



# Monetary Policy Report

May 2021





BANK OF ENGLAND

# Monetary Policy Report

May 2021

## Monetary policy at the Bank of England

### The objectives of monetary policy

The Bank's Monetary Policy Committee (MPC) sets monetary policy to keep inflation low and stable, which supports growth and jobs. Subject to maintaining price stability, the MPC is also required to support the Government's economic policy.

The Government has set the MPC a target for the 12-month increase in the Consumer Prices Index of 2%.

The 2% inflation target is symmetric and applies at all times.

The MPC's remit recognises, however, that the actual inflation rate will depart from its target as a result of shocks and disturbances, and that attempts to keep inflation at target in these circumstances may cause undesirable volatility in output. In exceptional circumstances, the appropriate horizon for returning inflation to target can vary. The MPC will communicate how and when it intends to return inflation to the target.

### The instruments of monetary policy

The MPC currently uses two main monetary policy tools. First, we set the interest rate that banks and building societies earn on deposits, or 'reserves', placed with the Bank of England – this is Bank Rate. Second, we can buy government and corporate bonds, financed by the issuance of central bank reserves – this is asset purchases or quantitative easing.

### The *Monetary Policy Report*

The MPC is committed to clear, transparent communication. The *Monetary Policy Report (MPR)* is a key part of that. It allows the MPC to share its thinking and explain the reasons for its decisions.

The *Report* is produced quarterly by Bank staff under the guidance of the members of the MPC.

This *Report* has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

## The Monetary Policy Committee

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Andrew Haldane  
Jonathan Haskel

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PowerPoint™ versions of the *Monetary Policy Report* charts and Excel spreadsheets of the data underlying most of them are available at [www.bankofengland.co.uk/monetary-policy-report/2021/may-2021](http://www.bankofengland.co.uk/monetary-policy-report/2021/may-2021)

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# Monetary Policy Summary

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The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 5 May 2021, the Committee judged that the existing stance of monetary policy remained appropriate. The MPC voted unanimously to maintain Bank Rate at 0.1%. The Committee voted unanimously for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted by a majority of 8–1 for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion.

Covid-19 (Covid) and the actions taken to contain it have continued to have a dramatic and rapidly changing impact on the United Kingdom and countries around the world. The Committee's updated projections for economic activity and inflation are set out in the accompanying May *Monetary Policy Report*.

Global GDP growth is likely to have slowed in 2021 Q1 as Covid-related restrictions weighed on economic activity, although growth appears to have been stronger than expected in the February *Report*. Covid vaccination programmes have progressed and picked up pace in many countries. Recently, however, new Covid cases have increased significantly in India and some other economies, leading to tighter restrictions. Advanced-economy risky asset prices have continued to increase and longer-term government bond yields have stabilised since March, such that they are higher than at the time of the February *Report*.

UK GDP is expected to have fallen by around 1½% in 2021 Q1, less weak than was assumed in the February *Report*. New Covid cases in the United Kingdom have continued to fall, the vaccination programme is proceeding apace, and restrictions on economic activity are easing. Reflecting these developments, GDP is expected to rise sharply in 2021 Q2, although activity in that quarter is likely to remain on average around 5% below its level in 2019 Q4. GDP is expected to recover strongly to pre-Covid levels over the remainder of this year in the absence of most restrictions on domestic economic activity. Demand growth is further boosted by a decline in health risks and a fall in uncertainty, as well as announced fiscal and monetary stimulus. Consumer spending is also supported by households running down over the next three years around 10% of their additional accumulated savings. After 2021, the pace of GDP growth is expected to slow as the boost from some of those factors wanes. The level of activity is higher in each quarter of the forecast than in the February projections.

The fall in activity over the past year has reflected a decline in both demand and supply. The LFS unemployment rate fell slightly to 4.9% in the three months to February, but it is likely that labour market slack has remained higher than implied by this measure. Overall, there is judged to be spare capacity in the economy at present. The extension of the Government's employment support schemes in *Budget 2021* is expected to limit significantly the near-term rise in the LFS unemployment rate. The MPC also expects the medium-term equilibrium rate of unemployment to rise by less than was forecast in February. Spare capacity is eliminated as activity picks up during 2021, and there is a temporary period of excess demand, before demand and supply return broadly to balance.

Twelve-month CPI inflation rose from 0.4% in February to 0.7% in March, with the February outturn triggering the exchange of open letters between the Governor and the Chancellor published alongside this monetary policy announcement. The weakness of recent CPI outturns has largely reflected the direct and indirect effects of Covid on the economy. As has been the case in recent MPC forecasts, inflation is projected to rise to close to the target in the near term as some of those effects fade. In the central projection, CPI inflation rises temporarily above the 2% target towards the end of 2021, owing mainly to developments in energy prices. These transitory developments should have few direct implications for inflation over the medium term, however. In the central projection, conditioned on the market path for interest rates, inflation returns to around 2% in the medium term.

The outlook for the economy, and particularly the relative movement in demand and supply, remains uncertain. It continues to depend on the evolution of the pandemic, measures taken to protect public health, and how households, businesses and financial markets respond to these developments.

In the central projections of the MPC's *May Report*, the economy experiences a temporary period of strong GDP growth and a temporary period of modestly above-target CPI inflation, after which growth and inflation fall back, with inflation around the target two and three years ahead. In judging the appropriate stance of monetary policy, the Committee will, consistent with its policy guidance and as always, focus on the medium-term prospects for inflation, including the balance between demand and supply, rather than factors that are likely to be transient.

The MPC will continue to monitor the situation closely and will take whatever action is necessary to achieve its remit. The Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

At this meeting, the Committee judged that the existing stance of monetary policy remained appropriate.

# 1: The economic outlook

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Covid-19 (Covid) and the actions to contain it have continued to have a dramatic and rapidly changing impact on the UK and countries around the world. The economic outlook will continue to depend on the evolution of the pandemic and measures taken to protect public health globally. It will also depend on the responses of households, businesses and financial markets to those developments.

In the Monetary Policy Committee's (MPC's) central forecasts, global GDP recovers in the near term as vaccination programmes lead to the easing of Covid-related restrictions on activity, although the outlook varies across regions. UK GDP recovers strongly over 2021 to pre-Covid levels as restrictions are loosened. Demand growth is boosted by a decline in health risks and a fall in uncertainty, as well as announced fiscal and monetary stimulus. Further out, the pace of GDP growth slows as the boost from these factors wanes.

The fall in activity over the past year has reflected a decline in both demand and supply. Spare capacity in the economy at present is eliminated as activity picks up during 2021, and there is a temporary period of excess demand, before demand and supply return broadly to balance.

CPI inflation is currently below the MPC's 2% target, largely reflecting the direct and indirect effects of the pandemic, but is projected to rise in the near term as some of those effects fade. CPI inflation rises temporarily above the target towards the end of 2021, owing mainly to developments in energy prices. Conditioned on the market path for interest rates, inflation is projected to return to around 2% in the medium term.

## 1.1: Recent developments

*Global growth slowed and UK activity fell in 2021 Q1, although both were higher than projected in February.*

Both global and UK GDP growth are likely to have slowed in 2021 Q1 as restrictions to control the spread of Covid were tightened in many countries around the world (Section 2). Bank staff estimate that UK-weighted world GDP rose by 0.4% in Q1, after increasing by 0.8% in 2020 Q4. Nevertheless, the level of world GDP is estimated to have been materially stronger than projected in the February *Report*, suggesting that activity was less affected by restrictions than expected. In 2021 Q1, the level of UK-weighted world GDP was around 2% lower than in 2019 Q4, prior to the pandemic.

UK GDP is expected to have fallen by around 1½% in 2021 Q1, to around 8¾% below its 2019 Q4 level. The decline in activity largely reflects the impact of Covid-related restrictions. The fall is much less sharp than was expected three months ago, however: in the February *Report*, GDP was projected to decline by around 4¼% in Q1. As in some other countries, the impact of restrictions on spending appears to have been smaller than anticipated. Measured government output was also higher than projected, largely reflecting higher spending on test and trace activities.

*Global activity is expected to pick up in the near term, although the outlook varies across regions.*

UK-weighted world GDP growth is expected to pick up to around 1% in Q2. US activity is projected to rise materially, partly reflecting the impact of substantial fiscal stimulus. Growth is also expected to pick up in the euro area, although to a lesser extent than was expected in February. That partly reflects recent rises in Covid cases in some countries, which are judged likely to result in continuing restrictions on activity. Similarly, the rise in Covid cases in some emerging market economies is likely to lead to somewhat slower growth.

*UK GDP is expected to rise by around 4¼% in 2021 Q2, as more people are vaccinated and Covid-related restrictions ease.*

In the UK, the number of new Covid cases has fallen markedly since the February *Report*, a lot more people have been vaccinated, and restrictions on activity are being eased earlier than was assumed in February. Reflecting those developments, high-frequency indicators of economic activity – for example, motor vehicle traffic, retail footfall and restaurant bookings – have picked up in recent weeks (**Chart 2.12**). UK GDP is expected to rise sharply in Q2, by around 4¼%, although GDP would still be around 5% below its level in 2019 Q4. Near-term growth will be supported by policy measures, including fiscal measures announced in the March *Budget*. The *Budget* contained an extension to the Coronavirus Job Retention Scheme (CJRS), which has significantly reduced the near-term projection for unemployment.

*Covid-related restrictions have reduced both demand and supply.*

A substantial proportion of the fall in UK GDP during the pandemic is judged to reflect lower supply capacity – as some businesses have been required to close, for example – although the MPC judges that the adverse effects on supply in recent quarters have been somewhat smaller than previously estimated. The decline in demand is still judged to have been greater than that of supply, however, such that at present there is spare capacity in the economy (Section 3). Consistent with that, the unemployment rate has risen since the beginning of 2020. There also appears to be more slack in the labour market than implied by the unemployment rate alone. For example, LFS data suggest that around 10% of furloughed workers were searching for work over the second half of 2020. In addition, companies are likely to be able to increase the hours of their existing workforce without upward pay pressures.

*Inflation has been below the MPC's 2% target, reflecting the direct and indirect effects of Covid, but is expected to return to close to the target in the near term.*

Slack in the economy is likely to have weighed on CPI inflation over the past year, although consumer prices have also been substantially affected by Covid-related temporary factors. A large part of the weakness in inflation – which was 0.6% in Q1 – reflects the impact of past falls in energy prices, for example. Inflation is expected to return to close to the target in the second and third quarters as the influence of these factors fades, and as more recent rises in energy prices feed through to household energy bills.

## 1.2: The MPC's projections

**Table 1.A:** Forecast summary<sup>(a)(b)</sup>

	Projections			
	2021 Q2	2022 Q2	2023 Q2	2024 Q2
GDP <sup>(c)</sup>	21.5 (17.6)	7.1 (8.9)	1.4 (1.3)	1.1
CPI inflation <sup>(d)</sup>	1.7 (1.6)	2.3 (2.0)	2.0 (2.1)	1.9
LFS unemployment rate	5.2 (7.7)	4.7 (5.4)	4.3 (4.9)	4.3
Excess supply/Excess demand <sup>(e)</sup>	-1¼ (-2½)	+½ (+¼)	0 (0)	0
Bank Rate <sup>(f)</sup>	0.1 (0.0)	0.1 (-0.1)	0.3 (0.0)	0.6

(a) Modal projections for GDP, CPI inflation, LFS unemployment and excess supply/excess demand. Figures in parentheses show the corresponding projections in the February 2021 *Monetary Policy Report*.

(b) Unless otherwise stated, the projections shown in this section are conditioned on: Bank Rate following a path implied by market yields; the Term Funding Scheme and Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises; the Recommendations of the Financial Policy Committee and the current regulatory plans of the Prudential Regulation Authority; the Office for Budget Responsibility's assessment of the Government's tax and spending plans as set out in *Budget 2021*; commodity prices following market paths for two quarters, then held flat; the sterling exchange rate remaining broadly flat; and the prevailing prices of a broad range of other assets, which embody market expectations of the future stocks of purchased gilts and corporate bonds. The main assumptions are set out in the 'Download the chart slides and data' link at *Monetary Policy Report – May 2021*.

(c) Four-quarter growth in real GDP. The growth rates reported in the table exclude the backcast for GDP. Including the backcast 2021 Q2 growth is 21.5%, 2022 Q2 growth is 7.1%, 2023 Q2 growth is 1.4% and 2024 Q2 growth is 1.1%.

(d) Four-quarter inflation rate.

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

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

*The MPC's projections assume that Covid-related restrictions ease in the near term in line with government plans.*

The outlook for the economy is uncertain. It is dependent on the evolution of the pandemic and the measures taken to protect public health. It will also depend on how governments, households, businesses and financial markets respond to those developments.

The MPC's projections are conditioned on an assumption that Covid restrictions in the UK ease in the near term in line with the plans set out by the UK Government and devolved administrations.<sup>(1)</sup> Most restrictions on domestic economic activity are therefore assumed to be lifted by the end of 2021 Q2. That is somewhat earlier than assumed in the February *Report*, which assumed that restrictions on economic activity would have unwound fully only by the end of Q3. As assumed in February, however, Covid-related health concerns and uncertainty about the outlook are expected to fade relatively gradually.

Elsewhere in the world, the path of Covid restrictions varies across regions. In the US, restrictions are currently looser than in some other countries, and are expected to ease further in the near term. Covid cases in some euro-area countries have risen over the past couple of months, and restrictions on average across the euro area are assumed to be about as strict in Q2 as they were in Q1. Some tightening of restrictions is assumed to occur in some emerging market economies, such as India, reflecting significant rises in Covid cases in those countries.

*UK government measures announced in Budget 2021 boost spending temporarily.*

Government support measures are assumed to evolve in line with announced policies. In *Budget 2021*, the Government announced further temporary fiscal support measures, to add to the substantial support announced over the past year (Box C). Measures included an extension of the CJRS until the end of September.<sup>(2)</sup> During Q2, an average of around 2¾ million employees are expected to be furloughed. That number is projected to decline to an average of ½ million during Q3. Most of those employees are expected to return to work when the scheme ends, given the expected near-term recovery in activity, so unemployment is projected to increase only slightly.

*Budget 2021* also included a range of other measures, including the capital allowance super-deduction which provides an incentive to boost investment in plant and machinery over the next two years. Taken together, the tax and spending measures in the Budget – excluding the impact of the CJRS and loan schemes – are estimated to boost UK GDP over the first two years of the forecast period, with a peak estimated impact of around ¾% of the level of GDP in 2022. Thereafter, the boost to activity fades, and the announced increase in corporation tax and the freezing of personal tax thresholds drag on the level of GDP in the third year of the forecast period.

*Monetary policy boosts demand throughout the forecast period, although the market path for interest rates is higher than in February.*

The MPC's projections are conditioned on the market path for interest rates. This is close to zero over the first half of the forecast period, and then increases to around 0.6% by the end (**Table 1.A**). The market path is around ¼ percentage points higher than in February on average, and around ½ percentage points higher at the end of the forecast period. The higher path for interest rates, combined with the 2¾% appreciation of sterling since the time of the last *Report*, means that monetary conditions provide somewhat less support to GDP relative to the February projection.

*The prices of risky assets have risen since February reflecting more positive growth prospects, and credit conditions have eased.*

Equity prices in the UK and other advanced economies have risen since February, boosted by improved expectations for global growth (Section 2.1). Credit conditions in the UK have eased, with mortgage rates and spreads declining from their recent highs (Box B). These developments are estimated broadly to offset movements in interest rates and the exchange rate, such that current overall monetary and financial conditions are little changed since the February *Report* (**Chart 2.11**). Mortgage spreads are projected to decline further over the forecast period. Corporate lending spreads are expected to rise somewhat in Q2 as the government loan support schemes introduced in 2020 close, before gradually falling back.

(1) The forecast is conditioned on an assumption that restrictions are eased in line with the earliest dates set out in plans.

(2) The CJRS has been extended until 30 September 2021. The UK Government will pay 80% of employees' usual wages for the hours not worked, up to a cap of £2,500 per month until 30 June 2021. From 1 July, the Government contribution will decrease – to 70% up to £2,187.50 in July, and to 60% up to £1,875 in August and September – with the employer contribution increasing such that furloughed employees continue to receive 80% of their wages, up to £2,500.

## Global GDP growth

*Global GDP recovers over 2021 as Covid vaccination programmes continue and Covid-related restrictions ease.*

UK-weighted world GDP rises over 2021 as vaccination programmes continue and Covid-related restrictions loosen, although the speed and extent of the recovery varies across regions. In the US, Covid-related measures continue to ease, and GDP is boosted by the substantial further fiscal stimulus which has been agreed, such that it rises above its pre-Covid level very quickly. In the euro area, activity recovers more slowly – exceeding its pre-Covid level in 2022 Q1 – reflecting a more persistent impact of Covid and less fiscal support.

Following the material increase in UK-weighted world GDP over 2021 as the impact of Covid wanes, the pace of growth slows in the latter years of the forecast period. Some longer-lasting effects from Covid dampen output a little. For example, the weakness of business investment is likely to weigh on the growth of the capital stock and reduce productivity growth, and unemployment is expected to be somewhat higher in some countries than before the pandemic. These scarring effects are smaller than previously expected in most countries, however.

In the central forecast, UK-weighted world growth recovers to 5% in 2021, from  $-4\frac{1}{2}\%$  in 2020. It is  $4\frac{1}{2}\%$  in 2022 and  $2\frac{1}{2}\%$  in 2023 (Table 1.B).

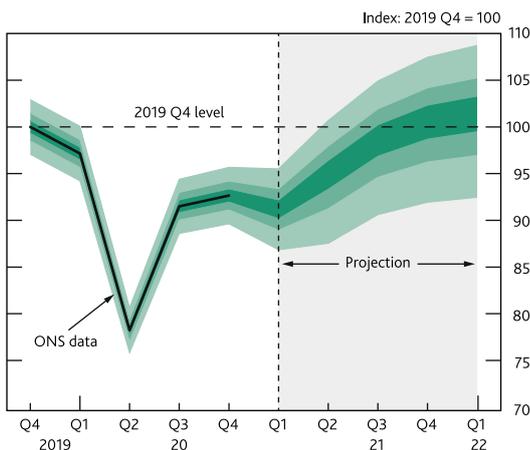
## UK GDP growth

*UK GDP also recovers materially as Covid-related restrictions are eased.*

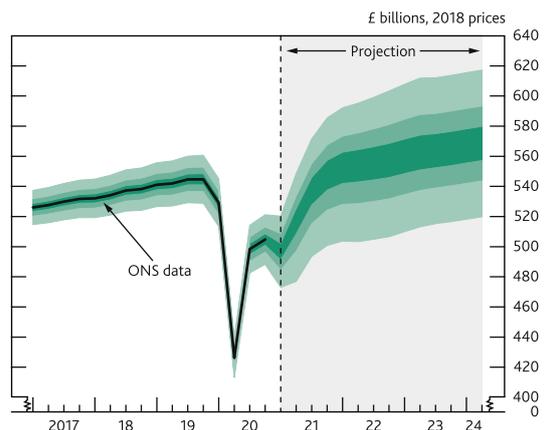
UK activity rises strongly in the near term as Covid-related restrictions ease, and as concerns around health and uncertainty about the outlook fade over time (Key judgement 1). Those factors boost consumer spending, which is also supported by households in aggregate running down over the next three years around 10% of the additional savings they have accumulated because spending on some activities has been restricted. Business investment rises as sales recover and uncertainty declines, and it is further supported in the first two years of the forecast period by the capital allowance super-deduction. The recovery in GDP is also supported in the near term by government spending. Overall, GDP is projected to rise materially over 2021, and to exceed its 2019 Q4 level in 2021 Q4 (Chart 1.1).

Over the later years of the forecast, GDP continues to grow, but the pace of the expansion slows (Chart 1.2), as the factors temporarily boosting growth fade (Key judgement 2).

**Chart 1.1:** Near-term GDP projection based on market interest rate expectations, other policy measures as announced



**Chart 1.2:** GDP projection based on market interest rate expectations, other policy measures as announced



The fan charts depict the probability of various outcomes for GDP. They have been conditioned on the assumptions in Table 1.A footnote (b). To the left of the vertical dashed line, the distribution reflects uncertainty around revisions to the data over the past. To aid comparability with the official data, it does not include the backcast for expected revisions, which is available from the 'Download the chart slides and data' link at [Monetary Policy Report – May 2021](#). To the right of the vertical line, the distribution reflects uncertainty over the evolution of GDP in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outcomes are also expected to lie within each pair of the lighter green areas on 30 occasions. In any particular quarter of the forecast period, GDP is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents.

### Excess supply/demand

*Spare capacity in the economy is eliminated in 2021 and there is a temporary period of excess demand, before demand and supply return broadly to balance.*

Supply capacity is expected to recover sharply in the near term as firms reopen and the majority of employees on furlough return to work (Section 3). But the recovery in demand – driven by easing restrictions, a decline in health risks, a fall in uncertainty and announced fiscal and monetary stimulus – is stronger. As a result, the spare capacity that is judged to exist currently is projected to be eliminated, with a margin of excess demand emerging from 2021 Q4. Firms meet that demand partly through working their existing resources harder, but also through increased hiring. The unemployment rate is expected to rise a little in the near term, however, to a peak of just under 5½% in 2021 Q3 (Chart 1.3), as not all previously furloughed employees return to work and as the higher-than-usual flows into inactivity seen while social distancing measures were in place begin to unwind (Box D).

