



BANK OF ENGLAND

Monetary Policy Committee



Monetary Policy Report

February 2021





BANK OF ENGLAND

Monetary Policy Report

February 2021

Monetary policy at the Bank of England

The objectives of monetary policy

The Bank's Monetary Policy Committee (MPC) sets monetary policy to keep inflation low and stable, which supports growth and jobs. Subject to maintaining price stability, the MPC is also required to support the Government's economic policy.

The Government has set the MPC a target for the 12-month increase in the Consumer Prices Index of 2%.

The 2% inflation target is symmetric and applies at all times.

The MPC's remit recognises, however, that the actual inflation rate will depart from its target as a result of shocks and disturbances, and that attempts to keep inflation at target in these circumstances may cause undesirable volatility in output. In exceptional circumstances, the appropriate horizon for returning inflation to target can vary. The MPC will communicate how and when it intends to return inflation to the target.

The instruments of monetary policy

The MPC currently uses two main monetary policy tools. First, we set the interest rate that banks and building societies earn on deposits, or 'reserves', placed with the Bank of England – this is Bank Rate. Second, we can buy government and corporate bonds, financed by the issuance of central bank reserves – this is asset purchases or quantitative easing.

The *Monetary Policy Report*

The MPC is committed to clear, transparent communication. The *Monetary Policy Report (MPR)* is a key part of that. It allows the MPC to share its thinking and explain the reasons for its decisions.

The *Report* is produced quarterly by Bank staff under the guidance of the members of the MPC.

This *Report* has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

The Monetary Policy Committee

Andrew Bailey, Chair
Ben Broadbent
Jon Cunliffe
Andrew Haldane
Jonathan Haskel

Dave Ramsden
Michael Saunders
Silvana Tenreyro
Gertjan Vlieghe



PowerPoint™ versions of the *Monetary Policy Report* charts and Excel spreadsheets of the data underlying most of them are available at www.bankofengland.co.uk/monetary-policy-report/2021/february-2021

Contents

Monetary Policy Summary	i
<hr/>	
1: The economic outlook	1
<hr/>	
1.1: Recent developments	1
1.2: The MPC's projections	2
1.3: Key judgements and risks	7
1.4: Constant rates	10
Box A: Monetary policy since the November 2020 <i>Report</i>	12
2: Current economic conditions	13
<hr/>	
2.1: The global economy	14
2.2: Financial markets and credit conditions	16
2.3: Demand and output	20
2.4: The labour market	23
2.5: Inflation	25
Box B: Explaining cross-country differences in GDP growth over the pandemic	27
Box C: Agents' update on business conditions	29
3: In focus – The potential impact of Covid vaccines on spending	32
<hr/>	
3.1: The potential impact of Covid vaccines on household spending	33
3.2: The potential impact of Covid vaccines on business investment	37
3.3: The impact of Covid vaccines on the MPC's projections	38
4: In focus – How has Covid affected inflation?	39
<hr/>	
4.1: How has inflation evolved since the start of the pandemic?	39
4.2: How has Covid affected underlying inflation?	41
4.3: What is the outlook for inflation?	44
Annex: Other forecasters' expectations	45
<hr/>	
Glossary and other information	46

Monetary Policy Summary

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 3 February 2021, the Committee judged that the existing stance of monetary policy remains appropriate. The MPC voted unanimously to maintain Bank Rate at 0.1%. The Committee voted unanimously for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted unanimously for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion.

The Committee's projections for activity and inflation are set out in the accompanying February *Monetary Policy Report*. Covid-19 (Covid) vaccination programmes are under way in a number of countries, including the United Kingdom, which has improved the economic outlook. Nevertheless, recent UK and global activity has been affected by an increase in Covid cases, including from newly identified strains of the virus, and the associated reimposition of restrictions. The United Kingdom and European Union also announced a trade agreement, which has applied since 1 January 2021.

Global GDP growth slowed in 2020 Q4, as a rise in Covid cases and consequent restrictions to contain the spread of the virus weighed on economic activity. Since the MPC's previous meeting, financial markets have remained resilient.

UK GDP is expected to have risen a little in 2020 Q4 to a level around 8% lower than in 2019 Q4. This is materially stronger than expected in the November *Report*. While the scale and breadth of the Covid restrictions in place at present mean that they are expected to affect activity more than those in 2020 Q4, their impact is not expected to be as severe as in 2020 Q2, during the United Kingdom's first lockdown. GDP is expected to fall by around 4% in 2021 Q1, in contrast to expectations of a rise in the November *Report*.

Labour market indicators remain difficult to interpret. The LFS unemployment rate rose to 5.0% in the three months to November, but other indicators suggest that labour market slack has remained higher than implied by this measure. The Government's employment support schemes are likely to limit significantly the immediate rise in unemployment. A further increase in unemployment is projected over the next few quarters. Average weekly earnings growth has been notably stronger than expected in the November *Report*, although this may overstate underlying pay growth.

GDP is projected to recover rapidly towards pre-Covid levels over 2021, as the vaccination programme is assumed to lead to an easing of Covid-related restrictions and people's health concerns. Projected activity is also supported by the substantial fiscal and monetary policy actions already announced. Further out, the pace of GDP growth slows as the boost from these factors fades. Spare capacity in the economy is eliminated as activity picks up during 2021.

Twelve-month CPI inflation rose from 0.3% in November to 0.6% in December. The weakness of recent outturns largely reflects the direct and indirect effects of Covid on the economy. CPI inflation is expected to rise quite sharply towards the 2% target in the spring, as the reduction in VAT for certain services comes to an end and given developments in energy prices. In the MPC's central projection, conditioned on the market path for interest rates, CPI inflation is projected to be close to 2% over the second and third years of the forecast period.

The outlook for the economy remains unusually uncertain. It depends on the evolution of the pandemic, measures taken to protect public health, and how households, businesses and financial markets respond to these developments.

The MPC will continue to monitor the situation closely. If the outlook for inflation weakens, the Committee stands ready to take whatever additional action is necessary to achieve its remit. The Committee 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.

At this meeting, the Committee judged that the existing stance of monetary policy remains appropriate.

1: The economic outlook

Covid-19 (Covid) and the actions to contain it have continued to have a dramatic and rapidly changing impact on the UK and countries around the world. Since the *November Report*, Covid vaccination programmes have begun in a number of countries, including the UK, which have improved the economic outlook. Nevertheless, recent UK and global activity has been affected by an increase in Covid cases, including from newly identified strains of the virus, and the associated reimposition of restrictions.

The economic outlook continues to be unusually uncertain. It will depend on the evolution of the pandemic and measures taken to protect public health around the world. It will also depend on the responses of households, businesses and financial markets to those developments.

The Monetary Policy Committee's (MPC's) forecasts assume that Covid-related restrictions and people's health concerns weigh on activity in the near term, but that the vaccination programme leads to those easing, such that GDP is projected to recover strongly over 2021 towards pre-Covid levels. Projected activity is also supported by the substantial fiscal and monetary policy actions already announced. Further out, the pace of GDP growth slows as the boost from those factors fades.

The fall in activity over the past year has reflected a decline in both demand and supply. Overall, there is judged to be a material amount of spare capacity in the economy at present. This is eliminated as GDP picks up during 2021.

CPI inflation is currently below the MPC's 2% target, largely reflecting the direct and indirect effects of Covid-19. As temporary effects fade and the impact of spare capacity diminishes over 2021, inflation rises towards the target. In the central projection, conditioned on the market path for interest rates, inflation is projected to be close to 2% over the rest of the forecast period.

1.1: Recent developments

Global and UK GDP growth slowed in 2020 Q4, although UK activity was higher than projected in the November Report.

Global and UK GDP both picked up sharply during Q3, but growth slowed in Q4 as Covid cases rose and restrictions to control the spread of the virus were tightened (Section 2). Bank staff estimate that, in 2020 Q4, UK-weighted world GDP fell a little to around 4% lower than in 2019 Q4. That is somewhat weaker than was projected in the *November Report*, largely reflecting the impact of tighter restrictions on activity, especially in the euro area.

While UK GDP growth also slowed in Q4, activity is projected to have risen a little, to around 8% below its 2019 Q4 level. That is materially stronger than the contraction in GDP that was previously expected, with activity less affected by Covid-related restrictions than had been anticipated, including as more businesses appeared to be better prepared to continue operating than during the first lockdown.

Covid vaccination programmes have improved the economic outlook, but Covid-related restrictions at the start of 2021 are tighter than was assumed in the November Report.

Since the November *Report*, Covid vaccines have been approved for use and vaccination programmes have begun in a number of countries around the world. That should both boost activity in future and reduce downside risks to the economic outlook. Nonetheless, recent activity has been affected by increases in Covid cases, including from newly identified strains of the virus. In many countries, Covid-related restrictions have been tighter in early 2021 Q1 than was assumed in the November *Report*. As a result, UK-weighted world GDP is projected to be somewhat weaker than previously expected. It is expected to be broadly flat in Q1, with a projected fall in GDP in the euro area offset by increases in activity in the US, China, and emerging market economies.

UK GDP is expected to fall by 4% in 2021 Q1.

In the UK, restrictions have been tightened materially to help contain the spread of cases resulting from a new strain of Covid, and are much stricter than was assumed in the November *Report*. As a result, UK GDP is expected to fall in 2021 Q1, and to be weaker than projected three months ago. That is consistent with initial evidence from high-frequency measures of economic activity – for example, spending on cards and indicators of travel have declined in recent weeks. Taking the extent of restrictions and early evidence of their effects together, UK GDP is expected to fall by around 4% in Q1, to about 12% below its 2019 Q4 level. While the widespread nature of the restrictions in place at present means that they are expected to affect activity more than those in Q4, their impact is not expected to be as severe as in 2020 Q2, during the first lockdown in the UK. Consistent with that, the proportion of businesses that paused trading rose in January, but was at a broadly similar level to that in June ([Chart 2.17](#)), by which time GDP had recovered over a third of the way from its April trough.

While Covid-related restrictions have reduced both demand and supply, overall there is judged to be a material amount of spare capacity in the economy.

While Covid-related restrictions have reduced supply as well as demand – as some businesses have been required to close, for example – there appears to be a material amount of spare capacity in the economy at present. Although the Government’s job retention scheme has attenuated the number of job losses very substantially, unemployment has risen, and is expected to rise further in Q1. There may also be some spare capacity within companies, with some capital – such as buildings and machinery – not being fully utilised.

Inflation has been below the MPC’s 2% target, reflecting the direct and indirect effects of Covid.

CPI inflation was well below the MPC’s target at 0.5% in Q4, broadly in line with the November projection. Spare capacity is likely to have dampened inflationary pressures, although much of the weakness of inflation reflects the impact of a number of specific Covid-related temporary factors, particularly falls in energy prices and the Government’s cut to VAT for certain services. Those factors are expected to continue to weigh on inflation in Q1 before dissipating later in 2021.

1.2: The MPC’s projections

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

	Projections			
	2021 Q1	2022 Q1	2023 Q1	2024 Q1
GDP ^(c)	-9.2 (-6.5)	14.2 (10.0)	1.3 (2.1)	1.3
CPI inflation ^(d)	0.8 (0.7)	2.1 (2.1)	2.1 (2.0)	2.0
LFS unemployment rate	5.5 (6.7)	5.7 (6.1)	5.0 (4.7)	4.5
Excess supply/Excess demand ^(e)	-1 (-2)	+¼ (0)	+¼ (+¼)	0
Bank Rate ^(f)	0.1 (0.0)	-0.1 (-0.1)	-0.1 (-0.1)	0.0

(a) Modal projections for GDP, CPI inflation, LFS unemployment and excess supply/excess demand. Figures in parentheses show the corresponding projections in the November 2020 *Monetary Policy Report*.

(b) Unless otherwise stated, the projections shown in this section are conditioned on: Bank Rate following a path implied by market yields; the Term Funding Scheme and Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises; the Recommendations of the Financial Policy Committee and the current regulatory plans of the Prudential Regulation Authority; the Office for Budget Responsibility’s assessment of the Government’s tax and spending plans as set out in *Spending Review 2020*, updated to incorporate policy announcements made up to 4 January 2021; commodity prices following market paths for two quarters, then held flat; the sterling exchange rate remaining broadly flat; and the prevailing prices of a broad range of other assets, which embody market expectations of the future stocks of purchased gilts and corporate bonds. The main assumptions are set out in the ‘Download the chart slides and data’ link at [Monetary Policy Report – February 2021](#).

(c) Four-quarter growth in real GDP. The growth rates reported in the table exclude the backcast for GDP. Including the backcast 2021 Q1 growth is -9.2%, 2022 Q1 growth is 14.2%, 2023 Q1 growth is 1.3% and 2024 Q1 growth is 1.3%.

(d) Four-quarter inflation rate.

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

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

The MPC's projections assume that Covid-related restrictions continue to weigh on spending in the near term, before easing as vaccination programmes continue.

The outlook for the economy remains highly uncertain. It is dependent on the evolution of the pandemic and the measures taken to protect public health. It will also depend on how governments, households, businesses and financial markets respond to those developments.

The MPC's projections are conditioned on an assumption that Covid restrictions weigh materially on UK and global activity in the near term. At present, all areas of the UK are subject to strict measures to control the spread of the virus, and restrictions are in place in many countries across the world. The MPC's forecasts assume that the restrictions in effect in the UK as of 27 January remain in place throughout 2021 Q1. Elsewhere in the world, restrictions are also generally assumed to remain close to their currently prevailing levels in Q1. In the euro area, average restrictions are assumed to remain somewhat looser than in the UK, although they are tighter than those assumed to be in place in the US.

Vaccination programmes are assumed to enable restrictions to be eased. In the MPC's central projections, restrictions on economic activity in the UK are assumed to ease over Q2 and Q3, and to have unwound fully by the end of the third quarter. While in place, restrictions weigh on activity directly. Covid is also assumed to affect spending via its impact on people's health concerns and uncertainty about the outlook. For example, in the January 2021 Bank/Ipsos MORI survey, over a quarter of people reported that they expected to spend less once restrictions have been lifted than before the pandemic began because they were cautious about going out. The impact of health concerns on spending is assumed to fade over 2021.

Government measures support spending in the near term.

Government support measures are assumed to evolve in line with announced policies. Employment and incomes will be supported by the extension of the Coronavirus Job Retention Scheme (CJRS) until the end of April.⁽¹⁾ Over Q1, around 4½ million employees are assumed to be furloughed, on average. As job support schemes are unwound, and as activity recovers, most workers are judged likely to return to work, although some jobs are likely to be lost.

In its *Spending Review 2020*, the Government announced significant additional spending measures which boost UK GDP materially over the first half of the forecast period, with a peak estimated impact of around 1% of the level of GDP in 2021 Q2. The increases in spending are time limited and targeted at Covid, such that their impact wanes over time.

New trading arrangements with the EU have applied since 1 January 2021; their economic impact is expected to be very similar to that underlying recent MPC projections.

The UK and EU agreed a new trading relationship – the Trade and Co-operation Agreement – on 24 December 2020 and it has been applied since 1 January 2021. The main features of the new agreement are similar to the assumptions made in the November 2020 and earlier *Monetary Policy Reports*. The economic effects of the agreement have been estimated using similar methodologies to those set out in previous Bank documents, including its November 2018 publication, *EU withdrawal scenarios and monetary and financial stability*. As a consequence, the economic effects of the new trading relationship are very similar to those underlying recent MPC projections, as set out in Box 1 of the *November 2019 Report*, for example.

The new trading arrangement (key features shown in **Table 1.B**) will result in barriers to trade, some of which are now in place. For example, customs, rules of origin and regulatory checks have raised administrative costs for firms engaging in goods trade and some cross-border provision of services is no longer possible. Other trade frictions – such as a divergence in regulatory standards – are likely to emerge over time. As a result of these barriers, trade between the UK and EU in both goods and services is likely to be lower than it would have been.

(1) The Government has announced that the CJRS has been extended until 30 April 2021, with the UK Government paying 80% of employees' usual wages for the hours not worked, up to a cap of £2,500 per month.

Table 1.B: Key features of the Trade and Co-operation Agreement

Trading arrangements with the EU

Goods	<p>No tariffs or quantitative restrictions for UK and EU goods, subject to rules of origin.</p> <p>Customs and some regulatory checks between the UK and EU have been introduced.</p> <p>No prohibition to divergence in regulatory standards.</p>
Services	<p>Regulatory barriers restrict cross-border trade in some sectors, for example in audio-visual and legal services.</p> <p>Cross-border financial services can no longer be provided through EU passporting arrangements.</p> <p>No right for UK workers to work in the EU on a permanent basis but short-term business visitors can spend 90 days in any 180-day period in the EU.</p> <p>No prohibition to divergence in regulatory standards.</p>

The effects of the agreement have been estimated using models and empirical relationships similar to those set out in *EU withdrawal scenarios and monetary and financial stability*. Based on these, and in comparison to a frictionless arrangement, UK trade is projected to be around 10½% lower in the long run under the new agreement, and productivity and GDP around 3¼% lower. In the MPC's projections, around two thirds of the impact on GDP would have been felt by the end of the forecast period. The estimates are very similar to those underlying recent MPC projections and there remains a large degree of uncertainty around them.

The adjustment to the introduction of new trading arrangements is expected to weigh on trade and activity in early 2021.

In the November *Report*, the MPC judged that the adjustment to new trading arrangements with the EU was also likely to lead to an additional adverse temporary effect on trade in the first quarters of 2021. Since that *Report*, some survey evidence suggested that preparedness for new trading arrangements had increased ahead of the end of the transition period, but generally continued to suggest that a significant minority of businesses were unlikely to have been fully prepared. Reflecting this, and uncertainty about whether tariffs would be applicable on UK-EU trade, some firms increased their stockholdings ahead of the end of the transition period. Available indicators and intelligence from contacts suggest that freight volumes have been subdued since the beginning of the year, even taking into account the seasonal pattern of trade in January. That could reflect firms using stocks they had built up, or a reduction in demand due to Covid-related factors. But it may also reflect some firms losing export orders, or choosing not to trade on account of potential delays at the border, or as they prepare the necessary new documentation. Companies in some sectors reported that new requirements at the border had also resulted in disruption to trade. At the same time, there had been a sharp rise in some shipping costs, which appeared to reflect a pickup in demand for shipping containers alongside a lack of availability of those containers in some parts of the world.

In its February forecasts, the MPC has retained its assumption that trade and activity will be lower in the first half of 2021 as firms adjust to the introduction of new UK-EU trading arrangements. The reduction in exports and the impact on domestic supply chains is projected to lower GDP by around 1% in 2021 Q1. That is assumed to reflect a reduction in demand as well as supply. These additional effects on trade are assumed to dissipate by the end of Q2.

Monetary policy boosts demand over the forecast period.

The MPC's projections are conditioned on the market path for interest rates, which is close to zero over the forecast period (Table 1.A). They are also conditioned on the prevailing prices of a broad range of assets, which embody market expectations of the future stocks of purchased assets.

Risky asset prices have risen since November, in part given positive news about Covid vaccines.

Across advanced economies, non-financial corporate bond spreads have fallen and equity prices have increased sharply over the past few months, as risk sentiment has been boosted, particularly by positive vaccine news. As a result, UK financial conditions have loosened somewhat. The sterling exchange rate has appreciated by around 2% relative to the November *Report*, while UK credit conditions are little changed, in aggregate.

Global GDP

Global GDP picks up substantially over 2021 as Covid vaccination programmes continue.

UK-weighted world GDP is projected to be broadly flat in 2021 Q1, as Covid-related restrictions continue to weigh on activity, before picking up over subsequent quarters as they ease. The recovery in global GDP continues to be supported by policy measures. Activity in the US is projected to recover relatively quickly, reflecting the comparatively

rapid vaccination programme that is in prospect, as well as the impact of fiscal stimulus. In the euro area, activity is expected to be reduced by tighter restrictions at the start of the year and is projected to recover to pre-Covid levels a little later, partly reflecting the comparatively slower start to the vaccination programme.

Taken together, UK-weighted world GDP picks up materially over 2021. Some longer-lasting effects dampen output over the forecast period, however. For example, weaker business investment is likely to weigh on the growth of the capital stock and reduce productivity growth. Unemployment is expected to remain elevated relative to levels before the pandemic. In the central forecast, UK-weighted world growth recovers to 4¾% in 2021, from -4¾% in 2020. It is 5% in 2022 and 2¼% in 2023 (Table 1.C).

UK GDP

UK GDP also recovers materially as Covid-related restrictions are eased.

UK activity is expected to fall in Q1, mainly reflecting the impact of actions taken to help contain the spread of Covid. The initial adjustment to the UK and EU's new trading relationship temporarily lowers activity somewhat too. The vaccination programme means that Covid-related restrictions are assumed to ease from 2021 Q2, and, over time, concerns around health and uncertainty about the outlook fade (Key Judgement 1). As a result, GDP picks up strongly during 2021 (Chart 1.1). Consumer spending rises materially as restrictions ease, and as people's worries about the risks to their own and others' health dissipate, although they take a few quarters to fade fully. Consumption is supported by households running down around 5% of the additional savings they have accumulated in aggregate while spending on some activities has been restricted (Key Judgement 1). Business investment also rises as sales recover and uncertainty declines, albeit more slowly than consumer spending. The recovery in GDP is also supported by substantial growth in government spending. GDP is projected to reach its 2019 Q4 level by 2022 Q1.

In aggregate, Covid weighs on activity over 2021 as a whole by somewhat more than in the November projections. The vaccination programme enables the easing of restrictions and lowers concerns about the virus, such that the economic impact of Covid fades somewhat more rapidly than previously projected. However, that effect is outweighed by the impact of the tighter restrictions required to contain the spread of the virus, which weigh materially on GDP in the near term.

Over the second and third years of the forecast, GDP continues to grow, but the pace of growth slows (Chart 1.2). Over that period, the boosts to demand from easing health risks, reduced uncertainty and government spending fade.

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

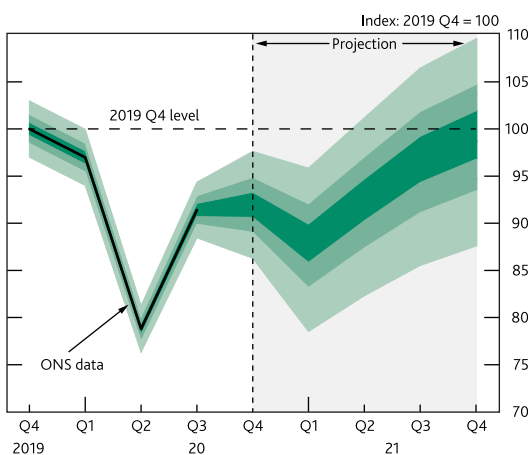
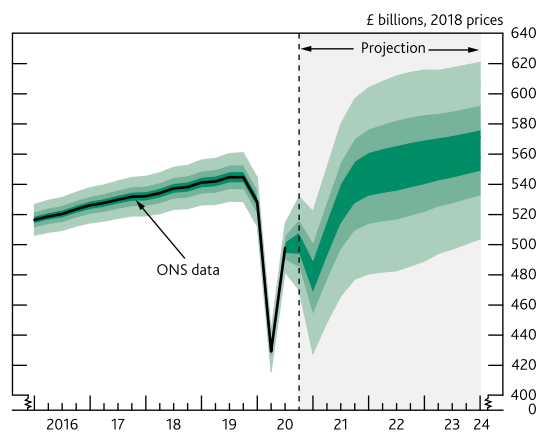


Chart 1.2: GDP projection based on market interest rate expectations, other policy measures as announced



The fan charts depict the probability of various outcomes for GDP. They have been conditioned on the assumptions in Table 1.A footnote (b). To the left of the vertical dashed line, the distribution reflects uncertainty around revisions to the data over the past. To aid comparability with the official data, it does not include the backcast for expected revisions, which is available from the 'Download the chart slides and data' link at [Monetary Policy Report – February 2021](#). To the right of the vertical line, the distribution reflects uncertainty over the evolution of GDP in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outcomes are also expected to lie within each pair of the lighter green areas on 30 occasions. In any particular quarter of the forecast period, GDP is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents.

