



BANK OF ENGLAND

Speech

Remarks on Covid-19 and Monetary Policy

Speech given by Professor Jonathan Haskel, External Member of the Monetary Policy Committee

Brighton Chamber of Commerce (by Zoom)

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My thanks to Tom Belsham, Jamie Lenney, Elizabeth Levett, Matthew Swannell and Marilyne Tolle for their comments and assistance in preparation for this event. Errors and opinions are my own.

Thank you for hosting me today, and in particular to Plus Accounting from Brighton for sponsoring this event. I hope to be able to meet you all in person when circumstances permit.

Let me echo my MPC colleagues by saying that the current pandemic is first and foremost a health emergency and express my deepest sympathies for all those who have suffered during the outbreak. And my gratitude to the NHS health professionals, carers and volunteers who have been the front line of defence across the UK.

I shall make some remarks on the economic situation and the policy context. But I also want to hear about your experiences to date and your thoughts on the challenges and opportunities as social distancing measures relax, and we try to return to some semblance of normalcy.

Background

The UK is in the midst of an unprecedented economic shock. Due to covid-19 and associated social distancing measures we expect a significant decline in output and rise in unemployment over the course of 2020 somewhere in line with the scenario we published in our May *Monetary Policy Report*¹ (MPR), (see **table 1**). I find one can only truly grasp the scale of this potential decline by comparing it to a long time series such that is available from the Bank of England's millennium dataset². **Figure 1** indicates 2020 could turn out to be the most significant single-year decline in economic activity since 1706, larger than what we saw in the financial crisis a decade ago or during the time of Spanish Flu and the return to the gold standard after World War I.

MPC policy to date

The Bank of England and the UK government have responded accordingly to such a significant shock. Since the onset of the crisis, the MPC has cut Bank Rate from 0.75% to 0.1% and expanded our asset purchase programme by £200bn in March and a further £100bn in June. The majority of the initial £200bn in purchases is complete, and we expect to complete the remaining announced purchases by around the end of the year. The first round of purchases aimed to prevent and stop in its tracks the financial market dysfunction resulting from the significant financial market adjustment that occurred at the onset of this crisis in March³. **Figure 2** illustrates that in the lead up to our announcement to expand asset purchases on 19 March, the UK government debt market was showing significant signs of strain. This was apparent in falling and volatile prices (**panel A**) and rising intermediation costs (**panel B**). These spikes we see in the panels, are highly unusual in what should be a deep and calm market for safe UK government debt. But this was no normal time, with heightened uncertainty creating a surge in the demand for cash ('a dash for cash'). By stepping in and providing a reliably ample supply of cash in the form of central bank reserves, the Bank of England was able to restore, almost immediately, normal market functioning, as we can see in **figure 2**. This in turn helped the functioning of broader UK financial markets and limited the potential amplification of the dramatic slowdown in economic activity we are experiencing. However, as **figure 3** shows, financial markets and conditions more broadly remain relatively

¹ <https://www.bankofengland.co.uk/report/2020/monetary-policy-report-financial-stability-report-may-2020>

² <https://www.bankofengland.co.uk/statistics/research-datasets>

³ For a more detailed commentary on these events, see Andrew Hauser's speech (<https://www.bankofengland.co.uk/speech/2020/andrew-hauser-speech-hosted-by-bloomberg-via-webinar>).

tight. This, combined with an uncertain economic forward path, and in my view, risks skewed to the downside concerning employment and more medium-term economic adjustments, prompted my vote and approval of a further expansion of asset purchases in June to guard against any unwarranted future tightening and help support the economic recovery as social distancing measures come off.

I should point out, while QE and interest rate cuts grab headlines, in March we also revived our term funding scheme to reinforce the pass-through of lower interest rates by temporarily allowing banks access to loans from the Bank of England at close to Bank Rate. Given the membership of the Chamber is particularly concentrated on small firms, this programme provides particularly strong incentives for banks to lend to SMEs. Finally, we are working with the government to lend directly to firms through the Covid Corporate Financing Facility, which has to date facilitated around £18bn in loans to (mostly larger) businesses.

