BANK OF ENGLAND

UK Inflation Outlook

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Main messages

1. A material amount of spare capacity has emerged in the UK economy that is expected to weigh on domestic price pressures in 2020-2021

2. In the medium term the implications of Covid-19 as a supply shock that necessitates temporary and permanent structural economic adjustments will be important

3. Near-term risks are clearly skewed to the downside and I stand ready to provide more stimulus should it be required.

In the UK we anticipate a temporary period of subdued inflationary pressure

	Projections			
	2020 Q4[c]	2021 Q3	2022 Q3	2023 Q3
GDP[d]	-5.4	8.6	3.0	1.9
CPI inflation[e]	0.3	1.8	2.0	2.2
LFS unemployment rate	7.5	6.6	4.7	4.0
Excess supply/Excess demand[f]	-2¼	-¼	+½	+¾
Bank Rate[g]	0.0	-0.1	-0.1	-0.1

(c) Data for 2020 Q4 are shown to abstract from volatility and measurement issues in some profiles in the near term.

(d) Four-quarter growth in real GDP. Excludes the backcast for GDP.

(e) Four-quarter inflation rate.

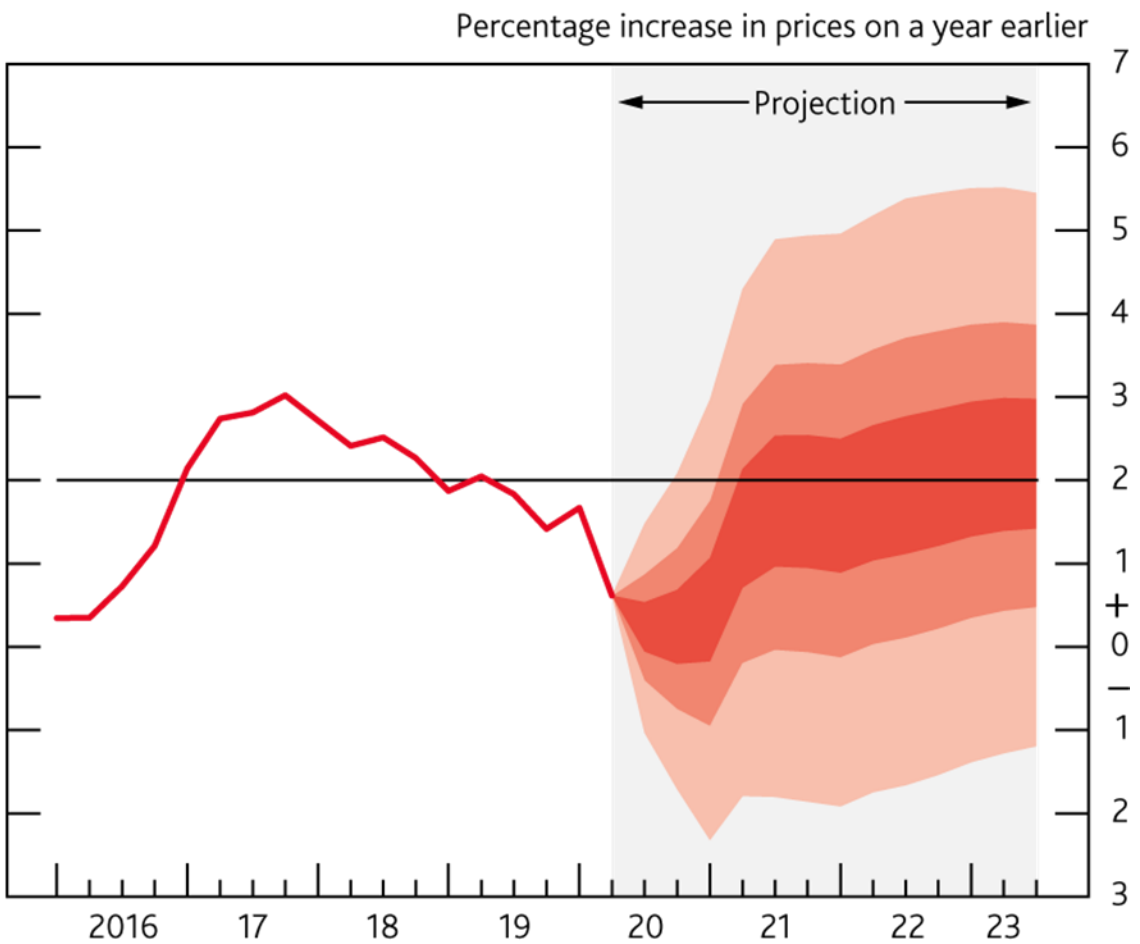
(f) Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.

