



BANK OF ENGLAND

Monetary Policy Committee



Monetary Policy Report

August 2020



On 7 August, the third panel in Chart 2.18 was corrected. Missing data for 2023 were also added to the May market path for policy rates in the euro area in Chart 2.7.



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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.

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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 <http://www.bankofengland.co.uk/report/2020/monetary-policy-report-financial-stability-report-august-2020>

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Monetary Policy Summary

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. In that context, its challenge at present is to respond to the economic and financial impact of the Covid-19 pandemic. At its meeting ending on 4 August 2020, the MPC voted unanimously to maintain Bank Rate at 0.1%. The Committee voted unanimously for the Bank of England to continue with its existing programmes of UK government bond and sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, maintaining the target for the total stock of these purchases at £745 billion.

The Committee's projections for activity and inflation are set out in the accompanying *August Monetary Policy Report*. Although recent developments suggest a less weak starting point for the Committee's latest projections, it is unclear how informative they are about how the economy will perform further out. The outlook for the UK and global economies remains unusually uncertain. It will depend critically on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these factors. The MPC's projections assume that the direct impact of Covid-19 on the economy dissipates gradually over the forecast period. Given the inherent uncertainties regarding the evolution of the pandemic, the MPC's medium-term projections are a less informative guide than usual.

Global activity has strengthened over recent months, although it generally remains below its level in 2019 Q4. Covid-19 has continued to spread rapidly within a number of emerging market economies, however, and there has been a renewed rise in cases in many advanced economies.

UK GDP is expected to have been over 20% lower in 2020 Q2 than in 2019 Q4. But higher-frequency indicators imply that spending has recovered significantly since the trough in activity in April. Payments data suggest that household consumption in July was less than 10% below its level at the start of the year. Housing market activity appears to have returned to close to normal levels, despite signs of a tightening in credit supply for some households. There is less evidence available on business spending, but surveys suggest that business investment is likely to have fallen markedly in Q2 and investment intentions remain very weak.

Employment appears to have fallen since the Covid-19 outbreak, although this has been very significantly mitigated by the extensive take-up of support from temporary government schemes. Surveys indicate that many workers have already returned to work from furlough, but considerable uncertainty remains about the prospects for employment after those support schemes unwind. In the near term, the unemployment rate is projected to rise materially, to around 7½% by the end of the year, consistent with a material degree of spare capacity.

In the MPC's central projection, GDP continues to recover beyond the near term, as social distancing eases and consumer spending picks up further. Business investment also recovers, but somewhat more slowly. Unemployment declines gradually from the beginning of 2021 onwards. Activity is supported by the substantial fiscal and monetary policy actions in place. Nonetheless, the recovery in demand takes time as health concerns drag on activity. GDP is not projected to exceed its level in 2019 Q4 until the end of 2021, in part reflecting persistently weaker supply capacity. Given the scale of the movements in output, as well as the inherent uncertainty over the factors determining the outlook, the evolution of the balance between demand and supply is hard to assess. The MPC's central projection implies that a margin of spare capacity is likely to remain until the end of next year. The risks to the outlook for GDP are judged to be skewed to the downside.

Twelve-month CPI inflation increased to 0.6% in June from 0.5% in May. CPI inflation is expected to fall further below the 2% target and average around ¼% in the latter part of the year, largely reflecting the direct and indirect effects of Covid-19. These include the impact of energy prices and the temporary cut in VAT for hospitality, holiday accommodation and attractions. As these effects unwind, inflation rises, supported by a gradual strengthening of domestic price pressures as spare capacity diminishes. In the MPC’s central projection, conditioned on prevailing market yields, CPI inflation is expected to be around 2% in two years’ time.

The Committee will continue to monitor the situation closely and stands ready to adjust monetary policy accordingly to meet its remit. The MPC will keep under review the range of actions that could be taken to deliver its objectives. The Committee does not intend to tighten monetary policy 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 judges that the existing stance of monetary policy remains appropriate.

1 The economic outlook

The spread of Covid-19 and the actions to contain it have had a dramatic impact on the UK and many countries around the world. Global activity fell sharply during the first few months of 2020. Since then, output has recovered, but remains below levels at the start of the year.

The outlook for the UK and global economies remains unusually uncertain. It will depend critically on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses respond to these factors. The MPC's projections assume that the direct impact of Covid-19 on the economy dissipates gradually over the forecast period. Conditional on that assumption, UK GDP is projected to continue to recover over the forecast period. Activity is also supported by substantial fiscal and monetary policy actions. Nonetheless, the recovery in demand takes time as health concerns drag on activity. The risks are skewed to the downside.

The supply capacity of the economy has also fallen materially over the first half of the year, and the balance between demand and supply is difficult to gauge. On balance, there is judged to be a material degree of spare capacity at the moment. That is eroded as activity picks up, before a margin of excess demand builds during the second half of the forecast period.

CPI inflation is projected to remain well below the MPC's 2% target in the near term, largely reflecting the direct and indirect effects of Covid-19. These include the temporary impact of lower energy prices and cut in VAT, as well as downward pressure from spare capacity in the economy. As these effects wane, inflation rises. In the central projection, inflation is projected to be around 2% in two years' time.

1.1 Recent developments

Activity around the world — including in the UK — fell sharply over March and April, as social distancing affected spending...

The spread of Covid-19 and the social distancing to control it have restricted economic activity across a wide range of countries. Bank staff estimate that UK-weighted world GDP fell by around 12% over the first half of the year. That fall, while very substantial, is materially less sharp than was the case in the illustrative scenario in the [May Report](#). That reflects restrictions being eased sooner than assumed and, even while some restrictions remained in place, a more rapid recovery in consumer spending.

The timing and magnitude of the falls in activity have varied across countries, partly reflecting differences in the spread of the virus and lockdown measures, including when they began to be eased. The variation is also likely to reflect differences in the structure of economies, such as the amount of spending that involves interactions with other people. That has been particularly affected by Covid-19, as social distancing measures have been introduced and as people's health concerns have risen. In the UK, relative to some other countries, lockdown measures were

eased later and the proportion of spending involving high degrees of social interactions is bigger in normal times. As a result, the impact of Covid-19 on UK activity has been relatively large. UK GDP is expected to have been 23% lower in 2020 Q2 relative to 2019 Q4.

...but it has recovered somewhat since then.

Indicators of activity have recovered in many countries over the past few months, although they generally remain below their pre-Covid levels (Section 2.1). In the UK, GDP rose in May. Higher-frequency indicators suggest that spending has recovered further since then. For example, indicators from payments data suggest that consumer spending in July was, in aggregate, no more than 10% below its level at the start of the year, after falling to around 30%–40% below it early in the lockdown.

The recovery in the UK has been earlier and more rapid than was assumed in the illustrative scenario in the May Report...

The recovery in UK output has been somewhat more rapid than was assumed in the MPC's illustrative scenario in the *May Report*. That partly reflects lockdown measures being eased earlier than had been assumed. It also reflects activity having been stronger than assumed under lockdown, partly due to greater online spending.

...but it has not been evenly distributed across the economy.

Some aspects of consumer spending have recovered rapidly. For example, spending that can be delayed — including on items such as clothing, household furnishings and other larger items — fell sharply after restrictions were introduced, but has since returned to close to pre-Covid levels at the start of the year (Section 2.3). In addition, spending on staples, such as on food and household energy, has remained above pre-Covid levels for most of the period since May. Reflecting those developments, retail sales have risen sharply since April, and in June were close to their pre-Covid levels.

In contrast, other spending has remained subdued. Household spending that involves high levels of interactions with others fell the furthest and has recovered only partially from its lows. Evidence from surveys also suggests that business investment has remained weak. For example, respondents to the DMP Survey in July reported that they would spend around 30% less than previously expected on investment in Q2.

In part, those differences reflect the impact of measures introduced by the Government to slow the spread of the virus, which affected household spending related to social interactions the most. They are also likely to reflect the impact of consumer and business confidence, as well as uncertainty about the outlook. Elevated concerns about health risks are likely to constrain households' social interactions. And heightened business uncertainty about the economic outlook can weigh heavily on investment, as it increases the incentive to postpone projects until more clarity emerges (see Section 4 of the *November 2019 Report* for more detail). The effect of uncertainty on investment spending is likely to have been compounded by the need for businesses to conserve cash flow in the face of sharp falls in sales.

The reduction in activity has resulted in lower employment, although government policies have significantly limited the number of job losses.

In aggregate, consumer spending has fallen by much more than household incomes. Incomes and employment have been supported by government measures — such as the Coronavirus Job Retention Scheme (CJRS) and Self-Employment Income Support Scheme (SEISS) — which have been widely used. Over 9 million jobs were furloughed at some point under the CJRS, with Bank staff estimating that the peak number of employees on furlough was over 7 million in May. Bank staff estimate that around 6 million employees were furloughed on average during Q2, broadly in line with the assumption embodied in the *May Report* scenario. For those furloughed employees, the Government initially paid 80% of their income, up to £2,500 per month. Bank staff estimate that furloughed employees received 85% of their usual pay on average in Q2, a greater proportion than previously assumed, as the Government's contribution was topped up by some employers. In addition, around 80% of eligible self-employed workers made use of the SEISS, which corresponds to over 2½ million total claims.

Despite having been supported by the CJRS and SEISS, employment has fallen since the Covid-19 outbreak. There is a lot of uncertainty about the exact magnitude of the decline in employment, with different data sources providing substantially different estimates. Based on a range of evidence, Bank staff expect total employment to have fallen

in Q2 as a whole, although by much less than output (Section 2.4). Lower employment, alongside a reduction in hours by others remaining in work — including by employees on the furlough scheme — has resulted in a sharp fall in hours worked (Section 3).

Bank staff estimate that unemployment has increased. While LFS data suggest that unemployment was little changed in the three months to May, alternative sources suggest that it has begun to rise, although it appears to have increased by substantially less than in the illustrative scenario in the *May Report*. In addition, lockdown measures, including school closures, mean that some people who have lost their jobs are likely to have not been actively searching for a job, or have not been available to start work. As a result, the proportion of the population classed as inactive has also increased.

The supply capacity of the economy has fallen, as businesses have shut and employees have been furloughed.

While demand has fallen sharply over the first half of the year, the supply of goods and services has also declined materially. Many businesses closed: around a quarter of companies reported being temporarily closed in early April, with 7% reporting that they remained closed in July. Others have temporarily reduced production and furloughed employees. And some companies have had to adjust working practices — reflecting more working from home, or to accommodate social distancing guidelines, for example — which might have weighed on productivity.

Nonetheless, there is judged to be spare capacity in the economy.

Notwithstanding these effects on supply, the MPC assesses that the contraction in demand is likely to have resulted in a material amount of additional spare capacity in the UK economy. The MPC judges that there is less slack than was assumed in the scenario in the *May Report*, however. Activity has fallen by somewhat less over the first half of the year than in the illustrative scenario, although a similar number of employees have been furloughed. Less slack is also consistent with the smaller rise in unemployment than was in the scenario.

The precise extent of spare capacity is highly uncertain, though. There will also be significant variation in the degree of spare capacity across different sectors and firms (Section 4).

Inflation has been very weak, largely reflecting the direct and indirect effects of Covid-19.

Spare capacity will have exerted some downward pressure on domestic prices. Wage growth has been significantly affected by the impact of the CJRS. Underlying wage growth is likely to have weakened. There is evidence from the Bank's Agents that wage pressures are muted.

In addition, CPI inflation has been affected by lower energy prices, as oil prices fell markedly in response to the fall in global GDP. That accounts for a large part of the fall in inflation from 1.7% in Q1 to 0.6% in Q2.

1.2 The MPC's projections

Table 1.A Forecast summary^{(a)(b)}

	Projections			
	2020 Q4 ^(c)	2021 Q3	2022 Q3	2023 Q3
GDP ^(d)	-5.4	8.6	3.0	1.9
CPI inflation ^(e)	0.3	1.8	2.0	2.2
LFS unemployment rate	7.5	6.6	4.7	4.0
Excess supply/Excess demand ^(f)	-2¼	-¼	+½	+¾
Bank Rate ^(g)	0.0	-0.1	-0.1	-0.1

(a) Modal projections for GDP, CPI inflation, LFS unemployment and excess supply/excess demand.

(b) Unless otherwise stated, the projections shown in this section are conditioned on: Bank Rate following a path implied by market yields; the TFS and TFSME; the Recommendations of the Financial Policy Committee and the current regulatory plans of the Prudential Regulation Authority; the OBR's assessment of the Government's current tax and spending plans; 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 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 www.bankofengland.co.uk/report/2020/monetary-policy-report-financial-stability-report-august-2020.

(c) Data for 2020 Q4 are shown to abstract from volatility and measurement issues in some profiles in the near term.

(d) Four-quarter growth in real GDP. Excludes the backcast for GDP.

(e) Four-quarter inflation rate.

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

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

Uncertainty is currently elevated, reflecting concerns about the impact of Covid-19. The MPC's projections assume that it dissipates gradually over the forecast period.

The outlook for the economy is highly uncertain. It is dependent on the evolution of the pandemic and the measures taken to protect public health. Equally, it will depend on how governments, households, businesses and financial markets respond to those developments. In the MPC's projections, it is assumed that the current shock has resulted in heightened uncertainty about the outlook for both health and the economy. That is consistent with a range of evidence from businesses and households. In the UK, three quarters of businesses responding to the DMP Survey reported that overall uncertainty was high or very high in July, compared to around 40% before Covid-19 restrictions were introduced. Survey indicators suggest that households remain cautious overall, with GfK/EC consumer confidence remaining well below its historical average in July. And an ONS survey suggests that substantial proportions of adults would feel uncomfortable about some social activities, such as going to the cinema or eating indoors at a restaurant, at present (Section 2.3).

Over time, that uncertainty is assumed to wane, but only gradually. The path for uncertainty is consistent with improved treatments or other health interventions becoming available. Over the forecast period, those developments are assumed to reduce the health and economic risks facing households and businesses. As a result, the direct effects of the pandemic on the economy are assumed to fade. For example, households are assumed to increase their social interactions gradually over the first half of the forecast period. Nonetheless, the pandemic has a longer-lasting impact on both the demand and supply sides of the economy, through lower capital accumulation, higher labour market mismatch and other scarring effects (Key Judgement 2).

The proportion of employees furloughed from their jobs is assumed to decline, with most re-employed.

Government support measures are assumed to evolve in line with government policy. The CJRS is unwound. Employers are liable for employees' National Insurance and pension contributions from August, and will need to contribute at least 10% of their salary in September and 20% in October, with the scheme closing at the end of October.

Surveys indicate that some workers have already returned to work from furlough, and that companies expect the proportion of employees on furlough to continue to drop in the near term (Section 3). The central projections assume that around 2 million employees are furloughed in Q3 on average and around 1 million are furloughed in October. In line with evidence from surveys, most workers are judged likely to return to work at their employer as demand recovers, although some jobs are lost.

Fiscal policy actions support spending...

Since the start of the year, the Government has increased spending materially to support the economy. In its *Summer Economic Update* in July, the Government announced a Job Retention Bonus of £1,000 for each previously furloughed employee still employed by 31 January 2021, alongside other schemes to support jobs. It also announced a temporary cut in VAT for hospitality and accommodation and a temporary increase in the Stamp Duty threshold. In addition, government spending was increased. Taken together, these measures boost activity substantially over the forecast period.

...as does monetary policy.

In June, the MPC announced that it would increase the target stock of purchased UK government bonds, financed by the issuance of central bank reserves, by £100 billion, to take the total stock of asset purchases to £745 billion. The MPC's forecast is conditioned on the market path for interest rates, which has fallen over the past three months, and averages close to zero over the forecast period (**Table 1.A**).¹ The sterling exchange rate has depreciated by around 1¾% over the past three months.

UK financial conditions have eased over the past three months, although they remain somewhat tighter than at the start of the year.

Globally, risky asset prices fell sharply over the first few months of the year. Since then, those moves have unwound somewhat, with equity prices rising and corporate bond spreads falling. Movements in UK asset prices

¹ The forecast assumes that the transmission mechanism for changes in Bank Rate implied by the market path for interest rates is as usual. There could be risks around that (see Box 1).

have broadly mirrored global developments, although the rise in UK equity prices over recent months has been somewhat less than in other advanced economies. The improvements in financial market conditions have supported credit supply conditions to companies since May, as have government-backed lending schemes. However, credit conditions for households have tightened somewhat, with the Bank's *Credit Conditions Survey* suggesting that the availability of both secured and unsecured borrowing has fallen.

Overall, UK financial conditions have eased somewhat since the *May Report*, although they remain tighter than in January. Credit conditions are assumed to remain tighter over the forecast period than was projected before the Covid-19 shock.

The MPC's central projections are conditioned on the assumption that there is an immediate but orderly move to a comprehensive free trade agreement with the EU on 1 January 2021.

Consistent with government policy, and as in previous *Reports*, the MPC's central projections assume that there is an immediate but orderly move to a comprehensive free trade agreement between the UK and the EU on 1 January 2021. Some restrictions on trade between the UK and EU are assumed to come into place at that point as the UK leaves the EU's Single Market and Customs Union.

The UK Government has stated that it would be willing to trade with the EU without a free trade agreement, should such an agreement not be reached. This would involve the introduction of tariffs on some goods traded with the EU and, relative to the central case, greater non-tariff barriers to trade, such as more onerous border checks or higher regulatory barriers. The possibility of an orderly transition to such trading arrangements, in line with government policy, is therefore included in the fan charts.

Global GDP growth

Global GDP is projected to continue to recover as restrictions ease and policy remains supportive...

Following a sharp fall in the first half of the year, global GDP picks up in 2020 H2. Indicators of activity have already begun to recover in many countries as social distancing measures have been eased, and the recovery is projected to continue in the near term. Thereafter, spending is continued to be supported by the dissipation of uncertainty about both health and the economy and the very large policy responses that have been put in place. The profile of the recoveries in spending vary across countries, reflecting differences in public health and associated actions to control the spread of Covid-19, as well as the magnitude of policy responses. For example, the recovery in the US is assumed to be a little slower as a result of the increase in Covid-19 cases in recent weeks.

...although activity is dampened by scarring effects.

While global activity rises over the next three years, the MPC judges that some longer-lasting effects will dampen output over the forecast period. Weaker business investment is likely to weigh on the growth of the capital stock, and could reduce productivity growth via lower research and development spending. Moreover, unemployment is expected to remain elevated.

In the central forecast, PPP-weighted world growth falls sharply from 3% in 2019 to -5% in 2020. It increases strongly in 2021 — to 7½% — reflecting the recovery in activity, before growing by 5% in 2022. Weighted by UK export shares, world GDP growth falls from 1¾% in 2019 to -6¼% in 2020. It recovers to 6% in 2021 and is around 4¼% in 2022 (**Table 1.C**).

UK GDP growth

UK GDP also continues to pick up...

Spending in the UK is projected to rise relatively rapidly over the second half of the year (**Chart 1.1**), consistent with recent developments in high-frequency indicators. Further out, the pace of the recovery slows. However, activity continues to pick up, supported by the assumption that heightened uncertainty about the outlook for both health and the economy wanes gradually over time. That leads to further rises in consumer spending on social activities. The significant increase in fiscal spending and the accommodative stance of monetary policy also support demand. At the end of this year, GDP is projected to be 5% below its level a year earlier. There is higher uncertainty than usual around the outlook for unemployment. It is forecast to rise to around 7½% in Q4, before gradually declining.

...although the gradual decline in uncertainty means that the recovery takes time...

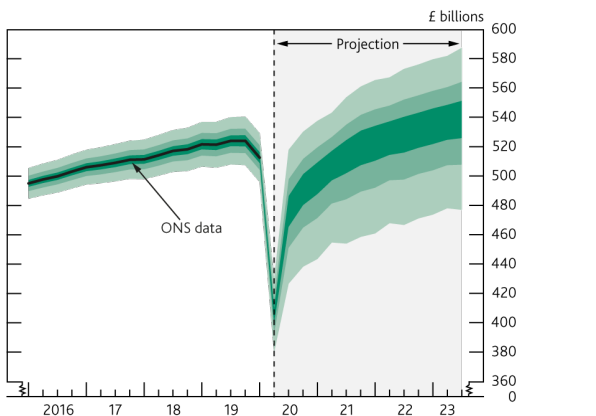
Over 2021, spending remains weaker than it would have been in the absence of Covid-19. Uncertainty is assumed to fade gradually, so it continues to dampen spending. Tighter financial conditions also weigh on output. In the MPC's central projection, GDP does not exceed its level in 2019 Q4 until the end of 2021. Over 2021, GDP is, on average, more than 3% weaker than in the MPC's January forecast.

The recovery in GDP is accounted for mainly by household consumption — partly as spending on social activities increases — and government spending. Business investment also picks up, but the level of investment spending remains subdued for longer than consumer spending, as the effects of uncertainty and financial conditions are more marked. Net trade drags on growth somewhat on average over the forecast period.

...and some effects weigh on output persistently.

The Covid-19 shock has a persistent effect on output, via its impact on the supply capacity of the economy. Lower investment weighs on the productive capacity of the economy over time. It also reduces innovation, dampening productivity growth. Tighter credit conditions impair productivity by reducing how efficiently capital is allocated across the economy. Consequently, the supply capacity of the economy is around 1½% lower than it would have been in the absence of Covid-19 by the end of the forecast period.

Chart 1.1 GDP projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for GDP. It has 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 www.bankofengland.co.uk/report/2020/monetary-policy-report-financial-stability-report-august-2020. 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 outturns 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.

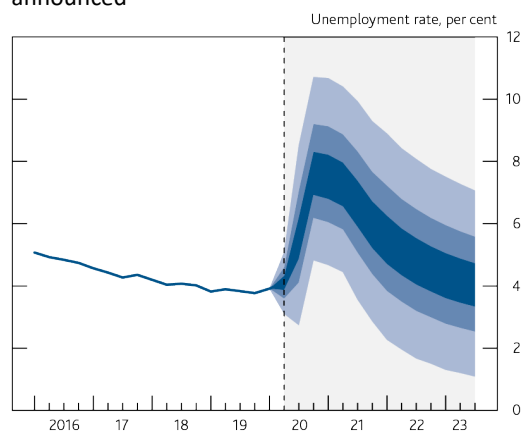
Excess supply/demand

Unemployment increases over 2020 H2, and declines only gradually.

The MPC judges that the weakness of activity in the second half of 2020 is likely to continue to be reflected in a material amount of spare capacity in the economy. In particular, the rise in unemployment is reflected in slack in the labour market.

Labour market slack persists over the first half of the forecast period, as unemployment is judged likely to decline only gradually after peaking in Q4 (**Chart 1.2**). The gradual decline in part reflects an expectation that hiring will pick up relatively slowly, consistent with uncertainty affecting companies' demand for labour. In addition, the MPC judges that there is likely to be some reduction in the efficiency with which people can find jobs. That tends to happen as unemployment rises, as some people take time to find new jobs, and their skills erode. Moreover, in the present conjuncture, the dispersed effects of Covid-19 on economic activity across sectors are judged to be likely to result in a greater degree of mismatch than usual, given differences between the sectors from which workers have

Chart 1.2 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 **Chart 1.1**, 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 2020 Q2, a quarter earlier than the fan for CPI inflation. That is because Q2 is a staff projection for the unemployment rate, based in part on data for April and May. The unemployment rate was 3.9% in the three months to May, and is projected to be 4.1% in Q2 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.

been made unemployed and the sectors in which firms are posting vacancies. While the increase in labour market mismatch slows the pace of the decline in unemployment, it also leads to a rise in the medium-term equilibrium rate of unemployment, such that not all of the increase in unemployment reflects labour market slack. The long-term equilibrium rate of unemployment is not assumed to rise, however.

Slack is eroded as demand recovers, and excess demand builds over the second half of the forecast period.

Over the third year of the forecast period, the unemployment rate declines below its medium-term equilibrium rate, and excess demand builds.

CPI inflation

CPI inflation is very low over the rest of 2020, reflecting the impact of temporary factors...

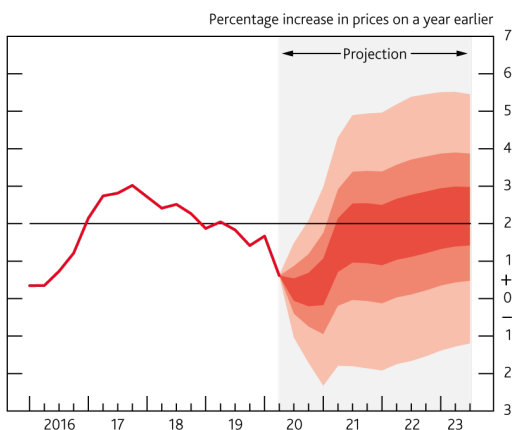
After declining sharply to 0.6% in Q2, CPI inflation is expected to fall somewhat further below the MPC's 2% target over the second half of 2020. Lower energy prices continue to weigh on inflation over coming months. In addition, the Government's announced cut to VAT will act as a drag on inflation over the second half of the year.

...but it returns to the target as those effects fade and as domestic price pressures pick up.

