HOUSE OF COMMONS

Treasury Committee

Oral evidence: Spending Review 2020, HC 1029

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Mr Steve Baker; Felicity Buchan; Siobhain McDonagh.

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Witnesses

I. Richard Hughes, Chair, Office for Budget Responsibility; Professor Sir Charlie Bean, Member, Office for Budget Responsibility; and Andy King, Member, Office for Budget Responsibility.

Examination of witnesses

Witnesses: Richard Hughes, Professor Sir Charlie Bean and Andy King.

Q1 **Chair:** Good morning and welcome to the Treasury Committee evidence session on the spending review 2020. We are joined today by some important representatives from the Office for Budget Responsibility as witnesses, and I would just like them to now briefly introduce themselves for the public record.

Richard Hughes: Good morning. I am Richard Hughes, chairman of the Office for Budget Responsibility.

Professor Sir Charlie Bean: I am Charlie Bean, economic expert at the OBR as well as a professor at LSE.

Andy King: Good morning. I am Andy King. I lead on fiscal issues at the OBR.

Q2 **Chair:** Thank you very much and a very warm welcome. It is very good to see you again before the Committee. The questions will generally, as you know, be directed at specific members of the panel, but if you do wish to say something and you have not been asked to come in, please raise your hand and I will endeavour to bring you in at that point.

Richard, can I start with you? We have a big vote in the Commons tonight about whether we accept or otherwise the lockdown tiered arrangements that the Government have come forward with. It is fairly clear at this stage, given where Labour is on the matter, that these will go through. However, there has been much debate around whether the amount of information provided to Members on the economic consequences of these measures has been transparent and full enough on the part of the Government.

I know that it is not your role as the OBR to produce that kind of impact analysis on tiering and the different measures, but could I just ask you what discussions the OBR may have had with the Treasury around those kinds of issues? When you have had discussions with the Treasury, is it the case that you have discussed what the Treasury's view has been on the economic impact of tiering on, say, sectors or different regions of the country?

Richard Hughes: From the point of view of producing the forecast that we published last week, we did have to provide some kind of assessment about the impact of the tiered public health restrictions on the economy. It is important to emphasise, though, that we had to look at them in the context of the other elements of the Government's public health response.

To some extent, they were the residual that was left after we looked at the impact of the lockdown in reducing cases, test, trace and isolate, and being able to manage whatever number of cases came out of lockdown and, therefore, what general level of public health restrictions were required to keep the virus under control. We very much looked at the impact of tiered public health restrictions from the point of view of what was necessary to keep case numbers down in the light of what else was working about the other elements of the Government's public health response in the near term until a vaccine became available over the medium term.

Another thing to emphasise is that it is not just public health restrictions that matter for economic availability but also the number of cases. All the evidence, including that summarised by the IMF in its most recent World Economic Outlook, stresses that, for advanced economies, it is about half public health restrictions and half just voluntary social distancing—individuals making their own choices about not going to shops or restaurants and not engaging in economic activity to reduce their likelihood of becoming infected or transmitting it to others.

You need to think about the impact of the virus not purely in terms of the consequences of public health restrictions on economic activity but also of what those public health restrictions are trying to achieve in terms of reducing case numbers, transmission and that other element of the impact of the virus on activity, which is the way that individuals respond to it.

We produced our own analysis. We discussed it with the Treasury. There was a top-down element, where we looked at the impact of tiered restrictions economy-wide—both the lockdown back in April but also the regional impact of the higher tiers on places like Leicester, which were under stricter restrictions for a period of time, and you can look at the implications of restrictions for that local area. We also looked at it from the bottom up, from the point of view of what implications it had for different sectors and which were likely to be affected in the context of a lockdown, and also in the context of what kind of regime might exist post lockdown.

We did discuss our analysis with the Treasury but I should emphasise that it was very much our own assessment. It shared with us information that it had about the historical impact of lockdown restrictions on activity across the country and in particular areas, but I should stress that the analysis that you see in front of you is the work that we have done on the implications of those restrictions, rather than anything that necessarily affects the Government's view.

Q3 **Chair:** Thank you. That is very helpful. It sounds like you are saying that there has been some analysis at your end of the economic consequences of the tiering and that you have had discussions with the Treasury about that. In the SAGE minutes of 21 September, it states, "Policy makers will need to consider analysis of economic impacts and the associated harms alongside the epidemiological assessment. This work is under way under the auspices of the chief economist". Are you familiar with that work as described there? Was that part of the discussions you had with the Treasury and, if so, what was that work? Could you describe it to us?

Richard Hughes: I am not familiar with that work as it is described. The discussions we had with the Treasury were largely sharing with us our analysis of the economy-wide impact as well as the sectoral impact of the public health restrictions as they had evolved between March and the autumn, testing our own analysis against the Treasury's assessment of these sorts of things. I am not privy to what analysis the Treasury shared with SAGE and what the nature of it was, or how detailed it was. The discussions that we had were about our own assessment rather than the Treasury's evaluation.

Q4 **Chair:** Would it be your assessment that the kind of information that you were aware of during those discussions with the Treasury, had it been published prior to the vote tonight, would have provided further useful information when it came to Members of Parliament taking decisions as to whether to support these measures? In other words, would it have shed some further light, albeit not necessarily a huge amount, on the economic impacts of the tiering measures?

Richard Hughes: I would hate to speculate on what might have an impact on people's thinking. We have reproduced in the EFO and presented to you in the context of that documentation the information that we found useful, informative and helpful in producing the forecasts. The Government were quite open with us in terms of the information that they had and were willing to share, including information about the impact of tiering on the course of the virus as well as on the economy. To the extent that we found it useful and relevant to the production of the forecasts, we have provided it to you in the EFO document.

Q5 **Chair:** On the bit of that information that relates to the impact of the tiering on the economy and sectors, could you tell us a bit more about that? Would that be saying that, if an area of the country is under tier 1, say, one might expect these consequences for jobs or output? Is that the nature of that information that was being discussed?

Richard Hughes: These were our own calculations rather than those shared by the Treasury. We came up with our own assessment of the impact of the first lockdown on the economy as well as looking at parts of the country that were subject to stricter tiers over the summer that were analogous to tiers 1, 2 and 3 as they emerged in the autumn—places like Leicester and other places in the north that were subject to stricter restrictions—and looking at what it did to output in those areas relative to the rest of the country.

Ultimately, we had to make some judgments of our own. We did not know what the Government's new tiering regime was going to be—that news came out after we closed the forecast—so we had to make some judgments of our own about what tiering might be necessary to control case numbers coming out of lockdown, which depends on how effective lockdown and test and trace are on 2 December, and what the impact of those different tiers would be on activity, thinking about that from the top down, such as how Leicester was doing relative to the rest of the country when it was under tighter restrictions, as well as from the bottom up in terms of which sectors are able to operate at what level of activity under different levels of activity. Those calculations were very much things that we arrived at ourselves rather than taking on analysis produced by the Treasury.

We discussed it with the Government's public health experts, so that we could understand what level of tiers and restrictions were necessary to control the virus, and they shared with us some interesting analysis, which has now been published, about what the old tiers 1, 2 and 3 did to the infection rates and the extent to which they were either growing or going down.

Q6 **Chair:** Would it be a fair summary, in the general area that I am pushing into here, that the OBR was producing some impact analysis around tiering and its economic consequences for different parts of the country such as Leicester, et cetera, and that the Treasury was aware of that information and had access to it, and could, if it felt it appropriate, have made that information public?

