



BANK OF ENGLAND

Speech

Response to the Covid-19 pandemic: UK and US experiences

Speech given by

Silvana Tenreyro

External Member of the Monetary Policy Committee, Bank of England

Federal Reserve Bank of San Francisco

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Introduction

Good morning. It is an honour to be giving the keynote speech at this year's San Francisco Fed Macroeconomics and Monetary Policy conference. The intersection between policymaking and economic research has never been more vital than now, and I am excited to see many great new papers today.

A year ago, I had planned to be in San Francisco in person to deliver the keynote speech to the 2020 conference. As we know, life and the world have changed dramatically in the intervening period. As well as its tragic consequences for human health, the onset of the Covid-19 pandemic resulted in an enormous economic shock, from which both the UK and the US are still attempting to fully recover.

To try to counteract the effects of the virus on our economies, policymakers used all tools at their disposal, at massive scale, commensurate with the size of the shock. Monetary policy was loosened through cuts in interest rates and quantitative easing, supported by forward guidance about future policy. Given the nature of the shock, however, fiscal policy has played the primary role in most advanced economies in limiting the economic impact of Covid.

In the US and the UK, while the economic policy responses were similar in their aims, the specific set of fiscal policies implemented has been quite different. This has led to some marked differences in the evolution of each economy over the past year. As researchers, we have and will continue to learn about how the vast range of policy measures have worked. This will inform both our economic understanding as well as future economic policy, in response to both large shocks and more regular cyclical fluctuations.

For monetary policymakers, the crucial question is what these different policy responses will mean for activity, unemployment and inflation as we proceed through the economic recovery phase of the pandemic. In my speech today, I will explore what we have learned from the short-term evolution of the US and UK economies. And I will discuss how the respective fiscal responses might influence the appropriate setting of monetary policy as health concerns hopefully fade, and our economies reopen.

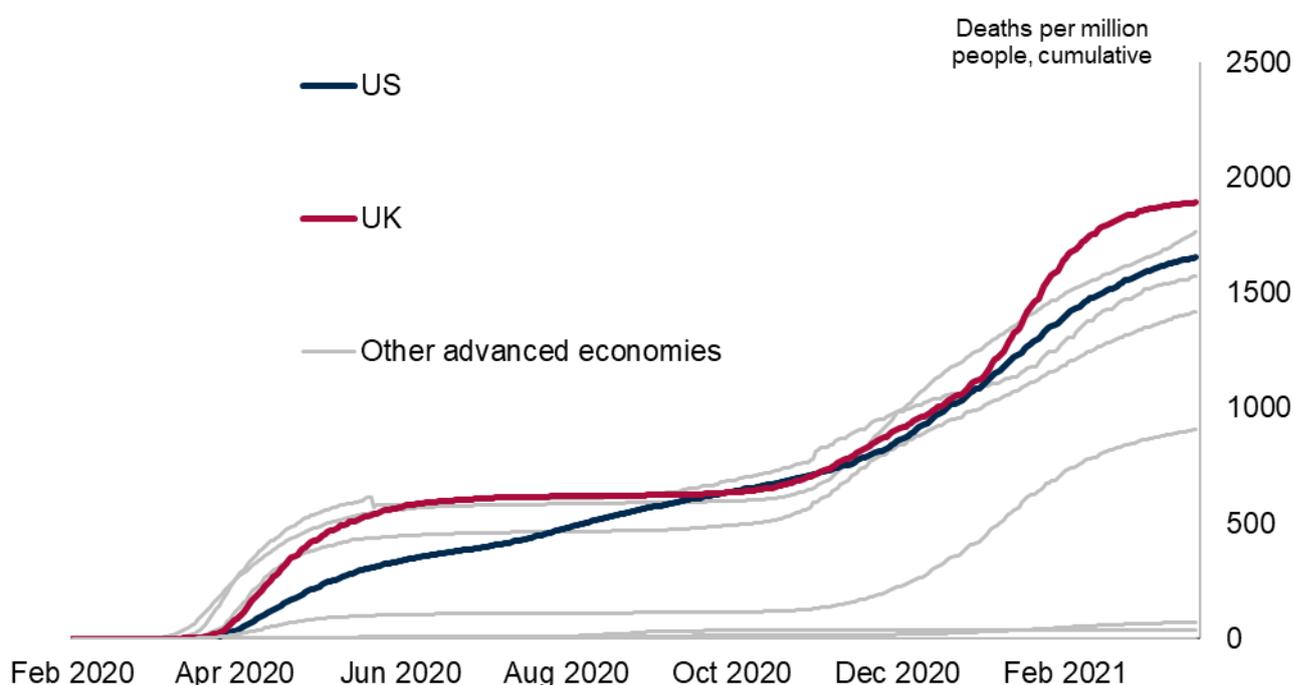
1 Pre-pandemic: similar starting points

At the beginning of 2020, before the pandemic started to take off, the US and the UK faced similar economic conditions. By historical standards, labour markets appeared tight in both countries, with high employment and participation rates, and unemployment at record lows. In contrast, inflationary pressures had been subdued and inflation was below target in both economies. The divergence

between labour-market quantities and price inflation had been the source of debate about the slope of the price Phillips curve, the size of the output gap, and the level of full employment.¹

From those similar starting positions, the US and the UK were both affected in broadly similar ways by the spread of Covid (**Chart 1**). At a national level, both were among the worst affected nations in terms of infections and mortality in the spring, particularly in the major travel hubs of New York and London. Similarly, after a period of declining cases during the summer, both had extremely large second waves of the virus during the autumn and winter of 2020, leading to the current national lockdown in the UK.

Chart 1: Covid-19 mortality has been high in the US and UK



Sources: John Hopkins University CSSE Covid-19 Data, Bank calculations.

Notes: Other advanced economies included are Australia, Canada, France, Germany, Italy, Japan and Spain.