The supply capacity of the economy is affected in the medium term by some longer-lasting scarring effects of Covid as well as the UK's withdrawal from the EU.

The pandemic and the measures taken to control its spread have affected sectors differently, and some resources are likely to need to move between sectors as a result. That reallocation is likely to reduce the supply capacity of the economy as it takes place (Key Judgement 2). In addition, lower investment could reduce innovation and weigh on the productive capacity of the economy over time. The UK's withdrawal from the EU is also projected to have a persistent effect on supply, as trade barriers result in lower cross-border trade, which in turn dampens investment and productivity growth.

Excess supply/demand

The MPC judges that there will remain a material degree of spare capacity in the economy in the very near term, which is eliminated as demand recovers.

Covid-related restrictions have reduced the supply capacity of the economy over the past year, although demand is judged to have declined by more, such that there is currently a material amount of spare capacity in the economy. Unemployment has risen, and is expected to rise further over the first half of 2021, as the job support scheme is assumed to unwind as currently set out in government plans. The unemployment rate is projected to peak at around 7¾% in the middle of 2021. It subsequently declines gradually over the forecast period (Chart 1.3). The recovery in spending leads to the elimination of spare capacity within companies, as some initially meet the rebound in demand by working their existing resources somewhat harder. The sharp rebound in spending over 2021 results in a small margin of excess demand emerging by the end of the year. Excess demand diminishes gradually over the third year of the forecast and by the end of the forecast period, conditioned on the assumptions outlined above, demand and supply are judged likely to be broadly in balance.

CPI inflation

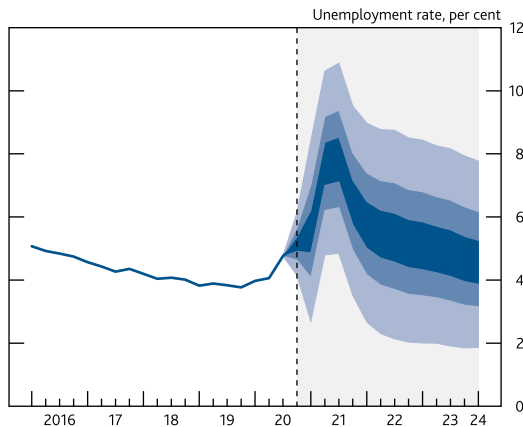
CPI inflation is projected to remain low in early 2021, but to return to around the 2% target as temporary effects fade and spare capacity is eroded.

The previous falls in energy prices and the impact of the cut to VAT for certain services which accounted for much of the fall in inflation over 2020 will continue to weigh on CPI inflation in Q1. As those effects drop out of the annual calculation over the rest of 2021, and recent rises in energy prices feed through to petrol and utility prices, inflation is projected to rise sharply towards the target (Chart 1.4). Over 2021, domestic price pressures are dampened by the influence of spare capacity (Key Judgement 3), although the MPC continues to judge that the impact of spare capacity on inflation will be a little less than usual in the near term while activity is particularly weak (see Section 4 of the [August 2020 Report](#)). The elimination of spare capacity means that domestic price pressures pick up over time. Conditioned on the market path for interest rates, CPI inflation is close to the 2% target over the second and third years of the forecast period.

Policy decision

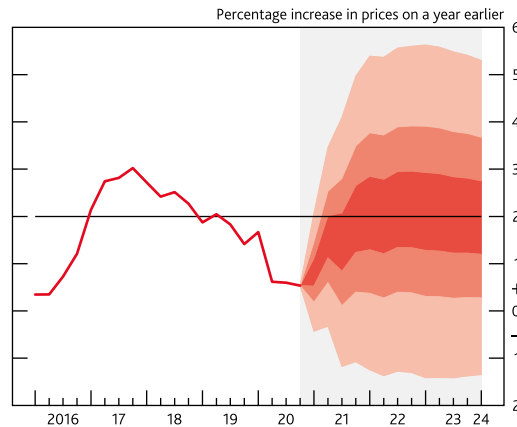
At its meeting ending on 3 February 2021, the MPC judged that the existing stance of monetary policy remained appropriate. The Committee voted to maintain Bank Rate at 0.1%. The Committee voted for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted for the Bank of England to continue with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion. The factors behind that decision are set out in the Monetary Policy Summary on pages i–ii of this Report and in more detail in the Minutes of the meeting.

Chart 1.3: Unemployment projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for LFS unemployment. It has been conditioned on the assumptions in Table 1.A footnote (b). The coloured bands have the same interpretation as in Charts 1.1 and 1.2, and portray 90% of the probability distribution. The calibration of this fan chart takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to unemployment in one quarter will continue to have some effect on unemployment in successive quarters. The fan begins in 2020 Q4, a quarter earlier than for CPI inflation. That is because Q4 is a staff projection for the unemployment rate, based in part on data for October and November. The unemployment rate was 5.0% in the three months to November, and is projected to be 5.1% in Q4 as a whole. A significant proportion of this distribution lies below Bank staff's current estimate of the long-term equilibrium unemployment rate. There is therefore uncertainty about the precise calibration of this fan chart.

Chart 1.4: CPI inflation projection based on market interest rate expectations, other policy measures as announced



The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumptions in Table 1.A footnote (b). If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outcomes of inflation are also expected to lie within each pair of the lighter red areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

1.3: Key judgements and risks

Key judgement 1: activity is weak in the near term, due largely to actions to help contain the spread of Covid, but spending recovers materially towards pre-Covid levels as the vaccination programme results in restrictions easing and uncertainty dissipating.

There is uncertainty around the evolution of the pandemic and the associated restrictions...

The MPC's central case projections for the UK are conditioned on an assumption that current Covid restrictions are in place until the end of 2021 Q1, before being eased over Q2 and Q3 as an increasing proportion of the population is vaccinated. In the rest of the world, the evolution of restrictions is assumed to differ across countries, although measures are generally assumed no longer to be in effect by late 2021. The uncertainty around how the pandemic might evolve – including the potential emergence of further new strains of the virus – and how government measures change in response, means that there are substantial risks around these assumptions. Different developments could have material effects on the paths of UK and global activity. As a result, the MPC judges that the outlooks for the UK and global economies continue to be unusually uncertain. Reflecting that, the MPC's forecast fan charts remain wider than usual, particularly in the near term. The MPC judges that the risks around activity from pandemic developments are to the downside, although less so than in the November *Report*, and the risks are judged to be broadly balanced by the end of the three-year forecast period.

...as well as how people respond to health concerns.

There is also a great deal of uncertainty about how households and companies continue to respond to the pandemic. Households' concerns about both their and others' health appear to be an important driver of their decisions to spend, particularly on social activities. For example, in 2020 Q4 spending on social activities in the UK appears to have remained well below its levels in 2019 Q4 even when restrictions on activity had been relatively light. The vaccination programme will substantially reduce the risks to people's health posed by Covid, although there is uncertainty about the speed at which people's concerns about their and others' health fade.

The MPC's projections assume that households' willingness to spend increases only a little in 2021 Q2, even as restrictions ease, before rising more rapidly in Q3. The impact of health concerns on spending is assumed to have dissipated by the end of the year. If concerns recede more quickly as those most at risk from Covid are vaccinated, consumer spending could increase more rapidly. Alternatively, some people could remain cautious about social

activities until vaccination is much more widespread and Covid cases have declined markedly, which could pose a downside risk to consumer spending.

Spending could recover more rapidly if those households with accumulated savings choose to run them down by more...

The evolution of consumer spending will also depend on the extent to which households' savings are run down over the forecast period. Over the past year, the fall in UK consumption has been large relative to the fall in household incomes, such that households in aggregate have increased their savings markedly (Section 3). For example, data on households' deposits suggests that between March and November 2020 consumers accumulated a stock of savings of over £125 billion in excess of what might otherwise have been the case, and that stock is likely to rise substantially further over the first half of 2021. The MPC's central projection assumes that households spend around 5% of these additional accumulated savings over the forecast period. That is broadly consistent with UK evidence on how much households tend to spend out of increases in their wealth. Recent evidence suggests that the majority of households do not expect to increase their spending relative to pre-pandemic levels once restrictions are lifted. For example, in a Bank/Ipsos MORI survey, just over 10% of households said that they expected to spend more at that point than before the pandemic began.

However, the current environment is clearly highly unusual historically, and there are reasons to think that households may choose to spend more of their recently accumulated savings. For example, much of these are likely to have been accumulated by households who have not been able to spend as usual, and so their savings at present might exceed materially their desired stock. As restrictions ease, they might be keen to catch up a higher amount of their previously forgone spending than would be suggested by past evidence. Moreover, a large proportion of the higher-than-usual stock of savings is in liquid bank deposits, of which households have tended to spend more historically. As a result, the MPC judges that the risks to spending from households' saving behaviour are skewed to the upside.

...although other households who have not built a buffer of savings might want to do so for precautionary reasons, which could weigh on spending.

The recent rise in savings has not been equally distributed across households, however. Survey evidence suggests that much of the recently accumulated savings has accrued to those who already have sizable savings, have higher incomes, and are older. Such households tend to be less likely to spend from savings. And other households that have not accumulated a buffer of savings might aim to do so, particularly if unemployment is expected to remain elevated.

Investment spending recovers as sales pick up and uncertainty declines, although there are risks around the speed at which that happens.

In the MPC's central projections, business investment recovers over the forecast period, although that recovery is gradual: investment spending does not exceed its 2019 Q4 level until 2022 Q4. The recovery should be supported by increasing revenues as activity rises. It should also be supported by a decline in uncertainty from its heightened levels over the past year, as uncertainty about both Covid and the UK's trading relationship with the EU wane. Survey evidence from Deloitte suggests that over 70% of chief financial officers believed that uncertainty was 'high' or 'very high' during all four quarters in 2020, a larger share than at any other time since the survey began in 2010. And responses to a recent Decision Maker Panel Survey suggested that overall uncertainty remained much higher in January than before Covid. High uncertainty is likely to have dampened investment as businesses postpone irreversible projects until more is known about the outlook. As the vaccinated share of the population rises, uncertainty could decline quickly, which could support a more rapid pickup in investment than that underlying the MPC's central projections. Spending could pick up more slowly, however, if many companies who have increased their borrowing substantially over the past year increase spending slowly to enable them to reduce their outstanding loans.

On balance, the MPC judges the risks to the central projection for GDP to be skewed somewhat to the downside.

Taken together, while highly uncertain, the risks to the central projections for GDP in both the world and the UK are judged to be skewed somewhat to the downside, although that skew diminishes over time.

Key judgement 2: in the medium term, lower trade with the EU and some long-lasting effects of the pandemic weigh on activity.

GDP growth slows in the medium term as the impacts of the factors boosting demand fade.

Over the second and third years of the forecast, GDP continues to grow, but the pace of growth slows. That reflects an easing of the boosts to demand from declining health risks, waning uncertainty and higher government spending.

Medium-term GDP growth will also be affected by the magnitude of any persistent effects of the pandemic, posing two-sided risks to the outlook.

GDP growth in the medium term is also judged likely to be affected by some persistent effects of the pandemic weighing on the supply capacity of the economy. The MPC's central projections incorporate the effect of weak investment in lowering the productive capacity of the economy, as well as frictions in the reallocation of labour and capital across different sectors of the economy. Taken together, Covid-related effects are projected to result in the supply capacity of the economy being around 1¾% lower than it would have been in the absence of the pandemic by the end of the forecast period.

As discussed more fully in the November *Report*, the risks around these judgements are judged to be two-sided. For example, the MPC's central forecast includes effects on the capital stock of the economy through lower investment, which reduces capital accumulation. But there is a downside risk that it is lowered further if some capital is scrapped prematurely, which might happen if the capital needed in the sectors that are expanding is different to those sectors declining. In addition, more persistent changes to the mix of spending in the economy could result in a greater required degree of reallocation of resources between sectors, which could weigh temporarily on supply growth.

On the upside, however, the Covid crisis may encourage greater investment in digital technologies to support new business models and practices, for example, which would have the potential to boost productivity. In addition, working from home could remain much more common after the pandemic, which could raise working hours and labour market participation, increasing labour supply. The risks around the potential effects of remote working on productivity are likely to be two-sided. Some studies suggest that working from home can increase worker output in jobs involving certain tasks. But others suggest that some tasks requiring collaboration become more difficult when colleagues are physically separated.

There is uncertainty around the extent to which the UK's withdrawal from the EU will lower trade and productivity growth over the forecast period.

The new trading arrangement between the UK and the EU entails higher barriers to trade. As a result, trade between the UK and EU is likely to be lower than it would have been, which in turn is expected to reduce investment, productivity and GDP. GDP is projected to be around 3¼% lower in the long run due to lower trade with the EU, with around two thirds of that effect assumed to have occurred by the end of the forecast period in the MPC's central projection. There is, however, a large degree of uncertainty around such estimates. The paths for productivity and GDP will also be affected by how UK trade with other countries evolves.

Key judgement 3: inflation rises to around the target as the effects of temporary Covid-related factors unwind and the influence of spare capacity diminishes.

There is uncertainty about the extent of the downward pressure on inflation from spare capacity...

At present, temporary factors related to Covid are weighing substantially on inflation. Those are expected to unwind in the near term, leading to a sharp pickup in inflation towards the MPC's 2% target.

The MPC judges that inflation is also currently being dampened by spare capacity in the economy. The extent of that spare capacity is difficult to judge, however. While demand for goods and services has fallen sharply during the pandemic, so has firms' ability to supply them, and the net effect of these large swings is difficult to gauge with any precision. Measures of underlying inflation have been relatively subdued, although they have fallen by much less than headline CPI inflation (Section 4). The inflation rate of core services prices has declined since February 2020, which is consistent with lower spending being particularly skewed towards consumer services.

...as well as the impact of higher unit costs for firms on prices.

Firm-level evidence suggests that weak demand has exerted a drag on price inflation, although that has been partially offset by higher unit cost pressures. Some firms' costs have increased as they have adjusted their business and premises to make them Covid-secure although, in aggregate, that appears to have been offset by lower spending on other expenses, such as travel. However, as sales have fallen sharply, companies' fixed costs have been spread over a smaller amount of output, such that the cost of producing a unit of output has risen. It is difficult to know how the balance of upward pressure from these higher unit costs and downward pressure from spare capacity is likely to play out in the near term. Both pressures are expected to be reduced over time, however. Even those Covid-related measures that are permanent are likely to be one-off adjustments, so their impact on inflation should be temporary. Moreover, as sales recover towards pre-Covid levels, unit cost growth should ease. Spare capacity is projected to be eliminated, however, placing upward pressure on inflation.

The risks around CPI inflation are judged to be broadly balanced.

Overall, the risks to the MPC's inflation projection are judged to be broadly balanced. Measures of inflation expectations remain well anchored.

1.4: Constant rates

In the MPC's projections conditioned on the alternative assumption of constant interest rates at 0.1%,⁽²⁾ activity is projected to be slightly weaker and CPI inflation is projected to be a little lower.

(2) The assumption is that Bank Rate remains at 0.1% throughout the three years of the forecast period, before moving towards the market path over the subsequent three years.

Table 1.C: Indicative projections consistent with the MPC's forecast^{(a)(b)}

	Averages		Projections			
	1998–2007	2010–19	2020	2021	2022	2023
World GDP (UK-weighted)^(c)	3	2¼	-4¾ (-5¼)	4¾ (5½)	5 (3¾)	2¼ (2½)
World GDP (PPP-weighted) ^(d)	4	3½	-4 (-4½)	6 (7)	5½ (4¾)	3½ (3¾)
Euro-area GDP ^(e)	2¼	1½	-7 (-6¾)	3½ (6)	6½ (3¾)	1¾ (2)
US GDP ^(f)	3	2¼	-3½ (-3¾)	6½ (4)	3¼ (3¾)	1¾ (2¼)
Emerging market GDP (PPP-weighted) ^(g) of which, China GDP ^(h)	5½	5	-3 (-4)	6¾ (8¾)	5¾ (5½)	4½ (4¾)
UK GDP⁽ⁱ⁾	3	1¾	-10 (-11)	5 (7¼)	7¼ (6¼)	1¼ (1¾)
Household consumption ^(j)	3¼	1¾	-12¼ (-11¼)	4¼ (8¼)	11¾ (4¼)	1 (2)
Business investment ^(k)	2¾	3¾	-15 (-18¾)	4 (5¾)	12 (13¾)	4½ (4¼)
Housing investment ^(l)	3¼	3¾	-10½ (-19¾)	10¾ (13¾)	3½ (12½)	6¼ (5¾)
Exports ^(m)	4¼	3¼	-13½ (-11¾)	-3 (-1¼)	5½ (3¾)	4¾ (3)
Imports ⁽ⁿ⁾	5¾	3½	-19 (-18¼)	5¼ (7¾)	12¾ (6)	3½ (3)
Contribution of net trade to GDP ^(o)	-¼	-¼	2 (2¼)	-2½ (-2¾)	-2¼ (-1)	0 (0)
Real post-tax labour income ^(p)	3¼	1¾	1½ (0)	-1 (¾)	1 (2¼)	1¾ (2)
Household saving ratio ^(q)	8	8½	17¾ (15¼)	15¼ (10¾)	6½ (8½)	6½ (8)
Credit spreads ^(r)	¾	2½	2 (2¼)	2¼ (2¼)	2¼ (2¼)	2 (2)
Excess supply/Excess demand^(s)	0	-1¾	-1¼ (-2)	-1¼ (-1¼)	+¼ (+¼)	0 (+¼)
Hourly labour productivity ^(t)	2¼	½	2¾ (1¾)	-3¼ (-2¼)	2 (1¾)	½ (½)
Employment ^(u)	1	1¼	-1¼ (-3)	-¾ (¾)	2¼ (2¾)	1¼ (1¼)
Average weekly hours worked ^(v)	32¼	32	29¾ (29½)	32¼ (32)	32 (32)	32 (32)
Unemployment rate ^(w)	5¼	6	5¼ (6¼)	6½ (6¾)	5 (5)	4½ (4¼)
Participation rate ^(x)	63	63½	63¾ (63½)	63¾ (64)	64 (64)	64 (64)
CPI inflation^(y)	1½	2¼	½ (½)	2 (2)	2¼ (2)	2 (2)
UK import prices ^(z)	0	1½	1¾ (1¼)	-½ (-¼)	0 (¼)	0 (¼)
Energy prices – direct contribution to CPI inflation ^(aa)	¼	¼	-½ (-½)	½ (¼)	0 (0)	0 (0)
Average weekly earnings ^(ab)	4¼	2¼	4¼ (1)	¾ (2¼)	2½ (2½)	2¼ (3¼)
Unit labour costs ^(ac)	3	1½	13½ (11)	-8¼ (-7)	2½ (2¼)	2¼ (2¾)
Private sector regular pay based unit wage costs ^(ad)	1¾	1¾	14 (10¾)	-5¾ (-5¼)	2 (3¼)	3 (3¼)

Sources: Bank of England, Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, Eurostat, IMF *World Economic Outlook (WEO)*, National Bureau of Statistics of China, ONS, US Bureau of Economic Analysis and Bank calculations.

(a) The profiles in this table should be viewed as broadly consistent with the MPC's projections for GDP, CPI inflation and unemployment (as presented in the fan charts).

(b) Figures show annual average growth rates unless otherwise stated. Figures in parentheses show the corresponding projections in the November 2020 *Monetary Policy Report*. Calculations for back data based on ONS data are shown using ONS series identifiers.

(c) Chained-volume measure. Constructed using real GDP growth rates of 188 countries weighted according to their shares in UK exports.

(d) Chained-volume measure. Constructed using real GDP growth rates of 189 countries weighted according to their shares in world GDP using the IMF's purchasing power parity (PPP) weights.

(e) Chained-volume measure. Forecast was finalised before the release of the preliminary flash estimate of euro-area GDP for Q4, so that has not been incorporated.

(f) Chained-volume measure.

(g) Chained-volume measure. Constructed using real GDP growth rates of 155 EME countries, as defined by the IMF *WEO*, weighted according to their relative shares in world GDP using the IMF's PPP weights.

(h) Chained-volume measure.

(i) Excludes the backcast for GDP.

(j) Chained-volume measure. Includes non-profit institutions serving households. Based on ABJR+HAYO.

(k) Chained-volume measure. Based on CAN8.

(l) Chained-volume measure. Whole-economy measure. Includes new dwellings, improvements and spending on services associated with the sale and purchase of property. Based on DFEG+L635+L637.

(m) Chained-volume measure. The historical data exclude the impact of missing trader intra-community (MTIC) fraud. Since 1998 based on IKBK-OFNNI/(BOKH/BQKO). Prior to 1998 based on IKBK.

(n) Chained-volume measure. The historical data exclude the impact of MTIC fraud. Since 1998 based on IKBL-OFNNI/(BOKH/BQKO). Prior to 1998 based on IKBL.

(o) Chained-volume measure. Exports less imports. GDP data based on the mode of the MPC's GDP backcast.

(p) Wages and salaries plus mixed income and general government benefits less income taxes and employees' National Insurance contributions, deflated by the consumer expenditure deflator. Based on [ROY]+ROYH-(RPHS+AIV-CUCT)+GZVX)/[(AB)Q+HAYE]/(ABJR+HAYO)].

(q) Annual average. Percentage of total available household resources. Based on NRJS.

(r) Level in Q4. Percentage point spread over reference rates. Based on a weighted average of household and corporate loan and deposit spreads over appropriate risk-free rates. Indexed to equal zero in 2007 Q3.

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

(t) GDP per hour worked. GDP data based on the mode of the MPC's GDP backcast. Hours worked based on YBUS.

(u) Four-quarter growth in LFS employment in Q4. Based on MGRZ.

(v) Level in Q4. Average weekly hours worked, in main job and second job. Based on YBUS/MGRZ.

(w) LFS unemployment rate in Q4. Based on MGSX.

(x) Level in Q4. Percentage of the 16+ population. Based on MCGW.

(y) Four-quarter inflation rate in Q4.

(z) Four-quarter inflation rate in Q4 excluding fuel and the impact of MTIC fraud.

(aa) Contribution of fuels and lubricants and gas and electricity prices to four-quarter CPI inflation in Q4.

(ab) Four-quarter growth in whole-economy total pay in Q4. Growth rate since 2001 based on KAB9. Prior to 2001, growth rates are based on historical estimates of AWE, with ONS series identifier MD9M.

(ac) Four-quarter growth in unit labour costs in Q4. Whole-economy total labour costs divided by GDP at constant prices, based on the mode of the MPC's GDP backcast. Total labour costs comprise compensation of employees and the labour share multiplied by mixed income.

(ad) Four-quarter growth in private sector regular pay based unit wage costs in Q4. Private sector wage costs divided by private sector output at constant prices, based on the mode of the MPC's GDP backcast. Private sector wage costs are average weekly earnings (excluding bonuses) multiplied by private sector employment.

