JOINT INTERIM FINANCIAL STABILITY REPORT AND MONETARY POLICY REPORT PRESS CONFERENCE

Thursday 7 May 2020

Opening Remarks by Andrew Bailey, Governor

Ben Broadbent, Deputy Governor for Monetary Policy

Jon Cunliffe, Deputy Governor for Financial Stability

Hello, this is Andrew Bailey.

Welcome to this presentation of the Bank's May *Monetary Policy* and *Interim Financial Stability Reports*.

I am first going to take you through the headline conclusions from those *Reports* before handing over to Ben Broadbent to go through the details on the Monetary Policy Committee's scenarios and to Jon Cunliffe to take you through the work the Financial Policy Committee has been doing to explore the implications for the banks and for affected companies.

The spread of Covid-19 is having a significant economic impact around the world. Activity has fallen sharply and unemployment has risen.

Governments and central banks have acted promptly to support households and companies through the economic disruption caused by the pandemic. In the UK, the Government has launched a range of initiatives that are improving companies' access to finance, supporting corporate cash flows and people's incomes.

The Bank's three policy committees have taken complementary actions to lower the cost of borrowing, to put the banking system in a position to lend and to support the functioning of financial markets. However, the scale of the shock and the measures necessary to protect public health mean that a significant loss of economic output has been inevitable in the near term despite this very significant policy support.

Economic prospects are highly dependent on the evolution of the pandemic and how governments, households and businesses continue to respond to it.

Recognising these uncertainties, the MPC has published a simple illustrative scenario in today's *Monetary Policy Report* to help to illustrate the impact of Covid-19 on the economy, in place of its usual projections that describe how likely the MPC views different outcomes

for the economy. The scenario is conditioned on a set of highly stylised assumptions about which there is a high degree of uncertainty. We assume what appears to be the most likely course of public health policy, only a gradual lifting of the lockdown. The *Report* also includes a number of estimates of the sensitivity of the economy to different assumptions.

Together, the scenario and sensitivities illustrate the important drivers of the UK economic outlook and provide a framework to guide the decisions of the MPC and FPC as further information becomes available.

The MPC's decision

So let me now turn to the MPC's decision. The nature of the economic shock from Covid-19 is very different from those to which the MPC has previously had to respond. The social distancing measures implemented to slow the spread of the disease require a sharp but temporary suppression of economic activity.

While monetary policy cannot prevent the losses of revenue and income that companies and households suffer as a result of the pandemic, it does have a role in helping the economy through and supporting the recovery. In doing so, monetary policy helps to limit any longer-term damage to the economy, including through so-called "scarring effects" on the supply side.

Monetary policy is supporting households and companies by bolstering cash flows and helping maintain the flow of credit. Monetary policy can also support orderly financial market functioning, and in doing so guard against an unwarranted tightening in financial conditions that would prevent the MPC achieving the inflation target.

That is why the MPC responded at speed and in scale to the Covid-19 shock, easing policy along a number of dimensions including:

- reducing Bank Rate to 0.1%;
- introducing a Term Funding scheme with additional incentives for Small and Medium-sized Enterprises; and
- undertaking £200 billion of asset purchases to be completed as soon as operationally possible, consistent with the improved functioning of markets.

We are now approaching what appears to be the start of the next phase. The Government will decide later this week whether to ease the lockdown, guided by the advice of public health

experts. This decision will shape the path by which the economy is brought back into action. As our scenario indicates, we expect the recovery of the economy to happen over time, though much more rapidly than the pull back from the global financial crisis. Nonetheless, we expect that the effects on demand in the economy will go on for around a year after the lockdown starts to lift. We expect that there will be some longer-term damage to the capacity of the economy, but in the scenario we judge these effects to be relatively small. The role of monetary policy, alongside other government policies, is to support the economy though the next phase and beyond.

The MPC will continue to monitor the situation closely and, consistent with its remit, stands ready to take further action as necessary to support the economy and ensure a sustained return of inflation to the 2% target.

The FPC's assessment

Let me now turn to the FPC's assessment. Given the material developments in recent weeks, the FPC decided to supplement its normal practice with an additional interim *Financial Stability Report*, alongside the *Monetary Policy Report*.

Major UK banks entered into this period of stress with an aggregate core tier 1 capital ratio more than three times higher than before the global financial crisis, and held approximately £1 trillion of liquid assets. This is the result of the major regulatory reforms following the financial crisis and the rigorous annual stress testing of major banks.