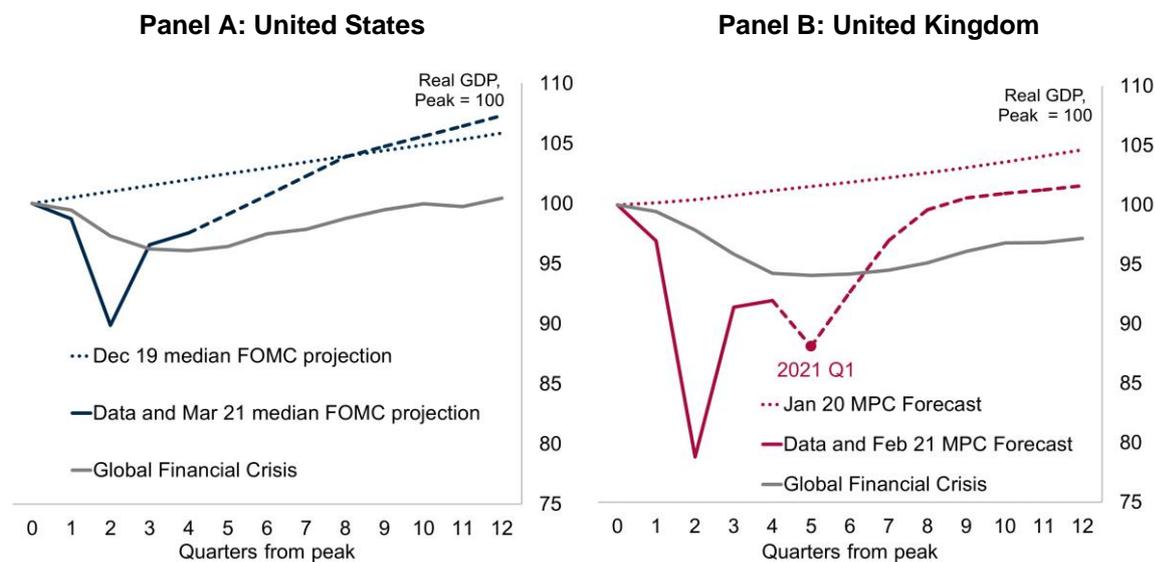
2 Covid shock: large differences in short-term outcomes

Given the two countries had similar economic starting positions, faced a similar global shock and saw a similar development of Covid-19 infections since the start of the pandemic, we might have expected economic developments to also have been comparable.

While there were many broad similarities in how different economies evolved, there were also some striking differences in economic outcomes between the US, on the one hand, and the UK and most of Europe on the other. These differences were largest in the immediate aftermath of the initial Covid shock. And they were most evident in the data on economic activity and the labour market.

¹ See for example, Barnichon and Mesters (forthcoming), McLeay and Tenreyro (2020) and Hooper, Mishkin and Sufi (2019) on the Phillips curve.

Chart 2: A large and a very large hit to economic activity



Sources: BEA, Federal Reserve and Bank calculations.
Notes: FOMC lines interpolate quarterly path from annual projections.

Sources: ONS, Bank of England and Bank calculations.

In GDP terms, while the drop in US output was enormous, it was far smaller than in the UK (**Chart 2**)². The peak-to-trough fall of around 10 percent of US GDP in Q2 2020 was sharper than in the global financial crisis, but smaller than most other advanced economies. On the other side of the spectrum, UK GDP in the second quarter of last year was almost 22 percent below the level of GDP in Q4 2019, one of the largest falls amongst advanced economies. As the MPC set out in its February 2021 *MPR*, these international output comparisons are partly driven by differences in measurement across countries. But setting those aside, consumption has also fallen by less in the US than in the UK and most other advanced economies.

Differences in the public health response to Covid-19 obviously affect these GDP and consumption profiles. The UK has imposed more widespread restrictions than the US to combat the spread of the virus. Given that their design involves intentionally restricting some types of economic activity, the direct impacts of these Covid restrictions give only partial information about the underlying strength of the economy. Perhaps more informative, during the summer of 2020, when restrictions were relaxed in the UK and the US, output recovered to only around 9% below its pre-Covid peak in the UK, but a little over 3% below its pre-Covid peak in the US.

Similarly, looking ahead, although we should see a fast recovery in both countries, US GDP is expected to pick up more quickly, and to a higher level than in the UK. In the MPC's February 2021 forecast, UK GDP returned almost to its pre-Covid peak by the end of 2021, a much faster recovery than during the financial crisis. However, by the same point, the median FOMC member now

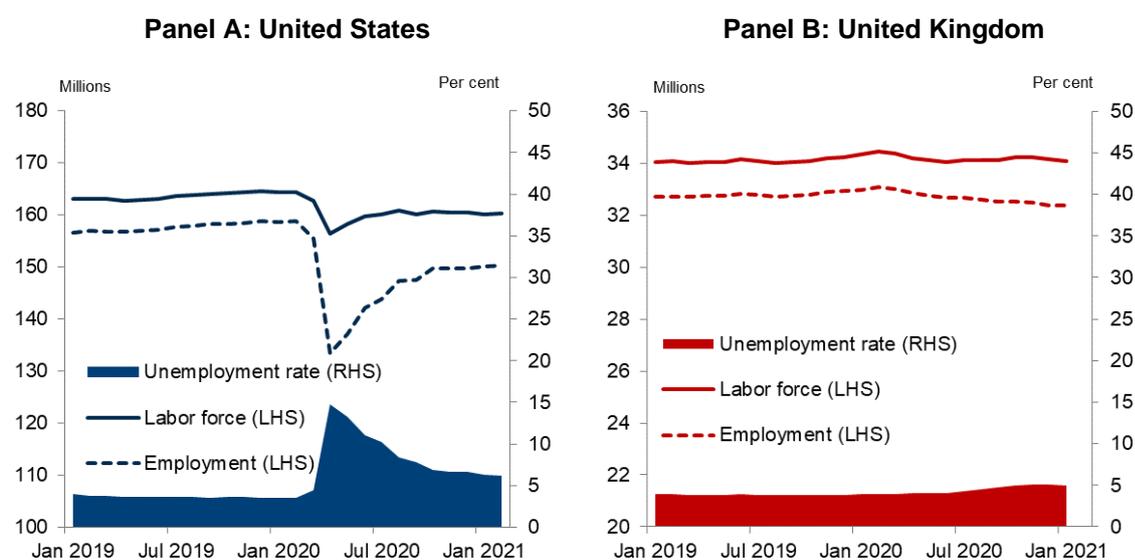
² This borrows from similar charts used in Vlieghe (2021) and Haskel (2021).

anticipates that US GDP will be 4% above its earlier peak. (The MPC will be updating its collective forecast in May for the latest news, including the UK's fast vaccine rollout, and recent moves in financial markets.)