Box A: Monetary policy since the November 2020 Report

At its meeting ending on 16 December 2020, the MPC voted unanimously to maintain Bank Rate at 0.1%. The Committee voted unanimously for the Bank of England to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20 billion. The Committee voted unanimously for the Bank of England to continue with the programme of £100 billion of UK government bond purchases, financed by the issuance of central bank reserves, and also to commence the previously announced programme of £150 billion of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these government bond purchases at £875 billion and so the total target stock of asset purchases at £895 billion.

The main news since the November Report had been the successful trialling of some Covid vaccines and initial plans to roll them out widely over the first half of next year. This was likely to reduce the downside risks to the economic outlook from Covid previously identified by the Committee. Financial markets worldwide, and some surveys of businesses and consumers, had reacted positively to these developments which were likely to support future UK and global activity.

Nevertheless, recent global activity had been affected by the increase in Covid cases and associated reimposition of restrictions. UK-weighted global GDP growth in 2020 Q4 was likely to be a little weaker than expected at the time of the November Report.

The near-term UK outlook had evolved broadly in line with the Committee's expectations in the November Report. UK GDP had grown by 0.4% in October, leaving it 8% below its level in 2019 Q4. Activity had been stronger than expected, despite the recent rise in Covid cases and associated lockdowns. Nevertheless, the restrictions on activity introduced after those lockdowns had been tighter than the Committee had assumed in its November forecast, and were expected to weigh more on activity in 2021 Q1. The Committee judged that the successful rollout of vaccines should support the gradual removal of restrictions and rebound in activity that had been assumed in the November Report, although it was less clear how this prospect would affect the immediate economic behaviour of households and businesses. The additional fiscal measures in *Spending Review 2020* were likely to boost GDP by an estimated peak of over 1% during 2021–22.

Developments in the labour market had remained difficult to interpret. The LFS unemployment rate had risen to 4.9% in the three months to October, but other indicators suggested that labour market slack had increased by more than implied by this measure. The extension of the Government's employment support schemes was likely to limit significantly the near-term rise in unemployment, although a substantial further increase was still likely over the next few quarters.

Twelve-month CPI inflation had fallen to 0.3% in November, from 0.7% in October, triggering the exchange of open letters between the Governor and the Chancellor. The weakness of recent outturns largely reflected the direct and indirect effects of Covid on the economy. CPI inflation was expected to rise quite sharply towards the target in the spring, as the VAT cut comes to an end and the large fall in energy prices earlier in 2020 drops out of the annual comparison.

The outlook for the economy remained unusually uncertain. It depended on the evolution of the pandemic and measures taken to protect public health, as well as the nature of, and transition to, the new trading arrangements between the European Union and the United Kingdom. It would also depend on the responses of households, businesses and financial markets to these developments.

At this meeting, the Committee judged that the existing stance of monetary policy remained appropriate.

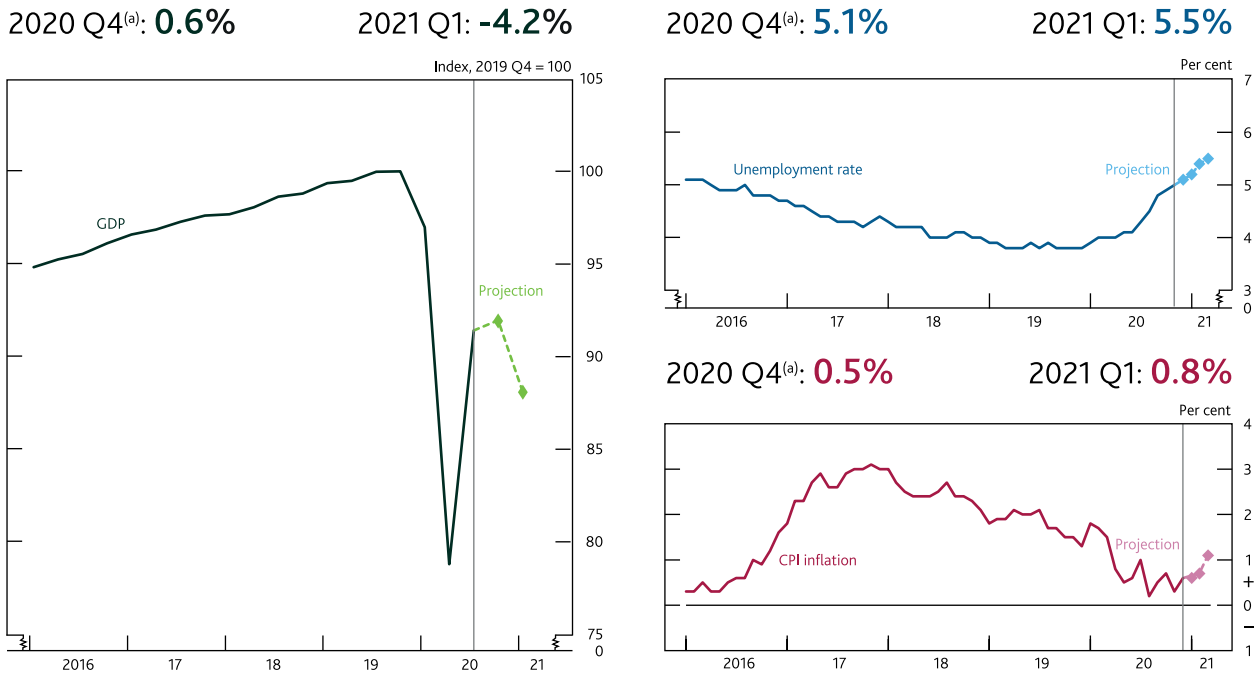
2: Current economic conditions

Global GDP fell slightly in 2020 Q4, and was around 4% lower than in 2019 Q4. Activity is expected to be broadly flat in 2021 Q1 before recovering as vaccination programmes are implemented and restrictions are eased, although the outlook is uncertain. Global asset prices have risen since November, in part given positive news about Covid vaccines.

Output in the UK is expected to have increased slightly in 2020 Q4 but is likely to fall in 2021 Q1 as a result of the latest measures to control the spread of Covid. The vaccination programme is expected to support a recovery over the rest of the year. New UK-EU trading arrangements took effect at the beginning of the year; trade volumes have been subdued by historical standards since then.

Unemployment increased over the second half of 2020 as redundancies rose and hiring remained subdued. It is expected to continue rising over the first half of 2021 H1. CPI inflation was 0.5% in 2020 Q4, below the 2% target. It is projected to rise over 2021 H1 as the contribution from energy prices increases and the temporary cut to VAT ends.

Chart 2.1: GDP in 2021 Q1 is expected to be 12% below its 2019 Q4 level as a result of the lockdown measures. Unemployment and inflation are expected to increase over coming months
Near-term projections



Sources: ONS and Bank calculations.

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

2.1: The global economy

Global GDP fell slightly in 2020 Q4, and was around 4% lower than its 2019 Q4 level.

After a strong recovery in global activity in 2020 Q3 as Covid-related restrictions eased, UK-weighted world GDP fell slightly in Q4 (**Table 2.A**), and was weaker than expected at the time of the *November Report*. This partly reflects weakness in the euro area. A rise in Covid cases (**Chart 2.2**) and the restrictions to contain the spread of the virus weighed on economic activity. The level of global GDP in Q4 is projected to have been around 4% below its level in 2019 Q4, prior to the Covid crisis.

Table 2.A: After a marked recovery in Q3, UK-weighted world GDP fell slightly in Q4

GDP in selected countries and regions^(a)

	Percentage changes on a quarter earlier						
	Quarterly averages				2020		
	1998–2007	2008–09	2010–18	2019	Q2	Q3	Q4
United Kingdom ^(b)	0.7	-0.6	0.5	0.3	-18.8	16.0	0.6
Euro area (38%)	0.6	-0.6	0.3	0.3	-11.7	12.4	-0.7
United States (21%)	0.7	-0.3	0.6	0.6	-9.0	7.5	1.0
China (4%) ^(c)	2.5	2.3	1.9	1.4	11.6	3.0	2.6
UK-weighted world GDP ^{(b)(d)}	0.7	-0.2	0.6	0.4	-8.4	8.0	-0.4

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

(a) Figures in parentheses are shares in UK exports in 2019.

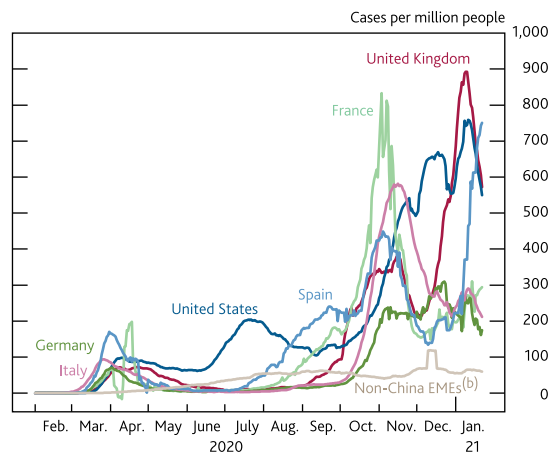
(b) Figures for 2020 Q4 are Bank staff projections.

(c) Estimates from 2010 Q4 onwards are from the National Bureau of Statistics of China.

(d) See footnote (c) of **Table 1.C**. The forecast was finalised before the release of the preliminary flash estimate of euro-area GDP for Q4, so that has not been incorporated.

Chart 2.2: Confirmed Covid cases rose sharply in some countries over the past three months

Daily new confirmed Covid-19 cases in selected countries^(a)



Sources: COVID-19 Data Repository by the Centre for Systems Science and Engineering (CSSE) at Johns Hopkins University, World Bank and Bank calculations.

(a) Seven-day moving averages, scaled by 2019 population. Data are shown to 22 January and are not seasonally adjusted. Cases in overseas departments are included in line with World Bank definitions of population.

(b) Series includes Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey.

Rising Covid cases and new restrictions weighed on euro-area activity...

There was a substantial increase in Covid cases in several euro-area countries during Q4. This led to progressively stricter restrictions being imposed in many countries to contain the spread of the virus. Mobility indices fell sharply in France, Germany and Italy, though to a somewhat lesser extent than in the first wave of Covid in early 2020 (**Chart 2.3**). As a result, economic activity fell, and euro-area GDP is estimated to have contracted by 0.7% in Q4. Survey-based indicators of activity such as the euro-area composite PMI have remained below the 50 'no-change' mark since November, and suggest that the fall in activity has largely been driven by the services sector. Other economic indicators such as consumer confidence remained weak over the period.

...while the impact on the US appears less pronounced.

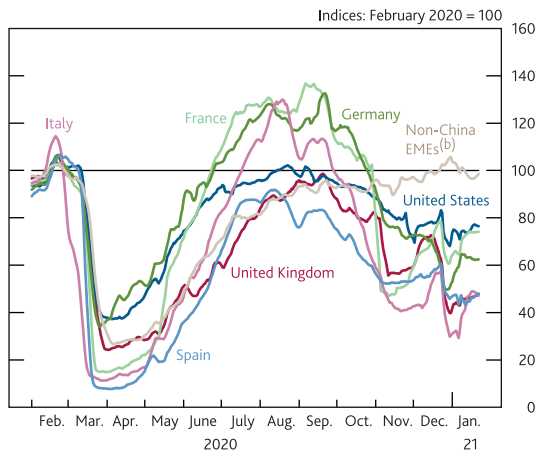
The US also saw a sharp rise in Covid cases, though the extent of restrictions has been lower compared with the euro area. Mobility indices are higher in the US, and GDP has continued to rise. US activity has also been supported by further fiscal stimulus. That said, US GDP growth slowed sharply in 2020 Q4 (**Table 2.A**), and the recovery in the US labour market also levelled off. While the unemployment rate has fallen materially from its peak of 14.8% in April 2020 to 6.7% in December, the pace of decline slowed in Q4. Non-farm payrolls fell by 140,000 in December, largely due to an increase in job losses in sectors most affected by tighter restrictions, such as leisure and hospitality.

Box B explores the reasons for differences in GDP growth rates across countries over 2020.

China's economic recovery continued.

The economic recovery in China continued, with GDP increasing by a further 2.6% in Q4, to around 6.5% above its level in 2019 Q4. The recovery in GDP for much of 2020 had been investment and export-led, in part reflecting the focus of policy support measures. Recent activity indicators point to a more balanced recovery in Q4, although the pickup in consumption remained weaker.

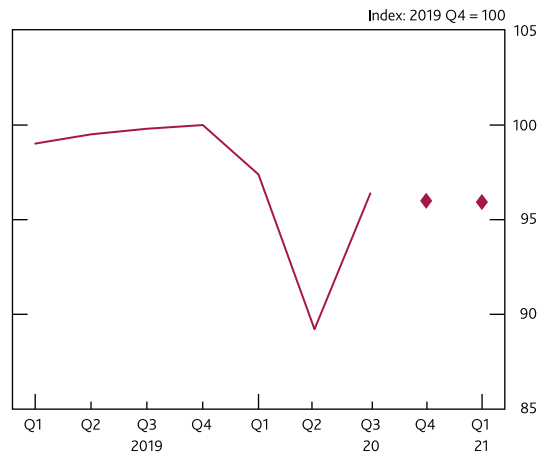
Chart 2.3: Mobility has fallen, albeit to a slightly lesser extent than during the first wave of the pandemic
Apple mobility indices^(a)



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

- (a) Level of requests for directions in Apple Maps. Mobility is assumed to stay constant where data are missing. Seven-day moving averages to 22 January. Data are not seasonally adjusted.
(b) The average of indices for Brazil, India, Indonesia, Mexico, Russia, South Africa and Turkey weighted by their shares in PPP-weighted world GDP.

Chart 2.4: UK-weighted world GDP is projected to be flat in 2021 Q1
UK-weighted world GDP^(a)



Sources: Eikon from Refinitiv, IMF WEO, ONS and Bank calculations.

- (a) See footnote (c) of Table 1.C. Diamonds represent Bank staff projections for 2020 Q4 and 2021 Q1.

Across other emerging market economies in aggregate, PPP-weighted GDP is estimated to have risen by around 1% in 2020 Q4. GDP growth has varied across economies, however, largely driven by differences in Covid infection rates. For example, cases in Russia and South Africa have risen sharply, while cases in India have fallen.

Further fiscal and monetary policy measures continue to support activity.

Significant fiscal and monetary policy support continues to underpin economic activity across major economies, with further stimulus measures being announced in the euro area and US since the November *Report*. Government net borrowing in the US, China and the euro area is projected to have increased substantially in 2020, and to remain historically high in 2021 (Chart 2.5).

In the euro area, the ECB Governing Council expanded its asset purchase programme in December by a further €500 billion to €1.85 trillion, and extended its targeted longer-term refinancing operations until June 2022. ECB President Lagarde has reiterated the need for continued accommodative policy to support the economic recovery and guide inflation back towards target.

In the US, a new fiscal support package worth around US\$900 billion was agreed in December, including additional income support policies such as direct payments to households and increased unemployment insurance. This announcement took the total size of US fiscal stimulus in 2020 to over 20% of GDP, and a further stimulus package was proposed by the new Biden administration in January, although this has not yet been passed by the US Congress. The Federal Open Market Committee left the target range for the federal funds rate unchanged at its recent meetings, and committed to continuing its asset purchase programme until substantial further progress had been made towards its employment and price stability goals.

Market-implied paths for policy rates in the US, UK and euro area have been little changed since the November *Report*, suggesting that rates will remain at very low levels for several years (Chart 2.6).

Global output is expected to be broadly flat in 2021 Q1.

Bank staff expect UK-weighted world GDP to be broadly flat in 2021 Q1 (Chart 2.4), as the tighter restrictions to help curb the transmission of the virus continue to weigh on activity. The development of Covid vaccines is expected to boost activity further out in 2021, as restrictions on activity can be eased and health concerns are likely to fade. There is uncertainty around how the pandemic might evolve and how government measures change in response, however (Section 1).

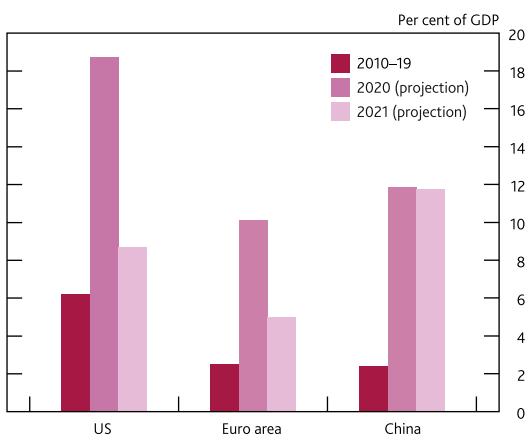
Positive vaccine news is likely to have boosted perceptions of future global demand, including for commodities. The Brent spot oil price has increased to US\$55 per barrel, around US\$14 higher than at the time of the November *Report*, although still lower than at the end of 2019. Oil prices have also been boosted by the announcement that Saudi Arabia would cut oil production further in 2021 Q1. Many non-oil commodity prices have also risen since November.

Inflation remains subdued across advanced economies.

Despite the recent increase in commodity prices, inflation across advanced economies remains low. In the euro area, the 12-month headline inflation rate was -0.3% in December, unchanged since September. Headline inflation is zero or negative in all four of the largest euro-area economies. Core inflation – which strips out the impact of energy prices and other volatile elements – was slightly positive at 0.2%. In the US, annual headline PCE inflation picked up marginally to 1.3% in December, while core PCE inflation was 1.5%. Market-implied measures of longer-term inflation compensation in the US have risen since November (**Chart 2.27**).

Chart 2.5: Fiscal policy is providing significant support to global activity

General government net borrowing^(a)

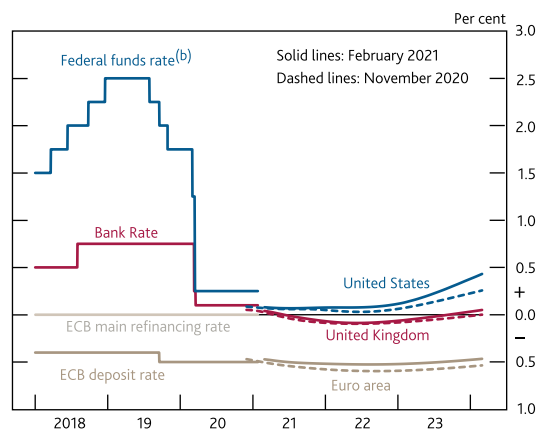


Source: IMF WEO.

(a) Average net borrowing in 2010-19 and IMF projections for 2020 and 2021. Data are from the October 2020 WEO, so they do not reflect policy announcements since then.

Chart 2.6: Monetary policy remains accommodative in advanced economies

International forward interest rates^(a)



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

(a) All data as of 27 January 2021. The February and November curves are estimated using instantaneous forward overnight index swap rates in the 15 working days to 27 January 2021 and 28 October 2020 respectively.
(b) Upper bound of the target range.

2.2: Financial markets and credit conditions

Global risky asset prices have risen sharply since November.

Global equity prices have increased sharply since the November *Report* (**Chart 2.7**), as risk sentiment was boosted by the approval of Covid vaccines, continued support from monetary and fiscal policy, and the removal of uncertainty around the result of the US presidential election. The US S&P 500 index has risen by around 15% since its lows prior to the US election in late October. The Euro Stoxx index has increased by around 13% since the November *Report*, despite weaker-than-expected economic activity. Across advanced economies, corporate bond spreads continued to fall, with non-financial investment-grade spreads now at or below their levels at the beginning of 2020 (**Chart 2.8**).

Sterling has appreciated by around 2% since the November Report.

Sterling has appreciated by around 2% since the November *Report* (**Chart 2.9**), partly reflecting a reduction in Brexit-related uncertainty following the agreement of a UK-EU trade deal in December. There was little immediate reaction in wider UK asset prices to the agreement of the trade deal. The FTSE All-Share is up 15% since the November *Report*, boosted by the same factors that have supported equity prices globally.

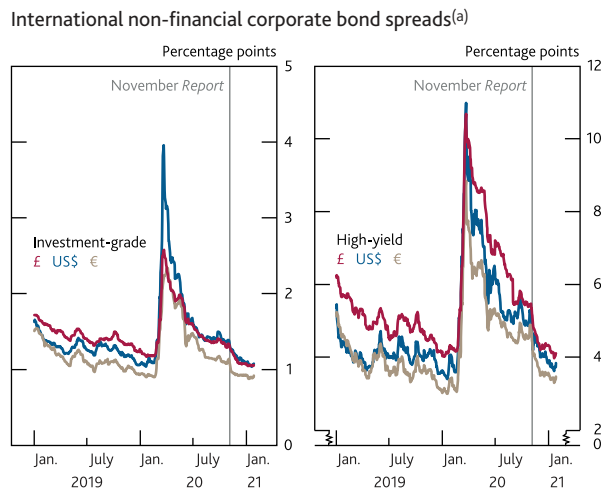
Chart 2.7: Global equity prices have increased substantially since the November Report



Sources: Eikon by Refinitiv, MSCI and Bank calculations.

(a) In local currency terms, except for MSCI Emerging Markets which is in US dollar terms.
 (b) The MSCI Inc. disclaimer of liability, which applies to the data provided, is available from the [February 2021 Monetary Policy Report](#).

Chart 2.8: Corporate bond spreads have continued to fall since November



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

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

Many companies report that new credit continues to be available, although credit conditions remain tight for some smaller businesses and those in sectors particularly affected by Covid.

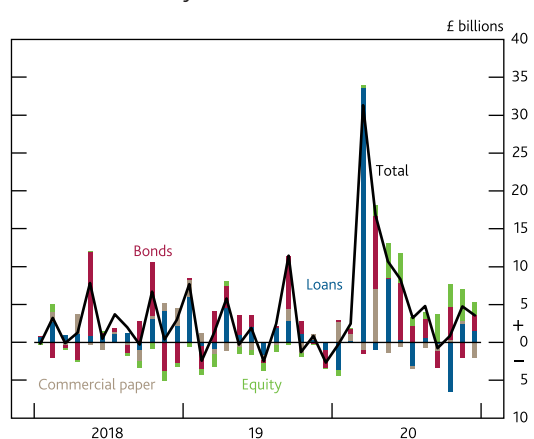
Corporates raised £86 billion of net finance in 2020. This strength partly reflects strong demand from companies borrowing to make up for cash-flow shortfalls due to the Covid pandemic. The majority was raised in the few months following the announcement of government-backed loan schemes (Chart 2.10). Net finance raised was lower in the second half of 2020. Over 2020 as a whole, bank lending growth has been strong. It has been particularly high for small and medium-sized enterprises (SMEs) with annual growth reaching over 25% in December, the highest since the series began in 2012.

Many companies report that new credit continues to be available, although credit conditions remain tight for some, especially in sectors particularly affected by Covid. For large companies, the net balance of respondents to the *Deloitte CFO Survey* reporting that new credit was available rose to 33% in Q4 compared to 23% in the previous quarter. Credit availability for small businesses, however, reportedly became more constrained according to the Q4 *Small Business Index* survey, from the Federation of Small Businesses. Agency intelligence continues to highlight a reduced appetite among banks to provide new loans to small businesses and sectors particularly affected by Covid, such as retail and hospitality, outside of government-guaranteed lending schemes. Rates on new loans to companies, including SMEs, have fallen over the past year (Table 2.B).

Chart 2.9: Sterling has appreciated by 2% since the November Report



Chart 2.10: Corporates raised a significant amount of net finance in 2020, reflecting Covid-related demand



Sources: Bank of England and Bank calculations.

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

Interest rates on new mortgages remain higher than a year ago...