(g) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.

Factors in 2020-2021

- Low energy prices and fiscal policy (VAT cuts and ‘eat out to help out’) currently weigh on inflation.
- These factors will continue weigh into 2020-2021
- Lower levels of economic activity will create spare capacity and put downward pressure on wage growth
- Household uncertainty around their economic prospects and the fear of infection will hold back demand.

CPI Inflation Projection



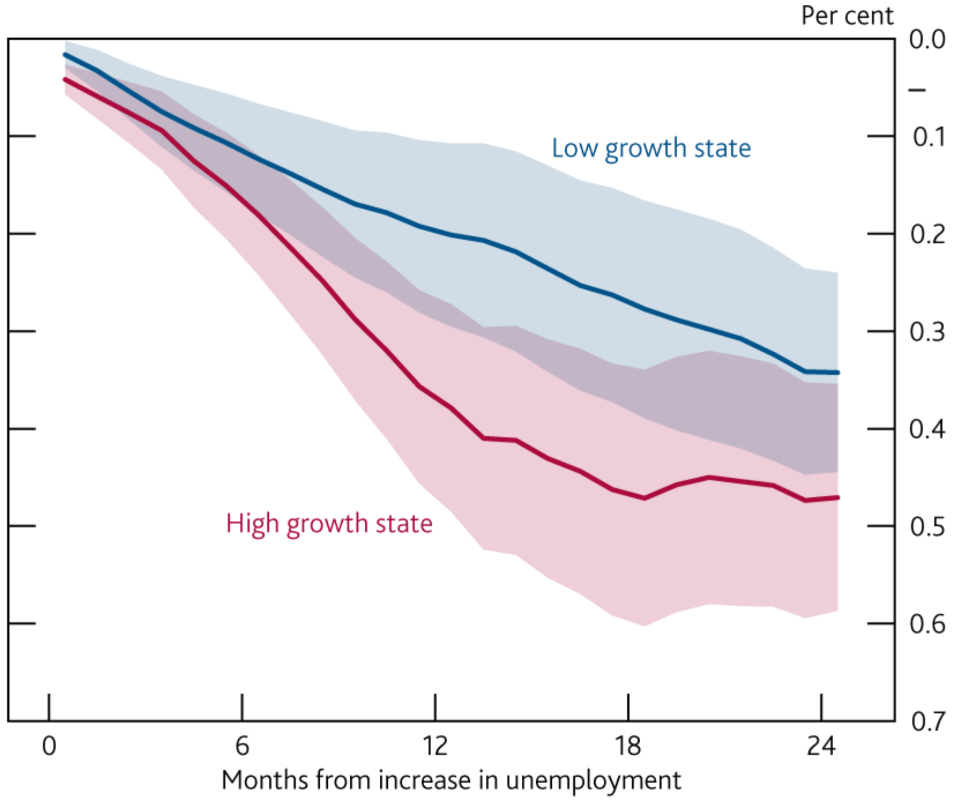
The fan chart depicts the probability of various outcomes for CPI inflation in the future. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background.

The Philips curve will be flatter in the near term

$$\pi_t = \beta E[\pi_{t+1}] + \kappa \hat{y} + u_t$$

- Downward nominal rigidities in the service sectors will dampen price adjustment
- Elevated levels of uncertainty may deter price changes

Bank staff's estimated impact of a 1 percentage point increase in the unemployment rate on core services CPI

