Report to the Treasury Committee

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Economy and voting record

1. Since my reappointment hearing with the Treasury Committee in July 2020, the pandemic has continued to shape the evolution of the economy. My monetary policy votes since then have followed a similar rationale to the one I set out at the start of the Covid crisis.

2. As the MPC explained in its March 2020 minutes, monetary policy during Covid was part of a broader public policy response aimed at supporting households and businesses through the disruption caused by the virus. I further clarified my own thinking on the role of monetary policy in my first post-Covid speech, given in April 2020.[1] The nature of the virus meant that some sectors of the economy were bound to see both supply and demand contract far more than others. Fiscal policy, which is able to target particular sectors, was therefore the largest part of the policy response – particularly via the furlough scheme.[2] Monetary policy contributed through two channels: first, it helped maintain or boost demand in sectors and businesses that were still active. And second, it bolstered the cash flows of businesses and households, reduced borrowing costs and improved the availability of finance (for both active and temporarily inactive businesses). This intended to limit defaults and business failures, and help prevent temporary weakness in activity turning into permanent falls in supply. By doing so, policy aimed to meet the inflation target while also minimising economic scarring.

3. In the same April 2020 speech, I outlined my view that Covid was likely to complicate measurement and interpretation of much of our economic data over the course of the pandemic. I focused in particular on the volatility this would create in measured CPI inflation. Large temporary changes in production and demand for some products (but not others) was likely to lead to large volatility in relative prices, including commodity prices, as well as difficulties with inflation measurement. As a result, observed CPI inflation during Covid was likely to be less informative than usual about future inflation developments and appropriate monetary policy. Similarly, I stressed how the growth of GDP during both lockdowns and re-openings was mainly telling us about the scale of mandated business closures, and less about the underlying strength of the economy. These points remain highly relevant in interpreting current data.

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[1] Tenreyro, S. (2020), "Monetary policy during pandemics: inflation before, during and after Covid-19" Speech given at an online webinar.

[2] While the furlough scheme has been crucial in determining the economic impact of Covid, a wider range of fiscal measures have also been important influences. These have included self-employment income support, government-guaranteed loans to businesses, stamp duty holiday and the joint Bank of England/HM Treasury Covid Corporate Financing Facility for larger firms. Other measures such as eviction bans for tenants and loan repayment holidays have also helped to limit effects on household and business finances.

4. Forecasting has also been uniquely challenging during Covid, in large part because the main determinant of the outlook has been the spread of the virus, rather than traditional economic drivers, as well as a number of public policies whose joint impact could not be precisely gauged. I have therefore valued highly the insights I have gleaned from epidemiologists and public health experts over the past 18 months. There have also been important two-way interactions between the economy and the spread of Covid, which spurred a plethora of new 'epi-macro' research, combining the two fields. My speech in July 2020 discussed what I had learned from this work and other recent research on Covid economics.[3]

5. Many of these insights had influenced my view of the economy last summer, as well as my vote to expand our QE programme in June. As expected, GDP had quickly recovered part of the reduction in output that was a direct consequence of the lockdown. But GDP and consumption had remained substantially below their pre-Covid levels. I argued that one reason for this, as the new research on Covid economics made clear, was that there were important interactions between economic behaviour and perceived Covid risks. Without any vaccines yet available, I thought there was a natural limit to how far consumption could recover in some sectors – too much would lead to increased spread of the virus, triggering renewed risk aversion and social distancing. Moreover, it was likely that the announced end of the furlough scheme would lead to a further step-up in unemployment, causing second-round falls in incomes and spending. Given these risks, I judged that a further £100bn of QE purchases were warranted.

6. I did not expect that the decision to increase asset purchases would lead to a large amount of additional stimulus to the economy. Long-term interest rates were already very low, and they are constrained by market expectations of future policy rates. With Bank Rate at its then lower bound, there was little room for long rates to be reduced further. Rather, I saw continued asset purchases mainly as insurance against the risk of renewed market dysfunction, similar to what we had seen in March 2020. An end to the QE programme while the pandemic was still likely to resurge domestically or abroad could lead to new episodes of increased liquidity premia and higher borrowing costs, which would have weighed on activity and exacerbated any downside risks.

7. As 2020 progressed, it became increasingly clear that the UK and many other countries were going to experience very large winter waves of Covid. Irrespective of the specific lockdown policies implemented, this was likely to lead to further social distancing, either voluntary or mandated, badly affecting revenues in some sectors. The extension of the furlough scheme ensured that fiscal policy was offsetting a large part of the impact of this on incomes and employment. But low interest rates also remained important to continue to support demand in unaffected sectors, and limit the effect on cashflows. I also felt it was prudent to announce that we would continue with QE purchases through

[3] Tenreyro, S. (2020), "Covid-19 and the economy: what are the lessons so far?" Speech given at the London School of Economics, Covid-19: The Policy Response webinar series.