Developments in the UK and US labour markets stand in contrast to those in output (**Chart 3**). US employment fell sharply in the early months of the pandemic, with unemployment peaking at 14.8% in April 2020. This was both the highest level and the sharpest increase in unemployment on record. The unemployment rate has since fallen back gradually to 6.2% as of February 2021. But that is still almost three percentage points higher than pre-Covid. Meanwhile, despite a much larger hit to GDP, measured UK unemployment has only risen by about one percentage point so far.

Measurement and conceptual issues mean that the unemployment rate does not paint the full labour market picture right now in either economy. In the US, participation in the labour force also fell sharply.³ While in the UK, alternative HMRC data on employees suggest that the actual unemployment rate is higher than the headline estimate. But this distortion is not large enough to alter the massive differences in labour-market developments.

Chart 3: Contrasting effects on the labour market



Source: BLS.

Source: ONS Labour Force Survey.

For the large part, the main cause of these vast differences in short-term developments has been the specific policy measures used to mitigate the economic damage from the pandemic in each country. In both economies, a large part of the economic policy response has aimed to protect household incomes. But it has done so in quite different ways.

³ Brainard (2021) discusses how this implies greater slack that would be inferred from unemployment alone.

For researchers, the fact that different policymakers have chosen different approaches to protect their economies offers an opportunity to improve our understanding of different policy tools, as well as their state dependency. Borrowing a crude sports analogy – regardless of whether you prefer an American or British game – you could say that UK policy along with most other European countries have chosen individual defence, while the US has opted to use zone defence.⁴

In Europe, employment support schemes such as the UK government's furlough scheme mean that governments temporarily take over wage bills to avoid mass unemployment. This aims at defending the jobs of individual workers. This protects the existing micro-structure of labour market matches, effectively freezing the economy to make sure it can reopen smoothly once restrictions are lifted and health concerns fade.

In the US, the pandemic was allowed to flow through the labour market to a larger extent, accepting the loss of many job matches. Instead, US fiscal policy has sought to protect household incomes via enhanced unemployment benefits and stimulus cheques, both as a form of retroactive social insurance and to sustain demand. The latter – to the extent it is effective amid pandemic conditions – should have reduced the spike in unemployment relative to the counterfactual of no fiscal support.

These differences in approach to fiscal stabilisation may have implications for future monetary policy. They have had a major effect on how each economy has evolved in the short term. But with US unemployment having since fallen back, and UK output anticipated to recover quickly, it is less clear whether this will also imply differences beyond 2021.

An important question for monetary policymakers is the degree to which the downturn will lead to persistent reductions in output. As **Chart 2** shows, current central bank forecasts would suggest a smaller lasting adverse effect of the pandemic recession on the US economy than on the UK economy. The MPC's February forecast anticipated a persistent hit to supply ("scarring") of nearly two percentage points, compared to pre-Covid expectations. The median FOMC member's projection for the US implies GDP recovering to above its pre-Covid trend, with inflation only slightly above target, suggesting little if any scarring. But the extent of scarring is itself likely to depend on both the fiscal and monetary policies in each economy.

With that in mind, I will now discuss the differences in approaches and outcomes in more detail.

3 The labour market

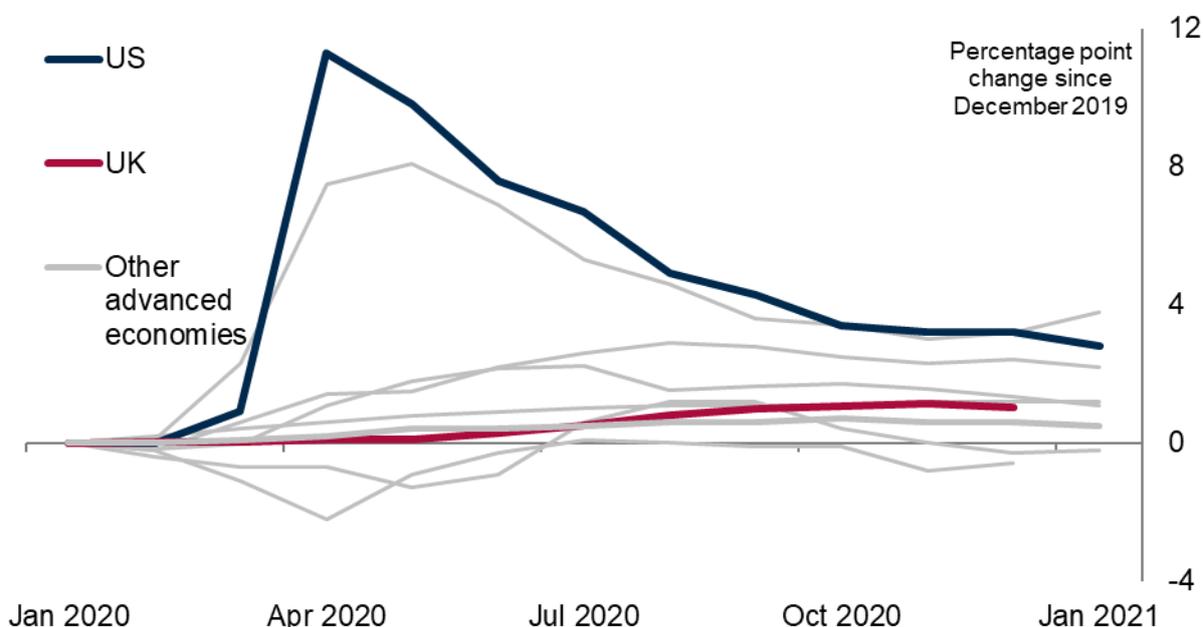
Looking first at the labour market, the US experience is more in line with what we would have expected based on historical experience. A standard Okun's law empirical relationship between output and jobs would have told us to expect such a large fall in GDP to translate into a sizeable