Slack in the economy dampens domestic price pressures over the first half of the forecast period. However, the MPC continues to judge that it is likely that, while demand is especially weak, inflation will be affected by a little less than usual for a given degree of spare capacity. That judgement partly reflects research on price-setting which finds that firms are less able to increase demand for their goods and services by reducing prices when demand is low (Section 4). As demand picks up in the scenario, prices become more responsive again.

Inflation rises during 2021 (**Chart 1.3**), as the impacts of energy and the VAT cut fade. As excess demand builds over the second half of the forecast period, domestic price pressures rise. In 2022 Q3, in the central projection, CPI inflation is 2.0%. It is then projected to rise slightly above the target.

Chart 1.3 CPI inflation projection based on market interest rate expectations, other policy measures as announced

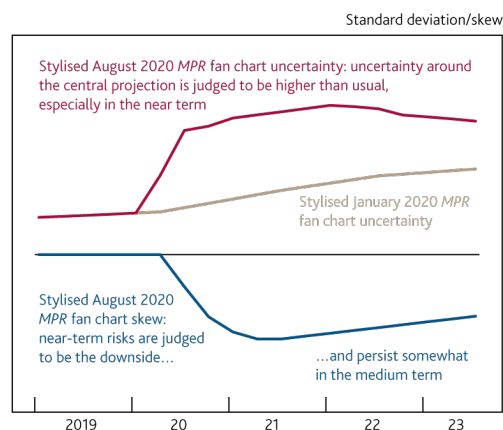


The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumptions in **Table 1.A** footnote (b). If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns 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.

Policy decision

At its meeting ending on 4 August 2020, the MPC judged that the existing stance of monetary policy remained appropriate. The MPC voted to maintain Bank Rate at 0.1% and for the Bank of England to continue with its existing programmes of UK government bond and sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, maintaining the target for the total stock of these purchases at

Chart 1.4 Stylised representation of the MPC's views on uncertainty and risks around the central projection for GDP



£745 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

As reflected in the fan charts, uncertainty around the MPC’s central projections is unusually high...

The MPC’s forecast fan charts are wider than usual, reflecting the unusually high uncertainty about the outlooks for the UK and global economies. That is consistent with the MPC’s conditioning assumption that the current shock has resulted in elevated uncertainty for households and businesses about the outlook for both health and the economy. The uncertainty around the central projections fades a little over time (**Chart 1.4**), as the health and economic risks fade.

...and the risks are judged to be skewed to the downside.

The MPC judges that the risks to the path for uncertainty in the forecast are skewed towards the downside for activity. As a consequence, the risks around the associated key judgements are also skewed to the downside. For example, greater concerns about health outcomes would be likely to result in less social spending by households. It could also result in greater long-lasting effects on the supply side of the economy.

Key judgement 1: as uncertainty dissipates gradually, household spending recovers.

Consumer spending will be affected by health risks.

The MPC’s projected recoveries in GDP both in the UK and globally depend importantly on the judgement that uncertainty about health risks gradually declines. Recent studies of consumer spending over the past few months suggest that social spending has been reduced by a ‘fear factor’ associated with health risks, rather than just lockdown measures which constrain spending (for example, [Goolsbee and Syverson \(2020\)](#) and [Chetty *et al* \(2020\)](#)).

Given that health concerns are assumed to fade gradually in the forecast, consumer spending around the world — particularly on social activities — should pick up. Households’ health concerns could fade more rapidly if the risks from the virus diminish more rapidly than currently expected. As noted above, however, the MPC judges that the risks around that assumption are probably skewed to the downside.

Some households might opt to hold a greater stock of precautionary savings to guard against the risk of loss of income, posing a downside risk to spending.

In addition to health risks, household spending may also be dampened by concerns about the economic outlook. In particular, saving tends to be sensitive to people’s perceived job security, which is often related to the outlook for unemployment. Based on historical relationships, the recent sharp rise in the saving rate in the UK resulting from the sharper fall in consumption than real incomes should provide households in aggregate with a sufficient stock of such precautionary savings, given the projected rise in unemployment. And the saving rate is projected to remain somewhat elevated as unemployment falls back. However, the rise in savings has not been equally distributed across households. In particular, higher savings appear to have been concentrated in high-income households (see Box 3). As a result, lower and middle-income households that have not accumulated a significant buffer might want to save more as the unemployment rate rises. That is judged to pose a downside risk to UK consumer spending over the next year or so.

While the potential desire of some households to run down ‘involuntary’ savings poses an upside risk to spending...

The accumulation of savings by higher income households is likely to pose an upside risk to UK consumer spending, however. Given that some of the accumulation of savings is likely to be an involuntary result of lockdown measures, spending by these households could pick up sharply if they choose to run them down. For example, they may choose to substitute spending on other goods and services for social spending.

...the MPC judges that overall risks to demand are skewed to the downside.

The risks resulting from changes in saving behaviour can be sizable. For example, in stylised illustrations, UK household and corporate saving rates being temporarily 2 percentage points higher or lower have large,

immediate impacts on UK activity — of around 1% of annual GDP lower or higher, respectively.² While there are risks on both sides of the central projections, the MPC judges that the risks around the world and UK demand projections are skewed to the downside.

Key judgement 2: there is some long-lasting scarring, largely due to persistent weakness in productivity.

There is uncertainty about the speed of the recovery from the Covid-19 shock.

The extent to which activity recovers over the forecast period will depend on the operation of channels which can increase the persistence of downturns. The nature of the Covid-19 shock, as well as the policies put in place to help support households and businesses, might be expected to result in a relatively rapid recovery. Nonetheless, GDP in many countries is persistently lower in the MPC's central projections than it would have been in the absence of the shock. In the UK, the supply capacity of the economy is projected to be around 1½% lower by the end of the forecast period, largely due to weaker productivity.

Investment and productivity will be affected by the entry and exit of firms...

Investment and productivity will be affected by the degree to which new firms are formed and other firms exit the market. In the UK, new firms tend to account for an outsize proportion of investment as they grow, so a shortfall in young firms would dampen the recovery in investment, although higher firm entry usually initially exerts a drag on productivity growth due to the lower productivity level of new entrants. An increase in firms exiting the market could potentially raise capital scrapping, which would weigh on productivity. But, offsetting that effect, firms which do exit typically have lower productivity rates than surviving firms, so higher exit could boost average productivity.³ These channels are judged likely to pose two-sided risks to the outlook for productivity.

...as will hiring, which will also be affected by the extent of labour market mismatch.

Bank staff analysis of the recovery of the UK from the financial crisis has found that the persistence of unemployment over that period was in large part due to a slow recovery in the flow of workers from unemployment to employment (Section 3). Hiring by firms picks up over the forecast in the MPC's central projection. It could pick up more rapidly if companies substitute towards labour and away from capital in an environment of high uncertainty, as the fixed costs associated with capital spending can be higher than those for labour, particularly for lower-skilled workers. The nature of uncertainty related to the pandemic — in particular, concerns about public health — could make companies more uncertain than usual about their hiring plans, however. Alternatively, hiring could recover more gradually than in the central case because of a greater degree of labour market mismatch than has been assumed. While the MPC's central projection embodies an assumption that there is likely to be some reduction in the efficiency with which people can find jobs over the forecast period, the Covid-19 shock could lead to a more substantial reduction if it results in significant longer-lasting changes to the structure of economies. Those changes could make it harder for those who become unemployed to find new work in a different sector. That would lead to a slower decline of unemployment, and a greater pickup in the medium-term equilibrium rate of unemployment, than is assumed in the central projections.

The risks around activity in the medium term are also judged to be weighted somewhat to the downside.

The downside risk to activity from uncertainty is likely to translate into downside risks to GDP over the medium term. In particular, uncertainty can weigh on decisions which incur fixed costs for firms, such as investment and hiring. Slower recoveries in investment and hiring could also weigh on the supply capacity of the economy through their spillover effects on productivity growth and labour market mismatch. The downside skew to activity in the medium term is judged to be somewhat lower than in the near term, however.

² In the stylised illustrations, shown in the [May 2020 Monetary Policy Report](#), the consumption and business investment impacts are calibrated to deliver household and corporate saving rates being 2 percentage points higher/lower for one quarter before unwinding over the subsequent 12 quarters. The effect on activity is the impact on GDP over the three months following the change, expressed as a proportion of annual GDP in 2019, to abstract from recent sharp changes in GDP.

³ This analysis was produced using statistical data from ONS. The use of the ONS statistical data in this work does not imply the endorsement of the ONS in relation to the interpretation or analysis of the statistical data. This work uses research datasets which may not exactly reproduce National Statistics aggregates.

Key judgement 3: inflation is weak in the near term, but it returns to the target as the drag from temporary Covid-related factors wanes and spare capacity is eroded.

In the near term, there are risks around the extent to which the cut in VAT is passed through to prices.

CPI inflation is projected to fall a little further over the second half of the year, in part reflecting the impact of the Government's cut to VAT for some goods and services. The MPC's projections assume that 50% of the cut in VAT is initially passed through to consumer prices, with that effect fading over time. But there are risks around that assumption.

The outlook for CPI inflation will be influenced by the sectoral dispersion of the shock to activity.

Throughout the forecast period, CPI inflation will be affected by the extent of spare capacity, and the distribution of that spare capacity across sectors. The effects of the pandemic have fallen unevenly across sectors. Those differences may interact with other differences — such as the frequency with which prices are changed, or the mix of inputs used in production — to alter how any spare capacity affects inflation. Bank staff analysis suggests that the hit to output arising from Covid-19 has been concentrated in highly consumer facing services, which tend to exhibit higher price stickiness than the average CPI basket. As a result, any spare capacity might have a smaller downward effect on CPI inflation than is usually assumed, consistent with the judgement underlying the MPC's central projection.

Cost pressures are also likely to vary across sectors. In the DMP Survey, the accommodation, food, and recreational services sectors reported being most likely to have significantly higher costs resulting from Covid-19. Those sectors also tend to have a relatively high proportion of their costs accounted for by labour, however, which might result in decreased cost pressures as wage growth falls in response to labour market slack.

The risks around CPI inflation are judged to be to the downside.

These risks are judged to be relatively broadly balanced. Nevertheless, the risks to the MPC's inflation projection are skewed to the downside, particularly in the near term, reflecting the downside risks to the outlook for demand. As a result, the mean projection for CPI inflation is a little below the MPC's modal projection (**Table 1.B**).

Table 1.B CPI inflation projection

	Mode	Median	Mean
2021 Q3	1.8	1.6	1.6
2022 Q3	2.0	1.9	1.9
2023 Q3	2.2	2.2	2.1

The table shows four-quarter CPI inflation rate projections. The projections are conditioned on the assumptions in **Table 1.A** footnote (b).

1.4 Constant rate projections

In the MPC's projections conditioned on the alternative assumption of constant interest rates at 0.1%,⁴ activity is still projected to recover over the forecast period, although it is slightly weaker. As a result, excess demand builds to a somewhat lesser extent, and CPI inflation is projected to be a little lower.

⁴ 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.C Indicative projections consistent with the MPC's forecast^{(a)(b)}

	Averages		Projections			
	1998–2007	2010–18	2019	2020	2021	2022
World GDP (UK-weighted) ^(c)	3	2½	1¾	-6¼	6	4¼
World GDP (PPP-weighted) ^(d)	4	3¾	3	-5	7½	5
Euro-area GDP ^(e)	2¾	1½	1¼	-8	6¼	4
US GDP ^(f)	3	2¾	2 ¼	-5¾	5¼	4¾
Emerging market GDP (PPP-weighted) ^(g) <i>of which, China GDP^(h)</i>	5½	5¼	3¾	-4¼	8½	5¾
UK GDP ⁽ⁱ⁾	3	2	1½	-9 ½	9	3 ½
Household consumption ^(j)	3¾	2	1	-9¼	8	3
Business investment ^(k)	3	3¾	¾	-19	10½	9¼
Housing investment ^(l)	3¾	2¾	0	-21¾	26½	11¼
Exports ^(m)	4¼	3¾	5	-10½	4½	¾
Imports ⁽ⁿ⁾	5¾	3¾	4¾	-11¼	7½	1¼
Contribution of net trade to GDP ^(o)	-¾	-¾	0	¼	-1	-¼
Real post-tax labour income ^(p)	3¾	1½	1 ¼	3	-4¼	4
Household saving ratio ^(q)	8¼	8¾	5¾	14¼	7¼	8¾
Credit spreads ^(r)	¾	2½	1½	2½	2	2
Excess supply/Excess demand ^(s)	0	-1¾	-¼	-2¼	-¾	+½
Hourly labour productivity ^(t)	2¾	½	0	-¼	¾	¾
Employment ^(u)	1	1¼	1	-3¾	2½	2
Average weekly hours worked ^(v)	32¾	32	32	31¾	32	32
Unemployment rate ^(w)	5¼	6¼	3¾	7½	6	4½
Participation rate ^(x)	63	63½	64	63¾	64	64
CPI inflation ^(y)	1½	2¼	1½	¼	1¾	2
UK import prices ^(z)	0	1½	-¼	-¾	¼	¼
Energy prices — direct contribution to CPI inflation ^(aa)	¼	¼	0	-¾	0	0
Average weekly earnings ^(ab)	4¼	2	2¾	-1¼	3	3¾
Unit labour costs ^(ac)	3	1¼	3	1¼	-¾	3½
Private sector regular pay based unit wage costs ^(ad)	1¾	1½	3¾	4¾	-¾	3¾

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 growth, CPI inflation and unemployment (as presented in the fan charts).

(b) Figures show annual average growth rates unless otherwise stated. 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 the euro-area GDP for Q2, so that has not been incorporated.

(f) Chained-volume measure. Forecast was finalised before the release of the advance estimate of the US GDP for Q2, so that has not been incorporated.

(g) Chained-volume measure. Constructed using real GDP growth rates of 155 emerging market economies, 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 GANS.

(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 (ROYJ+ROYH-(RPHS+AIIV-CUCT)+GZVX)/((ABJQ+HAYE)/(ABJR+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 1

Negative policy rates

Since the financial crisis, nominal interest rates in the UK and elsewhere have reached historically low levels. As that has happened, central banks have had to make judgements about the ‘effective lower bound’ (ELB) for their respective policy rates — the point at which further cuts in the policy rate no longer provide stimulus or at which adverse effects, such as in the financial sector, can arise. Some central banks have judged their ELB to be below zero, and have implemented negative policy rates as a tool to stimulate the economy. In recent years, the MPC has judged that the ELB for Bank Rate is close to but just above zero. But that judgement can change, and in the past has changed. As a result, the MPC regularly reviews evidence about whether cutting interest rates further could provide stimulus to the economy in an effective way, including comparing it with other policy tools — for example, asset purchases and forward guidance.

The MPC is currently considering whether the ELB for Bank Rate could be below zero; that is whether a negative policy rate could provide economic stimulus. The effectiveness of a negative policy rate will depend, in part, on the structure of the financial system and how the policy transmits through banks to the interest rates facing households and companies. It will also depend on the financial and economic conditions at the time. The MPC will continue to keep under review the appropriateness of a negative policy rate alongside all of its policy tools.

This box sets out the potential issues that a negative policy rate could raise and how these could impact the effectiveness of negative rates as a monetary policy tool.

Why have central banks considered using negative policy rates and how do they work?

Over the past 12 years, the traditional tool of monetary policy — the central bank interest rate — has fallen to very low levels, in response to structural changes and economic shocks...

The global fall in central bank interest rates to very low levels in part reflects falls in the ‘equilibrium interest rate’ — the interest rate at which monetary policy is neither expansionary nor contractionary. The equilibrium interest rate has fallen to very low levels over the past few decades across advanced economies. Much of that fall can be explained by structural factors such as an ageing global population and declining trend productivity growth (see Box 6 of the [August 2018 Inflation Report](#)). Alongside that, since the global financial crisis, central banks in the UK and other countries have had to lower policy rates below the equilibrium rate to provide stimulus in response to headwinds to growth and inflation.

...but the central bank interest rate is constrained by an ‘effective lower bound’.

The ‘effective lower bound’ (ELB) for policy rates is the level below which it is judged that macroeconomic stimulus is no longer provided, or that adverse effects, such as in the financial sector, outweigh any possible macroeconomic benefit. Since the financial crisis, many central banks — including the Bank of England — have used other monetary policy tools — such as asset purchases and forward guidance — to boost their economies as the policy rate was judged to be at or close to the ELB.

Different central banks have lowered their policy rates to different extents.

Judgements about the ELB vary across time and across central banks. Since the financial crisis, several central banks have judged that the ELB was below zero and introduced negative policy rates. For example, the Danish National Bank cut rates to below zero in 2012, as did the ECB in 2014, the Swedish Riksbank and the Swiss National Bank in 2015 and the Bank of Japan in 2016. For some other central banks, the ELB has been judged to be higher and lie above zero. Judgements about the ELB can reflect different circumstances across countries as well as different structural features, including differences in financial systems.

The MPC has judged in the recent past that the effective lower bound for Bank Rate was close to but slightly above zero. But the factors determining this level can change over time.

The MPC keeps its judgement about the ELB for Bank Rate under active review, as it can vary over time as circumstances change. In the aftermath of the global financial crisis, the MPC judged that the ELB for Bank Rate was

0.5%. In 2016, it judged that the ELB had fallen to ‘close to, but a little above zero’. Those judgements were based on evidence about how any further rate cuts might be passed through to the economy at that time, and the risks they might pose to the financial sector.

Cuts that result in negative policy rates would affect the economy through some of the same channels as cuts that keep rates positive...

In practice, a negative policy rate means that some or all of the cash reserves held by private sector banks at the central bank are charged interest rather than earning interest. The rate of interest on those reserves influences a wide range of interest rates in the economy and borrowing costs in financial markets. Asset prices would be expected to rise in response to a reduction in rates, as companies’ future earnings are discounted at a lower interest rate. Higher asset prices would boost the economy by increasing the value of companies’ and households’ collateral, thereby enabling them to raise external funds more cheaply and encouraging borrowing. Lower financial market interest rates would also be expected to lead to a depreciation of the exchange rate, boosting demand for UK exports, and raising inflation via higher import prices.

...but some aspects of the transmission mechanism are likely to be different, which could have an impact on how effective a negative interest rate policy would be in boosting the economy.

A cut to Bank Rate below zero might not affect interest rates in the wider economy in the same way as when it is cut to a level above zero, however. In particular, the transmission to household deposit rates might be attenuated. A report from the Committee on the Global Financial System at the Bank for International Settlements on unconventional monetary policy concluded that, in countries that have set negative policy rates, many aspects of the monetary policy transmission mechanism functioned roughly as normal after a cut in policy rates to below zero. But deposit rates for households typically did not fall below zero. That, in turn, can affect banks’ behaviour, increasing uncertainties about the macroeconomic effects of negative policy rates. The borrowing rates faced by most households and businesses tended to fall in other countries, but remained positive. The effectiveness of the transmission of a negative policy rate might also be affected if it is perceived to be unusual and affects households’ and businesses’ confidence.

What are the uncertainties around the effectiveness of negative policy rates on the macro economy?

All policy tools come with uncertainties as to their impact on the economy and the MPC regularly reviews the effectiveness of all its policy tools.

The MPC assesses the appropriate monetary policy stance at each meeting, and also keeps under review the appropriate tools for achieving its objectives. The appropriateness of each policy tool can change over time. It can depend on the shock hitting the economy — for example, tools which act to loosen credit constraints might be desirable in response to a financial shock. It can also depend on the state of the economy — for example, according to the balance sheet strength of households, businesses and financial institutions. The following section considers the particular issues around the effectiveness of negative policy rates.

Uncertainties about the impact of negative policy rates arise particularly from the tendency for household deposit rates to not fall below zero.

As policy rates fall, interest rates faced by households and businesses in the economy usually follow. International experience suggests that, while some corporate deposit rates fall below zero, interest rates on households’ bank deposits tend not to go below zero. In part, that might reflect the existence of cash as an alternative to holding money in deposit accounts. If deposit rates go negative, depositors may decide to withdraw their savings and hold them in cash rather than pay a fee to hold their money with a bank. While there are some costs and difficulties with holding cash, such as storage costs and the practicalities of paying bills and receiving wages, the incentive to use it as an alternative to a deposit account is likely to increase if interest rates fall below zero. Banks might also be unwilling to lower deposit rates below zero for other reasons. For example, a negative interest rate could affect depositors’ confidence.

If deposit rates do not fall below zero, the transmission of a cut in policy rates to loan rates could also be attenuated, lowering their expansionary effect.

Banks pay interest on deposits and earn interest on loans. If lending rates and deposit rates fall in tandem, banks' interest margins remain unchanged, other things equal. But if deposit rates cannot fall below zero, while some existing loan rates are linked to policy rates — or other market interest rates — then the wedge between lending and deposit rates will narrow as policy rates enter negative territory. As the wedge narrows, banks' interest margins decline, and as a result, their profitability can fall, although they can benefit from an increase in the value of the financial assets they hold.¹ All else equal, the impact on banks' profitability would be larger the greater their reliance on retail deposit funding compared with other sources of funding, for which interest rates would be expected to fall alongside Bank Rate. In the UK, smaller banks and building societies are generally most exposed to these risks.

To sustain their interest margins, banks might choose not to reduce new lending rates fully in line with declines in policy rates. That could support bank profitability. But it would also reduce the expansionary effect of negative policy rates. In countries that have implemented negative policy rates, studies typically find positive and often strong pass through to lending rates despite household deposit rates not going below zero.² However, pass-through is likely to depend on the structure of the financial system, as well as the prevailing economic and financial conditions.

The volume of lending could also be restricted, although this would be expected to occur only when lenders are concerned about future capital ratios.

Banks could also potentially respond to the prospect of declining interest income by reducing the pace of net lending. If banks are particularly worried about maintaining their capital ratios — the ratio of capital to risk-weighted assets — they could choose to reduce risk-weighted assets by reducing lending. This strategy might be more likely to be employed when banks are under balance sheet pressure, perhaps because credit losses are accumulating.

Importantly, these risks vary over time, and downside risks to lending are likely to be higher when banks are concerned about losses on existing loans increasing.

As a result, banks might be more likely to widen lending spreads or reduce their lending in response to lower interest income during an economic downturn. When activity in the economy is falling, and unemployment is rising, losses on banks' existing loans are likely to pick up. Their balance sheets — and capital ratios — might therefore be less healthy than they otherwise would be and there is likely to be greater uncertainty over their future capital ratios. [Altavilla et al \(2019\)](#) find that negative policy rates have boosted investment spending in the euro area, but that effect depends on the health of banks' balance sheets.

UK banks are resilient, but they are likely to face further losses from the effects of the Covid-19 economic shock...

The UK financial system is sound, and banks' capital ratios have increased markedly over the past decade (see the [August 2020 Financial Stability Report](#)). Nonetheless, risks to banks' balance sheets are likely to be rising at the moment. The impact of Covid-19 on the economy will result in losses for lenders, as some businesses fail and some households lose their jobs. As a result, implementing negative policy rates might be less effective in providing stimulus to the economy at the current juncture than at a time when banks' balance sheets are improving.

...and some households and corporate balance sheets may be more vulnerable to shocks at the present time.

Moreover, banks currently have an important role to play in the economic recovery, by providing finance to households and companies. If banks curtailed lending to households and, in particular, corporates at the current juncture, it would provide a headwind to spending.

Central bank actions can partially mitigate these effects...

Some central banks have introduced a tiering system for central bank reserves to help partially mitigate the effect of negative policy rates on banks' net interest income. Under a tiering system, different parts of the outstanding balances of financial institutions' accounts with the central bank have different interest rates applied to them, so that not all reserves are subject to negative rates. Central bank funding schemes can also act as a partial mitigant, as the interest rates on that funding can be linked to policy rates.

...and if the economic outlook improves in response to monetary policy stimulus, that can boost bank profits by lowering impairments.

Negative policy rates may still boost the economy even if the transmission via household and corporate interest rates is attenuated, and that could have a positive effect on banks' balance sheets. Improved prospects for the real economy should reduce the amount of impaired loans banks might experience, boosting their profitability. That is consistent with some evidence from the euro area, which found that losses were lower than they otherwise would have been following the introduction of negative policy rates by the ECB.³ The resulting improvement in profitability was sufficient to offset the impact from reduced interest income.

Conclusion*The effectiveness of a negative policy rate in stimulating the economy will depend importantly on its transmission through the banking sector.*

The appropriate policy tools for achieving the MPC's objectives can change over time depending on economic and financial conditions. At present, banks' balance sheets will be negatively affected by the period of severe economic disruption arising from Covid-19. And they have an important role to play in helping the UK economy recover by providing finance for individuals and companies. As a result, negative policy rates at this time could be less effective as a tool to stimulate the economy. That said, the wider economy and banks' balance sheets would be boosted by stimulus. The net effect of negative policy rates depends on these, among other, factors.

The MPC will continue to review the appropriateness of a negative policy rate as a policy tool alongside its broader toolkit.

The MPC has other instruments available — for example, asset purchases and forward guidance. The MPC will continue to assess the appropriate monetary policy stance and will keep the appropriate tools for achieving its remit — including negative policy rates — under review.