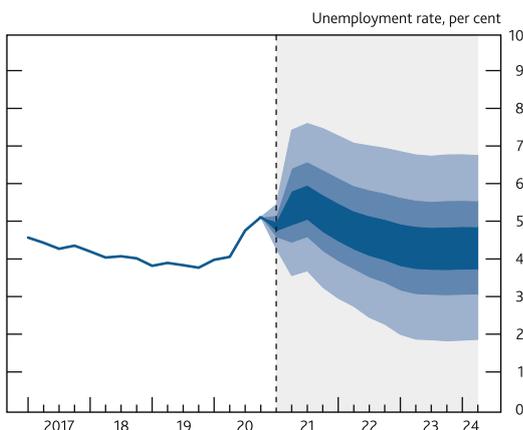
Potential supply growth slows as the boost from easing restrictions wanes and, towards the end of the forecast period, potential supply returns to growing at the relatively subdued rates seen before Covid. There are some longer-lasting scarring effects from Covid which weigh on the level of supply capacity over the forecast period, such that it is around 1¼% lower than it would have been in the absence of the pandemic at the forecast horizon. Demand growth slows by somewhat more than supply growth, however, as the boosts to demand growth from easing health risks, reduced uncertainty and fiscal policy fade. As a result, excess demand is eroded over the second year of the forecast, with demand and supply returning broadly to balance, conditional on the assumptions outlined above.

### CPI inflation

*CPI inflation rises temporarily above the target towards the end of 2021, largely driven by energy prices, but returns to around 2% in the medium term.*

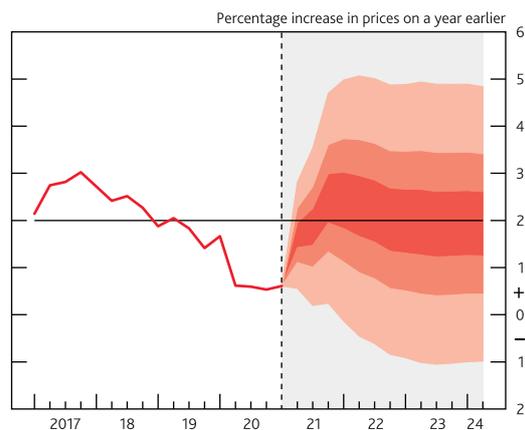
As previous falls in fuel and utility prices drop out of the annual calculation, and more recent rises in energy prices feed through to household bills, inflation rises (Section 2.3). There is also some upward near-term price pressure from recent increases in other input costs, for example higher freight and raw material prices. Inflation is projected to peak in 2021 Q4 at around 2½% (Chart 1.4). As changes in energy prices tend to be passed through relatively rapidly to consumer prices, their effect on inflation should prove temporary. Other cost pressures are also expected to be transitory. As a result, inflation is projected to fall back towards the target over the second and third years of the forecast period (Key judgement 3). In the medium term, conditional on the market path for interest rates, inflation is close to the 2% target.

**Chart 1.3:** Unemployment projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for LFS unemployment. It has been conditioned on the assumptions in Table 1.A footnote (b). The coloured bands have the same interpretation as in Charts 1.1 and 1.2, and portray 90% of the probability distribution. The calibration of this fan chart takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to unemployment in one quarter will continue to have some effect on unemployment in successive quarters. The fan begins in 2021 Q1, a quarter earlier than for CPI inflation. That is because Q1 is a staff projection for the unemployment rate, based in part on data for January and February. The unemployment rate was 4.9% in the three months to February, and is projected to be 4.9% in Q1 as a whole. A significant proportion of this distribution lies below Bank staff's current estimate of the long-term equilibrium unemployment rate. There is therefore uncertainty about the precise calibration of this fan chart.

**Chart 1.4:** CPI inflation projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumptions in Table 1.A footnote (b). If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outcomes 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. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

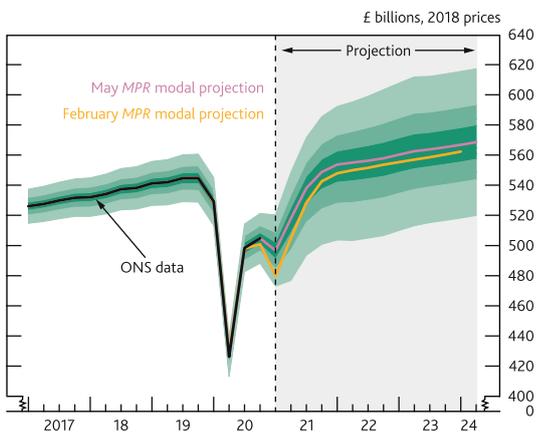
### Comparison with the February *Report* projections

*UK GDP is projected to be somewhat stronger than in February, reflecting higher supply and demand.*

Global GDP is projected to be somewhat stronger than in February. In the near term, that reflects stronger-than-expected data outturns, as well as the impact of larger-than-anticipated US fiscal stimulus. The stronger outlook for demand is also expected to result in a smaller impact of the pandemic on global supply capacity, as higher investment results in smaller adverse effects on the capital stock and total factor productivity, for example.

In the UK, GDP is higher than in the February projection over the forecast period (**Chart 1.5**). Activity has been stronger over the recent past than was expected and the slightly earlier easing of restrictions also contributes to higher GDP in the very near term. In 2021, annual average GDP growth is projected to be around 7¼%, compared with around 5% in the February *Report* (**Table 1.B**). The support from fiscal policy is larger over much of the May projections than in February – including via higher investment, owing to the capital allowance super-deduction – although the boost to GDP dissipates, and announced future changes to corporation tax and personal tax thresholds drag on the level of GDP by the forecast horizon. Over the forecast period, activity is boosted by an expectation that households will run down their savings by somewhat more than previously assumed, broadly consistent with the latest information from the Bank/NMG household survey (Section 2.2).

**Chart 1.5:** Comparison of February *Report* modal projection for GDP with May *Report* projection



The fan chart depicts the probability of various outcomes for GDP in the MPC's May 2021 projection, as shown in **Chart 1.2**, alongside the modal path for GDP in the MPC's projections in May 2021 and February 2021.

The extension of the CJRS announced in *Budget 2021* means that unemployment is projected to pick up by much less than previously anticipated. The CJRS is currently scheduled to finish at the end of September 2021; prior to the March *Budget*, it was set to finish at the end of April. Over Q2 and Q3, GDP is projected to rise substantially. As a result, the scheme is now projected to come to an end when activity is much closer to its pre-pandemic level. For example, in 2021 Q1, GDP is expected to have been around 8¾% below its 2019 Q4 level; in 2021 Q3, GDP is projected to be around 1¼% lower, on average. Unemployment is projected to remain lower than in February over the forecast period, partly reflecting the more positive outlook for activity.

Alongside the upward revisions to GDP, the economy's supply capacity is also projected to be higher than in February. That means that the higher path for GDP does not translate one-for-one into a higher level of capacity use in the economy as a whole. Supply capacity is estimated to have been higher than expected in recent quarters: the temporary adverse effects of the pandemic on productivity – for example, through enforced working from home – are judged to have been smaller than expected, and to be likely to fade quicker than in the February projections. The MPC also judges that persistent effects from Covid on supply are likely to be somewhat smaller than previously anticipated. The MPC expects the medium-term equilibrium rate of unemployment to rise by less than was forecast in February. That is consistent with the downward revision to unemployment, which is likely to result in more matches in the labour market being maintained. The higher projection for investment is also likely to boost productivity growth, all else equal. Consequently, both supply and demand are projected to be somewhat higher throughout the forecast period.

*The medium-term projection for CPI inflation is broadly similar to three months ago.*

CPI inflation is projected to pick up by somewhat more in the near term than in February, largely reflecting higher prices for fuels and household energy. In the medium term, the outlook is broadly similar, with inflation returning to close to the 2% target.

### Policy decision

At its meeting ending on 5 May 2021, the MPC judged that the existing stance of monetary policy remained appropriate. The Committee voted to maintain Bank Rate at 0.1%. The Committee voted for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion. The factors behind that decision are set out in the Monetary Policy Summary on pages i–ii of this *Report* and in more detail in the Minutes of the meeting.

## 1.3: Key judgements and risks

### Key judgement 1: activity recovers to pre-Covid levels in late 2021 as the vaccination programme results in the easing of restrictions and fading uncertainty.

*There is uncertainty around the evolution of the pandemic and how people respond.*

The MPC's central case projections for the UK are conditioned on an assumption that Covid restrictions ease over Q2 as an increasing proportion of the population is vaccinated, and the reopening of parts of the economy leads to a sharp rebound in supply and demand. In the rest of the world, there are differences in the paths of restrictions across countries, reflecting developments in Covid cases and vaccination programmes. There is uncertainty around how the pandemic might evolve, and so there are risks around these assumptions – including from renewed waves of infections in the UK and other countries, as well as the potential emergence of further new variants of the virus. Different developments could have material effects on the paths of UK and global activity.

How people respond to risks around the potential evolution of the pandemic will also be important for the outlook. Health concerns and uncertainty are assumed to dissipate gradually over the coming year or so in the MPC's central UK forecast, boosting demand. On the one hand, concerns could recede more quickly as those most at risk from Covid are vaccinated, and spending could increase more rapidly. For example, some survey evidence suggests that the vaccination programme will reduce people's fear of catching Covid substantially (**Chart 2.14**). On the other hand, the risks of a renewed wave of infections or new variants could lead to a more prolonged period of heightened uncertainty and more persistent cautionary behaviour, which could weigh on household and company spending.

*Spending could recover more rapidly if households with accumulated savings choose to run them down by more...*

The path of consumer spending will also depend on the extent to which the savings that households have accumulated over the past year are run down over the forecast period. The fall in consumption over the past year was much larger than the fall in household incomes, as a result of spending on some activities being restricted. Consequently, households in aggregate have increased their savings markedly.

The MPC's central projection assumes that households spend around 10% of these additional accumulated savings over the forecast period, higher than the 5% figure assumed previously. That is broadly consistent with the latest Bank/NMG survey evidence (Section 2.2). That survey suggests that the share of households who expect to spend some of their savings has increased (**Chart 2.15**), which could reflect higher confidence as a result of the vaccination programme. It is plausible that confidence continues to rise over 2021, and therefore that the proportion of savings that households plan to spend could increase further.

*...although other households who have not built up a buffer of savings might want to do so, which could weigh on spending.*

The recent rise in savings has not been equally distributed across households, however. Survey evidence suggests that much of the recently accumulated savings has accrued to those who already have sizable savings, have higher incomes, and are older. Such households tend to spend less from any extra savings they accumulate. And other households that have not built up a buffer of savings might aim to do so, particularly if they remain uncertain about the economic outlook. The latest Bank/NMG survey also suggests that around a third of households expect to spend less than pre-Covid levels over the coming year, which might be consistent with a slower rebound in consumer spending over 2021 than in the MPC's central projection.

*Spending is projected to be supported materially in the near term by the substantial policy measures that have been enacted.*

The MPC's global and UK forecasts are conditioned on announced fiscal policy measures. Governments around the world have provided substantial fiscal stimulus over the past year, which will support the projected recoveries in activity. In the UK, government tax and spending measures announced over the past year are estimated to provide a material boost to demand over 2021, before fading over the forecast period. In addition, measures to provide support to households and companies – through the CJRS and loan schemes, for example – have limited the rise in unemployment and firm failures. Elsewhere, activity is also projected to be boosted by fiscal policy. In particular, the US Government has provided significant fiscal stimulus, which will boost US activity, as well as demand in other countries around the world. There is uncertainty around the exact impact of all of these measures, however. For example, academic studies of past tax incentives point to a wide range of estimates of the potential boost to the economy from the UK's temporary capital allowance super-deduction. And the MPC's forecasts will continue to be affected by future changes in government policies.

*On balance, the MPC judges the risks to the central projection for GDP to be skewed to the downside in the near term, but broadly balanced further out.*

Taken together, the risks to the central projection for UK GDP are judged to be skewed to the downside in the first year of the forecast period, reflecting risks from pandemic developments. Further out, risks are judged to be broadly balanced. The uncertainty around the GDP projection is judged to be lower than in February, though still heightened by historical standards.

**Key judgement 2: in the medium term, the pace of the expansion in UK GDP slows, as supply growth returns to subdued longer-term trends and the effects of some factors boosting demand growth wane.**

*In the medium term, there are two-sided risks to activity from the outlook for potential supply growth.*

In the MPC's central projections, potential supply recovers materially over 2021 as Covid-related restrictions are lifted. As that boost to growth fades, the pace of the expansion in potential supply slows. Towards the end of the forecast period, potential supply grows at subdued rates, similar to those seen in the few years before Covid.

The MPC judges that there are two-sided risks to supply growth. There could be upside risks to productivity growth arising from the degree of innovation, for example. The MPC's central forecast incorporates a judgement that weak investment growth over the past year is likely to weigh on innovation. However, the Covid crisis may have encouraged greater investment in digital technologies to support new business models and practices, for example, which could have the potential to boost productivity. On the downside, there is a risk that the pandemic leads to material, persistent changes in the structure of the economy, and frictions in the reallocation of labour and capital across different sectors could weigh on the growth of supply.

There is also uncertainty around the extent to which the UK's withdrawal from the EU will lower supply growth over the forecast period. The new trading arrangement between the UK and the EU entails higher barriers to trade, and lower trade between the UK and EU is expected to reduce investment and productivity growth. There is, however, a large degree of uncertainty around the estimated scale of such effects.

Taken together, the MPC judges that the risks to the forecast for potential supply growth are broadly balanced. Any changes in potential supply growth would also be likely to feed through to demand growth over time, through their effects on household incomes, for example. As a result, the risks to supply growth would be unlikely to affect materially the risks around the inflation outlook in the medium term.

*In the second half of the forecast period, demand is projected to grow somewhat more slowly than supply, as the boosts to growth from easing health risks, reduced uncertainty and fiscal policy wane.*

In the MPC's central projections, demand growth also slows as the boost from the lifting of Covid-related restrictions wanes. Relative to supply growth, however, demand growth slows by more, reflecting the temporary nature of some of the boosts from easing health concerns, reduced uncertainty, and fiscal policy.

Demand growth could slow by less if households choose to run down more of their savings over time than is assumed in the central projection. That might particularly affect the medium-term outlook if household confidence increases more than expected over the second and third years of the forecast period. Alternatively, demand growth might slow by more in the medium term if the boost to investment growth from the capital allowance super-deduction reflects a greater than assumed proportion of spending being brought forward to the next year or two from future years.

**Key judgement 3: inflation rises in the near term and temporarily rises above 2% in late 2021 reflecting the impact of energy prices; in the medium term, supply and demand are broadly in balance and inflation is around the target.**

*CPI inflation has been quite volatile over the past year, and is likely to continue to be in the near term.*

CPI inflation has been quite variable during the pandemic. Restrictions on activity have affected pricing, including typical seasonal patterns, especially in clothing and footwear, with prices tending to fall during lockdowns rather than in the usual winter and summer sales periods. As a result, their contribution to inflation has been unusually volatile. As the economy recovers from the pandemic, some prices might continue to evolve in unusual ways. In addition, the near-term path for CPI inflation is likely to be affected by large temporary factors moving in and out of the annual comparison. For example, the Eat Out to Help Out scheme is estimated to have pushed down inflation by around 0.4 percentage points in August 2020 and so will boost inflation in August 2021. As a result, there is projected to be substantial volatility in the monthly path for inflation over the coming year.

*The near-term outlook for CPI inflation will also continue to be substantially affected by developments in energy prices.*

Abstracting from month-to-month volatility, CPI inflation is expected to pick up over 2021, peaking at around 2½% in 2021 Q4, before declining to around the 2% target two and three years ahead. Oil and gas prices fell at the start of the pandemic, which fed through to lower household energy bills and motor fuel prices in 2020, weighing on inflation. As those changes continue to fall out of the annual comparison, inflation is projected to rise. Moreover, wholesale energy prices have since risen, such that household energy prices are projected to push up the annual inflation rate in late 2021 and early 2022. That upward pressure is temporary, however, with energy prices assumed to exert little pressure in either direction on CPI inflation over the second half of the forecast period. The projections will continue to be sensitive to movements in energy prices, although, as they tend to have only a temporary impact on inflation, they should have few direct implications for the medium-term outlook.

*There are two-sided risks to the inflation outlook from developments in firms' costs.*

The inflation outlook will also be influenced by other developments in companies' costs. In the UK and globally, indicators of firms' input costs have picked up strongly in recent months, particularly for manufacturers. This is consistent with reports to the Bank's Agents of significant and widespread increases in companies' input costs, for example from freight and raw materials. The MPC's forecast is consistent with some pass-through of those cost pressures into consumer prices, although pass-through so far appears to have been limited, perhaps reflecting heightened competition and uncertainty about the evolution of demand, as suggested by Agency intelligence. If higher input cost pressures persist, there is a risk that there is greater upward pressure on consumer prices than projected. However, there also appear to be mitigating downward pressures on firms' total costs from other sources – for example, travel and corporate entertainment costs have been lower for many companies during the pandemic, and commercial rent inflation has fallen.

*Risks to inflation also arise from uncertainty about the evolution of spare capacity in the economy.*

The MPC judges that there is currently spare capacity in the economy, and that has been putting downward pressure on inflation. Low services inflation is judged likely to reflect in part the impact of spare capacity, for example.

There is a great deal of uncertainty around the degree of spare capacity in the economy at present, however. The scales of the falls in both supply and demand have made the difference between them difficult to gauge. Standard approaches to estimating spare capacity are hard to use at present due to the unusual nature of the Covid-related changes to the economy – for example, the CJRS has changed the usual relationship between GDP and unemployment. And some data which can be used to shed light on the degree of slack have been very noisy – for example, wage growth has been affected by the CJRS and the changing composition of employment during the pandemic. While a range of indicators of spare capacity are consistent with there being a degree of slack in the economy, there is uncertainty about its exact magnitude.

Moreover, the relative movement in demand and supply during the recovery from the pandemic is also very uncertain. In the MPC's central forecast, demand grows more rapidly than supply in the near term, such that slack is eroded, and a degree of excess demand emerges towards the end of 2021. Further out in the forecast period, however, demand growth slows to below supply growth, and consequently excess demand diminishes, before demand and supply return broadly to balance.

*The risks around CPI inflation are judged to be broadly balanced.*

Overall, the risks to the MPC's inflation projection are judged to be broadly balanced. Most measures of inflation expectations have been broadly stable since the February *Report*, and the MPC continues to judge that inflation expectations remain well anchored.

## 1.4: Constant rate projections

In the MPC's projections conditioned on the alternative assumption of constant interest rates at 0.1%,<sup>(3)</sup> activity is projected to be slightly stronger, unemployment to be somewhat lower by the end of the projection and CPI inflation to be a little higher.

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(3) The assumption is that Bank Rate remains at 0.1% throughout the three years of the forecast period, before moving towards the market path over the subsequent three years.

**Table 1.B:** Indicative projections consistent with the MPC's forecast<sup>(a)(b)</sup>

	Averages			Projections		
	1998–2007	2010–19	2020	2021	2022	2023
<b>World GDP (UK-weighted)<sup>(c)</sup></b>	<b>3</b>	<b>2¼</b>	<b>-4½ (-4¾)</b>	<b>5 (4¾)</b>	<b>4½ (5)</b>	<b>2½ (2¼)</b>
World GDP (PPP-weighted) <sup>(d)</sup>	4	3½	-3½ (-4)	6¼ (6)	4¾ (5¼)	3½ (3½)
Euro-area GDP <sup>(e)</sup>	2¼	1½	-6¾ (-7)	3¾ (3½)	5½ (6½)	2¼ (1¾)
US GDP <sup>(f)</sup>	3	2¼	-3½ (-3½)	6¾ (6½)	4¼ (3¾)	1¾ (1¾)
Emerging market GDP (PPP-weighted) <sup>(g)</sup> <i>of which, China GDP<sup>(h)</sup></i>	5½	5	-2½ (-3)	7 (6¾)	5¼ (5¾)	4¾ (4½)
<b>UK GDP<sup>(i)</sup></b>	<b>3</b>	<b>1¾</b>	<b>-9¾ (-10)</b>	<b>7¼ (5)</b>	<b>5¾ (7¼)</b>	<b>1¼ (1¼)</b>
Household consumption <sup>(j)</sup>	3¼	1¾	-11 (-12¼)	5¼ (4¼)	9¼ (11¾)	1¾ (1)
Business investment <sup>(k)</sup>	2¾	3¾	-10¼ (-15)	7 (4)	13½ (12)	1¼ (4½)
Housing investment <sup>(l)</sup>	3¼	3¾	-12½ (-10½)	13½ (10¾)	4¾ (3½)	3¼ (6¼)
Exports <sup>(m)</sup>	4¼	3¼	-15¾ (-13½)	1 (-3)	4½ (5½)	4½ (4¼)
Imports <sup>(n)</sup>	5¾	3½	-17¾ (-19)	8½ (5¼)	10 (12¾)	4 (3½)
Contribution of net trade to GDP <sup>(o)</sup>	-¼	-¼	¾ (2)	-2¼ (-2½)	-1¾ (-2¼)	0 (0)
Real post-tax labour income <sup>(p)</sup>	3¼	1¼	1 (1½)	-¾ (-1)	1½ (1)	¾ (1¾)
Household saving ratio <sup>(q)</sup>	8	8½	15¾ (17¾)	12 (15¼)	6 (6½)	6 (6½)
Credit spreads <sup>(r)</sup>	¾	2½	2 (2)	2¼ (2¼)	2 (2¼)	2 (2)
<b>Excess supply/Excess demand<sup>(s)</sup></b>	<b>0</b>	<b>-1¾</b>	<b>-2 (-1¼)</b>	<b>-¾ (-1¼)</b>	<b>+¼ (+¼)</b>	<b>+¼ (0)</b>
Hourly labour productivity <sup>(t)</sup>	2¼	½	¾ (2¾)	¼ (-3¼)	½ (2)	¾ (½)
Employment <sup>(u)</sup>	1	1¼	-1¾ (-1¼)	1¼ (-¾)	1¼ (2¼)	¾ (1¼)
Average weekly hours worked <sup>(v)</sup>	32¼	32	30¼ (29¾)	32¼ (32¼)	32 (32)	32 (32)
Unemployment rate <sup>(w)</sup>	5¼	6	5 (5¼)	5 (6½)	4½ (5)	4¼ (4½)
Participation rate <sup>(x)</sup>	63	63½	63½ (63¾)	64 (63¾)	64 (64)	64 (64)
<b>CPI inflation<sup>(y)</sup></b>	<b>1½</b>	<b>2¼</b>	<b>½ (½)</b>	<b>2½ (2)</b>	<b>2 (2¼)</b>	<b>2 (2)</b>
UK import prices <sup>(z)</sup>	0	1½	2 (1¾)	-1½ (-½)	0 (0)	¼ (0)
Energy prices – direct contribution to CPI inflation <sup>(aa)</sup>	¼	¼	-½ (-½)	¾ (½)	0 (0)	0 (0)
Average weekly earnings <sup>(ab)</sup>	4¼	2¼	4¾ (4¼)	-½ (¾)	2¾ (2½)	2¾ (2¼)
Unit labour costs <sup>(ac)</sup>	3	1½	11¾ (13½)	-8 (-8¼)	2¼ (2½)	2¼ (2¼)
Private sector regular pay based unit wage costs <sup>(ad)</sup>	1¾	1¾	10¾ (14)	-4½ (-5¾)	1 (2)	3 (3)

Sources: Bank of England, Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, Eurostat, IMF *World Economic Outlook (WEO)*, National Bureau of Statistics of China, ONS, US Bureau of Economic Analysis and Bank calculations.