Q2 so far

Since our initial policy decisions in March, we have been able to observe and digest the data for the UK economy in Q2. **Figure 4** shows the declines in output in aggregate (**panel A**) and by sector (**panel B**). The overall fall in output in April was as dramatic as expected in our scenario and panel B shows us that the accommodation and food sector almost completely shut down, with other sectors operating at about ½ the level in April as they were in 2019.

Is there any good news? **Figure 5** shows a glimmer of hope relative to our envisaged scenario, namely that activity appears to be coming back faster than we anticipated. Retail sales and spending more broadly appear to be recovering from their April lows, and we now expect Q2 as a whole will not be quite as negative as expected. We've also seen a higher uptake of the government's furlough schemes than we might have anticipated with near enough 12 million claims for the schemes combined (**figure 6, panel A**). That is a staggering number at around one third of the UK's labour force. This higher uptake should for now be taken as a positive sign relative to the counterfactual of mass unemployment as maintaining valuable employer-employee matches will facilitate a smoother transition back to higher and more normal levels of economic activity. But we should remember this past quarter is still likely to see by far the largest decline in output since quarterly national accounts began. Worryingly the indicators of rising unemployment are already revealing themselves (**figure 6, panel B**), with unemployment claims recorded to date enough to put us back to levels of unemployment not seen since the financial crisis. Furthermore there remains a great deal of uncertainty as to how many of the currently furloughed workers will be able to return to their jobs, which in large part will depend on our success as a nation managing and suppressing the virus, and the state of household finances and consumers' appetite for resumption of discretionary economic activity.

Finally as an MPC member it would be remiss of me not to mention our target: CPI inflation. **Figure 7** shows it currently lies well below our target of 2%. The effects of the pandemic account for this in large part. The collapse in global oil prices has had direct effects on inflation, via the prices of motor fuels and utilities (**Panel B**), and indirect effects by reducing input costs in other sectors of the economy. The sharp drop in domestic activity is

also adding to downward pressure on inflation through increased spare capacity in most sectors of the economy and supports our decision to maintain a historically loose monetary policy stance.

Working from home and Central Bank independence

I want to finish my remarks on two closely-related subjects, namely working from home and central-bank independence.

Whilst the pandemic has caused hardship for many, I suspect there are at least some who, perhaps secretly, are rather enjoying working from home. You can avoid the commute, distractions from co-workers and perhaps you are enjoying social distancing from your boss. On the employer side, for firms whose workers can largely work from home, I'm sure many are now asking themselves: what's the point of paying sky-high rents simply in order to be located next door to another firm who is paying sky-high rents?

Coming to work however does have quite a bit of value. First, you might well be learning a lot from your fellow employees. On-the-job training is especially valuable for younger workers at the start of their careers.

Second, working from home exposes an employee to risk. Regardless of where you work, there are occasions when, despite your best efforts, you cannot do your job as well as you would like through no fault of your own: a supplier lets you down, the economy takes a nosedive and you cannot clinch that sale. Of course, you can go to your employer and explain that it was not your fault. The problem arises if the employer cannot monitor your performance. You call tell the employer you were trying as hard as you can, but you might have been down at Brighton Beach for all they know.

Economic theorists are interested in what contracts look like when there is this "asymmetric information" situation (you know if you were at the beach, the employer doesn't).⁴ One way to get over this problem is to simply accept the state of affairs and write a contract conditioned on performance with a whole series of clauses to try to allow for events beyond the employee's control. Most employees and employers, including I would suspect, many in this Chamber, do not like complicated contracts. Even with the best intentions, they often turn out to difficult to word and implement (incomplete in economist's language). So in practice it's inevitable that without being able to monitor beach attendance, the employer will have, to some extent, to tie rewards to employee performance. That exposes the employee to risk: sometimes they won't get paid well, but for no fault of their own.

The more attractive alternative is to dispense with a complicated contract. Here's a much easier one. The employee has to turn up at work. By requiring the employee to come into work the employer at least knows that the employee is not watching widescreen TV or going down to the beach. That is to say, the requirement – to turn up at work – is part of the contracting mechanism that enables employees and employers to get over the difficulties of contracting under this condition of asymmetric information. And there's a famous example of this.

⁴ A summary is to be found in, for example, the work of Oliver Hart and Bengt Holmström (<https://www.nobelprize.org/prizes/economic-sciences/2016/press-release/>).