¹ See for example, [Brunnermeier and Koby \(2018\)](#).

² See for example, [Erikson and Vestin \(2019\)](#) for Sweden, [Adolfson and Spange \(2020\)](#) for Denmark and [Altavilla et al \(2019\)](#) for the euro area. For a contrasting view on the Swedish experience, see [Eggertsson et al \(2019\)](#).

³ See [Altavilla et al \(2018\)](#), [Rostagno et al \(2019\)](#) and [Boucinha and Burlon \(2020\)](#).

Box 2

Monetary policy since the May Report

At its meeting ending on 17 June 2020, the MPC voted unanimously to maintain Bank Rate at 0.1%. The Committee voted by a majority of 8–1 to increase the target stock of purchased UK government bonds, financed by the issuance of central bank reserves, by an additional £100 billion, to take the total stock of asset purchases to £745 billion.

Risky asset prices had recovered further from their March lows, although they had remained sensitive to news on the evolution of the pandemic. Recent data outturns suggested that the fall in global GDP in 2020 Q2 would be less severe than expected at the time of the May *Monetary Policy Report*. There were signs of consumer spending and services output picking up, following the easing of Covid-related restrictions on economic activity. Additional announcements of easier monetary and fiscal policy would help to support the recovery. Downside risks to the global outlook remained, however, including from the spread of Covid-19 within emerging market economies and from a return to a higher rate of infection in advanced economies.

UK GDP contracted by around 20% in April, following a 6% fall in March. Evidence from more timely indicators suggested that GDP started to recover thereafter. Payments data were consistent with a recovery in consumer spending in May and June, and housing activity had started to pick up. The LFS unemployment rate was unchanged at 3.9% in the three months to April. But other and more timely indications from the claimant count, HMRC payrolls data and job vacancies suggested that the labour market had weakened materially. Following stronger than expected take-up of the Coronavirus Job Retention Scheme, a greater number of workers were likely to be furloughed in the second quarter. Evidence from business surveys and the Bank's Agents was consistent with a weak outlook for employment in coming quarters. Some households were also worried about their job security.

Twelve-month CPI inflation declined from 1.5% in March to 0.8% in April, triggering the [explanatory letter from the Governor to the Chancellor](#) published alongside the monetary policy announcement. CPI inflation fell further in May, to 0.5%. Below-target rates of CPI inflation could in large part be accounted for by the effects of the pandemic. The collapse in global oil prices had direct effects on inflation, via the prices of motor fuels, and indirect effects by reducing input costs in other sectors of the economy. The sharp drop in domestic activity was also adding to downward pressure on inflation through increased spare capacity in most sectors of the economy.

The unprecedented situation meant that the outlook for the UK and global economies was unusually uncertain. It would depend critically on the evolution of the pandemic, measures taken to protect public health, and how governments, households and businesses responded to these factors.

The emerging evidence suggested that the fall in UK GDP in 2020 Q2 would be less severe than set out in the May *Report*. Although stronger than expected, it was difficult to make a clear inference from that about the recovery thereafter. There was a risk of higher and more persistent unemployment in UK. Even with the relaxation of some Covid-related restrictions on economic activity, a degree of precautionary behaviour by households and businesses was likely to persist. The economy, and especially the labour market, would therefore take some time to recover towards its previous path. CPI inflation was well below the 2% target and was expected to fall further below it in coming quarters, largely reflecting the weakness of demand.

At this meeting, the MPC judged that a further easing of monetary policy was warranted to meet its statutory objectives.

2 Current economic conditions

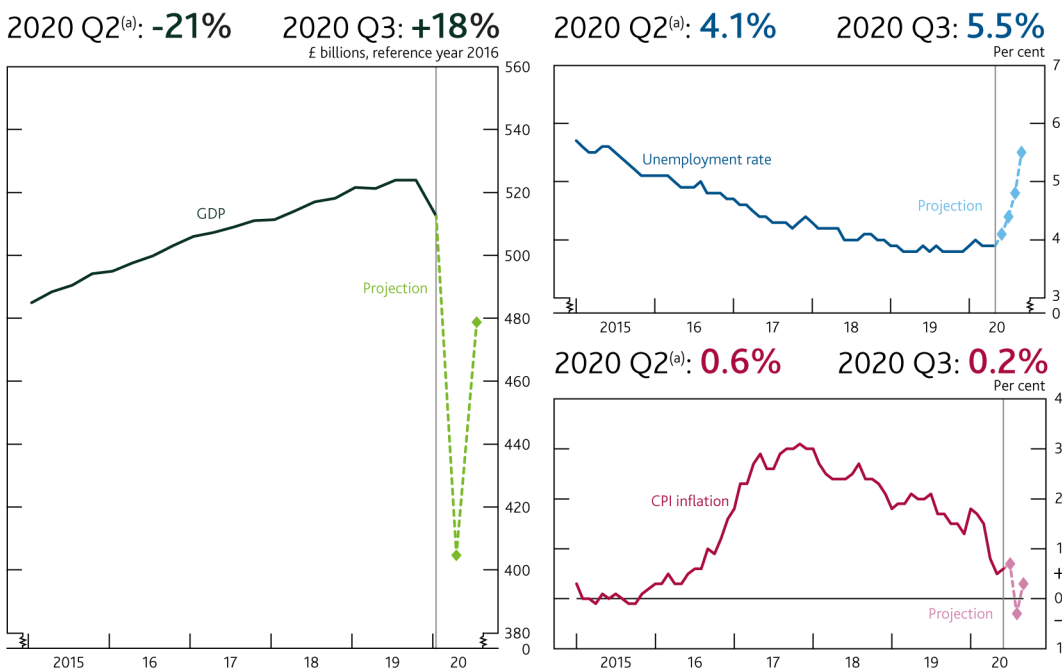
Global activity fell sharply in March and April following the widespread introduction of social distancing measures. There has been a partial recovery since then as lockdowns have been relaxed. Financial conditions have eased since the *May Report*, although they remain tighter than at the start of the year.

Similarly, UK activity fell very sharply, as actions to control the spread of Covid-19 affected spending, but has recovered somewhat since April. Nonetheless, UK output is expected to have fallen by 21% in Q2 as a whole and to remain well below its late-2019 level in the near term. The unemployment rate is expected to increase to 5.5% in Q3 and 7.5% by the end of the year.

Inflation was 0.6% in Q2, and has been depressed by the effects of Covid-19 on global energy prices and UK activity. These effects are likely to continue to drag on inflation in the near term. Government measures, including the VAT cut on some consumer services from July, mean that inflation is expected to remain well below the MPC’s 2% target over the rest of the year.

Chart 2.1 Economic activity has fallen sharply. Unemployment is expected to rise. Inflation is expected to remain well below the MPC’s target.

Near-term projections



Sources: ONS and Bank calculations.

(a) GDP and unemployment projections are based on official data to May. CPI inflation figure is an outturn.

2.1 The global economy

Global GDP fell sharply in 2020 Q2 as social distancing measures became more widespread...

Global activity fell for a second consecutive quarter in 2020 Q2 (**Table 2.A**). Having fallen by 2.6% in Q1, Bank staff estimate that UK-weighted world GDP fell by around a further 9% in Q2. This is over four times larger than any quarterly fall recorded during the financial crisis. The severity of the contraction reflects social distancing measures being widespread across the UK's major trading partners for a large part of the quarter. The restrictions on activity are apparent in the sharp fall in mobility indices, which capture changes in the number of people travelling (**Chart 2.2**).

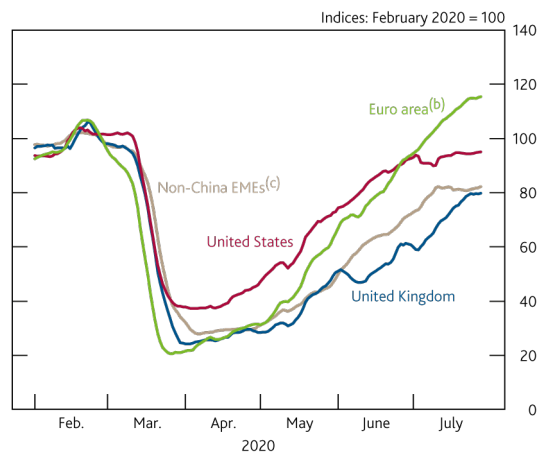
Table 2.A Global activity fell sharply in 2020 Q2
GDP in selected countries and regions^(a)

	Quarterly averages						
	1998–	2008	2009	2010–	2019	2020	
	2007			18		Q1	Q2
United Kingdom ^(b)	0.7	-0.9	-0.4	0.5	0.3	-2.2	-21.0
Euro area (40%)	0.6	-0.5	-0.6	0.3	0.2	-3.6	-12.1
United States (19%)	0.7	-0.7	0.0	0.6	0.6	-1.3	-9.5
China (4%) ^(c)	2.5	1.8	2.7	1.9	1.5	-10.0	11.5
UK-weighted world GDP ^{(b)(d)}	0.7	-0.3	-0.1	0.6	0.4	-2.6	-9.2

Sources: Eikon from Refinitiv, IMF *World Economic Outlook (WEO)*, National Bureau of Statistics of China, OECD, ONS and Bank calculations.

- (a) Figures in parentheses are shares in UK exports in 2018.
 (b) Figures for 2020 Q2 are Bank staff projections.
 (c) Estimates from 2010 Q4 onwards are from the National Bureau of Statistics of China.
 (d) See footnote (c) of **Table 1.B**.

Chart 2.2 Activity was restricted by lockdown measures
Apple mobility indices^(a)



Sources: Apple Mobility Index, IMF *WEO* and Bank calculations.

- (a) Level of requests for directions in Apple Maps. Mobility is assumed to stay constant where data are missing. Seven-day moving averages. Data are not seasonally adjusted.
 (b) The PPP-weighted average of indices for France, Germany, Italy and Spain.
 (c) The PPP-weighted average of indices for Brazil, India, Indonesia, Mexico, Russia, Turkey and Saudi Arabia.

...but an easing of lockdowns led to some recovery in the euro area, US and some emerging markets.

Having fallen sharply in April, survey indicators of activity in the euro area, US and some emerging markets picked up in subsequent months (**Chart 2.3**) as lockdown measures were eased. Some employees returned to work, non-essential shops started to reopen and travel restrictions eased. Other measures of activity, such as industrial production and retail sales, have recovered somewhat since April.

Chart 2.3 Survey measures of activity generally fell sharply in March and April before recovering in May and June
Selected global purchasing managers' indices



Sources: Caixin, Eikon from Refinitiv, IHS Markit, IMF *WEO*, US Institute for Supply Management and Bank calculations.

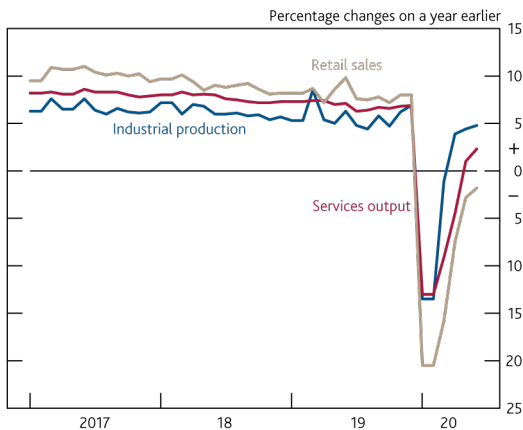
- (a) US services data are for the non-manufacturing sector.
 (b) The services series is constructed using PMIs across three countries (Brazil, India and Russia). The manufacturing series is constructed using PMIs across seven countries (Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey). Series are weighted according to their shares in world GDP using IMF PPP weights.

Chinese growth rebounded in Q2 after an earlier easing of lockdown restrictions.

China's lockdown both began and eased earlier than other large economies. With parts of the country in lockdown from late January, Chinese GDP contracted by 10% in the first quarter. As restrictions started to ease from late February, industrial production recovered sharply (**Chart 2.4**). Service sector output and retail sales also picked up, albeit to a lesser extent. Overall, GDP grew by 11.5% in 2020 Q2.

Chart 2.4 Chinese activity rebounded in Q2

Indicators of Chinese economic activity^(a)

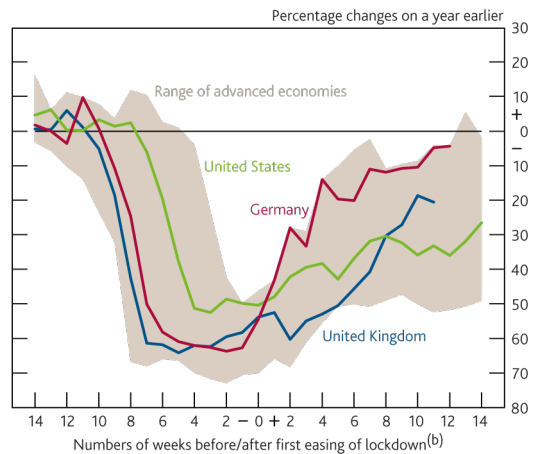


Sources: Eikon from Refinitiv and National Bureau of Statistics of China.

(a) Industrial production and services output are measured in constant prices. Retail sales are measured in current prices.

Chart 2.5 The recovery in social consumption appears to have been subdued in many countries

Google searches related to social spending^(a)



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

(a) Searches related to the words 'restaurant', 'bar', 'hotel', 'café', 'cinema' and 'museum'. The swathe includes data for Australia, Austria, Canada, France, Germany, Italy, Japan, New Zealand, Norway, South Korea, Spain, United Kingdom and United States. Data are not seasonally adjusted.

(b) Date of lockdown easing defined as the first reduction in the Oxford Stringency Index. For the US, an in-house stringency index is used.

Overall, the fall in world GDP in Q2 was around half that assumed in the May illustrative scenario.

Taken together, the estimated 9% fall in world GDP in 2020 Q2 was materially less sharp than was the case in the May illustrative scenario. That is largely because social distancing measures were eased earlier than assumed in a number of countries. It also appears that consumer spending began to recover across a number of countries even before official lockdown measures were eased.

Absent a widespread resurgence in lockdown measures, output is expected to recover somewhat in Q3...

UK-weighted world GDP is expected to grow by 4.5% in 2020 Q3. All major regions are expected to record positive quarterly growth as activity continues to recover. Nonetheless, world GDP is expected to still be around 7½% below its level at the end of 2019.

The extent of the recovery in activity will depend importantly on how well countries control the spread of the disease and whether the widespread reimposition of lockdowns is required. A rise in cases in some areas of China, Europe and the US has led to the reintroduction of localised lockdown measures. And some indicators, such as US credit card transactions and restaurant bookings, suggest that these measures are affecting spending.

Even without lockdown measures, fear of infection may continue to weigh on spending. Despite an easing in lockdowns, demand for goods and services that involve social interaction has remained subdued in many countries. For example, Google searches for social activities, an indicator of social spending, remain around 25% below their level a year ago in the US (**Chart 2.5**). Social spending has recovered faster in regions where the virus has been more contained, such as Germany. Uncertainty over the spread of the virus is also likely to weigh on business investment.

...and activity continues to be supported by the unprecedented policy response from governments and central banks.

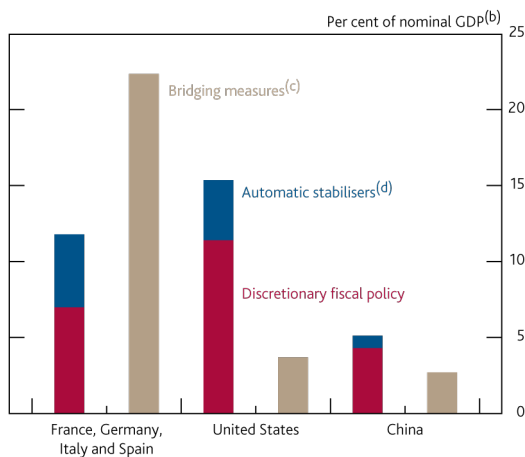
At the time of the *May Report*, monetary policy had been loosened markedly, lending facilities had been created to support firms' cash flow and governments had provided substantial direct help to support employment and income (**Chart 2.6**).

Additional fiscal announcements have been made since the *May Report*. For example, EU leaders have agreed a €750 billion recovery fund to help tackle the crisis and a sizable fiscal package is being debated in the US Congress. These actions will support activity alongside the usual 'automatic stabilisers' — higher benefit payments and lower tax receipts — that operate when the economy slows.

Monetary policy remains accommodative. At its June meeting, the ECB Governing Council increased the size of its Pandemic Emergency Purchase Programme by €600 billion to €1.35 trillion. The Federal Open Market Committee indicated that it would, having gradually slowed its asset purchases during May, maintain at least the current pace in the coming months. Market-implied paths for policy rates are a little lower than in the run-up to the *May Report* (**Chart 2.7**).

Chart 2.6 Governments have provided substantial support in response to the crisis

Bank staff estimates of announced fiscal policy responses^(a)



(a) Government spending announced in response to Covid-19. Does not include the package of measures currently under discussion in the US. Does not include supranational measures, such as the EU's recovery fund, worth 5.4% of EU GDP, which once operational is expected to provide grants and loans to member states. A number of fiscal measures involve both discretionary and bridging elements and the precise split is a matter of judgement.

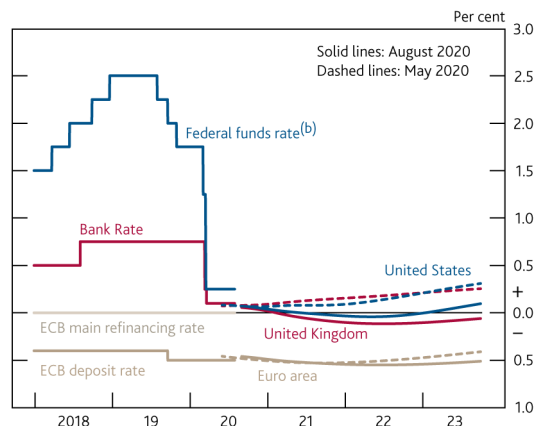
(b) Policy announcements as a percentage of nominal GDP in 2019.

(c) Bridging measures are temporary actions that will eventually be repaid (eg tax deferrals, state loans). The actual uptake of programmes may be lower than the announced packages. China's bridging measures include policies that aim to increase financing to the small and medium-sized enterprise (SME) sector. Other measures have been announced to enhance loan guarantees for the agriculture sector and SMEs; they have not been included due to estimation difficulties.

(d) Projected impact of automatic stabilisers in 2020.

Chart 2.7 Market-implied paths for policy rates are a little lower than in May

International forward interest rates^(a)



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

(a) All data as of 29 July 2020. The August and May curves are estimated using instantaneous forward overnight index swap rates in the 15 working days to 29 July and 29 April respectively.

(b) Upper bound of the target range.

Commodity prices have risen as global activity has increased.

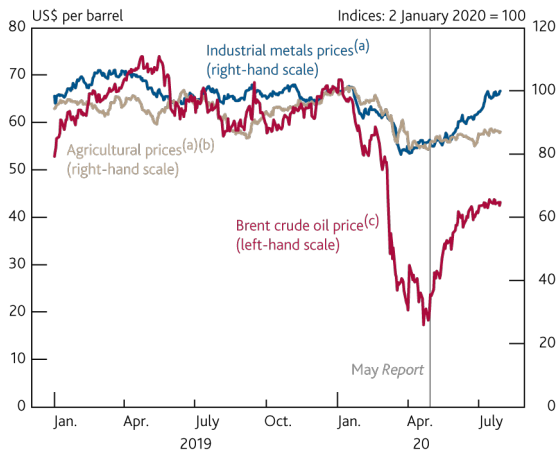
Oil and other commodity prices have picked up since May. The price of a barrel of Brent crude oil fell below US\$20 in April (**Chart 2.8**), as transport restrictions led to a sharp fall in demand for fuel, and major oil producers failed to reach an agreement on restricting production. As global demand has recovered and producers in the US, Canada and OPEC+ countries have lowered production, the oil price has risen to above US\$40 per barrel, although it remains well below its level a year ago.

Inflation remains subdued in many countries.

The partial recovery in oil prices has led to a slight pickup in the latest headline inflation figures for some countries, although fuel prices continue to act as a drag overall. Euro-area inflation picked up a little from a four-year low of 0.1% in May, to 0.3% in June (**Table 2.B**). Similarly, inflation has risen by 0.3 percentage points in the US. Headline inflation remains weak, however. And core inflation — which strips out the impact of energy prices and other volatile elements — has continued to fall in both the euro area and the US.

Chart 2.8 Commodity prices have risen as global activity has recovered

US dollar oil and other commodity prices



Sources: Bloomberg Finance L.P., Eikon from Refinitiv, S&P indices and Bank calculations.

- (a) Calculated using S&P GSCI US dollar commodity price indices.
 (b) Total agricultural and livestock S&P commodity index.
 (c) US dollar Brent forward prices for delivery in 10–25 days' time.

Table 2.B Inflation remains subdued

Inflation in selected advanced economies

Per cent

	Monthly averages		2020					
	1998–2007	2010–19	Jan.	Feb.	Mar.	Apr.	May	June
Annual headline consumer price inflation								
United Kingdom	1.6	2.2	1.8	1.7	1.5	0.8	0.5	0.6
Euro area	2.0	1.4	1.4	1.2	0.7	0.3	0.1	0.3
United States ^(a)	2.1	1.6	1.8	1.8	1.3	0.5	0.5	0.8
Annual core consumer price inflation (excluding food and energy)^(b)								
United Kingdom	1.2	2.1	1.6	1.7	1.6	1.4	1.2	1.4
Euro area	1.6	1.1	1.1	1.2	1.0	0.9	0.9	0.8
United States ^(a)	1.8	1.6	1.8	1.9	1.7	0.9	1.0	0.9

Sources: Eikon from Refinitiv, Eurostat, ONS, US Bureau of Economic Analysis and Bank calculations.

- (a) Personal consumption expenditure price index inflation.
 (b) For the euro area and the UK, excludes energy, food, alcoholic beverages and tobacco. For the US, excludes food and energy.

2.2 Financial markets and credit conditions

Financial conditions tightened significantly following the outbreak of Covid-19.

Financial markets were extremely volatile after the worldwide spread of Covid-19 became apparent in March. A precautionary demand for liquidity and the need for a dramatic distribution of that around the financial system resulted in an abrupt and disruptive ‘dash for cash’. This was associated with a period of severe market dysfunction, and a combination of falling equity prices and rising borrowing costs meant that global financial conditions were at their tightest since 2008. Markets stabilised in April following an exceptionally large policy response from governments and central banks around the world. The [August Financial Stability Report](#) discusses these events in more detail.

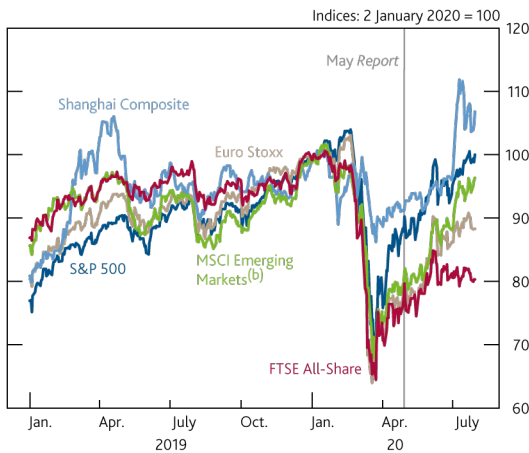
Risky asset prices have increased since the May Report...

Global equity prices have increased since the *May Report* (**Chart 2.9**), reflecting the easing of lockdown measures, stronger-than-expected macroeconomic data, and economic support measures from governments and central banks. The US S&P 500 and the Euro Stoxx indices are now around 40% higher than their March lows and around 15% higher than in the run-up to *May Report*. Measures of equity price volatility, such as the VIX, remain above their historical averages, but have fallen since their March highs. Market intelligence suggests the level of volatility will continue to be sensitive to investor concerns over news about the spread of the pandemic, as well as geopolitical tensions.

Corporate bond spreads have narrowed. The spreads on high-yield bonds have fallen by between 140 and 240 basis points since the *May Report* and investment-grade spreads have also fallen significantly, although both remain higher than at the start of the year (**Chart 2.10**).

Chart 2.9 Equity prices have increased since the May Report

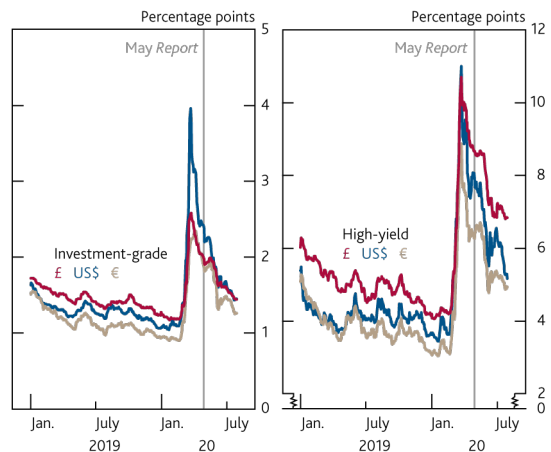
International equity prices^(a)



Sources: Eikon by Refinitiv, MSCI 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 [August 2020 Monetary Policy Report](#).