- (a) The profiles in this table should be viewed as broadly consistent with the MPC's projections for GDP, CPI inflation and unemployment (as presented in the fan charts).  
(b) Figures show annual average growth rates unless otherwise stated. Figures in parentheses show the corresponding projections in the February 2021 *Monetary Policy Report*. Calculations for back data based on ONS data are shown using ONS series identifiers.  
(c) Chained-volume measure. Constructed using real GDP growth rates of 188 countries weighted according to their shares in UK exports.  
(d) Chained-volume measure. Constructed using real GDP growth rates of 189 countries weighted according to their shares in world GDP using the IMF's purchasing power parity (PPP) weights.  
(e) Chained-volume measure. Forecast was finalised before the release of the preliminary flash estimate of euro-area GDP for Q1, so that has not been incorporated.  
(f) Chained-volume measure. Forecast was finalised before the release of the advance estimate of US GDP for Q1, so that has not been incorporated.  
(g) Chained-volume measure. Constructed using real GDP growth rates of 155 emerging market economy countries, as defined by the IMF *WEO*, weighted according to their relative shares in world GDP using the IMF's PPP weights.  
(h) Chained-volume measure.  
(i) Excludes the backcast for GDP.  
(j) Chained-volume measure. Includes non-profit institutions serving households. Based on ABJR+HAYO.  
(k) Chained-volume measure. Based on GANB.  
(l) Chained-volume measure. Whole-economy measure. Includes new dwellings, improvements and spending on services associated with the sale and purchase of property. Based on DFEG+L635+L637.  
(m) Chained-volume measure. The historical data exclude the impact of missing trader intra-community (MTIC) fraud. Since 1998 based on IKBK-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBK.  
(n) Chained-volume measure. The historical data exclude the impact of MTIC fraud. Since 1998 based on IKBL-OFNN/(BOKH/BQKO). Prior to 1998 based on IKBL.  
(o) Chained-volume measure. Exports less imports. GDP data based on the mode of the MPC's GDP backcast.  
(p) Wages and salaries plus mixed income and general government benefits less income taxes and employees' National Insurance contributions, deflated by the consumer expenditure deflator. Based on [ROY]+ROYH-(RPHS+AIV-CUCT)+GZVX]/[(AB)Q+HAYE]/(AB)R+HAYO].  
(q) Annual average. Percentage of total available household resources. Based on NRJS.  
(r) Level in Q4. Percentage point spread over reference rates. Based on a weighted average of household and corporate loan and deposit spreads over appropriate risk-free rates. Indexed to equal zero in 2007 Q3.  
(s) Annual average. Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.  
(t) GDP per hour worked. GDP data based on the mode of the MPC's GDP backcast. Hours worked based on YBUS.  
(u) Four-quarter growth in LFS employment in Q4. Based on MGRZ.  
(v) Level in Q4. Average weekly hours worked, in main job and second job. Based on YBUS/MGRZ.  
(w) LFS unemployment rate in Q4. Based on MGSX.  
(x) Level in Q4. Percentage of the 16+ population. Based on MGWG.  
(y) Four-quarter inflation rate in Q4.  
(z) Four-quarter inflation rate in Q4 excluding fuel and the impact of MTIC fraud.  
(aa) Contribution of fuels and lubricants and gas and electricity prices to four-quarter CPI inflation in Q4.  
(ab) Four-quarter growth in whole-economy total pay in Q4. Growth rate since 2001 based on KAB9. Prior to 2001, growth rates are based on historical estimates of AWE, with ONS series identifier MD9M.  
(ac) Four-quarter growth in unit labour costs in Q4. Whole-economy total labour costs divided by GDP at constant prices, based on the mode of the MPC's GDP backcast. Total labour costs comprise compensation of employees and the labour share multiplied by mixed income.  
(ad) Four-quarter growth in private sector regular pay based unit wage costs in Q4. Private sector wage costs divided by private sector output at constant prices, based on the mode of the MPC's GDP backcast. Private sector wage costs are average weekly earnings (excluding bonuses) multiplied by private sector employment.

## Box A: Monetary policy since the February Report

At its meeting ending on 17 March 2021, the MPC voted unanimously to maintain Bank Rate at 0.1%. The Committee voted unanimously for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted unanimously for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion.

Since the February *Monetary Policy Report*, developments in global GDP growth had been a little stronger than anticipated, and the substantial new US fiscal stimulus package was expected to provide significant additional support to the outlook. In part reflecting this, and alongside positive news on some vaccination programmes, advanced economy longer-term government bond yields had risen rapidly to levels similar to those seen shortly before the pandemic. For the most part this had reflected higher real yields. Risky asset prices had remained resilient. In the United Kingdom, the sterling effective exchange rate had appreciated and mortgage credit conditions had eased a little. An aggregate measure of UK financial conditions had been broadly unchanged since the February *Report*.

The rates of Covid infections and hospitalisations had fallen markedly across the United Kingdom and the vaccination programme was proceeding at a rapid pace. Plans for the easing of restrictions on activity had been announced and envisaged that restrictions could be lifted somewhat more rapidly than had been assumed in the February *Report*. *Budget 2021*, published in March, contained a number of significant new policy announcements, including the extension of the Coronavirus Job Retention Scheme and other measures to support the economy in the near term which had not been reflected in the February *Report*.

UK GDP had fallen by 2.9% in January. This had been less weak than expected, due mainly to developments in public sector output, but still left GDP around 10% below its 2019 Q4 level. The news in recent plans for the easing of restrictions on activity may have been consistent with a slightly stronger outlook for consumption growth in 2021 Q2 than was anticipated in the February *Report*, although it was less clear that this represented news to the MPC's medium-term forecast.

The LFS unemployment rate had risen to 5.1% in the three months to December, but it was likely that labour market slack had remained higher than implied by this measure. The extension of the Government's employment support schemes was likely to mean that the near-term rise in the LFS unemployment rate would be more moderate than suggested by the MPC's February *Report* projections, which had been constructed on the basis of existing government policy at that time.

Twelve-month CPI inflation had risen slightly to 0.7% in January. The weakness of recent outturns had largely reflected the direct and indirect effects of Covid on the economy, in particular the decline in oil prices seen in early 2020. As had been the case in recent MPC projections, CPI inflation was expected to return swiftly to around the 2% target in the spring, as the effects of those earlier falls in oil prices drop out of the annual comparison, and reflecting more recent increases in energy prices. These developments should have few direct implications for inflation over the medium term, however. Inflation expectations had remained well anchored.

There was judged to be a material degree of spare capacity. The outlook for the economy, and particularly the relative movement in demand and supply during the recovery from the pandemic, remained unusually uncertain. It continued to depend on the evolution of the pandemic, measures taken to protect public health, and how households, businesses and financial markets respond to these developments.

At this meeting, the Committee judged that the existing stance of monetary policy remained appropriate.

# 2: Current economic conditions

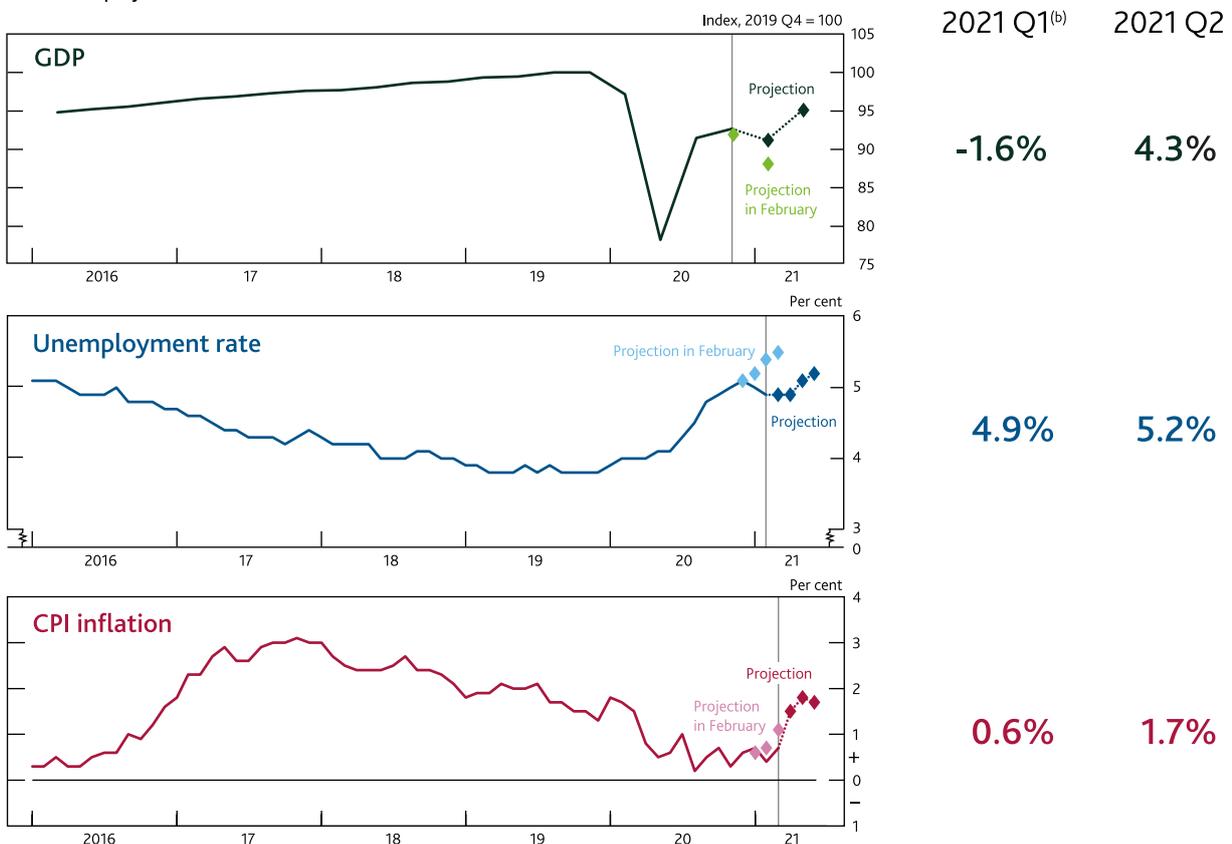
Global GDP increased slightly in 2021 Q1, and activity is expected to pick up further in the near term as more people receive vaccinations and restrictions are eased. More positive growth prospects have led to a rise in advanced-economy government bond yields and risky asset prices.

UK output is expected to have fallen in Q1, with Covid restrictions in place during the quarter, although the fall is expected to have been smaller than anticipated in February. GDP is expected to grow strongly in Q2 as restrictions are eased. Demand will also be supported throughout 2021 by the fiscal loosening announced in the March *Budget*.

The unemployment rate has remained broadly stable over the past few months, as the furlough scheme continued to support employment. Unemployment is expected to rise a little during Q2 as more people currently out of work begin searching for jobs. Energy prices, the cut to VAT and weak demand continued to weigh on CPI inflation, which was 0.6% in Q1. Inflation is expected to rise towards 2% from Q2 as some of those effects fade.

**Chart 2.1:** GDP is expected to increase in 2021 Q2; unemployment is expected to rise a little; and inflation is expected to rise closer to the target.

Near-term projections<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) The lighter diamonds show Bank staff's projections at the time of the February 2021 *Monetary Policy Report*. The darker diamonds show Bank staff's current projections.  
 (b) GDP and unemployment projections are based on official data to February. CPI inflation figure is an outturn.

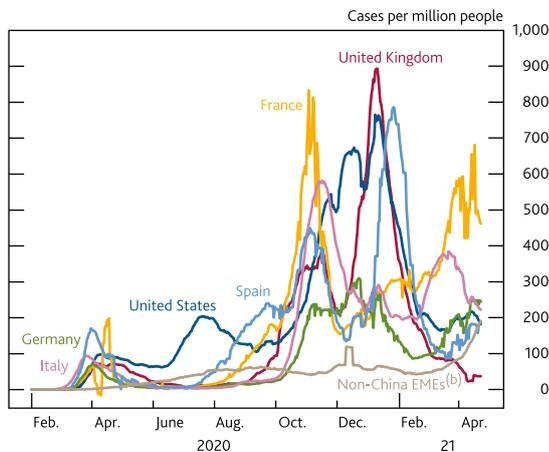
## 2.1: Global developments and financial conditions

### *UK-weighted world GDP growth slowed in 2021 Q1, but was higher than expected in February.*

UK-weighted world GDP growth is estimated to have slowed to 0.4% in 2021 Q1, from 0.8% in 2020 Q4. Following a rise in Covid cases ([Chart 2.2](#)), more stringent restrictions have been imposed in many regions since the start of 2021. However, global activity is projected to have been stronger than expected in the [February Report](#), as recent restrictions appear to have had a smaller-than-expected impact on activity. The impact of restrictions on GDP has lessened when compared to the early stages of the pandemic ([Chart 2.3](#)), suggesting that many economies have better adapted to operating under them. Despite continued growth in Q1, the level of UK-weighted world GDP still remained 2% below its level in 2019 Q4, prior to the pandemic. Global growth is expected to pick up to 1% in Q2, although the pace of growth varies across regions.

**Chart 2.2: In some advanced economies, Covid cases rose around the turn of the year before falling back**

Daily new confirmed Covid-19 cases in selected countries<sup>(a)</sup>



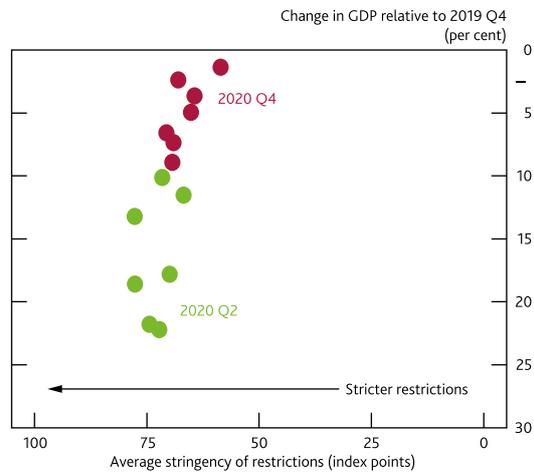
Sources: COVID-19 Data Repository by the Centre for Systems Science and Engineering at Johns Hopkins University, World Bank and Bank calculations.

(a) Seven-day moving averages, scaled by 2019 population. Data are shown to 23 April and are not seasonally adjusted. Cases in overseas departments are included in line with World Bank definitions of population.

(b) Series includes Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey.

**Chart 2.3: The impact of restrictions on economic activity appears to have lessened**

Average stringency of restrictions and GDP<sup>(a)</sup>



Sources: OECD, ONS, Oxford Covid-19 Government Response Tracker (Blavatnik School of Government) and Bank calculations.

(a) Data points shown are for France, Germany, Italy, Spain, UK, US and the average across Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey.

### *The economic recovery in the US continued, and further substantial policy support measures were introduced which should provide a boost to global growth.*

US GDP grew by 1.6% in 2021 Q1, higher growth than in 2020 Q4. Mobility indices in the US were higher compared to other major advanced economies over this period. Household spending was strong in Q1, boosted by direct payments to households from the Government, as part of US fiscal stimulus measures. Labour market conditions have been improving, with unemployment falling further to 6.0% in March from 6.7% in December.

US growth is supported in the near term by the further substantial fiscal stimulus package agreed by the US Government in March. That package totalled US\$1.9 trillion, and included direct payments to households, an extension of enhanced unemployment benefits, and an extension of business support schemes. The total US fiscal stimulus introduced since the onset of the Covid crisis has been over 25% of annual US GDP. This is expected to provide a significant boost to global GDP over the forecast period, through both the impact on the US and through spillovers to other countries.

### *Output in the euro area fell in Q1, but by less than expected in February.*

Euro-area GDP fell by 0.6% in 2021 Q1, less than expected at the time of the [February Report](#). Greater restrictions were imposed in some countries during the quarter, following a rise in Covid cases, but households and businesses appear to have better adapted to operating with additional restrictions. Some indicators of economic sentiment have improved and GDP growth is expected to return to positive territory in Q2, though the increase in GDP is more moderate than expected in February. Some countries such as France and Germany have seen a further rise in Covid cases ([Chart 2.2](#)) and the near-term path of restrictions is likely to be tighter than was expected at the time of the [February Report](#).

*The economic recovery in China remains strong, though the pace of growth moderated somewhat in Q1.*

Quarterly GDP growth in China slowed to 0.6% in 2021 Q1, reflecting the re-imposition of some Covid-related restrictions. But the economic recovery in China has been relatively strong, with GDP now almost 7% higher than its level in 2019 Q4. The latest data are consistent with continued steady growth: in particular, mobility indices have returned to around normal levels, suggesting that activity would pick up again in Q2.

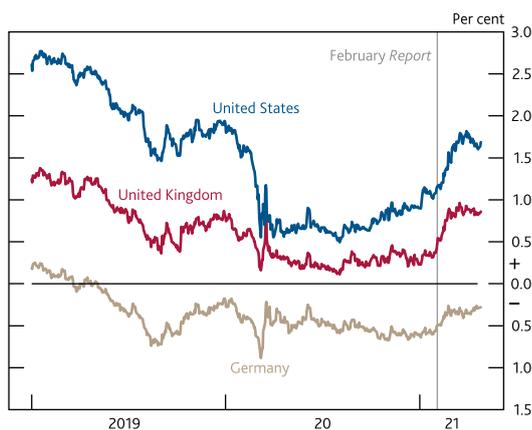
After recovering more strongly than previously expected in the second half of 2020, growth in other emerging market countries is expected to have slowed a little in 2021 Q1. Following a rapid rise in Covid cases since March (**Chart 2.2**), more restrictions on mobility have been imposed in several countries, such that growth is projected to slow somewhat in the near term.

*More positive growth prospects have led to a rise in yields across advanced economies...*

Longer-term government bond yields in advanced economies, which tend to be highly correlated, have risen sharply in the US and UK since the February Report (**Chart 2.4**), and are now back to around their levels before the pandemic. This rise in nominal yields in the US and UK has been largely driven by higher real rates (**Chart 2.5**). These moves are likely to reflect positive news on global growth prospects, including the boost from US fiscal policy, and anticipation of vaccine effectiveness. The implied-inflation component of long-term bond yields has also risen since the February Report (red bars in **Chart 2.5**). Market-implied measures of long-term inflation expectations in advanced economies are now a little higher than their levels prior to the pandemic (**Chart 2.25**).

**Chart 2.4:** Long-term yields have risen across advanced economies since February...

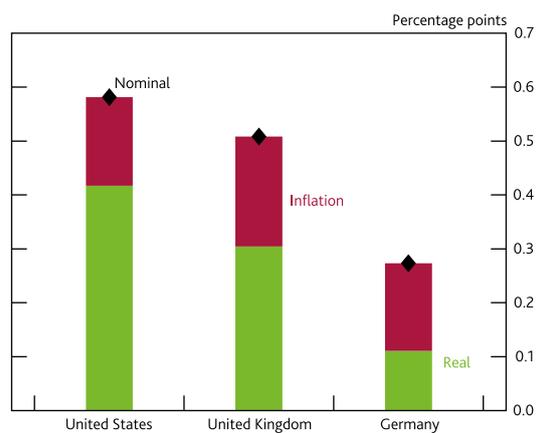
10-year nominal interest rates



Sources: Bloomberg Finance L.P., Tradeweb and Bank calculations.

**Chart 2.5:** ...and in the UK and US, these moves in yields have been largely driven by real interest rates

Decomposition of changes in 10-year nominal interest rates since the February Report into implied-inflation and real rates<sup>(a)</sup>



Sources: Bloomberg Finance L.P., Tradeweb and Bank calculations.

(a) Changes between the 15 working days to 27 January and the 15 working days to 27 April. UK and German series are derived from interest rate swaps. US series is derived from breakeven inflation implied by nominal and inflation-protected Treasury bonds. The instruments used are linked to RPI for the UK, CPI for the US and HICP for Germany.

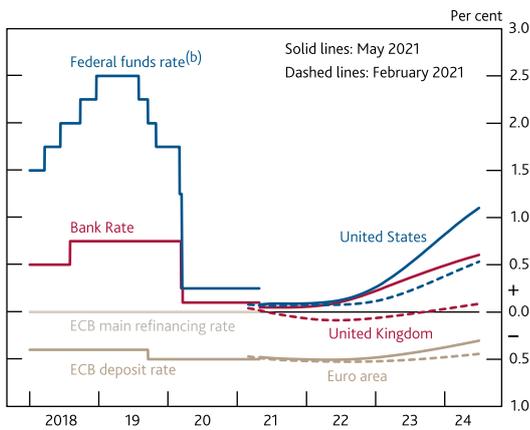
At shorter horizons, market-implied paths for policy rates have also picked up, with the path for US and UK rates steepening more materially than in the euro area (**Chart 2.6**). The market-implied path for Bank Rate is now around  $\frac{1}{4}$  percentage points higher than in February on average, and rises to around 0.6% at the three-year horizon.