The rise in advertised rates on some new mortgages has levelled off since the November *Report*, although they remain higher than in early 2020 (**Chart 2.11**). Interest rates for mortgages with a 75% loan to value (LTV) ratio have increased by 34 basis points compared to a year ago, while those with a 90% LTV have increased by 160 basis points. While rates on new mortgages increased in 2020, rates on the stock of variable-rate mortgages fell (**Table 2.B**), reflecting the impact of the cuts in Bank Rate in March 2020.

...reflecting a riskier economic outlook and strong demand for secured credit.

Retail banks take a number of factors into account when deciding how to price their loans, aiming to reflect the costs and risks associated with their lending. As discussed in the November *Report*, the rise in new mortgage rates in 2020 largely reflects the impact of a riskier economic outlook, combined with strong demand for mortgages which has resulted in some operational constraints for lenders. That has offset the downward impact of lower risk-free rates, including in relation to Bank Rate cuts in March 2020, and lower bank funding spreads, which partly reflect the effects of the Term Funding scheme with additional incentives for Small and Medium-sized Enterprises.

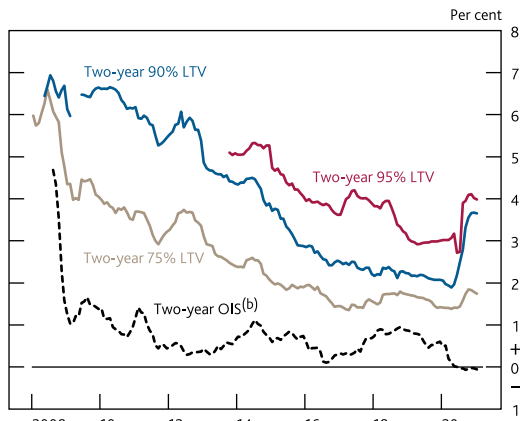
Although mortgage rates have risen, secured borrowing has increased, reflecting strong demand for housing (Section 2.3). Mortgage approvals increased in recent months, and household secured borrowing was a little over £5.5 billion in November and December, its highest monthly levels since 2016. In the *Credit Conditions Survey (CCS)*, lenders expected an increase in the availability of secured credit in 2021 Q1 (**Chart 2.12**).

Tighter credit availability and lower demand have led to a fall in unsecured lending.

In the latest *CCS*, lenders reported that the availability of unsecured lending to households had increased marginally in Q4, but that follows a period of sharp declines (**Chart 2.12**). Tighter availability, combined with a decline in the demand for credit as consumer spending fell, contributed to a fall in lending volumes in 2020. The annual growth rate of consumer credit reached a record low of -7.5% in December, with net lending falling across all components of consumer credit including credit cards and other forms of consumer credit (eg personal loans).

Chart 2.11: Mortgage rates picked up in 2020

Two-year OIS rate and quoted rates on two-year mortgages^(a)

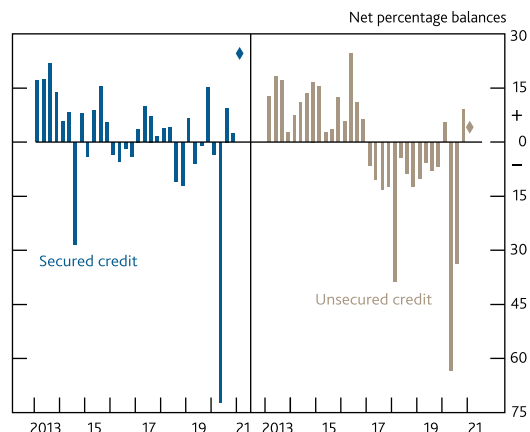


Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

- (a) See footnote (a) of **Table 2.B** for more detail on the Bank's quoted rates series.
 (b) Monthly averages of two-year sterling overnight Index swap (OIS) rates.

Chart 2.12: The availability of secured credit to households is expected to increase in coming months

Household secured and unsecured credit availability^(a)



Source: Bank of England *Credit Conditions Survey*.

- (a) Lender responses are weighted by market shares. A positive balance indicates an increase in availability. The diamonds show the expected changes over the next three months, as reported in the 2020 Q4 Survey.

UK financial conditions have loosened slightly since the November Report.

A summary measure of UK financial conditions suggests that conditions are slightly looser than at the time of the November *Report* (**Chart 2.13**), reflecting the pickup in equity prices.

Table 2.B: Rates on new loans to companies have fallen over the past year

 Selected household and corporate interest rates^(a)

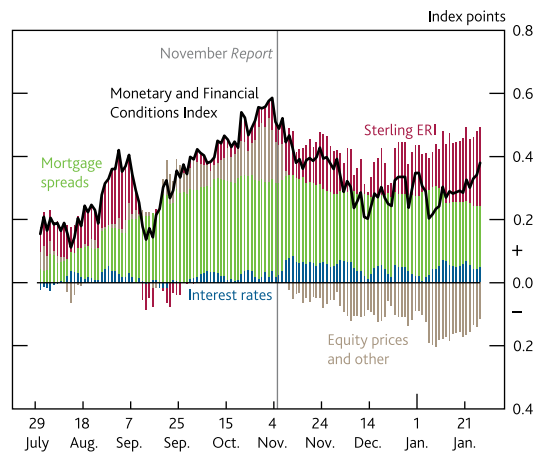
	Latest (per cent)	Changes since (basis points)			
		Nov. 2020	Aug. 2020	Jan. 2020	Jan. 2016
Quoted rates on new lending and deposits					
<i>Mortgages</i>					
Two-year fixed rate, 75% LTV	1.75	-8	16	34	-18
Two-year fixed rate, 90% LTV	3.65	-2	86	160	80
<i>Consumer credit</i>					
£10,000 personal loan	3.60	0	19	2	-69
Credit card	20.96	4	40	19	300
<i>Deposits</i>					
Instant access	0.06	-1	-1	-35	-41
One-year fixed-rate bond	0.29	-7	-15	-68	-79
Effective rates^(b)					
<i>Mortgages^(c)</i>					
Fixed-rate mortgage	2.05	-1	-5	-11	-99
Floating-rate mortgage	2.36	6	8	-58	-52
PNFCs					
New loans	1.86	20	23	-82	-79
<i>of which to SMEs</i>	2.32	28	58	-105	-100

(a) The Bank's quoted rates series are weighted monthly average rates advertised by all UK banks and building societies with products meeting the specific criteria. In February 2019 the method used to calculate these data was changed. For more information, see 'Introduction of new Quoted Rates data – Bankstats article'. The Bank's effective rate series are weighted monthly averages of rates from a sample of banks and building societies with products meeting the specific criteria. Data are not seasonally adjusted. Latest quoted rates data are flash estimates for January using data to 25 January and are subject to change until publication on 5 February. Latest effective rates data are for December.

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

(c) Mortgages to individuals and individual trusts.

Chart 2.13: UK financial conditions have loosened slightly since November

 Contributions to changes in the UK Monetary and Financial Conditions Index^(a)


Sources: Bloomberg Finance L.P., Eikon from Refinitiv, ICE/BoAML Global Research and Bank calculations.

(a) The UK Monetary and Financial Conditions Index (MFCI) summarises information from the following series: short-term interest rates, the sterling ERI, corporate bond spreads, equity prices, and household and corporate bank lending spreads. The series weights are based on the estimated impact of each variable on UK GDP. The chart shows changes in the MFCI from the average level over the 15 working days to 29 July 2020. An increase in the MFCI signals tighter financial conditions and a decrease signals looser conditions. For more information, see 'How can we measure UK financial conditions?'.

2.3: Demand and output

UK output fell in November as rising Covid cases led to tighter restrictions.

The output of the UK economy increased between May and October, but fell again in November (Chart 2.14) as restrictions to control the spread of Covid were tightened. The restrictions had particularly significant effects on a few sectors: output in the accommodation and food services sector fell by almost half; in the arts, entertainment and recreation sector it fell by 14%.

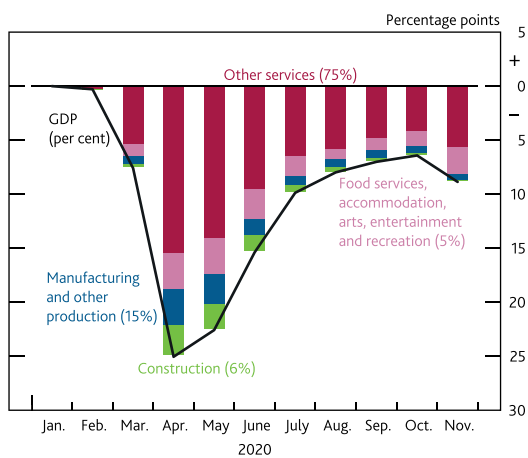
Nevertheless, the fall in GDP in November was smaller than expected. Bank staff now expect GDP to have risen by 0.6% in 2020 Q4 as a whole, leaving it 8% lower than in 2019 Q4 (Chart 2.1). In the *November 2020 Report*, staff had expected GDP to fall by 2% in 2020 Q4. Stronger-than-expected activity appears to reflect firms being better prepared to continue operating under restrictions, especially when compared to the first national lockdown in the spring. Output actually increased in the manufacturing and construction sectors in November, in contrast to April – the first full month of the first lockdown – when many firms in those sectors temporarily closed. Output in the retail sector also fell by much less than in April, partly reflecting businesses having adapted. For example, the Agents report that more retailers now have the ability to sell online. Government output was also higher than expected.

Consumer spending recovered over 2020. There was little recovery in business investment.

Much of the recovery over the summer and autumn reflected increased consumer spending (Chart 2.15). There was a small recovery in measured government consumption as some education and health services were restored. In contrast, there was very little recovery in business investment. Consumer spending is expected to have fallen slightly in Q4, with restrictions hitting social spending in particular ahead of the normally busy Christmas period.

Chart 2.14: Output fell in November as restrictions to control the spread of Covid were tightened

Contribution to change in monthly GDP since January 2020^(a)

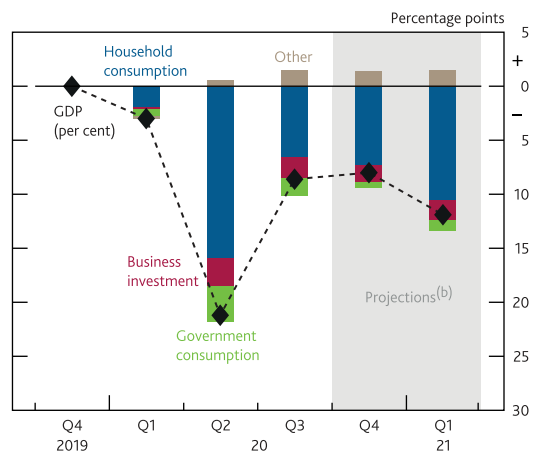


Sources: ONS and Bank calculations.

(a) Figures in parentheses are weights in Gross Value Added in 2018. Weights and contributions may not sum to the total due to rounding.

Chart 2.15: GDP is expected to fall in 2021 Q1, but to a lesser extent than in 2020 Q2

Contribution to change in quarterly GDP since 2019 Q4^(a)



Sources: ONS and Bank calculations.

(a) Household consumption data include non-profit institutions serving households (NPISH) and net trade data exclude the impact of missing trader intra-community fraud.
(b) Bank staff projections.

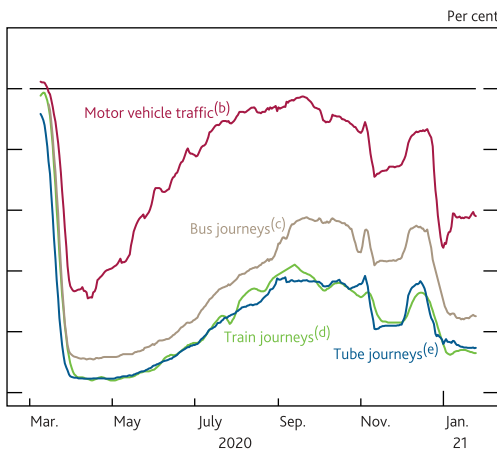
The latest lockdown measures are expected to cause output to fall in 2021 Q1.

Amid a sharp increase in Covid cases, almost all parts of the UK were moved into lockdown by the end of December. High-frequency indicators of activity have fallen since then (Chart 2.16). Most indicators have fallen further than in November reflecting tighter, more extensive restrictions and the stronger 'stay at home' message. Schools have been closed, which will weigh directly on public sector output. However, the overall economic impact of lockdown is not expected to be as severe as it was in April. The proportion of businesses that have paused trading is broadly similar to June (Chart 2.17), by which time GDP had recovered over a third of the way from its April trough. The number of employees furloughed also appears to be much lower (Section 2.4).

Taking the extent of restrictions and early evidence of their effects together, Bank staff expect GDP to fall by around 4% in 2021 Q1 (Chart 2.1). That would mean GDP is 12% lower than in 2019 Q4 (Chart 2.15). That projection is unusually uncertain, and depends on the evolution of the pandemic and the measures taken to protect public health. It assumes there is no material easing in restrictions during Q1 (Section 1), which weighs on social spending in particular. The vaccination programme is assumed to allow restrictions to be eased later in the year (Section 3).

Chart 2.16: Indicators of activity have fallen sharply since December, although not as far as in April

Transport use relative to normal levels^(a)

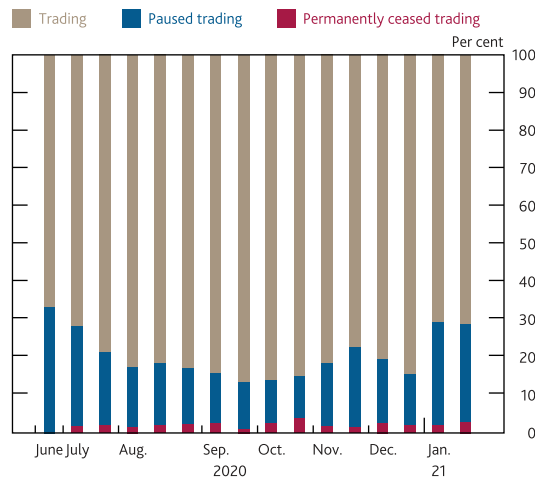


Sources: Department for Transport and Bank calculations.

- (a) Seven-day moving averages to 25 January 2021.
- (b) Percentage change from the equivalent day in the first week of February 2020.
- (c) Percentage change from the equivalent day of the third week of January 2020, adjusted for bank holidays.
- (d) Percentage change from the equivalent week in the previous year.
- (e) Percentage change from the equivalent day in the previous year.

Chart 2.17: The proportion of businesses that have paused trading is broadly similar to June

Businesses by trading status^(a)



Sources: ONS and Bank calculations.

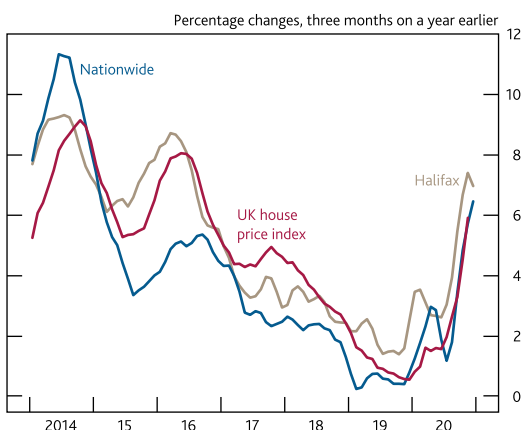
- (a) Based on weighted estimates from the Business Impacts of Coronavirus (Covid-19) Survey.

Demand has been strong in the housing market.

Despite the subdued economy, the housing market has been strong in recent months. House prices have picked up sharply (Chart 2.18) and the number of mortgage approvals has increased. The strength can be partly explained by temporary property transaction tax holidays in the UK. The resilience of household incomes relative to spending is also likely to have played a role; total household incomes were 1.2% higher than a year earlier in Q3, while nominal spending was 10% lower (Chart 2.19). As a result, the household sector in aggregate has built up a large stock of savings (Section 3), some of which may have been used to help fund house purchases. Households may also have reassessed their housing needs in light of the pandemic and experience of working from home; several other advanced economies have also seen strong house price growth recently. The increased level of transactions may itself have pushed prices up due to higher-quality matches becoming possible (Ngai and Tenreyro (2014)).

Chart 2.18: House prices picked up sharply over 2020

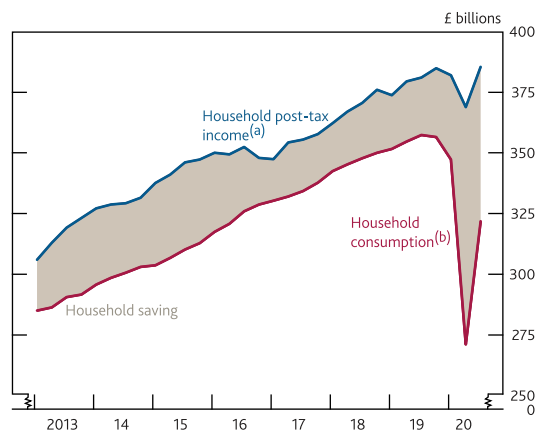
House prices



Sources: Halifax house price index by IHS Markit, HM Land Registry, Nationwide and Bank calculations.

Chart 2.19: Household incomes were much more stable than spending in 2020, on average

Household income and nominal consumption



Sources: ONS and Bank calculations.

- (a) Total available household resources, including NPISH.
- (b) Includes NPISH.

There are some signs that the market will cool over the next few months. Growth in new buyer enquiries and new instructions to sell have fallen over the past few months according to the RICS survey, and respondents to the December survey expected sales to fall over the next three months. That might reflect the temporary tax changes coming to an end in March.

Business investment has been weak; surveys suggest growth will pick up but remain low in the near term.

Business investment remained weak in Q3, at 19% below its 2019 Q4 level. Surveys of investment intentions remain consistent with historically weak rates of investment growth, although they have improved in recent months (**Chart 2.20**). Respondents to the January Decision Maker Panel (DMP) Survey expected investment to be 23% lower in 2021 Q1 than it would have been in the absence of Covid, although the shortfall was expected to shrink in the following quarters. The recent period of reduced investment is one of the reasons Covid is expected to lower the economy's supply capacity in the medium term (Section 1).

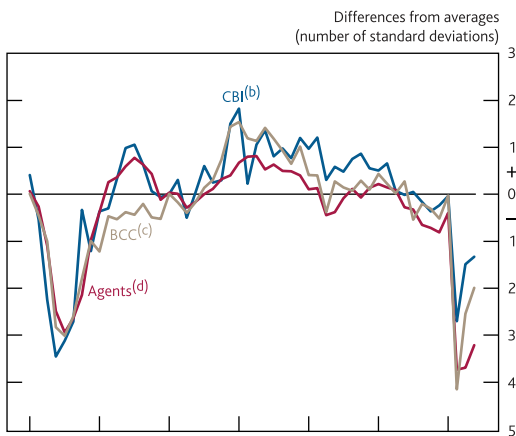
Imports and exports picked up ahead of the end of the transition period as firms built stockpiles.

The UK left the EU's Single Market and Customs Union and moved to new trading arrangements with the EU on 1 January. Ahead of this deadline, preparedness for the new arrangements among businesses appeared to improve, though surveys generally suggested a significant minority were not fully prepared (see Section 4 of the [November 2020 Report](#)). At the same time, prior to the deal being announced on 24 December, there was uncertainty over the final arrangements, including whether tariffs would be applicable on UK-EU trade. As a result, many firms increased their stockholdings ahead of the end of the transition period, which is likely to have boosted trade. The latest official trade data showed that imports of goods from the EU picked up by 9% in November; exports to the EU picked up by 12%. Surveys suggest stockbuilding increased further in December.

Some cross-border trade was disrupted at the end of the year because of Covid-related border restrictions, with road hauliers crossing the UK-France border via Dover particularly affected. The restrictions were eased after a new Covid testing regime for drivers had been put in place.

Chart 2.20: Investment intentions have improved slightly in recent months, but remain historically weak

Survey indicators of investment intentions^(a)

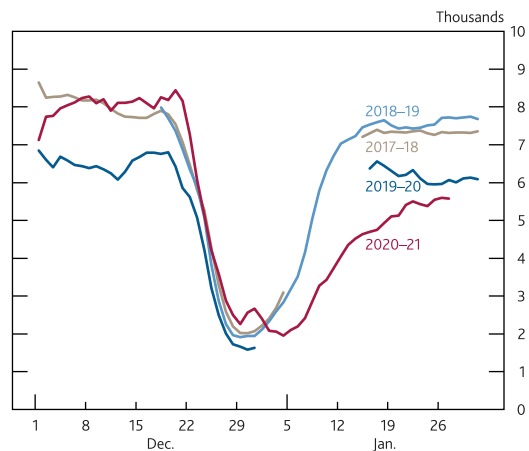


Sources: Bank of England, BCC, CBI, ONS and Bank calculations.

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

Chart 2.21: Some data suggest cross-border trade with the EU has been lower than normal in January

Number of heavy goods vehicles on roads around Dover^(a)



Sources: Highways England and Bank calculations.

- (a) Seven-day moving averages based on road traffic sensor data. The data cover traffic going both in and out of the port of Dover and are not seasonally adjusted. Gaps in the series are the result of sensor data not being available.

Trade volumes were unusually low over January.

The EU began implementing customs and other border checks on trade with the UK at the beginning of the year. The available indicators and intelligence from contacts suggest that freight volumes have been subdued in the early weeks of 2021, even taking into account the usual seasonal pattern of trade in January (**Chart 2.21**). That might reflect firms having built up stocks in Q4, or a reduction in demand due to Covid-related factors. But it may also reflect some firms losing export orders, or choosing not to trade on account of the potential for congestion at the border, or as they prepare the necessary new documentation. There have been reports of disruption to trade in some sectors arising from new requirements at the border.

Although there is little evidence of any price changes as a result of the new trading arrangements so far, prices may be affected by wider developments in global trade. The cost of shipping goods in containers has increased sharply in recent months on some routes; the 'Shanghai Containerized Freight Index' – which measures the cost of container freight from Shanghai specifically – has more than trebled since June. The increase appears to be a result of strong demand for Chinese exports coupled with empty containers being stranded in Europe and the US. If sustained, this could push up the prices of a few specific goods that are imported to the UK in containers, especially bulky items for which shipping is a material cost.

2.4: The labour market

Lower demand for labour has led to an increase in the number of employees furloughed.

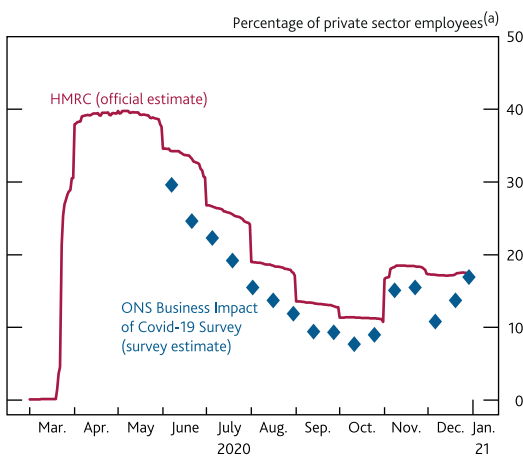
The reduction in economic activity over the past year has lowered the demand for labour. The Government's job retention scheme, the CJRS, allows firms to temporarily furlough workers during periods of weak demand. According to Her Majesty's Revenue and Customs (HMRC) statistics, around 4 million jobs – equivalent to around 18% of private sector workers – were fully or partially furloughed in November, up from October levels, but well below the peak seen during the first national lockdown (**Chart 2.22**), and below the level expected in the *November 2020 Report*. That probably reflects more businesses remaining open, and some firms having made redundancies in the intervening period. The number of people furloughed fell slightly in December, but is expected to have increased in January.

Unemployment has also risen as a result of redundancies and subdued hiring.