Chart 2.10 Corporate bond spreads have narrowed
International non-financial corporate bond spreads^(a)



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

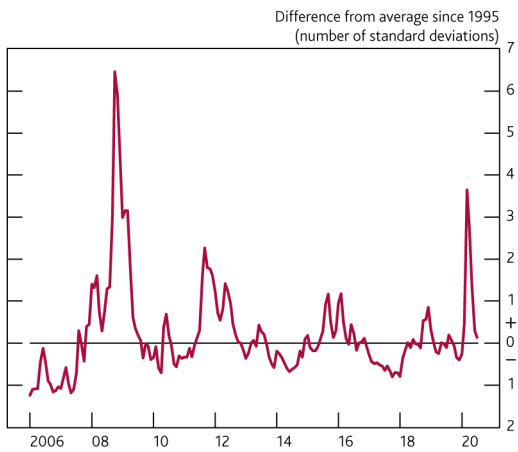
- (a) Option-adjusted spreads on government bond yields. Investment-grade corporate bond yields are calculated using an index of bonds with a rating of BBB3 or above. High-yield corporate bond yields are calculated using aggregate indices of bonds rated lower than BBB3. Due to monthly index rebalancing,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

...and financial conditions have eased.

According to a summary measure covering 43 countries, financial conditions have eased since the May Report (**Chart 2.11**). This reflects a combination of rising equity prices, lower volatility and falling borrowing costs. Nevertheless, financial conditions remain somewhat tighter than they were before the pandemic.

Chart 2.11 Global financial conditions have eased since May

Global financial conditions index^(a)

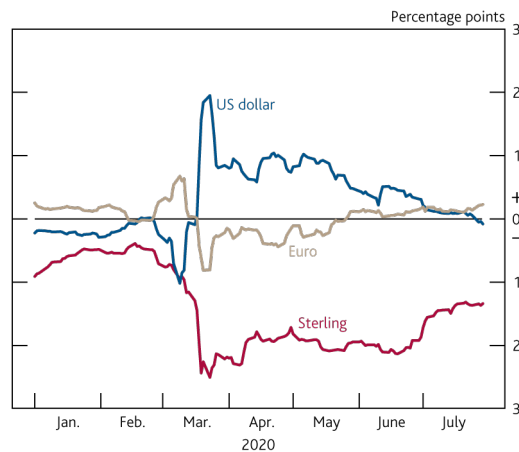


Sources: Bloomberg Finance L.P., Eikon from Refinitiv, IMF WEO and Bank calculations.

- (a) Financial conditions indices (FCIs) estimated for 43 economies using principal component analysis and weighted according to their shares in PPP-weighted world GDP. The FCIs summarise information from: term spreads, interbank spreads, corporate spreads, sovereign spreads, long-term interest rates, equity price returns, equity return volatility and relative financial market capitalisation. An increase in the index indicates a tightening in conditions. Data are to end-July 2020.

Chart 2.12 Market participants still place more weight on sterling depreciating than appreciating

Six-month risk reversals^(a)



Source: Bloomberg Finance L.P.

- (a) 25-delta risk reversals. Risk reversals show the difference between the implied volatilities of equally 'out of the money' put and call options. Negative risk reversals mean that it is more expensive to insure against currency depreciations than appreciations. Series are trade weighted.

Movements in UK asset prices have broadly mirrored global movements...

As in other advanced economies, UK equity prices have risen (**Chart 2.9**) and sterling corporate bond spreads have narrowed (**Chart 2.10**) since the May Report. The market-implied path for Bank Rate is lower than in the run-up to the May Report (**Chart 2.7**). The yield curve dips below zero over coming years, suggesting that market participants attach some weight to the possibility of negative policy rates.

...but the recovery in UK equity prices has been weaker than in other advanced economies and sterling has depreciated.

The rise in the FTSE All-Share index has been smaller than gains in equity price indices in some other advanced economies, and it remains 20% below its level at the start of the year. That partly reflects the sectoral composition of the FTSE index, which, relative to its foreign counterparts, is weighted more towards sectors which have been hard hit by the pandemic, such as oil and gas, and less towards others, such as technology. But it could also reflect weaker data outturns and lower expectations for near-term economic growth in the UK relative to other advanced economies. Sterling has also depreciated by around 1¼% since the *May Report*. Market participants place more weight on sterling depreciating than appreciating in the coming months: insuring against a large depreciation remains much more expensive than insuring against a large appreciation (**Chart 2.12**). Market intelligence suggests that Brexit-related uncertainty continues to weigh on sterling.

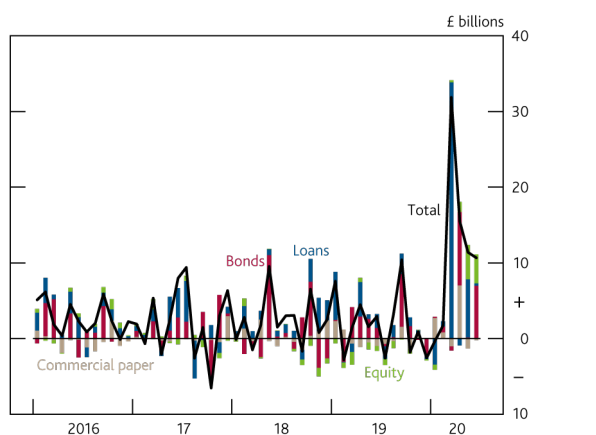
The supply of credit to UK companies appears largely to have met the very strong demand from firms.

UK companies have raised a significant amount of finance since the outbreak of Covid-19. Net finance raised was around £70 billion in the four months to June, more than triple the amount raised in 2019 as a whole (**Chart 2.13**). For large companies much of this has been met through capital markets. As noted in the *August Financial Stability Report*, equity issuance and investment-grade corporate bond issuance by UK firms have been much higher recently than in previous years.

A significant amount of finance has also been raised from the banking sector. Lenders reported a significant increase in the availability of credit across all firm sizes in the Q2 *Credit Conditions Survey (CCS)*, with the net percentage balances the highest since the question was first asked in 2009. Only a very small proportion of firms in the latest Decision Maker Panel (DMP) Survey expected credit to be unavailable if required (**Chart 2.14**).

Chart 2.13 Firms have raised around £70 billion since March

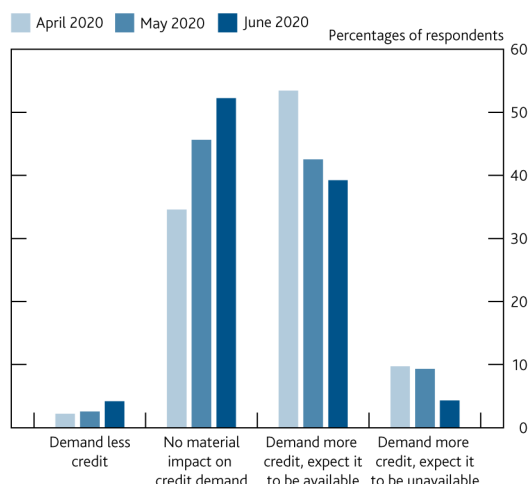
Net finance raised by private non-financial corporations^(a)



(a) Components may not sum to total as a result of seasonal adjustment. Data are for UK-resident PNFCs.

Chart 2.14 Most firms that think they will need credit expect it to be available

Impact of Covid-19 on firms' demand for credit^(a)



Sources: DMP Survey and Bank calculations.

(a) Question: 'Relative to what would have otherwise happened, how do you expect the spread of Coronavirus (Covid-19) to affect your demand for credit in 2020 Q2?'

This has been supported by government-backed loan schemes...

The availability of credit has been supported by government-backed loan schemes. Since their launch, around £50 billion has been approved in total under the Bounce Back Loan Scheme (BBLs), the Coronavirus Business Interruption Loan Scheme (CBILs) and the Coronavirus Large Business Interruption Loan Scheme (CLBILs) (**Chart 2.15**). In addition, as of 29 July, large companies had outstanding drawings of around £17 billion under the Covid Corporate Financing Facility.

...but some firms in disrupted sectors may be subject to credit constraints.

Additional financing will be needed this year to fill some firms' continuing cash-flow deficits and to refinance existing debts (see the *August Financial Stability Report*). Despite the strength in aggregate lending so far, some firms may find it hard to raise the necessary funds. For example, the Bank's Agents have received reports that some

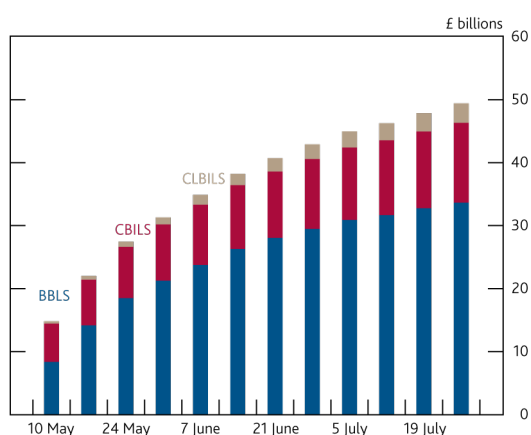
firms in vulnerable sectors, such as retail and travel, are struggling to access finance (Box 4). Some firms in these sectors may also be struggling to access trade credit. There has only been a modest tightening in the availability of trade credit so far and the Government's trade credit insurance guarantee scheme has supported existing lines of business. The Bank's Agents have reported that insurers remain reluctant to write new policies for the most exposed sectors, however.

The introduction of government schemes has lowered borrowing costs for firms...

Under the CBILS and BBLs, firms pay no interest on loans for the first year. That has helped to lower interest rates on new lending to non-financial businesses in aggregate. In June the average effective rate was around 90 basis points lower than in April, and around 120 basis points lower than in February (**Table 2.C**). Within this, the average effective rate on new lending to SMEs fell sharply.

Chart 2.15 Around £50 billion of lending has been approved under government-backed loan schemes

Cumulative approvals under government loan schemes^(a)

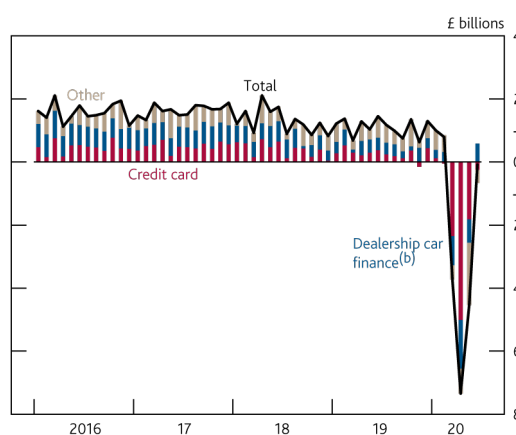


Source: HM Treasury.

(a) Based on data to 26 July 2020.

Chart 2.16 Consumer credit volumes were broadly flat in June having fallen in previous months

Net consumer credit lending^(a)



Sources: Bank of England, ONS and Bank calculations.

(a) Sterling net lending by UK monetary financial institutions (MFIs) and other lenders to UK individuals (excludes student loans).

(b) Identified dealership car finance lending by UK MFIs and other lenders.

...but movements in household borrowing rates have been mixed.

Households that already had a variable rate mortgage have benefitted from the cuts to Bank Rate the MPC made in March. The average effective rate on these mortgages has fallen by around 70 basis points since February. Some customers have taken mortgage payment holidays; one in six mortgages in the UK is currently subject to a payment holiday according to UK Finance.

Quoted rates on new fixed-rate mortgages have not fallen, however. While rates on low-LTV mortgages have been little changed in recent months, rates on high-LTV mortgages have picked up (**Table 2.C**). The CCS suggests that lenders reduced the availability of secured credit across both high and low LTV mortgage products in Q2. Respondents indicated that this reflected concerns over the economic outlook and a reduced appetite for risk. Those factors, as well as ongoing operational constraints, could have put upward pressure on mortgage spreads, which have widened as risk-free rates have fallen. Demand for mortgages has also fallen sharply during lockdown as the housing market stalled. Mortgage approvals picked up somewhat in June, but remained around half their February levels.

Unsecured borrowing rates, such as those on credit cards and personal loans, are also little changed since the May Report. The level of consumer credit was broadly flat in June, having fallen from March to May (**Chart 2.16**) as consumer spending fell (Section 2.3). The CCS suggests that lenders restricted the availability of unsecured credit in Q2.

Overall, UK financial conditions have eased slightly since the May Report.

Overall, UK financial conditions have eased slightly since the May Report, although they remain tighter than in January (**Chart 2.17**). In terms of their overall effects on economic growth, the widening in household credit

spreads since May has been offset by the fall in risk-free rates, gains in equities, the depreciation of sterling and lower spreads on corporate borrowing.

Table 2.C Corporate borrowing rates have fallen following the introduction of government schemes

Selected household and corporate interest rates^(a)

	Latest (per cent)	Changes since (basis points)				
		June 2020	May 2020	Apr. 2020	Mar. 2020	Feb. 2020
Quoted rates on new lending and deposits						
<i>Mortgages</i>						
Two-year fixed rate, 75% LTV	1.45	4	3	7	5	5
Two-year fixed rate, 90% LTV	2.66	39	72	78	72	69
<i>Consumer credit</i>						
£10,000 personal loan	3.48	-3	-6	4	-8	-11
Credit card	20.54	0	-4	-9	-24	-23
<i>Deposits</i>						
Instant access	0.09	-7	-14	-19	-30	-32
One-year fixed-rate bond	0.46	-5	-17	-23	-51	-51
Effective rates^(b)						
<i>Mortgages^(c)</i>						
Fixed-rate mortgage	2.12	n.a.	-2	-2	-3	-4
Floating-rate mortgage	2.29	n.a.	4	-10	-56	-67
<i>PNFCs</i>						
New loans	1.34	n.a.	29	-92	-102	-122
<i>of which to SMEs</i>	1.18	n.a.	20	-131	-183	-226
Interest-bearing sight deposit	0.13	n.a.	-10	-13	-19	-28

(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. 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 quoted rates data are for July and latest effective rates data are for June.

(b) Effective rates on the outstanding stock of loans and deposits, unless otherwise stated.

(c) Mortgages to individuals and individual trusts.

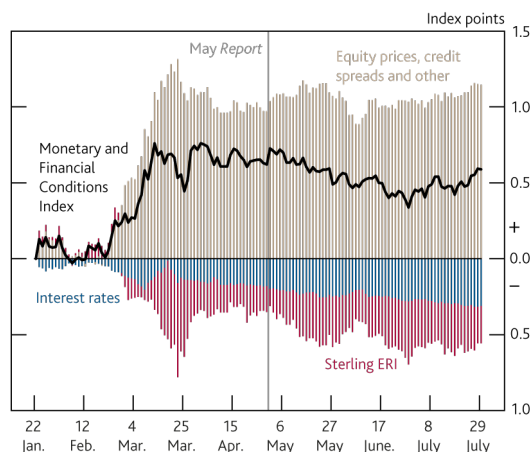
2.3 Demand and output

Actions introduced to limit the spread of Covid-19 have had widespread effects on the UK economy...

On 23 March, the UK Government implemented restrictions which required people to stay at home except for very limited reasons, with enforced closure of non-essential shops and many consumer-facing service businesses. International and domestic travel were reduced to a fraction of normal levels, while restaurants and non-food retail businesses saw extremely low footfall (**Chart 2.18**).

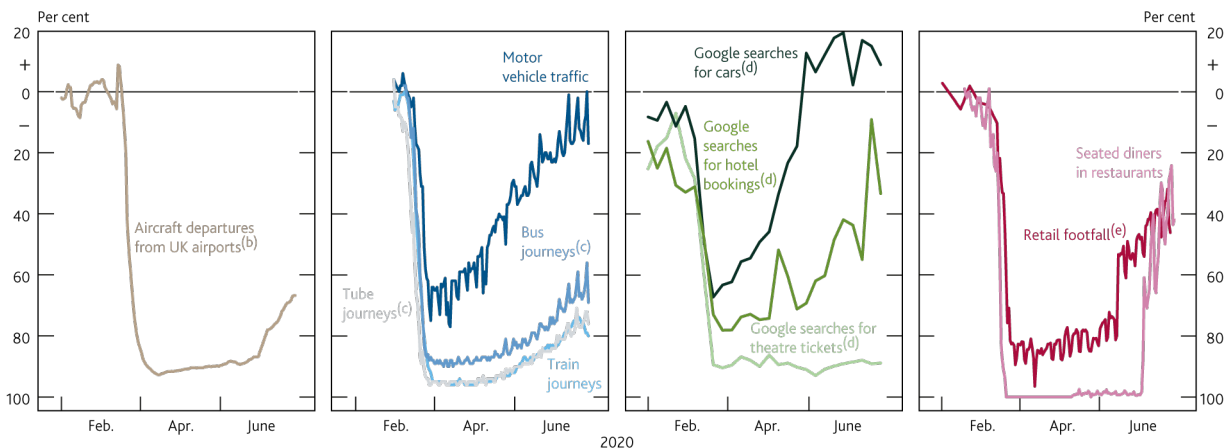
Chart 2.17 Overall UK monetary and financial conditions have eased slightly since the May Report

Contributions to changes in the UK Monetary and Financial Conditions Index since the January 2020 Report^(a)



Sources: Bloomberg Finance L.P., Eikon from Refinitiv, ICE/BoAML Global Research 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 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. The cut-off for data in the May MPR was 29 April 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?'

Chart 2.18 High-frequency indicators show the change in behaviour that resulted from the pandemicHigh-frequency indicators of economic activity^(a)

Sources: Department for Transport, Google Trends, OpenSky Network, OpenTable, ShopperTrak and Bank calculations.

(a) Data are not seasonally adjusted. Road and rail travel data are shown relative to normal levels. All other data are shown relative to a year earlier.

(b) Seven-day moving averages of flight departures tracked by the OpenSky Network from Birmingham, Gatwick, Heathrow, Luton, Manchester and Stansted airports.

(c) The number of tube journeys is based on Transport for London data and the number of bus journeys do not include London buses.

(d) Google searches data are weekly averages of the Google Trends index of UK search volumes. Searches for cars shows the average of changes in search volumes for the six highest-selling car brands in the UK.

(e) Weekly changes to 14 March and daily thereafter. Data have been adjusted to remove distortions caused by bank holidays.

...although restrictions have been relaxed somewhat since mid-May.

Since mid-May, there has been a phased easing of lockdown restrictions. In England, this has included the reopening of non-essential shops in June, with pubs and restaurants allowed to open from early July. The exact timings have differed across the UK. While there have been some examples where targeted local restrictions have had to be reinstated, the share of total consumption that has been restricted by Covid-19 measures has fallen significantly since May (**Chart 2.19**).

Output is expected to have fallen by 21% in 2020 Q2...

Since the Covid-19 outbreak began to have a direct effect on UK households and businesses, demand has fallen sharply. GDP fell by around 7% in March alone — such that output fell by just over 2% in Q1 as a whole — and in April it fell by a further 20%. Output rose modestly in May, and is expected to have recovered to a greater extent in June. Nonetheless, GDP is expected to have fallen by 21% in Q2 as a whole, and by 23% relative to 2019 Q4.

...which is a smaller fall than in the May illustrative scenario...

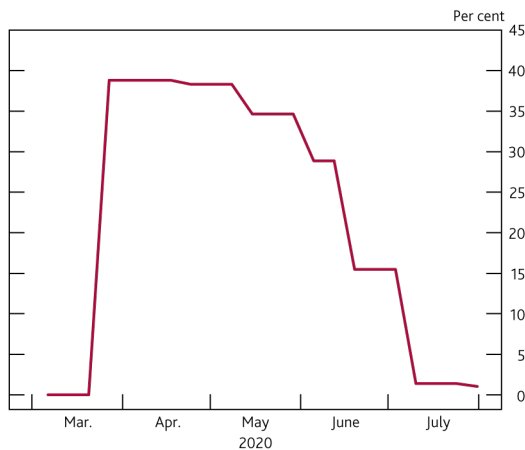
The fall in output in Q2 is expected to have been less severe than was assumed in the illustrative scenario in the *May Report*. In that scenario, it was assumed that restrictions would be gradually unwound between early June and late September, but they were lifted earlier. Some activity was also a little stronger than expected under lockdown. By the start of June, motor vehicle traffic was around 30% below its usual level, having been about 65% below normal at the start of April (**Chart 2.18**).

...but larger than in some other countries.

The fall in UK activity in Q2 is expected to have been larger than in some other countries (**Table 2.A**). That mainly reflects differences in the timing of lockdown measures, which were in place for a larger part of Q2 in the UK than in other economies. The mobility indices recovered more slowly in the UK than the US and euro area (**Chart 2.2**), although the lifting of restrictions may provide more scope for recovery in the UK in Q3. Beyond the effect of mandatory social distancing requirements, activity in specific countries will also be affected by the prevalence of Covid-19. A YouGov poll suggests that in countries with a higher number of cases, around 50% of households avoided going out to some extent, compared with less than 30% in countries with fewer cases.

It is also possible that certain features of the UK economy meant that Covid-19 had a larger impact on activity. In the UK, spending on things that typically involve interactions with other people — such as attending cinemas, restaurants, or live sports events — represents around 13% of total output, compared with around 11% in the US and 10% in the euro area, and this type of spending has been particularly affected by Covid-19.

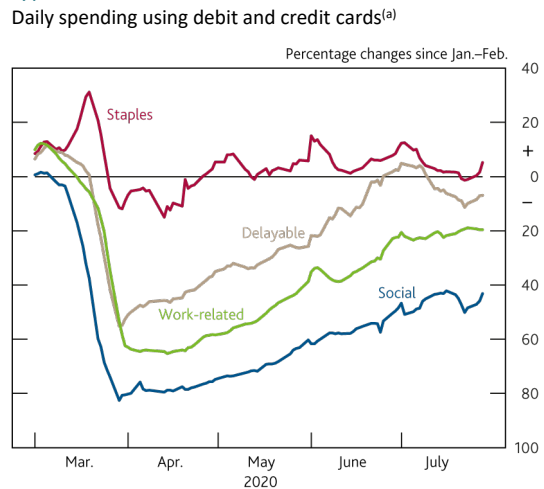
Chart 2.19 The share of consumption restricted by social distancing measures has fallen significantly since May
Weekly estimates of the share of restricted consumption^(a)



Sources: ONS and Bank calculations.

(a) Updated every Friday, based on Government guidance on [Closing certain businesses and venues in England](#). Where consumption weights are not available, shares are calculated using CPI weights, rescaled to account for imputed rents. Does not reflect online consumption and deliveries and so should be viewed as indicative.

Chart 2.20 Some types of spending have recovered to close to their levels at the start of the year, but other types remain subdued
Daily spending using debit and credit cards^(a)



Sources: CHAPS and Bank calculations.

(a) Based on the CHAPS payments that a sample of around 90 UK companies receive from their merchant acquirers on a daily basis, which proxy the sales that these companies make through debit and credit card purchases. Seven-day rolling averages. Companies that have not started to receive payments through CHAPS following the easing of lockdown measures are assumed to remain closed or to be making a very limited number of sales (though they may have started to receive payments from merchant acquirers through other payment systems). Firms' data are mapped to the closest available ONS consumption categories and then weighted together using the equivalent shares in the ONS consumption basket. For definitions of the different consumption groups see the May 2020 MPR. Data are nominal, not seasonally adjusted, and shown to 29 July.

Some types of consumer spending have picked up in Q2...

Payments data suggest that early in the lockdown, consumer spending was around 30%–40% below its level at the start of the year, but that it has recovered somewhat following the relaxation of restrictions. The recovery in spending has varied across different goods and services, however. Delayable spending — including on items such as household furnishings, clothing and other larger items — fell materially after restrictions were introduced, but has since picked up. The initial sharp recovery might have reflected some pent-up demand, with spending falling back a little recently (**Chart 2.20**). Spending on staples — which includes types of expenditure that cannot generally be delayed, such as on food and household energy — has remained robust throughout the pandemic. That is likely to reflect, in part, substitution by consumers — for example, more food purchases instead of restaurant dining. Work-related spending — which largely reflects spending on fuel and public transport — and social consumption — spending that involves interactions with other people — are still some way below their levels at the start of the year.¹

While total consumer spending remains somewhat subdued, retail spending has largely recovered, partly due to an increase in non-store sales, the majority of which represents online retailers (**Chart 2.21**). The sharp increase in online sales is consistent with reports from the Bank's Agents that companies have improved their capacity to process sales online.

...and spending is expected to rise further in Q3.

Consumption is expected to have fallen by 20% in Q2 as a whole, but the recovery in spending that began during the quarter is expected to continue, such that growth is strongly positive in Q3. The number of seated diners in pubs and restaurants was close to zero until the end of June, but has picked up since those businesses were allowed to reopen in early July, for example (right panel, **Chart 2.18**).

