Monetary policy as the economy recovers

This box provides further guidance on the setting of monetary policy once the unemployment threshold has been reached.

- **The MPC sets policy to achieve the 2% inflation target, and, subject to that, to support the Government's economic policies, including those for growth and employment.**
- **Despite the sharp fall in unemployment, there remains scope to absorb spare capacity further before raising Bank Rate.**
- **When Bank Rate does begin to rise, the appropriate path so as to eliminate slack over the next two to three years and keep inflation close to the target is expected to be gradual.**
- **The actual path of Bank Rate over the next few years will, however, depend on economic developments.**
- **Even when the economy has returned to normal levels of capacity and inflation is close to the target, the appropriate level of Bank Rate is likely to be materially below the 5% level set on average by the Committee prior to the financial crisis.**
- **The MPC intends to maintain the stock of purchased assets at least until the first rise in Bank Rate.**
- **Monetary policy may have a role to play in mitigating risks to financial stability, but only as a last line of defence if those risks cannot be contained by the substantial range of policy actions available to the Financial Policy Committee and other regulatory authorities.**

Monetary policy since the financial crisis

The objective of monetary policy is to achieve the inflation target, and, subject to that, to support the Government's economic policies, including those for growth and employment. The stance of policy to achieve the inflation target will vary over time depending on the economic circumstances. Following the global financial crisis, the MPC reduced Bank Rate to its historically low level of 0.5% and purchased assets amounting to £375 billion. Last August, as the economy showed early signs of recovery but the degree of spare capacity remained large, the Committee provided guidance on the future stance of monetary policy, stating its intention to maintain (at a minimum) the current degree of exceptional monetary stimulus at least until the unemployment rate reached 7%, subject to maintaining price and financial stability.

Unemployment has since fallen sharply as the recovery has gained momentum, and it seems likely that data released in the next few months will show that the 7% threshold has been reached. This box provides further guidance on the setting of policy once the unemployment threshold has been reached.

Scope remains to absorb spare capacity further

With inflation expectations well anchored, and in the absence of external price pressures, the MPC can consistently achieve the 2% inflation target in the medium term only if the economy is operating close to capacity. When inflation is at target but the economy is operating below potential levels of activity, the MPC will, in the absence of other influences, set policy to stimulate demand to eliminate that spare capacity.

Spare capacity comprises slack within the labour market — one component of which is the gap between the actual unemployment rate and its medium-term equilibrium rate — and slack within companies. Last August, given its assessment that there was substantial slack in the economy, the MPC specified the unemployment rate as the threshold for its policy guidance. Although the Committee recognised that unemployment was not a comprehensive measure of economic slack, it chose the unemployment rate because it is less volatile than some alternative measures of slack, is not prone to substantial revisions, and is widely understood.

At the time it provided its policy guidance, the MPC stated that once unemployment had fallen to the 7% threshold, it would assess the state of the economy more broadly, drawing on a wide array of indicators. Given that the threshold is likely to be reached in the next few months, that assessment is provided in this *Inflation Report*. The MPC's view is that the economy currently has spare capacity equivalent to about 1%–1½% of GDP, concentrated in the labour market. Around half of that slack reflects the difference between the current unemployment rate of 7.1% and an estimate of its medium-term equilibrium rate of 6%–6½%. The remaining slack largely reflects a judgement that employees would like to work more hours than is currently the case. Companies appear to be operating at close to normal levels of capacity, although this is subject to some uncertainty.

The existence of spare capacity in the economy is both wasteful and increases the risk that inflation will undershoot the target in the medium term. Moreover, recent developments in inflation mean that the near-term trade-off between keeping inflation close to the target and supporting output and employment is more favourable than at the time the MPC announced its guidance last August: CPI inflation has fallen back to the 2% target more quickly than anticipated and, with domestic costs well contained, is expected to remain at, or a little below, the target for the next few years. The MPC therefore judges that there remains scope to absorb spare capacity further before raising Bank Rate.