*...and have supported risky asset prices...*

Advanced-economy equity prices have increased further since the February Report (**Chart 2.7**), boosted by positive sentiment regarding global growth prospects, despite the associated rise in yields. Equity prices in emerging markets have fallen slightly, which may reflect concerns around rising Covid cases in some countries. Corporate bond spreads across the US, UK and euro area remain close to their recent lows (**Chart 2.8**).

**Chart 2.6: Market-implied paths for policy rates have steepened in the UK and US**

International forward interest rates<sup>(a)</sup>



Sources: Bloomberg Finance L.P. and Bank calculations.

- (a) All data as of 27 April 2021. The May and February curves are estimated using instantaneous forward overnight index swap rates in the 15 working days to 27 April and 27 January 2021 respectively.
- (b) Upper bound of the target range.

**Chart 2.7: Advanced-economy equity prices have risen further since the February Report**

International equity prices<sup>(a)</sup>



Sources: MSCI, Refinitiv Eikon from LSEG and Bank calculations.

- (a) In local currency terms, except for MSCI Emerging Markets which is in US dollar terms.
- (b) The MSCI Inc. disclaimer of liability, which applies to the data provided, is available from the [May 2021 Monetary Policy Report](#).

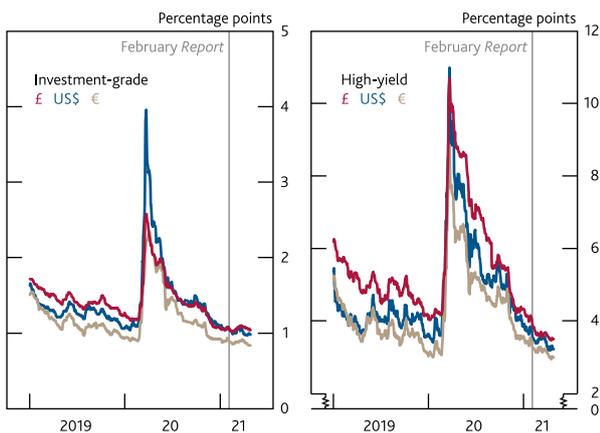
*...and commodity prices.*

Dollar oil prices have risen by around 15% since the February Report, partly reflecting improved prospects for oil demand.

Higher oil prices have contributed to a pickup in inflation across advanced economies since the February Report. In the euro area, the 12-month headline inflation rate rose to 1.3% in March, from -0.3% in December. In the US, annual headline personal consumption expenditures inflation picked up to 2.3% in March from 1.2% in December. Core inflation was lower, at 0.9% in the euro area and 1.8% in the US.

**Chart 2.8: Corporate bond spreads remain close to their recent lows**

International non-financial corporate bond spreads<sup>(a)</sup>



Sources: ICE/BoAML Global Research, Refinitiv Eikon from LSEG and Bank calculations.

- (a) Option-adjusted spreads on government bond yields. Investment-grade corporate bond yields are calculated using an index of bonds with a rating of BBB3 or above. High-yield corporate bond yields are calculated using aggregate indices of bonds rated lower than BBB3. Due to monthly index rebalancing, movements in yields at the end of each month might reflect changes in the population of securities within the indices.

**Chart 2.9: Sterling has appreciated by 2¾% since the February Report**

Sterling ERI



Sources: ICE/BoAML Global Research, Refinitiv Eikon from LSEG and Bank calculations.

*UK asset prices have also risen.*

Since the February *Report*, and similar to moves seen in other advanced economies, UK equity prices have risen further (**Chart 2.7**), sterling corporate bond spreads have remained low (**Chart 2.8**), and the UK yield curve has steepened (**Charts 2.4 and 2.6**). Models that aim to decompose moves in UK asset prices into global and UK-specific factors suggest that both have played a role. The UK-specific factors are likely to be related to a more positive domestic growth outlook and the high initial vaccination rate. These factors could also partly explain the appreciation of sterling, which is up by around 2¾% since the February *Report* (**Chart 2.9**).

*Credit is available for many companies, although conditions remain tight for some smaller businesses and those most affected by the pandemic...*

Credit appears to be available for many companies, with the Bank's Agents reporting strong investor appetite for issuance in debt and equity markets, and bank credit was also generally reported to be available in stable and growing sectors. However, contacts note that some smaller businesses and firms in sectors that have been most affected by the pandemic continue to report tight credit availability.

In March, a new government-backed loan scheme – the Recovery Loan Scheme (RLS) – was announced, which succeeds the Bounce Back Loan Scheme and the two Coronavirus Business Interruption Loan Schemes. Approximately £70 billion of finance was raised by UK businesses over the past year through the earlier schemes. The introduction of RLS is expected to provide continued support for corporate borrowing overall, though corporate lending spreads might rise somewhat in the near term. Supervisory intelligence indicates that the terms of the scheme may limit access for some small and higher risk small and medium-sized enterprises, particularly in sectors which are more affected by the pandemic. Although, in the latest *Credit Conditions Survey* (CCS), lenders expected overall corporate credit availability to increase slightly in 2021 Q2 (**Chart 2.10**).

*...while household credit conditions have eased a little since the February Report.*

In the latest CCS, lenders reported an improvement in the availability of secured lending to households in Q1, and availability was expected to increase further in Q2 (**Chart 2.10**). As discussed in more detail in Box B, new mortgage rates and spreads have fallen during 2021 (**Chart A** in Box B), although they remain significantly higher, particularly for high LTVs, than at the beginning of 2020.

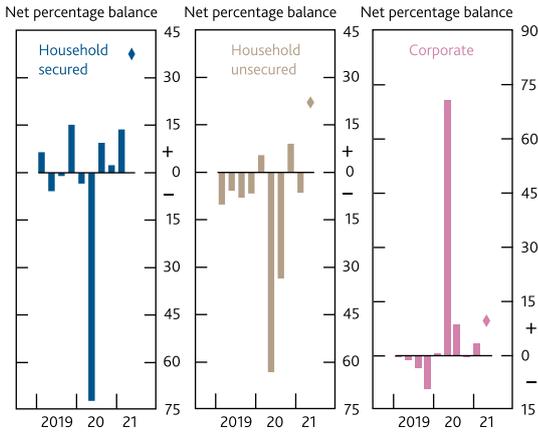
Lenders reported that the availability of unsecured credit decreased slightly in Q1, although it was expected to rise in Q2 (**Chart 2.10**). Unsecured lending volumes remain weak. The annual growth rate of consumer credit remained near its record lows, at -8.6% in March, which in large part reflected repayments on credit card loans continuing to exceed subdued gross lending.

*Overall, UK financial conditions appear to be little changed since the February Report.*

The appreciation of sterling and the increase in risk-free rates over the past few months would be likely to dampen UK GDP, all else equal, while higher equities and lower mortgage spreads would serve to boost it. Financial conditions indices can act as useful summary measures to help investigate how financial variables affect the economy. The Bank's Monetary and Financial Conditions Index (MFCI) is one example (see '[How do we monitor UK financial conditions?](#)' for more details). This suggests that current financial conditions have been little changed since the February *Report* (**Chart 2.11**). But the impact of financial market movements on the economy will depend on what has caused them, so the MFCI is best considered as part of a broad range of metrics when assessing financial conditions.

**Chart 2.10: Lenders expect an increase in household and corporate credit availability in Q2**

Household and corporate credit availability<sup>(a)</sup>

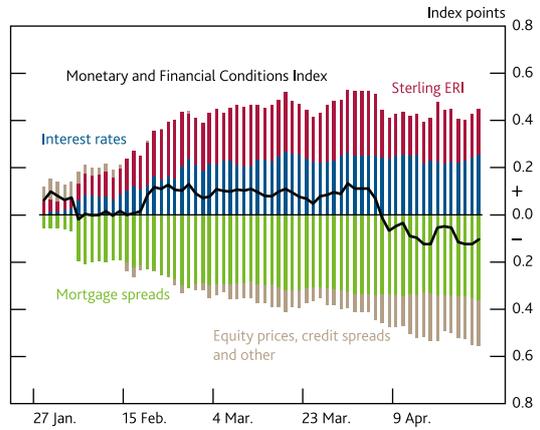


Source: Bank of England Credit Conditions Survey.

(a) Lender responses are weighted by market shares. A positive balance indicates an increase in availability. The diamonds show the expected changes over the next three months, as reported in the 2021 Q1 Survey.

**Chart 2.11: A summary measure suggests that financial conditions have been little changed since the February Report**

Contributions to changes in the UK Monetary and Financial Conditions Index<sup>(a)</sup>



Sources: Bank of England, Bloomberg Finance L.P., ICE/BoAML, IMF World Economic Outlook, Money Facts, Refinitiv Eikon & I/B/E/S, both from LSEG, Tradeweb and Bank Calculations.

(a) The UK Monetary and Financial Conditions Index (MFCI) summarises information from the following series: short-term interest rates, the sterling ERI, corporate bond spreads, equity prices, and household and corporate bank lending spreads. The series weights are based on the historical association of each variable with UK GDP. The chart shows changes in the MFCI from the average level over the 15 working days to 27 January 2021. An increase in the MFCI signals tighter financial conditions and a decrease signals looser conditions. For more information, see [‘How can we measure UK financial conditions?’](#).

## 2.2: Demand and output

*With significant Covid restrictions in place during Q1, UK output is expected to have fallen...*

Amid a sharp increase in Covid cases (**Chart 2.2**), stricter restrictions came into effect throughout almost all of the UK around the end of December and many remained in place throughout Q1. Activity fell sharply at the start of the year. For example, motor vehicle traffic was more than 40% below normal levels in January, having been around 25% lower during December (**Chart 2.12**). The tighter restrictions and the closure of many businesses caused GDP to fall back in January, with spending on services accounting for a large part of the decline (**Chart 2.13**). Output rose by 0.4% in February, but is expected to have fallen by 1.6% in Q1 as a whole.

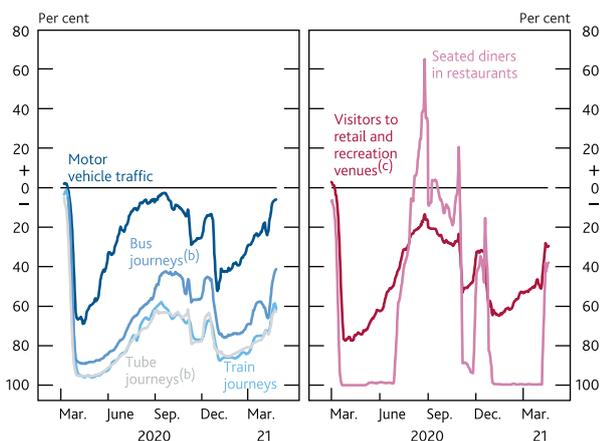
However, that fall is expected to have been around 2½ percentage points smaller than anticipated in the *February Report*. That is due in part to higher government output, largely reflecting higher spending on the test and trace system, although the estimates may be subject to revision. As has been the case in other economies, Covid-related restrictions appear to have had a smaller economic impact than in the past, perhaps because businesses and households have learned to adapt to them.

*...but GDP is expected to rise sharply in Q2 as restrictions are eased.*

The vaccination programme, much lower numbers of Covid cases and the easing of Covid restrictions are expected to support GDP growth in Q2. By mid-April, all over-50s and the clinically vulnerable had been offered their first vaccine dose. Daily Covid cases fell from over 50,000 at the start of the year to less than 5,000 at the end of the first quarter, and to fewer than 2,000 since. The latest government plans suggest that restrictions on activity will be lifted somewhat more rapidly than was assumed in the *February Report*. These plans envisage that most businesses in England in all but the highest risk sectors will be able to reopen from 17 May, for example. The fiscal loosening announced in the *March Budget* is also expected to support growth in the near term (Box C).

Overall, GDP is expected to rise by 4.3% in Q2, largely reflecting the easing of restrictions, though that would still leave GDP 5% below its level in 2019 Q4.

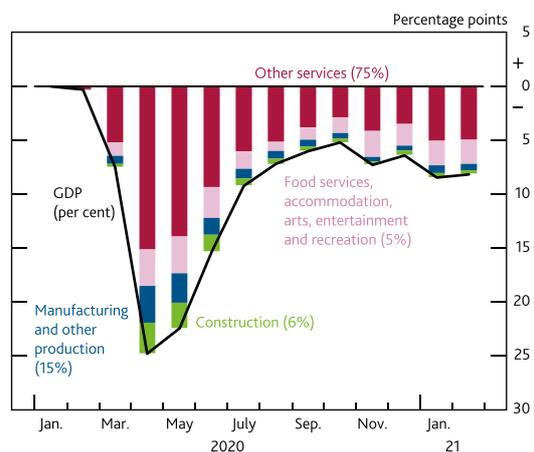
**Chart 2.12: The number of journeys increased in April, and retail and restaurant activity also picked up**  
High-frequency indicators of economic activity<sup>(a)</sup>



Sources: Department for Transport, Google Covid-19 Mobility Reports, OpenTable and Bank calculations.

- (a) Seven-day moving averages to 26 April for transport data and 24 April for retail footfall and restaurant bookings. Data are not seasonally adjusted. All data are shown relative to normal levels.  
 (b) The number of tube journeys is based on Transport for London data and the number of bus journeys does not include London buses.  
 (c) Numbers of visitors to places such as restaurants, cafes, shopping centres, theme parks, museums, libraries and cinemas.

**Chart 2.13: GDP fell in January, largely due to weaker services output, and only recovered a little in February**  
Contribution to change in monthly GDP since January 2020<sup>(a)</sup>



Sources: ONS and Bank calculations.

- (a) Figures in parentheses are weights in gross value added in 2018. Weights and contributions may not sum to the total due to rounding. Latest data are for February 2021.

*Household spending is expected to have fallen back in Q1.*

Consumption is expected to have fallen by around 5% in Q1, a smaller decline than in the *February* projection. Credit and debit card data from Barclaycard suggest that spending on services that involve contact with other people fell back as Covid restrictions were tightened. Retail sales fell sharply in January as shops closed, although they recovered to just below December levels in March, as Covid cases fell and mobility rose through the quarter.

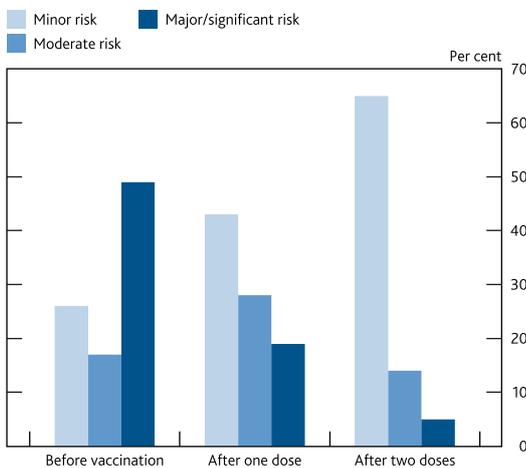
Household spending is then expected to rise by 8% in Q2, although that would still leave it 7% below its level in 2019 Q4. Transport journeys increased during April (Chart 2.12). Retail footfall also picked up when stores selling non-essential items were allowed to reopen and restaurant reservations recovered strongly. Consistent with that, confidence indicators have risen and are close to their long-run averages. The extension of the Coronavirus Job Retention Scheme (CJRS) is also expected to support incomes and reduce job losses (Box C), which is likely to boost consumption.

*One uncertainty around the near-term spending path is how much voluntary social distancing will persist.*

The vaccination programme is expected to lead to a fall in voluntary social distancing, although the extent of that is uncertain. Some survey evidence suggests that the vaccination programme will reduce people’s fear of catching Covid significantly. For example, in a survey of over-80s from February, only 5% of respondents thought they would see Covid as a major personal risk following two vaccine doses, compared with almost 50% without vaccination (Chart 2.14). Some voluntary social distancing is expected to continue after Covid restrictions are lifted across the UK, however, for example reflecting ongoing fears linked to Covid variants.

**Chart 2.14: Only 5% of over-80s expected Covid to pose a significant risk after receiving two vaccine doses**

Percentage of over-80s that see Covid as a personal risk<sup>(a)</sup>

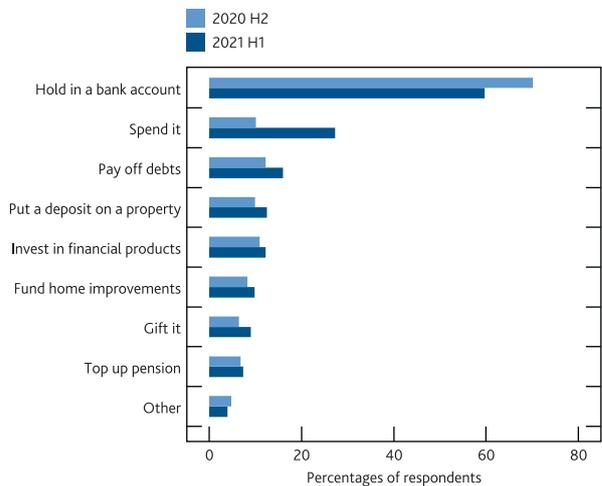


Source: ONS Over 80s' Vaccines Insights Study.

(a) Question: 'To what extent do you think coronavirus poses a risk to you personally?'. Based on responses from all over-80s. Survey conducted between 15 and 20 February 2021. Categories do not sum to 100 because responses of 'Don't know' and 'Prefer not to say' are excluded.

**Chart 2.15: Of the households that have increased their savings, around a quarter say they will spend at least some part**

Planned use of funds among households with increased savings<sup>(a)</sup>



Sources: NMG Consulting and Bank calculations.

(a) Those people who reported that their savings had increased as a result of changes in income or spending due to the pandemic were asked what they plan to do with those savings. Shares do not sum to 100 because respondents were able to choose more than one option.

*There is also uncertainty around the extent to which households will spend their accumulated savings.*

The widespread Covid restrictions in place during Q1 prevented households from spending on certain items, and savings increased over the quarter as a result, as was also the case over much of 2020. The distribution is uneven, however, with additional savings concentrated in high-income households in particular (see Section 3 of the February Report).

A key judgement in the MPC’s recent forecasts has been the extent to which those accumulated savings will be spent. The latest Bank/NMG survey – like the one before it – suggests that most households with extra savings plan to continue to hold at least some of them in their bank accounts. The share of households expecting to spend some part of those savings has risen somewhat since the previous survey, however (Chart 2.15). That could reflect increased confidence in the economic outlook as a result of the vaccination programme. Recent research also suggests that people’s willingness to spend after receiving a cash windfall may be higher than for other shocks to their wealth, possibly because cash windfalls are particularly observable (Baker et al (2020) and Kubota et al (2021)). Given that households’ accumulated savings tend to be held in liquid bank accounts and are therefore also observable, this might suggest a larger share will be spent than other estimates imply. In the MPC’s projections, households spend 10% of accumulated savings over the forecast period, a higher proportion than in February. That is broadly consistent with information from the Bank/NMG survey on how much of their savings those who have built them up expect to spend.

*Since the start of the pandemic, investment has fallen, although not by as much as previously thought.*

Business investment has fallen since the start of the pandemic across a range of industries. These data are typically volatile, however, and prone to revision. The latest estimates suggest that the decline was significantly smaller than was estimated at the time of the *February Report*, with investment falling by 10% in 2020, compared with an expected 15% fall previously.

*Investment is expected to have fallen in Q1, but evidence from the DMP Survey suggests it will rise in Q2.*

Business investment is expected to have fallen by 4% in Q1, as some temporary strength in the transport and storage sector in 2020 Q4 is expected to have unwound.

In the Decision Maker Panel (DMP) Survey, firms expected Covid to weigh on investment in Q2, but by much less than it has done over the past year. Responses also suggest firms believe Covid will weigh on investment over much of 2021 by less than they previously thought (**Chart 2.16**). That could reflect the impact of the announced tax measures in *Budget 2021* (Box C).

Uncertainty – associated with Covid and Brexit – has weighed on investment in recent years. Most respondents to the DMP Survey suggest that uncertainty remains elevated. And those businesses that report higher uncertainty – or that expect Covid uncertainty to take longer to resolve – also report weaker investment intentions. Uncertainty is expected to decline in the near term; the proportion of respondents citing Covid as their main source of uncertainty fell in the latest DMP Survey.

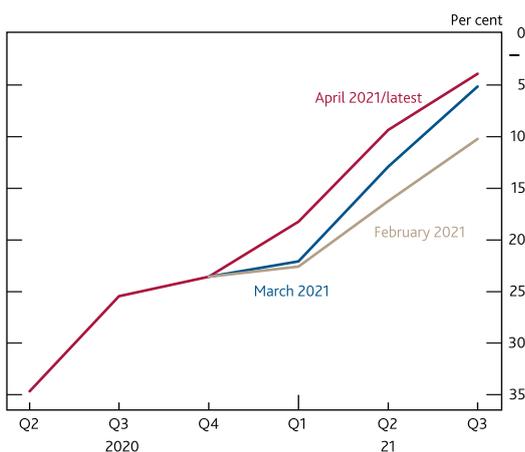
*Trade with the EU fell sharply at the start of the year.*

At the time of the *February Report*, Agency contacts and high-frequency indicators suggested that UK-EU trade had fallen in January following the move to new trading arrangements. The official trade data have borne that out: UK goods exports to the EU – excluding volatile components – fell by 46% in January, while goods imports from the EU fell by 30% (**Chart 2.17**).

Early evidence suggests that firms are beginning to adjust to the new UK-EU trading arrangements. EU goods exports recovered somewhat in February, for example, and were at similar levels to non-EU exports relative to their 2019 averages, although imports from the EU remained very low.