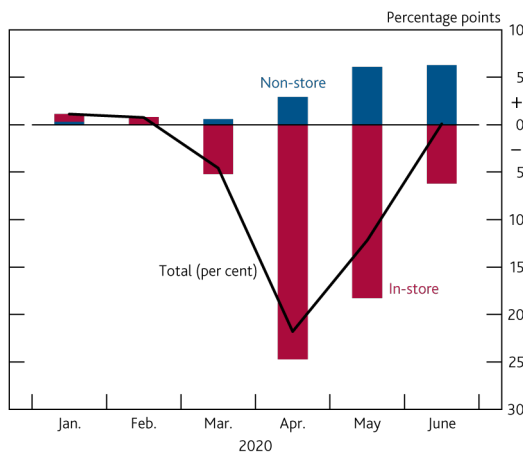
Overall, output is expected to remain well below its late-2019 level in Q3, although it is projected to be higher than in the May illustrative scenario.

This pattern of consumer spending is the main driver of the MPC's projected near-term path for output (**Chart 2.22**). That expected path is not as weak as in the May illustrative scenario, with Q3 output expected to be 9% below its 2019 Q4 level, compared with 18% lower in the scenario.

¹ For definitions of the different consumption groups see Chart 3.2 of the May *Report*.

Chart 2.21 In-store retail sales have fallen, but this has been offset by a rise in non-store sales

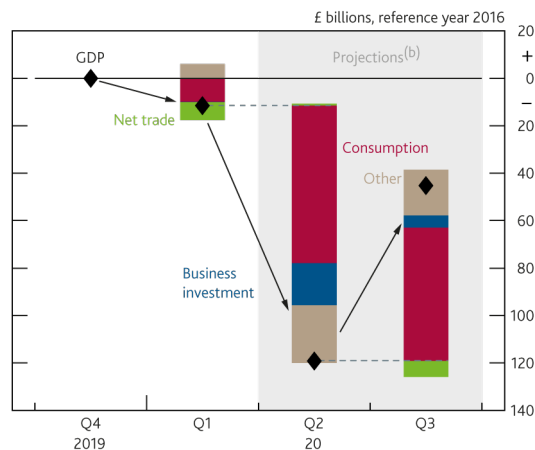
Contributions to retail sales growth since December 2019



Sources: ONS and Bank calculations.

Chart 2.22 Household spending is expected to be the main driver of the fall and partial recovery of GDP

Changes in output since 2019 Q4^(a)



Sources: ONS and Bank calculations.

(a) Consumption data include non-profit institutions serving households (NPISH) and net trade data exclude the impact of missing trader intra-community (MTIC) fraud. Other includes household investment, public sector spending, changes in inventories and acquisitions less disposals of valuables.

(b) Bank staff projections.

The fall in consumption in Q2 is expected to have caused a sharp pickup in the saving rate.

While spending dropped sharply during lockdown, incomes fell by less, partly due to government schemes such as the Coronavirus Job Retention Scheme (CJRS) and Self-Employment Income Support Scheme (SEISS), which supported employment and earnings. As a result, household savings rose sharply in aggregate. Consistent with that, deposits in household bank accounts increased by an average of £17 billion a month in the four months to June, compared with an average of £5 billion a month in the previous six months. Overall, the saving rate is estimated to have risen sharply in Q2, reaching 25%.

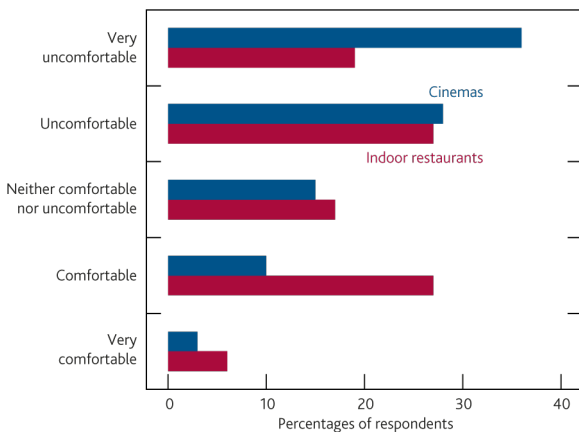
The saving rate is expected to fall back in the near term, but remain higher than it was at the end of 2019.

The easing of Covid-19 restrictions should result in a further recovery in spending, and saving is likely to fall alongside that. Households may decide to spend more of their income in the coming months, although the saving rate is expected to remain elevated in Q3 compared with its level at the end of 2019.

Continuing uncertainty could hold back the recovery in spending.

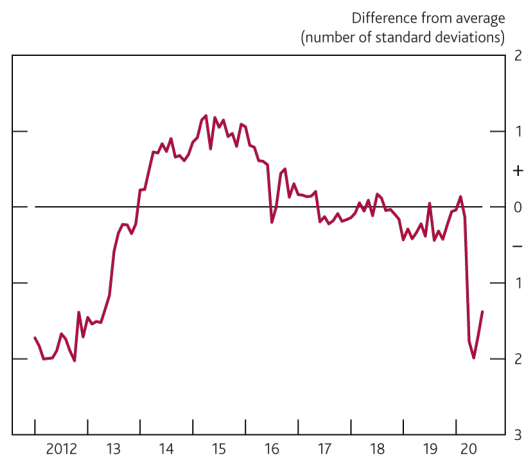
While spending is expected to recover somewhat, continued uncertainty around the continuing risk to health from Covid-19 could hamper that recovery. An ONS survey on the social impacts of Covid-19 suggests that more than 60% of all adults would feel uncomfortable about going to the cinema at present and close to 50% would feel uncomfortable about eating indoors at a restaurant (**Chart 2.23**). Estimates based on US data suggest that fear of Covid-19 has had a significant effect on spending there (Goolsbee and Syverson (2020)).

For households that are uncertain about the economic outlook, and in particular those that are concerned about possible redundancies, there could be an incentive to save a higher share of their income for precautionary reasons. The GfK/EC consumer confidence indicator picked up in July, but remains well below its historical average, suggesting that households remain cautious overall (**Chart 2.24**). Each household faces different circumstances and these differences will influence their spending decisions (Box 3).

Chart 2.23 Responses to an ONS survey suggest continued caution about social consumptionConfidence in visiting cinemas and indoor restaurants^(a)

Sources: ONS and Bank calculations.

(a) Questions: 'At this time, how comfortable or uncomfortable would you be going to the cinema/eating indoors at a restaurant?'. Responses of 'Not applicable', 'Don't know' and 'Prefer not to say' are not included, so proportions will not sum to 100. Based on survey responses from 15 to 19 July.

Chart 2.24 Consumer confidence has picked up slightly in recent months, but remains very subduedConsumer confidence^(a)

Sources: GfK (research carried out on behalf of the European Commission) and Bank calculations.

(a) Difference from average since 1997. Based on the average of five survey balances: general macroeconomic situation over the past 12 months and expectations for the next 12 months, personal financial situation over the past 12 months and expectations for the next 12 months, and major purchases at present.

Housing market activity fell significantly in April, when the market was effectively closed...

Housing transactions fell significantly as a result of Covid-19, as restrictions on housing market activity prevented a large number of house purchases that would otherwise have taken place. In April, just over 40,000 transactions were completed, compared with close to 100,000 per month at the start of 2020. There were not enough transactions in April and May for the ONS to produce reliable house price statistics, so the publication of the data was temporarily suspended.

...but the reopening of the market has led to a recovery in activity in recent months.

Since restrictions were eased, activity in the housing market has picked up. RICS new buyer enquiries increased substantially in May and June, recovering from record lows in April. The temporary increase in the threshold at which homebuyers start paying Stamp Duty is also expected to boost the number of transactions. House prices fell in Q2 according to the Nationwide and Halifax data, but other indicators suggest some signs of a pickup since then: Rightmove data suggest that asking prices in Great Britain increased by 2.4% between March and July.

Businesses expect their revenues to be lower as a result of Covid-19...

Most businesses expect Covid-19 to have a large and persistent negative impact on their sales. Many were not able to operate at their normal level of capacity, or at all, while social distancing measures were in place. For those that were able to open, in many cases demand was much weaker than usual. Respondents to the DMP Survey expected sales to be 30% lower in Q2 as a result of Covid-19 and to still be 8% lower at the start of 2021.

...and are facing significant uncertainty.

Businesses have been reporting higher uncertainty since March, although there is some evidence that it has fallen back a little since its April peak. Three quarters of DMP Survey respondents reported that overall uncertainty was high or very high in July, compared with around 40% before Covid-19 restrictions were introduced. Firms' uncertainty around their year-ahead sales expectations has followed a similar pattern.

Lower sales and higher uncertainty are both expected to have contributed to a fall in investment.

In 2020 Q2, business investment is expected to have been 35% lower than at the end of 2019, as weaker sales reduce corporate cash flows and higher uncertainty increases the incentive to postpone investment projects (see Section 4 of the [November 2019 Report](#) for more detail on the impact of uncertainty on investment). That is consistent with the results from the DMP Survey, where businesses reported that they would spend 33% less on investment than they otherwise would have in Q2 (**Chart 2.25**). Intelligence from the Bank's Agents also suggests that firms have cut investment significantly, with some reports of investment spending being redirected towards

reopening and implementing Covid-related working practices, such as social distancing measures and remote working.

Business investment is expected to remain weak in the near term, with some indicators of investment intentions at historical lows (**Chart 2.26**). The near-term path of business investment will reflect the lags involved in investment spending, such that the full impact of Covid-19 could take some time to materialise. The UK will move to new trading arrangements with the EU on 1 January 2021, so additional uncertainty around the nature of those changes could also weigh on business investment.

As in other countries, UK exports and imports have been weak.

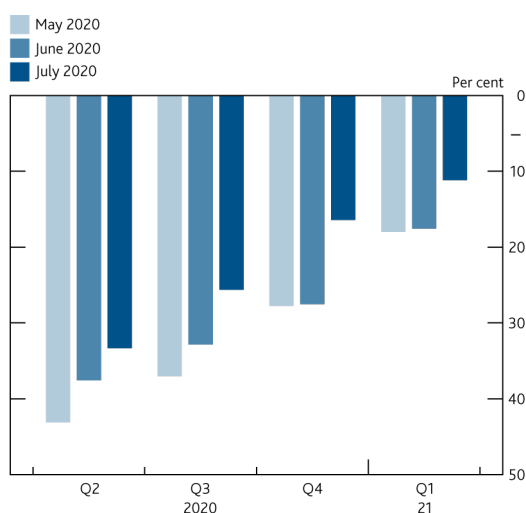
Both exports and imports have been hit by Covid-19 restrictions. The weakness of global growth, along with disruption to global supply chains, is expected to have led to a fall in UK exports of around 20% in Q2 compared with 2019 Q4. Similarly, the weakness of UK domestic activity has also reduced the demand for imports, such that they are expected to have fallen by a similar amount. Travel restrictions in place in the UK and around the world have also significantly reduced the flow of tourists to and from the UK. The move to new trading arrangements between the UK and EU is expected to weigh on both import and export growth in 2021.

Fiscal policy is expected to support demand.

The Government has increased spending materially to support the economy, via the *Budget 2020* fiscal package and further policies announced in response to Covid-19 (see Box 3 of May *Report*). Since May, the Government has announced additional measures, including temporarily lowering VAT from 20% to 5% on restaurant dining, accommodation and attractions as well as incentives for firms to retain furloughed workers and hire new apprentices. The projections set out in this *Report* are conditioned on the OBR's assessment of the Government's current tax and spending plans (Section 1).

Chart 2.25 Businesses expect to invest much less as a result of Covid-19, but have become slightly less pessimistic recently

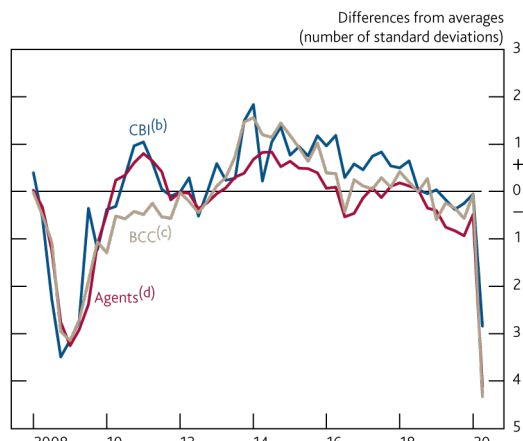
Businesses' expected impact of Covid-19 on investment by DMP Survey date^(a)



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 2020 Q2, 2020 Q3, 2020 Q4 and 2021 Q1?'

Chart 2.26 Investment intentions have fallen sharply
Indicators of investment intentions^(a)



Sources: Bank of England, BCC, CBI and Bank calculations.

- (a) Differences from averages since 2000.
- (b) Planned investment in plant and machinery over the following year relative to the previous year. Sectors within CBI (manufacturing, distribution, financial services and business/consumer/professional services) are weighted together using shares in real business investment.
- (c) Based on reported changes to planned investment in plant and machinery over the past three months. Weighted average of the manufacturing and services sectors based on shares in real business investment.
- (d) Planned expenditure on tangible non-financial assets over the following 12 months.

2.4 Employment, costs and prices

Covid-19 has caused a significant shock to the labour market...

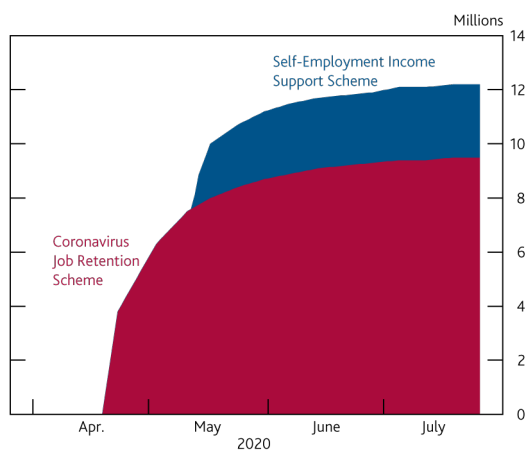
Under the restrictions introduced in response to Covid-19, many households and business were unable to function normally. Those that could not work from home were unable to work at all in many cases. Many businesses were ordered to close, and many others chose to cease trading due to concerns over employee safety and lack of demand. Their demand for labour fell sharply as a result.

...although government schemes have enabled many businesses to retain their workers.

While businesses' demand for labour fell, given the nature of the shock, many employees were temporarily furloughed under the CJRS. Under that scheme, the Government paid 80% of the income of employees that were furloughed, up to £2,500 per month. The SEISS also provided grants to the self-employed. Take-up of both schemes has been high. Close to 80% of businesses that responded to the June DMP Survey reported having made use of the CJRS and 9½ million jobs have been furloughed under the scheme at some point (**Chart 2.27**), although the number of furloughed jobs at any one time will be lower.² Similarly, around 80% of eligible self-employed workers made use of the SEISS, which corresponds to 2.7 million total claims.

Chart 2.27 Around 12 million claims have been made under the CJRS and the SEISS

Total claims under government schemes^(a)



Sources: HMRC and Bank calculations.

(a) Where daily claims data are not available they are linearly interpolated from weekly data. CJRS data refer to the total number of furloughed jobs and SEISS data refer to the total number of claims.

The official data suggest that employment fell in the three months to May...

Despite having been supported by the CJRS and SEISS, employment has fallen since the Covid-19 outbreak, although different indicators give different steers as to the size of the change. According to the latest Labour Force Survey (LFS) data, employment fell by 130,000 in the three months to May, but the fall was more than accounted for by lower self-employment. According to HMRC Pay As You Earn (PAYE) data, the number of employees decreased by over half a million in the three months to June, equivalent to a 2% drop (**Chart 2.28**).

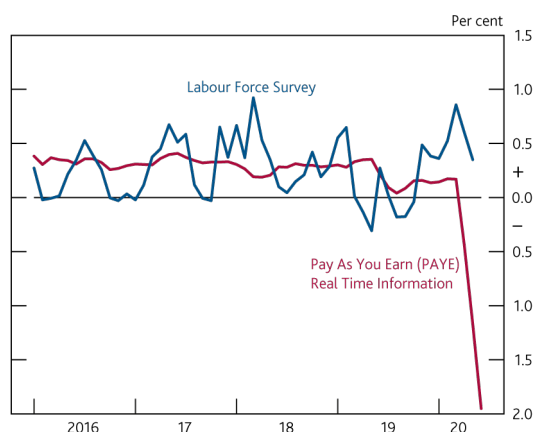
...while unemployment was little changed...

According to the LFS, unemployment was little changed in the three months to May. That will partly reflect the impact of staff being retained on furlough and changes in participation. The ONS has also noted the practical challenges associated with collecting statistics at this time. The LFS estimates are based on reduced response rates due to Covid-19, and for non-respondents it is assumed that there is no change in labour market status.³

Alternative sources of data suggest that unemployment has begun to rise. There has been a much larger rise in the number of people claiming benefits: the claimant count rose by 1.2 million in Q2 (**Chart 2.29**) and the claimant

Chart 2.28 Income tax data suggest that there has been a large fall in the number of paid employees

Three-month change in the number of employees



Sources: HMRC, ONS and Bank calculations.

² This refers to furloughed jobs, as opposed to the number of furloughed workers. Bank staff estimate that the peak number of employees on furlough was over 7 million in May and that around 6 million employees were furloughed on average during Q2.

³ See the ONS article '[Coronavirus and the effects on UK labour market statistics](#)' for more details.

count rate — at around 7% — has risen above the LFS unemployment rate for the first time. It is possible that the claimant count overstates the extent of unemployment, however. Some claimants will be entitled to claim benefits while having a job and some people that lost their jobs in March may have claimed benefits at that time, but then subsequently been placed on furlough. Over half a million excess claims were made before it was announced that employees previously made redundant could be placed on furlough under the CJRS.

Bank staff estimate that unemployment has risen, although it appears to have increased by substantially less than in the illustrative scenario in the *May Report*. Unemployment is expected to increase further in the near term (Section 3). Intelligence from the Insolvency Service suggests redundancy intention notifications rose notably in June and the number of internet searches for terms related to redundancies has remained elevated (**Chart 2.30**).

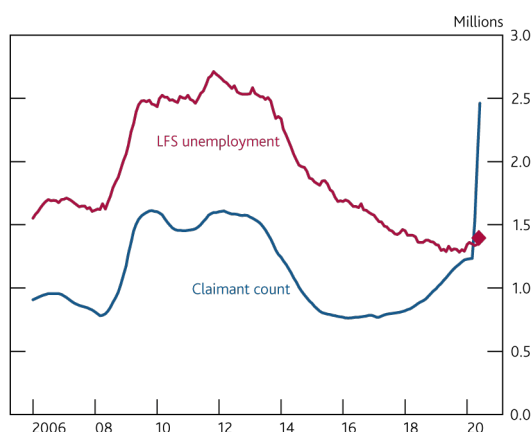
...as inactivity has picked up markedly. Underemployment also rose sharply.

Many people who have lost their jobs have been recorded as inactive, as opposed to unemployed, given that they have not been actively searching for a job. Consistent with that, there has been a significant rise the number of working-age people that are inactive but would like a job in the three months to May. Lockdown measures, including school closures, might have meant that some people have not been looking for work, or have not been available to start a new job.

In addition to those leaving employment, lower labour demand has also resulted in a fall in the number of hours people have worked. Weekly LFS data suggest average hours fell by around 20% in the week that lockdown measures were introduced and there was a sharp increase in the number of people who reported working fewer hours than normal due to economic conditions. Furloughed employees were not working at all at that time, which largely explains the fall in hours worked among employees, while the average hours worked by the self-employed also fell sharply. If workers would like to increase their hours, this would add to the degree of labour market slack. For a more detailed discussion of spare capacity in the labour market, see Section 4.

Chart 2.29 LFS unemployment is expected to increase only modestly in Q2, but the rise in the claimant count has been much larger

LFS unemployment and the claimant count^(a)

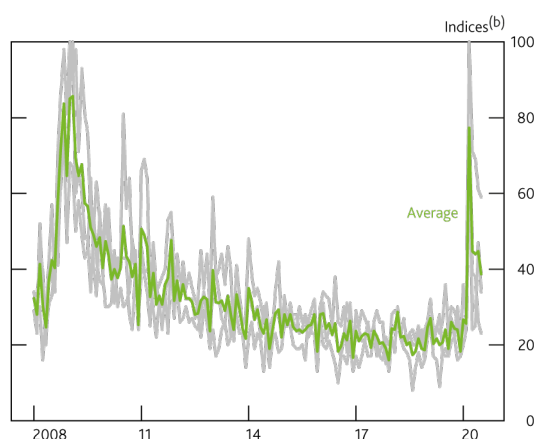


Sources: ONS and Bank calculations.

(a) Three-month rolling averages. The diamond shows Bank staff's projection for LFS unemployment in the three months to June, based on official data to May.

Chart 2.30 The number of internet searches for terms related to redundancies picked up sharply in March and has remained elevated since

Internet searches related to redundancies^(a)



Sources: Google Trends and Bank calculations.

(a) The terms included are 'unemployment benefits', 'unemployment insurance' and 'redundancy insurance'. Data are monthly averages and are not seasonally adjusted. July 2020 data points are the average to 29 July 2020.

(b) Search volumes are calculated as an index where 100 represents the maximum search volume for the term.

Many workers have seen a reduction in their earnings

Average pay growth has fallen sharply. In the three months to May, whole-economy total annual pay growth was -0.3%, down from 2.9% in the three months to February. In the private sector, bonuses fell by almost 15% in the three months to May compared with a year earlier, the largest fall since 2009. Agency intelligence suggests that in many cases, bonuses have been scaled back or withdrawn altogether for this year. Excluding bonuses, private sector pay growth was zero.

A large number of employees have seen their incomes reduced, including those entering the CJRS. Under the CJRS, the Government committed to paying 80% of the wages of furloughed workers initially, although some employers reported paying their furloughed workers over and above this. That would have had a negative direct effect on the AWE data, which Bank staff estimated to be of the order of 2½% on private sector AWE at the peak in Q2.

Some downward pressure on wage growth is also likely to have resulted from the sharp fall in demand across a number of sectors. Survey data are consistent with this, with REC pay indicators falling to levels last seen in 2009. And Agency intelligence suggests that the incidence of pay freezes or cuts has increased. However, the rise in the National Living Wage in April will have increased the pay of some workers.

Output per worker is likely to have fallen in Q2...

Given that people on furlough are still counted as employed, the furloughing of workers will have mechanically reduced aggregate output per worker, although output per hour is expected to have increased. Until July, furloughed employees were not permitted to undertake any work, reducing their output to zero. Largely as a result, annual growth in output per worker is estimated to have been -22% in Q2. The large fall in average hours worked means that growth in output per hour is expected to have picked up to 2.4%, however.

...which is expected to lead to a spike in measured unit labour cost growth.

The marked fall in the growth of output per worker is much larger than the decline in wage growth. As a result, annual growth in unit labour costs (ULCs), which measure the labour cost of producing one unit of output, is expected to have picked up very sharply in Q2. As the sharp rise in annual ULC growth in large part reflects the impact of furloughing, though, it is likely to be temporary. Whole-economy ULCs also do not currently reflect businesses' labour costs, as the Government is paying the majority of furloughed workers' wages. The actual cost to businesses of producing a unit of output — excluding CJRS payments for furloughed workers — has also increased, because the productivity of those in work has fallen by more than their pay, which tends to be slow to adjust. The rise in costs is expected to have been significantly smaller on this basis, however. As pay adjusts and output recovers, the underlying trend for ULCs will become clearer.

The changing composition of the workforce — with lower-paid workers more likely to have lost their jobs as a result of Covid-19 — may push up average pay and productivity to some extent, partly offsetting the effect of weaker demand. Given that both pay and productivity are likely to be affected in a similar way, however, this should have relatively little effect on ULCs.

CPI inflation has fallen well below the target..

CPI inflation fell from 1.7% in Q1 to 0.6% in Q2. That fall partly reflected declines in energy and utility prices that were in train before the Covid-19 outbreak had widespread effects, as well as the impact of Covid-19 on economic activity in the UK and globally. Reflecting weaker global growth, US dollar oil prices fell significantly between January and April and, although they have recovered somewhat since, they remain around 35% lower than at the start of the year (**Chart 2.8**). That has had a direct effect on inflation via the prices of motor fuels (**Chart 2.31**), as well as an indirect effect by reducing input costs in other sectors of the economy.

...and is expected to decline further in Q3.

Inflation is expected to turn briefly negative in the near term, falling to -0.3% in August. Lower energy prices are expected to continue to weigh on inflation and the announced cut to VAT on restaurant dining, accommodation and attractions will act as an additional drag, reducing inflation by an estimated 0.3 percentage points in Q3 and 0.4 percentage points in Q4 respectively. The Government's Eat Out to Help Out scheme is expected to pull down inflation by a further 0.4 percentage points in August. Following the expiry of that scheme in September, inflation is expected to pick up to around ¼%. While the effect of those measures will be temporary, the effect of weaker demand on domestic price pressures is expected to be more persistent (Section 4).