The Silicon Valley CEO, Marissa Mayer, started her tenure as CEO of Yahoo! in 2013 by banning working from home, requiring employees to come into work or quit the company.

What then happens when employees can't come to work? It makes this kind of contracting more difficult. So what are the outcomes? The implications for the macroeconomy are still to be fully worked out, but one can immediately speculate on three. First, the class of contracts that employees have to accept might get more risky, which in turn may increase risk-averse behaviour among employees. That increased caution would hold spending down on many of the activities that your businesses are involved in, and lower aggregate demand.

Second, there is going to be even more intense sorting of workers into those who can and cannot perform without supervision. Expect the returns to experience and soft skills, such as trust and reliability, to rise and, perhaps prospects for young workers, who have not established such a reputation, to worsen. If that puts downward pressure on wages, this will test the flexibility of the labour market and perhaps widen this dimension of inequality.

The third is that in order to cope with all of this, firms are going to have to invest in new business processes⁵. Expect then a sustained period of low measured productivity, as firms have to spend more resources revising their business processes. More speculatively, the returns to buildings might fall, as firms move away from specific geographical locations, but the returns to a well-managed business will rise as firms put in place new organisational design for their employees. Future economic policy will in large part depend on the extent of this required adjustment (i.e. how different the economy will ultimately look post Covid-19) and the challenge for us as policymakers will be to forecast this and set policy accordingly.

Let me finish by turning from the contract between employers and employees to the (perhaps implicit) contract between the state and the public. Here the relationship at hand is between a public trying to predict what public authorities will do about monetary policy. Politicians of all colours always face the temptation to "run the economy hot" as an election nears. If the public can work this out, then inflation expectations can become de-anchored which sets off a wage-price spiral that benefits nobody. What can improve upon this situation?

The answer from contract theory is to change the terms of the contract, in this case to delegate the setting of monetary policy to an independent body, such as the central bank, as a commitment not to overheat the economy. And indeed in crisis periods, the value of that commitment is all the more important, since citizens want clarity and commitment as they navigate their way through uncertain times. This is why the recent discussion around Central Bank independence and quantitative easing is important. I want to join my colleagues on the MPC in saying a few words about why quantitative easing (QE) is not a threat to central bank independence.

⁵ According to the ONS the UK spent £26bn on organisational capital and £29bn on training in 2016, about 2.8% of GDP combined. It is also important to point out that these significant investments do not currently make it into our estimates of GDP.
<https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/articles/experimentalestimatesofinvestmentinintangib leassetsintheuk2015/2016>

As a reminder QE is the large-scale purchase of UK government debt⁶ on secondary markets by the Bank of England. As discussed, the Bank of England has engaged in QE in response to Covid-19, and in recent history, after the Brexit vote (2016) and after the financial crisis (2009-2012). The mere coincidence of quantitative easing and a large-scale increase in the issuance of government debt is consistent with the fact that a very large negative shock has hit the economy. When such a shock hits the economy, an independent central bank will under most conditions, make monetary policy more accommodative. It does so to reduce borrowing costs and help expand economic activity in order to push inflation back to target. That reduction of borrowing costs applies to all borrowers including the government⁷. When there is a severe negative shock, the government – through the automatic stabilisers and discretionary interventions – will borrow more money. This is in line with widely accepted economic theory, which says that governments should try to smooth out shocks to the economy. Thus the accommodative monetary policy, which central banks correctly are employing, eases credit conditions both private and public. This can create the appearance of purchases of government debt ‘propping up the government’. As a number of my colleagues have pointed out⁸, the critical issue is the objective not the accounting. The central bank is undertaking this easing in order to hit its target. Were we in danger of overshooting the target, the central bank would reverse its monetary policy stance and do what is necessary to return inflation to target. Thus the observation of large-scale central bank purchases and government issuance is not evidence of the erosion of Central Bank independence.

The policy outlook

At our last policy meeting, I readily joined the majority of colleagues on the MPC in voting for more QE to avoid a tightening of financial conditions which could have jeopardised hitting our inflation target. In thinking about our prospects some commentators have raised the question of what the Bank should do if there were a second wave of the pandemic. The answer, I would suggest, is that a second wave would be a statement about public health and the Bank’s job would be to respond to the prospective economic consequences of this. Those consequences would depend on a number of factors, including the reaction of the fiscal authorities and on whether other countries are facing similar difficulties for example. It is also the case that cautious behaviour by consumers is already built into our published scenario and we have demonstrated that we can respond quickly and effectively to financial market dysfunction. In conclusion, I believe the current stance of monetary policy is appropriate but, on balance, risks are to the downside.