⁴ These terms are also known variously as player-to-player, man-to-man, woman-to-woman or zonal marking, depending on the gender or sport.

increase in unemployment. The US is an outlier on unemployment only because the UK and other European governments elected to adopt job-preserving policies that effectively broke Okun's law (Chart 4).

The UK government introduced the Coronavirus Job Retention Scheme (CJRS) early in the pandemic, with further extensions announced in response to developments, including the extension in the March 2021 budget. Firms that need to temporarily shut or face reduced demand can place some or all of their employees on 'furlough' instead of making them redundant. Firms do not pay salaries to furloughed employees, who are instead paid 80% of their normal salary by the government (up to certain limits). The intention of this scheme is to protect labour-market matches and ensure that firms can easily resume 'business as normal' once restrictions are lifted and health concerns fade. That should help limit labour market scarring, reducing the possible longer-term hit to potential output.

Chart 4: US unemployment dynamics an outlier among peers



Sources: OECD and Bank calculations.

Notes: Harmonised unemployment rate. Other advanced economies included are Australia, Canada, France, Germany, Italy, Japan and Spain.

The UK furlough scheme limited the rise in unemployment throughout the pandemic – which likely mitigated the risk of labour-market scarring in the UK. There is ample evidence that short-term unemployment can become longer lasting. When employees leave the labour force for an extended period of time, it becomes increasingly difficult for them to find a new job. This can be due to many different damaging effects of unemployment, including the loss of motivation and skills. And while furloughed workers may suffer some of the same loss of skills as unemployed workers, maintaining matches and keeping firms afloat should reduce the likelihood of those workers ever transitioning into permanent or long-term unemployment.

Since unemployment did rise significantly in the US, an important question for US policymakers will be to assess whether this has increased the likelihood of labour-market scarring. Looking at the evidence so far, on the one hand, Ganong *et al.* (2020) find high recall shares out of unemployment in recent months, which might suggest that many labour-market matches survived a temporary severance. It is possible that paying generous unemployment benefits in a flexible labour market and while vacancies were at all-time lows had similar effects as the European furlough schemes did. Moreover, the relatively rapid recovery in US demand means that many workers who were not recalled may have less difficulty in finding new jobs.

On the other hand, as recently discussed by SF Fed President Daly, US employment among low-wage workers has been harder hit and more persistently depressed than for higher-wage workers.⁵ There is also evidence that sectoral or regional factors cannot explain all of this difference, which could raise concerns about a jobless recovery.⁶ In response to the restrictions on interpersonal contact brought on by the pandemic, some firms may also have found it optimal to lay off workers permanently and shift production processes to use more technology, capital or imports instead of low-wage US labour. Furlough schemes in Europe may be discouraging this kind of response by firms, maintaining medium-term demand for low-skilled labour at pre-pandemic levels.

4 Consumption and savings

The picture is the other way round when we look at household incomes. (This point was previously made by my colleague Jan Vlieghe).⁷ In the UK, aggregate household income fell as it normally does in recessions (although by much less than would usually be implied by the scale of the drop in GDP). This is shown in the solid lines in **Chart 5**, along with the proportion of income consumed (dashed line), and the difference between them, which makes up the flow of savings.⁸ Income in the UK fell by less than would be implied by the usual automatic stabilisers, given the relatively generous replacement rates offered by the furlough scheme. However, income replacement rates for laid off and furloughed workers were below 100%, and many self-employed workers also saw falls in income.

In normal recessions, low automatic stabilisers in the US would typically imply a relatively large fall in household income. Standard unemployment insurance replacement rates are at around 40% in the US, while they range from 50% to 80% in Europe as well as in Canada and Japan.⁹ In response to the pandemic, a quite different approach to US fiscal stabilisation led to a very different outcome this time round.

A key element of the US fiscal response to Covid-19 was the protection of household incomes via enhanced unemployment insurance and stimulus checks. A \$600 weekly top-up of unemployment

⁵ Daly (2021).

⁶ See for example Cajner *et al.* (2020) and Chetty *et al.* (2020).

⁷ Vlieghe (2021).

⁸ This is an updated version of a similar chart in Vlieghe (2021).