2021, again to insure against any tightening in borrowing costs from market dysfunction. I voted for a further £150 billion of asset purchases in November 2020.

8. While virus prevalence and mortality continued to increase, we also had extremely positive news in the form of the successful development of Covid vaccines. These developments meant that on the one hand, we had a worse near-term outlook for activity in the first part of 2021, but on the other hand, less uncertainty about the recovery later in the year. I thought the precise timing of the recovery would depend largely on the speed of vaccine rollout both at home and abroad, and more generally on the prevalence of Covid and its effects on health and on household behaviour.

9. With such an outlook at the start of 2021, I thought that the justification for providing support via low interest rates was stronger than ever. Vaccines helped create more certainty that consumption would return closer to pre-Covid patterns – and that a large part of the shock would ultimately be temporary. Many badly-affected businesses, which had been viable pre-Covid, were therefore likely to be viable again, if they could bridge through the period of weak revenues caused by the winter wave. I therefore continued to vote to keep Bank Rate at its then lower bound, bringing inflation back to target as quickly as possible, while minimising any scarring to potential output. Being at the lower bound also highlighted the importance of having additional loosening options in our toolkit. My speech in January 2021 evaluated the evidence and explained my view of the transmission mechanism of one of those options, negative interest rates.[4] Negative rates have now been made operationally feasible, meaning that the MPC has additional policy space in the event of a future downturn.

10. As the UK winter lockdown reduced the prevalence of Covid, and vaccine rollouts progressed, the resulting reduction in Covid cases and hospitalisations allowed governments to relax public health restrictions. As the direct effects of lockdowns on activity disappeared, output and prices in many sectors were able to normalise relatively quickly. With many sectors of the economy returning rapidly towards their pre-Covid configuration, but the level of output and employment still well below their medium-term potential, and inflation returning towards target from below, I judged it appropriate to leave policy unchanged in subsequent months.

The current outlook

11. The current economic picture reflects two main factors. First, the vaccine rollout in the UK and many of our trading partners has continued to reduce hospitalisations and mortality for a given number of Covid cases. With the impact of mandated social distancing much reduced, the extent of voluntary distancing, as well as traditional economic drivers, have become the limiting factors for output in the UK. On the demand side, a new economic influence on the extent of the consumption recovery is how quickly households drawdown the involuntary savings that some built up during lockdown periods. On

[4] Tenreyro, S. (2021), "Let's talk about negative rates" Speech given at UWE Bristol webinar.

the supply side, misalignment between the speed of recovery in different regions, sectors and producers is leading to a number of bottlenecks, which cannot be immediately unwound.

12. The second factor is the arrival of the Delta variant, and the accompanying increases in case numbers in the UK and abroad. This is also impacting both the demand and supply sides of the economy. In the UK, there is some evidence that its spread is influencing the amount of voluntary distancing, which may be partly behind the recent moderation in the speed of the recovery. It has also had temporary effects on the supply of labour as individuals were required to self-isolate, although this is likely to have abated somewhat as case numbers have fallen from recent peaks, and rules and requirements have changed. In other countries, where vaccination rates among the most at risk are lower, the amount of economic disruption is likely to be even larger. This is especially the case in many emerging and developing economies.

13. In the data, inflation fell back to our 2 per cent target in July, but will rise significantly over the next few months. In common with central banks in other countries, we have had a significant amount of upside news to our inflation forecast this year. The main sources of the pick-up are well understood. In part, the annual inflation rate is being buffeted by base effects – whereby comparing the current price level to an unusually low price level 12-months ago exaggerates the underlying trend. A large part of the news can also be explained by increases in the prices of oil and other commodities, as well as internationally traded goods more generally, in the face of strong global demand. For a number of goods, larger than usual price rises can be explained by a number of shortages and bottlenecks that have arisen in supply chains, as the effects of Covid on demand and supply wax and wane in different regions. I think there are good reasons why the MPC should be cautious in its policy reaction to the recent inflation news.

14. First and foremost, I agree with the central view in the MPC's August forecast that the coming increase in inflation is likely to be temporary. The MPC remit states that the inflation target is forward-looking and it acknowledges that the actual inflation rate could at times depart from the target as a result of shocks and disturbances. Movements in the prices of energy and other commodities are typically shocks that have a one-off effect on the level of prices, affecting CPI inflation for one year before dropping out of the calculation. As long as there are no broader second-round effects, responding to these movements would induce undesirable volatility in output. Similarly, goods demand is likely to fall back next year as households revert to more normal spending patterns. Supply bottlenecks should also fade and supply should expand in response to price increases. Finally, base effects are simply echoes of where prices were in the past, and tell us nothing about where inflation is heading. In all, I see some of the recent inflation readings as examples of the volatility in the data brought about by the pandemic. Extracting the signal from the noise will be challenging, but crucial, as we observe the data in the coming months.

