



BANK OF ENGLAND

# Speech

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## Remarks on challenges to the economic outlook

Remarks given by

Jonathan Haskel, External Member of the Monetary Policy Committee, Bank of England, and Imperial College Business School, Imperial College, London

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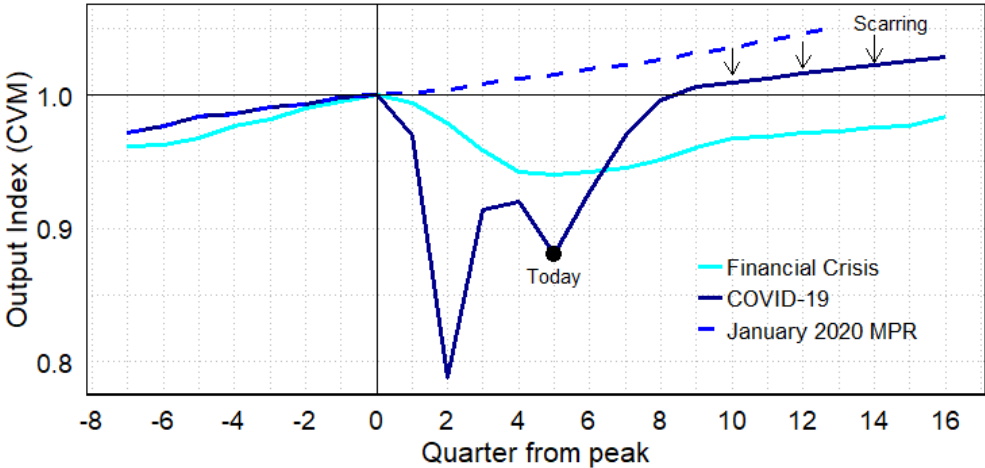
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It is a pleasure to sit with this panel today to discuss some of the upcoming economic challenges for the new US Treasury Secretary. In my brief remarks, I will offer a UK perspective and reflect upon some of the issues the Monetary Policy Committee (MPC) at the Bank of England has been considering for the UK outlook.

To begin with, let me consider the below **Figure 1** which plots real GDP for the financial crisis and during the current pandemic, including our forecasts.

**Figure 1: The UK Recovery**



<b>Growth Rates (pp)</b>	Pre-Crisis	Financial Crisis	Post-Crisis	COVID-19 <sup>+</sup>	2021-2022 <sup>+</sup>	2023 <sup>+</sup>
GDP	2.6	-4.8	1.8	-9.7	8.5	1.2
Productivity <sup>++</sup>	1.8	-1.9	0.6	-2.3	2.1	0.5

Source: ONS, Bank of England and author calculations.

Note: Profiles of recoveries are indexed to the level of output in the quarter before the recession. The dashed blue line is the forecast in the January 2020 *MPR*, the dark solid blue line the forecast in the February 2021 *MPR*. Scarring assumptions explain the majority of the difference between the two forecasts by quarter 16. The table shows average annualised growth rates for 2001Q1-2008Q1, 2008Q2-2009Q2, 2009Q3-2019Q4, 2019Q4-2021Q1, 2021Q2-2022Q4 and 2023. <sup>+</sup> Denotes the forecast from February 2021 *MPR*. <sup>++</sup> Productivity is GDP divided by aggregate hours worked.

This figure illustrates that:

- 1) In 2020 the UK experienced an extraordinary economic contraction. In fact it was the largest annual contraction in economic output recorded since 1709. The economic historians among you will know this as the Great Frost (the coldest European Winter for 500 years).
- 2) Today, in the midst of a third national lockdown, we are still a long way from our pre-recession trend line and a ways off where we were at the equivalent point of the financial crisis.
- 3) We expect a strong recovery (from a low base), and to ultimately fare better in this recovery than we did after the financial crisis: returning more quickly and closer to the pre-crisis trend.

- 4) We expect to return to pre-pandemic growth rates but will not make up for lost time and thus, at least in the medium term, the level of economic output is permanently lower or 'scarred'<sup>1</sup>.

The proximate challenge is to prevent (1) and (2) from jeopardising (3), and to minimise (4).

