

Jonathan Haskel, 13th July 2021, Reappointment to Monetary Policy Committee questionnaire for Treasury Select Committee.

Personal

- 1. Do you have any business or financial connections or other commitments that might give rise to a conflict of interest in carrying out your duties as an external member of the Monetary Policy Committee (MPC)?**

My father is on the House of Lords Economic Affairs Committee. We do not discuss confidential matters.

- 2. Do you intend to serve out the full term for which you have been reappointed?**

Yes.

- 3. What other work commitments, if any, do you expect to take on during your second term on the MPC?**

I am a non-executive director of the UK Statistics Authority (2016-2022) and a Professor at Imperial College Business School, Imperial College London (part-time appointment).

The Monetary Policy Committee

- 4. During your first term, have you had the support and analytical resources from the Bank of England that you need to carry out your duties as an external member of the MPC effectively?**

Yes. The support by the Bank given to me as an external member has been excellent.

- 5. The response to the pandemic has seen unprecedented levels of fiscal and monetary intervention, including a rapid expansion in quantitative easing at the same time as a huge increase in government borrowing. Do you think that the UK's monetary-fiscal framework has proven robust and the MPC's independence has been effective? Are there now any increased pressures on the MPC's independence from government?**

Since the onset of the pandemic, the MPC has, amongst other actions, substantially increased its target stock of government bond purchases, in order to achieve the inflation target and, subject to that, support growth and employment. At the same time, the government has increased its borrowing in order to finance a range of unprecedented measures to support households and firms as economic activity collapsed.

The coincidence of expansionary monetary and fiscal policy over the past year has been fully justified. It has reflected appropriate responses to the very rapid and severe deterioration of economic activity as the pandemic struck. For the MPC, mitigating the pronounced disinflation and target undershoot that accompanied the sharp fall in economic activity was the primary aim of our actions.

Expansionary monetary policy operates by lowering borrowing costs in the economy. The purpose is to loosen the financial conditions experienced by households and firms, such that the overall level of spending in the economy is maintained, consistent with the inflation target.

In light of the severe impairment to financial-market functioning in March 2020, our decision to increase large-scale asset purchases that month ensured that markets could resume working smoothly, alleviating the tightening of financial conditions. Our subsequent decisions in June and November 2020 to increase the target stock of government bond purchases further have helped to ensure that the slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target.

Our commitment to the inflation target and our operational independence from the government to enact that commitment can be seen in the stability of measures of inflation expectations. That stability is a sign of confidence in the UK's monetary-fiscal framework.

The MPC will continue to set policy according to its mandate of price stability. I will vote on policy to do just that, exactly in line with our operational independence.

The economy and monetary policy issues

6. How has your assessment of the overall prospects for UK economic growth, inflation, spare capacity and unemployment over the short and medium term evolved since your most recent annual report to and appearance before the Treasury Committee in February 2021? Do you continue to see “the downside risks [as] much more prevalent”?

The economy has started to recover over the past few months and overall economic prospects have improved. But it is clear we are not out of the woods yet. At the time of writing, May GDP is still estimated to be around 4.5% below pre-pandemic levels 2019 Q4¹, roughly 5% of private-sector jobs are still furloughed, and the Delta variant has an R number of 1.5.

The outlook for economic activity has brightened since I submitted my annual report in February. Improved public health on the back of the successful vaccination campaign has allowed the progressive lifting of restrictions and consequent rebound of demand. And indications are that the marginal economic effect of restrictions has reduced since the start of the pandemic. The fall in activity in 2021 Q1 was sharp but not nearly as severe as during the first lockdown in the spring of 2020. This has not only reflected less stringent restrictions but also better preparation. BICS data show that more businesses remained open in 2021 Q1 than in June 2020 and it seems that firms have innovated, fulfilling orders with delivery and click-and-collect services for example. In sum, the economy is more resilient to a lockdown than at the start of the pandemic.

My assessment of the economic outlook has also improved for the medium-term. I expect there to be less supply-side damage (scarring) than embedded in the May *MPR*. Why is this? To the extent that scarring occurs via lower productivity, the resilience of investment in intangible capital, such as software and R&D, in 2020 is cause for optimism.

The table below breaks out the capital stock and investment into three types of assets: buildings and tangible capital (e.g. machinery), and intangible capital (e.g. intellectual property). The fall in investment in 2020 was concentrated in tangible capital and buildings, whereas intangible investment held up fairly well. The fact intangible investments have held up over 2020 should help to mitigate the extent of any scarring to the productive capacity of the economy thanks to positive spillover effects on total factor productivity.