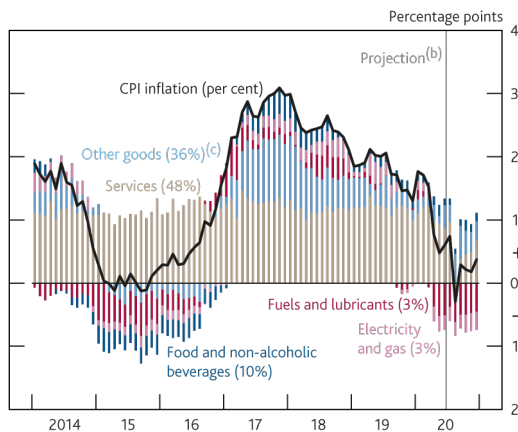
Some indicators of companies' inflation expectations remain low, but the expectations of external forecasters have been little changed, and movements in household measures have been mixed.

Some indicators of companies' inflation expectations remain low. Companies' reported expectations in the distribution sector tend to be quite volatile, but these are at 0.4% at the one-year horizon and 1.0% at the two-year horizon (**Table 2.D**). Firms' plans for prices have also softened according to the DMP Survey (**Chart 4.10**).

However, expectations of external forecasters and financial markets participants have remained broadly unchanged. In terms of households' inflation expectations, the fall in actual inflation might have been expected to lead to lower short-term inflation expectations, but expectations have been broadly stable at the one-year horizon. The Bank/TNS survey suggests households' medium-term inflation expectations have fallen, but a change to the survey method may have affected those estimates in Q2.⁴ The YouGov/Citigroup measure of households' medium-term expectations has been broadly stable. Overall, the MPC judges that inflation expectations remain well anchored.

Chart 2.31 Lower energy prices are expected to weigh on inflation in the near term

Contributions to CPI inflation^(a)



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

- (a) Contributions to annual CPI inflation. Figures in parentheses are CPI basket weights in 2020.
 (b) Bank staff's projection. Fuels and lubricants estimates use Department for Business, Energy and Industrial Strategy petrol price data for July 2020 and are then based on the sterling oil futures curve.
 (c) The difference between CPI inflation and the other contributions identified in the chart.

Table 2.D Inflation expectations remain well anchored

Measures of inflation expectations^(a)

Per cent

	2000– 07 ^(b)	2010– 18	2019	2020	
				Q1	Q2
One year ahead inflation expectations					
Households^(c)					
Bank/TNS	2.4	3.0	3.2	3.0	2.9
YouGov/Citigroup	2.5	2.4	2.7	2.7	3.1
Companies^(d)					
Financial markets ^(e)	2.6	2.9	3.4	3.1	2.8
Two to three year ahead expectations					
Households^(c)					
Bank/TNS	n.a.	2.8	3.0	2.9	1.9
Companies^(d)					
External forecasters ^(f)	2.0	2.1	2.0	2.0	2.0
Financial markets ^(e)	2.8	3.1	3.6	3.5	3.4
Five to ten year ahead expectations					
Households^(c)					
Bank/TNS	n.a.	3.3	3.5	3.4	2.6
YouGov/Citigroup	3.5	3.2	3.1	3.1	3.0
Financial markets ^(e)	3.0	3.3	3.5	3.4	3.4
Memo: CPI inflation	1.6	2.3	1.8	1.7	0.6

Sources: Bank of England, Bloomberg Finance L.P., CBI, Citigroup, ONS, TNS, 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.

⁴ See 'Bank of England/TNS Inflation Attitudes Survey - May 2020' for more details.

Box 3

Insights from Bank surveys on the impact of Covid-19 on households' finances

This box uses evidence from the Bank-commissioned surveys by Ipsos MORI and NMG Consulting to assess the impact of Covid-19 on households' financial positions at different points in the income distribution.

Covid-19 has reduced incomes for a significant proportion of households.

Survey evidence suggests that around 30%–40% of households have experienced falls in income due to Covid-19. Increases in income have been much less common, reported by around 10% of households. Much of the fall in aggregate income resulted from people being made unemployed or furloughed. For those still working, the self-employed have reported the largest hits to income, on average.

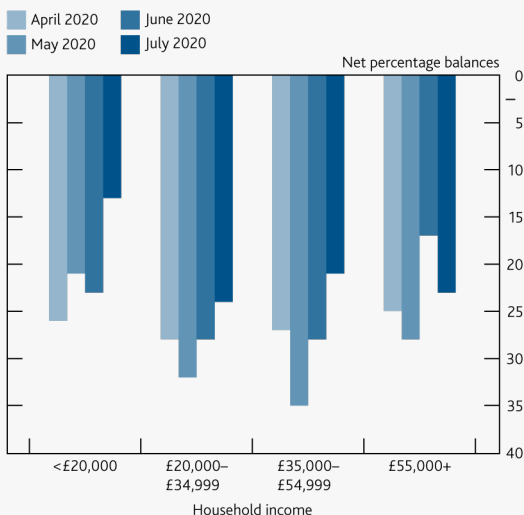
A similar proportion of people have reported income falls across different income brackets...

The proportion of households reporting that their income has fallen has been relatively similar across the income distribution (**Chart A**). [Brewer and Gardiner \(2020\)](#) found a similar pattern analysing YouGov survey data. This is despite those with lower incomes being more likely to be furloughed or made unemployed due to Covid-19 (Section 3). Using Money Dashboard data, [Bourquin et al \(2020\)](#) found that, although the earnings of the lowest income households had fallen more than others between January and May, incomes had not.

There are several factors which might explain this.¹ First, those on lower incomes are likely to receive a larger proportion of any lost earnings back via government support. This has been re-enforced by the recent increases in support provided through Universal Credit and the CJRS ([HM Treasury \(2020\)](#)). Second, a significant proportion of people with low incomes were not employed before the pandemic and may have seen their incomes rise as Universal Credit rates increased. Finally, individuals earning low wages are not necessarily in low income households, once incomes of other household members have been taken into account. For example, research by the Institute for Fiscal Studies has shown that the majority of minimum wage earners live in middle-income households ([Cribb et al \(2019\)](#)).

Chart A A similar proportion of people have reported income falls across income brackets

Reported changes in household income due to Covid-19^(a)

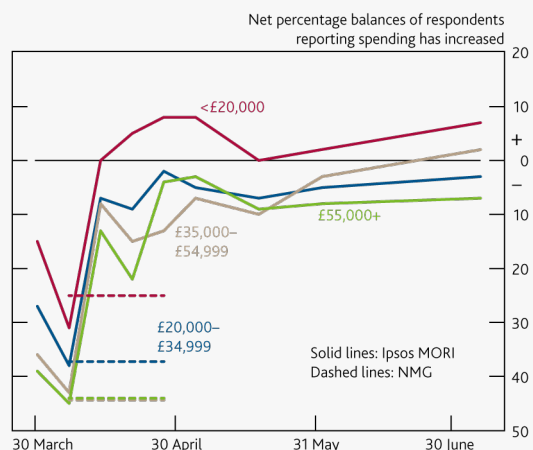


Sources: Bank of England, Ipsos MORI and Bank calculations.

(a) Question: 'Thinking about your total household income from all sources over the last week, including any pay or benefits you might receive, on balance, would you say that your household income has increased, decreased, or stayed the same compared with before the coronavirus outbreak?'. July data were collected 3 to 6 July and the question asked about income over the last month. Data are not seasonally adjusted.

Chart B A smaller proportion of lower income households have reduced spending

Reported changes in spending due to Covid-19, by household income^(a)



Sources: Bank of England, Ipsos MORI, NMG Consulting and Bank calculations.

(a) Ipsos MORI question: 'Thinking about your total household spending (eg on food and household goods, products and services, on commuting, bills, etc) on balance would you say that your household spending has increased, decreased, or stayed the same, compared with before the coronavirus outbreak?'. Ipsos MORI data are shown on the last date of each survey period. NMG question: 'Over the past month, how if at all, has your overall spending changed, relative to what you would usually have spent, as a result of the outbreak of coronavirus?'. NMG data were collected 2 to 28 April 2020. Data are not seasonally adjusted.

¹ These channels are set out in more detail in [Brewer and Gardiner \(2020\)](#).

While income falls have been less common for those with lowest incomes, their effects may be felt more acutely. They are likely to place finances under more pressure than an equivalent fall for a higher income household.

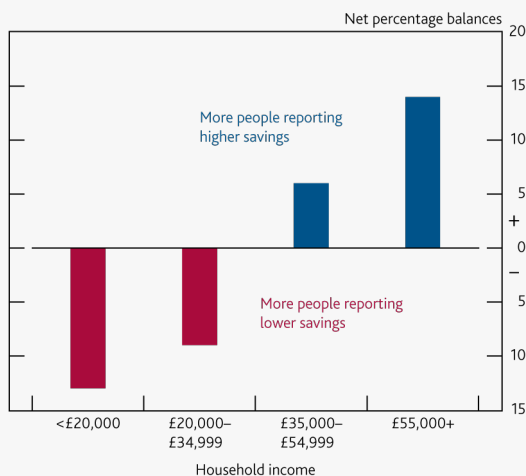
...but spending has fallen for fewer lower income households...

In contrast to changes in income, changes in spending have been different across income brackets. A smaller proportion of lower income households cut spending in response to the pandemic (**Chart B**). Differences in spending patterns between households before the pandemic might help to explain some of the variation in responses. Data from the Living Costs and Food Survey show that ‘social consumption’ accounts for more than a quarter of higher income households’ total spending, a larger share than for other households. Much of that spending has not been possible during lockdown as it typically involves social interaction, such as eating out or live entertainment. Spending on staples is a more important component of consumption for lower income households. It accounts for just under half of spending for households in the lowest income quintile, compared to less than a third for households in the highest quintile.

...such that lower income households are more likely to have been left with lower savings.

The aggregate saving rate increased in Q1 and is likely to have risen sharply in Q2 (Section 2.3), but survey data indicate that rises in saving have been heavily skewed towards high income households. Lower income households have been more likely to report that their savings have fallen as a result of Covid-19 (**Chart C**). This is supported by estimates that show, on average, those in the lower 60% of the income distribution have a deficit between changes in income and changes in spending (Brewer and Gardiner (2020)). The differences are driven by spending responses. Those with higher incomes, with larger cuts in consumption, are more likely to have built up savings.

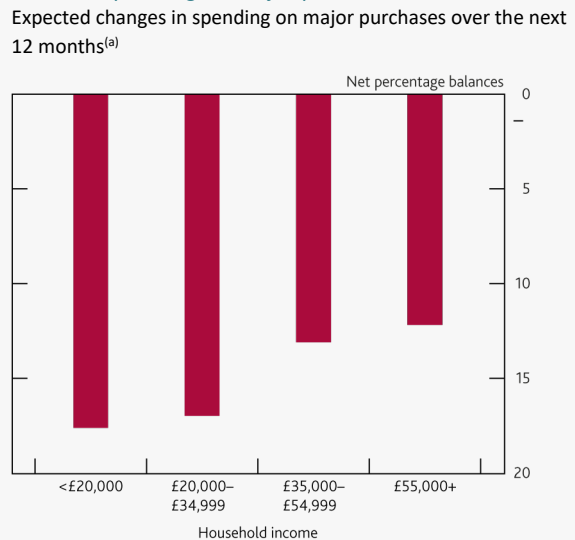
Chart C More lower income households report having run down savings, while others have built them up
Reported changes in savings due to Covid-19^(a)



Sources: Bank of England, Ipsos MORI and Bank calculations.

(a) Question: ‘As a result of the measures taken around the coronavirus pandemic, would you say that your household savings have increased, decreased, or stayed the same?’. Data were collected 3 to 6 July 2020 and are not seasonally adjusted.

Chart D Fewer people on lower incomes expect to increase spending on major purchases
Expected changes in spending on major purchases over the next 12 months^(a)



Sources: NMG Consulting and Bank calculations.

(a) Question: ‘Compared to the last 12 months, do you expect to spend more or less money on major purchases (such as a car, furniture and electrical goods) over the next year?’. Data were collected 2 to 28 April 2020 and are not seasonally adjusted.

These differences across households may influence the recovery in spending.

How spending evolves will depend on how different households respond as social distancing measures are eased. Savings have been concentrated in higher income households (**Chart C**). Lower and middle-income households appear to have built up less savings or run them down. These households also tend to report more pessimistic expectations about employment, potentially increasing the desire to build savings, and report slightly weaker expectations for spending on major purchases (**Chart D**). That could pose a downside risk to spending over the next year or so. But those households that have built up savings may seek to substitute foregone spending on social consumption with other types of spending over time. This could mean that consumer spending is stronger than expected. The risks around the outlook for consumption are discussed further in Section 1.

Box 4

Agents' update on business conditions

The key information from Agents' contacts considered by the Monetary Policy Committee at its August meeting is highlighted in this box.¹

Firms experienced a varied recovery in output following a significant easing of lockdown measures throughout June and July.

Agency intelligence gathered since late June indicates that economic activity is recovering across an increasing range of sectors as social distancing measures have been eased further. However, persistent caution has dampened the outlook, particularly for sectors reliant on consumer footfall. For instance, those restaurants and pubs that have reopened have often reported severely depressed sales compared to normal, even when reduced capacities due to social distancing measures are taken into account. Sectors involving social interaction have generally been severely impacted by the pandemic, and demand growth has not increased in line with expectations. In contrast, retailers of non-food goods reported that aggregate customer spending — combining online and stores sales — is now close to normal levels compared with a year ago. Continued strong growth in online sales compensated for depressed in-store activity. Taken together, sales of consumer goods and services in aggregate have only partially recovered as more sectors have reopened.

In manufacturing, the vast majority of sites are now in operation. However, activity has generally remained weak, and the majority of contacts reported operating at around 20% below capacity due to social distancing requirements. Firms supplying automotive and civil aerospace sectors continued to report subdued demand. In contrast, contacts in sectors supplying chemicals, healthcare and personal protective equipment continued to report strong demand.

Contacts that import and export reported increasing concerns about these activities once the transition period between the UK and EU has come to an end on 1 January 2021. They cite concerns about short-term delays as new rules come into force, and increased overhead costs over the long term due to new administrative procedures.

In business services, contacts reported demand recovering only gradually in June and July following a significant fall in activity in April. Demand is still substantially down on a year ago, and the scale of the recovery is mixed across sectors. In professional services, demand is strong across corporate restructuring, insolvency, audit, debt management, employment law and IT. This contrasts with weaker demand in areas such as mergers and acquisitions. Following a severe contraction in April, marketing, advertising, recruitment and office equipment wholesalers have since reported a gradual recovery in demand. Demand for business travel, hotels, conferencing and corporate entertainment has remained particularly weak.

In construction, contacts reported that activity reached 80% of pre-Covid levels during July. The introduction of the 'one metre plus' rule on sites allowed many to marginally increase their rate of activity. However, social distancing measures continued to be the primary hurdle for further increases in the near future. Contractors that are focused on public sector projects reported they expect output to increase gradually over the coming months. Some anticipate they could increase activity enough to compensate for some of the time that sites were shut during lockdown, falling only 10% short of their output targets for 2020. The pipeline of new orders for large construction projects is low, though continued high demand for distribution buildings bucks this trend.

Across the housing market, pent-up demand had resulted in high levels of activity in secondary and new home markets in June and July. Reflecting increased levels of remote working, and its likely persistence in the future, properties with gardens and space to support home working were reported to be particularly popular. Seasonal

¹ A comprehensive quarterly report on business conditions from the Agents is published alongside the MPC decision in non-*Monetary Policy Report* months. The next report will be published on 17 September 2020

rental demand from university students was subdued as online teaching increased and the number of overseas students fell.

The outlook for the housing market during the remainder of 2020 is mixed. The temporary cut to stamp duty is expected to support increased activity. However, an anticipated increase in unemployment, alongside a general tightening of availability for mortgage products, is expected to slow activity by the end of the year.

Activity in commercial real estate sectors remained subdued. Demand for retail space continued to fall, with expected increases in vacancy rates throughout the remainder of 2020. Contacts reported that deliberations are underway about office space requirements in light of successful remote working, though few definitive decisions have been made. Demand for warehouse space remained strong, reflecting an accelerated shift towards online shopping.

Contacts reported that collection rates for commercial property rents were weak for the second quarter in a row, particularly among retail tenants. Pressure is reported to be growing on landlords to restructure lease terms to link future rents with the occupiers' turnover.

The majority of firms are revising investment plans significantly downwards in 2020 and 2021.

Contacts regularly reported plans for lower investment in 2020 and 2021 (**Chart A**). Many have delayed or cancelled plans outright. These decisions can primarily be explained by the majority of contacts, having experienced a significant reduction in sales during the pandemic, remaining uncertain about how demand will recover over the rest of the year.

Areas where investment plans have been maintained include large capital projects. This is particularly the case for projects focused on construction activity, where long-term commitments cannot be easily revised. Some contacts also reported redirecting some expenditure towards new IT equipment as remote working becomes embedded across a wider range of firms.

Chart A Investment plans have been revised in response to the pandemic.

Investment intentions over the next 12 months



Chart B Firms expect to make significant redundancies over the next 12 months.

Employment intentions over the next 12 months



The outlook for employment and pay has worsened, with increases in the scale of redundancies and widespread cancellation of pay awards for 2020.

Contacts reported a deterioration in the employment outlook (**Chart B**), with the rate of redundancies having increased in June and July, ahead of the start of mandatory employer contributions to the Coronavirus Job Retention Scheme (CJRS) in August. Further, even where activity has remained strong, a few contacts reported that productivity-improving changes made during the pandemic are leading to redundancies or the reduction of hiring plans. The heaviest job losses in recent weeks were reported by airline carriers, holiday operators, non-food retailers, automotive manufacturers, and firms along aerospace supply chains.

Contacts in a few sectors, including pharmaceutical, food processing, and logistics companies, reported the continued hiring of new staff. Most also reported attempts to maintain apprenticeship and graduate hiring schemes. The prospect for many of these are conditional on an improving economic outlook during the second half of 2020.

Contacts from charity and voluntary organisations reported that retail income sources had been adversely affected during lockdown. Income from corporate donations had also fallen, and contacts reported having to draw on their cash reserves. Many were concerned that they would not be able to survive a prolonged economic downturn. However, at the same time, demand for their services has increased during the pandemic, and is expected to increase further if unemployment rises as the CJRS is phased out.

On pay, the majority of contacts who reported topping up wages for furloughed staff have stopped doing so. Pay increases and bonuses are being deferred for 2020, except for legally mandated increases associated with the National Living Wage.

Credit availability increased for firms, especially SMEs, although pockets of tightness remained in sectors most affected by the pandemic.

Contacts reported a significant improvement in the availability of credit for small firms after the introduction of the Bounce Back Loan Scheme. Following exceptionally high levels of borrowing for the few weeks after its introduction in early May, demand for credit from small firms eased but remained strong. Contacts also reported widespread use of the Coronavirus Business Interruption Loan Scheme. However, in hard-hit sectors such as retail, hospitality and leisure, there has been a tightening of credit availability as expectations of business failures increase.

There was a mixed picture for larger firms. Contacts reported that many felt credit would be available if required, but also increasing availability of funding through capital markets reduced the need to draw upon credit facilities. In contrast, large non-investment grade firms found the funding environment more difficult, especially those most vulnerable to the impact of the pandemic. Take up of the new Coronavirus Large Business Interruption Loan Scheme had been limited to date.

The need to create Covid-secure environments has increased cost pressures, while there is an uncertain outlook for pricing strategies.

Contacts reported an increase in non-labour costs overall, although the picture is mixed. The need to create and maintain 'Covid-secure' environments for staff and customers increased costs, as had sterling's depreciation. Partly offsetting that, cost pressures from energy and raw material inputs eased.

Contacts reported that pricing strategies will primarily be guided by the strength of the recovery in demand during the second half of 2020. Some firms have been exploring whether consumers are more or less responsive to price discounting than they were pre-Covid. At the same time, there are pressures to at least maintain prices at pre-Covid levels to ensure margins over increased costs — in part resulting from lower productivity due to social distancing measures — do not get squeezed too much.

Reports suggest the recent temporary VAT reduction to 5% from 20% is unlikely to be fully passed on to consumers in the form of lower prices. For some firms, the cut is perceived as an opportunity to partially restore margins over the higher costs experienced during the pandemic.

3 In focus The outlook for the labour market

Bank staff estimate that around 6 million workers were furloughed on average during 2020 Q2, and numbers in employment have started to fall. Most of those furloughed are expected to be re-employed as output picks up in the second half of 2020. Nevertheless, the unemployment rate is expected to rise to around 7½% in 2020 Q4, as sales do not recover fully for some businesses. The MPC judges that unemployment is likely to decline only gradually from this peak. Firms may be reluctant to make hiring decisions while uncertainty is high and the differential impact of Covid-19 on economic activity across sectors is likely to increase the mismatch between vacancies and those looking for work.

The pandemic has had a profound effect on the UK labour market. Social distancing rules have meant that businesses have had to adapt working practices and some have been shut for a time since March. The reduction in activity has also reduced firms’ demand for labour. The number of vacancies fell to a record low in Q2 (**Chart 3.1**) and existing workers worked many fewer hours. At one point, around a third of private sector employees were furloughed as part of the Coronavirus Job Retention Scheme (CJRS): this led to the sharpest fall in hours worked on record (**Chart 3.2**). Some workers have had their pay cut or been made redundant.

This *In Focus* considers the outlook for the labour market. Understanding how the labour market might evolve is important for the MPC as it has implications for both price stability and economic growth. Households’ employment and income expectations affect spending and saving decisions. The labour market also has implications for inflation via pay growth (Section 4). Section 3.1 looks at how the pandemic has affected different industries and workers and how the labour market might evolve in the second half of 2020. Section 3.2 considers how persistent the expected increase in unemployment might be. The MPC’s projection for unemployment is covered in Section 3.3.

Chart 3.1 Vacancies declined to their lowest level on record in Q2

Number of vacancies

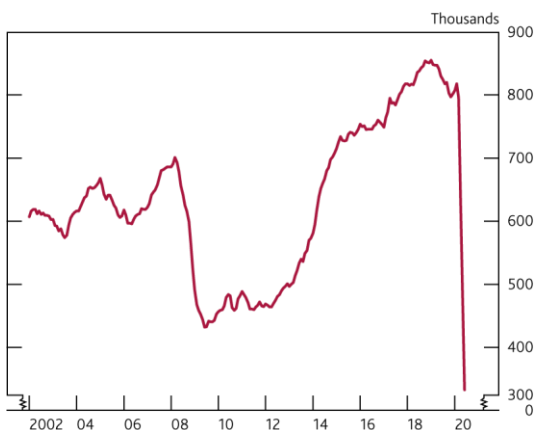
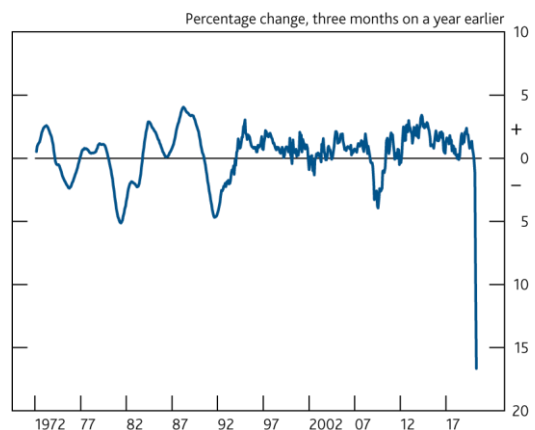


Chart 3.2 Hours worked fell by a record amount in the three months to May

Total weekly hours worked



Sources: ONS and Bank calculations.

3.1 How might the labour market evolve in the second half of 2020?

Bank staff estimate that around 6 million workers were furloughed on average over Q2.

In the first half of the year, Covid-19 caused a sharp reduction in spending, some businesses closed completely for a time, and social distancing measures made it difficult for employees in some sectors to work (Section 2.4). These factors meant that a material proportion of the labour force was not working for some or all of the time in Q2.

Given the sharp, temporary nature of some aspects of the shock — for example, mandated business closures — the Government put in place the CJRS to help support firms and their employees through the period. As a result, most employees who stopped working were furloughed. This meant they remained attached to their employer, with wages subsidised by the Government. HMRC data suggest that a total of 9½ million jobs were furloughed at some stage in recent months. Bank staff estimate that around 6 million workers were on furlough over Q2, on average, peaking at over 7 million in May.

This has been concentrated in industries hit hardest by the pandemic...

Industries that experienced the largest output falls were those where workers or customers need to be in close proximity. Industries providing services for social consumption — such as restaurants and hotels — lost nearly all of their sales during the height of lockdown. Unsurprisingly, these industries made most use of the CJRS (**Chart 3.3**).

Chart 3.3 Industries hardest hit by Covid-19 have generally furloughed more of their employees

Falls in output and furlough take-up rate, by sector



Sources: HMRC, ONS and Bank calculations.

- (a) Employments furloughed before end-June as a percentage of eligible employments.
- (b) Percentage change in output between the average monthly level over 2019 Q4 and May 2020, inverted.
- (c) Fall in output is shown for real estate activities on a fee or contract basis only. Other real estate activities, including actual and imputed rents, are excluded given the limited role of labour.

...which tend to be labour-intensive.