## The challenges

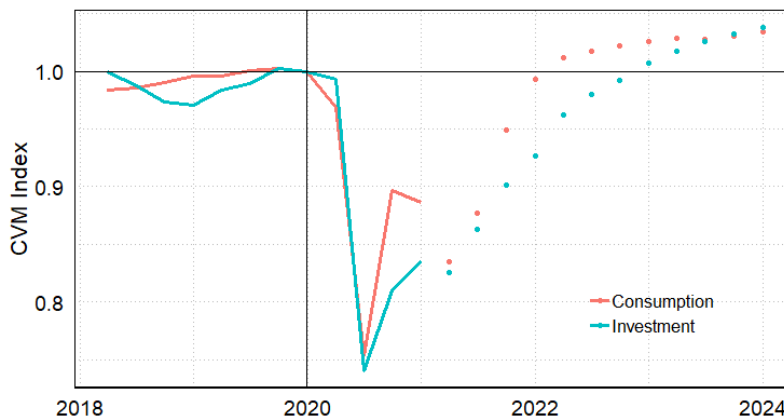
### Scarring

Let me first consider the potential for economic 'scarring'. In its best collective view the MPC has forecast that some persistent effects of the pandemic will weigh on the supply capacity of the UK economy, to the extent that the level of potential GDP ( $Y^*$ ) is around 1¾ percent lower by the end of 2023 than it otherwise would have been. Why is this? To help us think about this let us consider a formula<sup>2</sup> for the level of potential GDP  $Y^*$ :

$$Y^* = \left(\frac{Y^*}{H^*}\right) H^* = f\left(A^*, \frac{K^*}{H^*}\right) H^*$$

This formula tells us that potential GDP is composed of potential per-hour productivity  $\left(\frac{Y^*}{H^*}\right)$  and potential labour supply  $H^*$ . Potential productivity is a function of general technical progress  $A^*$  and capital services  $K^*$  relative to  $H^*$ . In other words, labour productivity growth is underpinned by investment in capital that makes workers more efficient as well as general improvements in workers' efficiency ( $A^*$ ) that arise from a variety of sources, including individual experience on the job and process innovations.<sup>3</sup> The pandemic has and will continue to disrupt both of these channels.

**Figure 2: The recovery of consumption and investment**



Sources: ONS and Bank of England.

Note: Volume measures of consumption and investment indexed to 2019Q4. Profiles shown by the dotted lines to 2023Q4 should be viewed as broadly consistent with the MPC's projections for GDP, CPI inflation and unemployment (as presented in the fan charts) in the February 2021 MPR.

<sup>1</sup> Note that we are talking here about scarring in terms of levels, as we expect to return to productivity growth rates of around ½% per annum, similar to the rates of growth observed before the pandemic. This is much lower than the productivity growth we sustained before the financial crisis, which was close to 2 percent.

<sup>2</sup> This formula is typical of the formulae that sit within macroeconomic models of the business cycle.

<sup>3</sup> We are here relegating improvements in human capital to  $A$ .

**Lower  $K^*$ :** Starting with tangible capital, overall investment in capital goods collapsed in 2020 and failed to recover to the same extent as we saw for consumption (**Figure 2**). Looking forward, residual uncertainty and risk aversion over the recovery are likely to continue to weigh on investment, as they have in past recoveries (Cominetti et al, 2021). Therefore, we expect workers will be operating with less capital than they otherwise would.

**Lower  $A^*$ :** In terms of intangible capital, reduced levels of investment in research and development and process improvements will drag on overall levels of efficiency in the medium term. In terms of human capital, we also anticipate that time out of the labour force through the government's furlough scheme (Coronavirus Job Retention Scheme) in 2020 and 2021, and higher unemployment in 2021 and 2022, will reduce the accumulation of human capital through less 'learning by doing'.

**Lower  $H^*$ :** Elevated levels of unemployment can also lower the supply capacity of the economy. Unemployment in our forecast peaks at 7¾ percent in the middle of 2021 and then comes down. However, if that unemployment translates into higher structural unemployment, then one can have a high-unemployment economy but with lower potential supply. This will especially be the case when there is a substantial mismatch between the characteristics of unemployed workers and posted vacancies, for example a regional or industry mismatch or differences in required skills and experience. This was significant after the financial crisis (Sahin et al, 2014).<sup>4</sup> We have made no specific assumptions about the underlying causes of any labour market mismatch over the forecast but lasting changes to the way we work and consume are possible candidates, alongside broader forces of creative destruction that might accelerate in a recovery. While this labour mismatch effect is likely to be temporary, we currently expect it to persist into the medium term.