**Chart 2.16:** Firms expect Covid to continue to weigh on investment, but by less than previously thought

Impact of Covid on investment<sup>(a)</sup>

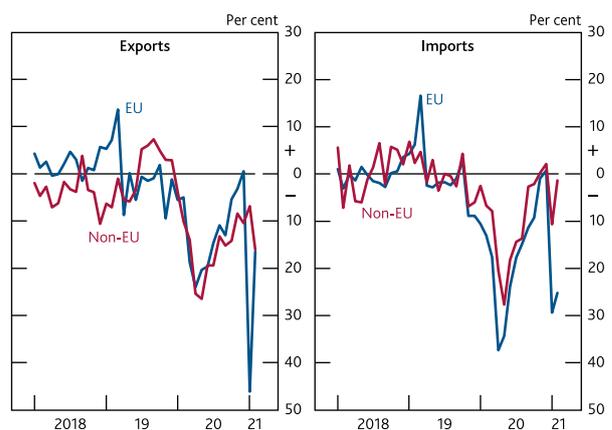


Sources: DMP Survey and Bank calculations.

(a) Question: "Relative to what would have otherwise happened, what is your best estimate for the impact of the spread of coronavirus (Covid-19) on the capital expenditure of your business in the following quarters?".

**Chart 2.17:** Trade with the EU fell sharply in January, but exports recovered somewhat in February

Changes in UK trade in goods with EU and non-EU countries relative to 2019 averages<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) Monthly trade data, excluding unspecified goods. Latest data points are for February 2021.

## 2.3: The labour market, costs and prices

*The unemployment rate remained broadly stable in early 2021, even as restrictions were re-imposed...*

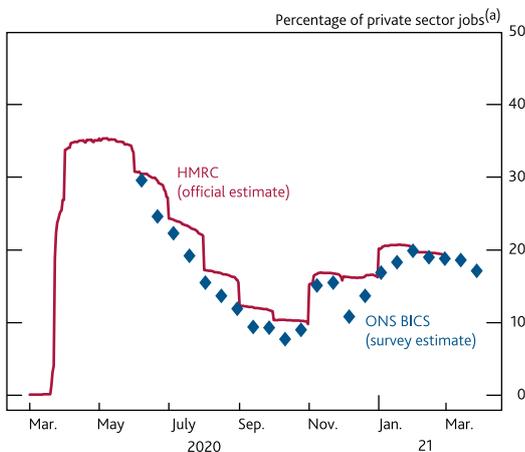
According to the Labour Force Survey (LFS), the unemployment rate was 4.9% in the three months to February, almost a percentage point higher than a year earlier (Chart 2.1). This is a little lower than the 5.1% in the three months to December, despite the fall in monthly GDP since then (Section 2.2). Use of the CJRS picked up at the start of the year, as further restrictions meant some businesses needed to close temporarily. According to official data, just under 5 million jobs were furloughed on average during January and February, equivalent to around 20% of private sector jobs, but survey data suggest this fell a little towards the end of Q1 (Chart 2.18).

The CJRS has helped workers stay attached to jobs and can account, in large part, for why the increase in unemployment over the past year has been relatively subdued given the fall in output. In addition, the proportion of people participating in the labour market has fallen. However, it is likely that some people would re-enter the labour market were it to strengthen. Partly as a result, spare capacity in the labour market is likely to be higher than implied by the LFS unemployment rate at present (Box D).

*...and is expected to rise only slightly in Q2.*

Unemployment is expected to rise a little to 5.2% in Q2. The furlough scheme, alongside a projected recovery in activity and demand for labour, is expected to support employment. Job vacancies – an indicator of labour demand – had already begun to pick up during Q1 (Chart 2.19). However, unemployment is nevertheless expected to rise as more people start to search for jobs as social distancing measures ease, and so some of the fall in labour market participation unwinds (Box D). The projection for the unemployment rate is significantly lower than in the February Report. This is primarily due to the extension of the CJRS to the end of September, as well as the stronger projection for output.

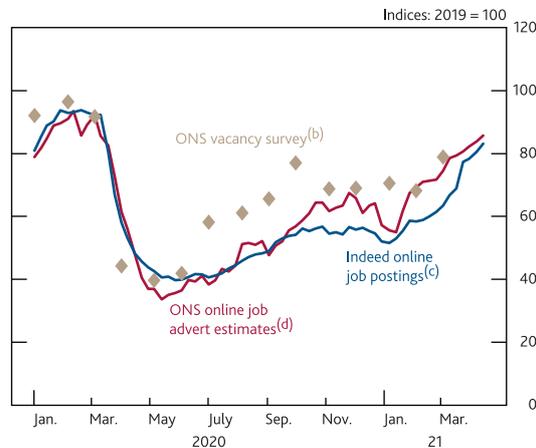
**Chart 2.18: The number of jobs furloughed increased in Q1**  
Furloughed jobs



Sources: Her Majesty's Revenue and Customs (HMRC), ONS and Bank calculations.

(a) Total employee jobs minus public sector employment.

**Chart 2.19: Some indicators of job vacancies suggest rising labour demand in March and early April**  
High-frequency indicators of job vacancies<sup>(a)</sup>



Sources: Adzuna, Indeed, ONS and Bank calculations.

(a) Data are not seasonally adjusted.

(b) Single-month vacancy estimates. Data are to March 2021.

(c) Stock of job postings on Indeed UK. Data are seven-day averages to 16 April 2021.

(d) Based upon job advertisements provided by Adzuna. Data are adjusted to remove duplicates and are to 16 April 2021.

*Average wage growth remains strong, although some of the strength reflects compositional effects...*

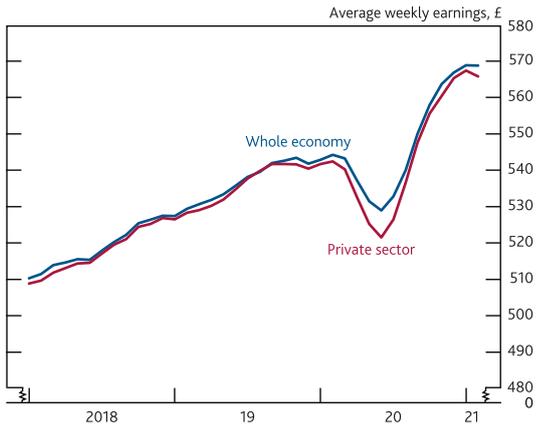
Measures of average weekly earnings suggest that pay growth has been strong in recent months: total whole-economy pay increased by 4.5% in the three months to February 2021, relative to the same period a year earlier (Chart 2.20). However, these data have been affected by the significant changes in the labour market caused by Covid. On the one hand, lower pay for those who have been furloughed has dragged on average wages. The size of that effect has varied according to the proportion of employees furloughed and the extent to which employers have topped up wages above the share paid by the Government. On the other hand, the fact that job losses have been skewed towards lower-paid and part-time roles has boosted average wages for those still in employment. An ONS estimate suggests that these types of compositional effects are boosting average annual pay growth measures by almost 3 percentage points,

compared to around 1 percentage point before the pandemic (**Chart 2.21**). Bank staff analysis suggests that these compositional effects have outweighed the impact of furlough in recent months.

Measures of average wages are likely to reflect the effects of the pandemic for some time. For example, even if total pay stays flat over the coming months, annual growth would rise to around 7% by May, because of the sharp falls in wages in Q2 last year. Further ahead, average wage growth would be depressed if job creation were skewed towards lower-paid roles, thereby reversing to some degree the compositional shifts seen last year.

**Chart 2.20: Average earnings have increased materially relative to pre-pandemic...**

Measures of total pay<sup>(a)</sup>

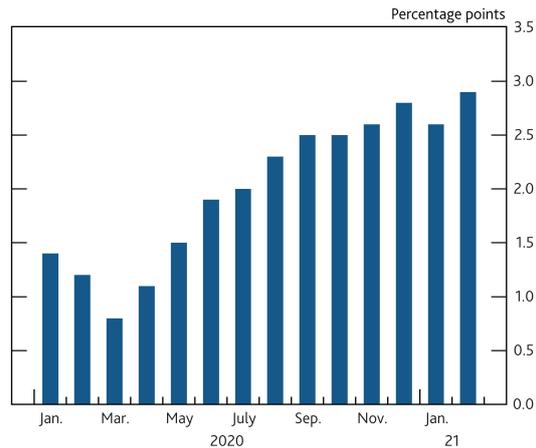


Sources: ONS and Bank calculations.

(a) Three-month moving averages. Data are to February 2021.

**Chart 2.21: ...but some of this strength can be explained by compositional effects**

Estimated contribution of compositional effects to total average earnings growth on a year earlier<sup>(a)</sup>



(a) ONS estimates of the contribution of the changes in the proportion of part-time jobs, the proportion of jobs in lower-paying occupations and age profile of jobholders to average pay growth. For more information, see 'Average weekly earnings in Great Britain: April 2021'.

### ...and wider pay indicators point to more modest pay pressures.

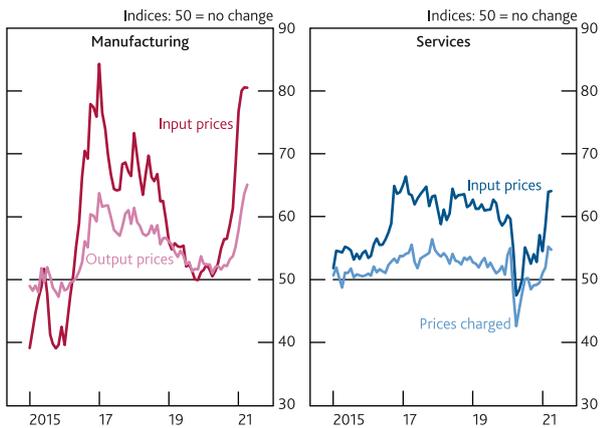
Wider indicators point to more subdued pay pressures. Median company pay settlements remain close to long-run averages. The REC Permanent Salaries Index, which had indicated pay falls in almost all months since April 2020, rose above the 50 'no change' mark in March, although it remained below past averages. Reports to the Bank's Agents suggest that while pay freezes have been less frequent and pay settlements of around 1.5% to 2% more common, overall growth in labour costs remains subdued.

### Some indicators of firms' other costs have picked up sharply in recent months.

Input price PMIs have increased sharply in recent months, particularly for the manufacturing sector (**Chart 2.22**). This is consistent with reports to the Bank's Agents of significant and widespread increases in input costs, for example via higher freight costs and raw material and commodity prices. Shipping costs were elevated in Q1, with container freight cost indices at around three times their 2019 average levels, and have risen a little further in April. The six-day blockage in the Suez Canal in late March may have delayed any normalisation in freight costs.

Firms were already reporting that unit costs were higher over 2020 than in 2019 in the Agents' survey on pay and costs. Small reported falls in total costs – as businesses made savings on travel and corporate entertainment for example, offsetting extra costs to make their operations Covid-secure – were accompanied by much larger falls in sales volumes (Section 4 of the [February Report](#)). The rises in input costs at the start of 2021 are likely to have added to the input cost pressure reported last year. Firms reported that Covid had increased their Q1 unit costs by 8% on average in the March DMP Survey, up from 5% in January. Agents' intelligence suggests that at least some of these higher costs are being passed through into manufacturers' prices, but pass-through into consumer prices so far is likely to have been more limited (Box E). Pressure on unit costs is also likely to ease as sales volumes normalise.

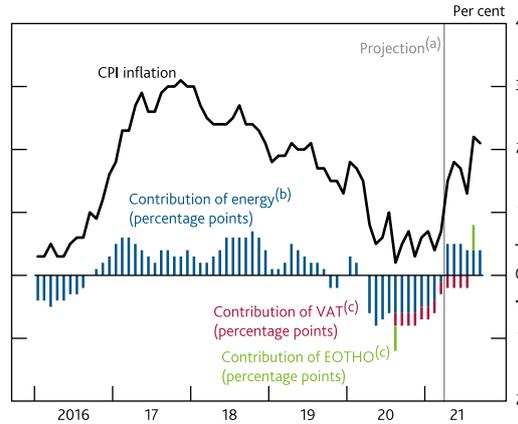
**Chart 2.22: Input prices appear to have risen sharply**  
Survey indicators of input and output prices<sup>(a)</sup>



Source: IHS Markit/CIPS.

(a) Data for April 2021 are flash estimates.

**Chart 2.23: Inflation is expected to reach 2% during Q3**  
CPI inflation and the contributions of energy prices, VAT and the Eat Out to Help Out (EOTHO) scheme



Sources: Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, ONS and Bank calculations.

- (a) Bank staff's projection. Fuels and lubricants estimates use Department for Business, Energy and Industrial Strategy petrol price data for April 2021 and then are based on the sterling oil futures curve.
- (b) Contribution of fuels and lubricants, electricity, gas and other fuels to CPI inflation.
- (c) Bank staff estimates of the direct contribution of the EOTHO scheme and the temporary reduced rate of VAT for hospitality and tourism to CPI inflation. There is uncertainty around the precise magnitude of these estimates.

### *Inflation remained weak in Q1, due to temporary Covid-related factors...*

CPI inflation fell to 0.4% in February, from 0.7% in January, before rising to 0.7% in March (**Chart 2.23**). The outturns in February and March were weaker than expected at the time of the *February Report*, largely due to sharp falls in clothing and footwear prices which, in February, contributed to the largest monthly drop in core goods inflation for almost 10 years. Covid has affected the typical seasonal pricing patterns in clothing and footwear, with prices tending to fall during lockdowns rather than in the usual winter and summer sales periods, meaning their contribution to CPI has been unusually volatile.

The latest data mark the eighth consecutive month that CPI inflation has been below 1%. As in previous months, the deviation from the target can be explained, in large part, by energy and services prices. The sharp falls in wholesale energy prices at the start of the pandemic (**Chart 2.24**), which fed through to household energy bills and motor fuel prices, were still weighing on inflation. Inflation in services prices has been weak since the middle of 2020. This has been driven by a combination of Covid-related factors, for example the VAT cut for the hospitality and tourism sectors and the Eat Out to Help Out (EOTHO) scheme. Subdued consumer demand for services, as well as uncertainty around future demand, is also likely to have played a role.

### *...but is expected to reach 2% during Q3.*

Inflation is expected to rise close to the 2% target in April and May, reaching 1.7% in Q2, up from 0.6% in Q1, as the influence of some Covid-related factors unwinds. The reduction in fuel prices early in the pandemic falls out of the annual comparison in Q2. In addition, subsequent rises in wholesale electricity and gas prices (**Chart 2.24**) will feed through to household energy bills: Ofgem increased the price cap on energy bills by 9% from 1 April, largely to account for higher wholesale prices. Overall, energy prices are expected to contribute around half a percentage point to CPI inflation in Q2, relative to dragging by around 0.3 percentage points in Q1. Covid-related price weakness seen last spring, when non-essential shops first closed, will also drop out of the annual comparison.

Inflation is expected to increase further to 1.9% in Q3 on average, before rising to 2.5% in Q4 (Section 1). There is substantial volatility in the monthly path however, as inflation is affected by particularly large temporary factors moving in and out of the annual comparison (**Chart 2.23**). For example, services inflation rose temporarily by almost 0.4 percentage points in July 2020, in part as the service sector reopened and certain firms faced higher Covid-related costs. This will drag on inflation in July 2021, when it is expected to fall to 1.3%. Conversely, the EOTHO scheme lowered inflation by around 0.4 percentage points in August 2020 and so will boost inflation in August 2021, when it is projected to rise to 2.2%.

The rise in inflation in Q2 and Q3 is expected despite a drag from some other factors. Changes to the CPI basket and weights<sup>(1)</sup> are forecast to start to drag on inflation during Q2. The VAT cut to 5% for hospitality and tourism has been

(1) See 'Consumer price inflation basket of goods and services: 2021' for more details.

extended to September, so will continue to weigh on inflation throughout Q2 and a little in Q3. According to the Bank's Agents, the cut has been passed on to prices only partially, but it is still estimated to have been pulling down inflation by around 0.2 percentage points, on average, since August 2020.

### *Inflation expectations have been broadly stable and remain well anchored.*

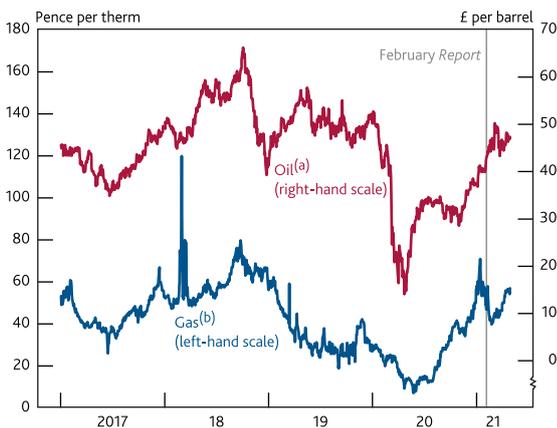
Most measures of household inflation expectations have been stable since the February Report (Table 2.A). The YouGov/Citigroup one year ahead expectation had picked up relatively sharply at the end of 2020, but has since fallen back to levels closer to previous averages. Longer-term expectations reported in this survey were little changed, as were household expectations in the Bank/Kantar survey. Companies' price expectations in the distribution sector fell materially in Q1 but these expectations tend to be quite volatile. Expectations for inflation in two years' time rose in the 2021 Q1 Deloitte CFO Survey.

In financial markets, implied expectations for inflation were unchanged on average over Q1, but longer-term expectations appear to have picked up since the February Report (Chart 2.25). They were just above 3.6% in the run up to the May Report, a little higher than long-run averages.

Overall, the MPC judges that inflation expectations remain well anchored.

**Chart 2.24: Oil prices have risen further since the February Report**

Sterling oil and wholesale gas prices



Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

- (a) US dollar forward prices for delivery in 10–25 days' time converted into sterling.  
 (b) One-day forward price of UK natural gas.

**Chart 2.25: Longer-term implied UK inflation expectations have picked up since the February Report**

Changes in five-year, five-year forward inflation compensation<sup>(a)</sup>



Sources: Bloomberg Finance L.P. and Bank calculations.

- (a) Derived from swaps. The instruments are linked to the UK RPI, US CPI and euro-area HICP measures of inflation.

**Table 2.A: The MPC judges that inflation expectations remain well anchored**

Measures of inflation expectations<sup>(a)</sup>

Per cent	2000–07 <sup>(b)</sup>	2010–19	2020				2021
			Q1	Q2	Q3	Q4	
<b>One year ahead inflation expectations</b>							
<b>Households<sup>(c)</sup></b>							
Bank/Kantar	2.4	3.0	3.0	2.9	2.8	2.7	2.7
YouGov/Citigroup	2.5	2.5	2.7	3.1	3.1	3.4	3.0
<b>Companies<sup>(d)</sup></b>							
Financial markets <sup>(e)</sup>	n.a.	1.7	0.0	0.4	2.1	1.8	0.5
<b>Two to three year ahead expectations</b>							
<b>Households<sup>(c)</sup></b>							
Bank/Kantar	n.a.	2.8	2.9	1.9	2.2	2.1	2.2
Companies <sup>(d)</sup>	n.a.	n.a.	1.3	1.0	1.9	1.5	0.6
<b>External forecasters<sup>(f)</sup></b>							
Financial markets <sup>(e)</sup>	2.0	2.1	2.0	2.0	1.9	1.9	1.9
<b>Five to ten year ahead expectations</b>							
<b>Households<sup>(c)</sup></b>							
Bank/Kantar	n.a.	3.3	3.4	2.6	2.8	2.9	2.9
YouGov/Citigroup	3.5	3.2	3.1	3.0	3.4	3.4	3.3
Financial markets <sup>(e)</sup>	3.0	3.4	3.4	3.4	3.5	3.5	3.5
<b>Memo: CPI inflation</b>							
	1.6	2.2	1.7	0.6	0.6	0.5	0.6

Sources: Bank of England, Bloomberg Finance L.P., CBI, Citigroup, Kantar, ONS, YouGov and Bank calculations.

- (a) Data are not seasonally adjusted.  
 (b) Averages from 2000, or start of series, to 2007. Financial market data start in October 2004, YouGov/Citigroup data start in November 2005 and external forecasters' data start in 2006 Q2.  
 (c) The household surveys ask about expected changes in prices but do not reference a specific price index.  
 (d) CBI data for the distributive trades sector. Companies are asked about the expected percentage price change over the coming 12 months and the following 12 months in the markets in which they compete.  
 (e) Instantaneous RPI inflation one and three years ahead and five-year RPI inflation five years ahead, derived from swaps.  
 (f) Bank's survey of external forecasters, CPI inflation rate three years ahead.

## Box B: Recent developments in mortgage rates

### Advertised rates on new mortgages, particularly at high LTVs, increased in 2020...

Advertised rates on new mortgages increased in the second half of 2020, particularly for high loan to value (LTV) lending. For example, the average quoted interest rates on two and five-year fixed-rate mortgages with a 90% LTV ratio increased at their peak by around 170 basis points, relative to January 2020. Those rates have declined somewhat since the start of this year, although they still remain significantly higher than a year ago (Chart A).

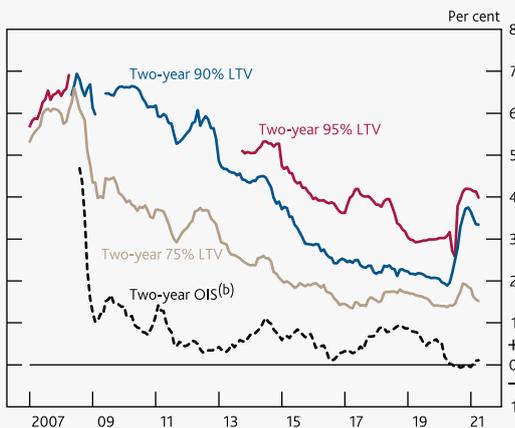
New mortgage rates were at historically low levels before the rise in rates occurred. Rates had been on a downward trend (Chart A), partly reflecting low risk-free interest rates and significant competition in the mortgage market. Competition in the market may have been amplified by the ring-fencing of major UK banks which separated retail banking services from other activities (see Box 2 of the [May 2019 Report](#)).

### ... while risk-free rates fell, leading to higher mortgage spreads.

The rise in new mortgage rates last year occurred against the backdrop of a fall in Bank Rate and wider risk-free rates, meaning that mortgage spreads widened. Spreads on two-year 90% LTV mortgages rose by around 230 basis points during 2020, while spreads on 75% LTV mortgages increased by around 110 basis points.