Thank you for your kind attention and I’d be delighted to hear about your experiences in these difficult times and, if I can, answer any questions.

⁶ For the most part. As part of these asset purchase programmes we have also announced the purchase of investment-grade corporate bonds. £10bn was announced and purchased from 2016 and a further £10bn from March 2020.

⁷ See my colleague Silvana Tenreyro’s comments at the LSE public event podcast “[COVID-19: the economic policy response](#)” (18 May 2020)

⁸ See my colleague Gertjan Vlieghe’s speech (<https://www.bankofengland.co.uk/speech/2020/gertjan-vlieghe-speech-monetary-policy-and-the-boes-balance-sheet>) and my colleague Michael Saunders’ speech (<https://www.bankofengland.co.uk/speech/2020/speech-by-michael-saunders-28-may-2020>).

Tables and figures

Table 1

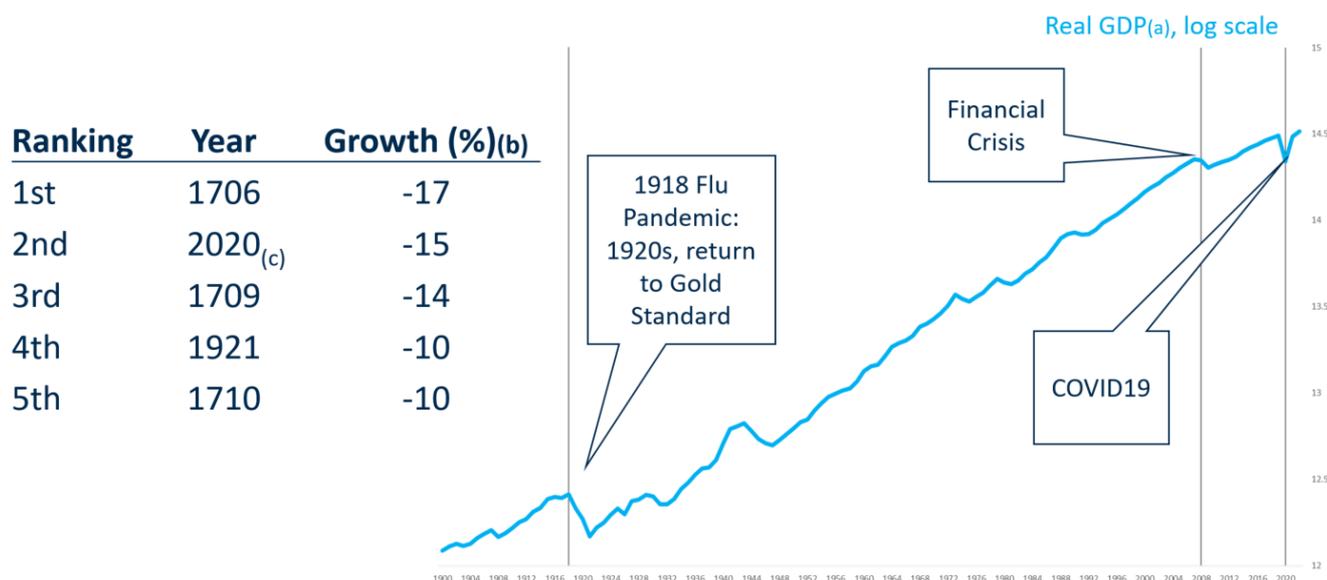
	1998-2007 ^(a)	2008	2009	2010-18	2019	2020
UK GDP ^(b)	3	0	-4	2	1	-14
LFS Unemployment rate	5	6	8	6	4	8
CPI Inflation ^(c)	1.6	3.6	2.2	2.3	1.8	0.6
Bank Rate ^(d)	5.1	4.7	0.6	0.5	0.8	0.2

Sources: Bank of England, ONS and Bank calculations.