15. If above-target inflation proves somewhat more persistent, we will face a trade-off, as output and employment still have some way to recover to their medium-term potential. I emphasise medium-term potential supply, because although the MPC forecast expects demand to be in line with short-run supply during the third quarter, supply is being affected by a range of temporary factors such as the furlough scheme and bottlenecks. To illustrate the scale of how far supply could recover, in the Q2 data, there were still around 2¾ million more people (8 per cent of the labour force) either unemployed, inactive, or furloughed than there were in the three-months to February 2020.[5] Even if some fraction do not return to employment, there is still a material margin of potential labour supply for the economy to draw on. The faster that output and employment can return towards their pre-Covid trends, the less likely that temporary reductions in supply translate into more persistent scarring.

16. My upcoming policy votes will be affected by some large uncertainties over how the recovery will proceed in the coming months. First among these is how economies will be affected by reductions in fiscal stimulus in the next few quarters – in the UK, the withdrawal of the furlough scheme in particular. My central case forecast is that there will no longer be a sharp increase in unemployment as the scheme ends, given that consumer behaviour is now closer to normal than it has been at any point so far in the pandemic. But there remain risks that the adjustment is less smooth. These risks interact with the evolution of Covid and its effect on behaviour. If the rotation of consumption towards its pre-Covid pattern stalls, or reverses, owing to concerns about the Delta variant, then we are likely to see a larger rise in unemployment as furlough ends. There is also the risk that the anticipated rise in inflation could prove more persistent than we currently expect, particularly if it were to become embedded in higher wage and price inflation expectations.

17. The MPC updated its strategy on future policy in its August minutes. If the economy evolves as in our forecast, which is conditioned on a gradually rising path for Bank Rate, then I anticipate some tightening will be required to achieve the inflation target sustainably. But given the large uncertainties facing the economy at the moment, it will be important to assess the incoming data, particularly in the labour market and on inflation, before judging the appropriate stance. I also concur with the MPC guidance that it intends to start unwinding QE, first through ceasing reinvestment, when Bank Rate reaches a lower level than set out in earlier guidance. Bank Rate remains my preferred tool to affect aggregate demand and inflation – its impact is less uncertain and less dependent on the prevailing economic conditions. But with a negative Bank Rate now available as a loosening instrument, it should also be possible to begin unwinding QE earlier, while still maintaining Bank Rate as the active policy instrument. The judgement also depends on the expected impact of unwinding QE. I expect that if asset sales are carried out gradually and predictably, their impact will be small compared to the impact of asset purchases conducted during periods of market dysfunction.

[5] The calculation uses the number of people furloughed on 30 June 2021, rather than averaged over the quarter.

Explaining monetary policy

18. Since the onset of Covid, there have been few opportunities to speak in person about the economy and monetary policy. I have sought to compensate for this through a wide range of meetings, visits and talks held virtually, to communicate all aspects of my thinking on economic developments and my policy decisions.

19. I have given four on-the-record speeches on UK monetary policy since March 2020. In April 2020 I discussed prospects for inflation during and after the pandemic. In July 2020, I detailed the insights for monetary policy from the new wave of academic research on the economics of Covid. I gave a speech in January 2021 explaining the history and practice of negative interest rate policies, and summarised the wide range of empirical evidence that now exists on how they work. And finally, I published a speech in April 2021 comparing and contrasting the policy responses to the pandemic in the UK to that of the US.

20. In the past year I have also participated in four virtual agency visits to hear from businesses around the country (in Central Southern, Yorkshire and Humber, the East Midlands and the North East). These visits involve roundtables and one-to-one meetings to listen and learn about what is being experienced by individuals and businesses in different regions and sectors. Given the unique nature of the pandemic in how it has affected everyone differently, as well as the difficulties in collecting and interpreting macroeconomic data, these insights have been more important than ever over the past 18 months. I have also used the visits as an opportunity to explain MPC forecasts and decision-making to different groups, including talks to school students and interviews with local media.

21. Finally, I have continued to take up opportunities to appear on panels to discuss key policy issues and further our knowledge base by presenting and publishing research on relevant topics for UK monetary policy. Over the past year, I have participated in a wide range of events, including at the Bank of England, World Bank, IMF-University of Frankfurt, Banque de France, Resolution Foundation, IIES/SNS Stockholm, IZA Institute of Labour Economics Bonn, University of Oxford and Michigan University.