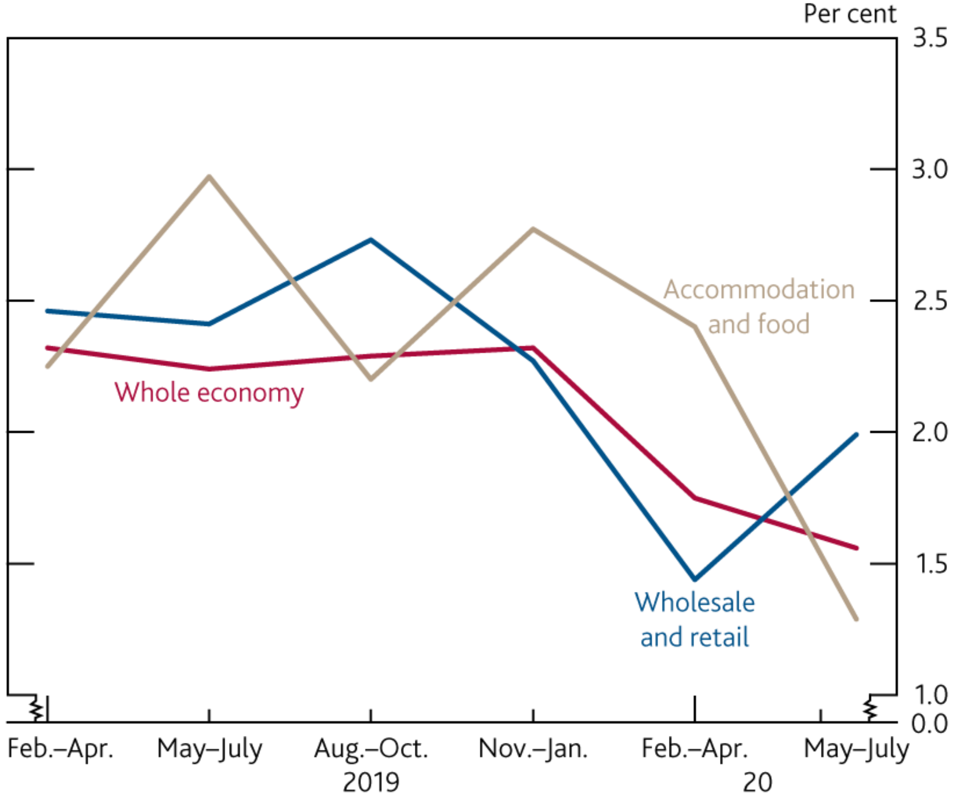


Sources: ONS and Bank calculations.

Chart shows the estimated impact of a demand-driven one percentage point increase in the unemployment rate using an approach similar to Tenreyro and Thwaites (2016). Shaded areas show 68% confidence intervals.

