Michael Saunders Report to the Treasury Select Committee, 17 May 2021

Economy and Voting Record

My previous Report to the TSC was in mid-February last year. The economy's path since then has been heavily affected by the Covid-19 pandemic and associated policies, and by the response of firms and households to those developments.

As infections rose in the UK early last year, voluntary social distancing and increased government restrictions (including the first lockdown) caused economic activity to fall sharply, and the level of real GDP in April 2020 was 25% below Q4-19 (and the level of hours worked in Q2 2020 was 20% down from Q4-19). As infections fell and restrictions eased, the economy recovered partially from May 2020 onwards. With a renewed surge in infections, hospitalisations and deaths, further lockdowns were implemented across the UK in Q4 last year and early 2021, and activity over that period has fallen.

As a result, economic activity in Q1 this year was well below its pre-pandemic level: real GDP in Q1 was 8-9% below Q4-19, with a decline of 13% for consumer spending and 5% for investment (and 18% for business investment). Consistent with this, the level of hours worked in the economy in the three months ending February this year was 8-9% below the Q4-19 level. This drop in hours worked has been reflected in the heavy use of the furlough scheme, a marked decline in employment, with sizeable increases in both employment and workforce inactivity.[1]

On the ONS's first quarterly estimate, the level of real GDP in Q1 was close to the MPC's forecast in the MPR of May this year, and close to the forecast for Q1-2021 in the Nov-20 MPR. It was 3-4% above the forecast in the Feb-21 MPR, but 1-2% below the forecast in the Aug-20 MPR. In Q1, government investment and government consumption (which includes test and trace) were notably stronger than in recent MPR forecasts.[2] Private spending was more mixed. Consumer spending in Q1 was above the Feb-21 MPR forecast, but below the forecasts for Q1-21 in the MPRs of Aug-20 and Nov-20. By contrast, business investment and housing investment in Q1 were both below the forecasts in the Feb-21 MPR (but actually above the forecasts in the MPRs of Aug-20 and Nov-20). The ONS GDP figures are, of course, more uncertain than usual at present and subject to revision.

The pandemic has affected every household and business in the UK, but the effects have been very uneven. Many sectors of the economy showed extreme weakness in the early part of last year as the pandemic developed, but some recovered quite quickly even while the pandemic continued. This is partly because Covid-related restrictions have become much more focussed, and directly impacted some sectors far more heavily than others (eg sales by pubs and restaurants have been closed or curtailed). It is also because the pandemic and associated restrictions have over time triggered large behavioural changes and expenditure switching (eg the accelerated shift of consumer spending to online purchases and to digital operations for businesses, as well as widespread working from

[1] HMRC data show that 4.8 million jobs were furloughed on average in Q1, 14% of all jobs or 16% of jobs excluding the self-employed. The level of employment fell by roughly 500,000 people from Q4-2019 to the three months ended February 2021, a drop of 1.5%. Over that period, the level of unemployment rose by roughly 400,000 people, with the jobless rate up 3.8% to 4.9%. The number of people aged 16-64 years that are not in the workforce rose by roughly 200,000, rising from 20.5% of that age group to 20.9%.

[2] The ONS has noted that the recent estimates for the effects of test and trace activity on GDP will be refined as a new method is introduced later this year.

home), and these have affected some parts of the economy more than others. In addition, the housing market has been supported by fiscal measures (namely the Stamp Duty changes).

The uneven impacts of the pandemic are evident in activity data. The drop in aggregate consumer spending has been concentrated in services rather than goods;[3] while the drop in investment has been concentrated in buildings and structures (down 9% from Q4-19). Investment in ICT, plant and machinery and intellectual property combined has fallen by just 1% since Q4-19.[4] Investment in housing has risen by 6% since Q4-19. The housing market in general has been buoyant recently, partly because of the stamp duty holiday but perhaps also because some people are seeking to upgrade their property given the prospect of more persistent working from home. These disparities in spending have been much greater than in the recession of 2008/09, which saw roughly equal (and large) declines in consumer spending on both goods and services, with sizeable declines also in all the main categories of investment (ie housing, non-housing buildings and structures, ICT and other plant and machinery).