Richard Hughes: These discussions were happening over the course of the autumn in the run-up to the EFO. I should say that we made them public on 25 November, which was our deadline for publishing the EFO. Up until then, they were not in a position where we would have been comfortable making them public because it was part of our confidential economic forecasts. I cannot speak for the Treasury as to when it would have been appropriate for it to share information that it had.

Q7 **Chair:** In *The Times* today, you may have seen on the front page its headline "Secret dossier on Covid damage". It suggests, "The Government has drawn up a secret dossier detailing the impact of coronavirus on the economy, with a dozen sectors rated 'red' and facing significant job cuts and revenue losses". It talks about the sectoral impacts dashboard that is prepared by officials from across Whitehall and is frequently updated. It says it "gives 'granular' detail on the effect of coronavirus on nearly 40 areas of the economy. Among the sectors with a red rating are aerospace, the automotive industry, retail, hospitality and tourism, arts and heritage", and so on. Do you recognise the information that is being described there?

Richard Hughes: It is not a document that I am familiar with, although I confess that I have not read the *Times* article this morning in detail. We did have discussions with the Treasury about the sectoral impact of different restrictions. The results of our assessment were reproduced in the EFO document and the Government reproduced it again in the document that was produced yesterday. We attached GVA losses to each of the major sectors and, as you can see in table 2.2, we provide our assessment of how they fared during the last lockdown.

Q8 **Chair:** Sorry to interrupt but let me just press you on this point. Whether it is a discrete document or otherwise, do you recognise the kind of analysis that this article is claiming that the Treasury carried out in which, for example, the impact on the economy has these different sectors in red, green or amber? Do you recognise any of that from any of the discussions that you had with the Treasury, or does that just sound like something that might not exist at all or work that has not been carried out?

Richard Hughes: It is not a document that I specifically recognise, no.

Q9 **Chair:** Did you have any discussions with the Treasury in which, for example, it said, "We do not have a document that we are going to give you but we have categorised different parts of the economy as red, amber and green and we are concerned, for example, particularly in the red category of aerospace, automotive, retail and hospitality, et cetera"? Was there any of that kind of conversation that was held?

Richard Hughes: There was in the sense that we shared with them our assessment of the sectoral impact of the virus and tiered restrictions, and I would say that those two things—infection rates and public health restrictions—played an equally important role in reducing activity. We sought that guidance as people who were also looking at and trying to answer the same kinds of questions: "What do you think of this as an assessment of the impact of these restrictions on different sectors over the coming months?" I should stress that, in the end, these were our judgments and our views, and we sought the Treasury's input as people who were also concerned with these questions.

Q10 **Chair:** This is a very specific question: was there any point in those discussions at which the Treasury said, "We have categorised sectors as red, amber and green"?

Richard Hughes: No, not to my recollection.

Q11 **Chair:** Thank you very much for that. That is helpful. I spent a bit more time on this than I thought I might, so can I just very quickly turn to the forecasts themselves? It would be useful as a scene-setter just to quickly walk us through—and I am happy for any member of the panel to do this; it might be Charlie or Andy—the forecasts that you have made here and what the different parameters are, including progress on the health front and vaccines and how you factor in deal, no deal, et cetera?

Richard Hughes: Maybe I can just start by saying that part of the role that we set for ourselves in this EFO was to provide an account of the toll that the pandemic has taken on the economy up until now and get us through to the end of this year. Our near-term forecast is that the economy is going to shrink by about 11% this year, which is the deepest recession since the Great Frost of 1709, which hit our then mostly agrarian economy. Unemployment has already risen by around 4% to 5%. The virus has already taken a heavy toll on the public finances, with about £400 billion of borrowing this year, which is about a fifth of our economy and the highest level since 1944.

The bulk of that cost has gone on public spending in this crisis, which is a bit different from the financial crisis, where a lot of the fiscal costs came on the revenue side. The Government have spent about £280 billion fighting Covid so far. About half of that has gone on the health service and other public services, a quarter on supporting workers and another quarter on supporting businesses.

A second challenge that we set for ourselves was to provide a picture of where we go next and what the future looks like. It was important for us to emphasise that it would be wrong to focus on a single central scenario. There is extraordinary uncertainty about where we are going next. There has clearly been some very welcome news about potential vaccines but there remains a lot of uncertainty about their effectiveness and, in particular, when they might become available. Rather than focus on a single central focus, we set out three potential scenarios, depending on, as I mentioned, the effectiveness of three key aspects of the Government’s public health response: the effectiveness of the lockdown in reducing case numbers; the effectiveness of the test, trace and isolate system, which would then take over once lockdown is lifted in trying to identify and tamp down cases; and then how effective different vaccines are and when they will become available.

Depending on the effectiveness of those different parameters, we had an upside scenario, which assumes that all three stages of that rocket fire in perfect sequence, which is that lockdown gets case numbers down to low levels, which allows a test, trace and isolate system to take over and manage local outbreaks of cases and allows a much looser level of general public health restrictions, and a vaccine becomes widely available in the spring. In that scenario, additional unemployment is largely avoided, the furlough scheme provides an effective bridge from here to there, the economy recovers by mid-summer and we are back to pre-virus levels of activity by 2021. I should say that that is not our central forecast; that is our best-case scenario.

Our central scenario assumes that lockdown does not get case numbers down to sufficiently low levels so that a reformed test, trace and isolate system can be used to manage local outbreaks and we still need to maintain a relatively strict level of general public health restrictions somewhere around tier 3 as was in the old system; that a vaccine does not become widely available until the middle of summer, which means that some people fall between the gaps between the end of the current furlough scheme, which ends in March, and the recovery of the economy, which does not start gathering pace until the second half of this year; and that that means unemployment rises by about a million to 7.5% and it takes the economy until the end of 2022 to get back to pre-virus levels.

We also have a downside scenario, which assumes we still have relatively high rates of infection post lockdown. Our test, track and isolate system becomes overwhelmed and cannot be used to manage the outbreak in any real degree, so a fairly strict level of restrictions needs to remain in place until spring—somewhere between national lockdown and the old tier 3. In this scenario, none of the vaccines prove effective and, therefore, unemployment rises to a much higher level, to around 4%. There is a third wave of cases in the winter, requiring another lockdown over Christmas, and the economy suffers a third economic downturn next winter. After that, there is a much slower and more painful process of adjustment to, essentially, living with the virus, because we do not have a vaccine to enable us to go back to a normal level of interaction, and we do not go back to pre-pandemic levels of economic activity until 2024.

Chair: That is a very helpful overview. Thank you very much indeed.

Q12 **Felicity Buchan:** Good morning, everyone. I want to start with a few of your forecasts. Richard, you just talked on unemployment but, as you say in your central forecast, you now have unemployment peaking at 7.5%. That is dramatically different from your July forecast, which had unemployment at 12%. It is interesting that it is lower than the rates of unemployment that we saw after the financial crisis, where I believe we peaked at 8.5%. I just wonder if you, Charlie or Andy can give more colour, specifically on the central unemployment forecast.

Professor Sir Charlie Bean: The first thing to be said is that the summer scenarios in the fiscal sustainability report were not full forecast exercises. We did not go through the full set of processes that we go through in an economic and fiscal outlook.

The key difference between the summer scenarios and where we are now is a change of judgment about the sort of people who would flow into unemployment. In particular, in the summer, based on the initial information we were getting about the use of the furlough scheme, it was very heavily concentrated in low-wage, low-productivity workers, with the consequence that, when a fraction of those ultimately flowed into unemployment when the furlough scheme ended, there was an increase in economy-wide productivity through a sort of “batting average” effect: you get rid of low-productivity workers and that raises the average.

