppresses economic activity. There is also a large behavioural response of households and firms to the prevalence of the virus, which supresses demand for certain types of economic activity even without any lockdown measures in place. What this means, concretely, is that easing lockdown measures is not sufficient to bring back economic activity. If lockdown measures are eased but there is still a high prevalence of the virus, demand for certain types of consumption, and the related investment and employment, is likely to remain supressed.

It is therefore highly significant that, even as we learned that the economy picked up a little more quickly in recent months and from a somewhat shallower trough than we had initially feared, we also learned that the virus is likely to be with us for longer than we had initially hoped. A large number of countries have been experiencing a renewed increase in new daily cases in July, including most of the EU member countries and the UK itself. Many countries have therefore had to reimpose some restrictions on activity or social interaction, usually either limited in scope or in geographical coverage.

Over the past few months, we have received an increasing amount of data covering the early stages of the recession. Most economic data relies on surveys, and there is always some uncertainty about how accurately it reflects the underlying state of the economy. That is even more true during the pandemic, as survey response rates have been lower and some types of activity have fallen to such low levels that they become increasingly difficult to measure.

Keeping that measurement challenge in mind, it now appears that the UK economy fell by about a quarter in March and April, before starting to recover in May and growing faster in June. Despite a record monthly growth rate in June, the economy at the end of June was still some 17% below its level at the end of last year.

There is tremendous uncertainty about the precise scale of the initial downturn, both ahead of the event and even now. But a few months of rapid growth in the period when lockdown measures were eased and new daily virus cases had been lowered significantly, tells us little about how the economy will evolve further out. If we set the level of economic activity just before the pandemic to 100, the economy fell sharply to around 75 by April, and rose to 83 by June. I am fairly confident that, in the months ahead, the economy will bounce back to the low or mid-90s. But that would still leave GDP 5% or more below its pre-pandemic level. For context, 5% of GDP is still a large recession worth of lost output. The amount of economic slack from those last few missing percentage points would be sufficient to keep inflation well below target. The key question for monetary policy is therefore how quickly we recover those last few percentage points, which will depend on the evolution of the virus itself, how firms and households respond to that virus path, and to what extent fiscal policy continues to support demand.

Viewing the economic response from the perspective of the labour market, rather than GDP, illustrates the scale of the challenge even more starkly. Based on a range of different data sources, the MPC judges that, at its peak, around 7.5 million workers were furloughed, which represents a third of private sector employees. By July, that number had been reduced to 3.5 million, so 4 million workers were able to restart work already in the space of just a few months. As the economy continues to recover, more of these furloughed workers should be able return to work. But note that every million of furloughed workers who are not able to return to their previous job and do not immediately find another job, would represent roughly three percentage points on the unemployment rate. So I take little comfort from the fact that the unemployment rate has remained fairly stable so far.

The longer the virus remains prevalent enough to affect patterns of consumption, investment and employment, the higher the likelihood that some sectors will not be able to return to their previous level of activity. In turn, that would imply that demand in other sectors needs to rise sufficiently to use up the resulting spare capacity in the labour force and in other inputs such as commercial property and capital equipment. Such a reorientation of the economy towards a different sectoral composition is likely to be a slower process than a scenario where each sector is able to return to its pre-pandemic size. Based on these considerations, there is a material risk in my view that it could take several years for the economy to return to full capacity and inflation to return sustainably to target, even with monetary policy at its current settings.

Explaining monetary policy

I have given 38 talks on monetary policy and the economic outlook to wide-ranging audiences of businesses, schools, universities and financial market participants

I have made seven regional trips to meet with businesses, schools and universities around the UK.

I have given three on the record speeches and three newspaper interviews on the topic of the economy and monetary policy. The speeches were, respectively, about communicating the future path of policy more consistently; about the amount of monetary policy space that we have in a low real interest rate environment; and about the various ways in which the Bank of England’s balance sheet was deployed in response to the economic impact of the global pandemic.