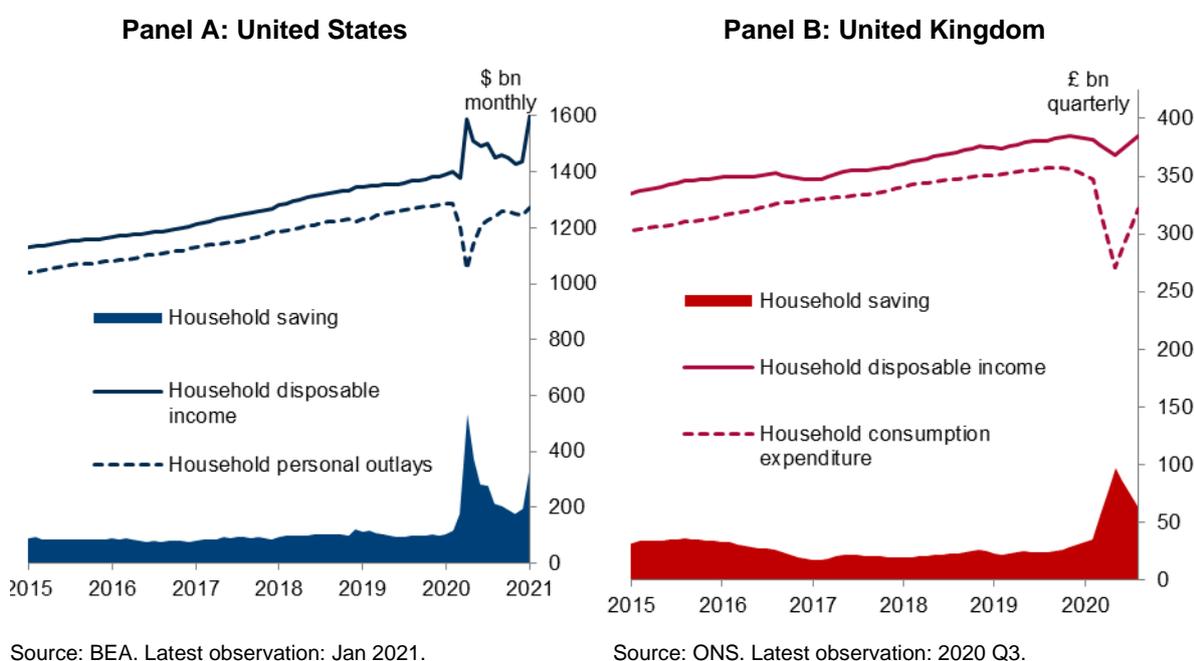
⁹ UK replacement rates vary substantially across this range for different workers, depending especially on whether or not they have children.

benefits for 17 weeks in April to July, followed by a \$300 weekly top-up for another six weeks in August and September more than closed the gap to replacement rates vis-a-vis other advanced economies. Combined with the \$1,200 stimulus cheques to most households, now to be followed by another round of stimulus cheques in the most recent fiscal package, the result has been that, so far, US household incomes actually increased rather than decreased during the pandemic.

In “normal” recessions, such as 2001 or 2008, one-off payments like stimulus cheques have been found to be quite effective tools to stimulate consumer spending.¹⁰ Research on “mental accounting” finds that when consumers encounter unexpected income, they may assign the funds to a “windfall” account and treat them as surplus to be spent.¹¹ The way unexpected income is received seems to matter. Cheques are more likely to end up in mental windfall accounts than funds that arrive via direct deposit. And a related “framing” literature finds that labelling stimulus cash as a “bonus” rather than a “rebate” or “disaster relief” could result in increased spending.¹²

Behaviour during Covid-19 may not be well captured by what happens in a normal recession, however. Consumer spending always tends to fall in downturns, but never before has it involved the entire shutdown or voluntary avoidance of some sectors. As well as the direct impact on spending, this has significantly reduced consumers’ options to spend whatever part of their incomes they may otherwise have assigned to mental windfall accounts.

Chart 5: Two large increases in household savings, though for different reasons



¹⁰ See for example Shapiro and Slemrod (2003) and Sahm et al (2012).

¹¹ For example Thaler (1999), Levay and McGraw (2018).

¹² See for example Epley et al (2006), Evans et al (2018).

In light of these restrictions on consumer behaviour, it is perhaps surprising that a number of studies have found fairly high marginal propensities to consume out of enhanced unemployment benefits as well as stimulus checks in 2020.¹³ There is some debate about how these propensities have differed across households by income and liquidity positions, but the evidence to date seems to suggest that one-off payments have supported consumption during the pandemic. In addition to different amounts of social distancing, this greater support to household incomes is a likely driver of the smaller fall in US consumption relative to the UK experience (**Chart 5**).

But the data also suggest that the additional consumer spending that can be attributed to US fiscal measures was concentrated in durable goods, with a much smaller increase in spending on in-person services.¹⁴ The stimulus may therefore have increased the aggregate level of spending, but not channelled money back to the businesses that lost the most revenue due to Covid.¹⁵ This supports the idea that while stimulus cheques may lead to higher spending than some other types of fiscal measures, fiscal multipliers more generally may be muted during a pandemic, when the worst-hit sectors benefit less from higher aggregate income. In light of this, it is perhaps better to think of some measures as a form of retroactive social insurance rather than aggregate demand management.

Looking ahead to the recovery, both US and UK households are set to exit the recession in a peculiar situation: Their aggregate balance sheets will look stronger than before Covid-19 due to the large amount of savings accumulated over the course of the pandemic. A key question for the outlook in both economies will be how quickly these savings are spent. Consumption behaviour will depend both on how the unexpected savings have accrued, as well as which households they have accrued to.

As discussed, US household savings are in part the result of reduced consumption, but also in part the result of higher than expected income. In the UK, the increase in savings is entirely due to depressed consumption, with household income down relative to the pre-Covid trend. In our February forecast, the MPC assumed that only a small proportion accumulated savings would be spent over the next three years, broadly consistent with the finding that marginal propensities to consume out of wealth are typically low. But this judgement is highly uncertain and much more research in this area is required in the years to come.

The mental accounting literature might suggest that unexpected additional income would be spent more quickly, but the income may no longer be mentally classed as windfall income by the time consumers are able to spend it freely – and to the extent that it is a salary replacement, it might again not be classed as unexpected. There is also little experience or research on whether savings that stem from forced periods of consumption restraint lead to periods of catch-up consumption or end up in households' savings or investment accounts.

¹³ See for example Chetty *et al.* (2020), Coibion *et al.* (2020), Ganong *et al.* (2021).

