Optimism in a time of coronavirus

While undoubtedly gloomy, today's *Monetary Policy* and *Financial Stability Reports* from the Bank of England envisage little lasting damage to the economy or financial system

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Jack Leslie and James Smith

Today the Bank of England's Monetary Policy Committee provided its first major assessment of the impact of coronavirus on the economy. The MPC envisage growth this year to be the weakest in over 300 years, with a fall of 25 per cent expected in the second quarter, and a fall of 14 per cent for the year as a whole. This was by far the largest markdown the MPC has made to its forecasts, overshadowing the financial crisis. But this assessment could have been worse: it is based on a relatively optimistic scenario for social-distancing measures; and incorporates a sharp recovery once the economy is reopened. No new monetary policy measures were announced despite the weaker outlook for demand and inflation. This underscores the changed role of monetary policy in this crisis: rather than being the key source of support for the economy, as it has been in previous recessions, it is now playing second fiddle to fiscal policy. Our view is that it is likely that difficult decisions may well lie ahead – particularly if social distancing measures need to remain in place for longer. In that case it is likely that the Bank would need to play an even larger role in future in allowing fiscal policy to continue in supporting the economy. There was better news in the *Financial Stability Report*, which provided a relatively upbeat assessment of the resilience of the UK financial system from the Financial Policy Committee. The FPC see banks playing a key role in helping businesses plug the gap in their cash flow during this crisis and announced some policy tweaks to help that happen.

The Bank of England's assessment of the impact of coronavirus on the economy makes gloomy reading

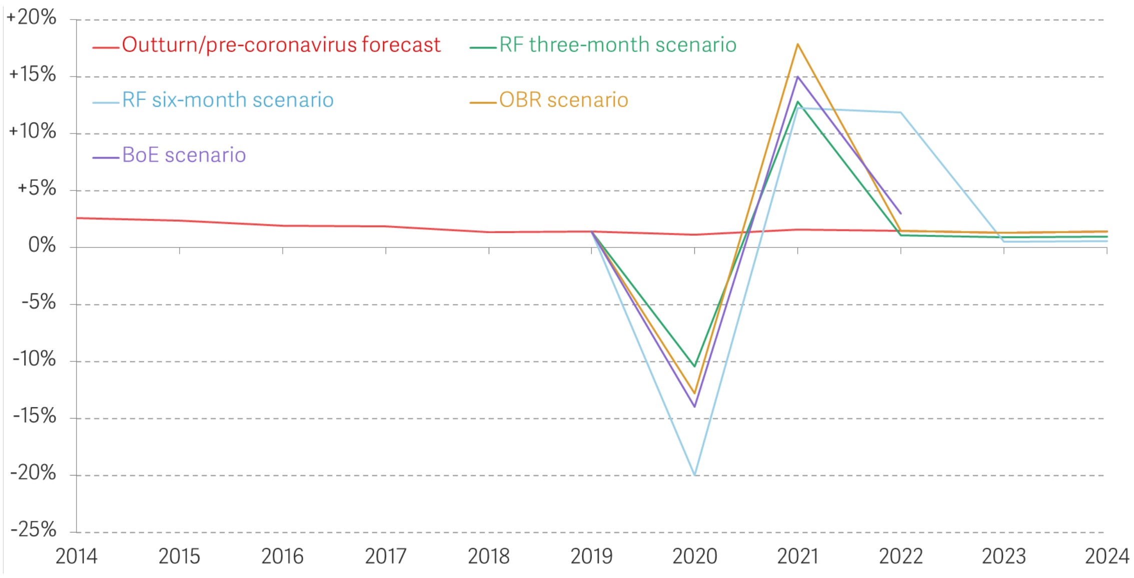
Today's *Monetary Policy Report* from the Bank of England provided a detailed assessment of the impact of the crisis. Given the uncertainty surrounding the outlook, the Bank's Monetary Policy Committee (MPC) did not provide its usual forecasts, opting instead to provide an 'illustrative scenario', given the importance of assumptions about the evolution of the pandemic. That scenario was based on two key assumptions:

- Tight social distancing restrictions remain in place until early June, and are then gradually lifted over the course of 4 months; and

- Fiscal support measures, such as the coronavirus job retention scheme (JRS) remain in place, but are unwound as the lockdown eases.