The FPC has carried out a desk-based stress test to assess the resilience of the core banking system and the losses it could face in the *Monetary Policy Report* scenario - and this is set out in the FSR we have just published. At £80 billion, the losses banks could face in the test based on the *MPR* scenario are materially lower than the £120 billion of losses banks were able to withstand in the 2019 stress test.

This is despite the fact that the *MPR* scenario incorporates a much sharper initial fall in output than in the 2019 stress test. The main factors that account for this difference include the faster pace of economic recovery from the initial fall, the impact of the current policy interventions such as the Job Retention Scheme that were not features of the 2019 stress test, and the effects of more prolonged low interest rates in this scenario on dampening the impairment rate on mortgage lending.

Major UK banks therefore have the capital buffers to draw on to withstand the losses that would be expected in this scenario, whilst continuing to provide credit to the real economy. By supporting households and business, banks will help to avoid a worse outcome for the economy as a whole, which would in turn generate greater credit losses and weaken their capital positions. The FPC's expectation is that banks should draw on the substantial capital and liquidity buffers that have been built up to be used as necessary to support the economy.

The Covid-19 shock is placing a strain on the cashflow of UK businesses and the *FSR* sets out a new and substantial analysis on the extent of the potential corporate financing shortfall under the *MPR* scenario.

Supported by a comprehensive package of policies put in place by both the Government and the Bank of England, credit is flowing to viable borrowers. The flow of bank lending to private non-financial companies increased to £33.5 billion in the first quarter, over 8 times the quarterly average over the past three years of around £4 billion. £18 billion has been delivered to large companies though the Bank's Covid Corporate Financing Facility; more than £4 billion has been approved through the Government's CBILS scheme; and there were 115,000 applicants for the new Bounce Back Loan scheme on its first day this Monday.

Continued expansion of bank credit will be essential to help the corporate sector weather the disruption related to the outbreak of Covid-19, thereby minimise the medium-term damage to the UK economy, and in turn, the UK banking system itself.

Let me now pass over to Ben and Jon to provide more detail on the MPC's scenario and sensitivities, and the FPC's assessment of financial stability.

The MPC's scenario and sensitivities

Thank you Andrew.

The scenario and sensitivities contained in today's *Monetary Policy Report* are designed to help illustrate the channels through which the pandemic is likely to affect the economy, and the important drivers of the economic outlook.

The scenario is conditioned on a set of stylised assumptions about the actions of governments, households and businesses in response to the pandemic.

- Social distancing measures in the UK and in the rest of the world are assumed to remain as they are until early June, before being gradually unwound over the third quarter of this year. Fiscal support measures are assumed to remain in place, and to be unwound, over the same period.
- Some of the spending foregone while social distancing measures are in place is made up, but lower confidence and higher uncertainty are assumed to persist for some time.

Under these assumptions, UK and global GDP both recover following the sharp fall in activity in the second quarter of this year as social distancing measures begin to be lifted.

Demand remains below where it might otherwise have been in the absence of Covid-19, however, reflecting the impact of continued caution on the part of households and businesses. As a result, the significant degree of spare capacity in the economy that emerges in Q2 persists for some time, even after formal social distancing measures are fully lifted.

The near-term shock also leads to some longer-term reduction in the supply capacity of the economy, due to lower investment and reduced innovation. Although as Andrew said earlier, that so-called "scarring effect" is relatively small.

CPI inflation is likely to fall to around zero at the end of this year, in part reflecting the impact of spare capacity in the economy but also because of the substantial fall in oil prices.

Both these factors weighing on inflation dissipate over time in the scenario, as the fall in energy prices drops out of the annual comparison and as the recovery in demand reduces the degree of slack. As a result, CPI inflation rises from an average of 0.6% in 2020 to 2% in 2022.

There is a set of sensitivities outlined in the *Report* that illustrate the important variables for the economic outlook. This depends heavily on how the global economy evolves, which affects the UK both directly through net trade and indirectly through supply chain and financial market spillovers. On how long social distancing and government support measures remain in place and how households and businesses respond once those measures are lifted. The outlook will also depend on the degree of scarring and the impact of changes in economic activity on inflation.

There are, of course, many other scenarios for the economy. The MPC's in this *Report* is just one of many plausible paths, even conditional on the particular assumptions we have made, and the MPC will monitor conditions closely as the situation develops.

Thank you and I'll now hand over to Jon.

The FPC's assessment

Thank you very much Ben.