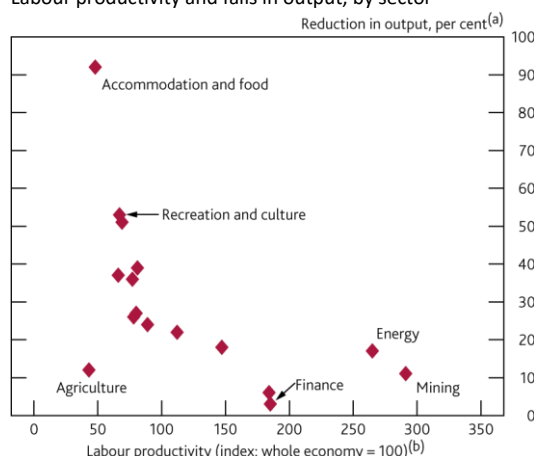
The most affected sectors tend to have high labour intensity, employing more workers and less capital for a given level of output. As a result, they tend to have lower labour productivity (**Chart 3.4**) and lower pay than average. The share of workers that have been furloughed was around three times as high in the bottom fifth of the income distribution than in the top fifth (**Chart 3.5**).

The rise in unemployment so far has been limited by government schemes and a rise in inactivity.

The CJRS and a reduction in working hours have kept more workers in their jobs than would have otherwise been the case. The Self-Employment Income Support Scheme may have caused fewer self-employed workers to be counted as unemployed over the past few months. In addition, a higher proportion of the reduction in employment has been reflected in inactivity, rather than unemployment, compared with usual. Lockdown measures, including school closures, mean that some people who have lost their jobs are likely to have not been actively searching for a job, or have not been available to start work. As a result, the proportion of those without work and classed as inactive has increased, which has also limited the rise in unemployment (Section 2.4).

Chart 3.4 The sectors most affected by Covid-19 tend to have lower labour productivity

Labour productivity and falls in output, by sector

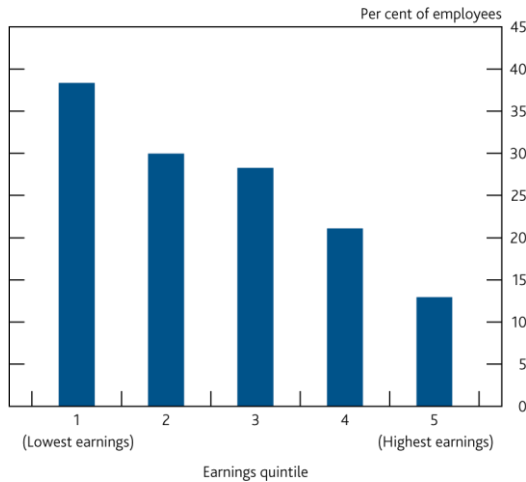


Sources: ONS and Bank calculations.

- (a) Percentage change in output between the average monthly level over 2019 Q4 and May 2020, inverted.
- (b) Output per hour in 2019.

Chart 3.5 Lower paid workers are more likely to have been furloughed

Proportion of employees reporting that they had been furloughed, by earnings quintile^(a)

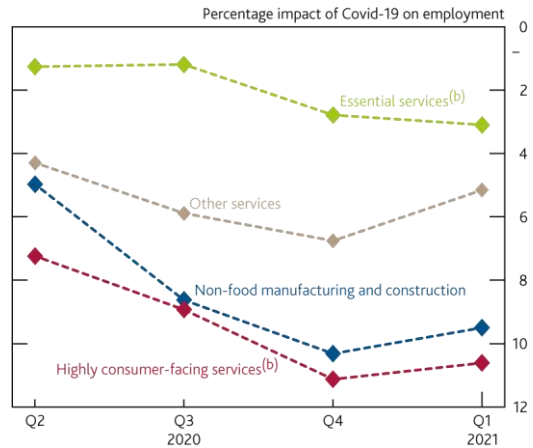


Sources: Understanding Society and Bank calculations.

(a) Question: 'Have you received a written letter or email from your employer to confirm that you have been furloughed under the Coronavirus Job Retention Scheme?'. Based on responses collected 24 to 30 April and 27 May to 2 June. Percentages reflect those reporting that they had been furloughed in either survey, including those who may have returned to work when responding to the second survey. Earnings quintiles are calculated using take-home pay in January and February 2020.

Chart 3.6 Firms expect to reduce the size of their workforces in the second half of 2020

Businesses' expected impact of Covid-19 on employment, by type of industry^(a)



Sources: Decision Maker Panel (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 employment of your business?'. Responses were collected from 3 to 17 July.

(b) Highly consumer-facing services includes accommodation and food, passenger transport, recreational services and non-food wholesale and retail. Essential services includes agriculture, utilities, health, food manufacturing and food wholesale and retail. Other services includes industries not captured by the other categories.

Support from the CJRS will be unwound during the second half of this year.

Support from the CJRS will be withdrawn gradually over the coming months. Employers are liable to pay National Insurance and pension contributions for furloughed employees from August, and the proportion of wages covered by the Government will begin to fall in September. The scheme is scheduled to close at the end of October. The Job Retention Bonus will pay employers £1,000 — roughly double the average weekly wage — for every previously furloughed employee who remains continuously employed to the end of January 2021. This will incentivise firms to keep on previously furloughed employees.

Most furloughed workers should be re-employed as output recovers...

As social distancing measures continue to ease and sales increase, demand for labour should pick up. Indeed, both the ONS Business Impact of Covid-19 (BICS) and Bank/Ipsos MORI surveys suggest that around a third of furloughed employees had already returned to work by the end of June. In the July BICS survey, firms expected that more than half of those previously furloughed would be back at work by the end of the month.

...but some firms in the worst-affected sectors are likely to make some workers redundant...

Some firms, especially those in the worst-affected sectors, are likely to make workers redundant if sales do not pick up sufficiently quickly. Many firms in highly consumer-facing sectors, manufacturing and construction expect to reduce their employment materially in Q3 and Q4 (Chart 3.6). Some of these industries are labour-intensive, employing more workers per unit of output than average. This means the total fall in employment will be higher than if all industries were reducing their workforces by similar percentages.

...and flows out of unemployment are likely to remain subdued.

At the same time, flows out of unemployment are likely to remain subdued in 2020. The number of vacancies fell to a record low in Q2 (Chart 3.1) and firms' reported hiring intentions remain very weak (Chart 3.7). Firms may be reluctant to make significant hiring decisions this year when the majority do not expect uncertainty about coronavirus to be resolved until at least next year (Chart 3.8).

More of those out of work may start looking for jobs, pushing up on measured unemployment.

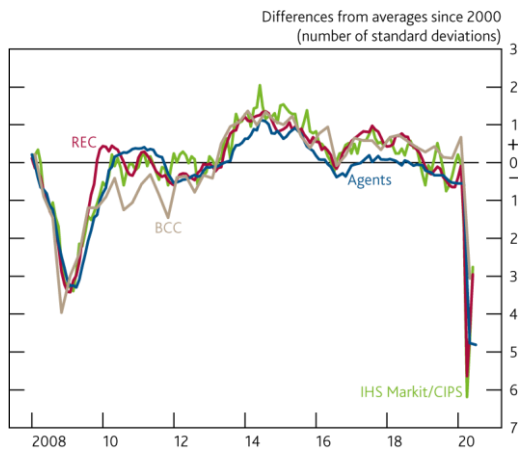
As restrictions are eased and the outlook for the economy improves, the proportion of those without work that are looking for, and are able to start, a job may return to more usual levels. So rising inactivity among those out of work may not limit the rise in unemployment to the extent that it did in the first half of the year.

Overall, the unemployment rate is expected to rise to 7½% by Q4.

The unemployment rate is expected to peak at around 7½% in Q4, based on survey evidence, high-frequency indicators, and the historical relationship between unemployment and output. This projection takes into account the expected sectoral pattern of output and, in particular, that the initial recovery in output is likely to be slower in more labour-intensive areas of the economy. The forecast is consistent with most furloughed workers returning to work by the end of the year. The number of people in employment is expected to fall by more than 3% in the second half of the year, however. This is supported by reports to the Bank’s Agents of planned staff cuts (Box 4).

Chart 3.7 Measures of employment intentions fell sharply after the onset of Covid-19 and remain weak

Surveys of employment intentions^(a)

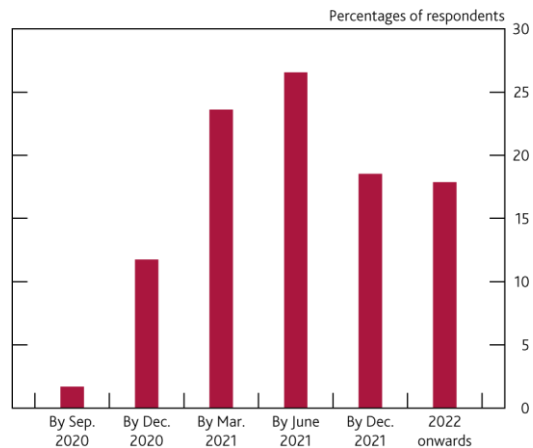


Sources: Bank of England, BCC, IHS Markit/CIPS, KPMG/REC *Report on Jobs* and Bank calculations.

(a) Surveys from the Bank’s Agents (employment intentions over the next 12 months), BCC (employment expectations over the next three months), IHS Markit/CIPS (PMI composite employment index) and KPMG/REC (index of demand for new staff). Agents’ scores are monthly until August 2016 and six weekly thereafter. BCC data are quarterly.

Chart 3.8 Most firms do not expect uncertainty about coronavirus to be resolved this year

Date by which coronavirus-related uncertainty is expected to be resolved^(a)



Sources: DMP Survey and Bank calculations.

(a) Question: ‘When do you think it is most likely that the coronavirus-related uncertainty facing your business will be resolved?’. Responses were collected from 3 to 17 July.

3.2 How long will higher unemployment persist beyond 2020?

Once unemployment has become elevated in the past, it has tended to persist.

After past recessions, the unemployment rate has continued to rise and then remained elevated for a period before beginning to fall (**Chart 3.9**). The unemployment rate took seven years to return to pre-recession levels after both of the past two recessions.

During the financial crisis, the flow of workers from employment to unemployment increased sharply, but half of that increase had reversed by 2010. In contrast, the recovery in the flow of workers between unemployment and employment did not take hold fully until 2014 (**Chart 3.10**). This could reflect a reluctance from firms to start hiring again, or increased difficulty matching those searching for work with vacancies.

How unemployment evolves beyond 2020 will be closely linked to the recovery in spending...

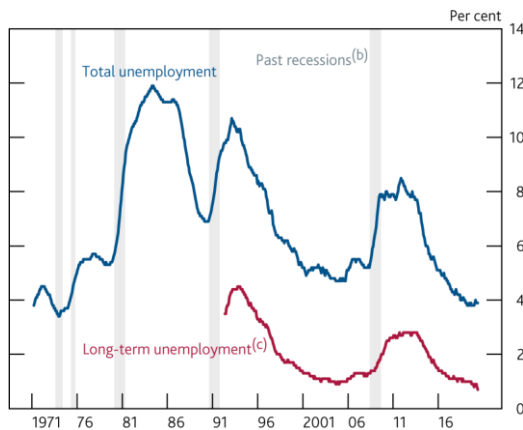
Firms’ employment intentions and expectations for future sales are closely linked. As demand picks up and firms are more confident about future sales, this should feed through into lower flows into unemployment and a pickup in hiring.

...which, given the nature of the Covid-19 shock, could mean the increase is reversed quickly.

The nature of the Covid-19 shock has been different to those that have led to past recessions. The reduction in spending has been very sharp and closely linked to social distancing measures. As measures are lifted, spending is expected to pick up relatively quickly. Some types of consumer spending have rebounded strongly already, although social spending might remain subdued, particularly if fears of infection persist (Section 2.3). In the July DMP Survey, firms expected the reduction in their sales due to Covid-19 to shrink from around 30% in 2020 Q2 to 8% by 2021 Q1. As a result, unemployment might fall back fairly quickly.

Chart 3.9 Unemployment has tended to remain elevated for a period following recessions

Unemployment and long-term unemployment^(a)

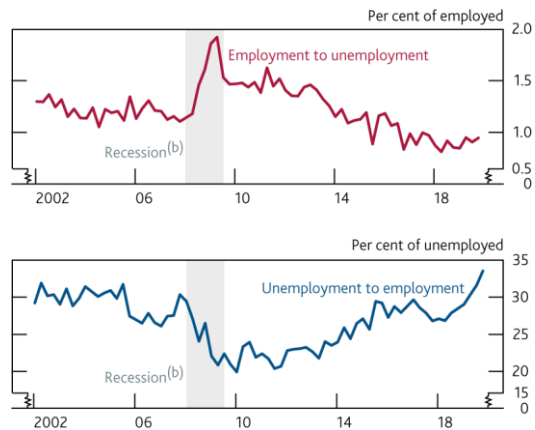


Sources: ONS and Bank calculations.

- (a) Per cent of the 16+ economically active population.
 (b) Recessions are defined as at least two consecutive quarters of negative GDP growth.
 (c) Those who have been unemployed for longer than twelve months.

Chart 3.10 Flows from unemployment to employment were subdued for several years after the financial crisis

Flows between employment and unemployment^(a)



Sources: ONS and Bank calculations.

- (a) Two-quarter flows. Based on employment and unemployment of people aged 16–64. Data are to 2019 Q4.
 (b) Recessions are defined as at least two consecutive quarters of negative GDP growth.

But labour demand could remain subdued because of risk aversion...

Some academic literature attributes cyclical reductions in hiring and investment to a reduction in the desire of businesses and investors to bear risk during downturns (Di Tella and Hall (2020)). Uncertainty can cause firms to delay hiring and firing decisions (Bloom *et al* (2018)). Since these are difficult to reverse, it can be optimal to wait until uncertainty might be resolved. Over half of firms responding to the July DMP Survey did not expect uncertainty around Covid-19 to be resolved until after March 2021 (Chart 3.8). This channel is likely to be weaker in sectors which tend to hire lower skilled workers, as hiring costs generally increase with skill requirements (Blatter *et al* (2012)).

Credit constraints can also cause firms to behave more cautiously. A firm that has built up debt during a recession may be unable or unwilling to take out further credit. This can make them less likely to hire new workers (Kehoe *et al* (2019)).

...which can also affect firm entry and exit.

These factors will also affect the number of new businesses being formed. Younger firms are an important source of new jobs, so hiring is likely to fall if fewer new firms start up. Lower employment from new firm entrants appears to account for just under half of the overall fall in employment during the financial crisis. There is mixed evidence to date on how Covid-19 has affected firm creation: new VAT registrations fell by around 20% in Q2, but the number of new companies incorporated has held up. Firm start-ups may be less affected than following the financial crisis, as the costs of entry tend to be lower for businesses in the sectors that have been worst hit by Covid-19. Access to credit has also been a key determinant of firm entry in the past, and corporate credit conditions do not appear to have tightened substantially in recent months (Section 2.2).

Firm exits also affect labour demand but it is more difficult to assess the scale of the role they play. According to Labour Force Survey data, firm closure only accounted for a small amount of the spike in redundancies in the financial crisis. But these data may not capture the full impact of firm failure, as firms may be able to survive temporarily by reducing employment before subsequently failing.

Changes in the pool of unemployed people might also reduce the job-finding rate...

While labour demand determines the number of vacancies, economic shocks can also change the composition of the pool of unemployed people, lowering the chances of a given vacancy being filled. As a result, a given unemployment rate will exert less downward pressure on wages and so cause the unemployment rate consistent with stable wage pressures to rise.

...if there are mismatches between vacancies and those looking for work...

If those in unemployment are not a good match for the vacancies which arise, the job-finding rate will fall, slowing the fall in unemployment ([Sahin et al \(2014\)](#)). Mismatch can be across various dimensions, for example sectors or skills.

Mismatch in the labour market could increase if some sectors do not restore employment to previous levels as quickly as others. Responses to the July DMP Survey suggest employment expectations differ materially across industries. Highly consumer-facing services expect employment to be 11% lower in 2021 Q1 than it would have been without Covid-19, compared with 3% for essential services (**Chart 3.6**).

There may also be mismatch between the skills of the unemployed and those required by hiring firms. Many of the roles that non-graduate recent education leavers typically enter first are sectors that have experienced the largest reductions in output ([Henehan \(2020\)](#)). While more experienced or skilled workers could choose to move down the skills spectrum to find a job in a different sector, it is much harder to move up the spectrum as it takes time to build skills. This mechanism can prolong unemployment ([Haldane \(2020\)](#)).

The extent of any labour market mismatch will depend on how long the differential impact of Covid-19 across sectors persists and how quickly people can build new skills. If this fades next year, any mismatch might be relatively short-lived. In the July DMP Survey, the differences across sectors between the estimated impacts of Covid-19 on sales were expected to narrow substantially by Q1 2021. But the impact of Covid-19 across sectors could be more persistent if the pandemic results in more structural changes to the economy — for example, in the ways and places that goods and services are consumed.

...and, over time, an increase in long-term unemployment.

During periods of high unemployment, the number of unemployed people who have been out of work for a prolonged period typically increases (**Chart 3.9**). As workers experience longer spells of unemployment, the likelihood they will find a job falls ([Krueger et al \(2014\)](#)). This could be because the skills of unemployed workers deteriorate as they are not used. They may also reduce the intensity of their job search over time.

3.3 The MPC's projection for unemployment

Based on the data discussed in Section 3.1, the unemployment rate is expected to peak at around 7½% in Q4. The MPC judges that unemployment is likely to decline thereafter, reflecting the nature of the Covid-19 shock and the policies put in place to support households and businesses.

As discussed in Section 3.2, heightened uncertainty about Covid-19 is expected to weigh on labour demand, so hiring picks up relatively slowly. In addition, the MPC judges that there is likely to be some reduction in the efficiency with which people can find jobs. That tends to happen as unemployment rises, as some people take time to find new jobs, and their skills erode. Moreover, in the present conjuncture, the differential impact of Covid-19 on economic activity across sectors is judged likely to create a greater degree of mismatch than usual between the sectors from which workers have been made unemployed and the sectors in which firms are posting vacancies. That is expected to slow the pace of the decline in unemployment and also lead to a rise in the medium-term equilibrium rate of unemployment, such that not all of the increase in unemployment reflects labour market slack. The long-term equilibrium rate of unemployment is not assumed to rise, however. This is usually affected by slow-moving structural features of the economy such as demographics and technological change (see Box 4 of the [February 2018 Inflation Report](#)).

The risks around these projections, such as the potential for greater long-lasting effects on the supply side of the economy, are discussed in Section 1.

4 In focus Spare capacity and domestic price pressures

The Covid-19 pandemic has led to a greater degree of spare capacity in the economy, although there may be large differences across sectors. The increase in spare capacity is likely to weigh on domestic prices. However, the relationship between spare capacity and prices may be weaker than usual, and some sectors will have higher costs.

The spread of Covid-19 and the measures to contain it have led to a marked drop in economic activity around the world. In the UK, output is expected to have fallen by more than 20% over the first half of the year (Section 2). The fall in output has reflected lower demand for goods and services, as well as a reduction in the economy's supply capacity. Although a recovery is now underway, the MPC expects the economy's output to remain below its potential level for over a year. The difference between output and its potential level is spare capacity.

Spare capacity matters for monetary policy because it affects the outlook for growth, employment and inflation. There can be spare capacity within firms or in the labour market. Higher levels of spare capacity within firms put downward pressure on inflation because firms may want to boost demand for their goods and services by lowering prices. Spare capacity in the labour market means there is less pressure to offer higher wages to attract and retain staff. This *In Focus* examines the outlook for spare capacity and domestic price pressures in more detail. Box 5 discusses some issues with the measurement of consumer price inflation at this time.

4.1 The impact of Covid-19 on spare capacity

The level of spare capacity in the economy at the moment is unusually uncertain.

The large declines in both demand and supply across the UK economy in recent months make it very difficult to judge the level of spare capacity. The demand for goods and services from consumers fell sharply during the first half of the year and, despite some recent recovery, remains well below pre-Covid levels (Section 2.3). However, the supply of goods and services has also been restricted during this period, including by government-mandated business closures. Around a quarter of businesses reported being temporarily closed in early April, although that proportion has since fallen to below 10% (**Chart 4.1**).

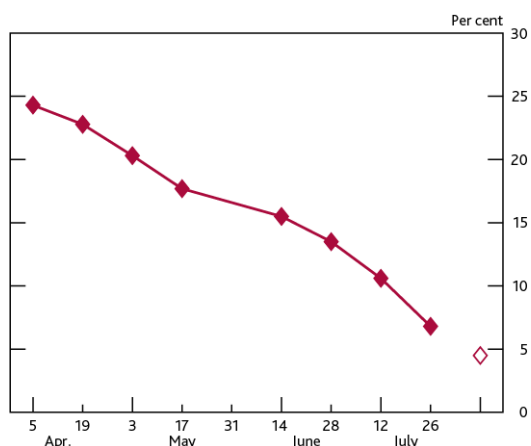
The large number of employees on the Coronavirus Job Retention Scheme (CJRS) also makes it difficult to see the extent of underlying spare capacity in the labour market. Bank staff estimate that, on average, around 4½ million people were on furlough over the three months to May (**Chart 4.2**), peaking at over 7 million in the single month of May. These workers remain employed but have been working no hours or — from 1 July — a fraction of their usual hours. Most of these people will be working fewer hours than they would otherwise choose to, so are, in a sense, a form of spare capacity. However, it is unlikely that many of these people are actively searching for new jobs, as most expect to return to their usual hours with their existing employer. As a result, the economic impact of furloughing is closer to a temporary reduction in supply.

But the MPC expects unemployment to increase over the coming months...

As more businesses are allowed to reopen and the CJRS is wound down, the extent of spare capacity is likely to become clearer. In the MPC's projections, unemployment rises to around 7½% by the end of the year as some workers are made redundant and hiring remains subdued (Section 3). That would represent around 2½ million people out of work and searching for jobs (**Chart 4.2**), the highest total since 2013, and a clear sign of spare capacity in the economy.

Chart 4.1 Many businesses temporarily closed, although most have now reopened

Proportion of businesses temporarily closed or paused trading^(a)

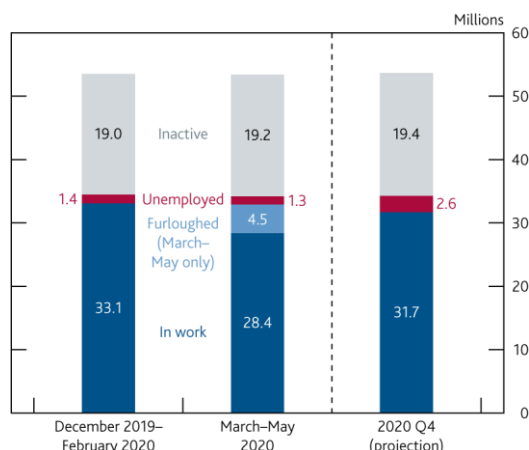


Source: ONS Business Impact of Coronavirus (Covid-19) Survey.

(a) Hollow diamond shows firms reporting that they had paused trading in the two weeks to 26 July and did not intend to restart in the following two weeks. Data are not seasonally adjusted.

Chart 4.2 The expected rise in unemployment represents an increase in spare capacity

Working age population by employment status^(a)



Sources: ONS and Bank calculations.

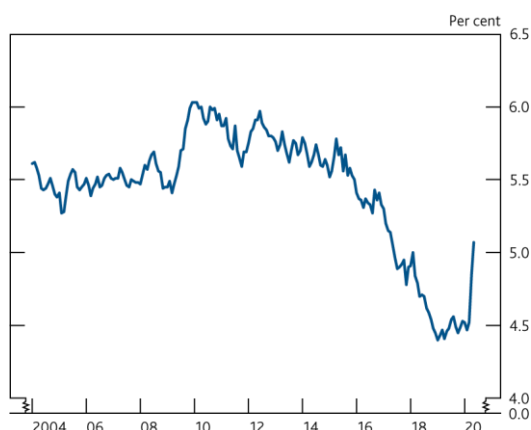
(a) 16+ population. March–May 2020 figures for 'furloughed' and 'in work' are Bank staff estimates based on analysis of the LFS, administrative data, and a range of business surveys. A relatively small number of furloughed workers over 2020 Q4 (reflecting workers expected to be on the scheme in October) are included as 'in work'.

...and there are likely to be other forms of spare capacity in the labour market.

Unemployment is not the only form of spare capacity in the labour market. Some people who lose their job may not look for a new job immediately and will be classified as 'inactive', but will begin to look for work when the lockdown eases or hiring picks up. As a result, they are a form of spare capacity in the labour market. The pool of people who are not currently in or seeking work, but who report they would like a job has already grown significantly; the sharp pickup in the 'marginal attachment' ratio between February and May (**Chart 4.3**) more than accounted for the increase in inactivity over that period (**Chart 4.2**).

