Report to the Treasury Committee

Andrew Bailey, Governor of the Bank of England

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The last twelve months have been dominated by the impact of Covid 19, both on the UK and world economies. The UK experienced an almost unprecedented decline in economic activity last spring followed by some recovery over the summer and then the resurgence of Covid and the necessary restrictions to contain it.

UK GDP fell by 1½% in 2021 Q1 to 8.7% below its 2019 Q4 pre-pandemic level. This fall is much less than was expected by the MPC at the time of the February *Monetary Policy Report* (MPR). The impact of restrictions on activity appears to have declined over time, as households and companies have adapted to the environment.

The MPC set out its best collective judgement of the economic outlook in the May MPR. I am in full agreement with that assessment. Over the last twelve months we have consistently taken the view that activity in the economy would bounce back quite sharply, but the timing of that effect has been delayed by the further wave of Covid. In the MPC's latest central forecast, UK GDP recovers strongly over 2021, albeit only back to pre-Covid levels. We find comparisons of levels more meaningful than comparing growth rates which are harder to interpret in such a volatile environment.

Demand growth is boosted in the latest forecast by a decline in health risks and a fall in uncertainty, as well as substantial stimulus from both fiscal and monetary policy. But further out in the forecast, beyond the first 12 months, the pace of GDP growth slows as the boost from these factors fades.

Inflation over the past twelve months has been at least a percentage point below the 2% target. 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 and motor fuel prices. It also reflects the cut to VAT for certain services. Lower demand, which would discourage firms from raising prices, also helps to explain the fall in inflation. As a consequence I have, as required by the MPC's remit, written to the Chancellor on 4 occasions to explain why inflation is more than 1% below the target.

Inflation is expected to rise in the near term as some of those effects fade. In the central projection in the May MPR, CPI inflation rises temporarily above the 2% target towards the end of 2021, mainly due to developments in energy prices. The MPC judges that these transitory developments should have few direct implications for inflation over the medium term.

In the central projection of the May MPR, conditioned on the market path for interest rates, inflation returns to around 2% in the medium term. The MPC continues to judge that inflation expectations remain well anchored.

Another important respect in which the last twelve months have been unusual is the behaviour of the output gap, the balance of aggregate demand and supply in the economy. Typically in a recession, there is a substantial fall in aggregate demand, but the supply capacity of the economy is much less affected. Over the last year or so there has been a large decline in both demand and supply, as parts of the economy have closed down.

The scale of the falls in demand and supply have made the output gap hard to gauge. A range of indicators of spare capacity are consistent with there being a degree of slack in the economy at present, though there is uncertainty about its scale. Supply capacity is expected to recover sharply in the near term as the economy re-opens and restrictions on domestic economic activity are lifted.

The extension of the Government's employment support schemes in the Budget is expected to limit significantly the near-term rise in the Labour Force Survey (LFS) unemployment rate. The schemes are now expected to come to an end when economic activity is much closer to its pre-pandemic level. In 2021 Q3, according to the central case of the May MPR forecast, GDP is projected to be around 1¼% below the 2019 Q4 level.

In view of the forecast near-term recovery in activity, most people on furlough are expected to return to work. The MPC has therefore revised down considerably its profile for unemployment so that it is now projected to increase to a peak of just under 5½% (compared to 7¾% in the February forecast). The increase in unemployment we expect is likely to reflect some movement of people from inactivity (not searching for a job) to unemployment (searching). Inactivity has risen notably in the last twelve months.

The MPC expects the medium-term equilibrium rate of unemployment to rise by less than was forecast in February. Consistent with that, we judge that persistent effects from Covid on supply capacity are likely to be somewhat smaller than previously expected. In the May central projection, we reduced the so-called scarring effect on GDP – the longer-term damage from Covid – by ½ percentage point to 1¼% of GDP.

Over the last 12 months the MPC has spent less time on Brexit related issues than it might have expected, largely as a consequence of Covid becoming the dominant issue. In the latest round we were able to assess the early evidence of the impact of the adjustment to the new UK-EU trading arrangements. This includes evidence from the Bank's agents around the UK. It suggests a growing adjustment taking place. According to the latest ONS data, following substantial declines in UK goods trade volumes in January, exports to the EU rebounded materially in February, although imports from the EU remained weak. However, it is too early to judge whether the effects – both in terms of short term temporary disruption and longer-term supply growth – continue to be in line with the assumptions made by the MPC in the lead up to the end of last year, which we have retained to date.

There are of course a number of key judgements that the MPC has had to make over the last year, in particular concerning Covid. The calibration of uncertainty, as represented in the width of the fan charts for GDP in particular reflects the unprecedented level of uncertainty. Likewise GDP fan charts in recent MPRs have included substantial downside risks.

There has been, and remains, substantial uncertainty around the evolution of the pandemic. The risk is however now more balanced. On one side, a new variant of Covid for which existing vaccines provide less protection would represent a substantial downside risk. On the other hand, on the latest view, spending could recover more rapidly if households with accumulated savings choose to run them down more quickly. On balance, the MPC judges the central projection for GDP to be skewed to the downside in the first year of the forecast period, but broadly balanced further out.

In the medium-term, the MPC judges that the pace of expansion in UK GDP slows as supply growth returns to its subdued longer-term trend and the effects of some factors boosting demand growth wane. 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. 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.

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. 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.

On the latest view the MPC considers that inflation will temporarily rise 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 projected to be around the target. CPI inflation has been quite variable over the past year, and is likely to continue to be so in the near term, substantially affected by developments in energy prices.