As we've just heard, the *MPR* scenario embodies an unprecedented economic shock, resulting in financing difficulties for businesses and in rising unemployment. And these developments would generate material losses for banks on their corporate and household loans.

In the desktop stress test, based on the scenario, carried out by the FPC, banks make credit losses of just over £80 billion. They draw down less than half of their capital buffers, remaining comfortably above their minimal requirements. Banks therefore have the capacity to withstand losses of output that are bigger than those embodied in the *MPR* scenario.

We stress the core banking system every year to ensure that it has the capital to withstand a very severe and plausible shock. The impact of the economic shock on bank losses in the *MPR* Covid scenario is smaller than the impact of the stress incorporated in our 2019 stress test. The three main reasons for this are:

- First, despite the sharper initial contraction in output in the *MPR* Covid scenario, the economy recovers more rapidly in that scenario than in the 2019 test in which the loss of output went on for longer.
- Second, corporate impairments are held down in the *MPR* scenario by the support to corporate cashflow from Government measures, including the Job Retention Scheme, by bank lending, supported where appropriate by government guarantee schemes, and by the reduction in Bank Rate.
- And third, the Job Retention Scheme is also expected to have a sizeable effect in holding down unemployment and as a result banks suffer fewer mortgage and consumer credit losses. Mortgage impairments are also held down by the reduction in Bank Rate and by the extensive use of mortgage payment holidays.

It is worth looking in more detail at the FPC's assessment of corporate impairment. The FPC has considered detailed estimates of the financing shortfall of the UK corporate sector. That shortfall rises steeply in the *MPR* scenario though this varies by firm and across sector and estimates rely on a number of key assumptions.

Coordinated policy actions by the Government and by the Bank aim to provide a bridge across this financing shortfall during the period of economic disruption in order to minimise the extent to which liquidity issues become solvency issues for businesses.

And the UK banks also have a key role to play in helping the corporate sector weather this shock. Doing so is in their own self interest. By providing essential credit to the economy, supported where necessary by government guarantee schemes, banks will ensure a better outcome for themselves. If banks were to fail to provide support, as they did in the financial crisis 10 years ago, the overall economic outcome would be worse, more businesses would fail, unemployment would go even higher and this would lead, in turn, to greater losses for banks. The calculations we are publishing today illustrate this very important point. On the basis of the scenario and of the desktop stress test, the economic impact of banks failing to provide support to the economy could worsen their own capital positions by around a full percentage point.

The Bank's analysis of the corporate sector also suggests that there is a group of highly vulnerable companies, for example those that were highly leveraged or had poor cashflow before the crisis that might not be in a position to take on more debt. Such firms would need to raise more equity or restructure their debts. Equity markets are open and some companies are issuing, but some of these firms might well fail. The desktop stress test illustrates that banks' capital buffers are sufficient to withstand losses on loans they have made to such firms.

Looking at the financial system more broadly, the *Financial Stability Report* examines the period of turbulence and instability in key financial markets that we witnessed in March, and which required major intervention by the Bank of England and by other central banks. This has brought back into sharp focus a number of vulnerabilities in the non-bank sector, vulnerabilities which the FPC has previously highlighted, which contributed to the recent market stress. The underlying issues in the non-bank sector will need to be addressed in due course. In the meantime the Committee continues to monitor financial markets closely.

Thank you.

Conclusion

So in conclusion, no-one can be sure exactly how the coronavirus pandemic will unfold, and its consequences will reach far beyond the economic effects. For its part, the Bank will continue to coordinate closely with the Government and is ready to work with its scientific advisors where our work can be of use.

The *Reports* published today demonstrate the UK economy and financial system are robust to a period of social distancing that extends through the summer and is phased out by September and to a number of sensitivities either side of that.

Monetary policy is able to assist the return of the economy to full employment and thereby guide inflation sustainably back to target. The fall in output is temporary and activity recovers to its previous level in the second half of 2021. Financial policy helps ensure that the financial system is part of the solution, meeting the needs of UK households and businesses during the period of economic disruption. Reflecting the success of Government support schemes there is only limited scarring to the economy.

The *Reports* provide a framework both to guide policy actions by the Bank in the future and to assist the Government as it takes its decisions on policies to contain the spread of the virus.

However the economic outlook evolves, the Bank will act as necessary to deliver the monetary and financial stability that are essential for long-term prosperity and meet the needs of the people of this country. This is our total and unwavering commitment.