There are similar large disparities between the growth rates of consumer spending on goods and services in the US and EU. US data also show strength in equipment investment, and housing, along with weakness in non-residential buildings. Consumer goods, as well as plant and machinery, have a relatively high import content. So this shift of consumer spending to goods from services across advanced economies, and resilience in ICT and plant and machinery investment, has helped world trade in goods to recover much faster than it did during the 2008/09 recession.

The uneven economic impacts of the pandemic also are evident in the labour market. The drop in employment has been disproportionately large in people aged over 65 years and, especially, among those aged under 25 years[5]. A key reason why the 16-24 year age group has been especially badly hit is that employment for that age group is skewed towards sectors that have seen substantial job losses, such as accommodation and food services, as well as wholesale and retail.[6] In addition, there appear to have been sizeable flows of people in that age group straight from education to unemployment, probably because some firms sought to shrink their headcount by refraining from taking on new staff.

The effects of the pandemic have also been uneven in geographic terms. Data for mobility and in-store spending suggest that activity has weakened more in major cities (eg Birmingham, Glasgow, Liverpool, Manchester – and, especially, central London) than in the UK as a whole, possibly reflecting the shift to working from home, as well as restrictions on consumer-facing services.

The MPC's monetary policy tools are (consistent with our remit) directed at aggregate spending and inflation rather than individual sectors or regions. But it is useful to analyse the detail and

[3] In Q4 2020, consumer spending on services fell 16.3% YoY in real terms, whereas consumer spending on goods rose actually 3.7% YoY (slightly above its longrun average), with especially strong growth (16% YoY, a record high) in spending on household equipment and furnishings.
[4] Investment in transport equipment also fell over this period, but is very volatile.
[5] In the three months ended February this year, employment fell by 10% YoY among people aged 16-24 years and fell by 8% among people aged 65 years and over. Employment among people aged 25-64 years fell by 0.6% YoY. People aged 16-24 years and 65+ years accounted for less than one sixth of the level of employment in the three months ending February 2020, at the start of the pandemic, but have accounted for three quarters of the drop in employment since then.
[6] In Q4 2020, employment in wholesale and retail services fell 8% YoY, while employment in accommodation and food services fell 16% YoY, much sharper than the declines in overall employment. These sectors accounted for 18% of total employment in 2019Q4, just before the pandemic, but accounted for 38% of employment for people aged 15-24 years.

divergences within the economy in order to understand the aggregates, as well as to appreciate effects (eg balance sheet vulnerabilities, localised bottlenecks) that may result.

As well as reducing activity, the pandemic (and associated policies) has also reduced the economy's potential output significantly since the start of last year. For example, some firms have faced severe restrictions on their operations -- and many have closed – especially during the lockdowns. Nevertheless, the drop in activity has been greater than that of potential output, and hence the economy has some spare capacity. This is evident in the increases in unemployment as well as various measures of under-employment (eg people working part-time that would like to work full-time, people in temporary jobs that would like permanent jobs, people that are classed as inactive but would like to work). In addition, a sizeable share of furloughed workers have been searching for a new job, presumably because they fear they may lose their current (furloughed) job.

That spare capacity, along with the drop in energy prices early last year and tax effects, has pushed down on inflation in the UK over the last year. Headline CPI inflation was at or below 1.0% YoY each month from April 2020 to March this year, and has been below the 2.0% target each month since August 2019. Core inflation (which excludes food, drink, tobacco and energy but includes the effects of the VAT cut for hospitality services) averaged 1.3% YoY over the period from March 2020 to March this year, well below a pace that is likely to be consistent with the 2.0% inflation target over time. Reflecting the split of spending, the inflation rate for services in the CPI has fallen since Q4-19, while the inflation rate for non-energy consumer goods has picked up since early last year.