What became clear in subsequent months, as we got more information from HMRC about the nature of workers on the furlough scheme and so forth, is that we had overcooked that judgment, so the main source of the downward revision in the peak in unemployment is that change in judgment, which is driven by getting more information about the composition of workers on the furlough scheme.

In addition, it is worth saying that there is an element of it that also reflects the effect of policy. In particular—and this is certainly embodied in our central scenario—with vaccines now on the horizon, it is reasonable to think that there are some businesses that previously might have laid workers off because they could see no light at the end of the tunnel when the furlough scheme ended. The furlough scheme will now be going through until March and vaccines, in the central scenario, will become widely available around about then and in the summer, so it would be reasonable to think that, even if there was no immediate work for some of those employees to do, some employers would hang on to their labour until the economy had recovered. That also knocks about 300,000, we reckon, off the level of unemployment.

As I say, the big source of the change is entirely a judgment-driven change on the basis of better information about the composition of workers on the furlough scheme.

Q13 **Felicity Buchan:** Just to follow up on that, is there a risk with the furlough scheme that, in certain cases, we are almost just delaying the inevitable and that these jobs are no longer viable? Are we simply pushing out the unemployment?

Professor Sir Charlie Bean: That will certainly be true of some. The whole point of the furlough scheme—and, indeed, all of the business support measures, including the loan guarantees, grants and so forth—is to prevent the loss of viable jobs and businesses, which has a long-term scarring effect, but you cannot target measures precisely just on those businesses that would be viable and go under. Inevitably, it is a broader hit.

It also means that there are some businesses and jobs that would have gone under but that have been kept afloat. The fact that insolvencies are about 30% below where they would normally be compared to where they were last year is an indication that some businesses are probably hanging on by virtue of the financial support provided by the Government and would otherwise have gone under. Presumably, when that support comes to an end, you will see at least some of those businesses folding and some jobs being destroyed. The big unknown in all of this is how many of the jobs on the furlough scheme cease to exist when the furlough scheme ends.

Q14 **Felicity Buchan:** Just on that point on scarring, your central forecast is 3% scarring. Can you give us more colour around that? I see that the Bank of England's central forecast is 1.75% scarring. What is the reason for the difference?

Professor Sir Charlie Bean: The first thing to be said is that there is a huge amount of uncertainty about this. This is a very unusual sort of economic shock, where there are not many parallels that we can look back at and say, "What happened then?" At least with the financial crisis, where we had the same sorts of issues, you could look at what had happened after previous financial crises. There are not so many of these pandemic events that one can look at. That is one reason why there is a lot of uncertainty about this.

I would not want to place great emphasis on that 3% in the central scenario. There is a range: in the best of all possible worlds, there could be negligible scarring, which we have built into our upside scenario, but it could be much greater, and we have put 6% into our downside scenario. As you say, the Bank has 1.75%, the IMF has 5% for the UK, and there is a range of estimates outside.

In terms of how that 3% is made up, one of the things that we have done in this forecast, which we did not do in our summer publication, was to try to flesh out the mechanisms beneath that. The arguments for why there might be scarring come from several different channels. The first is that investment has been hit by the pandemic; capital projects have been cancelled or put on hold, and that will have an effect on potential output.

There will have been some consequent slowing in innovation for essentially the same reasons. To the extent that there is disruption of viable jobs and businesses—as we have already said, Government policy is designed to try to prevent that, but no doubt there will be some good businesses that go under—that will have a lasting effect on potential output. A lot of businesses will go through to the post-pandemic world with higher levels of debt and there is plenty of empirical evidence that suggests highly indebted businesses tend to invest and innovate less.

There are also likely to be effects on the labour side of things. To the extent that people are unemployed, that means they are not acquiring useful skills that they would get while they were in work. The pandemic will probably reduce inward migration. In general, there is less migration during a pandemic, for obvious reasons. The UK is a net recipient of migrants, and so, on balance, that will have an effect on the population. We also expect some older workers to leave the labour force earlier than would otherwise have been the case—people like me who realise their own mortality and think, "I want to take advantage of the years that I have left". There will be some who do that.

There are lots of different channels. In the report, we provide a breakdown of that 3% scarring. Two percentage points of it are down to productivity, of which the majority is down to investment. Accumulated business investment over the five years of the forecast is 10% lower than it would be on the March forecast, which was essentially pre-virus, so that is a significant dent in the capital stock. The rest of that two-percentage-point productivity hit is a total factor productivity hit, in terms of efficiency in the way businesses are organised, reflecting things like the destruction of viable businesses and jobs, and possibly a reduced rate of innovation.

The other one percentage point of the 3% hit comes from labour market effects, of which half is participation, a quarter is population and migration and a quarter is from a higher-equilibrium unemployment over the forecast period, which is declining at the end but there is still a bit of it, reflecting a certain amount of restructuring that needs to take place in the economy.

That makes it all sound terribly precise although it is based on a lot of very careful analysis. The thing that I would want to stress is the extreme uncertainty about this. For that reason, I would not think it wise to make a lot of what are really quite small differences between different forecasting outfits, even though they may have significant consequences for what it implies about, say, how much fiscal consolidation may be needed in the medium term. It is important to determining that but we will only discover that with time.

Q15 **Felicity Buchan:** Thank you; that is very comprehensive. Let me pick up on one particular point: corporate indebtedness. I am concerned that you have these corporates that have taken out bounce-back loans and CBILS. Are they going to be inclined to invest at a rate that we would have anticipated in the past? What is your view on that and to what extent has that influenced your calculations in terms of scarring?

Professor Sir Charlie Bean: One of the peculiar features of this pandemic is the wide differences that it has across households and businesses. One’s natural inclination is to think that workers have been struggling because of the dent to their earnings, and that businesses have been struggling because of the hit to their revenues. The support measures that the Government have put in place have offset that to a significant degree and, on top of that, some sectors of the economy have been largely unaffected by what is going on.

Quite remarkably, the savings rate for households has shot up in the second quarter to very high levels. That was not because lots of people were terribly worried about the future and saving a lot but because a lot of people could not go out and spend. Similarly, as regards businesses—and this is where it connects with your question—one of the remarkable features is that profits in the third quarter were at record levels. They were weak in the second quarter but strong in the third quarter, and that reflects the fact that some businesses are doing relatively well. They are also in receipt of Government support, so they are potentially in quite a good position to invest going forward, but there are some businesses that are really struggling and relying on access to loans to get through, and they are not going to be in a good position when they come out at the other end.

You have this very strange mix, with some firms being well placed and some being much less well placed, and the net of where it comes out is quite difficult to judge. Certainly, though, we have a relatively slow pickup in investment in the central projection, so the recovery next year is mainly on the back of consumption, and it is the following year before investment really starts getting going again. Only in the tail-end of the forecast period do you have the projects that were delayed by the pandemic really coming back in and very strong investment starting to come through.

That judgment may be wrong and, in our upside scenario, there is implicitly a much faster bounce-back in investment and, per contra, in the downside scenario, it is even more depressed. You may hate me saying that there is a lot of uncertainty here but it really is a situation in which it is very difficult to know how strongly business investment will come back, but it is crucial to determining how much scarring there is in the medium term.

Q16 **Felicity Buchan:** Just on business investment, is there an argument that, once we get to 31 December and we know whether or not we have a free trade agreement with the European Union, that could be a spur for business investment because you have taken the uncertainty off the table?