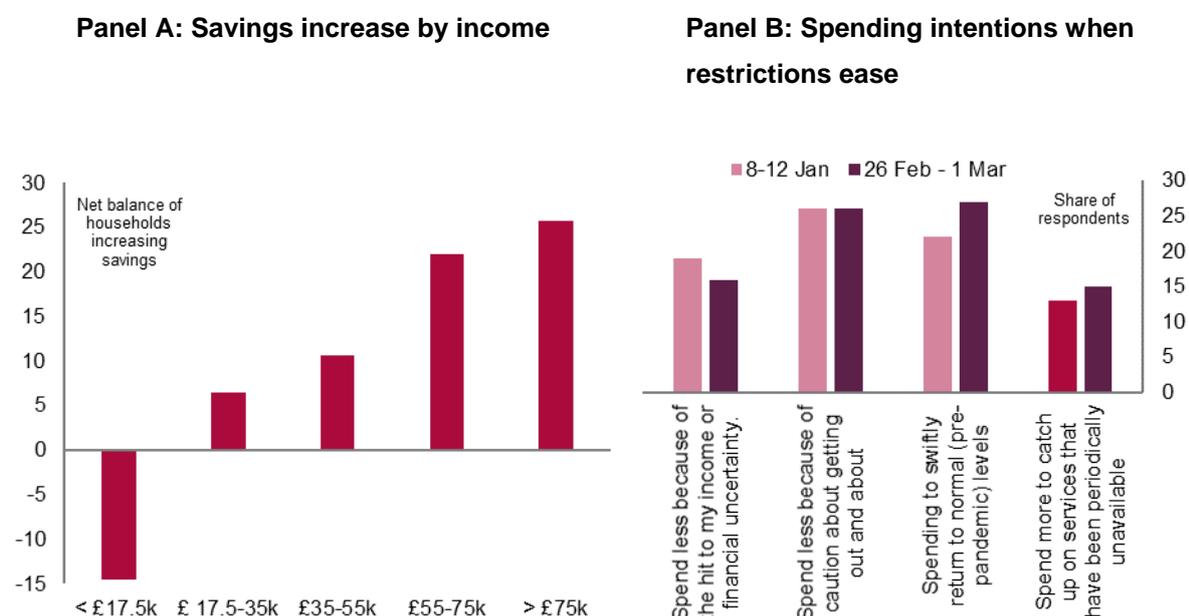
¹⁴ E.g. Chetty *et al.* (2020). See Broadbent (2021) for a discussion of intratemporal and intertemporal substitution during the pandemic.

¹⁵ These findings can be read in the context of the “Broken Keynesian Cross” mechanism described in Guerrieri *et al.* (2020).

Moreover, in both the UK and the US, the concentration of the weakness in spending in services consumption may limit any increase in pent-up demand. Services tend to require time to consume: for many types of lost spending, there is less opportunity to make it up, or less utility in increasing future consumption to do so. Workers can usually only take so much leave per year, for example, limiting their time for holidays or other social spending.¹⁶ In line with this, Beraja and Wolf (2021) find that in the US, following a shock to demand, while durable-goods consumption experiences a catch-up period, likely boosted by pent-up demand, services consumption only recovers back to its original level.

A second cross-country difference lies in the distribution of the additional savings across households. US micro evidence suggests that extra savings have been quite equally distributed across households of different income levels, and if anything have been slightly skewed towards lower income groups. For instance, Cox *et al.* (2020) find large increases in liquid asset balances for households throughout the income distribution, with lower-income households contributing disproportionately to the aggregate increase in balances relative to their pre-pandemic shares. In contrast, UK survey evidence (**Chart 6, Panel A**) suggests that increased savings have been concentrated in higher-income households and the retired, while low-income households in aggregate have reduced their savings.

Chart 6: UK savings accrued to higher-income households and may be less likely to be spent



Sources: Bank of England/NMG Household Survey and Bank calculations.¹⁷

Sources: Bank of England/Ipsos Mori Household Survey and Bank calculations.¹⁸

¹⁶ A point made in Tenreyro (2021) for the UK, and recently by Powell (2021) for the US.

¹⁷ Survey of UK households conducted by NMG Consulting on behalf of the Bank of England, taken 25 August – 15 September 2020. Net balance of increased-decrease responses to the question: ‘Over the past year, did you change the amount of money you saved each month? Please exclude any contributions to pension schemes?’

¹⁸ Surveys of UK households conducted by Ipsos Mori on behalf of the Bank of England, taken 8 January – 12 January 2021 and 26 February – 1 March 2021. Respondents answers to the question ‘A vaccine for Covid-19 is now being rolled out in the UK, and the government expects this to allow an easing of restrictions in the future. Once restrictions are lifted, how do you expect your spending will change compared to how it was before the pandemic began?’ Respondents could give both ‘spend less’ answers.

In my view, these factors – the different sources of savings in the two countries, combined with the associated differences in mental accounting; and the skewed distribution of savings towards high-income households in the UK – all stack the odds in favour of a stronger recovery in consumer spending in the US compared to the UK. Indeed, recent survey evidence indicates that only 15% of UK households plan to spend more to catch up on previously unavailable services once the economy reopens (**Chart 6, Panel B**), only slightly higher than was the case in January, and smaller than the amount of households who expect to spend less.

5 Open questions for researchers

We have seen two very different approaches to defending economies from the effects of a pandemic. The US fiscal response has focused on directly maintaining – and indeed boosting – household incomes. The UK response has done so indirectly, by focusing on maintaining existing jobs. These two approaches have led to different dynamics in unemployment, GDP and household incomes.

The large differences during the pandemic make clear how important policy can be in determining macroeconomic outcomes. They offer insights for researchers and policymakers in more normal times, when the impact of policy on cyclical fluctuations is more difficult to discern. To successfully explain or quantify macroeconomic differences across countries or over time, it is crucial to account for the role of countercyclical fiscal and monetary policies. Attempts to characterise business cycles ignoring the role of macroeconomic policies will be almost inevitably misleading.¹⁹

There is also an important set of questions for researchers over what factors determine how each policy approach might work to mitigate shocks. The **time horizon** of the shock is likely to be important in influencing the effect of the policies on scarring. Individual defence – furloughing workers to maintain existing micro structures of employment – may be most likely to prevent scarring when the shock is temporary and does not lead to significant changes to consumer preferences and/or the structure of production. In that case, with less need for reallocation, matches are more likely to be maintained when furlough ends. The **structure of the economy** may also matter. For example, if labour markets are flexible, then zone defence – that is, providing generous social insurance and protecting household incomes to maintain demand – may enable employment to recover quickly, with less risk of scarring as a result.