Business surveys suggest that inflationary pressure is weak

Expected average price change over the next year

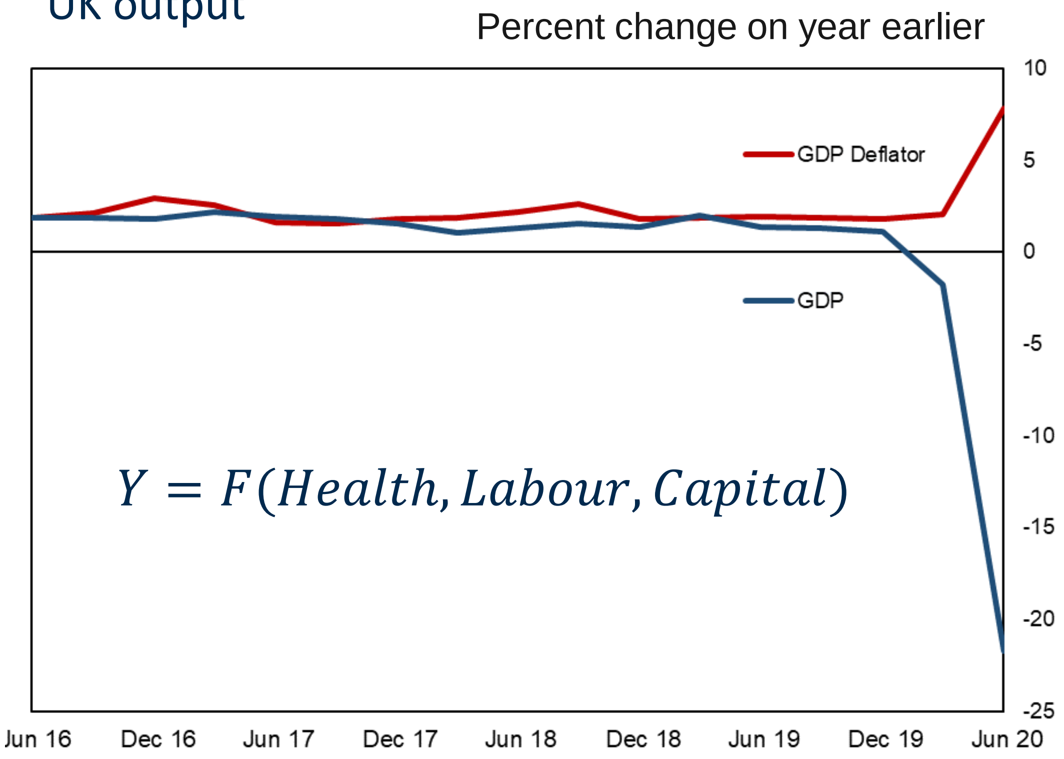


Sources: DMP Survey and Bank calculations.

Questions: ‘Looking ahead, from now to 12 months from now, what approximate percentage change in your average price would you assign to each of the following scenarios?’
(with five scenarios: lowest, low, middle, high, highest provided) and ‘Please assign a percentage likelihood (probability) to the % changes in your average prices you entered’.
Data shown are three-month averages.