Although the furlough scheme has prevented many job losses, unemployment has still risen as a result of redundancies and low levels of hiring. Redundancies increased sharply in the second half of 2020, following a spike in notifications of redundancy over the summer (**Chart 2.23**). The ONS estimates that 395,000 people – over 1% of employees – were laid off in the three months to November, a larger number than in any three-month period during the financial crisis. Payroll data suggest that the food services, accommodation and retail sectors have shed the most jobs since January 2020.

Chart 2.22: The percentage of employees furloughed has increased over the past few months

Furloughed employees

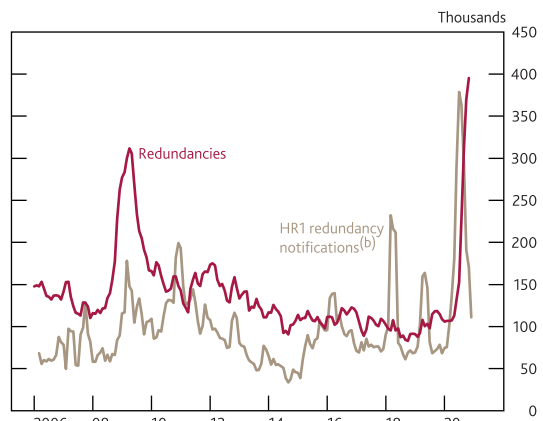


Sources: HMRC, ONS and Bank calculations.

(a) Total employees minus public sector employment.

Chart 2.23: Redundancies picked up sharply in 2020 H2, but are likely to fall back in the near term

Redundancies and HR1 redundancy notifications^(a)



Sources: Insolvency Service, ONS and Bank calculations.

(a) Three-month rolling sums. Latest redundancies data point is for November 2020; latest HR1 notifications data point is for December 2020.

(b) HR1 advance notices of redundancy are only required when employers propose to dismiss 20 or more employees at a single establishment. Not all employees given such notice will go on to be made redundant. The figures may also include some submissions relating to company restructures or changes in employee terms of contract. Great Britain only.

The availability of jobs continues to be well below normal, making it harder for redundant workers or new entrants to the labour market to find employment. The number of vacancies in Q4 was almost 30% lower than before the pandemic. A range of surveys suggest firms' employment intentions improved at the end of last year, but remain historically weak.

The combination of job losses and limited hiring has led the unemployment rate to increase from 3.9% at the start of 2020 to 5.0% in the three months to November (**Chart 2.1**). The existence of the CJRS has led to the rise being much smaller than the normal relationship between the output of the economy and employment would imply.

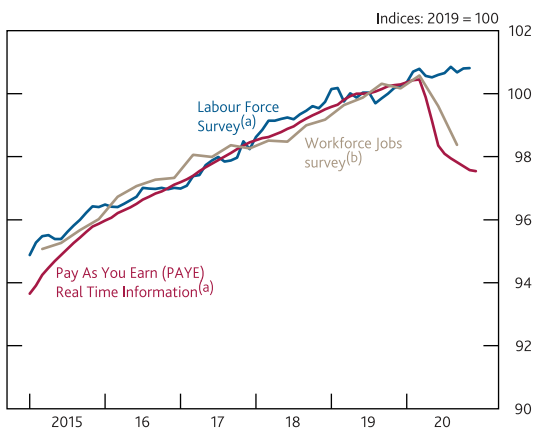
There is some uncertainty over the exact state of the labour market.

The increase in unemployment over the past few months has been much smaller than expected in the MPC's projections, although there is more uncertainty than usual around labour market developments. According to HMRC, the number of employees on company payrolls has fallen by over 800,000 since the start of 2020. A similar-sized fall was recorded by the Workforce Jobs survey. But the Labour Force Survey (LFS) – the source for the official employment and unemployment rates – continues to suggest employee numbers have been stable (**Chart 2.24**). It does show a significant fall in self-employment, however.

The ONS suggests that the HMRC figure is the best single, overall indicator of the labour market at the moment.⁽¹⁾ The degree of slack in the labour market has probably increased to a greater extent than implied by the LFS.

One issue contributing to the difficulty in constructing survey-based estimates of the total number of employees in the UK is uncertainty around migration numbers, and hence population numbers, during the pandemic. The LFS estimate of the number of employees is arrived at by scaling survey responses to the size of the UK population. That population estimate is a projection made before the pandemic. But the population may be lower than previously expected: while the usual source for migration data has been suspended, other sources suggest that the number of foreign-born UK residents has fallen recently (*O'Connor and Portes (2021)*). If that has happened, then the LFS may be overstating the total number of employees in the economy, although to what extent is unclear, as this issue also interacts with wider difficulties in sampling households during the pandemic. This issue should not materially affect proportions, such as the LFS unemployment rate, to the same extent: if the characteristics of those that have left the UK are similar to those that remained, both the numerator and denominator of those rates will be affected equally.

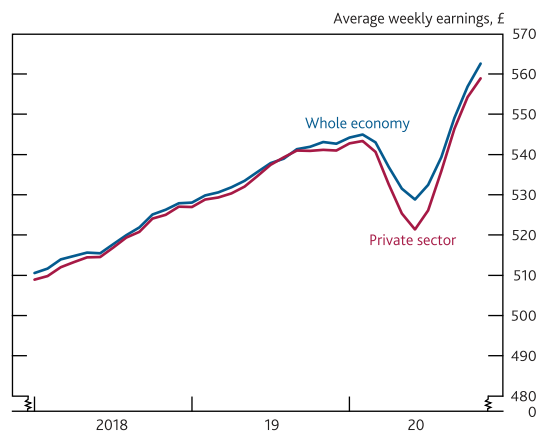
Chart 2.24: There were over 800,000 fewer employees on company payrolls at the end of 2020 than at the start
Number of employees



Sources: HMRC, ONS and Bank calculations.

- (a) Three-month moving averages. Latest data point from the Labour Force Survey is for the three months to November 2020. Latest data point for PAYE Real Time Information is for the three months to December 2020.
(b) Data are quarterly. Latest data point is for 2020 Q3.

Chart 2.25: Average weekly earnings are now higher than pre-pandemic, partly because of compositional effects
Measures of total pay^(a)



Sources: ONS and Bank calculations.

- (a) Three-month moving averages. Latest data point is November 2020.

Redundancies are expected to be lower over the coming months...

The number of new redundancy notifications fell sharply towards the end of the year (**Chart 2.23**), suggesting the pace of job cuts has fallen. That is consistent with Agency intelligence: although some firms in the hospitality and tourism sectors expected to make further job cuts, many contacts reported that they have finished adjusting the size of their workforce.

(1) See 'Painting the full picture: what our statistics tell us about the labour market' for more details.

...but the headline rate of unemployment is still expected to go up in 2021 H1.

Nevertheless, the headline rate of unemployment is expected to increase over 2021 H1. While GDP is expected to begin to recover from Q2, it is expected to remain below pre-pandemic levels, which will mean demand for labour remains lowered. The CJRS is due to expire at the end of April. Although the vast majority of furloughed employees are expected to go back to their regular working hours as the economy recovers, some may be at risk of redundancy when the scheme comes to an end and the relationship between output and employment starts to normalise. The unemployment rate is also expected to rise as more people begin looking for work as restrictions ease. That will reduce the number of people counted as 'inactive' and increase the number of people counted as unemployed.

Bank staff expect the unemployment rate to average 5.5% over 2021 Q1 (**Chart 2.1**). In the MPC's projections, it is projected to peak at around 7¾% in the middle of 2021. As with GDP, the projection for unemployment is unusually uncertain, and sensitive to the evolution of the pandemic, government policy, and measures taken to protect public health, including the vaccination programme (Section 1).

Pay is above pre-pandemic levels, although this partly reflects compositional effects.

The official statistics show that average weekly earnings in the three months to November were above their pre-pandemic levels (**Chart 2.25**). Annual growth of whole-economy regular pay was 3.6%, significantly stronger than expected at the time of the *November 2020 Report*. The strength in pay partly reflects compositional effects: many of the jobs lost this year have been in sectors with below-average levels of pay, such as hospitality and retail. There has also been a reduction in the share of workers working part time. ONS analysis suggests these compositional effects have boosted growth in average weekly earnings by over two percentage points over the past year. The impact of some workers on the CJRS receiving temporarily reduced pay will have exerted downward pressure on average earnings, though, partially offsetting that impact.

Wider indicators of pay pressures are mixed, but they appear relatively subdued. The median company pay settlement increased in Q4, although it remained relatively low and pay freezes continued to account for more than one in four settlements. In the Agents' annual pay survey, settlements in 2021 were expected to be slightly lower than the average for 2020 (Box C). The REC survey suggests there is little pressure to increase pay for new recruits. And the Government has announced that pay rises will be paused for all non-NHS public sector workers, except the lowest paid, in 2021–22.

Firms' unit costs have increased as a result of lower output and measures to control the spread of Covid.

Firms' production costs per unit of output appear to have increased. This is largely because most firms have some fixed costs which have recently been spread over a lower level of output (Section 4). Many firms have also faced extra costs to make their operations Covid-secure. Measures to make businesses Covid-secure are also likely to have reduced the productivity of labour – for example, as operational processes have needed to change. But aggregate productivity is likely to have been boosted by a similar compositional effect to that affecting pay: the sectors that have suffered the largest falls in output this year have tended to have below-average levels of productivity. Partly reflecting that effect, economy-wide hourly productivity was 4% higher than a year earlier in Q3. In contrast, research using the DMP Survey suggests that Covid has reduced 'within-firm' productivity – the concept most relevant for firms' costs – by 2% in Q3, and is expected to drag by a similar amount in 2021 H1 (*Bloom et al (2020)*).

2.5: Inflation

Inflation was 0.6% in December, but is expected to pick up sharply over the coming months.

CPI inflation was 0.6% in December (**Chart 2.1**), in line with the *November Report* forecast. It is expected to remain around this rate in January and February, before picking up quite sharply over the rest of the first half of this year. That is mainly the result of last year's fall in energy prices dropping out of the annual comparison and the more recent rises in oil and gas prices (**Chart 2.26**) feeding through. The temporary cut to VAT in the hospitality sector is also due to end in April. Going in the other direction, the annual update of CPI weights is expected to shift the CPI basket away from services and towards goods and push inflation down slightly in coming quarters. Section 4 discusses how Covid has affected inflation in detail.

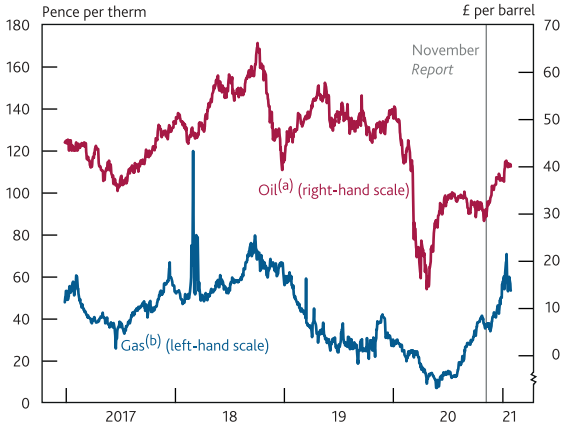
There have been mixed moves in indicators of inflation expectations.

Surveys of household inflation expectations have painted a mixed picture recently (**Table 2.C**). The YouGov/Citigroup one year ahead expectation picked up sharply in December, but fell back in January. The Bank/Kantar Q4 one year ahead expectation fell slightly to below its post-crisis average. Longer-term inflation expectations have been more stable.

In financial markets, implied expectations for inflation over five years, five years from now are at broadly similar levels to a year ago, and have been more stable over the past year than equivalent measures for the US and euro area (Chart 2.27). Retailers' inflation expectations fell slightly in Q4, but remain higher than a year ago.

Overall, the MPC judges that inflation expectations remain well anchored.

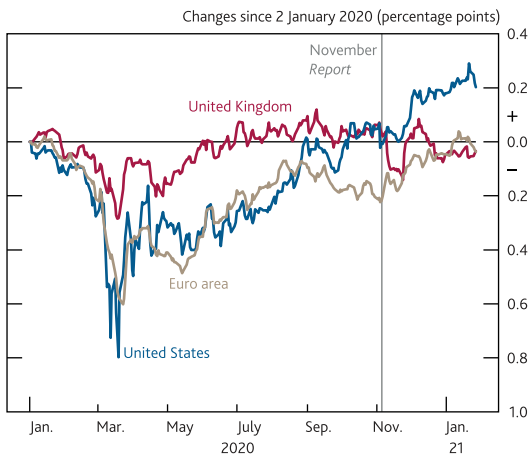
Chart 2.26: Oil and gas prices have risen since the November Report
Sterling oil and wholesale gas prices



Sources: Bank of England, Bloomberg Finance L.P. and Bank calculations.

(a) US dollar forward prices for delivery in 10–25 days' time converted into sterling.
(b) One-day forward price of UK natural gas.

Chart 2.27: Implied UK inflation expectations in financial markets are at similar levels to a year ago
Changes in five-year, five-year forward inflation compensation^(a)



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

(a) Derived from swaps. The instruments are linked to the UK RPI, US CPI and euro-area HICP measures of inflation.

Table 2.C: The MPC judges that inflation expectations remain well anchored
Measures of inflation expectations^(a)

Per cent	2000–07 ^(b)	2010–18	2019	2020			
				Q1	Q2	Q3	Q4
One year ahead inflation expectations							
Households^(c)							
Bank/Kantar	2.4	3.0	3.2	3.0	2.9	2.8	2.7
YouGov/Citigroup	2.5	2.4	2.7	2.7	3.1	3.1	3.4
Companies^(d)							
Financial markets ^(e)	2.6	2.9	3.4	3.1	2.8	3.1	3.2
Two to three year ahead expectations							
Households^(c)							
Bank/Kantar	n.a.	2.8	3.0	2.9	1.9	2.2	2.1
Companies ^(d)	n.a.	n.a.	0.8	1.3	1.0	1.9	1.5
External forecasters ^(f)	2.0	2.1	2.0	2.0	2.0	1.9	1.9
Financial markets ^(e)	2.8	3.1	3.6	3.5	3.4	3.6	3.5
Five to ten year ahead expectations							
Households^(c)							
Bank/Kantar	n.a.	3.3	3.5	3.4	2.6	2.8	2.9
YouGov/Citigroup	3.5	3.2	3.1	3.1	3.0	3.4	3.4
Financial markets ^(e)	3.0	3.3	3.5	3.4	3.4	3.5	3.5
Memo: CPI inflation	1.6	2.3	1.8	1.7	0.6	0.6	0.5

Sources: Bank of England, Bloomberg Finance L.P., CBI, Citigroup, Kantar, ONS, YouGov and Bank calculations.

(a) Data are not seasonally adjusted.
(b) Averages from 2000, or start of series, to 2007. Financial market data start in October 2004, YouGov/Citigroup data start in November 2005 and external forecasters' data start in 2006 Q2.
(c) The household surveys ask about expected changes in prices but do not reference a specific price index.
(d) CBI data for the distributive trades sector. Companies are asked about the expected percentage price change over the coming 12 months and the following 12 months in the markets in which they compete.
(e) Instantaneous RPI inflation one and three years ahead and five-year RPI inflation five years ahead, derived from swaps.
(f) Bank's survey of external forecasters, CPI inflation rate three years ahead.

Box B: Explaining cross-country differences in GDP growth over the pandemic

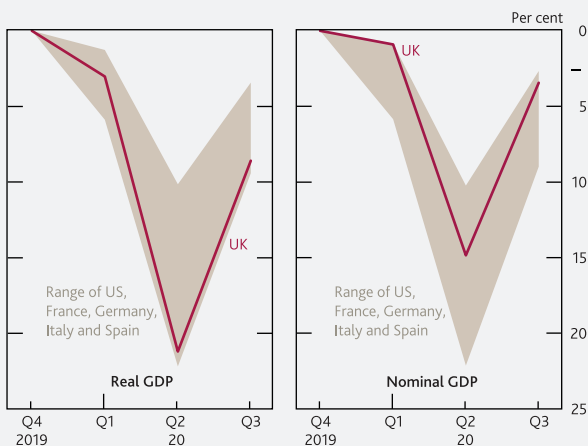
The pandemic caused large swings in GDP around the world in 2020, with advanced economies generally experiencing unprecedented declines in output in March and April followed by partial recoveries over the summer. GDP and expenditure data are often revised over time, and there is greater uncertainty around the data than usual at the moment.⁽¹⁾ Nevertheless, initial data suggest the UK experienced one of the largest falls in real GDP among advanced economies in 2020 Q2. Real GDP remained relatively low in Q3 (left-hand panel, **Chart A**). Real GDP measures the size of an economy adjusted for price changes. The fall in the UK's nominal GDP – the size of the economy without adjusting for price changes – was more in line with the average across advanced economies (right-hand panel, **Chart A**).

Some of the differences in real GDP growth across countries are accounted for by estimates of real government spending (green bars in **Chart B**). In the UK, real government consumption fell by 15% in Q2 and recovered only partially in Q3. Output in the government sector followed a similar path. In contrast, many other countries reported that real government consumption was stable, or increased slightly, over this period.

Some of this difference may be explained by different methods of measurement. In the UK, the output of government services that are consumed by individuals is often measured using volume indicators, such as the number of hospital operations and the number of school pupils taught. This approach is regarded as best practice internationally. In Q2, a lot of routine healthcare was postponed and schools were temporarily closed, causing measured real government output to fall. However, spending on healthcare and education actually increased, meaning the implied 'price' of government output increased sharply. In other countries, spending is more often used as a proxy for government output, especially in early estimates of output (*ONS (2021)*). As a result, even though many places had similar experiences with healthcare developments and school closures, their estimates of real government output were more stable. This also helps to explain why the differences in GDP growth between the UK and other countries are generally smaller in nominal terms.

Chart A: The UK experienced one of the largest falls in real GDP among advanced economies in 2020; the fall in nominal GDP was around average

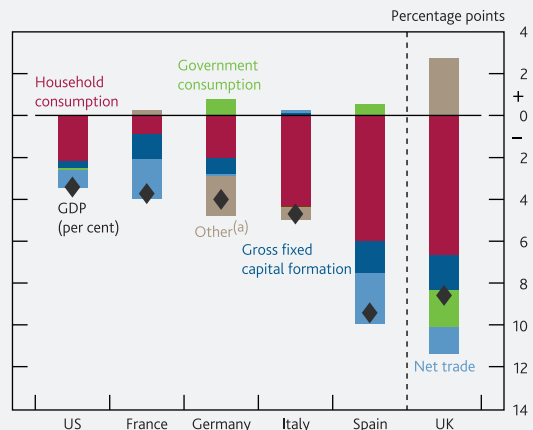
Percentage changes in GDP from 2019 Q4



Sources: Eikon from Refinitiv, OECD, ONS and Bank calculations.

Chart B: The measurement of real government spending accounts for some of the differences in real GDP growth

Contributions to changes in real GDP between 2019 Q4 and 2020 Q3



Sources: Eikon from Refinitiv, OECD, ONS and Bank calculations.

(a) Calculated as a residual.

Consumer spending also accounts for a large part of the difference in real GDP growth (red bars in **Chart B**). In the UK, household consumption fell by 22% in Q2 and remained 10% lower in Q3 than in 2019 Q4, compared to an average of 5% across the other countries shown. Consumer spending has also been relatively weak in nominal terms in the UK, implying prices are not important for explaining this difference. A number of factors may have contributed to the relative weakness.

(1) In addition to the measurement challenges covered in Box 4 in the *May 2020 Monetary Policy Report*, the ONS is having to incorporate novel forms of activity into GDP, such as the track and trace system. See 'The virus, the vaccine and GDP: measuring healthcare through the pandemic' for more information.

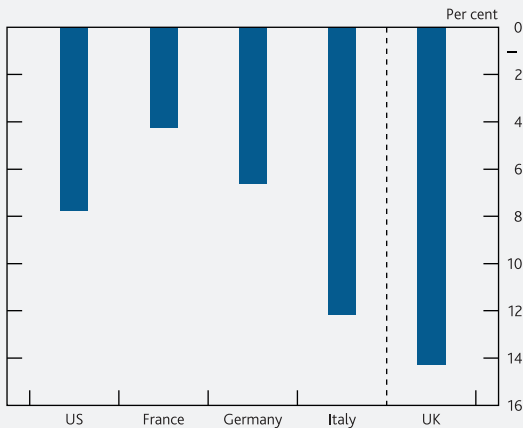
First, UK consumer spending is a little more heavily weighted towards activities that involve interaction with others. Social consumption – which includes things like attending cinemas, restaurants or live sports events – makes up 21% of total household spending in the UK, compared with 16% in the US and 18% in the euro area. This type of spending has been particularly affected by Covid. This is likely to account for a small part of the difference.

Second, and more importantly, it appears services consumption fell further in the UK than in other countries. This is partly because lockdown restrictions were often in place for longer in the UK. For example, the first national lockdown begun in March lasted for 69 days in the UK, compared to 28 days in Germany. However, spending on services remained relatively weak in Q3, even as restrictions were generally easing (Chart C). This may be related to mobility recovering more slowly in the UK (Chart 2.3). The composition of the UK jobs market may be one reason for this – the UK is thought to have a higher proportion of jobs that can be done remotely than many other countries (Dingel and Neiman (2020)). Consistent with this, some surveys have shown UK workers have returned to workplaces more slowly than elsewhere. This will have automatically lowered work-related spending, such as travel, and may also have prevented some social spending that would normally take place around workplaces. It is possible that a more cautious response to infection risk in the UK is a factor, especially in areas with greater reliance on public transport, such as London, where spending has been particularly weak. Some surveys suggest attitudes towards risk and behaviour changes in response to Covid have been broadly similar across countries, however (Chart D).

To the extent that the factors discussed in this box would be expected to unwind as the economy recovers, UK output might rebound more sharply over 2021 than in some other countries.

Chart C: Spending on services has been relatively weak in the UK

Percentage changes in real services consumption between 2019 Q4 and 2020 Q3^(a)

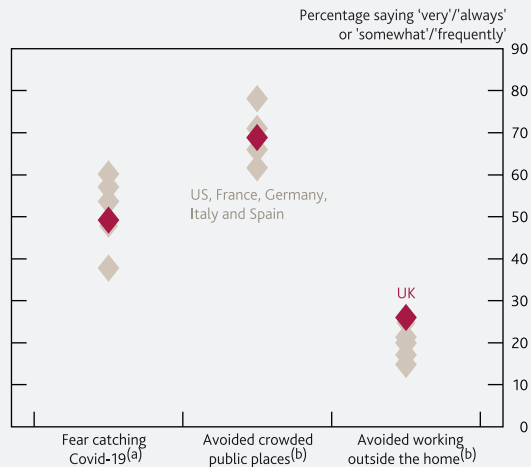


Sources: US Bureau of Economic Analysis, Eikon from Refinitiv, Eurostat, ONS and Bank calculations.

(a) Data are not available for Spain.

Chart D: Surveys suggest attitudes towards Covid were broadly similar across countries

Attitudes and behaviour changes in response to Covid-19 in 2020 Q2 and Q3



Sources: YouGov and Bank calculations.

(a) Question: 'Are you scared you will contract Covid-19?'. Chart shows the percentage responding 'very' or 'somewhat'.

(b) Question: 'Thinking about the last 7 days, how often have you taken the following measures to protect yourself or others from Covid-19?'. Chart shows the percentage responding 'always' or 'frequently'.

Box C: Agents' update on business conditions

The key information from Agents' contacts considered by the Monetary Policy Committee at its February meeting is highlighted in this box. The information was gathered in a period which saw a tightening of Covid-related restrictions across the UK.