Professor Sir Charlie Bean: You may have removed uncertainty but, of course, a lot will depend on what replaces it. If what is replacing the current situation looks worse than people expected, that will not necessarily be very good for investment. In general, the resolution of uncertainty is something that allows businesses to move ahead. If you have a lot of uncertainty, there is an incentive for businesses to hold off on irreversible expenditure, and much investment is irreversible expenditure—what is referred to as the option value of waiting.

Q17 **Felicity Buchan:** I would just like to end with a very specific question on the removal of VAT RES or, as the public may know it, tax-free shopping. I know that you put in a forecast that this is likely to save the Exchequer £360 million per year over a five-year period but you do note that it is a highly uncertain estimate, given the fact that you have a highly mobile group of international shoppers and, in removing that exemption, you have effectively made the purchases 20% more expensive and they could go off to shop in Paris or Milan. My question is twofold: first, how confident are you in that forecast? Secondly, have you also factored in that, if this highly mobile group decides that they are going to go off to Paris for all of their expensive shopping, we will lose all of the VAT on hotels, restaurants and other things in the UK?

Professor Sir Charlie Bean: You are clearly right that a lot is going to depend here on the elasticity of demand with respect to that change in the price. There were certainly discussions about this. It is probably best at this point if I turn it over to Andy, since this is very much his territory.

Andy King: I am happy to pick up, although I was excited there for a moment that Charlie was going to answer. You asked how confident we are in that number. The fact that we gave it a "highly uncertain" ranking should tell you that we are not particularly confident in any specific number. The estimates are uncertain, partly because HMRC does not have its own data on the cost of VAT-free shopping, so has drawn on evidence from the airports, where the forms are handed in. This is related to flows of tourism, which have been hit extraordinarily hard during the pandemic. In some ways, we have linked this to the judgments we have made about how long it will take the air passenger duty forecast to recover. That is all before you get to the behavioural response.

When we looked at this, there was rather more outside evidence brought to bear on this than many costings of similar size. We assumed a relatively high price-elasticity response from those affected, for the reasons you have set out. Whether that is going to be high enough or not is something that we cannot be very confident in. We are not going to be able to pick this apart with the benefit of hindsight, either because it is being introduced mid-pandemic.

The wider question about VAT on hotels and that kind of thing is not reflected in the £300 million a year that you mentioned. That number just looks at the degree to which shopping on the type of goods that are covered by the scheme at the moment will be affected. When we look at how the wider economy is affected by new policy measures, we do it in the round with all the measures that are announced in a Budget or a spending review. In this instance, with the best part of £100 billion being added to public spending, £500 million, at most, of tax takeaway is kind of swamped by that.

That is not at all to say that these are not important. If you were looking at this on its own, if it was the only thing that had happened in this Budget, we would have been looking at it in a slightly different way. That is not to say that the analysis that people have done is not relevant, but it is not factored into that specific line of numbers.

Q18 **Felicity Buchan:** I understand completely in terms of materiality but, if you were to look at this measure on its own, is there a risk that it could be negative to the Exchequer, if you were to take in the losses on VAT?

Andy King: I am afraid I have not looked at that specifically. Sorry; I do not have an answer for you.

Q19 **Mr Baker:** I refer to my registered interest in Glint Pay. Mr Hughes, I think it was you who a few minutes ago you mentioned the behavioural response, or it might have been Charlie; I have been listening closely but I may have mixed up who said it. I wonder if you are concerned, as I am, that, even from a lockdown-sceptical point of view such as I hold, people have not adequately taken into account the behavioural impact of coronavirus on the economy and on healthcare. For example, as coronavirus cases increase, people do not go out and use shops and pubs because they know the virus is abroad, and so some of the harms that people think are due to lockdown are due to the virus. Charles, you are nodding. Do you agree that that is a problem?

Professor Sir Charlie Bean: It is certainly true and is one of the things that we stress in the report. Indeed, Richard mentioned in his opening remarks that the impact of the pandemic on the economy comes through two routes: the route coming through the official response—restrictions on behaviour and stuff like that—but equally, individuals changing their behaviour. As you say, if people are conscious that there is a nasty disease out there that they might contract if they go out to the shops, restaurants, bars or whatever it might be, they are much less inclined to go there. There is evidence that what in the jargon is referred to as voluntary social distancing intensifies with the number of case numbers and fatalities. If there is more publicity about that, you would expect the effect to be stronger.

Although Richard talked at the outset about the IMF work, which says that, looking across countries, it looks like about half the effect has come through official restrictions and half through voluntary responses, it would be possible to say that, if you had fewer official restrictions, you would probably get a stronger voluntary response and that, if there are more cases as a result of having fewer official restrictions, individuals will adjust their behaviour more strongly.

Q20 **Mr Baker:** At the risk of hammering the nail in, I want to put on the record that I want any analysis of the social, health and economic costs of coronavirus to be accurate. Could I ask you to join me in calling on economists producing analysis of the costs to be careful not to fall into the error of miscategorising the source of harms?

Richard Hughes: It is something that we have stressed in the report that we produced: that it is important to take account both of voluntary responses and of public health restrictions in the impact of the virus on activity. It is not just an international phenomenon; you saw it in this country. In the real-time data looking out on a daily basis over the course of the last 10 months, you saw a slowdown in economic activity through September and into October, even before the tiered public health restrictions came in, and that was because people were reading news reports about rising case numbers and hospital admissions, and that has an impact on behaviour even before the Government respond with public health measures.

Q21 **Mr Baker:** Turning to public spending, your forecast, if I have understood it correctly, does not contain any spending on Covid from March 2022. Is this realistic?

Andy King: It is correct that the Government have not allocated a specific pot to Covid spending from 2022-23 onwards. The realism of that will be something that will emerge over the course of the next year as we learn more about how effectively the vaccines can be rolled out to the population. The news on their efficacy in terms of morbidity and mortality has clearly been excellent. I am not aware of as much information yet as to how they affect the transmission of the virus, and the demand for test-and-trace-type spending will be dependent on whether the virus is still circulating, even in a vaccinated population. It is not for us to comment on why and how the Treasury should make these decisions, but I am sure you can see a case for waiting until some of those uncertainties recede before deciding what to allocate in the way of virus-related spending from 2022 onwards.

Q22 **Mr Baker:** Is it consistent for the Government to have no allocation of spending on coronavirus in an economy where we have not yet fully seen companies recover from the impact of the disease and of lockdown? I suppose what I am asking you is whether it is realistic for the Government to think that they will have withdrawn all coronavirus support for companies.

Andy King: What we have seen over the past year is that the ebb and flow of the virus has affected how the Chancellor has made his decisions on support for companies, for individuals and for the public services that are affected. When we put together our downside scenario, we made a broad-brush assumption about future costs on account of making an assumption that there was a third wave of the virus. There are clearly risks here, and the risk is that virus-related spending of some sort continues beyond what has currently been allocated. Waiting to allocate it rather than setting aside something specific or something general is a public-spending decision that you can see why they might have made.

Q23 **Mr Baker:** I wonder whether, in those public-spending decisions, there has been a degree of optimism bias. It feels not that long ago that we were doing Eat Out to Help Out. We were trying to encourage people to go out and eat out; indeed, we were spending a lot of money encouraging them. We did not seem to be planning too much for extending the furlough scheme. Is there a problem of optimism bias in Government planning for spending on support?