Note: The profiles in this table should be viewed as broadly consistent with the illustrative scenario for GDP, CPI inflation and unemployment

(a) Averages over the period. (b) Excludes the backcast for GDP. (c) Annual average inflation rate. (d) Average Bank Rate (data) or implied Bank Rate indicated by overnight index swaps (forecast).

Figure 1



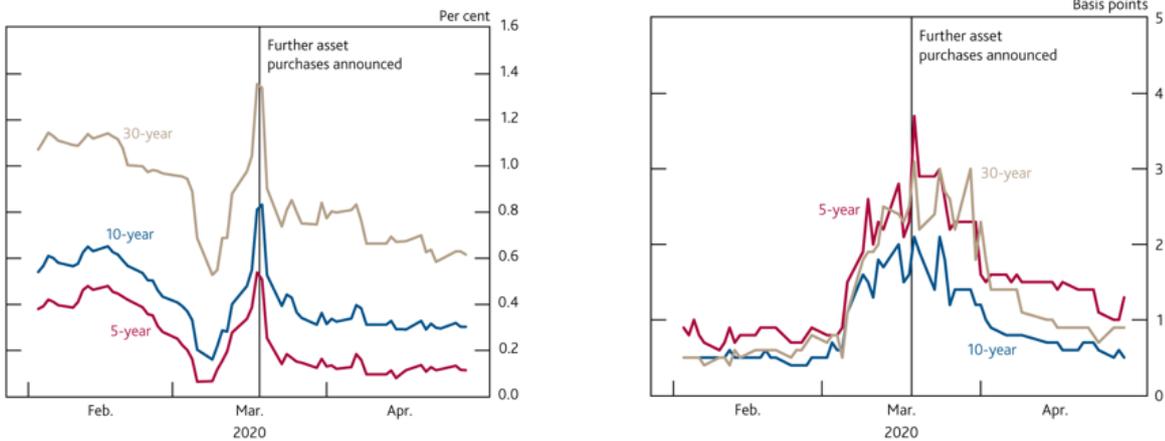
Sources: "A millennium of macroeconomic data for the UK", Bank of England. Author calculations.

Note: (a) Real UK GDP at market prices, geographically-consistent estimate based on post-1922 borders. £mn, Chained Volume measure, 2013 prices. From 2016 onwards it grows in line with MPC May 2020 MPR scenario. (b) Annual growth (%). (c) MPR scenario.

Figure 2

Panel A: Spot yields on UK gilts^(a)

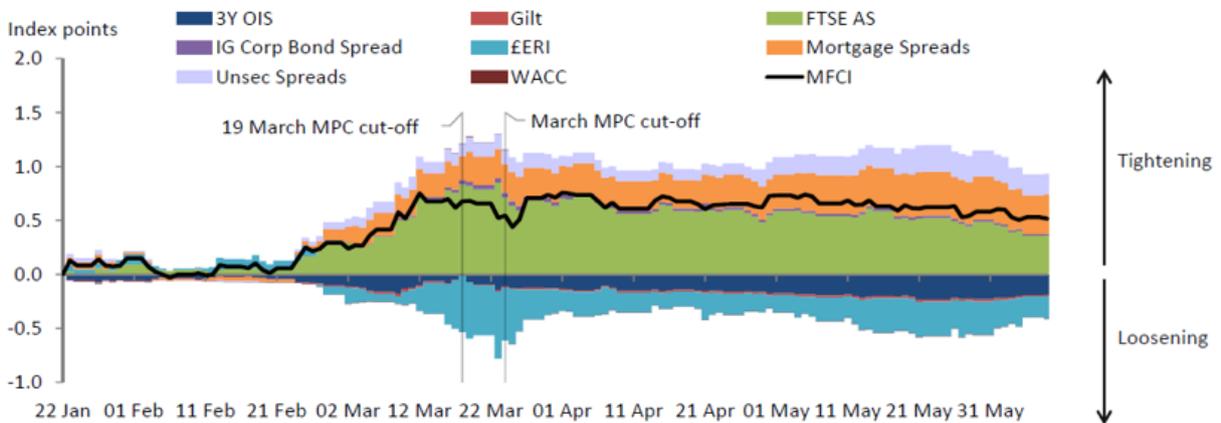
Panel B: Bid-offer spreads on UK gilts



Sources: (Panel A) Bloomberg Finance L.P. TradeWeb and Bank calculations. (Panel B) Eikon from Refinitiv and Bank calculations.
 Note: (a) Zero-coupon spot rates derived from government bond prices.