Assessing the effects of alternative policies is a big task for the research community and should improve policymakers' ability to respond to future recessions. Making that assessment on a best endeavours basis in real time is also crucial for monetary policymakers. If fiscal action creates the conditions for a fast recovery, central banks would need tighter policy than otherwise. And the more

¹⁹ Characterisations in the tradition of Kydland and Prescott (1982) and King, Plosser and Rebelo (1988), or attempts to quantify the cost of business cycle as in Lucas (1987) miss the important role played by macro-policies and their influence in business-cycle fluctuations.

fiscal interventions mitigate long-term damage to supply, the less central is the role for monetary policy to limit scarring through maintaining low borrowing costs.

The way events have unfolded so far suggests that as long as policy continues to support the economy, we may see a limited degree of labour-market scarring in both countries. In the US, recall rates have been high and have already allowed a fast reduction of unemployment from its peak. In the UK, while there is a downside risk that the furlough scheme is currently maintaining some jobs that will eventually disappear, the vast majority of furloughed UK workers are expected to return to work over 2021. Given current forecasts, UK and US unemployment look set to converge. It is conceivable that in the end both sets of policies lead to similar macroeconomic outcomes. Individual or zone defence may work similarly when your opponent is a pandemic. For now, though, they create a different set of risks, both to near-term demand and to long-term supply, which monetary policymakers need to take into account.

6 Implications for Monetary Policy

Since Covid took hold a year ago UK monetary policy has largely played a supporting role in mitigating the economic effects of the pandemic. The furlough and business loan schemes helped employees keep jobs and limited businesses failures. Lower policy rates aimed to bolster the cash flows of businesses and households, reducing borrowing costs and improved the availability of finance. Overall, economic policy has tried to mitigate the extent to which temporary falls in activity turn into permanent scarring to the supply potential of the economy.

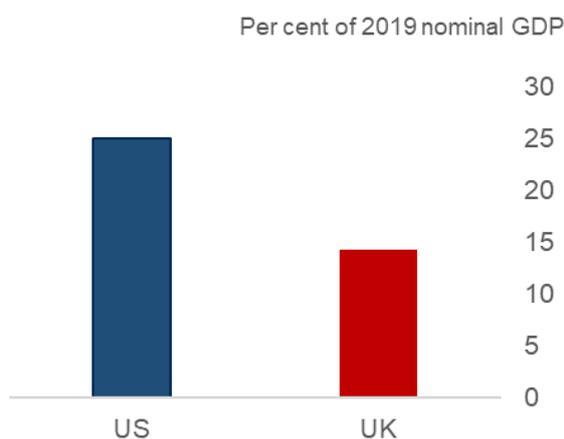
Looking ahead, assessing the impact of UK fiscal policy is a crucial consideration for the appropriate setting of monetary policy. The MPC takes fiscal policy as given, but because it is an important determinant of economic activity, changes in fiscal policy affect the stance of monetary policy needed to achieve the remit. We will be assessing the full implications of the March 2021 Budget as part of our next forecast round, but a key influence on the outlook will be the extension of the furlough scheme until the end of the third quarter, when all UK adults are expected to have been offered a vaccine. This has implications for demand, since it lowers the risk of a sharp rise in unemployment when the scheme ends. It also matters for supply, by reducing the risk of labour-market hysteresis.

Recent expansionary US fiscal policy will also be important for the UK outlook. The enacting of President Biden's new American Rescue Plan Act will boost activity substantially this year in the US. It also raises the global and UK outlook, given the importance of the US to the world economy and as a major UK trading partner. As always, there could be some offsetting effects going in the other direction, if markets' response to a stronger US outlook leads to tighter financial conditions, particularly in emerging markets. But the net impact from a UK perspective should be positive.

Comparing policies enacted in the US and the UK can also be informative for policymakers and other economists interpreting macroeconomic data. As well as the cross-country differences in the specific fiscal policies set out earlier in the speech, the most recent fiscal expansion in the US means that the *scale* of fiscal loosening since the start of the pandemic will be significantly larger than in the UK (**Chart 7, Panel A**). This has led to an active debate in the US about the size of the package, and whether it creates greater risks of persistent above-target US inflation. Despite the fiscal policy differences, I do not see a major divergence in long-term inflation risks across countries: monetary policymakers have the tools to contain and manage those risks, and would not hesitate to use them. All else equal, the greater fiscal boost in the US is likely to lead to a faster rise in the equilibrium rate of interest, r^* , than in the UK.

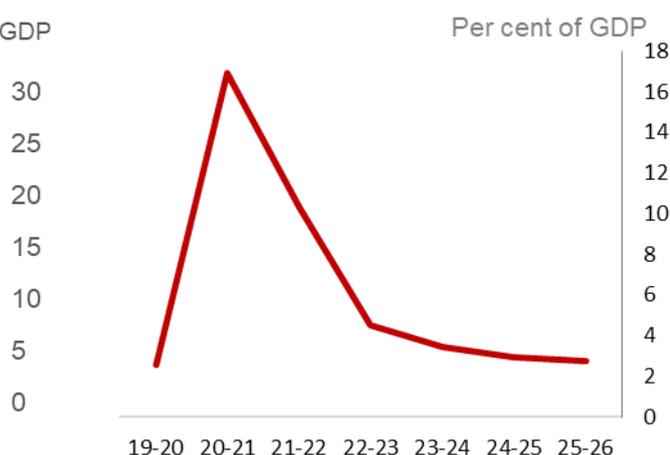
Chart 7: UK and US fiscal policy have diverged

Panel A: Discretionary spending measures taken or announced since March 2020



Sources: OBR, CBO, IMF and Bank calculations.
Notes: Excludes loan schemes and guarantees. US includes assumed \$1.87trn ARPA spending.