Spending on consumer services around the end of 2020 was significantly down on a year earlier, reflecting restrictions to control the spread of Covid, albeit to a lesser extent than in Q2.

Covid-related restrictions meant that many businesses in the hospitality and leisure sectors were unable to operate during what would usually be their busiest period of the year. Most hotels remained closed. Positive news on vaccines drove an increase in bookings for UK holidays later in 2021, although caution over foreign travel meant that overseas bookings remained muted.

Spending on goods was also lower than in the previous year, although some stores able to remain open reported a reasonably strong Christmas trading period.

Contacts also reported a decline in spending on goods compared to a year earlier. Some demand had moved online, but this did not entirely offset the loss of physical sales. Those store-based retailers that were permitted to remain open reported a reasonably strong Christmas trading period; supermarket sales of food and drink were particularly buoyant at the end of 2020.

Activity in business services showed continuing signs of a modest recovery. Manufacturing output was boosted by Brexit-related stockbuilding in Q4.

Business services activity continued to recover, although turnover remained below levels a year earlier. Activity was strongest in finance and professional services. Accountancy firms noted an increase in demand for advisory work and contacts reported strong demand for technology services. In contrast, business travel and events remained weak.

Manufacturers saw an uplift in demand as a result of Brexit-related stockbuilding by EU customers, although this was lower than around previous deadlines. Output of computing and electrical products at the end of 2020 was well ahead of the previous year, largely to meet higher demand for home working. Contacts in the pharmaceutical sector and those making personal protective equipment also continued to report strong demand. However, weakness in the aviation sector persisted. A number of manufacturers have faced capacity constraints due to Covid-related absences among their staff.

In the [November Monetary Policy Report](#), the MPC judged that trade and activity would be temporarily lower between the UK and EU as companies adjusted to the new trading relationship coming into effect. In the first few weeks of January, contacts reported some delays affecting cross-border trade. This was mainly due to incomplete paperwork and, in most cases, delays were minor and could be accommodated. Trade flows were lower than usual as businesses adapted to the new trading arrangements. Firms had also built up stocks in advance of the end of the transition period and some Covid-related disruption slowed freight movement. Some movement of goods from Great Britain to Northern Ireland was disrupted by rules of origin requirements, especially for foodstuffs. This led to some product shortages and shorter shelf lives.

Housing market activity started to slow after recent strength.

Activity in the housing market showed signs of slowing after a very strong second half of 2020. That probably partly reflected the upcoming end of temporary property transaction tax holidays in the UK, with buyers aware that sales agreed recently were unlikely to complete before that point, partly reflecting the fact that the completion process is taking much longer than usual. Initial indications suggested that the most recent lockdown measures also weighed on activity. Contacts expected house price inflation to slow, although most still expected modest price rises.

Partly as a result of strong demand in the past few months, private house builders reported shortages of materials which slowed activity. Supplies of timber, insulation and bricks were scarce and were likely to remain so at least in the short term as suppliers navigated potential delays at ports.

Contacts in commercial real estate reported lower levels of investor activity than normal, although interest from overseas investors in industrial properties and prime office space was evident, especially for those with reliable tenants in place. Rental income in the retail sector was well below normal and arrears were accumulating. Several larger retailers had turned to company voluntary arrangements to potentially force the restructuring of lease agreements.

Investment intentions picked up a little, but ongoing uncertainty continued to weigh on planned spending.

Lower cash flow, as well as uncertainties around future demand related to the ongoing pandemic and the effect of new trading arrangements with the EU, had weighed on planned investment. Nevertheless, some contacts reported that investment was likely to increase in 2021 from a very depressed level in 2020, although it was unlikely to return to pre-Covid levels before the end of the year.

Demand for bank credit from large businesses was subdued, but higher for SMEs.

For the largest businesses, demand for bank credit was subdued as they were able to raise funds from financial markets and through the sale and leaseback of properties and machinery. For small and medium-sized enterprises (SMEs), there was evidence that the recent tightening in Covid restrictions had reduced cash flow and increased the demand for finance. Rising demand from some companies may also reflect pre-emptive borrowing, as deferred payments for rents and VAT are due in Q2.

The furlough scheme has been helping to maintain jobs in the hardest hit sectors.

Fewer employees had been furloughed in recent weeks than was the case when the Coronavirus Job Retention Scheme (CJRS) was first launched, as more businesses had been able to remain open and because companies had made redundancies since then. The CJRS was especially supporting workers in the hospitality and retail sectors. Contacts in those sectors remained concerned over further job losses once the support was withdrawn.

A small but increasing number of firms were tentatively looking to hire in 2021 as demand improves. This includes businesses that cut headcount when the pandemic first hit and had seen demand recover faster than expected. Of those that were recruiting, some were now able to hire from across the UK as their businesses were better able to support working from home arrangements.

The pandemic had put increasing pressure on the voluntary sector, with reports of greater use of foodbanks and more need for mental health support. Charities reported that the pandemic appeared to have particularly affected young people. Some differences in home schooling related to the digital divide, for example, were reported to have affected access to education, with some raising concerns it may affect future employment.

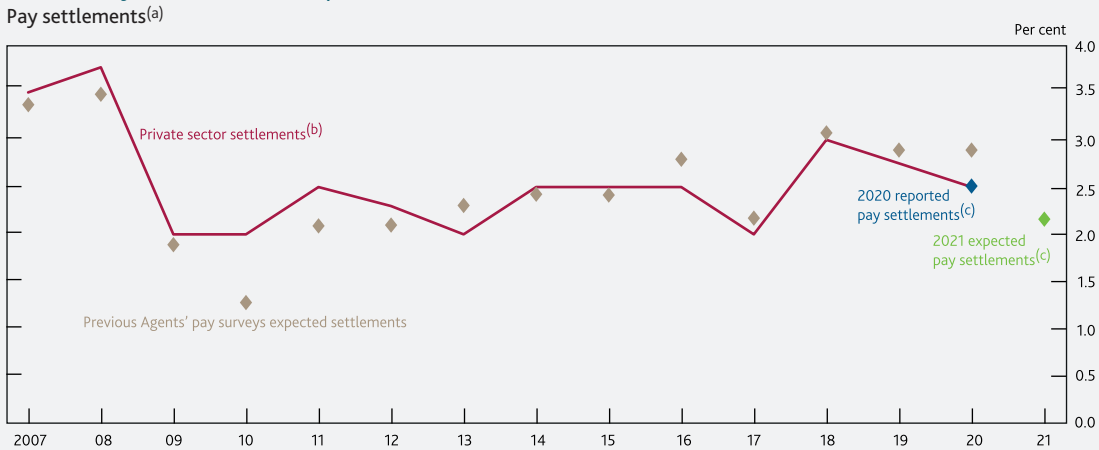
Pay settlements were expected to be slightly lower in 2021 than last year.

Pay growth was reported to have remained subdued. In a survey on pay and costs, contacts reported that the average pay settlement in 2020 was 2.5%, lower than the 2.8% reported for 2019 (Chart A).⁽¹⁾ The average pay settlement was expected to fall a little further to 2.2% in 2021.

On average, survey respondents reported that their total input costs had fallen slightly in 2020, but that unit costs had increased by around 5% in aggregate, as sales had fallen sharply (Section 4). Unit costs had increased by more for consumer services and construction businesses, who had experienced the greatest drop in sales volumes, while also incurring higher costs to ensure Covid safety than other sectors.

(1) The Agents' survey on pay and costs was conducted between 7 December 2020 and 12 January 2021, and responses were received from 245 contacts.

Chart A: Pay settlements are expected to be lower in 2021 than 2020



Source: Bank of England, including the wage settlements database (which draws on information from the Bank's Agents, Incomes Data Research, Incomes Data Services, Industrial Relations Services and the Labour Research Department).

- (a) Companies were asked to state their average UK pay settlement for 2020 and their expected average UK pay settlement for 2021.
- (b) Average over the previous 12 months, based on monthly data.
- (c) Data gathered from the 2021 Agents' survey on pay and costs.

Retailers report little scope to increase prices.

There were fewer reports of seasonal discounting over Christmas than in previous years and some clothing retailers had mothballed stock rather than offer heavy price reductions. Retailers generally reported little scope to increase prices. Price competition between supermarkets had increased in Q4; food price inflation was expected to be only modest in 2021 Q1.

3: In focus – The potential impact of Covid vaccines on spending

The Covid vaccination programme would be expected to lead to an easing of social distancing restrictions, reduced economic uncertainty, and higher activity, although the timing of those effects is hard to predict. Consumption is expected to recover materially in the near term as restrictions ease, and is supported over the forecast period by households spending around 5% of the savings accumulated during the pandemic. Investment is expected to rise as uncertainty falls back, but remains below its pre-pandemic level for some time. Key uncertainties surrounding the outlook include how households respond to changing health risks, the extent to which accumulated savings are spent, and whether businesses respond to lower uncertainty by increasing spending or repairing their balance sheets.

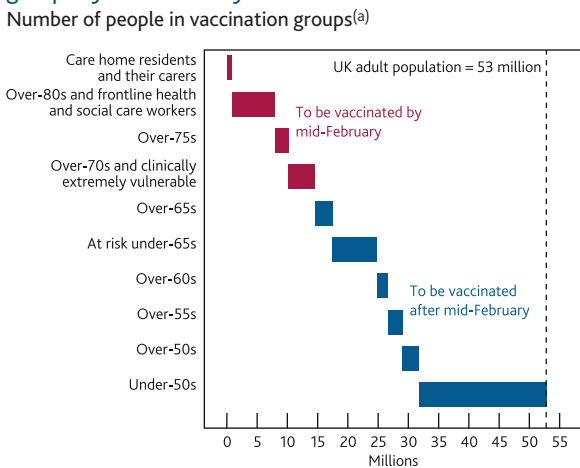
Covid has had a huge impact on households and businesses. Over the past few months, additional social distancing restrictions have been put in place in response to a rise in the number of cases. These developments will weigh on activity, and GDP is expected to fall in 2021 Q1 (Section 2).

Activity further ahead should be supported by the deployment of Covid vaccines, however. Since November, three vaccines have been granted approval for use in the UK and by mid-February the Government expects to have vaccinated the four highest-priority groups (Chart 3.1). According to the Department of Health and Social Care, those groups represent 15 million people and account for 88% of fatalities from Covid to date.⁽¹⁾

The development of vaccines has boosted confidence that the pandemic will be brought under control in the near term (Chart 3.2). There is uncertainty about the precise path of the rollout, however, as well as the duration of protection and the impact on transmission. New strains of Covid have added to the perceived level of uncertainty.

This *In focus* considers the potential impact of Covid vaccines on the near-term recovery of consumption (Section 3.1) and business investment (Section 3.2), with the impact on the MPC’s projections summarised in Section 3.3.

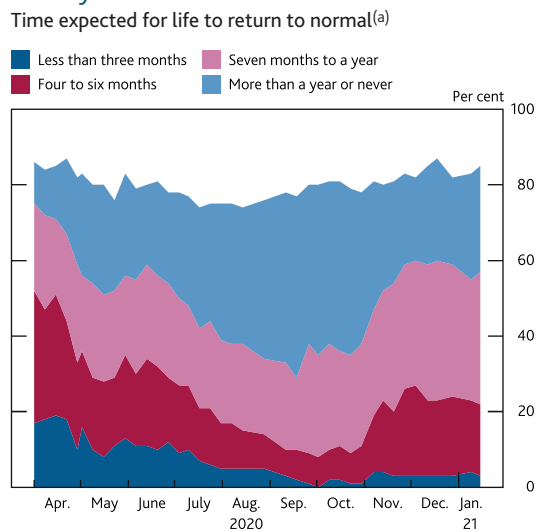
Chart 3.1: The Government aims to offer a first vaccine dose to the 15 million people in the most vulnerable groups by mid-February



Source: Department of Health and Social Care.

(a) Groups defined by the Joint Committee on Vaccination and Immunisation. Planned timetable as set out in the Government’s vaccines delivery plan, published 11 January.

Chart 3.2: The share of people that believe it will take less than a year for life to return to normal has risen



Sources: ONS Opinions and Lifestyle Survey and Bank calculations.

(a) Question: ‘How long do you think it will be before your life returns to normal?’. Areas do not sum to 100 because responses of ‘Not sure’ and ‘Prefer not to say’ are excluded.

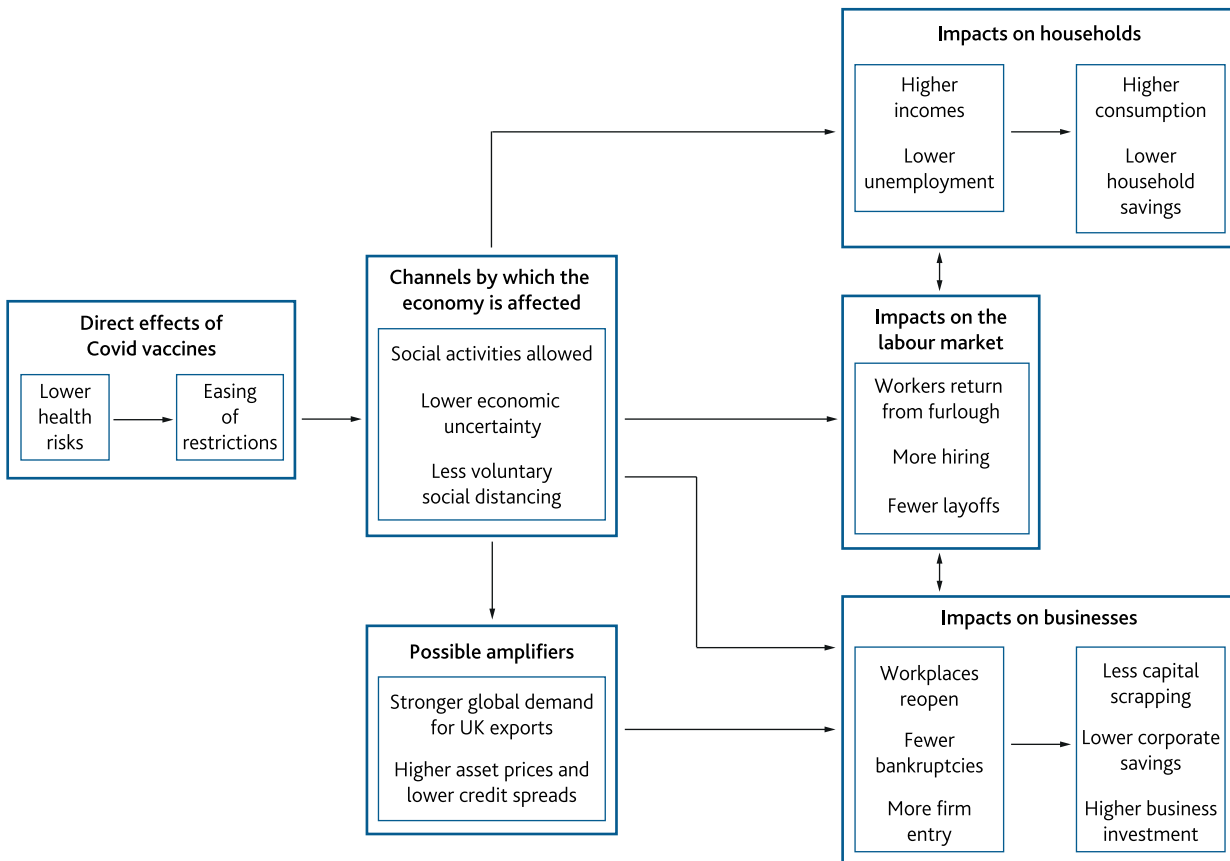
(1) See ‘UK Covid-19 vaccines delivery plan’, Department of Health and Social Care, published 11 January.

3.1: The potential impact of Covid vaccines on household spending

A successful vaccination programme would support a material recovery in household spending...

The vaccination programme should allow social distancing restrictions to be eased and reduce the fear of catching Covid, both of which would directly support household spending (Figure 1). Household spending might also be boosted indirectly if reduced economic uncertainty – for example because of a lower perceived risk of unemployment – results in less reason to save for precautionary reasons in future.

Figure 1: The vaccine is expected to affect households and businesses via various channels



...although the timing and extent of that is uncertain.

While a successful vaccination programme would be expected to support a pickup in consumption, the path of the recovery is uncertain. If consumers expect conditions to improve in the very near future, for example, that could cause them to delay some spending until that happens (Broadbent (2020)). In the near term, households may therefore choose to delay some spending while they wait to receive their vaccines. Restrictions on activity and voluntary social distancing are also likely to continue to some extent until a significant share of the population has been vaccinated. Once those restrictions are eased, spending on previously unavailable activities will recover. Indeed, pent-up demand for some previously unavailable goods could lead to a sharp pickup in spending on those items, as consumers make purchases they had previously postponed. That effect would be expected to wane over time, however.

Some features of household spending observed during the pandemic may be informative about the likely path of the recovery.

To gauge the likely effect of the vaccination programme on spending, it is useful to consider the ways in which households have responded to the pandemic so far. Three observations are potentially informative.

Observation 1: Spending that involves contact with other people, such as attending cinemas or restaurants, has been hit particularly hard during the pandemic. This social spending should recover once people have been vaccinated, although there may be a limit to which lost spending is made up.

Spending on social activities has fallen sharply.

Household consumption decreased by 25% over 2020 H1. Social consumption – which includes things like attending cinemas, restaurants or live sports events – fell by 80% and accounted for over half of that fall. This type of spending tends to be particularly affected by restrictions on activity, as well as any voluntary social distancing. Following a partial recovery in Q3, it is expected to have fallen back again in 2020 Q4 and 2021 Q1, as social distancing restrictions increased. Contacts of the Bank’s Agents suggest that, in November and December, increasing concern about the risk of infection also weighed on this type of spending.

That spending may recover strongly as a greater proportion of people are vaccinated...

The vaccination programme would be expected to reduce the need for social distancing restrictions, as well as lowering the health risks of Covid. As that happens, spending on social activities would be expected to recover towards pre-pandemic levels. Agency intelligence suggests positive news on vaccines has reduced consumers’ caution around booking domestic travel and accommodation for later in the year, for example.

...but some voluntary social distancing could persist for a while.

Households’ perceptions of health risks appear to be an important driver of social spending and it is possible that some voluntary social distancing will continue to weigh on spending, even as restrictions are eased. For example, in 2020 Q4, spending on social activities appears to have remained well below its levels in 2019 Q4 even when restrictions were relatively light. In response to the January 2021 Bank of England/Ipsos MORI survey, over a quarter of people reported that they expected to spend less once restrictions have been lifted than before the pandemic began, because they were cautious about going out. There may be some ongoing concerns among those who are vaccinated, even once they have received their second dose and allowed some time to develop full protection. It is also not yet known to what extent vaccinated people can pass on the virus, although the risk is expected to be reduced,⁽²⁾ so those people may continue to avoid social settings due to fear of transmission to others. Uncertainty about the possibility of new Covid strains emerging may also persist.

There is likely to be a limit as to how much of the lost social spending can be caught up.

While spending on social activities is likely to return towards pre-pandemic levels over time, the nature of social spending suggests there is limited scope for the fall in spending during the pandemic to be caught up. Following the vaccination programme, people are unlikely to have more haircuts than usual, for example. The experience of other countries so far generally supports this. In New Zealand, where restrictions have been eased substantially, spending on recreation and culture in 2020 Q3 was a little above its late-2019 level, but spending on restaurants and hotels, as well as on transport, did not rise above previous levels. In Australia, where restrictions have also been materially eased, spending on all three of these activities in 2020 Q3 remained somewhat below their late-2019 levels. For some producers and consumers, capacity constraints may limit the extent to which social consumption can rise above normal levels temporarily. Wedding venues will only be able to accommodate a certain number of ceremonies each year, for example, while employees wishing to do extra social activities may have limits on how much leave they can take from work each year.

Observation 2: Households have spent much less on durable goods during the pandemic. Spending is likely to recover as a greater proportion of people are vaccinated and some previously forgone spending may be made up.

Spending on durable goods fell significantly during the first lockdown.

Spending on durable goods – including on things like cars or home appliances – was 33% lower in 2020 Q2 than at the end of 2019. Sales of new cars fell to almost zero during the first lockdown as car dealerships and showrooms were closed (**Chart 3.3**) and between March and June 2020 as a whole, sales were around 60% below their average over similar periods in the past, equivalent to around 225,000 fewer sales.

(2) See Government advice on ‘[What to expect after your Covid-19 vaccination](#)’.

When restrictions on activity were eased, some goods saw a temporary spike in demand...

When social distancing restrictions were eased following the first lockdown, spending on some durable goods was higher than usual, consistent with pent-up demand for those items. Spending on household items – including things like furniture, carpets and appliances – was 7% above its late-2019 level in 2020 Q3, having fallen 11% below that level in Q2. Activity in the housing market was also high in 2020 Q3.

...but for many other goods, the size of the pickup was small relative to the previous decline.

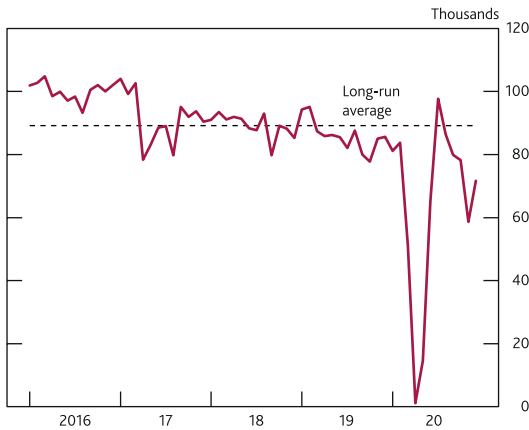
There was less evidence of pent-up demand for other durable goods, however. Demand for new cars appeared to be only a little higher than usual when showrooms reopened, for example. Private new car sales rose to 98,000 in July, before falling back in line with their long-run average in August, representing an overshoot of around 9,000 sales. There has been a strong increase in demand for second-hand cars, however (see Section 4). Overall, durable goods spending in 2020 Q3 was still 4% below its late-2019 level.

There may still be some pent-up demand for durable goods among consumers.

The reasons behind the fall in durable goods spending during the pandemic may be informative about the degree of pent-up demand for those items. One potential source of pent-up demand could arise from goods not being available to buy for a period. This does not appear to have been the case for many items, however, even when physical stores have been closed. A number of retailers have increased their online capabilities and a recent study found that while the closure of hospitality and non-essential retail businesses reduced spending on a range of goods and services, that was partially offset by increased spending at online retailers (Chart 3.4). Another potential reason for the release of pent-up demand would be lower economic uncertainty, for example due to greater job security.

Chart 3.3: New car sales fell to almost zero in April, with limited evidence of pent-up demand since then

Private new car registrations^(a)

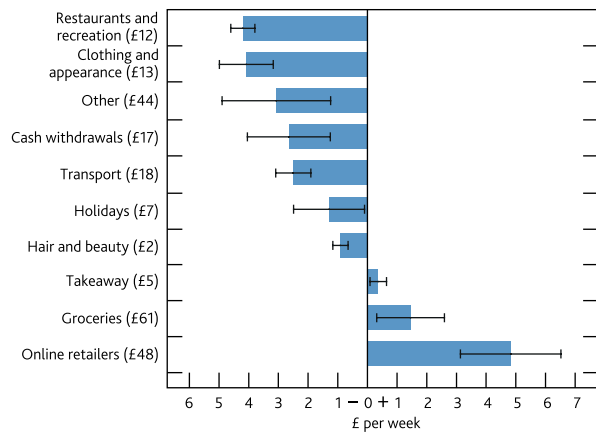


Sources: Society of Motor Manufacturers and Traders and Bank calculations.