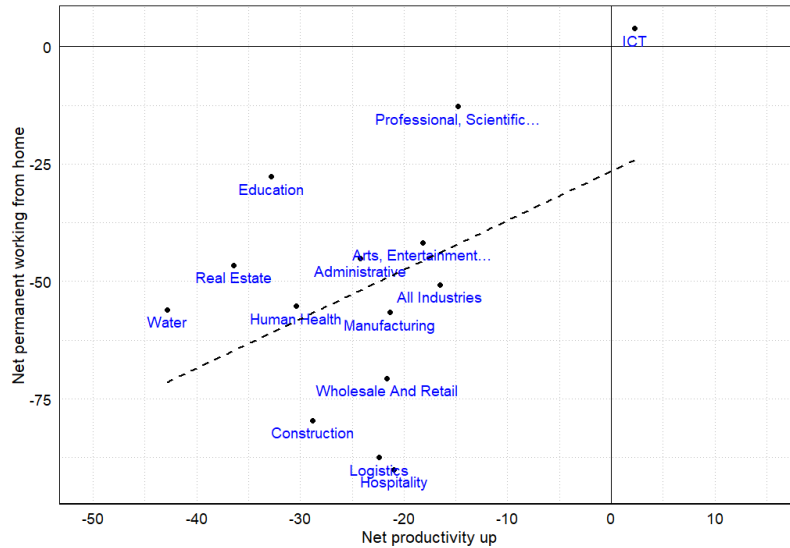
There are other channels, not incorporated in our forecast, that might also affect potential output. The first is the prospect of more significant structural change from increased working from home and shifts in the composition of consumption. I'll make two brief points on this. The first is that while it is remarkable that in recent months (according to the ONS BICS survey) almost 50 percent of the UK's active labour force was working from home, a net balance of firms across the vast majority of industries does not intend to use increased homeworking as a permanent feature going forward, nor do they think homeworking has improved productivity. This is illustrated in **Figure 3**, which captures these two points. First, as the y axis shows, there is only one industry where firms intend to increase homeworking permanently, Information and Communication, with all the other industries stating they do not intend to do so (Financial services are not surveyed). Second, there is a positive correlation, captured by the trend line, between the intent of permanent homeworking on the y axis and experiences of homeworking productivity on the x axis. All industries are in the bottom-left quadrant, with only Information & Communication in the top-right. This suggests, to me at least, it is likely that the majority of industries will return to the workplace when the pandemic restrictions are lifted, lessening the impact of structural change from this quarter.

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<sup>4</sup> See the [August 2020 MPR](#) for more discussion on this.

**Figure 3: Working from home prospects**

Net percentage expecting increased homeworking as permanent (y axis) vs net percentage reporting increased productivity from homeworking (x axis)

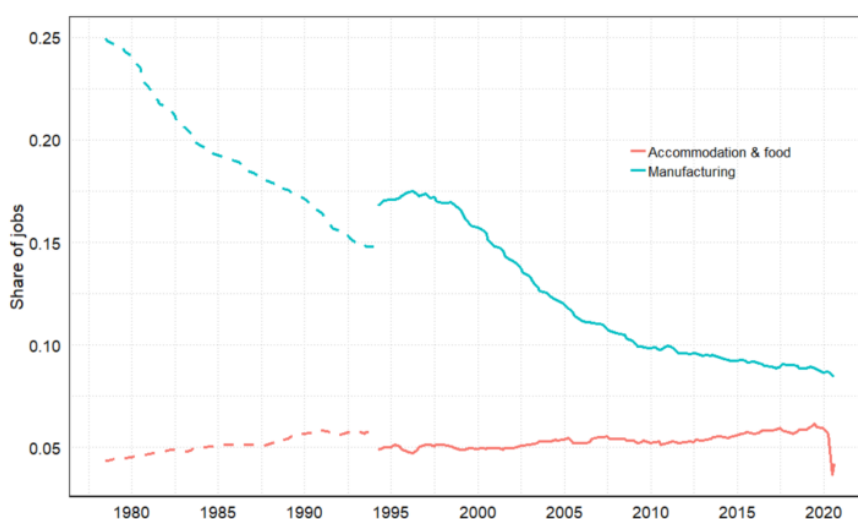


Source: Business Impacts of Coronavirus (COVID-19) Survey data. Average of waves 14 (21 September -4 October 2020), 16 (5-18 October 2020), 18 (16-29 November 2020), 20 (14-23 December 2020), 22 (11-24 January 2021) and 24 (25 January -7 February 2021). Note that “Other Services” has been removed from the sample.