¹ The ONS's purely output-based measure of GDP was 3.4% below 2019Q4.

Investment and capital formation by asset, 2019Q4 to 2020Q4

Asset	Change in Investment (1)	Change in capital stock (2)	Pre-pandemic growth of capital stock (3)	Share of capital stock (4)	Share of capital services (5)
Buildings	-11.5%	1.2%	1.4%	37%	32%
Intangibles	1.6%	2.2%	2.7%	12%	19%
Tangible	-21.9%	-1.1%	1.7%	51%	49%
Total	-12.2%	0.1%	1.7%	100%	100%

Source: ONS experimental productivity estimates

Note: Column (1) is the calendar-year change in real chain-weighted gross fixed capital formation between 2019 and 2020. Column (2) is the change in the capital stock between 2019Q4 and 2020Q4. Column (3) is the average annualised growth rate of the capital stock over the period 2014Q4-2019Q4. Column (4) is the asset share in the measured capital stock. Column (5) is the asset share in measured capital services, the estimated share of capital income accruing to the asset. Intangible assets are capitalised research and development, software, databases and artistic originals. Tangible assets are other structures, machinery, and equipment.

But in the short term, as the economy has reopened, the demand rebound has butted up against supply-side constraints e.g. production and transportation bottlenecks that are putting upward pressure on costs and wholesale prices for manufacturing goods and commodities (metals, agriculture, oil). I should acknowledge that the Bank's Agents have been very helpful in gathering intelligence on the ground.

Inflation jumped to 2.1% in May from 1.5% in April. Over the second half of the year, it can be expected to rise further, to more than 1pp above 2%, triggering a letter to the Chancellor.

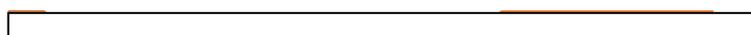
Now, the two main drivers of the expected rise of inflation mechanically push up on the measured annual inflation rate:

- Base effects. The sharp decline of prices at the onset of the pandemic arithmetically lifts the calculation of the annual inflation rate a year later. This is illustrated in the chart below. Assume a price level of 100 in January 2020. The pandemic hits and the economy shuts down, causing the price level to fall from 100 to 75 in March 2020. That translates into a fall in the annual rate of inflation from 0% to -25%. Assume no further shock to the price level. In the chart the price level remains constant at the lower level of 75. But in March 2021, the rate of inflation mechanically picks up from -25% to 0%, as the price level of 75 in March 2021 is now compared to its level of 75 in March 2020.

Base effects



Jan-20 Apr-20 Jul-20 Oct-20 Jan-21
 Apr-21 Jul-21



	40
120	20
100	0
80	-20
60	-40

- Energy. Energy price inflation, which has been affected by base effects, will be exacerbated by the recent rise of energy prices that is expected to continue into the autumn with fuel and utility price increases. Ignoring the indirect impacts of energy prices on other firms' costs, a 10% rise in wholesale prices typically lifts inflation by around 0.2pp after a couple of quarters. The pass-through of oil prices in particular tends to be a bit faster, with a 10% rise pushing up by about 0.1pp on CPI inflation after a couple of months. Here, prices fell to less than \$15 a barrel last year and have since recovered to above pre-pandemic levels, at about \$70-75 a barrel.

Beyond these effects, we should also expect increases in non-energy relative prices, indicative of the uneven pace of recovery in supply and demand. In particular, the wholesale non-energy price inflation seen to date has not yet translated into a sharp increase in consumer retail prices, as pass-through typically takes a little longer. Related to this for example, a 1% rise in non-fuel imported costs would boost inflation by about 0.1-0.2pp after a year, with pass-through lingering for 3-4 years.

It is reassuring that so far, inflation expectations have remained well anchored, but they require close monitoring. The gyrations in headline inflation have made it hard to disentangle signal from noise to get a read on spare capacity in the economy. The usual metrics of slack are harder to read than following a standard recession, reflecting the sudden-stop that afflicted the economy and the nature and scope of the government's policy response to it:

- The furlough scheme has affected the nature of the labour-market adjustment. Unemployment has risen but not nearly as much as the collapse of GDP would have implied based on historical relationships, as furloughed workers have remained in the official employment statistics, with spare capacity manifesting most visibly as a sharp fall in average hours worked.
- The proportion of private-sector workers still on full or partial furlough (5% or around 1¼ million according to the ONS BICS in late June) suggests there is still plenty of spare capacity in the labour market, with the prospect of their reabsorption into employment when the furlough scheme expires in September. But at the same time vacancy rates are back to above pre-pandemic levels. Does that mean mismatch has risen? The chart below shows an industry mismatch indicator following Sahin et al (2014). After rising sharply at the onset of the pandemic, mismatch has fallen back in the more recent data, although it remained above pre-pandemic levels as of April. More timely indicators suggest it has declined further since then. Thus at time of writing, I do not see mismatch as a problem.