As the adverse effects of the pandemic on the economy – and the prospect that it would be significantly disinflationary – started to emerge, the MPC loosened monetary policy markedly in 2020 in order to prevent a sustained undershoot of the inflation target. The first round of easing (announced in two stages during March 2020) comprised a cut in Bank Rate from 0.75% to 0.1%, the Term Funding Scheme with additional incentives for SMEs (TFSME), and £200bn of asset purchases to be completed at a very rapid pace. Subsequently, the Committee in June announced another £100bn of asset purchases, to be completed around the end of 2020. In November 2020, with rising infection rates and the announcement of further lockdowns across the UK, the Committee announced a further £150bn of asset purchases to be completed around the end of 2021.

These monetary policy measures have been aimed, consistent with the MPC's remit, at supporting the economy in order to ensure a sustained return of inflation to the 2% target in the face of the disinflationary effects of the Covid pandemic, and to limit persistent scarring on potential output through hysteresis in the labour market, business failures and weak investment. Had monetary policy not been loosened then – unless the economy received additional support from other policies (eg fiscal policy) – the economy now would probably be weaker, and with worse prospects (and a higher outlook for unemployment) than currently.

I voted in favour of all of these monetary easing measures. My only dissenting vote over the last year was in favour of an extra £100bn of asset purchases at the May meeting. At that stage, I judged it was highly likely that further asset purchases would be needed beyond the £200bn announced in March (which was due to be completed around the end of June) in order to achieve our remit. My view was that it would be preferable to announce in May that asset purchases would continue beyond the end of June, in order to limit risks that uncertainty over the continuation of asset purchase would create an undesirable tightening in financial conditions at a time when activity was still depressed. In practice, the Committee did vote for an extra £100bn of asset purchases at the June meeting.

The easing in monetary policy has gone alongside, but separate from, other measures to support the economy. This has included the FPC's decision to reduce from 1% to zero the counter cyclical buffer for UK banks in March 2020, and substantial fiscal support and credit easing measures by the government.[7]

The fact that the MPC has implemented large scale asset purchases (ie QE) at the same time that the government has provided fiscal support to the economy does not imply that the MPC is engaged in monetary financing of the fiscal deficit. Monetary and fiscal policies (and credit support measures) have all had to respond to the economic shock from Covid, which has produced the sharpest drop in economic activity for many decades and pushed CPI inflation well below target. It is entirely consistent with the MPC's remit to loosen monetary policy in such circumstances in order to prevent a sustained undershoot of the inflation target.

Economic Outlook

With the decline in Covid infections and ongoing vaccination programme, restrictions have recently been eased across the UK. As a result, the economy is now recovering, supported by the substantial fiscal and monetary measures that have been announced as well as some rundown of the extra savings accumulated by households during the pandemic.

In considering the state of the economy, it is important to focus on the level of GDP, not just the growth rate.

The MPC's most recent assessment of the economic outlook was published in the May Monetary Policy Report. In that MPR, the central forecast for the level of GDP is higher, and the forecast for the LFS unemployment rate is lower, in every quarter of the forecast than in the February MPR. The MPR forecasts a gain of 4% QoQ in real GDP for Q2, which would be one of the biggest QoQ gains of the last 60 years. But it would still leave the average level of real GDP in Q2 roughly 5% down from Q4-19, a decline that is worse than the early 90s recession (2% decline in GDP), similar to the early 80s (5% decline in GDP) and only slightly less severe than the 2008/09 recession (6% decline in GDP). If that shortfall in GDP persists, it is likely that unemployment would rise sharply once the furlough scheme ends, and inflation would undershoot the target over time.

The MPR projects that GDP will continue to recover in subsequent quarters and in Q4 will, on average, slightly exceed the Q4-19 level[8]. Even so, the MPR forecasts that the LFS unemployment rate will rise slightly in coming quarters, peaking at 5.4% in Q3 this year, as the furlough scheme starts to wind down and some of the recent rise in workforce inactivity reverses. In the forecast, the LFS unemployment rate falls back subsequently, and is around 4¼% at the end of the three year forecast period.

[7] Of the government's credit support measures, the BBL, CBIL and CLBIL were operated through the British Business Bank, while the BoE has acted as HM Treasury's agent in the Covid Corporate Financing Facility (CCFF).