Panel B: UK public sector net borrowing, March 2021 OBR projection



Source: OBR.

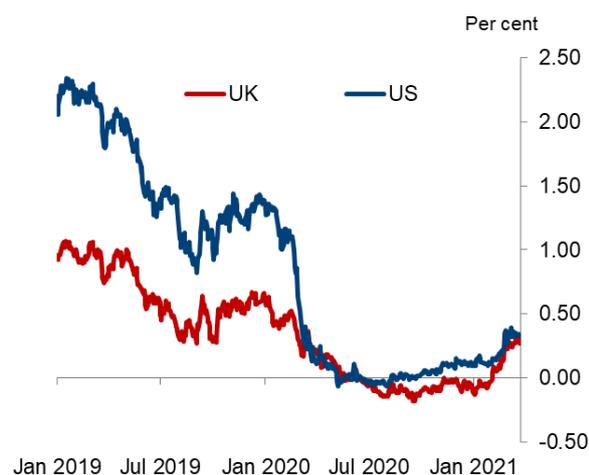
This simple ‘all else equal’ comparison of course misses the many other factors that will affect the monetary policy outlook. Even for a given fiscal package, its composition and its timing matter a lot for how it will impact inflation and therefore monetary policy. On the composition, measures that increase or bring forward investment, such as the enhanced deduction introduced in the March 2021 Budget, or higher public investment, will have direct impacts on demand. But to the extent that they increase productive investment, they will also increase supply in future, which may temper or reverse any inflationary pressures. On the timing, while the UK budget contained a near-term stimulus, it also incorporated a planned consolidation in future years (**Chart 7: Panel B**), which would lead to a hump-shaped impact on demand.

As the MPC discussed in its March minutes, US fiscal policy news is one factor that has driven recent increases in advanced-economy bond yields (**Chart 8: Panel B**). Consistent with the differences in

fiscal policy, these moves have been slightly larger, and to somewhat higher levels in the US than in the UK. Beyond the country-specific effects, co-movement likely reflects a range of factors, including the high degree of integration in financial markets, spillovers via trade channels and common developments across countries. In particular, the rapid vaccine rollouts so far in both the UK and the US have reduced, though not eliminated, the likelihood of further waves of the virus leading to more mandated or voluntary social distancing later in the year.

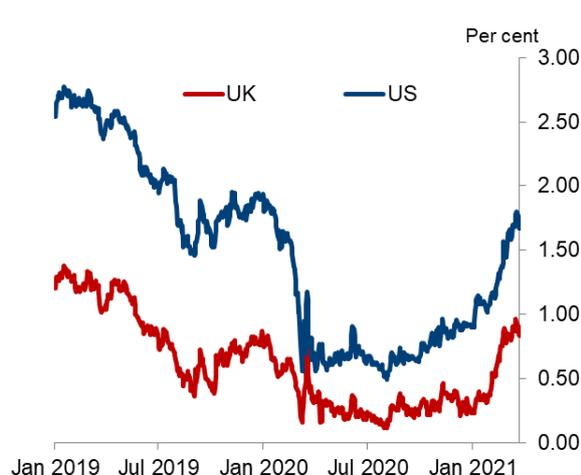
Chart 8: Interest-rate expectations and government bond yields have risen in 2021

Panel A: 2 year forward OIS rates



Sources: Bloomberg Finance L.P and Bank calculations.
Latest observation: 24 March.

Panel B: 10 year government bond yields



Sources: Bloomberg Finance L.P and Bank calculations.
Latest observation: 24 March.

Shorter-term interest rate expectations have also increased at the same time (**Chart 8: Panel A**) in both the US and UK. As well as differences in the economic outlook, it is possible that appropriate monetary policy during the recovery could differ across countries, given different objectives and frameworks. The US FOMC has a dual mandate to target both full employment and inflation, while the MPC has a primary objective of achieving a 2 per cent inflation target. Moreover, with the adoption of an average inflation targeting framework, the FOMC has committed to taking into account past deviations of inflation from target. The MPC's remit is clear that our target is forward-looking.

However the MPC remit has also always been clear that the MPC should target inflation flexibly.²⁰ Given that flexibility, it is important to differentiate between sustained rises in inflation and temporary volatility. We have specified in our guidance that we “did not intend to tighten monetary policy at least until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target sustainably”. I would not consider a pick-up in inflation to be sustainable if it was due to transitory one-off effects, which are likely given recent rises in energy prices, as well as base effects from sharp falls in inflation at the onset of the pandemic. Moreover, it is possible that short-run supply could be somewhat constrained owing to production bottlenecks as the

²⁰ See, for example, Bean (2017), for a discussion.

economy recovers, while current fiscal plans will lead to stronger demand in the near term, with weaker demand in future years. To the extent that these effects prove temporary, they would not imply any sustained pick-up in excess demand, nor in inflation, provided inflation expectations remain anchored.

Despite lessening downside risks, there also remain a number of scenarios that I would anticipate requiring looser policy later this year. While the risk of a sharp rise in unemployment is now lower, persistent changes in the way we work and consume may lead to lower demand for some industries, even as overall demand recovers. As a result, some proportion of furloughed workers are likely to become unemployed, with consequent effects on demand. And while the vaccine rollout has been fast in the UK, slower rollouts in many of our trading partners may continue to weigh on the global economy and demand for UK exports for longer. Finally, outside the direct sphere of monetary policy, there are risks of further waves of the virus and in particular, of vaccine-resistant strains. A delay or reversal in the relaxation of health restrictions, or renewed caution from households and businesses, would require more monetary support to help them bridge across to a period when health risks had been reduced. As always, the required loosening in monetary policy would also depend on the response of fiscal policy to any renewed economic weakness.

The MPC will continue to monitor the health and economic situations at home and around the world, and stands ready to take whatever action is necessary to achieve its remit.

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