(a) Long-run average shows average monthly new car sales between January 1999 and February 2020. Data are seasonally adjusted by Bank staff.

Chart 3.4: Public health restrictions reduced spending on most goods and services, but online sales increased

Change in spending per person as a result of closing hospitality and non-essential retail businesses^(a)



Source: Institute for Fiscal Studies.

(a) Estimated impact of closing hospitality and non-essential retail businesses on weekly spending, based on data from June to November 2020. Figures in parentheses are average weekly spending per person on each of the categories. Error bars show 95% confidence intervals. See Davenport *et al* (2020), 'The geographic impact of the pandemic on household spending' for more details.

Given that the closure of physical stores appears unlikely to account fully for the sharp fall in durables spending, it seems unlikely that their reopening alone will cause a significant temporary boost to demand. To the extent that ongoing uncertainty has caused the fall, there may be scope for some higher-than-usual spending for a period if the vaccination programme causes that uncertainty to fall back.

Observation 3: The fall in consumption during the pandemic has been large relative to the fall in household incomes, such that households in aggregate have increased their savings. Some of that stock of accumulated savings could be spent once a significant share of the population has been vaccinated.

Household savings have increased overall during the pandemic...

The sharp fall in total consumption since the start of the pandemic was larger than the fall in household incomes (Chart 2.19), which were supported by the Government's job retention and other income support schemes. The saving

rate increased sharply as a result, to 26.5% of disposable income in Q2. It fell back to 16.5% in Q3, although it was still 9 percentage points above its 2019 Q4 level. Those higher flows of savings have accumulated over time. Data on retail deposits suggest that in each month between March and November 2020, more money went into households’ bank accounts than usual. Adding up the additional deposits over those nine months suggests that households have accumulated an excess stock of savings of £125 billion (Chart 3.5). That figure is likely to rise substantially further over the first half of 2021.

...and part of the accumulated savings could be spent following a successful vaccination programme.

Much of the excess savings is likely to have built up because households have not been able to spend as usual, rather than because they actively chose to increase their savings. Those households with a higher-than-usual stock of savings in their bank accounts might choose to spend some of that money following a successful vaccination programme. That would boost monthly consumption relative to income, such that the savings rate may fall temporarily below its usual level.

It is highly unusual for households to accumulate such a large stock of savings...

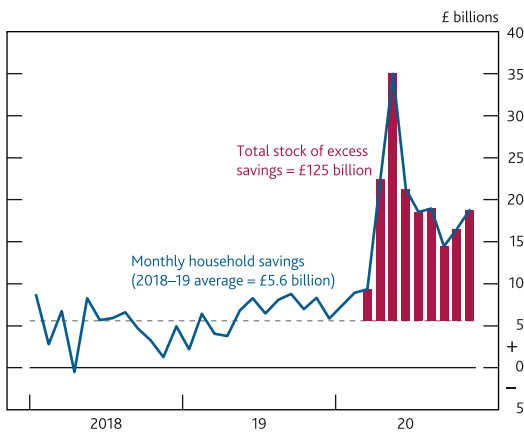
Past experience tells us little about the extent to which such a large stock of accumulated savings will be run down. Between 2012 and 2019, for example, the highest amount of equivalent savings accumulated over any nine-month period was around £25 billion.

...but there are reasons to think that a significant share may not be spent immediately.

The stock of savings accumulated during the pandemic is concentrated among households that may choose not to spend it immediately. The NMG survey shows that a significant share of retirees and higher-income households have increased their savings, whereas low-income households have in many cases reported having saved less than usual (Chart 3.6).⁽³⁾ Retired households are likely to receive the vaccine sooner, so may spend some of their accumulated savings relatively quickly. Higher-income households tend to spend a smaller fraction of their income on average, however.

Chart 3.5: Households have accumulated a significant stock of savings since March 2020

Monthly household savings^(a)

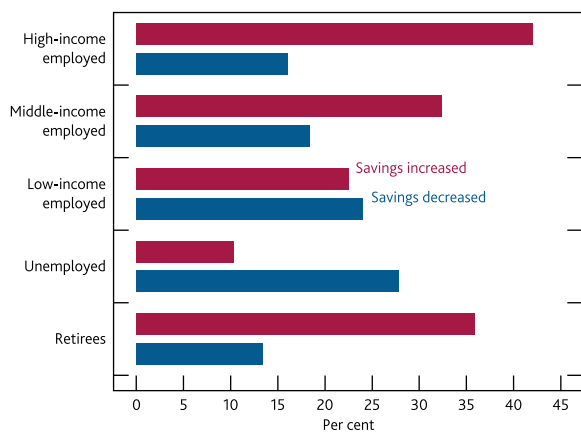


Sources: Bank of England, The Investment Association and Bank calculations.

(a) Calculated as the sum of flows into household deposits with banks, National Savings and Investment accounts, and retail funds. Data for retail funds have been seasonally adjusted by Bank staff. Latest data point is for November 2020.

Chart 3.6: High-income and retired households are more likely than low-income households to have increased savings

Percentage of households reporting changes in their savings^(a)



Sources: NMG Consulting and Bank calculations.

(a) Question: 'Over the past year, did you change the amount of money you saved each month? Please exclude any contributions to pension schemes'. Households are defined as employed, retired or unemployed according to the status of the main earner. High-income employed households have incomes in the top quintile; middle-income employed households have incomes in the second and third quintiles; and low-income employed households have incomes in the bottom two quintiles.

Survey evidence suggests that a significant share of accumulated savings may not be spent immediately. The NMG survey suggests that 10% of the households that increased their savings during the pandemic planned to spend at least part of the money they had saved, with around 70% planning to continue to hold the savings in their bank accounts. Others planned to use their savings to pay off debts, invest, or top up their pensions, which could boost future spending. According to the latest Bank of England/Ipsos MORI household survey, 13% of respondents expect to catch up some of their lost spending once restrictions are lifted.

(3) See Nourse *et al* (2020), 'How has Covid affected household savings?' for more details.

3.2: The potential impact of Covid vaccines on business investment

Vaccination programmes in the UK and abroad will support some businesses' revenues and investment spending...

Vaccination programmes in the UK and abroad are expected to increase some businesses' revenues, which could be used to finance higher investment. Some sectors, such as hospitality, have been required to close completely under social distancing restrictions, or to operate at reduced capacity, and the deployment of vaccines is expected to reduce the need for ongoing restrictions (Figure 1). For exporters, vaccination programmes elsewhere will also be important.

...while a reduction in uncertainty should also boost investment spending.

Any fall in uncertainty linked to vaccines would also be expected to support investment spending (see Section 4 of the [November 2019 Report](#) for a full discussion of the relationship between uncertainty and business investment).

Investment typically involves sunk costs and changes to processes, which make it costly to reverse. That creates an incentive to delay decisions if firms face heightened uncertainty about the future ahead of it being resolved. To the extent that vaccines reduce the uncertainty about the path out of the pandemic, they should lead to higher investment. Any associated boost to asset prices or fall in credit spreads could also make it easier to finance investment spending, particularly for credit-constrained firms.

Similar to households, some observations from the pandemic may be informative about the likely path of business investment.

To quantify the likely effect of the vaccination programme on business investment, two things observed during the pandemic to date are potentially informative.

Observation 1: Uncertainty has risen to very high levels since the start of the pandemic. If the vaccination programme causes that to fall back, investment could rise materially, although that may take time.

The pandemic has led to a large increase in uncertainty, so the vaccination programme could provide a material boost to investment...

Businesses have reported very high levels of uncertainty during the pandemic. The Deloitte survey suggested that over 70% of CFOs believed that uncertainty was 'high' or 'very high' during all four quarters in 2020, a larger share than at any other time since the survey began in 2010. The Decision Maker Panel (DMP) Survey suggests that increase in uncertainty is largely due to Covid. In April 2020, for example, 87% of respondents said that Covid was the largest source of uncertainty for their business.

The prevalence of Covid-related uncertainty suggests that vaccines could have a material effect on investment. The firms that report high uncertainty in the DMP Survey also report a larger negative impact from Covid on investment. Overall, business investment is expected to have fallen by 15% in 2020, so a vaccination programme which reduces uncertainty could support a material recovery.

...but it may take time for that to happen.

Uncertainty may not fall back to previous levels for some time, though. The DMP Survey suggests that almost 40% of firms do not expect Covid-related uncertainty to be resolved in 2021 (Chart 3.7). Contacts of the Bank's Agents also report that increased uncertainty linked to the latest social distancing restrictions means that investment is unlikely to recover to 2019 levels during 2021.

Observation 2: Some businesses have accumulated cash reserves during the pandemic. The vaccination programme may mean that some firms choose to run down that stock of savings by increasing investment, although other firms may look to rebuild balance sheets to some extent.

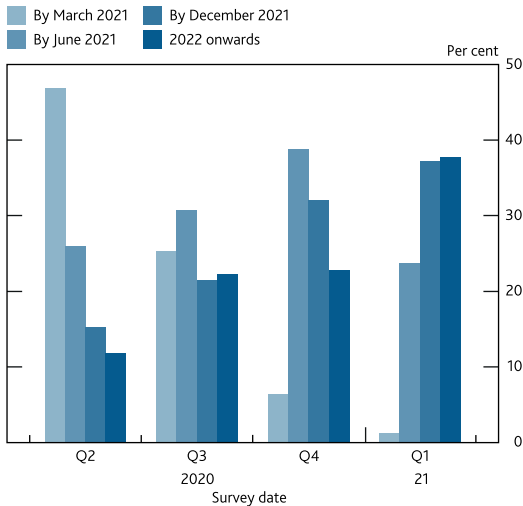
Some businesses, like households, have accumulated cash reserves during the pandemic.

While the picture is likely to vary significantly across different businesses, data on corporate deposits at banks suggest that, overall, firms accumulated excess savings of close to £100 billion between March and December 2020.⁽⁴⁾ That could be because firms have reduced investment relative to their revenues during the pandemic. Evidence from the DMP Survey suggests that investment spending has fallen by more than the decline in businesses' sales in aggregate, for example (Chart 3.8). Firm-level data available for over 500 large firms – which account for around 20% of business

(4) Based on the change in monetary financial institutions' sterling M4 liabilities to private non-financial corporations, relative to the 2018–19 average.

investment – suggest it was also due to firms raising large amounts of finance. Access to finance and uses of funds could be very different for smaller companies, however, where equivalent data are not yet available.

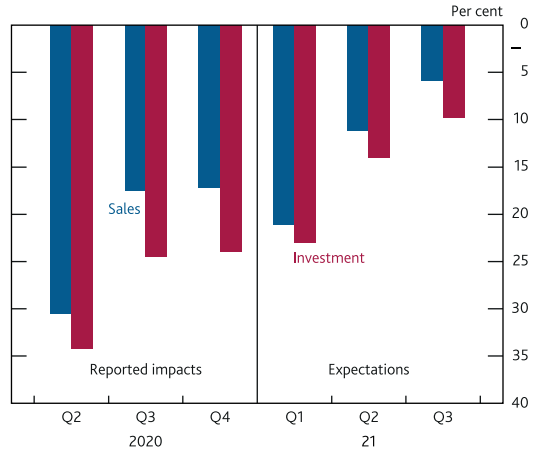
Chart 3.7: Almost 40% of firms do not expect Covid-related uncertainty to be resolved in 2021
Expected resolution date for Covid-related uncertainty^(a)



Sources: DMP Survey and Bank calculations.

(a) Question: 'When do you think it is most likely that the coronavirus-related uncertainty facing your business will be resolved?'. 2020 Q2 data are based on the June survey, Q3 data are based on the July, August and September surveys and Q4 data are based on the October, November and December surveys. 2021 Q1 data are based on the January survey. Not seasonally adjusted.

Chart 3.8: Firms report that their sales were hit by Covid, but that their investment fell by even more
Impact of Covid on sales and investment^(a)



Sources: DMP Survey and Bank calculations.

(a) Question: 'Relative to what would have otherwise happened, what is your best estimate for the impact of the spread of coronavirus (Covid-19) on the sales and capital expenditure of your business in the following quarters?'. Based on the January DMP Survey for 2020 Q4 onwards, and the most recent survey available for earlier quarters.

Firms that have accumulated savings might invest a higher share of their revenues temporarily...

Those businesses that have accumulated cash reserves during the course of the pandemic might be expected to spend more on investment as restrictions are lifted and confidence in the economic outlook increases. This could mean that those businesses invest a higher-than-usual share of their revenues temporarily as they run down accumulated savings.

...but other firms are likely to need to repair their balance sheets.

Similar to households, however, the distribution of corporate savings will affect the extent to which any accumulated cash reserves are used to finance additional spending. While some companies have accumulated cash reserves, others are likely to have depleted theirs, and some have taken on additional debt. The net finance raised by companies rose sharply over 2020 (Chart 2.10). The Bank's Agents report that businesses in Covid-affected sectors are more likely to have weaker balance sheets than those in other sectors. Small and medium-sized enterprises have seen larger declines in activity on average than larger firms (Saunders (2020)), and some of these firms in particular may choose to retain more savings than usual for some time.

3.3: The impact of Covid vaccines on the MPC's projections

The vaccination programme is expected to support a recovery in household and business spending.

In the MPC's central projection, the vaccination programme means that restrictions on activity are assumed to ease over Q2 and Q3, and to unwind by the end of the third quarter (see Section 1).

Consumer spending rises materially as restrictions ease, and as the vaccination programme leads to people's worries about the risks to their own and others' health dissipating, although they take a few quarters to fade fully. That is expected to support a recovery in social spending towards its pre-pandemic levels. Aggregate consumption is projected to recover to its 2019 Q4 level in 2022 Q1. Over the forecast period, consumption is supported by households running down around 5% of the additional savings they have accumulated during the course of the pandemic. That is broadly consistent with recent survey evidence, as well as UK evidence on the proportion of wealth that households tend to spend.

Business investment also rises as sales recover and uncertainty declines, albeit more gradually than consumer spending. Business investment does not reach its 2019 Q4 level until 2022 Q4.

4: In focus – How has Covid affected inflation?

Since the start of the pandemic, inflation has declined by just over 1 percentage point, and is well below the 2% target. Much of that fall represents the effects of temporary Covid-related factors, which are expected to unwind over the first half of 2021. Measures of underlying inflation are subdued, although they have fallen by much less. A material amount of spare capacity is judged to have opened up in the economy and is likely to be weighing on inflation, although there are a number of factors that may have dampened its impact. Excluding energy and VAT, CPI inflation is expected to remain subdued in the near term, but domestic inflationary pressures are then expected to build as spare capacity is eliminated, and inflation returns to the target.

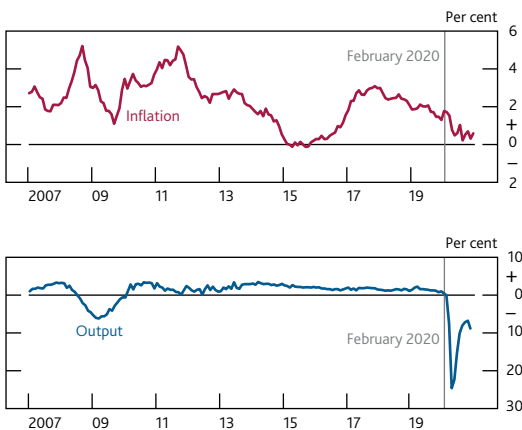
4.1: How has inflation evolved since the start of the pandemic?

Inflation declined over 2020 and is well below the MPC’s 2% target...

Covid-19 and the public health measures to contain it have led to a sharp contraction in UK economic activity and a fall in inflation (**Chart 4.1**). CPI inflation troughed at 0.2% in August. It has risen somewhat since then, to 0.6% in December, but remains well below the MPC’s 2% target and 1.1 percentage points lower than in February 2020. Covid has caused some difficulties with the measurement of inflation (see Box 5 of the *August Report*), with 17% of the CPI basket unavailable for measurement during November, but the estimated impact of this on measured inflation is small.

Chart 4.1: Covid has led to a sharp contraction in output and a fall in inflation

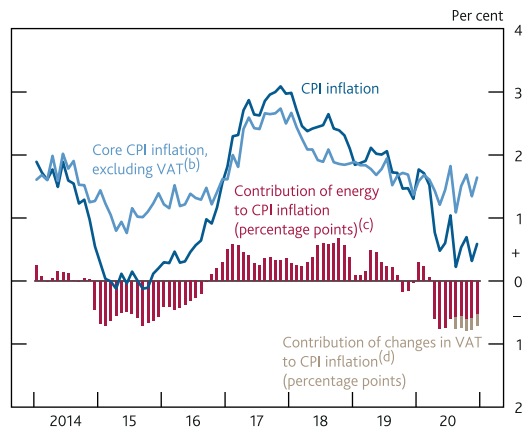
CPI inflation and 12-month output growth^(a)



(a) Inflation data are to December; output data are to November.

Chart 4.2: The fall in CPI inflation since February 2020 is mainly due to temporary Covid-related factors

CPI inflation, core CPI inflation and the contributions of energy prices and changes in VAT^(a)



Sources: ONS and Bank calculations.

- (a) Where Bank staff have adjusted for the estimated impact of changes in VAT there is uncertainty around the precise impact of that adjustment. Data are shown to December.
- (b) CPI inflation excluding energy, food, non-alcoholic beverages, alcoholic beverages and tobacco, adjusted to exclude the direct impact of changes in the rate of VAT.
- (c) Contribution of fuels and lubricants, electricity, gas and other fuels to CPI inflation.
- (d) Estimates of the direct contribution of changes in the rate of VAT to CPI inflation.

...driven primarily by temporary Covid-related factors.

Around half the fall in headline CPI inflation since February is accounted for by energy prices (Chart 4.2). The pandemic, which has restricted travel and led to lower global growth, has weighed on oil prices. Despite their partial recovery in the second half of the year, sterling oil prices remain around 20% lower than at the end of 2019. As a result, the price of motor fuels was around 8% lower in December 2020 than a year earlier. The prices of electricity, gas and other fuels were also around 9% lower. Taken together, energy prices have subtracted around 0.6 percentage points from CPI inflation since April 2020 on average.

Government policy measures to support the hospitality sector can also account for some of the fall in inflation. VAT in the hospitality and tourism sectors was lowered from 20% to 5% in mid-July. Contacts of the Bank's Agents suggest that this cut, which has been extended to March 2021, has only been passed on partially to consumer prices.

Nevertheless, it is estimated to have lowered the annual rate of inflation by around 0.2 percentage points, on average, since August (Chart 4.2). The Eat Out to Help Out scheme is estimated to have subtracted an additional 0.4 percentage points from inflation in August, but had no direct effect on inflation after that.

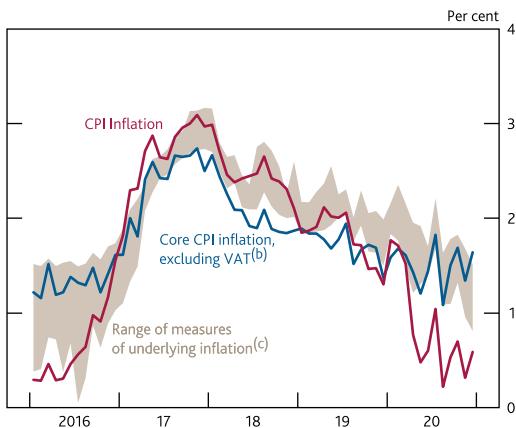
Measures of underlying inflation have fallen by much less...

There are a number of measures that aim to gauge underlying inflationary trends, typically by excluding or minimising the impact of volatile components of the CPI basket (see the box on pages 28–29 of the *August 2015 Inflation Report*). A standard measure is 'core' CPI inflation, which excludes energy, food, alcohol and tobacco prices. That has fallen by 0.3 percentage points since February 2020, around a quarter of the decline in headline inflation. Once the estimated impact of the VAT cut is excluded, that measure is broadly flat (Chart 4.2), although it is still around 0.4 percentage points below its post-financial crisis average. There are a range of other measures of underlying inflation constructed using various statistical techniques. Some of these point to a slightly larger fall (Chart 4.3), although their decline has still been smaller than the decline in headline inflation.

The relative stability of core inflation masks offsetting movements between goods and services. Core goods inflation has risen by 0.8 percentage points since February to 1.2% in December, while core services inflation has fallen by around 0.5 percentage points to 1.9% (Chart 4.4). This broad pattern is also seen internationally and is consistent with lower spending being particularly skewed towards consumer services.

Chart 4.3: Measures of underlying inflation have fallen by less than headline CPI inflation

CPI inflation and a selection of measures of underlying inflation^(a)

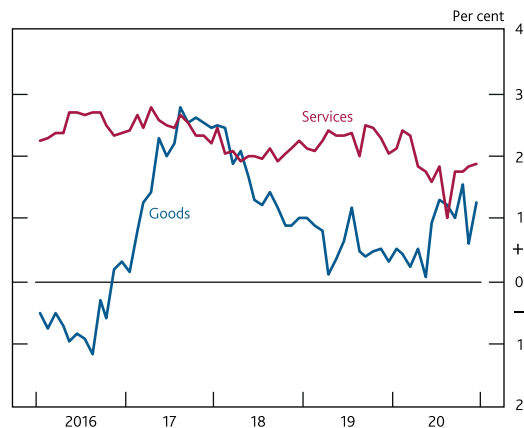


Sources: ONS and Bank calculations.

- (a) Where Bank staff have adjusted for the estimated direct impact of changes in VAT, there is uncertainty around the precise impact of that adjustment.
- (b) CPI inflation excluding energy, food, non-alcoholic beverages, alcoholic beverages and tobacco, adjusted to exclude the direct impact of changes in the rate of VAT.
- (c) The swathe of underlying inflation measures includes the weighted median inflation rate of all the sub-components of CPI; a 'trimmed mean' measure that excludes the most volatile CPI components; a measure of CPI that excludes fuel plus 10 other components with the largest variation in inflation rates and a 'volatility double weighted' measure where CPI weights are adjusted to reflect the components' past volatility. For all measures of underlying inflation, Bank staff have adjusted for the estimated impact of changes in VAT.

Chart 4.4: Core services inflation has declined, while core goods inflation has risen

Core services and core goods CPI inflation, excluding VAT^(a)



Sources: ONS and Bank calculations.

- (a) Core services CPI excludes airfares, package holidays and education. Core goods CPI excludes energy, food, non-alcoholic beverages, alcoholic beverages and tobacco. Bank staff have adjusted for the estimated direct impact of changes in VAT and there is uncertainty around the precise impact of that adjustment.

...and their decline in the UK is also a little smaller than in some other advanced economies.

Core inflation appears to have fallen by less in the UK than in many of its international peers. Core inflation has fallen by around 0.7 percentage points, on average, across the G7 since February, compared to 0.3 percentage points in the UK. This is perhaps somewhat surprising given the relative weakness in UK output over 2020 (see Box B).

There has been no clear decline in measures of near-term inflation expectations.

People's expectations for inflation can also provide an indication of underlying inflationary pressure. There is little evidence that households' and companies' near-term inflation expectations have declined during 2020. Movements in household measures have been mixed, while the CBI measure of companies' inflation expectations has picked up (Table 2.C). This is in sharp contrast to what occurred in 2008, when both households' and firms' near-term expectations fell sharply at the onset of the financial crisis.

4.2: How has Covid affected underlying inflation?

Covid has led to large falls in both demand and supply so the degree of spare capacity is uncertain, although the MPC judges that there is currently a material amount.