These assumptions are comparable to the ones made by the OBR and the Resolution Foundation's own 3-month scenario – which both assumed that the lockdown would last for 3 months with restrictions easing gradually after that. These three scenarios are compared in in Figure 1. As with those other scenarios, these assumptions leave the MPC expecting the economy to be extremely weak. Indeed the 14 per cent fall in GDP in 2020 – if realised – would be weakest year of growth since 1706, taking around £300bn off the size of the economy – the equivalent of £9,000 for every UK family (although it is important to stress that falls in household incomes will be cushioned by the Government's fiscal measures, most obviously the JRS).

Figure 1 **The MPC has published unprecedentedly weak forecasts**
Bank of England, OBR and Resolution Foundation scenarios for annual GDP growth



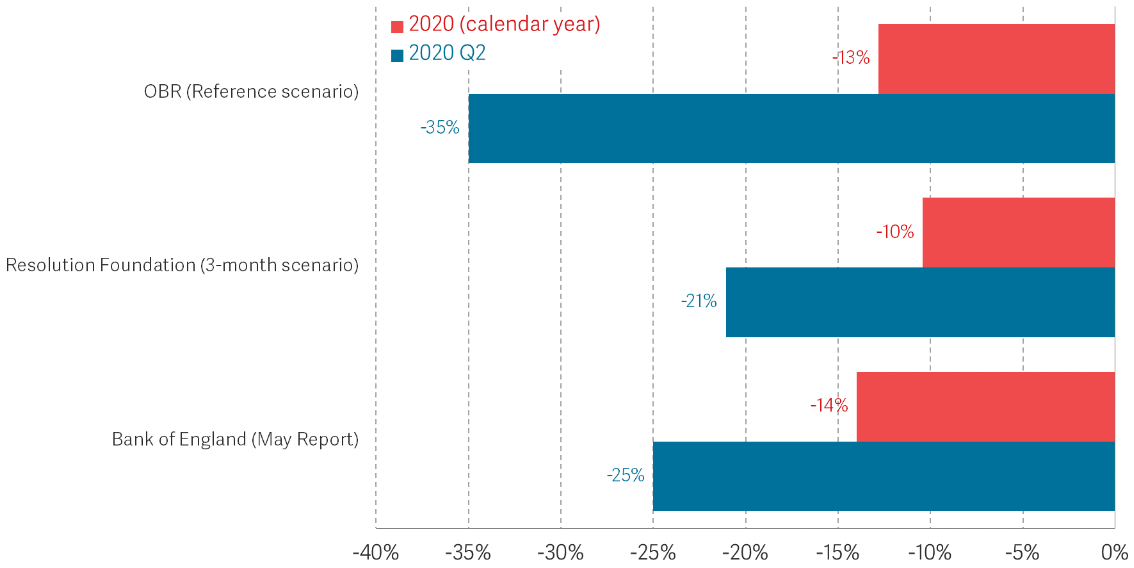
Notes: Pre-coronavirus forecast is based on the OBR's forecast.
Source: RF analysis of OBR, Bank of England.

While the big picture is that all of these scenarios are similar – particularly in the context of very significant uncertainty – it is striking that the MPC's scenario has the largest hit to GDP for this calendar year, despite having a smaller impact in Q2 than that from the OBR (Figure 2). This reflects two factors. First, a relatively pessimistic view about the impact in Q1: the Bank has a fall in GDP of 3 per cent; and second and more importantly, the Bank envisages a slower recovery. That reflects a judgement that much of the lost demand during the period in which social distancing measures are in operation will not return. In particular, in the illustrative scenario, three-quarters of the fall in consumption spending is lost permanently.

And for businesses only around 10 per cent of the investment spending foregone while social distancing measures are in force is assumed to ever be recovered.