Richard Hughes: Optimism bias is in human nature. Even when we were producing forecasts back in the summer, we were forecasting a vaccine coming along at some point in some of our scenarios, and it is in our nature to be hopeful about the future. It is no different within Government. You have seen as a pattern of Government behaviour, as we recorded in the EFO, that we have had to have 14 different mini-budgets over the course of the year, which is a reflection of the fact that the Government have had to repeatedly revise their assessment of what is necessary to keep the economy on life support throughout the pandemic.

One of the issues that we face is that we have to forecast the consequences for the economy of the withdrawal of support, even when it does not match up with our assessment of where the economy is at that point in time. As I mentioned at the outset, one of the reasons why we have a rise in unemployment next year up to 7.5% is that the furlough scheme is, at the moment, due to end in March, but our economic recovery in our central forecast is not really gathering pace until next summer, when we think a vaccine is likely to be widely available, based on the advice that we had from public health experts. That gap between an early withdrawal of support relative to the recovery in the economy means that some people fall through the gaps. Were that policy to be revised, we would have a different assessment of where unemployment and the economy would be.

Q24 **Mr Baker:** Sir Patrick Vallance told another committee of Parliament that the disease would be endemic and that it was not likely that we would have what he called, if I recall correctly, a fully sterilising vaccine. What is your assessment of the Government's willingness to live with the reality that this disease is now going to be endemic in our society?

Richard Hughes: It is not for me to comment on the Government's views on public health policy. We did have a number of quite in-depth discussions with the Government's public health experts about what they thought about the impact of different vaccines on the virus and on transmission. One of the reasons why we do have a residual level of scarring on the economy in our central scenario is, to some extent, factoring in an element of not 100% effectiveness of vaccines, still some low level of transmission going on, and the fact that that has consequences for things like sick leave or people being more inclined to take time off work in the future when they get ill, because there is a stronger social norm about not coming to work for those days, and so you just lose working days of output as a result. Our forecast reflects a lingering, latent consequence of the virus for the economy in perhaps the way you suggest.

Q25 **Mr Baker:** Have the Government adequately planned for things like additional PPE and ventilators within the NHS, or perhaps the need for a higher number of beds? One of the problems that we have seen is that there are just too few beds in the NHS.

Richard Hughes: We are not public health experts. It is a challenge enough for us to understand its impact on the economy, let alone on public health.

Q26 **Mr Baker:** Welcome to the problems of being an MP. The Government are cutting £10 billion a year from non-Covid departmental spending. How are they achieving this?

Richard Hughes: The truth is that we do not know. What the Government have pointed to is the fact that they have reduced the ODA budget and frozen public-sector pay outside the NHS, but this was in the fine print of the spending review rather than something that was itemised and categorised as a saving. Those two things in isolation probably do not add up to £10 billion a year and, again, what we do not know is, beyond the next spending review, what the Government plan to do with the ODA budget and whether they want to take it back up to 0.7% or leave it at 0.5%. If they want to take it back up to 0.7%, those savings are a one-off and they do not get the benefit of those for the remainder of the forecast period, unless they can find offsetting savings somewhere else.

Q27 **Mr Baker:** Does this mean that austerity has returned?

Richard Hughes: What it means is that the Government are spending £10 billion less than they planned back in March. "Austerity" is a loaded term and not one that you hear many economists using, to be honest.

Q28 **Mr Baker:** We are all going to spend the rest of this Parliament worrying about where the money is coming from. The Government are freezing public sector pay. What lessons might Members of Parliament take from this? What example should we set?

Richard Hughes: It is not for me to say how you set your pay.

Q29 **Mr Baker:** I will come on, Mr Hughes, to a point that you particularly made. Of course, our pay is set by IPSA, I should just say for those watching. Your forecast says that successive extensions to the asset purchase facility have further reduced the effective maturity of Government debt by substituting gilts with an average maturity of around 13 years with floating-rate central bank reserves. Can you just explain for the public a bit more about what that means for the public finances?

Richard Hughes: One of the paradoxes of the consequences of the pandemic for our public finances has been the fact that our debt burden has gone up from around 80% of GDP to already over 100% of GDP, and that it stays there for the five-year forecast period. It has not been at that level since 1960, but one of the paradoxes is that, despite the fact that our debt burden has gone up so much, the burden of servicing that debt has gone down relative to even what we were forecasting back in March, and has gone down considerably compared to how much having a 100% debt-to-GDP ratio cost us back in 1960. That has been because interest rates have been steadily falling over that period.

Part of that has been a secular trend in the fact that, globally, interest rates have been coming down. This is because we have been winning the fight against inflation and because Governments have established track records of servicing their debts. There is also an element of a temporary phenomenon of a flight to safety and people looking for safe assets. That makes it cheaper for Governments to borrow because people want to hold Government debt compared to other assets in the economy that might be impaired by the virus.

It also reflects the operation of the Bank of England's quantitative-easing activities. The Bank of England buys up mostly long-dated Government debt and finances that by issuing central-bank reserves, which is also public sector debt but at a very short maturity; it is, basically, overnight debt. In net terms, that makes the Government's debt a lot cheaper because longer-dated debt has a higher interest rate, whereas central-bank reserves have very low interest rates.

It also makes the Government more exposed to future rises in interest rates, because those long-term interest rates are not locked in. An increasing share of the Government's debt burden is, essentially, now being financed at bank rate, which can change overnight. To give you a sense of proportion, about a decade ago a quarter of public sector debt had a maturity of less than one year. That ratio is now more than a half, so more than a half of the Government's debt is now maturing within one year.

Interest rates are now very low and it is very cheap for Governments to borrow, but if that situation were to ever change, the consequences of a future rise in interest rates would be felt much more quickly than they have in the past because we do not have the benefit of that longer net-average maturity in debt that we used to have. We are rolling over a lot more of our debt at overnight, short-term interest rates and, therefore, the consequences of an interest-rate rise would hit the public finances much more quickly. We are seeing the benefit of falling interest rates benefiting the public finances much more quickly at the moment but, were that ever to reverse, we would see the consequences and the costs of that much more quickly.

Q30 **Mr Baker:** I hope you will not mind me saying that I found that to be one of the clearest, most helpful and most succinct explanations of this phenomenon that I have ever heard, but I wonder what your view is on the capacity generally of the public, of journalists and of Members of Parliament to understand what you have just explained about some of the fundamentals of the monetary system. Is it well understood that QE results in this shifting of the maturity of the Government's liabilities?

Richard Hughes: We have tried pretty hard. I have tried pretty hard in these fora to do so. We have tried pretty hard in the EFO to explain the fact that low interest rates are a good thing for the public finances. They help Government to finance what they need to do to fight the pandemic, but shortening maturities of debt also leave the public finances more vulnerable, if that situation ever changes. We have done work in this EFO and there is a box in there that tries to explain the mechanics of this. There was more journalistic coverage of this issue this time around than there has been before, so I hope that message is getting across.

Q31 **Mr Baker:** I have to say it is such a good explanation that you have negated the rest of my questions, but I will just ask Charles Bean if he would like to make any comments on this particular phenomenon.

Professor Sir Charlie Bean: I will because it is a particularly important and, as you have intimated, underappreciated point. It is not just the man in the street who does not understand it; there are plenty of my colleagues in the world of academic economics who have not really picked up on it.

Mr Baker: Forgive me interrupting but, after 10 years in politics and probably 20 years as an amateur reading about monetary economics, I am relieved to hear you say that.

Professor Sir Charlie Bean: Just the other day, I heard somebody on the "Today" programme talking about the low cost of finance for the Government and also saying, "And it has a very long maturity". This was somebody who is a professional economist and has a chair at a respected university. There are plenty of people who should be aware of this but who have not really put together the Bank of England's balance sheet with the central Government balance sheet to see the whole picture. You do need to think of the Bank's balance sheet really as being part of the consolidated public sector. You get a very different picture of the risks when you do that.