Figure 3

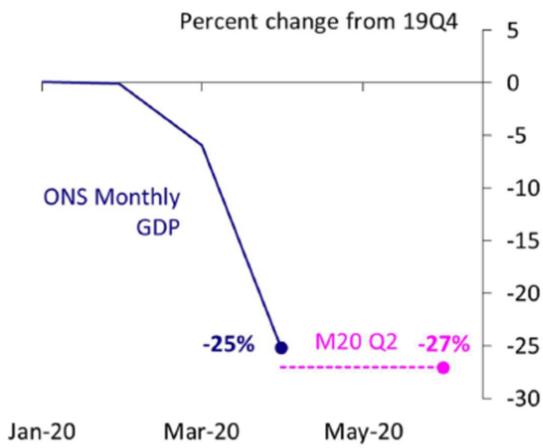
UK Monetary and Financial Conditions Index since January MPR



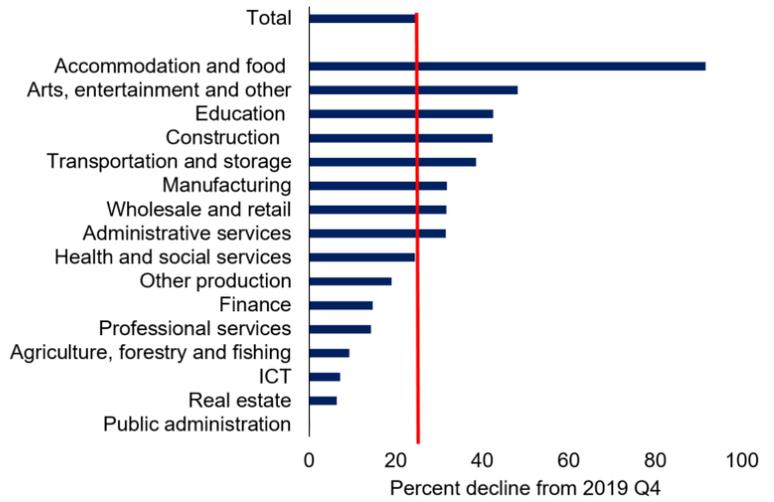
Sources: Bloomberg Finance L.P., Eikon from Refinitiv, ICE/BoAML Global Research and Bank calculations.
 Note: The UK Monetary and Financial Conditions Index (MFCI) summarises information from the following series: short-term and long-term interest rates, the sterling ERI, corporate bond spreads, equity prices, and household and corporate bank lending spreads. The series weights are based on the estimated impact of each variable on UK GDP. The chart shows changes in the MFCI from the average level over the 15 working days to 22 January 2020. An increase in the MFCI signals tighter financial conditions and a decrease signals looser conditions. For more information, see the Bank Overground post '[How can we measure UK financial conditions?](#)'.

Figure 4

Panel A: Monthly GDP



Panel B: Industry GDP

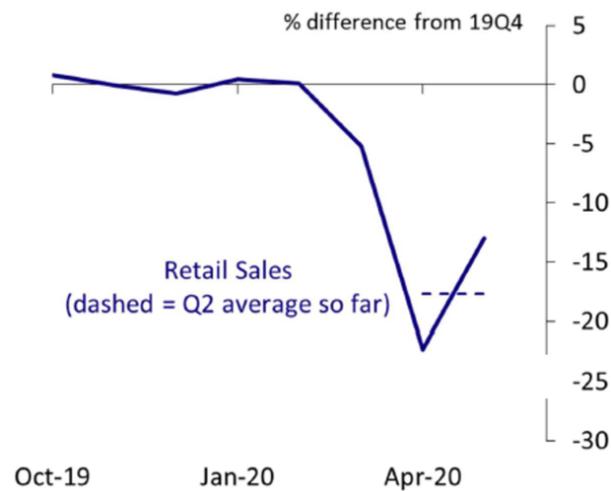


Sources: ONS and Bank calculations.