Figure 2 **The MPC's scenario has somewhat weaker growth for the year as a whole than that from OBR or RF**

Forecasts for GDP growth in 2020 and the second quarter of 2020



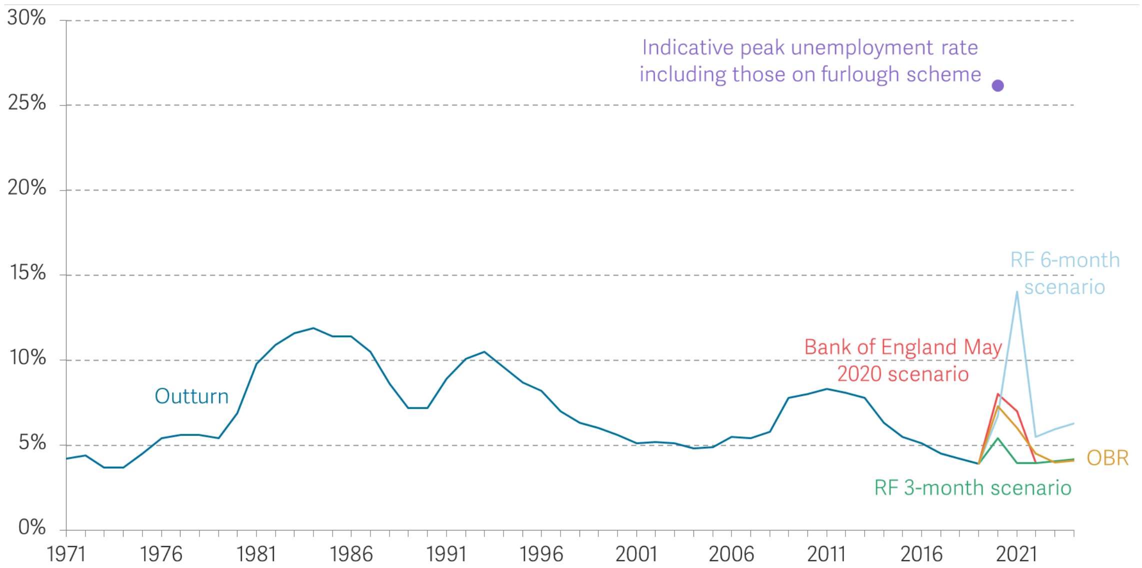
Source: Bank of England, OBR, IMF and RF analysis.

Perhaps the biggest judgement for the MPC is the extent of the permanent hit to the supply side of the economy. This is important because it will be crucial in shaping how quickly we can return to growth following the end of the crisis, and – on the fiscal side – will be a key determinant of the extent of any structural deficit that the Government will need to close. On this, the Bank has been relatively optimistic. While the MPC has taken a judgement that productivity growth will be weaker reflecting lower investment in physical capital, as well as R&D, and less on-the-job training, those effects are small. Indeed, by the end of 2022, the level of GDP is around 2 per cent lower in the illustrative scenario. This is similar judgement to that taken in the Resolution Foundation's own 3-month scenario, and reflects the impact of fiscal policy measures in reducing the permanent hit to the economy.

Another possible area where we could see some lasting economic damage is in the labour market. In the MPC's scenario, the unemployment rate picks up to 9 per cent in Q2. That would be the highest rate in over 25 years, and would see around 3 million people in unemployment (around 1.8 million increase). But while this is clearly a huge rise in unemployment, the MPC is again optimistic about the persistence of the long-run damage to the economy: the unemployment rate falls sharply, returning back below 4 per cent over the next three years (Figure 3).

Figure 3 **In the MPC scenario unemployment increases sharply but falls back quickly**

Scenarios for the unemployment rate



Notes: The indicative unemployment level when including those on the Government's furlough scheme (Coronavirus Job Retention Scheme) is based on the Bank of England's estimate of 6 million furloughed workers in 2020 Q2 combined with the annual figure for the unemployment rate.
Source: RF analysis of Bank of England.