Q32 **Mr Baker:** What advice would you give to this Committee about how we can better understand those risks, please?

Professor Sir Charlie Bean: It is about being aware of issues like this. There are a lot of people who are making the argument at the moment that interest rates are very low, so it is fine to borrow lots and lots. That may be a valid argument if you are going to borrow at very long maturities, but if you end up borrowing at very short maturities, which is what happens if there are simultaneous, large asset purchases by the Bank, you may have a low current cost of finance but it could change quite sharply if interest rates need to rise. That can happen if inflation pressures start building and the Bank needs to raise interest rates to head off that risk. There might also be declining confidence in the Government's commitment to meet their debt obligations. Also, as Richard referred to, the underlying interest rate has been drifting down for secular reasons, which there is a lot of debate about and which I have discussed when I have come before this Committee in the past, as have MPC members.

There is one particularly important factor that is changing direction, which is demographics. One of the drivers of declining interest rates in recent years has been the bulge of high-saving people of middle age. Those people are now moving into retirement and dis-saving. This is a global phenomenon; I am not talking about a UK phenomenon. That will put upward pressure on interest rates. It will not necessarily happen overnight but it is a reason why we may see a change of direction.

My colleague at LSE, Charles Goodhart, has a book that has just come out in the last couple of weeks, with Manoj Pradhan, which focuses on these deep tectonic forces that may be at work going forward and that generate higher interest rates and potentially higher inflation.

Mr Baker: It sounds like a book we should all go and read with great care. I am enjoying this immensely and I could probably get away with another couple of minutes but I have just noticed that my internet connection is dropping out, so I am going to hand back. Thank you very much indeed.

Chair: Thanks very much, Steve. That was a very interesting discussion around the monetary policy side of things.

Q33 **Siobhain McDonagh:** My questions are about housing and house prices. Richard, your forecast suggests that house prices will drop by 6% between 2021 and 2023. Can you explain why?

Richard Hughes: Charlie has a stronger pedigree on housing market developments and house prices than I do, so if you do not mind, I might hand over to him to have a first go at that one. You will get a better answer.

Professor Sir Charlie Bean: First of all, we have quite strong house-price growth this year. What we have seen in the data is quite a strong bounce in the housing market since the first lockdown ended. The stamp duty holiday, which is due to finish in the first part of next year, has encouraged some people to come into the market to buy ahead of the ending of that. In the near term, we have a bounce.

As we go into next year, some of those purchases have been brought forward, so you get the hangover, if you like. On top of that—and this is key to the projection that we have—in our central projection, as we have already discussed, there is a significant rise in unemployment and, typically, we find that, when there is higher unemployment, that dampens the housing market. That is the reason for the dip over the next year or two. Then house prices recover.

If you look at the whole period as a piece, going back to before the pandemic and to the end of last year, house prices rise a little over 15% over the whole of the forecast period relative to 2019 and that is pretty much the same as average earnings growth. That is really the key driver over the long term. You have these short-term wiggles and fluctuations associated with unemployment and policy decisions, but the underlying driver is what has happened to earnings.

Q34 **Siobhain McDonagh:** Have you done any analysis of where, geographically, price falls are concentrated?

Professor Sir Charlie Bean: Not particularly in this instance. We get into detailed geographical analysis when it looks like it might be material to understanding the national evolution. You could imagine that, in this particular setting, it might be important to look at what has happened to London prices but, on this occasion, digging down into the regional dimension is not particularly material to our judgment.

Q35 **Siobhain McDonagh:** Have you had any look at the potential economic impact of people falling into negative equity?

Professor Sir Charlie Bean: Not particularly, no.

Q36 **Siobhain McDonagh:** Have you considered the economic impacts of house-price falls on banks and building societies? What are the likely outcomes?

Professor Sir Charlie Bean: The key people there, of course, are the Bank of England and the Financial Policy Committee. This is the sort of thing that they keep a beady eye on. They are looking out for risks on banks' balance sheets. We tend to take our steer from them and their regular Financial Stability Report. We communicate regularly with Bank economists. They are pretty relaxed about British banks at the moment. Banks are very well capitalised and the re-regulation after the financial crisis means that they do not see major risks there. If there are risks, they tend to be outside the banking sector rather than residing within the banks. For that reason, we are reasonably comfortable about any macroeconomic consequences from this issue.

Q37 **Siobhain McDonagh:** Your forecast suggests that house prices will recover substantially from 2023 onwards. Why will house prices recover then?

Professor Sir Charlie Bean: It is basically on the back of earnings growth. As I said earlier, ultimately the thing that drives house prices is affordability, and that depends on people's pay packets. That is a key factor along with housing supply and the cost of borrowing. They are the three big elements and the big long-term trends in house prices. It is, basically, what is happening to incomes.

Q38 **Siobhain McDonagh:** This is quite a small area of housing policy but a significant one: in September 2018, the then Prime Minister, Theresa May, announced that a stamp duty surcharge of up to 3% would be imposed on overseas residential property investors, with all the money generated being directed to tackle homelessness. Six months later, the proposal was watered down to 1% before returning to 3% in the Conservative party manifesto and then being changed to 2% in the Budget from 2021. With a surcharge due to be implemented in April 2021, does this come into your forecast? What assessment have you made of the changing figures, if any?

Professor Sir Charlie Bean: This is one for Andy, as the tax expert. He will take you through all the gory detail of our stamp duty discussions.

Andy King: I would love to take you through all the gory detail of every change in this measure, but I am afraid I do not have those details in front of me. Each time we do a forecast, for any policy measure that has been announced but not yet implemented, the estimate is updated so that it is consistent with our wider view of the housing market and property receipts. Each time a parameter of the policy measure is changed, it is costed afresh and treated as a new policy measure. Each step in the process is documented. I am afraid I do not have the documentation in front of me, so I cannot tell you how precisely how it features in this latest forecast.

Siobhain McDonagh: It is a slightly unfair question to members of the panel, but it does seem an extraordinary thing that this matter has been hanging around so long and that the tax rates to impose keep changing, and yet the money is not raised to help people who are homeless, when you can only imagine that there is a benefit from taxing overseas investment in terms of transparency and all the rest of it. Thank you for everybody's answers.

Q39 **Rushanara Ali:** Good morning, everyone. I am going to start off with some further questions on assumptions about the vaccine rollout and also test and trace, and then go on to our favourite subject, Brexit. We cannot really avoid it, given the uncertainties.

Richard, you earlier set out very clearly the different scenarios in relation to test and trace but also the implementation of a vaccine. What is clear is that there is an assumption built in that the test and trace policy is only partially effective in the central scenario. Can you talk through what counts as "partly effective"? Is it not quite damning, considering the amount of money—£12 billion and then further billions—that is being spent on test and trace and the scale of funding that is being invested there, that it is still a long way off in terms of implementation and has led to a second lockdown? I would like you to then focus your remarks on what the economic impact, in numbers, has been as a result of test and trace not being effective in that scenario.

Richard Hughes: In terms of what we meant by test and trace in our central scenario only being partly effective, where the judgment about its effectiveness comes in is in two regards. Again, it is linked to this point about the different elements of the public health response having to dovetail with one other. Part of what determines the effectiveness of the TTI regime is how effective the initial lockdown is in getting case numbers back down to a level that is low enough to allow any test, trace and isolate system to operate effectively.