[8] The MPR does not include forecasts for the monthly GDP data, but it is possible the monthly level of GDP will regain the Q4-2019 level during Q3 this year even if the average level for that quarter remains below Q4-19.

In the MPR central forecast, the output gap closes in the next few quarters, with a temporary period of excess demand late this year and in early 2022, but (conditioned on the market path for interest rates, which includes a rise in Bank Rate of about 50bp over the next three years) supply and demand are roughly in balance two and three years ahead. The MPR forecasts that swings in energy prices and some impact from higher non-oil import prices will lift inflation close to the 2% target in the next quarter or two, with a temporary overshoot of the inflation target late this year and early next year. Thereafter, the MPR forecasts that inflation will return close to the 2% target two and three years out.

I broadly agree with that forecast.

The strength of global demand for goods, along with bottlenecks in some sectors, has recently led to price and cost pressures in commodities, shipping costs and manufactured goods prices more generally. Input and output costs for UK manufacturing have picked up markedly in recent months. As noted, these pressures are likely to play some role in returning UK CPI inflation to the 2% target in coming months, although the likely period of above-target inflation is much more due to swings in energy prices than to nonoil costs. I must stress though, that these cost pressures in global goods markets overstate the likely path of overall CPI inflation in the UK. This is likely to continue to be restrained for some time by spare capacity in the labour market, with relatively weak underlying wage growth and subdued service sector inflation.

The main upside risks to the outlook for activity probably are from a greater rundown of household savings. Related to that is the possibility of a bigger than expected boost to demand from the strong growth in broad money, especially household and corporate deposits, over the last year or so. There are downside risks from the rise in corporate debt and the prospect of higher corporate borrowing costs, especially for SMEs, as the various government lending schemes launched last year close and the Recovery Loan Scheme starts up. This may lead companies to prioritise balance sheet repair rather than investment and hiring. Another set of downside risks stem from the rise in Covid cases globally, and the possibility of a further resurgence of Covid in the UK, especially if accompanied by viral mutations that significantly reduce vaccine efficacy. This possibility could weigh on firms' hiring and investment decisions for some time, until it is clear that the pandemic is finally over. I agree with the MPR assessment that risks to the economy are biased to the downside of the MPR forecast in the next year (reflecting uncertainties around the pandemic) and roughly balanced after that.

Some of the shifts in the composition of activity are likely to unwind to an extent in the recovery. With the lifting of restrictions, the recovery of consumer spending is likely to be driven chiefly by consumer services rather than consumer goods. This may also help to reverse the sharp drop in employment among the age groups aged 16-24 years and 65+ years. But some of the changes in the composition of activity may be more persistent, because the pandemic has probably caused (or accelerated) some structural changes in the economy, notably the shift to digital business (including online shopping) and more widespread working from home. This may reinforce the shift in the composition of investment towards ICT and housing, rather than commercial and industrial buildings. Investment in plant and machinery in the next year or two additionally is likely to be lifted by the Corporation Tax super deduction.

Longterm Effects on the Economy from the Pandemic

In the May MPR, the MPC reduced its central estimate for expected persistent scarring from the pandemic on potential output to 1¼% of GDP at the end of the forecast period from 1¾% of GDP in the February MPR. This chiefly reflects a reduced estimate of labour market mismatch, as well as actual and expected trends in investment spending.

The MPR estimate for persistent scarring would represent a much smaller reduction in potential output than seen during and after the 2008/09 recession. This partly reflects the resilience of the financial sector during the pandemic, as well as the exceptional level of support from fiscal and monetary policies (including credit easing measures). This should all help to limit scarring compared to previous downturns, by limiting the rise in unemployment and business failures, and supporting investment (including training). As noted, investment in ICT and plant and machinery (which is an important driver of productivity gains) has held up relatively well. Nevertheless, there are substantial risks and uncertainties around that estimate, and at this stage it must be regarded as preliminary. Compared to the MPR estimates, there may be downside risks to potential output if health concerns lead to persistently lower workforce participation. But, in my view, there also are some upside risks around the MPR forecasts for potential output both over the next year or two, and further out.