The lack of further policy underscores the Bank of England's changed role in this crisis

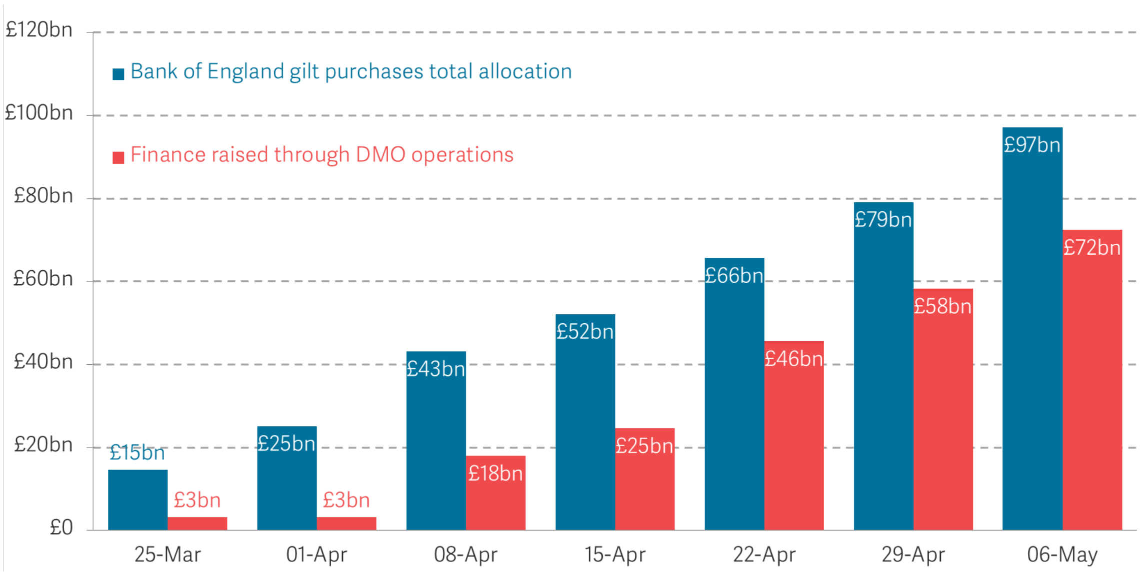
It was striking that there was no new large-scale easing in monetary policy announced today. With the MPC around a third of the way through the additional £200 billion of asset purchases (so-called Quantitative Easing, or QE), it was perhaps unsurprising that no new policy was announced. That said, the weakness in demand in the illustrative scenario along with a materially weaker outlook for inflation, could underpin an argument for further policy action (although, in the illustrative scenario inflation returns the MPC's 2 per cent target over three years). Indeed, two members of MPC – Jonathan Haskel and Michael Saunders – voted for an additional £100 billion of QE.

All this illustrates the changed nature of the Bank of England role in this crisis. During the financial crisis the MPC took the lead in supporting the economy – cutting its policy rate by more than five percentage points and launching QE. But one legacy of that crisis has been globally low interest rates – reducing the ability of central banks to cut their policy rates and thereby provide large-scale support to the economy. As we have discussed in previous work, the Bank's main role is now a supporting one: making sure the necessary fiscal measures can happen.

But, in fulfilling this role, there is good chance that more difficult decisions lie ahead. While it is striking that the Bank's QE purchases have tracked UK debt issuance closely in recent weeks (Figure 4) – meaning that no additional net demand is required for the Government to finance its fiscal policy. So far this has been enough to keep financing costs close to all-time lows. In future there is clearly a risk those cost could rise. As we have discussed in our recent scenario analysis, a longer period of social distancing measure would increase the scale of Government borrowing would need to engage in.

Figure 4 **The Bank of England's QE purchases have tracked Government debt issuance closely in recent weeks**

Weekly cumulative change in Bank of England QE gilt purchases and government debt issuance, since 18 March 2020



Source: RF analysis of DMO; Bank of England.

Our view is that the Bank of England should stand ready to provide direct financing to the Government if the debt market is unable to mobilise the necessary liquidity. In that case, rather than see the Government reduce support for the economy – or, even worse, try to open the economy up before the health crisis has ended – the Bank can provide temporary financing. While such a policy carries with it the risk of a perceived reduction in Bank of England independence, there steps that can be taken to minimise these risks. In particular, the Bank should only pursue such a policy if it is temporary, transparent and undertaken with the mutual agreement with the Treasury. Committing openly to such an approach should help build confidence in the UK policy framework.

There was better news on the risks to the financial system today…

The Financial Policy Committee (FPC) also published a special edition of their normally biannual *Financial Stability Report*. This provided an updated view on the condition of financial markets, a 'desk-based' stress test of the UK banking system and analysis of the funding needs of the UK corporate sector.