The risks around inflation are judged to be broadly balanced, though that contains some offsetting factors. Indicators of firms' input costs have picked up strongly in recent months, particularly for manufacturers, for instance from freight and raw materials. The May MPR forecast is consistent with some pass through of these cost pressures into consumer prices, but on a limited basis in line with the evidence to date, which may reflect competition pressures and uncertainty about post-Covid demand. 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 it has put downward pressure on inflation, but the relative movement in demand and supply during the recovery is highly uncertain. Overall, we judge the risks around inflation to be broadly balanced.

Turning to policy, over the last year or so the MPC has cut Bank Rate to 0.1%, and increased the total stock of asset purchases from £435bn to £895bn. Of this, £75bn remains to be undertaken this year. It has also introduced forward guidance in response to the exceptional level of uncertainty, which sets out that 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 its latest meeting the Committee amended the forward guidance language to reflect the more symmetric nature of the risks to the outlook.

In judging the appropriate stance of monetary policy, the committee will, as always, focus on the medium-term prospects for inflation, including the balance between demand and supply, rather than on factors that are likely to be transient. At its latest meeting the Committee judged that the existing stance of monetary policy remained appropriate.

Over the last twelve months, two other important issues have featured in the MPC's discussions. First, the MPC has had to focus more on what I term toolkit issues. This is about ensuring that the MPC has available an appropriate set of monetary policy tools. The need for these discussions has obviously been increased by the extraordinary nature and scale of the Covid shock. The MPC has responded promptly and forcefully to that shock. We have used policy tools pro-actively, as we must to meet our objectives. But in doing so, the scope for further action has become stretched, and it is therefore correct that we should consider what more might be needed to address future shocks to the outlook and ensure that appropriate preparations are undertaken. This has been the case with a negative Bank Rate setting. The MPC considers that there might be circumstances in the future where it could be needed. These are not circumstances that we currently expect to happen, but it is appropriate that we should undertake sensible preparations. The Committee has been clear that this should not be interpreted as a signal about the future path of monetary policy and that it did not wish to send any signal that it intended to set a negative Bank Rate at some point in the future.

Second, the MPC adopted forward guidance in 2018 that it did not intend to reduce the stock of purchased assets at least until Bank Rate reached around 1.5%. This guidance was adopted before Covid and the rapid expansion of the QE programme, and before the Bank undertook research in 2020 which emphasised the more state contingent nature of decisions on QE. The MPC has announced that it is reviewing the 2018 guidance in view of the changed circumstances. I was not a member of the MPC at the time, and take the view that this guidance is too prescriptive.

Covid has prevented me undertaking a programme of physical regional visits in the last 12 months. Instead, from September last year, I have undertaken virtual visits, spending around a day each month in discussions with people in a particular area of the country. To date, I have undertaken nine such "visits". They have been very helpful, but they are not a perfect substitute for actual physical visits, which I look forward to undertaking in the future. The same has been true for the Citizens Panels as well as Youth and Community Forums, which have also been virtual over the past year.

I hosted my first Community Forum where I met with 15 representatives from charity and third sector organisations to learn about the impact of Covid-19 on the third sector and the various communities across the UK that they serve. These forums are invaluable in helping the Bank learn about the economic concerns facing those lesser-heard or seldom represented groups.

The Youth Forum's purpose is to provide a new mechanism for the Bank to engage with young adults, who we have traditionally struggled to reach through other forums. Our members presented their projects to me on 1 July. The projects were focused on financial education, the labour market and communications. They also presented a survey they had conducted about the impact of Covid-19 on young people, their finances and employment opportunities. This information has helped us to better understand the channels through which the pandemic has affected younger people, and the effects this may have on the wider economy.

I have set out below my speeches, virtual visits and "attendance" at Citizens Panels and Forums.

Speeches on Monetary Policy

"Getting over Covid", given at the Resolution Foundation, 8 March 2021, available at: https://www.bankofengland.co.uk/speech/2021/march/andrew-bailey-speech-at-the-resolution-foundation

"Modern Challenges for the Modern Central Bank: perspectives from the Bank of England", given at the LSE German Symposium, 5 February 2021, available at: https://www.bankofengland.co.uk/speech/2021/february/andrew-bailey-lse-event-german-symposium

"The Future for Business Investment in the age of Covid and the role of Financial Services" given at TheCityUK National Conference, 17 November 2020, available at: https://www.bankofengland.co.uk/speech/2020/andrew-bailey-the-cityuk-national-conference-2020

"The Central Bank balance sheet as a policy tool: past, present and future", given at Jackson Hole Economic Policy Symposium, 28 August 2020, available at: https://www.bankofengland.co.uk/speech/2020/andrew-bailey-federal-reserve-bank-of-kansas-citys-economic-policy-symposium-2020

Virtual Regional Visits

Northern Ireland - 29 September 2020

Yorkshire & Humber - 7 October 2020

South West – 26 November 2021

Scotland – 12 January 2021

East Midlands – 9 February 2021

Central Southern – 25 February 2021

South East & East Anglia – 25 (PM) & 26 (AM) March 2021

North West – 15 April 2021

Wales – 13 May 2021

Virtual Citizens Panels

Friday 17 July 2020

Monday 12 October 2020

Wednesday 20 January 2021

Thursday 25 March 2021

Thursday 13 May 2021

Youth/Community Forums

Youth Forum - Wednesday 1 July 2020

Community Forum - Friday 21 August 2020