To me downside risks are still prevalent for two reasons:

- The sharp increase in Delta variant cases, though it has not translated into commensurate hospitalisation or death rates, could adversely affect consumer behaviour
- We have little visibility yet on how the ongoing phasing out of the government’s furlough scheme by the end of the summer will affect firm and household behaviour.

7. The MPC’s current policy guidance is that it “does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.” What evidence are you personally looking for before considering a vote to tighten policy?

The primacy of achieving the 2% inflation target sustainably needs to be considered alongside the MPC’s secondary objective of sustaining growth and employment. At this stage of the recovery, we still have some way to go to get back to pre-pandemic levels. The GDP shortfall is still about 4.5%, many workers remain on furlough, and we will learn before year-end about the extent to which they return to their pre-pandemic jobs, swell the ranks of the unemployed or leave the workforce altogether.

It is difficult to gauge the sustainability of the ongoing rise of inflation, but the signs so far is that it has reflected temporary factors. Since the onset of the pandemic, CPI inflation has been volatile, falling from 1.7% in February 2020 to a low of 0.2% in August 2020 before recovering to 1.5% in April 2021 and jumping to 2.1% in May 2021, just above the target. It is likely to exceed 3% in the autumn.

The expected deviation of more than 1pp above the target by year-end largely reflects a combination of the base effects related to the collapse of energy prices in March 2020 when the lockdowns came into effect, and the ongoing recovery of fuel and utility prices.

But we can also expect the rise in input costs and wholesale prices to feed through to higher non-energy consumer price inflation in the coming months, although it is difficult to gauge how sustainable that might be. I see those rising cost and price pressures as relative-price effects that reflect changes in relative demand as the economy re-opens and I expect them to be transitory.

During the pandemic, as the lockdown came into effect, consumer spending patterns changed dramatically. Consumers stopped spending on services such as restaurants,

entertainment and travel, and switched to goods, such as furniture, home improvements and fitness equipment. As restrictions are lifted, we have seen and can expect to continue to see a shift from the demand for goods to services. But instantaneously meeting a surge of demand for eating out – the number of UK seated diners has averaged 40% above the equivalent 2019 levels since the reopening of indoor hospitality on 17 May – can be difficult for restaurateurs, as they bring back employees from furlough. Anecdotal evidence suggests that increased hiring, Brexit, pandemic-related uncertainty and the furlough scheme have all weighed on available candidate numbers. Added to this, new ONS data suggests that the working-age population grew at just 0.2% in the year to 2020 Q4, its slowest rate of growth since the early 1990s.

The short-term lags in the recovery of supply relative to demand are temporary, but they do lead to price rises. I am inclined to look through such cost shocks, unless they give rise to sustainable second-round effects on underlying inflation. There is so far little evidence of such second-round effects: medium-term inflation expectations have remained well-anchored, from surveys of households, businesses and professional forecasters to financial market measures. This does not invite complacency and calls for close monitoring. Overall my inclination is not to tighten policy prematurely, while the recovery is still fragile, so long as there are no second-round effects.

As proximate indicators of the sustainability of inflation pressures, I continue to monitor various metrics of spare capacity, though these have been more difficult to interpret than during standard economic cycles.

Recall before the pandemic the MPC used a range of statistical filters when assessing the supply capacity of the economy. These often use well-established macroeconomic relationships between GDP, unemployment, and domestic inflation to separate changes in actual output into a trend and a cyclical component, the latter being an indicator of spare capacity. Over the past year, a number of Covid-related factors have altered these relationships, making these models difficult to use at present. Because of this, monitoring other quantity and price indicators of spare capacity has taken on more importance.