Factors determining the timing and pace of tightening

The legacy of the financial crisis and the persistence of economic headwinds mean that interest rates may need to remain at low levels for some time to come. As discussed in the box on page 40, even when the economy has returned to normal levels of capacity and inflation is close to the target, the appropriate level of Bank Rate is likely to be materially below the 5% level set on average by the Committee prior to the crisis.

Given that the headwinds weighing on the recovery are likely to persist for some time, when Bank Rate does increase, it is expected to do so only gradually. Raising Bank Rate gradually would also guard against the risk that, after a prolonged period of exceptionally low interest rates, increases in Bank Rate have a bigger impact than expected on output and spending.

The actual path Bank Rate will follow over the next few years is, however, uncertain and will depend on economic circumstances. Bank Rate may rise more slowly than expected, and increases in Bank Rate may be reversed, if economic headwinds intensify or the recovery falters. Similarly, Bank Rate may be increased more rapidly than anticipated if economic developments raise the outlook for inflation significantly.

The MPC's assessment of the timing and extent of future policy action will be centred on the following factors:

- **The sustainability of the recovery.** The MPC's central expectation is that the recovery will become more entrenched and more broadly based. Rising productivity should improve the outlook for pay and households' real incomes, and so support the durability of the pickup in consumer spending that is already in train. Moreover, the stronger demand outlook should encourage a rise in business investment, supported by further improvements in the cost and availability of credit. A more broadly based improvement in activity should provide reassurance that the recovery will not be threatened by a gradual removal of monetary stimulus.

- **The extent to which supply responds to demand.** An important part of the MPC's assessment is the judgement that productivity growth will gradually increase, slowing the pace at which spare capacity is used up relative to the recent past. Stronger demand, easier credit conditions and reduced uncertainty should facilitate movements of capital and labour to more productive uses, both within and across companies. But the recent weakness in productivity growth has caused the Committee to revise down its assessment of the likely strength of the response of productivity growth to higher demand. More generally, the precise timing and extent of the recovery in productivity is highly uncertain, and this uncertainty inevitably carries over into the outlook for policy. If the recovery in productivity is more (less) rapid than expected, Bank Rate could rise more (less) slowly.

- **The evolution of cost and price pressures.** Wage growth has remained muted, so that even with weak productivity growth, unit labour cost growth has been contained. Although pay growth is likely to pick up over the forecast period, this rise is expected to be modest by historical standards and largely to reflect a pickup in productivity growth. Import price pressures also appear subdued, while the moderate pace of demand growth is likely to limit the extent to which profit margins are rebuilt. The MPC judges that inflation expectations remain sufficiently well anchored and will continue to monitor them closely. A continuation of these benign trends in costs and prices would tend to make the case for removing monetary stimulus less pressing.

Asset purchases and the Bank's reinvestment policy

A final factor affecting the path of Bank Rate is the timing, extent and speed at which the MPC chooses to unwind its asset purchases. Last August, the MPC stated its intention not to reduce the stock of purchased assets at least until the 7% unemployment rate threshold was reached, and, consistent with that, to reinvest the cash flows associated with all maturing gilts held in the Asset Purchase Facility (APF). Updating this guidance, the MPC intends to maintain the stock of purchased assets, including reinvesting the cash flows associated with all maturing gilts held in the APF, at least until Bank Rate has been raised from its current level of 0.5%.

Monetary policy and risks to financial stability

Financial instability can have lasting effects on the economy, damaging growth and endangering price stability. The Committee remains mindful that a prolonged period of low rates could lead to risks to financial stability. The financial stability knockout recognises that, in some circumstances, monetary policy has an important role to play in mitigating financial stability risks, but only as a last line of defence; that is, if the risks cannot be contained by the substantial range of mitigating policy actions available to the Financial Policy Committee, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

This division of responsibilities between regulatory policy and monetary policy will continue once the 7% unemployment threshold is reached and the financial stability knockout no longer applies. This will allow monetary policy to remain focused on its primary objective of maintaining price stability while supporting a sustained recovery.