As you have seen in countries in Asia, to actually use TTI effectively you need to have very low case numbers. One judgment that we had to make was about, by 2 December, how low case numbers are going to be and whether a TTI system would be able to take over at that point and keep those numbers down by identifying outbreaks and tamping them down.

It also reflected, when we said in our central scenario that it was only partly effective, the reality that, up until now, it has not been particularly effective or it has not achieved the objectives that the Government have set out for it in terms of the percentage of cases actually identified and traced and the number of people who are actually isolating. In that sense, it also reflected the fact that we do not just take Government policy on faith that it is going to operate at 100%; we have to look at its effectiveness in the field.

On the scenarios where it is not fully effective, it partly reflects a judgment that there are going to be too many cases for it to try to manage, and also the fact that it has not been particularly effective, up until now, at managing the cases that it has been dealing with, even over the summer when you had fewer cases.

Q40 **Rushanara Ali:** You are right that the first lockdown was supposed to buy us time. Everybody followed the instructions of Government and we were led to believe that, if people—our constituents and the rest of us—made those sacrifices of a very stringent lockdown, that time would be used to sort out test, trace and isolate and there would therefore be less of a risk of a second lockdown. What has been the economic cost of not getting test, trace and isolate right from the first lockdown? What is the likely knock-on effect on the economy if this period of this lockdown does not have the effect of the improvements needed in TTI? What are the facts on that? What are the actual numbers?

Richard Hughes: We have not done a counterfactual analysis of what would have happened had test, track and trace been more effective over the last six months. You can see the difference with our upside scenario where the combination of lockdown, a reformed test, trace and isolate system and an early arrival of the vaccine generates quite a rapid recovery in economic activity and a return to normality by the end of next year. That is the benefit of all the aspects of public health responses. As I said, it is the rocket with all three stages firing in perfect sequence.

The cost of those things not happening in perfect sequence, which is what is assumed in our central forecast, and a vaccine coming later, is the fact that the economy takes a further year to get back to its pre-virus levels. That is not an assessment of what would have happened over the last six months but an assessment of what could happen over the next 12.

Q41 **Rushanara Ali:** Rather than looking backward, let us look forward at these different scenarios and all of these things working in sync effectively, as you say, in the upside scenario. To concentrate minds on getting the underlying systems in place to help the economy, what do we gain and what do we lose if we do not get into that scenario?

Richard Hughes: The upside scenario, where all aspects of the public health response work perfectly and the vaccine comes to the rescue earlier than our public health experts say, saves you a million jobs and keeps unemployment at levels more or less where they are now. It also means that we would forecast the economy getting back to some version of normality by the end of next year, back to pre-virus levels by the end of next year.

On our central forecast, where things fall between the gaps between different elements of the public health response, you have an extra million unemployed and you have the economy taking an extra year to get back to its pre-virus levels. Again, that is not just about lockdown and TTI but also about the arrival, availability and distribution of a vaccine.

Q42 **Rushanara Ali:** Just taking away what you are saying, a million jobs could be saved if the Government get the test, trace and isolate system right and improve it, given the things that have not gone according to plan, and the vaccine implementation. The key message is that a million jobs could be saved if they get this right, as well as the economic dimension.

Just in relation to that, I want to pick up on the other point that you made earlier to the Chair's questions, which is about the worst-case scenario where we could find ourselves in a third lockdown and another year of stop-start closing of the economy and lockdowns towards next winter. It does not bear thinking about, given where we are now. Can you talk through what, in that scenario, needs to happen if there are delays to implementing the vaccine and if test and trace is still too far off from getting to the level that some other countries have got it too? What needs to happen in relation to support schemes for people and tiered support? We have a situation at the moment where tier 3 areas are not getting the associated economic support that they really need.

Should the Government be ending the CJRS in that scenario or should they be planning for that in advance? It has been really frustrating for our constituents that, on 31 October, literally at the 11th hour, the Government finally said that they are going to extend it to March, whereas a lot of jobs could have been saved if some of that preparatory work and planning was done in advance with those scenarios in mind.

Richard Hughes: It is not for us to give the Government policy advice in any scenario. However, in the downside scenario we had to make some assumptions about the fiscal implications of it. It would not be reasonable to think that the Government would just sit on their hands in the face of a third wave and not do anything to support the health service, businesses and workers. We did factor in some additional costs in that downside scenario to Government. We did not attribute it to particular areas—either business support, worker support or support to public services—but we just assumed that it was about half the cost of the second wave of the virus were we to have a third wave. It is not for us to say what the Government should or should not do in particular scenarios.

Q43 **Rushanara Ali:** I have been wading through the report but, for the benefit of viewers, could you just remind us how many billions that would be if we have a third wave and it is half the cost of the second wave?

Richard Hughes: I am trying to remember exactly how much we factored in for the third wave and what the elements were.

Professor Sir Charlie Bean: I think £30 billion was what we put in.

Richard Hughes: I think it was about £30 billion factored as additional costs for the third wave.

Q44 **Rushanara Ali:** There is an additional cost of £30 billion if we do not get test, track and isolate done just in terms of support schemes, and then a million jobs will be lost if the Government do not get a grip on TTI and implement the vaccine effectively, not to mention another year of overall economic contraction. Would that be a fair summary?

Richard Hughes: It is not just about TTI in the sense that the downside scenario also assumes that a vaccine is not effective. Not all these things are in the gift of the Government. They depend on progress in science and the effect of these vaccines.

Q45 **Rushanara Ali:** I agreed, but we can see quite a lot of room for optimism in terms of the evidence so far on vaccine effectiveness. Obviously, you can still get upsets. What we have seen, though, is the Government making a dog’s breakfast of test, trace and isolate over the last few months. The second lockdown was meant to be more biding of time to get it right but there is no sense that that is happening. That does not bode well for implementing the vaccine, which is needed as you mention in your scenarios. I am focusing in on that because the economic dimension is not a trade-off but an interplay, as you say, between the two. The point is that, if we do not get this stuff right over the coming months, your downside scenario, leaving aside the vaccine point, could be in that order. Is that right?

Richard Hughes: The full consequences of the downside scenario also have no vaccine coming along to support an economic recovery. In the near term between now and when a vaccine is available, we are dependent on the lockdown currently in effect, test, trace and isolate, and the tiered public health restrictions as, essentially, our method for managing the virus and mitigating its impact on wider economic activities.

Q46 **Rushanara Ali:** That takes me neatly on to Brexit. People have had a year from hell. We have had four years of Brexit uncertainty, which has already substantially affected the economy in terms of uncertainty, confidence, reduced investment and the rest of it. We now have a very short window for the Government to secure a deal. You have set out in the report that, even with a typical deal and free trade agreement with the EU—and it would be good to get some more insights into that—long-term GDP would be substantially reduced by a number of percentages. It would be good to be clear on precisely how many percentage points. A WTO no-deal Brexit scenario, again, would have a very damaging effect.

Could you speak to those points? Then could you please explain to us whether you think a no-deal scenario is on par with the damage that coronavirus has done, or is the long-term effect likely to be in the order of two to three times higher, as the LSE analysis showed and that the Governor of the Bank of England concurred with? You said something slightly different in the report. If you could clarify those points, that would be really helpful.

Richard Hughes: In the near term, it is doubtless that coronavirus is the worst thing to happen to our economy in three centuries. In the near term, the hit from coronavirus is very significant and outweighs anything else that this country has had to face in many living memories.