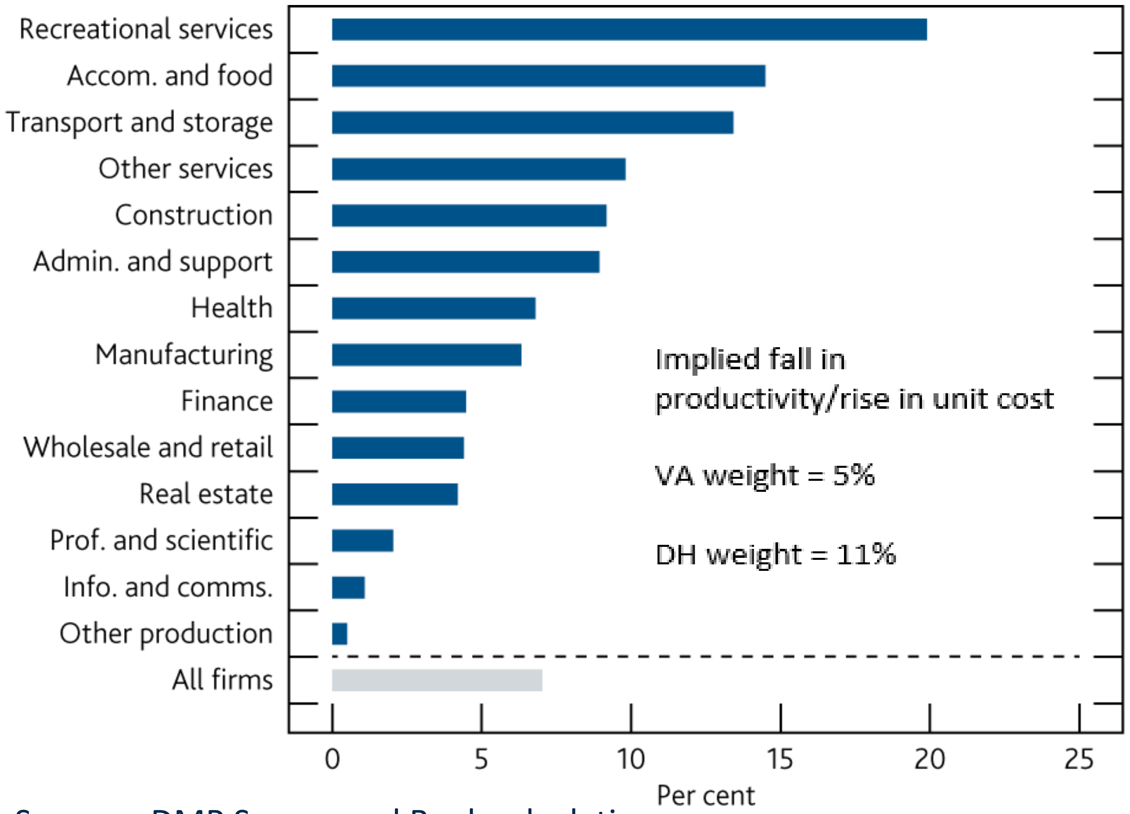
Covid-19 as a supply shock

UK output



Source: ONS
Note: Last data point in 2020Q2

Expected impact of Covid-19 on unit costs in 2020 Q3 by sector



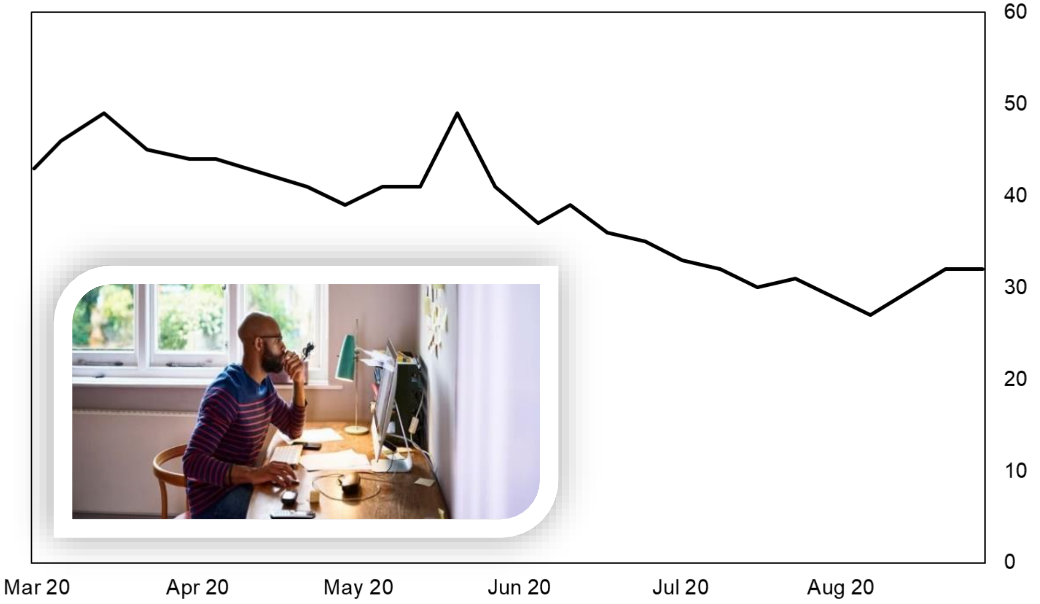
Sources: DMP Survey and Bank calculations.

Question: 'Relative to what would otherwise have happened, what is your best estimate for the impact of measures to contain coronavirus (social distancing, hand washing, masks and other measures) on the average unit costs of your business in 2020 Q3?' Responses were collected from 3 to 17 July.

The Covid-19 shock will likely bring permanent change to the global economy

- It seems likely there will be more remote working
- Interestingly this may be a less costly transition than expected
- But the longer run productivity implications are up for debate

Percentage of working adults that are working from home



Sources: ONS

Percent change (CVM)

		19Q4: 20Q1	20Q1 : 20Q2	19H1 : 20H1	Ann. Average (1996-2019)
UK	ICT	6.3	-3.9	**1.7**	7.3
	Hardware	5.5	-6.8	-3.4	8.5
	Business investment	-0.5	-26.5	-12.5	1.4
USA	ICT	-3.5	6.6	**-0.5**	10.1
	Hardware	-4.8	16.3	6.8	14.5
	Business investment	-1.7	-7.2	-4.9	4.5