**Chart A: Quoted mortgage rates increased during 2020**

Average quoted rates on selected fixed-rate mortgages and the two-year OIS rate<sup>(a)</sup>

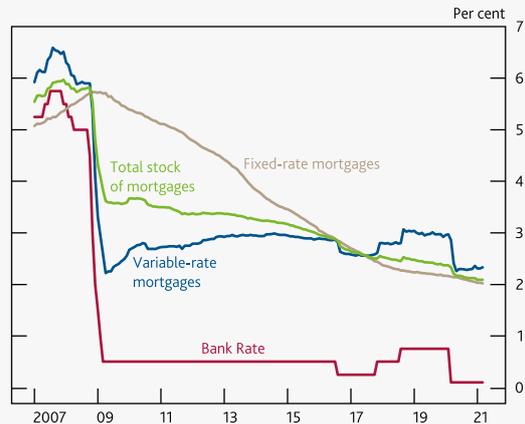


Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

- (a) The Bank's quoted rates series are weighted monthly average rates advertised by all UK banks and building societies with products meeting the specific criteria. In February 2019 the method used to calculate these data was changed. For more information, see ['Introduction of new Quoted Rates data – Bankstats article'](#). Latest quoted rates data are flash estimates for April using data to 27 April and are subject to change until publication on 10 May.
- (b) Monthly averages of two-year sterling overnight index swap (OIS) rates.

**Chart B: Rates on the stock of mortgages have fallen**

Bank Rate and effective interest rates on the stock of mortgages<sup>(a)</sup>



(a) The Bank's effective rate series are weighted monthly averages of rates from a sample of banks and building societies with products meeting the specific criteria. Data are not seasonally adjusted. Latest effective rates data are for March 2021.

### A riskier economic outlook and operational constraints in the face of higher demand pushed new mortgage rates higher...

Retail banks take a number of factors into account when pricing their mortgage loans, reflecting the costs and risks associated with their lending. These include credit risk charges, funding spreads, reference rates and other costs.<sup>(1)</sup> Surveys and supervisory intelligence suggest that two factors played a particularly important role in driving the increase in mortgage rates during 2020:

**Credit risk:** When pricing loans, banks take into account both the creditworthiness of the individual borrower, and the riskiness of the economic outlook. Over the past year, Agency and supervisory intelligence have highlighted lenders' concerns about the economic outlook and associated uncertainties about unemployment, borrower creditworthiness and house prices. In the *Credit Conditions Survey (CCS)*, banks reported that both the economic outlook and their risk appetite had been factors pushing down the availability of secured credit in 2020 Q2 and Q3. It is likely that these considerations led to a rise in the compensation demanded for the riskiness of mortgage loans, pushing up new mortgage rates. In addition, for high LTV mortgages, rates were also affected by some lenders exiting the market.

(1) For more information see Button, Pezzini and Rossiter (2010), ['Understanding the price of new lending to households'](#), *Bank of England Quarterly Bulletin*, 2010 Q3.

**Operational factors:** Demand for mortgages has been strong over much of the past year. Mortgage approvals for house purchase have been around 40% higher in the past three quarters than the average during 2019. In the face of this higher demand, and reflecting the impact of Covid, lenders faced operational constraints such as staff shortages, longer processing times and constraints on physical property valuations. These constraints were particularly apparent in the period after the first lockdown. They led some lenders to raise new mortgage rates in order to reduce the flow of mortgage applications, and to pare back the number of mortgage products on offer.

In addition to these factors, it is possible that part of the rise in new mortgage rates in 2020 reflected some lenders seeking to improve their net interest margins following a number of years of strong competition in the mortgage market and wider pressures on their overall net interest income.

With these factors pushing up on new mortgage rates, it is difficult to isolate the impact of the cut in Bank Rate in March 2020, which was supported by the Term Funding scheme with additional incentives for Small and Medium-sized Enterprises (TFSME). Nonetheless, it is likely that new mortgage rates would have been higher still in the absence of the easing in monetary policy.

For the existing stock of mortgages, the impact of Bank Rate on variable-rate products is clear: the average rate has fallen by around 65 basis points, in line with the fall in Bank Rate (**Chart B**). The average rate on fixed-rate mortgages has also fallen since January 2020. That may reflect people re-mortgaging onto lower fixed rates, as well as the changing composition of mortgages as banks moved away from higher LTV lending.

*...but these factors have begun to abate, and mortgage rates have declined this year.*

The CCS and intelligence gathered from supervisors and market contacts indicates that the influence of these factors has begun to ease in recent months. Indeed, new mortgage rates have declined during 2021 (**Chart A**). Rates on two-year 75% and 90% LTV mortgages have fallen by around 30 basis points and 40 basis points respectively since December 2020.

Despite a renewed increase in demand in the housing market following the extension of the property transaction tax holiday announced in March 2021, lenders are reporting increased operational capacity in order to manage the higher volume of mortgage applications. There has been an increase in the number of products on offer with most lenders returning to the high LTV market. Lenders also report a focus on retaining or increasing their market shares given competition in the market.

The observed fall in mortgage rates is also likely to reflect the improvement in the economic outlook (Section 1), which should reduce the compensation for credit risk required by lenders.

Conditional on risk-free rates evolving in line with the current yield curve (**Chart 2.6**), these factors could lead to some further reduction in mortgage rates and spreads in coming months.

## Box C: The impact of fiscal policy on the MPC's forecast

The MPC's projections are conditioned on the Government's tax and spending plans, as set out in *Budget 2021*. This box sets out how those plans have been incorporated into the MPC's forecast.

### *Since the start of the pandemic, the Government has loosened fiscal policy markedly...*

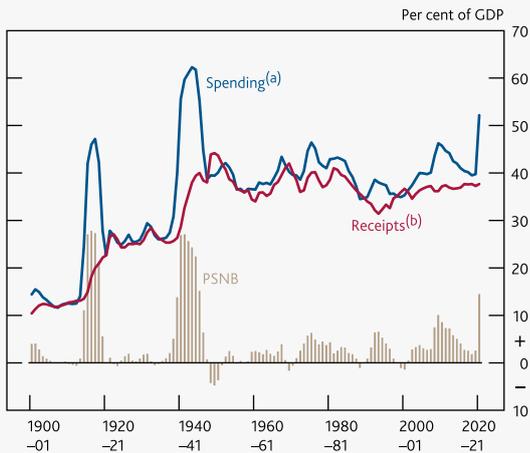
Fiscal policy has been loosened markedly since the start of the pandemic. Support for households totalled £80 billion in 2020–21, including the Coronavirus Job Retention Scheme (CJRS) and Self-Employment Income Support Scheme (SEISS), with a further £60 billion of support for businesses. Total government spending rose substantially as a share of GDP, while government receipts – mainly money paid in taxes – fell in cash terms, but were little changed as a share of output. As a result, public sector net borrowing (PSNB) was 14½% of GDP in 2020–21, the highest since the Second World War and a five-fold increase on 2019–20 (**Chart A**).

### *...and the March Budget set out plans for further temporary fiscal support in 2021–22.*

The measures in *Budget 2021* represent a further temporary loosening of fiscal policy in 2021–22 (**Chart B**). These include an extension to the CJRS and two further rounds of SEISS grants. Higher capital allowances will also allow investing firms to reduce the tax paid on their profits in 2021–22 and 2022–23. Further out, fiscal policy is tighter relative to previous plans, incorporating a rise in corporation tax rates and freezing of income tax thresholds. Bank staff have estimated the effects of these policies in different ways, as set out below.

**Chart A: Public sector net borrowing rose sharply in 2020–21 in response to the pandemic**

Government spending, receipts and borrowing since 1900

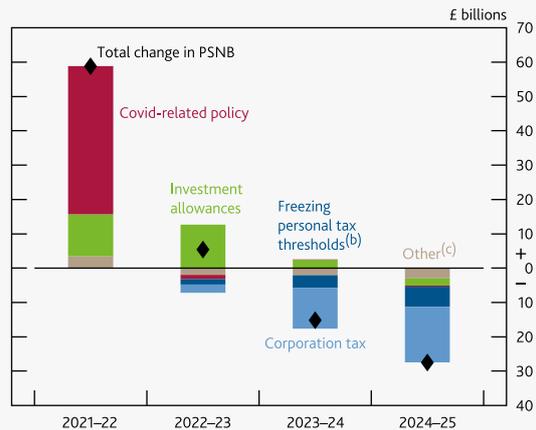


Source: Office for Budget Responsibility.

- (a) Total managed expenditure.  
(b) Public sector current receipts.

**Chart B: The near-term fiscal loosening in the March Budget largely reflects Covid-related policy changes**

Expected impact of *Budget 2021* policy measures on PSNB(a)



Source: Office for Budget Responsibility.

- (a) Positive numbers indicate higher borrowing.  
(b) Includes freezing income tax personal allowances and higher rate thresholds at 2021–22 levels.  
(c) Includes changes to departmental spending plans.

### *The CJRS and SEISS extension markedly reduces the MPC's near-term projection for unemployment.*

The CJRS and SEISS act as automatic stabilisers by reducing the impact of Covid on the labour market. CJRS claims tend to increase, for example, when Covid restrictions are put in place and activity falls (**Chart C**), supporting incomes and reducing job losses. To produce a forecast for the labour market under the schemes, Bank staff make judgements as to how firms' demand for labour – measured in hours worked – might evolve given the expected path of GDP and how much of that change will come from furlough, inactivity and unemployment.

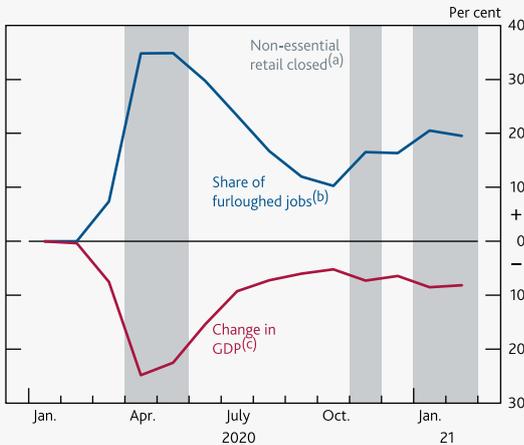
The downward revision to the MPC's projection for the unemployment rate in 2021 – which peaks at just under 5½%, compared with 7¾% in the February forecast – largely reflects the extension of the CJRS and SEISS in *Budget 2021*.

### *The capital allowance super-deduction is expected to support business investment in 2021 and 2022.*

By temporarily reducing the implied cost of capital in 2021 and 2022, the capital allowance super-deduction is expected to boost the level of business investment by around 10% at its peak, based on a similar estimation approach to the Office for Budget Responsibility (OBR). Decision Maker Panel (DMP) Survey responses are broadly consistent with that result and suggest larger effects in sectors that use a lot of assets that are eligible for the allowances

(Chart D). Some of the additional investment may be brought forward from future years, in which case investment could be lower further out. The corporation tax rise is also expected to weigh on investment towards the end of the MPC's forecast period.

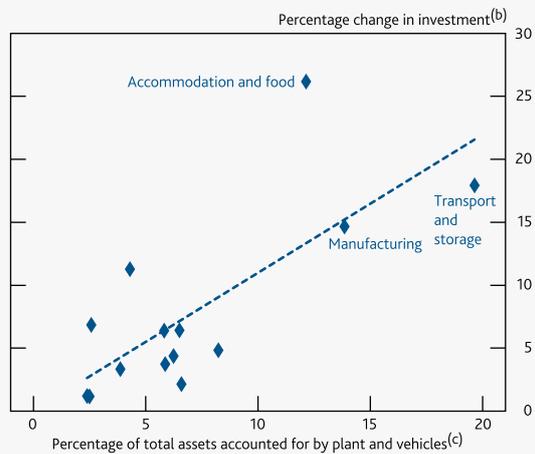
**Chart C: The CJRS has cushioned the impact on the labour market when output has fallen**  
Furloughed jobs and GDP



Sources: HMRC, ONS and Bank calculations.

- (a) Months where non-essential retail stores in England were closed for at least 20 days.
- (b) Number of jobs furloughed as a share of private sector jobs.
- (c) Change in GDP compared with its average level between October and December 2019.

**Chart D: Firms expect to increase investment over the next two years as a result of Budget 2021 tax changes**  
Impact of tax changes on investment over the next two years by sector<sup>(a)</sup>



Sources: DMP Survey and Bank calculations.

- (a) Question: 'Do you expect the corporate tax changes announced in the March 2021 Budget to affect your capital expenditure for the period between April 2021 and March 2023?'. Responses include investment brought forward due to tax changes. Dashed line shows line of best fit.
- (b) Percentage change in investment between April 2021 and March 2023.
- (c) Plant and vehicle assets as a percentage of total assets in 2019.

*Fiscal multipliers are used to estimate the impacts of other measures.*

The impacts of other measures in *Budget 2021* are estimated using 'multipliers', which capture the total effect of fiscal policy changes on GDP, including via indirect effects on private incomes and spending. These multipliers are based on a range of models, for example following the method proposed by [Blanchard and Perotti \(2002\)](#).

The multipliers vary according to the type of measure. Spending on benefits is expected to have a relatively large impact on output, for example, because recipients tend to spend a significant share of any extra money received. Some government investment could also encourage wider spending, for example if new transport links mean a firm chooses to build a new shop. These indirect effects may take time to materialise. If government investment rises by 1% of GDP, for example, the peak effect on total output – a boost of around ¾% – is generally expected to be seen two to three years ahead. The multipliers used in the MPC's forecast are broadly similar to those used by the OBR.<sup>(1)</sup>

Nonetheless, the impact of fiscal policy on output is particularly uncertain at present. There is some evidence effects could be larger than normal when there is spare capacity in the economy ([Auerbach and Gorodnichenko \(2015\)](#) and [Jordà and Taylor \(2016\)](#)). But some factors specific to the pandemic may mean the effect is smaller. Covid-related restrictions and voluntary social distancing may reduce the extent to which furloughed workers spend money received under the CJRS, for example. Government spending on items with a high import content such as personal protective equipment and Covid testing kits is also expected to have less of an impact on UK GDP.

*Budget 2021 measures are expected to boost GDP in the near term, but drag on growth further out...*

Since the start of the pandemic, looser fiscal policy has supported GDP. The measures in *Budget 2021* – excluding the impact of the CJRS and loan schemes – boost output in 2021 and 2022, with a peak estimated impact of ¾% on the level of GDP. The fall in Covid-related spending and other tightening measures then drag on growth further out.

*...while some tax changes lower the near-term inflation forecast relative to the February projection.*

Some tax changes in *Budget 2021* will affect inflation directly. The fuel duty freeze and extension of VAT reductions in the hospitality sector reduce the near-term inflation forecast by 0.1 percentage points, for example.

(1) See the November 2020 [Economic and fiscal outlook](#) for more details.

## Box D: What do the labour market data tell us about the rise in unemployment?

*According to the Labour Force Survey, employment has fallen by 650,000 and the unemployment rate has risen to 4.9% over the past year...*

According to the Labour Force Survey (LFS), employment was around 650,000 lower in the three months to February 2021 compared to a year earlier, and the unemployment rate has risen from 4.0% to 4.9% over the same period. However, given the sizable effect Covid has had on GDP (Section 2.2), the increase in unemployment seen so far has been relatively muted. In large part, this can be explained by the Government’s furlough scheme, which has kept workers attached to jobs (Section 2.3).

*...but there are uncertainties surrounding these estimates.*

As in other areas of the economy, labour market data have been challenging to collect during the pandemic. The ONS has changed the way it contacts people for initial LFS interviews, from face-to-face to telephone-based, in response to Covid. This change has reduced the overall response rate to the survey and also changed the mix of respondents. For example, the ONS has introduced housing tenure weights to help address the falling proportion of responses from households in rented accommodation.<sup>(1)</sup>

*The LFS unemployment rate is underpinned by stable employee numbers...*

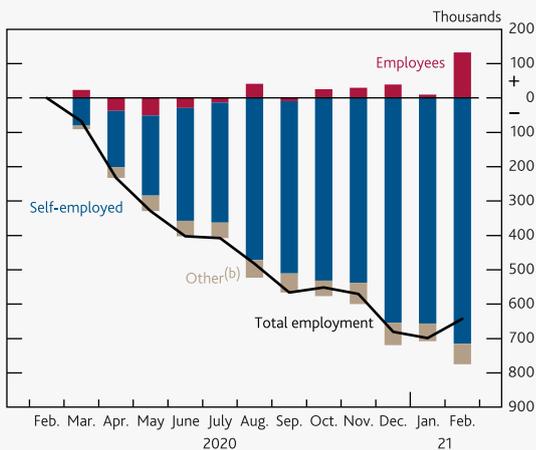
The number of employees recorded in the LFS has risen by more than 100,000 since February 2020 (Chart A). The fall of 650,000 in total employment during that time, has been driven almost entirely by falling numbers in self-employment.

*...but the HMRC payroll data, which the ONS suggests are the best single indicator, point to sizable falls.*

The ONS has suggested that data collected by Her Majesty’s Revenue and Customs (HMRC) on the number of employees on company payrolls are the best single overall indicator of the labour market at the moment.<sup>(2)</sup> According to HMRC, the number of employees on company payrolls has fallen by around 800,000 since February 2020 (Chart B). The Workforce Jobs survey suggests a fall of a similar scale and a range of other surveys, such as purchasing managers’ indices, also point to lower employee numbers.

**Chart A: Employee numbers have held up in the LFS, limiting the fall in total employment...**

Decomposition of changes in employment since the three months to February 2020<sup>(a)</sup>

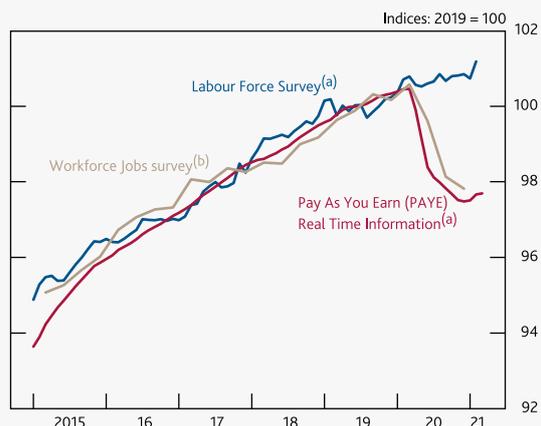


Sources: ONS and Bank calculations.

- (a) Three-month moving averages.
- (b) Unpaid family workers and those on government-supported training and employment programmes classified as being in employment.

**Chart B: ...but other sources show significant falls in employee numbers**

Number of employees



Sources: HMRC, ONS and Bank calculations.

- (a) Three-month moving averages. Latest data point from the Labour Force Survey is for the three months to February 2021. Latest data point for PAYE Real Time Information is the flash estimate for the three months to March 2021.
- (b) Data are quarterly. Latest data point is for 2020 Q4.

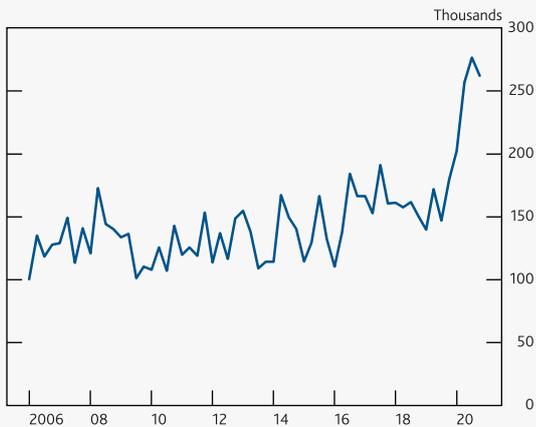
(1) See 'Coronavirus and its impact on the Labour Force Survey' for more details.  
 (2) See 'Painting the full picture: what our statistics tell us about the labour market' for more details.

*Some of the difference between the LFS and HMRC employee numbers may be explained by factors which do not affect the LFS unemployment rate...*

One of the reasons the LFS estimate of employees has been stable is that it has been supported by a large pickup in the inflow of workers from self-employment over the past few quarters, to almost double usual levels (Chart C). The ONS has suggested that this might be driven by people who have not changed jobs but have changed how they perceive their employment status during the pandemic.<sup>(3)</sup> Bank staff estimate that such a reclassification between self-employed and employee status could account for just over a third of the difference between HMRC and LFS employee numbers. This would mean that more of the fall in total employment in the LFS could have been accounted for by employees, and less by self-employed workers. But as both categories contribute to total employment, it would not affect the headline LFS employment or unemployment rates.

**Chart C: LFS employee numbers have been boosted by large inflows from self-employment**

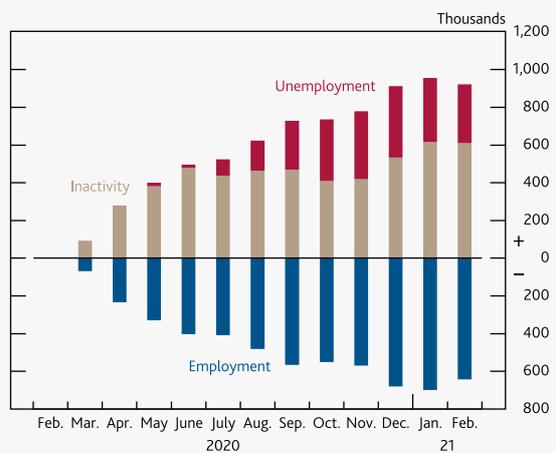
Flows from self-employed to employee<sup>(a)</sup>



(a) Two-quarter flows, not seasonally adjusted. Based on employment of people aged 16–64. Employees include unpaid family workers and those on government-supported training and employment programmes classified as being in employment. Data are to 2020 Q4.

**Chart D: The fall in employment has been reflected largely in rising inactivity, and less in unemployment**

Changes in employment, unemployment and inactivity since the three months to February 2020<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) Changes do not sum to 0 as the population is estimated to have increased during the period.