Questions: “How has the increase in homeworking affected the productivity of your workforce?” and “Does your business intend to use increased homeworking as a permanent business model going forward?”

The second point is the importance of putting any potential structural change in a longer-run context. People often discuss structural change in the context of the massive changes in manufacturing employment. To get some measure of this, **Figure 4** illustrates the significant shift away from employment in manufacturing in the UK since 1980, captured by the fall in the manufacturing industry’s share of employment. I also plot the share of employment in Accommodation and Food services, the sector that has been most affected by COVID-19 restrictions. In the 15 years from 1980-1995 the manufacturing share fell from around 25% to 15%, and in the following 15 years from 15% to 8%. Over that entire period Accommodation and Food hovered around 5%. Note that even under these extreme circumstances, the change in the share of aggregate hours in this industry in 2020 is actually small relative to the longer-run shift in manufacturing. Putting this together the prospects for large COVID-specific structural employment changes are probably small, at least in an economic sense.

**Figure 4: Industry employment shares**



Source: ONS

Note: Dashed lines are shares of total employment (jobs). Solid lines are hours shares of total hours worked from the Labour Force Survey. Last datapoint in 2020Q3.

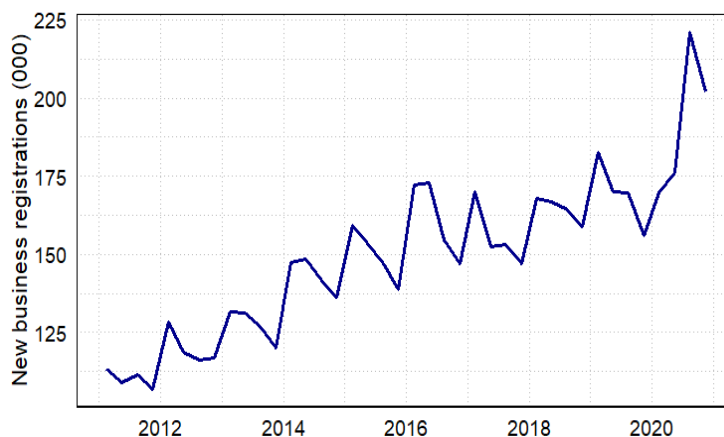
Another unincorporated channel is the prospect of lower future levels of intangible investment, an important driver of economic growth. I (Haskel, 2019) and others (Garcia-Macia, 2017) have discussed the post-financial-crisis slowdown in intangible investment. The hurdle for intangible investment is that it can be difficult to fund as the assets it generates are less easy to pledge as collateral and possibly riskier. For example significant spillovers may mean the benefits of the intangible investment accrue to third parties. A strong intangible economy therefore requires a financial system capable of lending against intangibles assets. Here is an area where we should expect to fare better this time round, as the financial system is in a much stronger position today than it was after the financial crisis<sup>5</sup>. An additional factor is that house prices have not decreased as they did during the financial crisis. In fact they grew by 8.5% in the UK over 2020, on the back of the stamp duty holiday and supportive fiscal and monetary policy. This might matter for investment that relies on private real estate as collateral, as shown in studies such as Bahaj et al (2020) and noted in a speech (Haskel, 2020) I made last year that highlighted the particular importance of this channel for intangible investment.

Reduced entry of innovative firms may also drag on growth over the medium term if a subdued economic environment deters them or new firms struggle to obtain finance. Again, a relatively stronger financial system should help mitigate some of this risk. So far I've yet to see material evidence of any decline – to the contrary,

<sup>5</sup> See December 2020 [Financial Stability Report](#).

**Figure 5** shows we have actually seen a surprisingly large uptick in new registrations, which requires more analysis.

**Figure 5: New business registrations in the UK**



Source: Companies House register. Note: Last data point is December 2020.