Supply fell sharply alongside demand at the onset of the pandemic, as mandatory and voluntary restrictions kept people at home, businesses shut and workers furloughed. But working from home has meant we discovered inputs – “home” capital – we didn’t know about. By repurposing homes into offices, enabled by digital connectivity, working from home allowed workers to continue to produce, preventing a much sharper collapse of activity. The business closures and furloughing were a temporary reduction in the supply capacity of the economy, and as the economy has reopened with the lifting of restrictions, demand has picked up and supply is recovering too. Businesses have reopened, with 89% currently trading according to the 8 July BICS survey – the highest proportion since comparable estimates began in June 2020. And the proportion of the private-sector workforce on furlough fell to 5% in late June 2021, its lowest level since the scheme began. My own estimates of the damage to the supply capacity of the economy suggest there has been little or possibly no scarring to supply in the medium-term, as previously described.

In the near term, I rely on several quantity metrics to assess the evolution of spare capacity and inform my thinking on the likely course of inflation. These are hard to gauge but they do point to some spare capacity at the moment:

- The unemployment rate has risen by just under 1 percentage point since February 2020. The degree of downward pressure exerted on wages by higher unemployment depends on how it evolves relative to the medium-term equilibrium rate of unemployment. But it is fair to say that most of the rise in unemployment to date represents an increase in slack or spare capacity.
 - Indeed the rise would have been higher without the furlough scheme, which has masked the opening up of spare capacity in average and total hours worked. The

juxtaposition of high vacancy rates and relatively high furlough rates in some sectors does point to some mismatch between the demand and supply of labour, and thus limited spare capacity.

- Various data also suggest that slack in the labour market is greater than suggested by the unemployment rate alone.
 - Experimental data from the LFS suggest that around 10% of furloughed workers have been seeking work and therefore represent a form of labour-market slack.
 - There has also been a significant rise in the number of people recorded as inactive. These people represent a form of slack to the extent that firms take them into account when setting wages.
 - There are signs of spare capacity amongst those that remain in work. There has been a rise in the proportion of part-time workers that have been unable to find a full-time job, as well as a rise in the proportion of temporary workers who cannot find a permanent job.

While most survey measures suggest that there is some slack within firms, these indicators are difficult to interpret at present.

- They might overstate the degree of slack that is relevant for thinking about near-term inflationary pressures. Some of the surveys measure firms' operations relative to 'normal' capacity, and so might be comparing their output to a period without restrictions on activity. Similarly, Agency intelligence suggests that companies often include furloughed workers when thinking about their spare capacity.

Price-based indicators can also provide signals regarding the level of spare capacity in the economy. They require close monitoring at the moment given their recent acceleration:

- Official measures of average wages have risen strongly in recent months and are now above pre-pandemic levels. However, getting a clear read on wage inflation has been made difficult by the opposing effects of:
 - The impact of the furlough scheme, which has weighed down on average pay as furloughed employees perceive less than their whole pay
 - The changing composition of employment during the pandemic: job losses were concentrated in lower-pay/lower-productivity sectors, mechanically lifting measured wage inflation by 2-3pp.
- Bank staff estimate that the compositional effects have outweighed the impact of furlough in recent months, such that measured wage inflation has been higher than underlying wage pressures. Now, the signal from average wages will be even harder to extract in coming months as annual wage growth could rise to around 7% on the back of base effects, since wages fell sharply in 2020 Q2. That said, we can get a sense of underlying wage inflation from the Bank's Agents. Their contacts report sporadic rather than general pay pressure, and private-sector pay settlements have been quite modest, in the 1½ to 2½ % range.
- Finally, core inflation, which strips headline inflation of food, beverages, alcohol and energy prices, touched 2% in May and is expected to remain close to target in 2021 H2. Core services inflation, which focuses on a subset of the CPI basket that is largely domestically produced and is therefore less affected by movements in the exchange rate, can be particularly useful for gauging domestic inflationary pressure. It rose to 1.9% in May and is expected to pick up further in the second half of the year.

I will continue to monitor closely real-time indicators of the economy, including the suite of ONS fast indicators.

8. Do you think that the MPC has effective tools to stimulate the economy further at present? By how much will the option of a negative Bank Rate increase policy space?

According to our latest projections, the economic outlook does not warrant additional monetary stimulus at present. Of course this might change in the future depending on the evolution of the economy. But this could go either way. And as we have seen over the past decade we have a range of monetary policy tools at our disposal.

At the onset of the pandemic, the MPC lowered Bank rate to 0.1% in March 2020 and it has increased the target stock of asset purchases to £895bn, including the ongoing round of £150bn of purchases that is expected to continue until around the end of 2021.