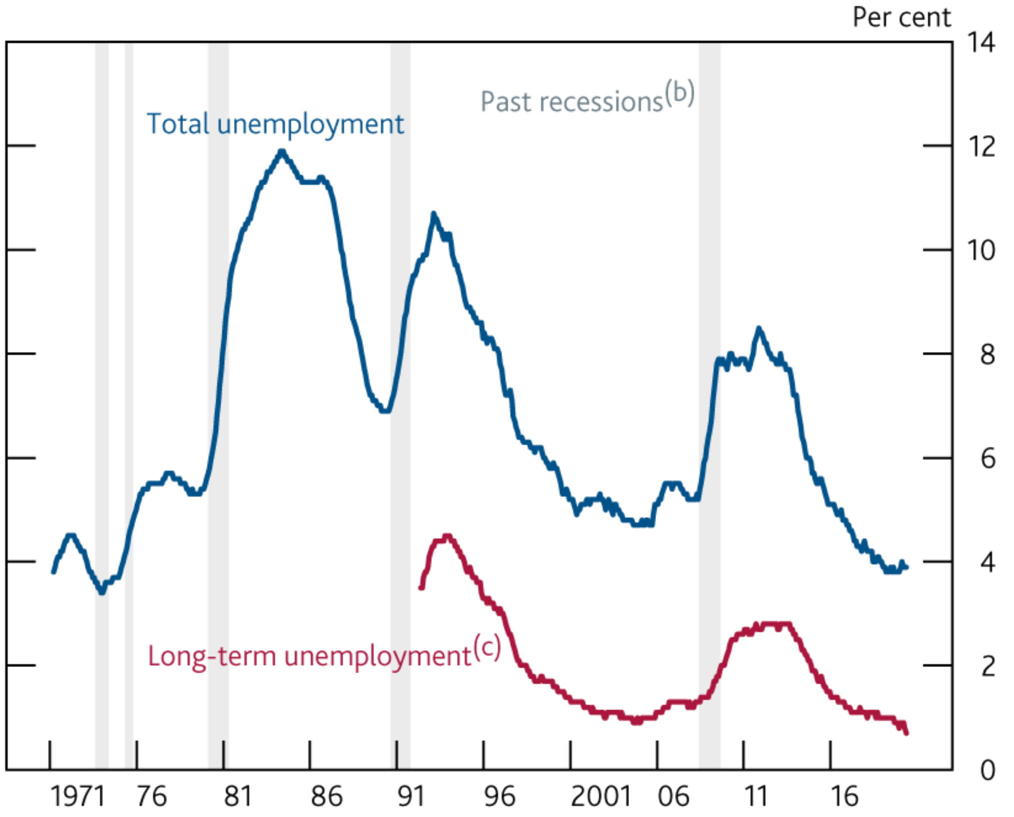
Sources: ONS, BEA

The Covid-19 shock will likely bring permanent change to the global economy

- Structural change will take time and bring re-allocation frictions which could drag on supply

- The ultimate balance of the creative vs destructive elements of these changes is yet to be determined.

Unemployment and long-term unemployment [(a)]



Sources: ONS and Bank calculations.

(a) Per cent of the 16+ economically active population.

(b) Recessions are defined as at least two consecutive quarters of negative GDP growth.

(c) Those who have been unemployed for longer than twelve months.

The Covid-19 shock will likely bring permanent change to the global economy

- Structural change will take time and bring frictions which could drag on supply
- The ultimate balance of the creative v's destructive elements of these changes is yet to be determined.
- A world where countries and people talk less to each other will be less productive
- Greater use of technology, automation and an enduring shift to more flexible working will likely push in a more productive direction (but likely lower measured productivity in the transition)

Policy

- In September the Committee was content that inflation expectations remained well anchored

- We are ready to act should more stimulus be required

Coronavirus and the latest indicators for the UK economy and society: 1 October 2020

Early experimental data on the impact of the coronavirus (COVID-19) on the UK economy and society. These faster indicators are created using rapid response surveys, novel data sources and experimental methods.

Faster indicator

Office for National Statistics

A faster indicator provides insights into economic activity using close-to-real-time big data, administrative data sources, rapid response surveys or Experimental Statistics, which represent useful economic and social concepts.

Business Impact of Coronavirus (COVID-19) Survey: preliminary weighted results

- I view near-term risks to output and inflation as being skewed to the downside

- I continue to review the range of actions and tools at the disposal of the MPC should more stimulus be required

Negative Rates

- August MPR Box on negative policy rates
- As discussed in the September MPC Minutes, we are currently working with stakeholders on the logistics of operationalising negative rates as other central banks have done
- Overall, positive evidence that negative rates have benefited the real economy as most transmission channels operated as suggested e.g. pass-through to corporate depositors, increased bank lending and business investment [Altavilla *et al* (2018, 2019), Bubeck et al (2019), Demiralp *et al* (2019), Heider *et al* (2018), Hong and Kandrac (2018), Rostagno *et al* (2019)]
- There are concerns that prolonged periods of negative rates may be counterproductive if banks are not able to successfully pass through negative rates to their customers [Beauregard and Spiegel (2020), Eggertsson *et al* (2019), Brunnermeier and Koby (2016)]
- The effectiveness of negative rates may be contingent on e.g. the structure of the financial system and position in the cycle

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