A final point on scarring is to note that we have not talked about scarring in terms of growth rates, nor do we forecast a lower rate of productivity growth beyond the medium term. This is in stark contrast to the slowdown witnessed after the financial crisis, where the average annual productivity growth rate in the UK fell from close to 2 percent to about ½ percent (**Figure 1**) – the unresolved ‘productivity puzzle’. Had we reverted to the pre-crisis trajectory of productivity growth after the financial crisis, the level of GDP in 2019 would have been about 13 percent higher than it was. Our forecasts are that productivity is set to grow still very slowly, at about ½% pa. In that sense, the growth scarring from the financial crisis is still with us.

#### Fiscal drawdown

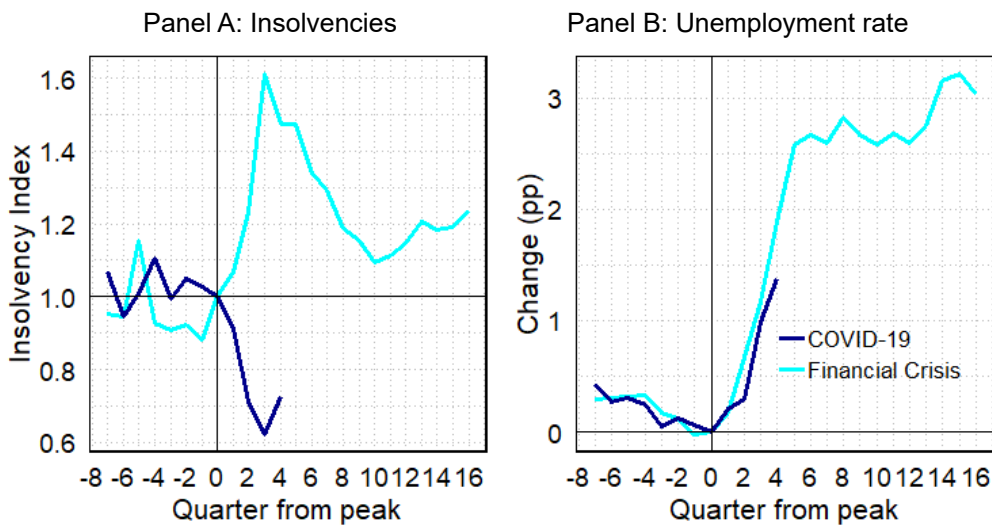
Rightly, governments around the world have stepped in to provide insurance against the economic impact of the pandemic. The cost of announced coronavirus-related policy measures alone is expected to be around 16 percent of GDP, of which about ½ has been spending on employment and business support, such as the furlough scheme, tax relief and government-guaranteed loans<sup>6</sup>. While the expiration of these measures is a moving target, we can expect them to be withdrawn once restrictions loosen sufficiently. In the Spring Budget delivered on 3 March, the government announced an extension to the support measures for jobs and businesses until the autumn. The transition away from government support represents a considerable test for the recovery. **Figure 6** below highlights how these support schemes have insulated employees and businesses. On the left hand side we see, remarkably, that unlike during the financial crisis, insolvencies actually fell over 2020. This is in large part due to capacity constraints on administrators and courts caused by the pandemic, such that we can expect a level of pent-up insolvencies to emerge. However, the business support schemes will

<sup>6</sup> See the Office of Budget Responsibility [March 2021 outlook](#) for more detail. Quoted numbers are from chapter 3 (Chart A) and are expressed relative to 2020 GDP.

also have played a part in this as well, by reducing cash-flow pressures on firms and banning commercial tenant evictions.

On the right hand side of **Figure 6**, we see that, remarkably, despite the significant difference in magnitude of the economic contractions, the change in the official unemployment rate over 2020 follows a similar trajectory to what we saw during the financial crisis. The government’s furlough scheme explains<sup>7</sup> this of course and the latest data from the ONS would suggest that 25% of the private-sector labour force is currently on furlough. Cominetti et al (2021) estimate that of these furloughed workers, half a million have been on furlough for at least six months. The extent to which these schemes have averted rather than simply delayed rising insolvencies and unemployment remains, for me, an open question.

**Figure 6: Insolvencies and unemployment**



Source: UK Government Insolvency Service, ONS and author calculations.

Note: Insolvencies and unemployment are plotted relative to the quarter containing the pre-recession peak in GDP.