In the next year or two, the central forecast in the MPR projects that potential growth will be temporarily reduced by some rise in the equilibrium jobless rate (the NAIRU), driven by increases in medium- and long-term unemployment. The evidence for this effect is mixed, and appears to have become more uncertain recently[9]. Moreover, the recent rise in unemployment has included a relatively high share of people with tertiary level education,[10] and people with tertiary level education tend to have relatively high flow rates from unemployment to employment. This – and the prospect of a strong recovery in the economy -- may reduce the risks that a high share of those who have become unemployed during the pandemic drift into long-term unemployment and become less employable or less attached to the labour market.

In addition, the structural changes in the economy, towards greater digital and online business and more widespread working from home, may actually be positive for potential output over time.

For example, the accelerated shift to online shopping has produced a 13% surge in retail sector productivity over the last year, a bigger gain than in the prior ten years combined (which was 11%).[11] Some of this productivity surge may reflect a composition effect from the forced closure of non-essential stores, and may partly reverse given the reopening of non-essential stores. But, provided the share of online sales remains well above pre-pandemic levels, some of these productivity gains will probably persist. The shift to online shopping is also likely to promote greater price transparency and reduce barriers to entry (and expansion) among small retailers, hence increasing competitive pressures.

The high level of enforced working from home (WFH) during the pandemic may initially have hurt productivity, especially early last year. However, as people have overcome initial barriers of learning how to operate home working in many jobs, recent evidence (including from the ONS BICS survey,

[9] See "*In Focus – Supply and Spare Capacity*", pages 35-40 of the May MPR.
[10] Roughly half of the total rise in unemployment over the year from Q4-2019 to Q4-2020 (and more than half the rise in medium-term and long-term unemployment) has been people with tertiary level (ie university or further education), whereas in the first year of rising unemployment in 2008-09, only 10-15% of the rise in unemployment consisted of people with tertiary level education.
[11] The gradual shift to online shopping already had been reflected in some pickup in retail sector productivity in the couple of years before the pandemic. See my report to the TSC of February 2020.

using results weighted by firm size) suggests that the rise in WFH is currently not affecting productivity much either way.[12]

Results from the Decision Makers' Panel survey suggest that many firms expect a persistent shift to a hybrid model, whereby (compared to the pre-pandemic period) many more people work remotely part of the time.[13] There may be challenges in how to ensure that more widespread working from home does not erode the benefits of collaboration that arise if people work in the same place as their colleagues at least some of the time. But a greater role for WFH (compared to the pre-pandemic period) also may offer advantages for some firms. These include more efficient use of the business capital stock and cost reduction, including savings on city centre office space. It may allow some firms to access a wider pool of staff (for example, people that cannot easily get to a specific work location), and to better match jobs to skills, while leading to lower absence from sickness (which may include caring responsibilities for family members). For some people, the option to WFH seems to be good for employee satisfaction and productivity, because of reduced distractions and a quieter work environment, as well as advantages from a better work-life balance. This may lead to better staff retention, and hence improved work skills, as well as cost savings from lower staff turnover. By cutting commuting time and costs, increased WFH also may expand labour supply, by allowing more people to enter the workforce (or stay in the workforce for longer).

Explaining Monetary Policy

Over the period since my last Report to the TSC (February 2020), I have done 4 virtual regional visits around the UK, as well as several presentations to various business groups.

I have also done four major speeches, covering the outlook for the economy and monetary policy.

Covid-19 and monetary policy May 2020

The economy and Covid-19: looking back and looking forward, September 2020

Some monetary policy options – if more support is needed, December 2020

Supply and demand during and after the pandemic, March 2021

[12] See "*Supply and Demand During and After the Pandemic*", speech on 26 March 2021.
[13] The DMP survey (carried out during 5-19 February this year) suggests that firms expect the share of full-time employees that are fully or partly remote working to rise to 34% in the next few years compared to 13.5% in 2019. Within this, firms expect the share of employees that will be remote working for part of the week to rise from 8% in 2019 to 27% for 2022 onwards. The share of employees expected to be remote working 5 days per week is expected to rise only slightly, to 7.3% in 2022 onwards from 5.5% in 2019.