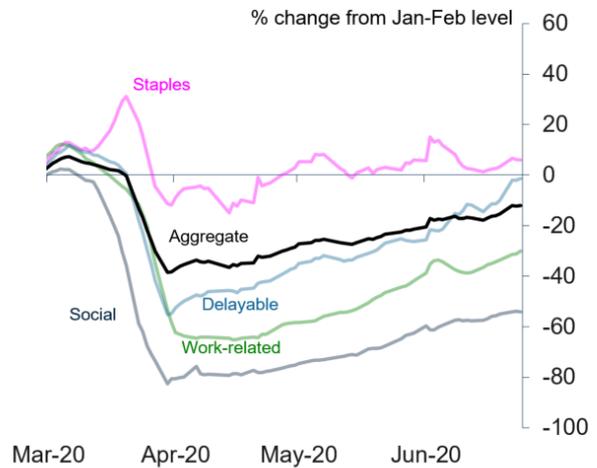
Note: Charts shows declines in output between the average level in 2019 Q4 and April 2020. M20 Q2 is the level implied in the scenario laid out in the May MPR.

Figure 5

Panel A: Retail sales



Panel B: CHAPS payments



Sources: ONS and Bank calculations.

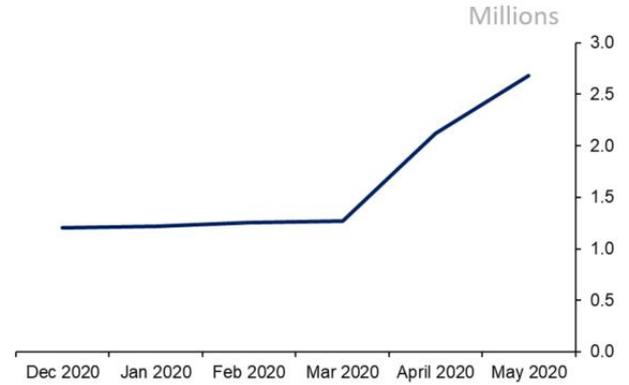
Note: CHAPS data is based on a sample of around 100 UK companies payments received from their merchant acquirers on a daily basis. These payments reflect the sales that companies make through debit and credit card purchases, which are summed to estimate rolling seven-day revenues. Social consumption includes corporate revenues from hotels, restaurants, air travel and cultural events. Delayable consumption includes household goods, clothing, vehicle purchases and recreational goods. Work related includes travel and fuel. Staples include housing, food and health. Spending data shown through 24 June.

Figure 6

Panel A: Furlough scheme claims



Panel B: Claimant count



Sources: ONS and HMRC.

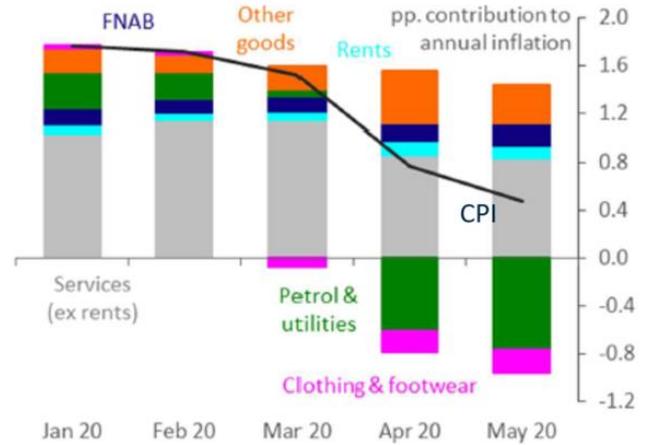
Note: The experimental Claimant Count consists of claimants of Jobseekers Allowance (JSA) and some Universal Credit (UC) Claimants. The UC claimants that are included are 1) those that were recorded as not in employment and those claimants of Universal Credit who are required to search for work, i.e. within the Searching for Work conditionality regime as defined by the Department for Work & Pensions (from April 2015 onwards). There were more than 34 million economically active individuals in the UK estimated in the most recent ONS labour market summary, covering the three-month period February 2020 to April 2020.

Figure 7

Panel A: CPI Inflation



Panel B: Decomposition of changes in CPI



Sources: ONS and Bank calculations.

Note: FNAB stands for food and non-alcoholic beverages. Core inflation is a measure of inflations that removes food, energy, alcohol and tobacco goods from the basket of prices measured.