### Vaccine efficacy vs vaccine effectiveness and escape mutants

A final challenge or concern is the distinction between vaccine efficacy and vaccine effectiveness (sometimes called implementation). Vaccine efficacy, that is, how well the vaccine works in a laboratory setting on screened participants, is very high – a tribute to the scientific community. Less is known about vaccine effectiveness, that is, how well the vaccine works in the field, which depends also on production, logistics and public health policies. The vaccine manufacturing and distribution processes would seem to be vulnerable to small disturbances at any point along the production and distribution chains (a sort of “O Ring” effect). Another issue is the emergence of highly transmissible variants of the virus, so-called “escape mutants”, of the kind that necessitated a re-imposition of lockdowns here and abroad earlier this year. The time needed to redesign and

<sup>7</sup> There are also some measurement issues related to the ONS’s labour force survey that mean the official unemployment rate has likely struggled to capture the true increase in unemployment. More detail [here](#).



redistribute vaccines that can deal with novel resistant strains could mean renewed restrictions and voluntary social distancing as health risks worsened.

## On the upside

I've largely focused so far on scarring and downside risks to the outlook but there are reasons to look to the upside as well.

First, the early evidence suggests vaccine efficacy is translating into vaccine effectiveness. Across the United Kingdom, more than 20 million<sup>8</sup> people have received a first dose of a vaccine, including nearly all of the most vulnerable groups in society. We are also beginning to see evidence of vaccine effectiveness. For example data from [Public Health England](#) shows one dose of the Pfizer-BioNTech vaccine reduces the risk of infection by more than 70 percent, rising to 85 percent after the second dose. They also report that those over 80 who develop a COVID-19 infection after vaccination are around 40% less likely to be hospitalised than someone with infection who has not been vaccinated. This is very promising but the true test will come when the majority of the country begins the process of easing restrictions next week (8 March).

Another potential upside is a stronger recovery in consumer spending, if households (on the back of an effective vaccine programme) choose to spend the savings involuntarily accumulated during the lockdowns (**Figure 7**). Approximately £125bn of extra savings accumulated between March and November 2020 as consumption fell due to COVID-related restrictions, while incomes were supported by government employment schemes. Due to continued support and restrictions, this stock is set to rise even further and could approach £300bn by the time restrictions are fully lifted. To put this into perspective, given there are approximately 30 million households in the UK, that £300bn translates into an additional £10,000 of savings per household on average (were the savings to be distributed equally – we comment on this below). That is a sizeable amount, equivalent to about what the median UK household holds in liquid saving accounts/cash ISAs<sup>9</sup>.

The MPC's central projection is for households to spend about 5% of these additional accumulated savings over the forecast but it is conceivable households might choose to spend even more, particularly since a large proportion of the accumulated savings is in liquid bank deposits, which can be spent easily. Pushing against that is the fact that household consumption changes out of additional wealth are not generally measured to be all that large, and the bulk of these savings will have accrued to wealthier households who are less likely to respond to this extra private wealth through higher consumption<sup>10</sup>. We also asked households<sup>11</sup> who had accumulated extra savings – which constituted 30% of households – what they intend to do with these extra savings in the 2020H2 NMG survey. Only a minority of those who had accumulated extra savings indicated they would use those savings to finance high spending, whereas around 70 percent responded they would save it in the bank (**Figure 8**).

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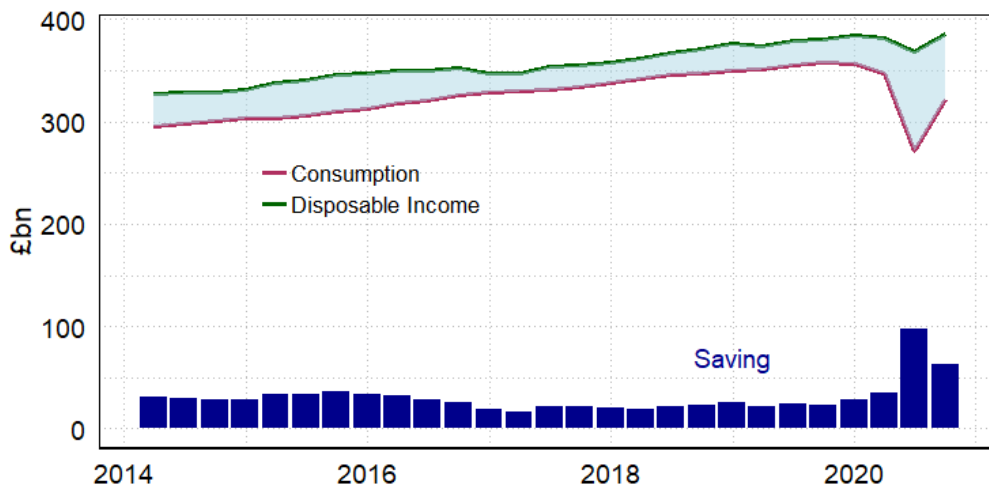
<sup>8</sup> At the time of writing, the figure was 21.3 million.