However, should market functioning worsen materially again, we stand ready to increase the pace of purchases to ensure the effective transmission of monetary policy. There is scope to re-evaluate the existing technical parameters of the programme to create more headroom for asset purchases if necessary in future. Forward guidance also remains another tool in our arsenal.

In the August 2020 *MPR*, we explained that negative interest rates should form part of the toolkit. Following this, in February 2021 we agreed to request that the PRA engage with PRA-regulated firms to ensure they start preparations to be ready to implement a negative Bank Rate at any point after six months.

The policy space created by a negative policy rate depends, in part, on the structure of the financial system and how the policy transmits through banks to the interest rates facing households and firms. It also depends on the financial and economic conditions at the time.

A key factor in the efficacy of a negative policy rate is the level of the “reversal rate”. This is the level below which a Bank Rate cut would contract lending rather than increase it.

A key determinant of the reversal rate is how a negative interest rate affects a bank’s net interest income. In normal times, one channel through which cutting Bank Rate boosts economic activity is by reducing lending rates and so increasing bank lending. When Bank Rate is low, a cut might hurt the profitability of commercial banks. Rates on loans should go down with Bank Rate but rates on deposits might not go down by as much if banks are unable to charge negative deposit rates – for instance because depositors can just switch to cash. This reduces a bank’s net interest margin and net interest income. And if their profitability goes down, banks might be less able or willing to pass the reduction in Bank Rate through to loan rates or they may reduce lending to maintain their margins.

Studies of countries that have set negative policy rates find that many aspects of the monetary policy transmission mechanism functioned roughly as normal. They typically see positive and often strong pass-through to lending rates. This is despite interest rates on households’ bank deposits tending not to go below zero. However there is not a perfect read across when comparing international experience to the UK. Pass-through of any interest rate cut to below zero is likely to depend on the structure of the financial system, as well as the prevailing economic and financial conditions.

While a negative interest rate might squeeze banks’ income via lower net interest margins, it can also provide a boost to the value of banks’ fixed income assets held on their trading book. If realised, these gains can temporarily mitigate the potential decline in net interest income caused by a negative interest rate. This is temporary though as these valuation gains are just a one-off boost to profits.

Where the reversal rate is located is very much uncertain. Brunnermeier and Koby (2019) focus on the bank lending channel and find a reversal rate of -1% for the euro area. However, in this context, I find it interesting to note that no central bank currently using negative rates has cut the policy rate to an even lower level during the pandemic. When looking at the international evidence, it's also worth bearing in mind that the reversal rate is likely to vary across time and jurisdictions. For instance, the reversal rate might be higher in countries like the UK where commercial banks are more reliant on deposit funding than in the Euro Area. The reversal rate might also be higher in circumstances where commercial banks' profitability and capitalisation are already under pressure from other negative shocks. Based on the existing literature and recent international experience, it seems that in practice the reversal rate is likely to be a small negative.

9. What is your view on whether the MPC should prioritise a withdrawal of quantitative easing or an increase in Bank Rate when it decides to tighten monetary policy?

In June 2018 the MPC said the Bank's balance sheet would be unwound at a gradual and predictable pace once Bank Rate had risen to a level of 1.5%. At the MPC's February 2021 meeting, we asked staff to reconsider this guidance, stressing it did not hold any signal about any change to the stance of monetary policy.

We are currently reviewing our framework for tightening monetary policy were tightening judged appropriate. That framework will consider a withdrawal of quantitative easing and the path for Bank Rate jointly, as Bank Rate and the stock (and in some cases the flow) of assets on the Bank's balance sheet determine the overall stance of policy.

As I explained in previous speeches, I favour a risk-management approach to monetary policy. This has two implications for my approach to tightening:

- 1) I am of the view that a withdrawal of quantitative easing should be gradual and predictable, so long as that remains consistent with achieving the inflation target. The effects of asset purchases on the economy depend on economic conditions. We can expect the channels through which balance-sheet unwind affects the economy to be state-contingent too. There is uncertainty regarding the magnitude of the macro-economic effects of balance-sheet unwind, which we have not implemented before.
- 2) I currently somewhat favour raising Bank Rate first and withdrawing quantitative easing later, to create sufficient headroom to be in a position to lower Bank Rate in case the QE withdrawal became unintentionally contractionary.

The additional policy space created by the operational feasibility of a negative Bank Rate means we are in a position to consider lowering the threshold for Bank Rate from the 1.5% in our 2018 guidance, before the unwind is implemented.

The Treasury Committee will publish your answers to this questionnaire. Please provide a full CV when returning this questionnaire.