The FPC's assessment was generally upbeat. Financial markets conditions have improved generally – although not universally – since the onset of the crisis. At that point markets were very volatile and asset prices fell sharply. Notably, measures of gilt market liquidity such as the bid-offer spreads, which had risen to four times normal levels, have improved in the wake of the Bank's announcement of additional QE. And 10-year nominal gilt yields have fallen by 50 basis points since the middle of March. Globally financial markets have remained more resilient than during the financial crisis as post-crisis reforms seem to have allowed markets to continue to function.

The FPC were also perky about the state of the UK banking system. Having previously cancelled its annual stress test of the banking sector in order to help banks reallocate resource to support additional business lending, the Bank has conducted a 'desk-based' version utilising the economic scenario designed by the MPC. These results are important as the scale of the economic crisis exceeds previous stress scenarios, leading to the risk that the banking sector might be undercapitalised. An undercapitalised banking sector could prove fragile, leading to a destabilising loss of confidence in the financial system as we saw in 2008.

The headline results show that, based on the MPC's economic scenario, the banking sector is sufficiently capitalised to provide substantial net lending to the economy without risking failure of the major banks. The key measure of the banking sector's resilience, the core equity tier 1 capital ratio, is expected to fall from close to 15 per cent to around 11 per cent. This is well above average minimum requirements of around 6 per cent. These falls are slightly smaller than those estimated during the 2019 stress test, despite a more severe macroeconomic environment. This is because reductions in capital ratios are substantially limited by the Government's economic support schemes, particularly: (i) the JRS which protects household and business finances reducing banks' credit impairments, and (ii) the Government-backed loan guarantees which materially reduce the capital-intensity of expanding net lending during the crisis.

The FPC assume that net bank lending rises by £130 billion during the stress; £70 billion of this is household lending, primarily mortgages as the housing market is expected to recover in the second half of 2020, equating to roughly twice total net household lending in 2019. The other £60 billion of net lending is for corporates, of which £20 billion has already taken place.

More broadly, the FPC estimate that UK businesses may have a £140 billion cash-flow deficit this year (net of the Government's fiscal response). Pre-coronavirus aggregate profit margins were sufficient to absorb a 16 per cent fall in turnover and continue to pay labour costs, with cash holdings and undrawn credit facilities large enough to absorb a further 42 per cent fall. But the latest ONS data show that 45 per cent of businesses have closed or are facing turnover falls of greater than half; and some businesses will have much tighter profit margins, lower cash holdings and credit facilities than average. This implies that many businesses will need access to additional finance.

…along with small changes to financial policy to help with the flow of credit to the real economy

Given the substantial demand for additional business lending, the FPC, jointly with the Prudential Regulation Committee (PRC), has rightly focussed on policy measures which allow banks to meet the demand. They have previously released the counter cyclical capital buffer – a measure which could allow an additional £190 billion of lending. They have also taken actions to ensure that Government guaranteed loans do not increase capital requirements by, for example, excluding 'bounce back loans' from the leverage exposure measure. A new policy, introduced alongside the FSR, freezes part of banks' minimum capital requirements. This means that capital requirements will rise by less over the next year than they would have otherwise. This is estimated to be 'worth' around 8 per cent of minimum requirements by 2021, facilitating additional lending equivalent to about half of that from the cut in the countercyclical buffer.[1]

The stress test results, while useful, are based on the MPC's relatively optimistic economic scenario. If social distancing restrictions were to remain in place longer than assumed, or if the economic recovery were slower, then the losses faced by banks would increase. The FPC estimate that an additional two-week extension of the lockdown would increase losses by four per cent – leading to a 0.2 percentage point reduction in core equity tier 1 capital ratios. This demonstrates that had the Bank taken a more pessimistic view of the length of the economic contraction, the stress test results would have been more concerning.

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1 Capital requirements rise when risk weighted assets (RWAs) increase. RWAs are the main measure of a banks' total risk level and typically rise as the economy deteriorates and when banks expand lending. RWAs are expected to rise by 33 per cent under the MPC scenario (primarily due to the change in risks rather than lending) which would normally raise minimum capital requirements close to 1-for-1. The policy change reduces this effect by around 25 per cent.