Chart 4.3 The proportion of people not currently looking for work, but who would like a job, has increased

Marginal attachment ratio^(a)

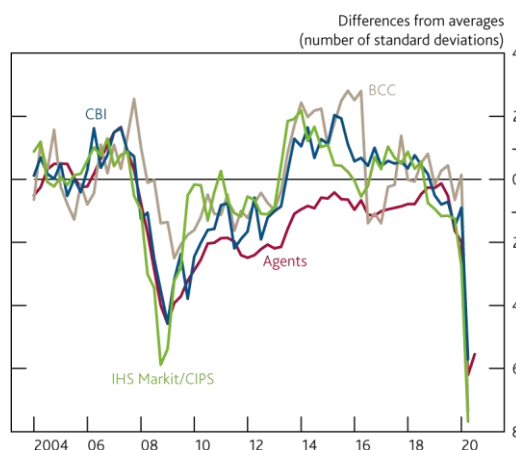


Sources: ONS and Bank calculations.

(a) Number of those aged 16–64 who say they are not in work or not actively looking for work but would like a job, as a percentage of the 16–64 population.

Chart 4.4 Businesses report working at much lower capacity than normal

Survey indicators of capacity utilisation^(a)



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; financial services, business/consumer/professional services and distributive trade — 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.

Spare capacity within firms may also increase...

There may also be spare capacity in the form of capital, such as buildings and machinery, not being fully utilised over the coming months. Survey measures of capacity utilisation have already fallen sharply (**Chart 4.4**): in the BCC's Q2 survey fewer than 20% of firms in both the manufacturing and services sectors reported working at full capacity, the lowest levels since 1993. Some survey responses may reflect temporary closures — in which case they

actually reflect temporary reductions in supply, rather than increases in spare capacity. But as those firms reopen, supply capacity will increase, and a degree of under-utilisation could persist.

...although some firms may have reduced capacity to supply.

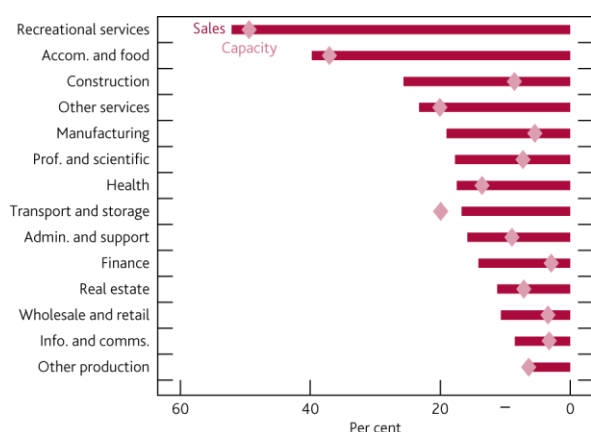
Some firms' supply capacity might continue to be constrained over coming months, however, as a result of measures to reduce the risk of virus transmission. Some shops and restaurants are limiting customer numbers to allow for social distancing, and some businesses such as dentists and barbers must do extra cleaning in between customers. In addition, some firms may be experiencing reduced productivity as they adapt business practices to accommodate widespread working from home ([Haskel \(2020\)](#)), or because of disruption to their supply chains.

There are likely to be large differences across sectors.

There are likely to be significant differences in capacity utilisation across sectors. The pandemic and the measures to contain it have most affected sectors where workers or customers are typically in close proximity. Consumer-facing services, such as recreational services and accommodation and food, expect the largest hit to sales in Q3 as a result of Covid-19. Some of this may reflect lower demand and lead to spare capacity. However, these sectors also expect the largest reductions in supply capacity because of measures to contain Covid-19 ([Chart 4.5](#)). The manufacturing and construction sectors expect smaller hits to sales, but the reductions are expected to be larger than the declines in capacity, implying lower levels of utilisation. The differences in the impact of Covid-19 might interact with other differences between sectors — such as the frequency with which prices are changed, or the mix of inputs used in production — to affect how any spare capacity influences inflation.

Chart 4.5 The effects of the pandemic have fallen unevenly across sectors

Expected impact of Covid-19 on sales and capacity in 2020 Q3 by sector^(a)

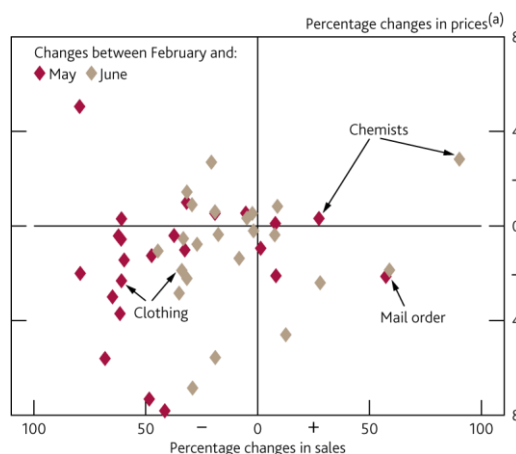


Sources: Decision Maker Panel (DMP) Survey and Bank calculations.

(a) Questions: 'Relative to what would have otherwise happened, what is your best estimate for the impact of the spread of coronavirus (Covid-19) on the sales of your business?' and 'Do you expect the measures to contain the coronavirus such as social distancing, hand washing, masks, and other measures to reduce the amount of goods or services that your business will be able to produce or offer in 2020 Q3?'. Responses were collected from 3 to 17 July.

Chart 4.6 Sales and prices of most retail goods have been lower recently

Changes in retail sales volumes and prices by category



Sources: ONS and Bank calculations.

(a) Implied price changes are calculated by dividing retail sales values by volumes.

4.2 The impact of spare capacity on domestic price pressures

The extent of any spare capacity will be an important influence on inflation in the medium term.

In the near term, movements in CPI inflation are expected to be largely driven by energy prices and the temporary reduction in VAT for the hospitality sector (Section 2.4). Looking further ahead, the extent of any spare capacity and its relationship with domestic price pressures will be key influences on inflation. Firms that have spare capacity may lower prices to boost demand. Unemployment and other forms of spare capacity in the labour market will put downward pressure on wage growth; this will lower firms' cost growth and therefore weigh on price inflation. However, some aspects of the pandemic may push prices up. In particular, some sectors may have higher operating costs as a result of measures to limit the risk of virus transmission.

Consumer demand is expected to remain weak, which will put downward pressure on inflation.

Since the outbreak of Covid-19, both sales and prices of retail goods have generally been lower than earlier in the year, although there was a partial recovery between May and June as more shops were allowed to reopen (**Chart 4.6**). In the consumer services sector, the Bank's Agents' score for prices fell to a record low in July. The weakness of consumer prices could indicate that demand fell by more than supply over this time. But it could also reflect the fact that many businesses were temporarily closed, and shops which were open had unusual levels of excess stock to sell. For example, the Agents report that some clothing retailers have been offering significant discounts to clear seasonal stock. In addition, some goods and services may have become cheaper because of the lower price of energy (Section 2.4).

Looking ahead, although consumer spending has begun to recover from its trough in April, demand is expected to remain subdued over the coming months. Consumer confidence remains well below average, and people may be nervous about resuming some forms of spending, such as eating out (Section 2.3). Agency contacts in the retail sector do not expect demand to return to normal for several months, and firms reliant on tourism expect an even longer period of poor trading. This shortfall in demand may mean there is pressure on firms to lower prices. This would be consistent with the behaviour of inflation after past pandemics, although differences in policy responses make comparisons difficult ([Tenreyro \(2020\)](#)).

Labour cost growth is likely to be limited, although the earnings data will be clouded in the short run.

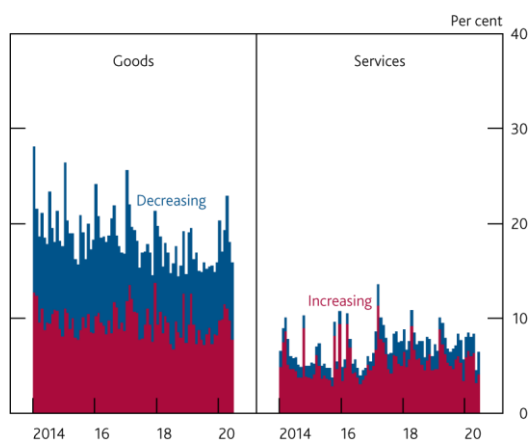
There is likely to be less pressure to increase wages because of a larger pool of unemployed workers over the coming months (Section 3). Labour is a significant input in the production of almost all goods and services, so this will reduce pressure on firms to increase prices, particularly for labour-intensive sectors, including some consumer services. The size of this impact may be hard to judge in the short term as the earnings data are expected to be affected by one-off effects, including the CJRS and the changing composition of the workforce (Section 2.4). But a range of surveys suggest pressures to increase pay have fallen sharply, and the Agents report that pay freezes and pay cuts have become more common recently.

However, many of the sectors hit hardest by the pandemic have 'stickier' prices than average.

Covid-19 has affected sectors differently, and that may interact with existing differences to reduce the impact of spare capacity on inflation. Some of the worst hit sectors are consumer services, but the prices of consumer services tend to change less frequently than those of goods (**Chart 4.7**), a pattern previously observed in the UK ([Bunn and Ellis \(2011\)](#)) and elsewhere ([Klenow and Malin \(2010\)](#)). As a result, any spare capacity in these sectors may have a smaller, or more delayed, impact on inflation ([Carvalho \(2006\)](#)). Sectors which remain closed are not able to adjust their prices at all (Box 5).

Chart 4.7 Services prices adjust less frequently than goods prices

Proportion of prices changing each month in the CPI basket^(a)

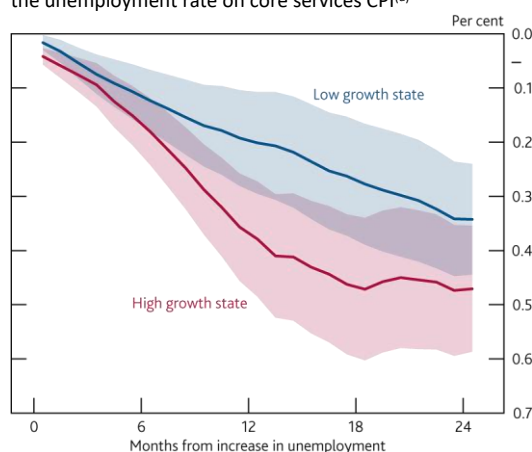


Sources: ONS and Bank calculations.

(a) Prices of locally collected items only, including sales. Data are not seasonally adjusted. This work was produced using statistical data from ONS. The use of the ONS statistical data in this work does not imply the endorsement of the ONS in relation to the interpretation or analysis of the statistical data. This work uses research data sets which may not exactly reproduce National Statistics aggregates.

Chart 4.8 Inflation appears to be less responsive to unemployment when demand is weak

Bank staff's estimated impact of a 1 percentage point increase in the unemployment rate on core services CPI^(a)



Sources: ONS and Bank calculations.

(a) Chart shows the estimated impact of a demand-driven one percentage point increase in the unemployment rate using an approach similar to [Tenreyro and Thwaites \(2016\)](#). Shaded areas show 68% confidence intervals.

Uncertainty about the economic outlook may cause firms to hold off changing their prices.

Elevated uncertainty might also reduce the sensitivity of inflation to changes in spare capacity. Firms may expect the current shock to demand to be temporary and choose not to change prices to avoid having to reverse the changes when conditions improve. Various models of price-setting have the feature that firms are less likely to change prices when they are more uncertain about the state of the economy ([Woodford \(2011\)](#)).

Inflation appears to be less responsive to unemployment when demand is weak.

In the past, inflation has been less responsive to spare capacity at times when demand has been very low. Bank staff estimate that the impact after a year of an increase in unemployment on core services prices — a common measure of domestic price pressures — when output growth is weak is around half the size of the impact when output growth is strong ([Chart 4.8](#)). This could be because firms are less able to create increased demand by lowering prices when consumers are less willing to spend. Large price cuts can actually lower profits if demand rises only a little ([Lindé and Trabandt \(2019\)](#)). Firms may also have liquidity constraints as a result of sharp falls in their cash flow. These might discourage them from cutting prices, as they prioritise short-term revenue generation ([Gilchrist *et al* \(2017\)](#)).

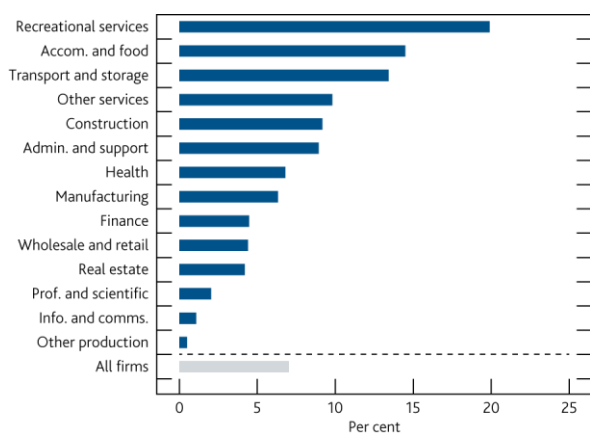
And some sectors may see costs rise or their capacity reduced, offsetting downward price pressure.

Some sectors may have higher costs as a result of measures to limit the risks of virus transmission, offsetting any downward pressure on prices from weak demand. Businesses have had to make their premises ‘Covid-secure’. This may involve staff using protective equipment and cleaning surfaces more often. Similarly, some firms may need to constrain supply to reduce the risk of transmission (Section 4.1), meaning their fixed costs will be spread across a lower level of business.

These measures will add to firms’ unit costs — the cost of producing one unit of output — which they may need to pass on to consumers to maintain profitability. Firms responding to the DMP Survey expected Covid-19 to increase their unit costs by an average of 7% in Q3 ([Chart 4.9](#)). The sectors most affected were the accommodation, food, and recreational services sectors.

Chart 4.9 Covid-19 is expected to increase unit costs sharply in some consumer service sectors

Expected impact of Covid-19 on unit costs in 2020 Q3 by sector^(a)

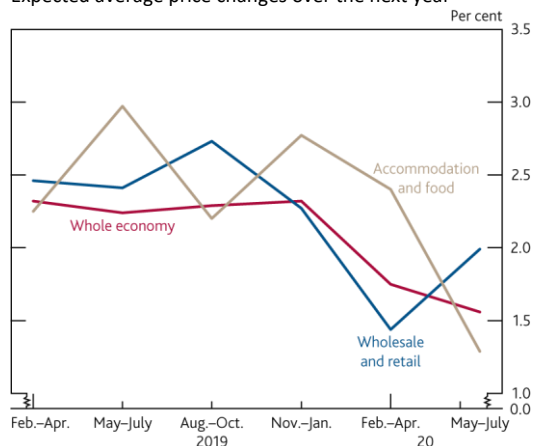


Sources: DMP Survey and Bank calculations.

(a) Question: ‘Relative to what would otherwise have happened, what is your best estimate for the impact of measures to contain coronavirus (social distancing, hand washing, masks and other measures) on the average unit costs of your business in 2020 Q3?’ Responses were collected from 3 to 17 July.

Chart 4.10 Price expectations have fallen since the start of the year, including in consumer-facing sectors

Expected average price changes over the next year^(a)



Sources: DMP Survey and Bank calculations.

(a) Questions: ‘Looking ahead, from now to 12 months from now, what approximate percentage change in your average price would you assign to each of the following scenarios?’ (with five scenarios: lowest, low, middle, high, highest provided) and ‘Please assign a percentage likelihood (probability) to the % changes in your average prices you entered’. Data shown are three-month averages.

Surveys suggest inflationary pressures have weakened.

Despite some sectors facing higher costs, surveys of firms suggest inflationary pressures have weakened overall. Price expectations in the CBI and BCC services surveys have fallen over the past few months, with the latter survey balance falling to its lowest level since 2009. In the DMP Survey, the average expected change in prices over the next year had fallen from 2.3% at the start of the year to 1.6% in the three months to July ([Chart 4.10](#)). Expectations in the accommodation and food sectors had fallen particularly sharply. This might suggest the

influence of weaker demand is expected to outweigh any unit costs increases, although price expectations will also be affected by other factors.

4.3 The MPC's projections for spare capacity and inflation

The reduction in output in recent months has reflected declines in both the demand for goods and services as well as the economy's supply capacity, and the balance between the two is difficult to gauge. Overall, the MPC judges that a material amount of additional spare capacity has emerged, and this will be predominately in the form of increased unemployment towards the end of the year. Although there may also be spare capacity within some firms, others will have a reduced capacity to supply because of new working practices.

Spare capacity in the economy is expected to weigh on domestic price pressures. However, based on the analysis outlined in this section, the MPC expect the impact of spare capacity on inflation to be a little smaller than usual. In the near term, inflation is expected to remain well below the 2% target, reflecting the continued drag from lower energy prices and the temporary cut in VAT for the hospitality sector.

Demand is projected to recover over the forecast period, eroding the degree of spare capacity and causing domestic price pressures to strengthen. Inflation is projected to return to target during 2022. Section 1 contains more detail on the MPC's projections.

Box 5

Measuring consumer price inflation during Covid-19

The spread of Covid-19 and the measures to contain it have presented a range of issues for the measurement of consumer price inflation. These have not significantly impaired the signal from the overall CPI inflation rate, but do mean some component-level inflation rates should be interpreted with care.

The biggest issue for data collection has been that, from April, some products have been unavailable to buy, such as cinema tickets and haircuts. The ONS identified 67 unavailable items in June representing around 17% of the CPI basket by weight. In these cases, the rate of inflation was set equal to the rate of inflation in the rest of the CPI basket. Bank staff estimate this might have reduced measured CPI inflation very slightly, by around 0.2 percentage points in June, compared to a counterfactual in which the omitted prices rose in line with their previous trends.

A smaller issue is that the prices of some products, despite being generally available for consumers, were harder to collect. In line with government guidelines, the ONS has been encouraging staff to work from home and to avoid unnecessary travel and social contact. A greater use of phone calls and websites has successfully replaced some store visits. But there has been a reduction in the availability of some items. In the few cases where the sample of prices has not been large enough for a robust average, the ONS has inferred the rate of inflation from a similar product or a wider product class. In June, only nine items received this treatment.

A potentially more significant issue is that households are buying a very different mix of goods and services to normal at the moment. This has prompted interest in alternative measures of consumer price inflation that use expenditure shares closer to those prevailing today. Although these measures are conceptually different to CPI inflation — which uses past expenditure shares by design — they generally show inflation rates similar to CPI inflation. [Cavallo's \(2020\)](#) measure of UK 'Covid inflation' was less than 0.1 percentage point above CPI inflation in May, although differences were larger for the US. [Dixon and Levell's \(2020\)](#) measure of UK 'lockdown-weighted' CPIH inflation was 0.3 percentage points higher than CPIH inflation in April, although the changes in the inflation rates since the start of the year have been very similar.

Annex

Other forecasters' expectations

This annex reports the results of the Bank's most recent survey of external forecasters, summarised in **Table 1**.⁽¹⁾

On average, respondents expected GDP to rise sharply in 2020 Q3 (**Chart A**). The unemployment rate was expected to rise and, on average, CPI inflation was expected to be weak, falling to below 0.5%. The range of projections was wide, reflecting, in part, continued uncertainty around the economic impact of Covid-19.

Table 1 Averages of other forecasters' central projections

	2021 Q3	2022 Q3	2023 Q3
GDP growth ^(a)	8.1	2.5	1.8
CPI inflation ^(b)	1.7	1.7	1.9
LFS unemployment rate (per cent)	6.5	5.8	5.3
Bank Rate (per cent)	0.2	0.6	0.8
Stock of purchased gilts (£ billions) ^(c)	791	828	834
Stock of purchased corporate bonds (£ billions) ^(c)	20	21	22
Sterling ERI ^(d)	78.6	79.5	80.0

(a) Four-quarter percentage change.

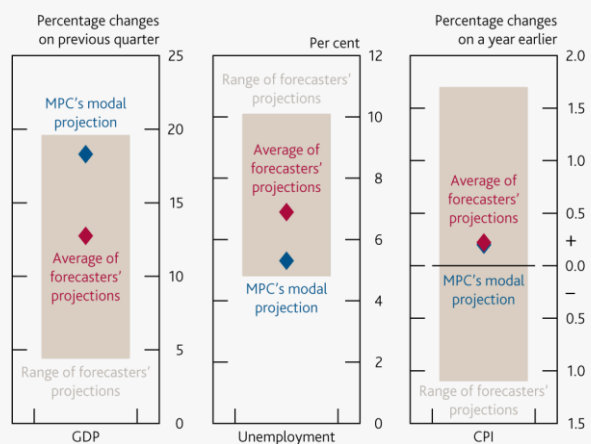
(b) Twelve-month rate.

(c) Original purchase value. Purchased via the creation of central bank reserves.

(d) Index: January 2005 = 100.

Chart A In 2020 Q3, GDP and unemployment were expected to rise, and CPI inflation to fall below 0.5%

Averages of other forecasters' central projections for GDP, the unemployment rate and CPI inflation in 2020 Q3

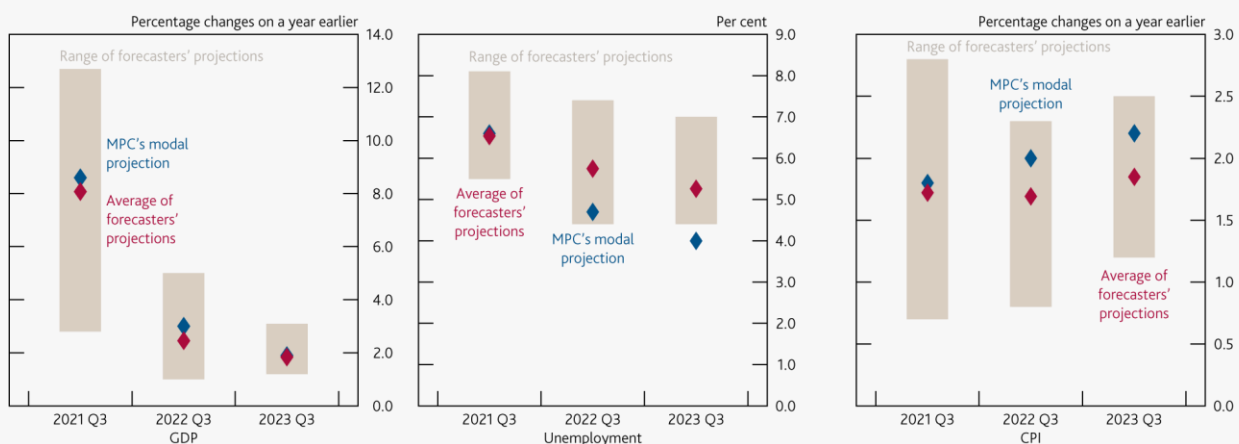


Further ahead, respondents expected strong GDP growth in the four quarters to 2021 Q3, as output recovers from the sharp falls this year. Four-quarter GDP growth was then expected to be around 2% in the medium term (left panel, **Chart B**). The unemployment rate was expected to fall gradually over the forecast, to around 5% on average (middle panel, **Chart B**). CPI inflation was expected to rise towards the MPC's 2% target (right panel, **Chart B**).

On average, respondents expected a further increase in the stock of purchased gilts of about £65 billion over the next year, in addition to the increase announced by the MPC in June which took the total stock of asset purchases to £745 billion (**Table 1**).

Chart B At the three-year horizon, external forecasters expect GDP growth to be around 2%, the unemployment rate to fall to around 5%, and inflation to be close to the MPC's 2% target

Projections for GDP, the unemployment rate and CPI inflation



¹ For detailed distributions, see 'Other forecasters' expectations'. Projections are as of 24 July 2020.

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.
CPIH – consumer prices index including owner occupiers’ housing costs.
DMP – Decision Maker Panel.
ERI – exchange rate index.
GDP – gross domestic product.
LFS – Labour Force Survey.
MFCI – Monetary and Financial Conditions Index.
PMI – purchasing managers’ index.
RPI – retail prices index.
RPI inflation – inflation measured by the retail prices index.
ULC – unit labour cost.

Abbreviations

BBLs – Bounce Back Loan Scheme.
BCC – British Chambers of Commerce.
CBI – Confederation of British Industry.
CBILS – Coronavirus Business Interruption Loan Scheme.
CCS – *Credit Conditions Survey*.
CLBILS – Coronavirus Large Business Interruption Loan Scheme.
CIPS – Chartered Institute of Purchasing and Supply.
CJRS – Coronavirus Job Retention Scheme.
ECB – European Central Bank.
EU – European Union.
FTSE – Financial Times Stock Exchange.
GfK – Gesellschaft für Konsumforschung, Great Britain Ltd.
HMRC – Her Majesty’s Revenue and Customs.
ICE/BoAML – Intercontinental Exchange/Bank of America Merrill Lynch.
IMF – International Monetary Fund.
LFS – Labour Force Survey.
LTV – loan to value.
MFI – monetary financial institution.
MPC – Monetary Policy Committee.
MSCI – Morgan Stanley Capital International Inc.
MTIC – missing trader intra-community.
NPISH – non-profit institutions serving households.
OECD – Organisation for Economic Co-operation and Development.

ONS – Office for National Statistics.
OPEC – Organization of the Petroleum Exporting Countries.
PAYE – Pay As You Earn.
PNFC – private non-financial corporation.
PPE – personal protective equipment.
PPP – purchasing power parity.
RICS – Royal Institution of Chartered Surveyors.
S&P – Standard and 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.
ULCs – unit labour costs.
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.