Population estimates used in the LFS may also help to explain some of the gap between the LFS and HMRC figures. The LFS employee numbers are calculated by scaling the percentage of employees derived from survey responses to the size of the UK population, which has been more uncertain than usual during the pandemic. The population size currently underlying the LFS employee numbers is based on an estimate of population growth made before the pandemic. The International Passenger Survey – the main source for migration data – has been suspended during the pandemic, but other sources suggest that the number of foreign-born UK residents has fallen recently. The ONS has recently published an early indicator of the size of the UK population in 2020, pointing to negative net migration in 2020 Q2 and a smaller rise in population numbers by mid-2020 than previously projected.<sup>(4)</sup> This suggests that the population, and therefore the number of employees, may be a little smaller than the estimate used in the LFS.

Measurement of the population is expected to have only a small effect on the LFS employee numbers. It would explain around 200,000 of the gap with HMRC employee numbers, using estimates consistent with ONS analysis of HMRC Real Time Information data.<sup>(5)</sup> But, according to ONS analysis, this should not affect the proportions in the LFS, such as the unemployment rate.<sup>(6)</sup> Consistent with that, Bank staff analysis suggests that the employment characteristics of those leaving appeared similar to those who have stayed.

*...but the remaining gap suggests that the unemployment rate may be higher than recorded in the LFS.*

Bank staff estimate that the effects of the movements from self-employed to employees and potential overestimates in population size can reconcile some of the difference between the number of employees recorded in the LFS and the HMRC data. Nonetheless, a gap of around 400,000 remains. While there are considerable uncertainties surrounding

(3) See 'Painting the full picture: what our statistics tell us about the labour market' for more details.

(4) See 'Early indicators of UK population size and age structure: 2020' for more details.

(5) See 'Coronavirus and the impact on payroll employment: experimental analysis' for more details.

(6) See 'Understanding the impact of Covid-19 on UK population' for more details.

the precise size of that estimate, it suggests that the LFS data might not be reflecting the full extent of the fall in employment during the pandemic.

It is difficult to estimate exactly how this larger fall in employment would translate into unemployment. Some of those who lost their jobs will not be searching for a new one currently, and so would be classified as inactive, rather than unemployed. There has been a material increase in the number of people recorded as inactive since February 2020. The fall in LFS employment was initially matched around one-for-one by increases in inactivity (**Chart D**). This is materially larger than would be expected based on past episodes of falling employment, probably due to the difficulty of searching for work during lockdown. Nonetheless, if employment has fallen by more than suggested by the LFS – and at least some of those people are searching for work – unemployment could be higher than estimated in the LFS.

*Irrespective of the uncertainty around the precise unemployment rate, the MPC judges that slack in the labour market is larger than implied by that rate alone.*

The HMRC data and other evidence suggest employment has probably fallen – and unemployment risen – by a little more than suggested by the LFS. Regardless, there is likely to be more slack in the labour market than implied by the unemployment rate alone. For example, evidence from experimental LFS data suggests that around 10% of furloughed workers are actively seeking work and so they are likely to represent a form of labour market slack, despite being classified as employed. There are also signs of underemployment among those that remain in work (Section 3). In addition, some of those who are recorded as inactive in the latest LFS data may begin to start searching for work as restrictions are eased, and this is expected to push up the unemployment rate a little in Q2 (Section 2.3).

## Box E: Agents' update on business conditions

The key information from Agents' contacts considered by the Monetary Policy Committee at its May meeting is highlighted in this box. The information was mostly gathered before restrictions to contain the spread of Covid began to be lifted in some parts of the UK.

### *Consumer spending remained weak compared with a year ago, but demand is expected to pick up quickly as Covid restrictions are phased out.*

Covid restrictions meant that non-essential retail and businesses in the hospitality, tourism and leisure sectors were closed in many places until mid-April, depressing sales. However, online retail, and sales of household goods remained strong. In general, contacts expected spending to increase over the rest of the second quarter and into 2021 Q3, as restrictions are lifted around the UK, and confidence is supported by the vaccine programme.

Reports from contacts in parts of the UK where non-essential retail was permitted to reopen from 12 April indicated that footfall increased rapidly in the first few days of trading. Restaurants and pubs with outdoor space and personal care businesses – such as hairdressers and beauty salons – also reported strong bookings ahead of reopening.

Demand for domestic holidays was reported to be much higher than pre-Covid levels, but bookings of overseas holidays weakened as consumers awaited more clarity on the restrictions on foreign travel. Restrictions on international travel in other countries were also expected to weigh on inbound tourism to the UK this year.

There were some signs of supermarket sales growth beginning to weaken, although this reported fall in annual growth mainly reflected base effects from a year ago when sales had been driven up by some panic buying during the first lockdown. Contacts expect sales growth to continue to ease as restrictions in the hospitality sector are lifted.

### *Activity in business services, manufacturing and construction continued to recover.*

For many business services firms, activity was close to pre-Covid levels. This was particularly the case for professional services firms – for example, accountancy work relating to taxation and mergers and acquisitions, and IT services relating to remote working and digitalisation. In contrast, activity relating to business travel, corporate hospitality and events, and marketing and advertising, remained markedly below pre-pandemic levels.

Logistics contacts said that although disruption at the border with the EU had eased since the start of the year, the new border and customs requirements were weighing on activity. Some UK exporters reported setting up distribution operations in the EU in order to be able to meet customer demand in continental Europe. And companies continued to report severe disruption to the transportation of goods to Northern Ireland from Great Britain – in particular for animal products and other foodstuffs.

Manufacturing output continued to improve, as customers rebuilt stocks that had been run down during the first few months of 2021, although it still remained slightly below its level in early 2020. Some contacts reported that demand from EU customers had returned to normal levels, and that demand from the US, China and Australia had risen.

Packaging manufacturers and those supplying the construction industry reported strong output growth. By contrast, restrictions on travel and hospitality continued to depress output in the civil aviation and food and drink sectors. In some sectors, for example the automotive industry, output was constrained by delays to imported materials and components.

Construction output improved modestly, supported by public infrastructure projects and private house building. Demand for logistics and warehousing facilities remained strong, but the pipeline for private commercial development was weak overall, in particular for office and hospitality premises.

Housing market activity was strong, in particular for people wanting to move out of cities to larger properties. Buyer confidence was supported by government measures to increase the availability of high loan to value mortgages and the extension of the transaction tax holiday in some parts of the UK. But the supply of properties available for

purchase remained constrained, pushing up house price growth. Contacts also reported a shortage of rental properties around most of the UK, although the rental market in London had cooled.

Contacts in commercial real estate reported lower levels of investor activity than normal, especially for some types of retail property. But demand for industrial and logistics property remained strong among investors and tenants. A large proportion of contacts said they expect to reduce their use of office space, particularly in areas where rents are high, such as London. Valuations for office premises appeared to be holding up, however, which may be linked to the fact that tenancy changes are generally made when leases expire.

*Companies expect to increase investment spending over the coming year.*

Contacts in several sectors said they expected to resume investment projects that had been put on hold during the pandemic, though that would be largely dependent on the extent to which demand and revenues pick up this year. Investment plans varied by sector, but generally companies reported spending on digitalisation, automation, upgrading machinery, and on research and development. Some consumer services contacts reported investing in refurbishment or expansion in preparation for reopening when Covid restrictions are lifted.

A number of contacts said they had been encouraged to bring forward investment plans in response to the Government's capital allowance super-deduction, which reduces the tax bill for companies that invest in plant and machinery.

*Demand for bank credit from large businesses was subdued, but it was higher for SMEs as they prepared to reopen.*

For the largest businesses, demand for bank credit was subdued as they were generally able to raise funds from financial markets. For some small and medium-sized enterprises (SMEs), the most recent Covid restrictions and the costs incurred in preparing to reopen had led to a modest increase in demand for finance.

Bank credit was readily available in stable and growing sectors, though some smaller businesses and those in sectors that have been most affected by the pandemic continued to report tight credit availability.

Companies in most sectors reported having large cash reserves, although contacts in hospitality and non-essential retail reported depleting cash buffers. Contacts said that while various government support schemes had helped to limit corporate failures to date, concerns remained of a rise in corporate distress later in the year as deferred payments fall due.

*Employment intentions continued to improve, but pay settlements remained subdued.*

Contacts across a range of sectors said that reductions to head count had largely been completed, and a growing minority of companies reported hiring again. Companies in the hospitality and leisure sector said the employment outlook remained very uncertain and would depend on how demand evolves in the coming months, though the extension of the Coronavirus Job Retention Scheme would help in the short term. In general, companies reported having little trouble recruiting, though it continued to be difficult to find professional staff or those with specialist skills, in particular in IT, engineering and logistics.

Pay awards generally remained subdued, with contacts commonly reporting settlements of 1.5%–2%. However, there were fewer reports of pay freezes. Where bonuses were being paid, these were generally lower than a year ago.

*Materials and freight costs increased, but there had been little pass-through to consumer prices so far.*

Increases in the cost of materials and commodities were reported to have become more broadly based, although some cost pressures were expected to abate later in the year. Freight costs continued to be high for imported goods. Container costs had already been elevated and contacts said that the Suez Canal blockage in March would prolong this.

Costs were increasingly being passed through into manufacturers' output prices, but so far there had been limited pass-through to consumer prices. Contacts said that uncertainty about demand was likely to limit price changes in some parts of the hospitality and tourism sectors. In the supermarket sector, strong competition has helped to contain food price inflation, but contacts thought cost pressures might lead to higher prices later this year.

# 3: In focus – Supply and spare capacity

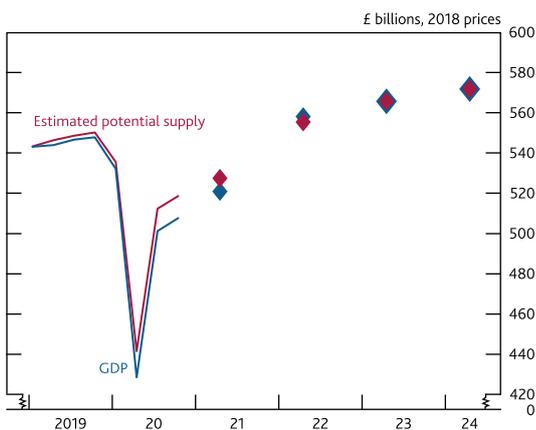
Covid-19 (Covid) and the public health measures to contain it have led to a sharp fall in both demand and supply. The magnitudes of these falls, and the unusual nature of the shock, have made it more difficult than usual to gauge the degree of spare capacity in the economy. Overall, the MPC judges there to be some spare capacity at present. As restrictions on activity ease, both demand and supply are expected to recover sharply. At the end of the forecast period, demand and supply are projected to be broadly in balance. There are large risks around these projections, however.

An economy’s potential supply capacity depends on the amount of existing labour and capital, as well as the efficiency with which businesses can combine them. It determines the level of output an economy can sustain without generating excess inflationary pressure. Movements in supply tend to be slow, largely determined by structural factors such as technological progress, capital accumulation and the size and skills of the labour force. Covid and the public health measures to contain it have led to a very large contraction in supply, however (Chart 3.1), as some businesses have temporarily ceased trading and workers have been furloughed (Chart 3.2).

The sharp fall in supply has occurred alongside a sharp reduction in demand (Section 2.2). The scale of these falls has made the degree of spare capacity – the difference between actual GDP and potential supply – difficult to gauge at present. Spare capacity matters for monetary policy because it affects costs and prices.

Section 3.1 in this *In focus* sets out recent developments in supply and assesses the signal that a range of indicators are giving about the current level of spare capacity in the economy. Section 3.2 sets out how supply and spare capacity are expected to evolve over the forecast period and the key risks around them.

**Chart 3.1: Supply is estimated to have fallen sharply alongside GDP since the onset of the pandemic**  
GDP and estimated potential supply<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) Diamonds are projections for 2021 Q2, 2022 Q2, 2023 Q2 and 2024 Q2. The profile for GDP is an MPC projection. The profile for estimated potential supply is estimated using the MPC’s projection for the level of GDP and the level of the output gap published in Table 1.A. Data include the backcast for GDP. For further information on MPC projections, see Table 1.A.

**Chart 3.2: A significant proportion of businesses have paused trading and jobs have been furloughed**  
Status of businesses and private sector jobs reported in 2021 Q1<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) Average of waves 22–26 of the ONS Business Insights and Conditions Survey.

### 3.1: Recent developments in supply and spare capacity

*Standard approaches for estimating potential supply capacity are difficult to use at present due to Covid-related factors...*

Estimates of an economy's potential supply capacity and spare capacity are inherently uncertain at all times (Tenreyro (2019)), as, unlike GDP, they cannot be observed directly. In the past, the MPC has used a range of statistical filters when assessing the supply capacity of the economy (Section 4 of the *January 2020 Report*). These filters often use well-established macroeconomic relationships between key variables, such as GDP, unemployment and inflation (Melolinna and Tóth (2016)), to separate changes in actual output into a trend and cyclical component, with that trend often interpreted as a measure of the economy's potential supply capacity. Over the past year, a number of Covid-related factors have altered these relationships, making these models difficult to use at present. For example, unemployment has risen by much less than would have been expected based on its historical relationship with GDP, because of the introduction of the CJRS.

*... which have led to a sharp but temporary reduction in the supply capacity of the economy.*

It is clear that Covid and the public health measures taken to contain it have led to a very sharp reduction in the supply capacity of the economy (Chart 3.1). For example, a substantial proportion of firms have paused trading (Chart 3.2) and others have reduced capacity to allow for greater social distancing. This fall in supply needs to be taken into account when assessing the current level of spare capacity and the prospects for inflation in the near term. For example, companies which are currently closed are not likely to be exerting downward pressure on prices. But much of this decline in the economy's supply capacity will only be temporary, as it will recover as restrictions ease and many firms reopen.

As companies' output has fallen, many have furloughed part of their workforce, with around a fifth of private sector jobs reported to have been furloughed under the CJRS in 2021 Q1 (Chart 3.2). Most furloughed workers are assumed not to be searching for jobs – experimental data from the LFS suggest that only around 10% were actively searching for work in the second half of 2020 – and so are probably not exerting the same degree of downward pressure on wages as the unemployed would. However, most should return to work as demand recovers, and so they currently represent a temporary fall in the supply of labour.

Covid may also have temporarily lowered the productivity of firms still operating. First, many businesses have had to make adjustments in order to accommodate social distancing guidelines, which will reduce productivity while they are in place. For example, many consumer-facing businesses have reduced the number of customers they can serve at any one time. Second, Covid has led to some disruption in trade – for example, because of Covid-related border restrictions. Third, enforced working from home probably lowered productivity in the early stages of the pandemic as businesses and employees adjusted to new working practices. All of these effects may have dissipated as Covid-related restrictions have eased and businesses and employees have adapted. And to the extent that they have persisted, they might have been offset by positive Covid-related effects on productivity. The pandemic may have encouraged increased digitalisation, for example, which could improve efficiency.

Taken together, these factors point to a substantial fall in the supply capacity of the economy (Chart 3.1), which should dissipate as Covid-related restrictions ease (Section 3.2). The sharp movements in both demand and supply make the degree of spare capacity difficult to judge, so the remainder of this section looks at the signal from various indicators of slack.

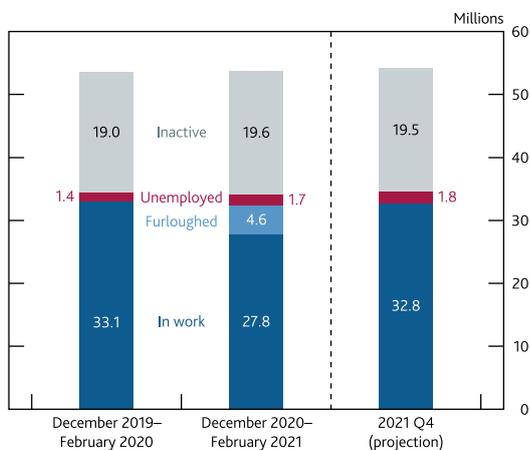
*Various indicators point to slack in the labour market.*

The unemployment rate has risen by just under 1 percentage point since February 2020, to 4.9% in the three months to February 2021 and, as described in Box D, there are reasons to suggest it may be higher than recorded in the LFS. The degree of downward pressure exerted on wages by higher unemployment depends on how it evolves relative to the medium-term equilibrium rate of unemployment (see Box 4 of the *February 2018 Report*). That equilibrium can be affected by temporary cyclical factors (Crump *et al* (2019)). For example, long-term unemployment typically rises during a recession and those people tend to exert less downward pressure on wages (Gordon (2013)). Since the onset of the pandemic, the number of people out of work for over six months has increased by over a third, which might point to some increase in equilibrium unemployment. But other research finds circumstances where the long-term unemployed still play an important role in determining wage pressure and inflation (Speigner (2014) and Kiley (2015)). Overall, the MPC judges that most of the rise in unemployment to date represents an increase in slack.

Various data also suggest that slack in the labour market is greater than suggested by the unemployment rate alone. First, as highlighted above, experimental data from the LFS suggest that around 10% of furloughed workers have been seeking work and therefore represent a form of labour market slack. Moreover, those workers who have been furloughed for longer periods may be more likely to search for work, so this proportion could increase in the near term as the scheme continues. Second, there has been a significant rise in the number of people recorded as inactive – people who do not have a job but are not currently actively searching for one (Chart 3.3). These people also represent a form of slack to the extent that firms take them into account when setting wages. Third, there are signs of spare capacity among those that remain in work. There has been a rise in the proportion of part-time workers that have been unable to find a full-time job, as well as a rise in the proportion of temporary workers who cannot find a permanent job (Chart 3.4). Finally, experimental data from the LFS suggest that there has been a slight rise in the desired hours of non-furloughed workers. This would suggest that the average hours of those in work could increase with little accompanying upward pressure on wages.

**Chart 3.3: The rise in unemployment has been limited by the introduction of furlough and a rise in inactivity**

Working-age population by employment status<sup>(a)</sup>

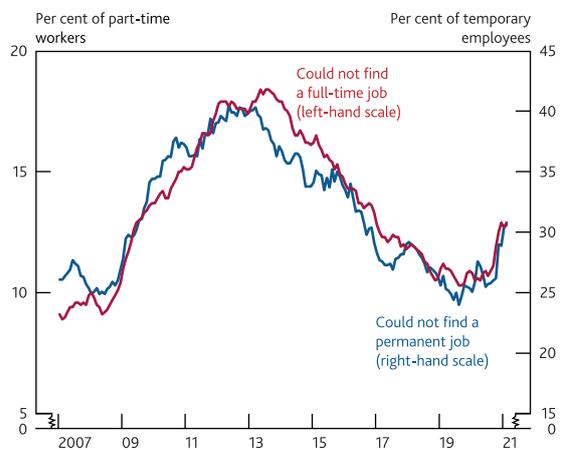


Sources: ONS and Bank calculations.

(a) 16+ population. December 2020–February 2021 figures for 'furloughed' and 'in work' are Bank staff estimates based on analysis of the LFS and administrative data.

**Chart 3.4: Some measures of underemployment have picked up**

Selected measures of underemployment



### Survey measures of spare capacity within firms are hard to interpret.

There could also be spare capacity within companies if capital is underutilised. While most survey measures suggest that there is some slack within firms (Chart 3.5), these indicators are difficult to interpret at present. Some of the surveys measure firms' operations relative to 'normal' capacity, and so might be comparing their output to a period without restrictions on activity. Similarly, Agency intelligence suggests that companies often include furloughed workers when thinking about their spare capacity. As restrictions are eased, and companies can reopen and return to normal levels of production, those employees can return to work. At present, however, these indicators might overstate the degree of slack that is relevant for thinking about near-term inflationary pressures.

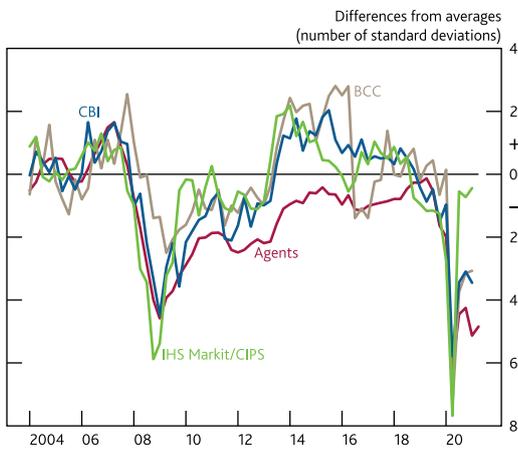
### Price-based indicators generally suggest that there is some spare capacity.

Price-based indicators can also provide signals regarding the level of spare capacity in the economy. For example, wage growth helps gauge the degree of slack in the labour market. Official measures of average wages have risen strongly in recent months and are now above pre-pandemic levels. Compositional effects make these data difficult to interpret at present, however. Other indicators suggest more modest pay pressures (Section 2.3).

The rate of inflation can also be indicative of the overall level of spare capacity in the economy. Excluding the estimated impact of changes in VAT, core CPI inflation was around 0.1 percentage points lower in March 2021 than December 2019 – a small fall relative to the sharp decline in output (see Section 4 of the February Report). This masks offsetting movements between goods and services inflation, however (Chart 3.6). Core services inflation, which focuses on a subset of the CPI basket that is largely domestically produced and so is therefore less affected by movements in the exchange rate, can be particularly useful for gauging domestic inflationary pressure. This has fallen by around 0.3 percentage points over the same period. Other measures of services price inflation, such as median services CPI inflation, have also declined.

Taken together, developments in pay and inflation are consistent with a degree of spare capacity. A model based on typical business cycle dynamics since 1997 suggests that, given developments in GDP, recent movements in pay and inflation are consistent with some spare capacity in the economy at the end of 2020.