In terms of its long-term impact, you are right to say that our forecasts since March have reflected our assumption that we are going to get some kind of free trade agreement with the EU. Compared with remaining in the EU in the long run, that reduces output by about 4%. That was included in our baseline forecast, our central forecast and all the scenarios we have been talking about up until now, which are premised on the fact that, at some point in the next four to five weeks, we will get a deal with the EU.

Because the Brexit negotiations represent a significant risk to the forecast, we provided an alternative no-deal scenario that looks at the implications of not arriving at a negotiated agreement with the EU and defaulting to WTO trading terms with the EU from 1 January onwards. In the long run, that would reduce output by another 1.5% to 2% compared to the FTA factored into our forecasts.

Professor Sir Charlie Bean: I just want to add a little more to what is in the forecasts at different vintages. As Richard says, our estimate of the effect of a typical FTA—free trade agreement—is based not particularly on work we have done but on the averaging of a range of outside studies. There is a table in the annex to the EFO that reports the various studies that we have looked at.

Different researchers use different models and come up with slightly different numbers, but 4% is an average for a typical free trade agreement relative to staying in the EU. Of that 4%, we reckon that about a third is effectively already in the data. Since the Brexit referendum, investment has stagnated as opposed to growing in the way that we expected it to. That has knocked a little under 1.5 percentage points off potential output. Some of that withheld investment would come back once the uncertainty is resolved. Essentially, part of the Brexit effect is already in the data.

The rest of the four percentage points are expected to come through partly within the five-year forecast period and partly beyond it. Back in March, we basically said that a third is in the data, a third comes through in the forecast period and the remaining third beyond the end of the forecast period because it takes quite a long time for the economy to fully adjust.

On top of that, if we end up with no deal and we have to revert to trading on World Trade Organisation terms, there are another couple of percentage points or so in the long run, some of which will probably come through in the next few years and some of which may take a bit longer.

The effect, in the long run, is broadly in the same order of magnitude as the scarring effects that we have been talking about. Neither of these numbers are calibrated sufficiently precisely to say that one is definitely bigger than the other.

Q47 **Rushanara Ali:** The Governor of the Bank of England agreed with the analysis that the LSE set out, of it being two to three times as bad as compared to coronavirus and its impact. You are saying it will be at least as bad. If we end up with no deal, we are going to have a second hit on the economy that is as bad as a recession that we have not seen anything like for 300 years caused by coronavirus.

Professor Sir Charlie Bean: This is where you are making a mistake by confusing the short run with the long run.

Q48 **Rushanara Ali:** Okay, so the coronavirus effect is the short-run one but you are looking at the long run.

Professor Sir Charlie Bean: Yes, the long-run scarring effects.

Q49 **Rushanara Ali:** We cannot deny that it is bad and then it is really bad. That is basically what we are looking at in terms of the hit of both the coronavirus effects on the economy and then a no-deal Brexit effect and the 4% that you mentioned even with an FTA. In the report, you refer to the USA trade deal, which is not going to make up for the loss of trade that we are going to face even with a deal with the EU, not to mention the Brexit scenario. It is not looking very optimistic. Why is the OBR so optimistic? The scenario with no deal is not good, of course. We all want a deal. We were promised a frictionless deal. The Governor yet again said that there is no such thing as a frictionless deal now, and you have confirmed that with the FTA point and what would be lost in terms of 4%. Are you still optimistic that we are going to secure a deal and, if so, why? You are suggesting that there will be.

Professor Sir Charlie Bean: We assume it and, basically, the Government have been telling us that it is their objective to secure a deal. We are supposed to produce our forecasts conditional on the Government's stated policies. There is obviously the possibility that that may not happen, which is why we thought it sensible to also give a no-deal scenario, which is what is in the annex.

We have assumed—and this might be something that you would take a different view on, as the Bank certainly has—that, even in the event of a deal, there might still be significant short-run disruption. We have assumed that that will be relatively small, essentially because we assume that, if there is a deal, both sides will try to make that deal work during the period of adjusting to the new terms.

There is clearly a downside risk relative to that. It is more likely to be an issue on the export side than on the imports, because the Government have already said that they will take a light-touch approach to the way they apply the new rules for the first few months to enable imports to keep on flowing. It is quite possible that you may find on the other side of the Channel that there is a little more insistence on sticking to the new rules right from the word "go". I could certainly see there being some significant short-term disruption while businesses adjust to the new world. We do note that some businesses are not fully prepared. Some have prepared as much as they can do. We would regard that as a downside risk for the first part of next year.

Q50 **Rushanara Ali:** I have a final question about the unemployment figures. The report suggests that it will go up to 8.3% in the third quarter under a no-deal scenario; nearly a 1% increase in unemployment associated with a no-deal Brexit scenario. Could you say something about the unemployment effects? We have talked about scarring in relation to Covid. This is not something that is happening to us; this is in part a political choice. In terms of whether we get a deal now or not, we are up against it. It would be helpful for our constituents to hear something more about the unemployment impact of these scenarios.

Richard Hughes: It partly reflects the differential impact of the coronavirus shock versus the Brexit shock. Some people have thought that Brexit is just another shock on top of a shock that we have already had so it does not add very much more. When you look at the sectoral impact of these two different shocks, they actually affect very different sectors of the economy. Coronavirus has affected the non-tradable services sector particularly hard but Brexit affects the tradeable goods and the tradeable services sectors such as manufacturing, financial services and agriculture. These are sectors that have been relatively spared by coronavirus.

That is not to understate that manufacturing struggled early on but they managed to adapt their operations to a significant extent to be Covid-safe and resume production and export. Financial services have been able to quickly adapt because you can operate at a social distance and you can operate online. Were we to leave the EU without a deal, these are the sectors in which output ends up getting hit the hardest by the fact that they lose access to a very important market for them, which is the EU, on tariff-free and other non-tariff-barrier-free terms.

In that sense, there is an additional hit to those sectors and the employment in those sectors from the fact that we would be leaving without a deal on top of the employment hit that you would get from coronavirus on our central scenario, which is affecting a different set of sectors in the economy, those being hospitality and sectors where the activities are largely contained within the UK.

Q51 **Rushanara Ali:** In summary, you have coronavirus, which has caused carnage in one sector of the economy, and then Brexit, whether there is no deal or the disruption that Charlie talked about even with a deal, will create further damage to other sectors of the economy that have not been hit by Covid, so you would get widespread effects on the whole economy.

Richard Hughes: Our sense is that these two shocks are additive rather than substitutive.

Professor Sir Charlie Bean: I want to add a little extra point on the unemployment consequences. The nature of the Brexit shock is such that it requires a restructuring of the British economy. There are going to be certain parts of the economy that are no longer so profitable and that have to downsize, and there will be other areas that will need to expand as a result of the changed terms of trade with the European Union.

That means resources, labour and capital need to flow from the sectors that are squeezed and the businesses that are less profitable to the ones that will be expanding. Typically, what happens here is that people lose their jobs in the declining industries before the new jobs are created in the ones that will expand, so there will be a period where unemployment needs to rise temporarily alongside that necessary restructuring. That is pretty much unavoidable with something like Brexit.

Rushanara Ali: Except you could argue it is avoidable. It could have been avoided but there we are.

Professor Sir Charlie Bean: It could have been avoided if you did not have Brexit.

Chair: That brings us to the end of this session. Could I thank our three witnesses, Richard, Charlie and Andy, very much indeed? This is a time when lucid explanations and clarifications of data and forecasts are particularly important. I have been struck, as have other members of the Committee today, at how lucidly and clearly you have explained and answered the questions that we have put to you. For that, we are very grateful.