UK output fell sharply over 2020. The decline in activity reflects a fall in supply as well as lower demand, as some businesses closed temporarily and others had to reduce capacity in order to make themselves Covid-secure. While the large falls in both demand and supply make the precise degree of spare capacity difficult to gauge, the MPC judges that there is a material amount at present.

Spare capacity is apparent in the labour market. This is judged to be largely in the form of unemployment, which has risen by around a percentage point since February and is expected to rise further in the near term (Section 2). Average hours declined sharply following the onset of the pandemic, and remain around 5% below 2019 Q4 levels. While much of that decline is likely to have reflected the impact of the furlough scheme, some may also represent a degree of underemployment.

There may also be spare capacity within some firms, in the form of capital, such as buildings and machinery, not being fully utilised. Surveys of capacity utilisation fell to near record-low levels in 2020 Q2. While some of this fall may have reflected temporary closures, and so reduced supply capacity, it is also likely to reflect greater slack. Indeed, as many firms reopened over Q3, a number of these indicators remained below normal levels.

That spare capacity may be having less of an impact on inflation than usual at present,...

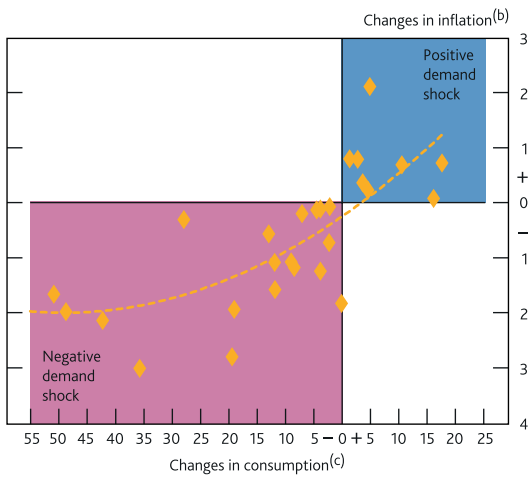
As outlined in the [August 2020 Report](#), there are reasons why spare capacity may be having a smaller-than-usual downward effect on CPI inflation at present. First, the hit to output arising from Covid has been concentrated in consumer-facing services, where prices tend to change less frequently than other components of the CPI basket ([Bunn and Ellis \(2011\)](#)). Second, in the past, inflation has been less responsive to changes in spare capacity when demand has been very low. Research on price-setting finds that firms are less able to increase demand for their goods and services under such conditions by their lowering prices, so have less incentive to do so ([Lindé and Trabandt \(2019\)](#)). Firms may also be facing liquidity constraints as a result of sharp falls in their cash flow, which may discourage them from cutting prices as they prioritise short-term revenue generation ([Gilchrist et al \(2017\)](#)). Third, the economic outlook remains unusually uncertain, and such uncertainty can discourage firms from changing prices ([Woodford \(2011\)](#)).

...exacerbated by the uneven patterns of demand across sectors.

There is tentative evidence to suggest that the uneven pattern of demand across sectors may also be affecting the extent to which aggregate spare capacity is affecting average prices in the economy ([Broadbent \(2021\)](#)). While the Covid shock led to a large fall in demand in aggregate, firms in some sectors have faced an increase in demand for their products as consumers altered their spending patterns. As it can take time to shift factors of production – such as workers, buildings and capital – from one purpose to another, it is likely to cost firms more than usual to produce the extra units of output demanded in those sectors in the short run. In contrast, the costs to firms facing a decline in demand are likely to fall by less as many of their costs will be fixed. As a result, big shifts in demand for the outputs of different sectors can raise average costs and prices across the economy as a whole for a given level of aggregate demand. There is some tentative evidence to suggest that this may have happened over the past year. The falls in inflation over 2020 in sectors that have faced very large falls in demand have not been much larger than the increases in inflation seen in sectors where demand has risen by a smaller amount ([Chart 4.5](#)).

Chart 4.5: Falls in inflation for goods and services seeing large declines in demand have not been much larger than for those facing smaller demand shocks

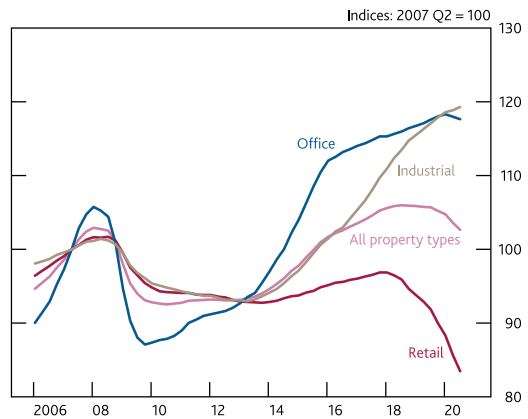
Changes in consumption and inflation across spending categories^(a)



Sources: ONS and Bank calculations.

- (a) Data points refer to goods and services that have been predominantly affected by a demand shock. These are spending categories where consumption and inflation have both increased, or where they have both decreased. Categories affected by changes in energy prices and those where prices are regulated are excluded. Air travel is also excluded. Dashed line represents the line of best fit.
- (b) Changes in inflation rates between the three-month average to February 2020 and October 2020, measured as the number of standard deviations from their 2012–19 average.
- (c) Consumption growth over the four quarters to 2020 Q3.

Chart 4.6: Rents have fallen in the retail sector
Commercial real estate rents^(a)



Sources: MSCI and Bank calculations.

(a) Latest observation is for 2020 Q3. Data are not seasonally adjusted.

The uneven pattern of changes in demand and supply across the economy also appears to have led to some large price movements in particular sectors. Used car price inflation, for example, reached a 10-year high in October, which appears to have been driven by an imbalance between demand and supply in that market. Intelligence from the Bank’s Agents suggests that consumers’ concerns about using public transport has pushed up demand for second-hand cars. It has also deterred some motorists from selling, constraining the supply of vehicles available for purchase.

Even after accounting for a weaker relationship between slack and prices, some models suggest that inflation has declined by less than developments in domestic economic activity and external price pressures would suggest.

Some economic models that relate inflation to its usual determinants suggest that, even after accounting for a weaker relationship between slack and prices, core inflation has fallen by less than might have been expected. A model based on typical business cycle dynamics since 1997, which has been adjusted to assume that the impact of slack on prices is around two thirds its usual magnitude, suggests that in November core inflation was around 0.8 percentage points stronger than changes in output, unemployment and external cost pressures would suggest.⁽¹⁾

It may be that the impact of slack on consumer prices is yet to have peaked.

It often takes time for the full influence of slack in an economy on prices to occur. Many costs can change quite slowly: rent and pay are often negotiated on an annual basis for example. Furthermore, it can be costly for firms to change prices. In general, the MPC’s forecasts tend to assume that the peak impact of slack on inflation takes around a year to come through, on average.

There have been signs that spare capacity has begun to weigh on firms’ costs...

There are signs that more slack has started to put downward pressure on some of firms’ costs. Increased spare capacity in the labour market appeared to reduce pressures to raise pay during 2020. For example, the median company pay settlement was around zero in Q3. Although the median picked up in Q4, pay freezes continued to account for more than one in four settlements. The latest Agents’ survey suggests that the average pay settlement fell in 2020 relative to 2019, and is expected to fall a little further in 2021 (see Box C).

(1) Model based on Del Negro *et al.* (2020), adapted for the UK.

Spare capacity has also weighed on commercial rents. Having fallen slightly over 2019, the pace of decline has increased since the start of the pandemic, driven largely by a fall in rental values in the retail sector (Chart 4.6). Overall, the market rental value for commercial property declined by 2.9% in the year to 2020 Q3. Some firms have also been able to postpone rent payments, while some landlords have agreed to write-off a portion of their rental arrears.

The emergence of spare capacity globally has also weighed on some input costs for firms. The decline in world demand led to falls in a number of commodity prices in early 2020, and world export prices also declined. Commodity prices have recovered somewhat in recent months (Section 2), however, such that the price of materials and fuels purchased by UK manufacturers was around its end-2019 level in December 2020.

The Agents’ survey on pay and costs suggests that, in aggregate, firms’ input costs have fallen a little over 2020 (Chart 4.7). As firms have cut production they have spent less on materials and goods. Changes to the way in which we work have reduced spending on corporate entertainment and business travel. This may have been partly offset for some firms by spending on equipment, such as masks and plastic screens, in order to make their businesses Covid-secure. Evidence from the Agents’ survey suggests that such spending only accounted for around 0.5% of firms’ total costs in 2020, however.

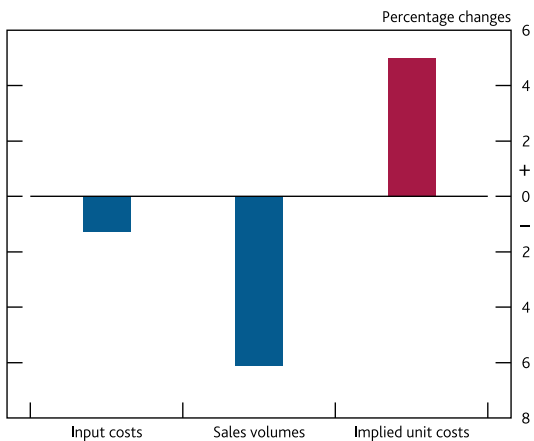
...but that effect has been small relative to the sharp fall in demand, such that unit costs have risen...

It is the marginal cost – the cost of producing an additional unit of output – that is important for firms’ pricing decisions and therefore inflation. Marginal costs are unobservable, however, so measures of the average cost of producing a unit of output such as unit labour costs (ULCs) are often used as proxies. The official ULC data are difficult to interpret at present, as the Coronavirus Job Retention Scheme (CJRS) has added volatility to the wage and productivity data. Excluding the impact of the CJRS, Bank staff estimate that ULCs increased by around 5% in the year to Q3.

The Agents’ survey of pay and costs suggests that a broader measure of average unit costs rose over 2020. While total input costs were reported to have fallen somewhat, firms reported that sales fell by around five times that amount, such that the implied unit cost had increased by around 5% (Chart 4.7). The relative stickiness in firms’ costs is likely to reflect the role of fixed costs. The rise in unit costs is consistent with evidence from the Decision Maker Panel (DMP) Survey, which suggests an increase of around 6% as a result of Covid.

Chart 4.7: Firms’ input costs are reported to have fallen by significantly less than their sales volumes

Annual changes in costs and sales volumes^(a)

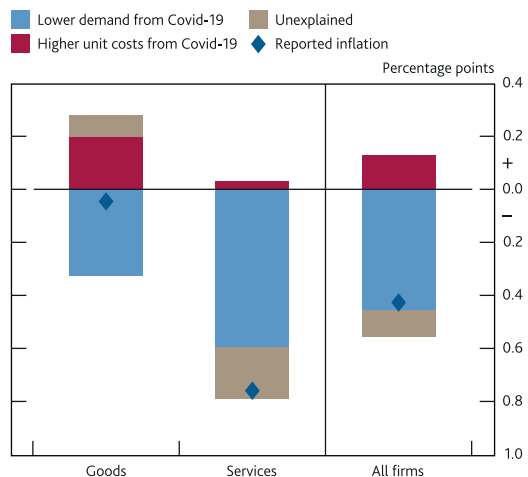


Source: Agents’ survey on pay and costs.

(a) Based on firms’ reported changes in total input costs and sales volumes between financial year 2020 and financial year 2019. Changes in firms’ implied unit costs are estimated as the difference between the growth rates of input costs and sales.

Chart 4.8: Higher unit costs from Covid have partly offset the impact of lower demand on inflation

Contributions to changes in reported inflation^(a)



Sources: DMP Survey and Bank calculations.

(a) Changes in reported inflation rates between 2019 Q4 and March to December 2020. The marginal impacts of changes in demand and unit costs as a result of Covid are estimated using difference-in-difference regressions with individual firm fixed effects, estimated separately for goods and services. Unexplained bars are residuals.

...which may have offset the impact of spare capacity on inflation so far.

The increase in firms’ unit costs may have offset some of the downward pressure from spare capacity. Analysis using DMP Survey data suggests that higher unit costs have exerted upward pressure on prices, although that has been outweighed by the impact of lower demand (Chart 4.8). Upward pressure from unit costs has been most notable

among firms that had less cash on their balance sheets before the pandemic. These firms may have been less able to absorb rises in average costs of production, and so more likely to have increased their prices. The impact of higher unit costs has been larger for goods producers than services firms. This may help to explain the relative strength in goods price inflation since the onset of the pandemic (Chart 4.4).

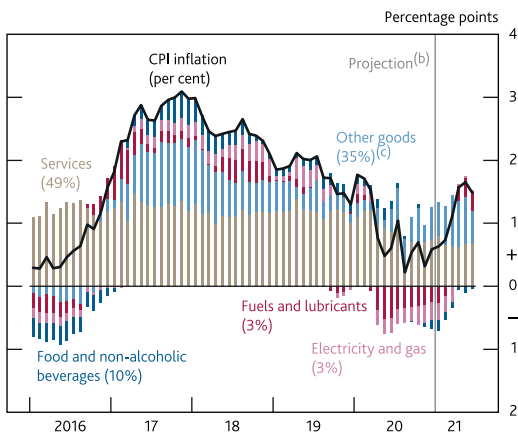
4.3: What is the outlook for inflation?

In the near term, CPI inflation is expected to increase quite sharply as the impact of temporary factors dissipates.

CPI inflation is expected to rise quite sharply towards the 2% target in the spring (Chart 4.9). That is mainly the result of last year’s falls in energy prices dropping out of the annual comparison and the recent rises in oil and gas prices feeding through to fuel and utility prices. The temporary cut to VAT in the hospitality sector is also due to end in April. These factors are expected to account for almost all of the projected 1 percentage point increase in inflation between December and April. In Q2 as a whole, CPI inflation rises to 1.6% from 0.8% in Q1. Abstracting from those factors, CPI inflation excluding energy and VAT is projected to fall a little during 2021, before rising towards 2% (Chart 4.10).

Chart 4.9: Headline CPI inflation is expected to pick up sharply over 2021 H1 as the drag from past falls in energy prices disappears

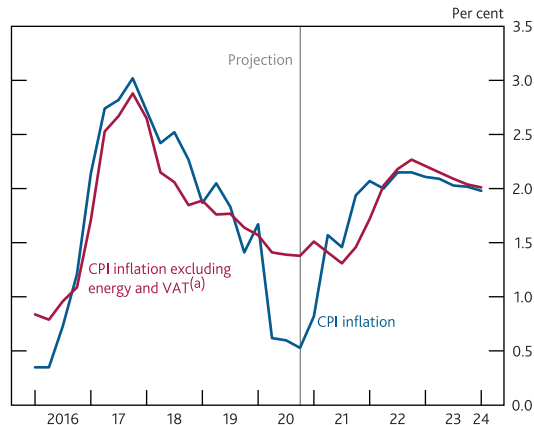
Contributions to CPI inflation^(a)



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

- (a) Contributions to annual CPI inflation. Figures in parentheses are CPI basket weights in 2020.
- (b) Bank staff’s projection. Fuels and lubricants estimates use Department for Business, Energy and Industrial Strategy petrol price data for January 2021 and then are based on the sterling oil futures curve.
- (c) The difference between CPI inflation and the other contributions identified in the chart.

Chart 4.10: CPI inflation excluding energy and VAT is expected to rise as spare capacity diminishes
CPI inflation and CPI inflation excluding energy and VAT



Sources: ONS and Bank calculations.

- (a) CPI inflation excluding fuels and lubricants, electricity, gas and other fuels, adjusted to exclude the direct impact of changes in the rate of VAT. Where Bank staff have adjusted for the estimated direct impact of changes in VAT there is uncertainty around the precise impact of that adjustment.

The factors that limited the fall in inflation over 2020 are not expected to affect inflationary pressures in the medium term...

The factors described in Section 4.2, which may have limited the fall in underlying inflation since the onset of the pandemic, are expected to dissipate over the forecast period. The incentives for firms to leave prices unchanged should reduce as activity returns towards pre-pandemic levels. In addition, that recovery in demand is expected to be skewed towards sectors most affected by the pandemic, such that the dispersion in demand narrows. As a result, the relationship between slack and inflation is expected to return to normal during the second half of 2021.

The impact of higher unit costs on inflation is also unlikely to persist. To the extent that higher unit costs reflected the sharp fall in sales, cost pressures should fall back as markets reopen and sales recover. Increases in Covid-related costs are also unlikely to affect inflation in the medium term. Some of these costs are likely to be temporary. Even those that are permanent are likely to be one-off adjustments, so should cease to exert upward pressure on inflation over time.

...and CPI inflation is projected to be around the 2% target.

The increase in demand also leads to spare capacity being eliminated. As a result, domestic price pressures pick up over time. Conditioned on the market path for interest rates, inflation remains close to the target over the second and third years of the forecast period (Section 1).

Annex: Other forecasters' expectations

This annex reports the results of the Bank's most recent survey of external forecasters. Expectations for the near term are summarised in **Chart A**, and those for further out are shown in **Table 1** and **Chart B**.⁽¹⁾

On average, external forecasters expected GDP to fall by 2.7% in 2021 Q1 (**Chart A**). The unemployment rate was expected to rise to 6.2% and CPI inflation was expected to be 0.7%. The range of projections is wide.

Chart A: On average, external forecasters expect GDP to fall by 2.7% in 2021 Q1, and unemployment to rise to 6.2%

Other forecasters' central projections for GDP, the unemployment rate and CPI inflation in 2021 Q1

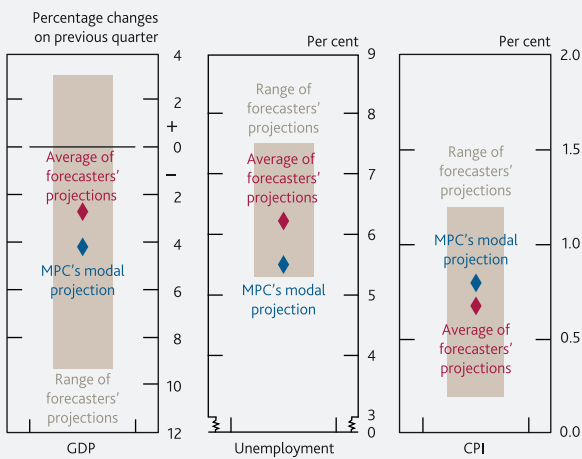


Table 1: Averages of other forecasters' central projections

	2022 Q1	2023 Q1	2024 Q1
GDP growth ^(a)	8.5	2.7	2.2
CPI inflation ^(b)	1.9	1.8	1.9
LFS unemployment rate (per cent)	6.5	5.6	5.0
Bank Rate (per cent)	0.1	0.3	0.6
Stock of purchased gilts (£ billions) ^(c)	906	921	928
Stock of purchased corporate bonds (£ billions) ^(c)	20	20	20
Sterling ERI ^(d)	79.3	80.1	80.6

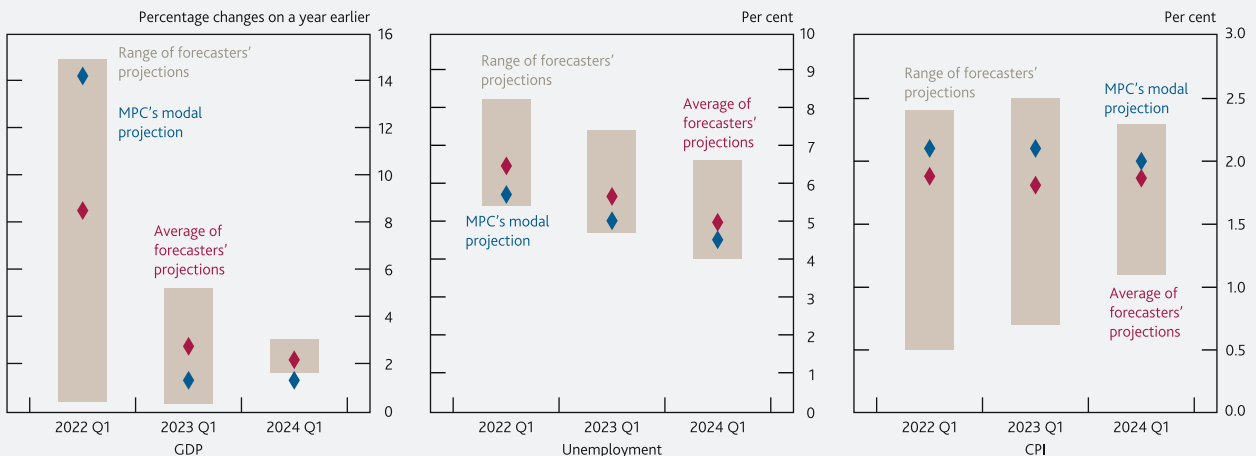
(a) Four-quarter percentage change.
 (b) Twelve-month rate.
 (c) Original purchase value. Purchased via the creation of central bank reserves.
 (d) Index: January 2005 = 100.

On average, respondents expected GDP growth of 8.5% in the four quarters to 2022 Q1. Four-quarter GDP growth is then expected to fall back gradually to just above 2% by 2024 Q1 (left panel, **Chart B**). The unemployment rate is expected to fall steadily from 6.5% in 2022 Q1 to 5% by 2024 Q1 (middle panel, **Chart B**). CPI inflation is expected to rise towards the target by 2022 Q1, and remain slightly below 2% during the rest of the forecast period (right panel, **Chart B**).

On average, external forecasters expected an increase in the stock of purchased assets of about £50 billion over the next three years, on top of the £895 billion announced by the MPC at the time of the survey (**Table 1**).

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

Projections for GDP, the unemployment rate and CPI inflation



(1) For detailed distributions, see 'Download the chart slides and data' link at [Monetary Policy Report – February 2021](#).

Glossary and other information

Glossary of selected data and instruments

AWE – average weekly earnings.
CPI – consumer prices index.
CPI inflation – inflation measured by the consumer prices index.
DMP – Decision Maker Panel.
ERI – exchange rate index.
GDP – gross domestic product.
HICP – harmonised index of consumer prices.
LFS – Labour Force Survey.
MFCI – Monetary and Financial Conditions Index.
OIS – overnight index swap.
PCE – personal consumption expenditure.
PMI – purchasing managers’ index.
RPI – retail prices index.
RPI inflation – inflation measured by the retail prices index.
ULC – unit labour cost.

Abbreviations

BCC – British Chambers of Commerce.
CBI – Confederation of British Industry.
CCS – Credit Conditions Survey.
CJRS – Coronavirus Job Retention Scheme.
CSSE – Centre for Systems Science and Engineering.
ECB – European Central Bank.
EME – emerging market economy.
EU – European Union.
FTSE – Financial Times Stock Exchange.
G7 – Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
HMRC – Her Majesty’s Revenue and Customs.
ICE/BoAML – Intercontinental Exchange/Bank of America Merrill Lynch.
IMF – International Monetary Fund.
LTV – loan to value.
MPC – Monetary Policy Committee.
MSCI – Morgan Stanley Capital International Inc.
MTIC – missing trader intra-community.
NHS – National Health Service.
NPISH – non-profit institutions serving households.

OECD – Organisation for Economic Co-operation and Development.
ONS – Office for National Statistics.
PNFC – private non-financial corporation.
PPP – purchasing power parity.
REC – Recruitment and Employment Confederation.
RICS – Royal Institution of Chartered Surveyors.
S&P – Standard & Poor’s.
SME – small and medium-sized enterprise.
VAT – Value Added Tax.
WEO – IMF *World Economic Outlook*.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Bank of England or the Office for National Statistics (ONS) and all data, apart from financial markets data and results from the Decision Maker Panel (DMP) Survey, are seasonally adjusted.

n.a. = not available.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.