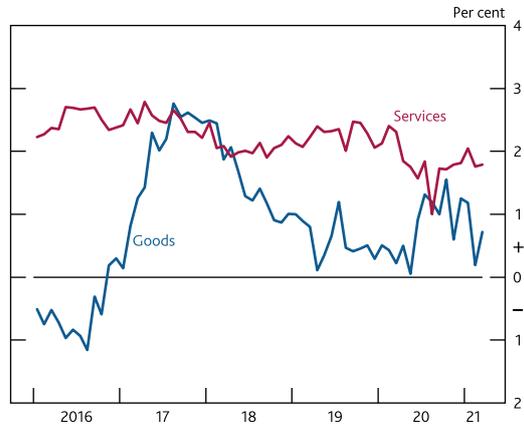
**Chart 3.5: Some surveys suggest spare capacity within firms, but these are hard to interpret at present**  
Survey indicators of capacity utilisation<sup>(a)</sup>



Sources: Bank of England, BCC, CBI, CBI/PwC, IHS Markit/CIPS, ONS and Bank calculations.

(a) Differences from averages between 2000 and 2007. Measures are from the Bank’s Agents, the BCC (non-services and services), the CBI (manufacturing – capacity; business/consumer/professional services and distributive trades – business relative to normal) and IHS Markit/CIPS (manufacturing – backlogs; services – outstanding business). Sectors are weighted using shares in gross value added. The BCC data are not seasonally adjusted. The Agents’ data for 2021 Q2 are April scores.

**Chart 3.6: Core services inflation has fallen since late 2019**  
Core services and core goods CPI inflation, excluding VAT<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) Core services CPI excludes airfares, package holidays and education. Core goods CPI excludes energy, food, non-alcoholic beverages, alcoholic beverages and tobacco. Bank staff have adjusted for the estimated direct impact of changes in VAT and there is uncertainty around the precise impact of that adjustment.

*Taken together, the MPC estimates that potential supply has fallen by somewhat less than the decline in demand, such that there is currently spare capacity in the economy.*

To summarise, potential supply is estimated to have fallen sharply alongside the decline in demand. GDP has been stronger than expected over the recent past, and it is judged that potential supply has also held up better than previously projected. Temporary adverse effects on productivity – for example, through enforced work from home – may have been smaller than expected. Assessing the difference between demand and supply is difficult, given the size of the falls and the unusual nature of the shock. Consistent with a range of quantity and price-based indicators, the MPC judges that there is currently spare capacity in the economy. But the uncertainty around the degree of spare capacity is greater than usual at present.

### 3.2: How are supply and spare capacity expected to evolve over the forecast?

*Potential supply capacity is expected to recover materially over the first year of the forecast, as many of the adverse effects on supply from the pandemic dissipate.*

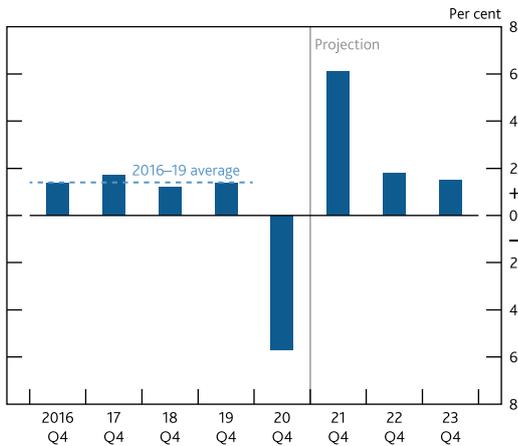
The vaccination programme is expected to lead to an easing of Covid-related restrictions, such that many of the factors that have been weighing on potential supply are expected to fade over the next year. Many firms that have been closed temporarily are expected to reopen, and the majority of employees who have been on furlough are expected to return to work (Chart 3.3). As a result, potential supply is projected to pick up very sharply over 2021 (Chart 3.7).

*Demand is also projected to recover markedly such that spare capacity is eliminated by the end of 2021, and a temporary period of excess demand follows.*

Demand is also expected to recover rapidly over 2021, as a decline in health risks and a fall in uncertainty boost consumption and business investment. Demand is further bolstered by the continued effects of fiscal and monetary stimulus. This is expected to lead to a margin of excess demand emerging in 2021 Q4. Firms are expected to meet some of the recovery in demand by working their existing labour and capital somewhat harder. For example, average hours are expected to rise. Firms are also expected to increase hiring. The unemployment rate is expected to rise a little in the near term to a peak of just under 5½% in 2021 Q3, however, as not all furloughed employees return to work and as the higher-than-usual flows into inactivity seen while social distancing measures were in place begin to unwind.

**Chart 3.7: Supply growth is expected to pick up sharply in 2021, before slowing further out**

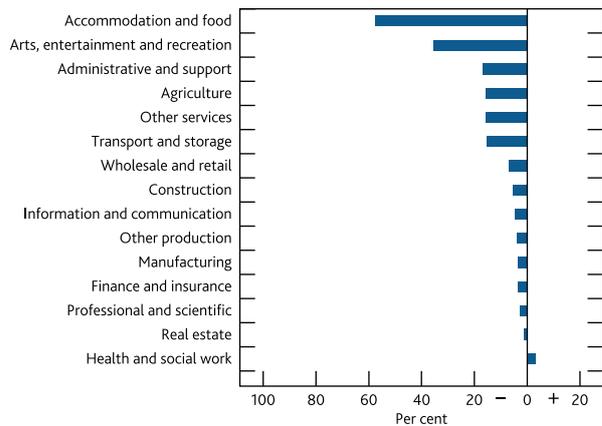
Four-quarter growth in estimated potential supply<sup>(a)</sup>



(a) Bank staff estimates for 2016–20. Bars for 2021, 2022 and 2023 are projections consistent with the MPC’s forecast.

**Chart 3.8: The pandemic has affected activity more in some sectors than others**

Change in output between 2019 Q4 and February 2021, by sector



Sources: ONS and Bank calculations.

*Potential supply continues to grow over the rest of the forecast period, albeit at a much slower pace...*

While the pace of growth slows from the rapid rates expected over the coming year, potential supply is expected to continue to rise over the remainder of the forecast period. Towards the end, potential supply growth returns to the relatively subdued rates seen before Covid (Chart 3.7), reflecting underlying trends in the growth of the capital stock, labour supply and productivity.

*...and there are some scarring effects from Covid on the level of potential supply.*

At the end of the forecast period, the level of potential supply is somewhat lower than what it would have been had it continued to grow at its pre-Covid pace. That partly reflects persistent effects from Covid: the level of supply capacity is expected to be around 1¼% lower than it would have been in the absence of the pandemic by the end of the forecast period.

The scarring effects from Covid on supply predominantly reflect the impact on productivity. Business investment growth has been weak over the past year, lowering the capital stock relative to what it would have been in the absence of the pandemic. Lower investment is also expected to have reduced growth in ‘total factor productivity’ – the efficiency with which labour and capital are combined – a little. In addition, workers that were made unemployed or were furloughed during the pandemic will not have gained the skills that they usually would have done while working, and that is expected to weigh on productivity somewhat when they return to work.

The persistent impact of Covid on supply is expected to be a little lower than assumed previously. In the *February Report*, it was expected that there would be some temporary mismatch between the skills of those that had been made unemployed during the pandemic and the sectors with vacancies. The extension of the CJRS to end-September, when social distancing restrictions are expected to have been relaxed, has materially reduced the projected rise in unemployment. As a result, more matches in the labour market are likely to be maintained. The higher projection for investment is also likely to boost productivity growth, all else equal.

*Demand growth also slows, such that demand and supply are broadly in balance at the end of the forecast period.*

Demand growth slows over the latter part of the forecast period, as the boost from easing health risks, reduced uncertainty and fiscal stimulus fade, and some fiscal consolidation begins. Demand grows a little more slowly than supply, such that excess demand gradually diminishes before demand and supply return broadly to balance.

*There are two-sided risks to the outlook for potential supply growth, and uncertainties around the evolution of spare capacity.*

The MPC judges that there are two-sided risks to the forecast for potential supply growth over the medium term (Section 1). On the upside, the pandemic may have encouraged greater investment in, and use of, digital technologies, as evidenced by the shift to online sales. That may boost productivity. On the downside, there is a risk that the pandemic leads to material persistent changes in the structure of the economy. The impact of Covid has varied substantially across different sectors, with many 'contact-intensive' sectors such as accommodation and food experiencing particularly sharp falls in output compared to others (**Chart 3.8**). If this sectoral dispersion persists, it is possible that frictions in the reallocation of labour and capital across different sectors could weigh on supply growth.

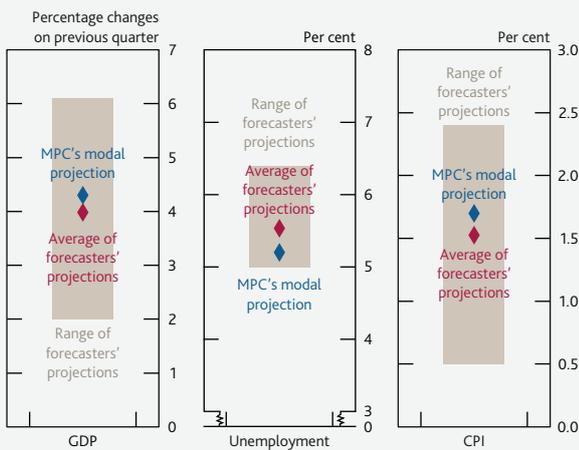
Given that movements in demand and supply are expected to continue to be relatively large (**Chart 3.1**), particularly during the near-term recovery, the difference between them will remain difficult to judge. That means that the degree of spare capacity will remain uncertain for some time.

## Annex 1: Other forecasters' expectations

This annex reports the results of the Bank's most recent survey of external forecasters. Expectations for the near term are summarised in **Chart A**, and those for further out are shown in **Table 1** and **Chart B**.<sup>(1)</sup>

On average, external forecasters expected GDP to rise by 4% in 2021 Q2 (**Chart A**). The unemployment rate was expected to rise to 5.5% and CPI inflation was expected to be 1.5%. The range of projections remains wide.

**Chart A: On average, external forecasters expect GDP to rise by 4% in 2021 Q2, the unemployment rate to rise to 5.5%, and CPI inflation to increase to 1.5%**  
Other forecasters' central projections for GDP, the unemployment rate and CPI inflation in 2021 Q2



**Table 1: Averages of other forecasters' central projections**

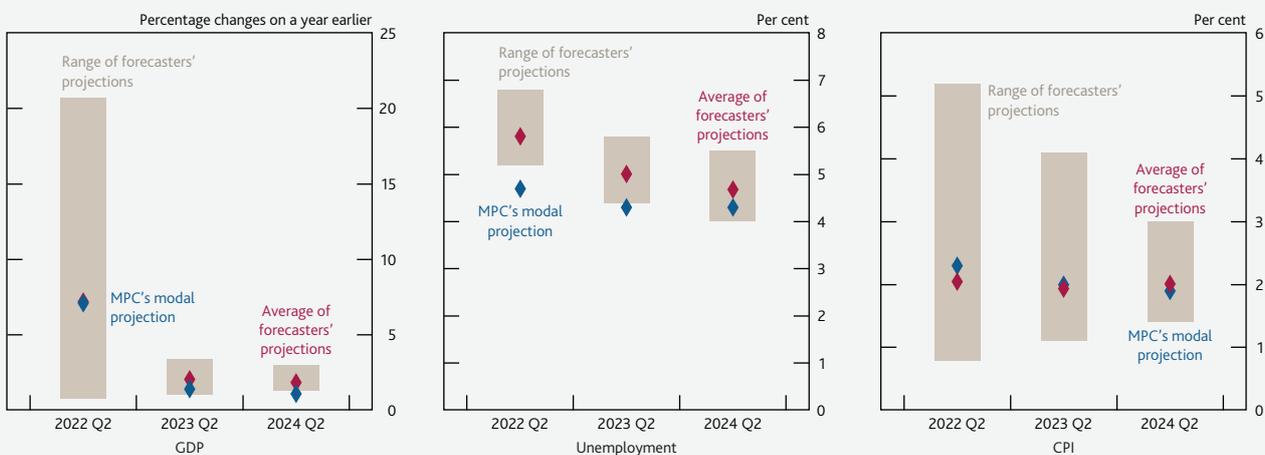
	2022 Q2	2023 Q2	2024 Q2
GDP growth <sup>(a)</sup>	7.2	2.0	1.9
CPI inflation <sup>(b)</sup>	2.0	1.9	2.0
LFS unemployment rate (per cent)	5.8	5.0	4.7
Bank Rate (per cent)	0.2	0.5	0.8
Stock of purchased gilts (£ billions) <sup>(c)</sup>	879	881	880
Stock of purchased corporate bonds (£ billions) <sup>(c)</sup>	19	20	20
Sterling ERI <sup>(d)</sup>	81.2	80.8	80.3

(a) Four-quarter percentage change.  
 (b) Twelve-month rate.  
 (c) Original purchase value. Purchased via the creation of central bank reserves.  
 (d) Index: January 2005 = 100.

On average, respondents expected GDP growth of 7.2% in the four quarters to 2022 Q2. Four-quarter GDP growth is then expected to fall back to just below 2% by 2024 Q2, a little higher than in the MPC's modal forecast (left panel, **Chart B**). The unemployment rate is expected to fall steadily from 5.8% in 2022 Q2 to below 5% by 2024 Q2 (middle panel, **Chart B**). CPI inflation is expected to return to the target by 2022 Q2, and remain close to 2% during the rest of the forecast period (right panel, **Chart B**).

On average, external forecasters expected the stock of purchased assets to remain broadly unchanged over the next three years (**Table 1**).

**Chart B: At the three-year horizon, external forecasters expect GDP growth to be just below 2%, the unemployment rate to be below 5%, and inflation to be at the MPC's 2% target**  
Projections for GDP, the unemployment rate and CPI inflation



(1) For detailed distributions, see 'Download the chart slides and data' link at [Monetary Policy Report – May 2021](#).

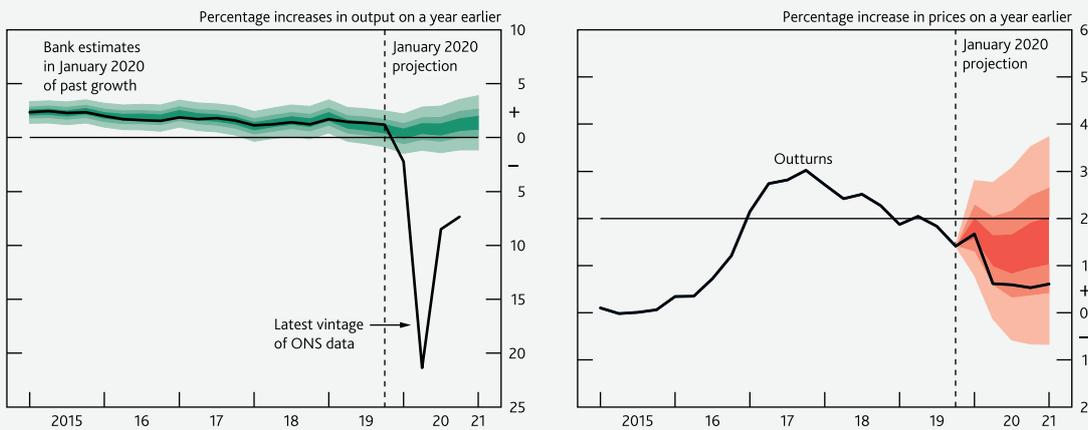
## Annex 2: How has the economy evolved recently relative to the MPC's projections?

On an annual basis, the MPC sets out how the economy has evolved relative to its forecasts.<sup>(1)</sup> Recent forecast errors almost entirely reflect the unexpected impact of Covid, so the lessons from these differences are limited.

Annual GDP growth in 2020 Q4 was around 9 percentage points weaker than expected in the *January 2020 Report* (**Chart A**), the last forecast made before Covid spread widely in the UK. Both household consumption and business investment were much weaker than expected as some businesses closed for a period and social distancing measures materially dampened consumer spending. Weakness in GDP was in evidence in many economies around the world.

**Chart A: Reflecting the impact of Covid, GDP growth and CPI inflation were lower than in the MPC's January 2020 projections**

GDP and CPI inflation outturns and projections in the *January 2020 Report*<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) For the conditioning assumptions on which the January 2020 projections were based, see the footnotes to Table 1.A of the *January 2020 Report*. See footnotes to **Charts 1.1, 1.2** and 1.4 of this *Report* for information on how to interpret the fan charts.

Also reflecting the effects of Covid, CPI inflation dipped in 2020 and was weaker than expected (**Chart A**). In 2020 Q4, CPI inflation was almost 1 percentage point lower than projected in January 2020. Some of that reflects the Covid-related fall in commodity prices feeding through into energy bills and motor fuel prices (Section 2.3). It also reflects the Government's cut to VAT for certain services. Lower demand, which would discourage firms from raising prices, may also help to explain the fall in inflation.

Although inflation has fallen, the decline has been modest compared to the very large decline in GDP. That partly reflects Covid reducing the supply capacity of the economy as well as demand, limiting the degree to which spare capacity increased. Other factors may also have limited the disinflationary pressure from Covid, as discussed in Section 4 of the *February Report*.

**Table 1**, which looks at the forecasts made at the beginning of the previous five years, shows how unusual the forecast errors in 2020 were. It also shows little consistent pattern in recent forecast errors. An [Independent Evaluation Office review of the Bank's forecasting performance in 2015](#) found that forecasts for GDP growth and inflation had shown no statistically significant evidence of bias. Looking at all forecasts made since 2004, outturns for GDP growth and CPI inflation have been distributed across all deciles of the MPC's fan charts (**Chart B**).

(1) For example see the *May 2020* and *May 2019 Reports*.

**Table 1: Pattern of one year ahead forecast errors over recent years**

Outturns a year ahead compared to past projections

Percentage point differences in annual average growth, unless otherwise stated

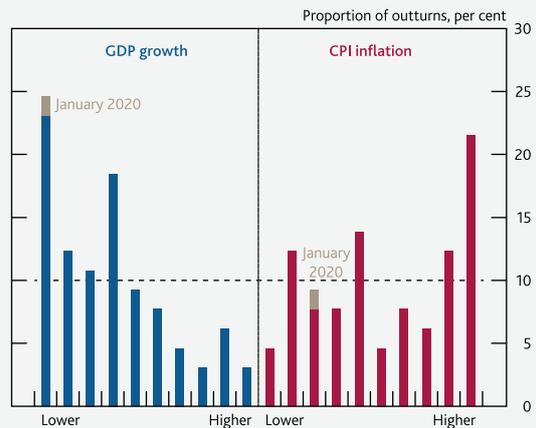
	Projection date				
	Feb. 2016	Feb. 2017	Feb. 2018	Feb. 2019	Jan. 2020
UK-weighted world GDP <sup>(a)</sup>	0.0	0.5	-0.5	-0.1	-6.3
UK GDP	-0.5	-0.3	-0.3	0.3	-10.5
Unemployment rate <sup>(b)</sup>	-0.1	-0.6	-0.2	-0.3	1.2
CPI inflation <sup>(c)</sup>	0.3	0.3	-0.2	-0.6	-0.9

Sources: IMF WEO, OECD, ONS, Refinitiv Eikon from LSEG and Bank calculations.

(a) Constructed using data for real GDP growth rates for 188 countries weighted according to their shares in UK exports.

(b) Differences between outturns and forecasts for the percentage point change in the unemployment rate. Negative values indicate a lower-than-expected unemployment rate.

(c) Differences between outturns and forecasts for the annual CPI inflation rate in Q4 of the first calendar year of the forecast.

**Chart B: GDP growth and CPI inflation outturns across deciles of the MPC's fan chart probability distribution<sup>(a)</sup>**


(a) Calculated for the market rate fan charts published since February 2004. Five quarters ahead. Outturn for GDP in 2021 Q1 is Bank staff's projection, based on official data to February.

# Glossary and other information

## Glossary of selected data and instruments

**AWE** – average weekly earnings.  
**CPI** – consumer prices index.  
**CPI inflation** – inflation measured by the consumer prices index.  
**DMP** – Decision Maker Panel.  
**ERI** – exchange rate index.  
**GDP** – gross domestic product.  
**HICP** – harmonised index of consumer prices.  
**LFS** – Labour Force Survey.  
**MFCI** – Monetary and Financial Conditions Index.  
**OIS** – overnight index swap.  
**PCE** – personal consumption expenditure.  
**PMI** – purchasing managers’ index.  
**RPI** – retail prices index.  
**RPI inflation** – inflation measured by the retail prices index.

## Abbreviations

**BCC** – British Chambers of Commerce.  
**CBI** – Confederation of British Industry.  
**CCS** – Credit Conditions Survey.  
**CJRS** – Coronavirus Job Retention Scheme.  
**ECB** – European Central Bank.  
**EME** – emerging market economy.  
**EOTH0** – Eat Out to Help Out.  
**EU** – European Union.  
**FTSE** – Financial Times Stock Exchange.  
**HMRC** – Her Majesty’s Revenue and Customs.  
**ICE/BoAML** – Intercontinental Exchange/Bank of America Merrill Lynch.  
**IMF** – International Monetary Fund.  
**LTV** – loan to value.  
**MPC** – Monetary Policy Committee.  
**MSCI** – Morgan Stanley Capital International Inc.  
**MTIC** – missing trader intra-community.  
**OBR** – Office for Budget Responsibility.  
**OECD** – Organisation for Economic Co-operation and Development.  
**Ofgem** – Office of Gas and Electricity Markets.  
**ONS** – Office for National Statistics.  
**ONS BICS** – Office for National Statistics Business Insights and Conditions Survey.

**PSNB** – public sector net borrowing.  
**PPP** – purchasing power parity.  
**REC** – Recruitment and Employment Confederation.  
**RLS** – Recovery Loan Scheme.  
**S&P** – Standard & Poor’s.  
**SEISS** – Self-Employment Income Support Scheme.  
**SME** – small and medium-sized enterprise.  
**TFSME** – Term Funding scheme with additional incentives for Small and Medium-sized Enterprises.  
**VAT** – Value Added Tax.  
**WEO** – IMF *World Economic Outlook*.

## Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Bank of England or the Office for National Statistics (ONS) and all data, apart from financial markets data and results from the Decision Maker Panel (DMP) Survey, are seasonally adjusted.

n.a. = not available.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.