<sup>9</sup> Based on calculations from the ONS's wealth and asset survey (2016 year).

<sup>10</sup> See February *MPR* section 3 and Vlieghe (2021) for more discussion.

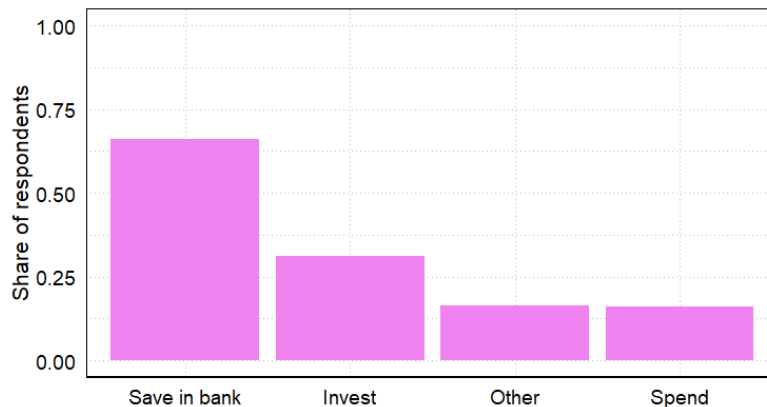
<sup>11</sup> Much more detailed information, in particular about the distribution of these additional savings, is set out here: [How has Covid affected household savings? | Bank of England](#)

**Figure 7: Household savings**



Source: ONS. Note: Last data point is 2020Q3.

**Figure 8: Household plans from extra savings**



Sources: 2020H2 NMG Household Survey and Bank calculations.

Note: Distribution of answers to the question “You said your savings have increased during the pandemic. What do you plan to do with these savings?”. “Other” includes giving to family/gift, not sure and prefer not to say.

### Where does this leave me on monetary policy?

The economy has some significant challenges to overcome on our road to recovery.

At the February 2021 MPC meeting, I judged alongside my colleagues that the existing stance of monetary policy remained appropriate, with the positive news related to the vaccine rollout offset by the near-term deterioration of the public-health outlook and stringent lockdown measures. The decision to leave policy unchanged was consistent with our guidance not to tighten monetary policy at least until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

My views on the supply outlook are balanced. While I see potential for greater scarring should the economy fail to overcome its near-term challenges, I don't draw significant parallels, at this time, between the risk to supply over the medium term and our experience after the 1980s recession and the financial crisis. The key issue after the financial crisis was a severe and unexplained permanent slowdown in productivity growth that we were grappling with before the pandemic.

The current *MPR* forecast shows the UK economy moving into a temporary period of excess demand in 2022. Nevertheless, given the endogenous nature of supply and the temporary factors underpinning that movement into excess demand, namely fiscal spending on health and some pent-up demand, I see relatively little risk of sustained above-target inflation over this period.

Finally, it is my view that risks to activity remain skewed to the downside. As I have consistently argued,<sup>12</sup> risk-management considerations dictate that policy should lean strongly against downside risks to the outlook<sup>13</sup> and I remain open to the possibility that the economy might need further support to return inflation to the target sustainably. This means guarding against any weakness in the economy being amplified by a tightening in monetary conditions that could slow the return of inflation to the target. It also means being ready to deploy, as and when needed, all the tools available to the MPC. That is why, following the completion of the PRA's initial consultation with regulated firms regarding the setting of zero or negative Bank Rate, I supported the decision alongside my colleagues to request that the PRA further engage with firms to ensure they start preparations to be ready to implement a negative Bank Rate at any point after six months. It is prudent for banks to start preparations regardless of the currently desired policy stance, for that is what it means for a negative Bank Rate to be in the MPC's monetary policy toolkit.

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<sup>12</sup> Haskel (2019).

<sup>13</sup> A risk-management approach proposes that the possibility of running out of monetary headroom warrants looser monetary policy in advance of it occurring. See Evans et al (2015) and Adam and Billi (2007).

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