BANK OF ENGLAND

**Press Office**
Threadneedle Street
London EC2R 8AH
**T** 020 7601 4411
**F** 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

# News release

21 September 2011

## Productivity and monetary policy - speech by Spencer Dale

In a speech to the South Tyneside Manufacturing Forum, Spencer Dale – Bank of England Chief Economist and member of the Monetary Policy Committee (MPC) – discusses productivity in the United Kingdom: the life blood of the long-term success for businesses and a matter of great importance to the MPC. Spencer Dale describes why productivity matters for the MPC: it is a key determinant of the balance of supply and demand in the economy and, therefore, on inflation pressure in the medium term. So understanding what is happening to productivity is crucial in assessing how monetary policy should respond to the current weakness of demand and output growth. “The recent behaviour of productivity has been puzzling and worrying in equal measure”, Spencer Dale argues. The level of private sector productivity is now lower than it was before the start of financial crisis more than three years ago, and stands around 9% short of the level it would have reached had it grown at its pre-crisis average of around 2.5% a year.

Why is that? Spencer Dale asks, and offers three types of explanation. First, measured productivity may overstate the weakness of growth in the economy’s underlying supply capacity – either because of data mismeasurement or because firms ‘hoarded’ labour during the recession, knowing how difficult it is to re-employ skilled workers once let go. The latter would imply that firms have a substantial degree of spare capacity. But this does not seem consistent with businesses’ responses to surveys, which imply relatively limited spare capacity within firms. Nor can it explain why businesses have been hiring new staff: despite some disappointing weakness in the very latest employment data, the UK has added more jobs over the past year than at any time since 1997. A second explanation is that we might have expected a slowing in productivity growth, even absent the financial crisis. In particular, there has been a structural slowdown in the pace of productivity growth in North Sea energy extraction, while the strong growth in financial services output, underpinned by the process of financial liberalisation, was unlikely to continue indefinitely. But those explanations, however valid, probably only account for at most one half of the ‘productivity puzzle’.

The third possibility is that “...underlying productivity growth has been weakened by the impact of the financial crisis”, Spencer Dale argues. That might have occurred because the degree of economic uncertainty and restrictions in the supply of bank credit have caused firms to cut back on investment spending, although this is unlikely to have been the main factor. Rather, the financial crisis may have impaired the pace of efficiency gains in the economy: “Many smaller companies and new businesses, which are a critical source of innovation in our economy, have struggled to secure the finance they need to grow and expand", Spencer Dale observes. And even if companies can borrow funds, he notes, "some companies have become more cautious, preferring to hang onto liquidity or pay down debt rather than invest in increased levels of training and R&D." More generally, he says, "…the amount of management time devoted to … managing banking relationships has increased very substantially, diverting attention from the search for new products and new markets." Spencer Dale concludes that there are good reasons to think that the "…impact of the financial crisis may have dampened underlying productivity growth in recent years." "…we need the banks to be working for our economy to grow and prosper", he adds. As a consequence of a combination of all these explanations, he assesses that "...the degree of slack within firms is probably significantly less than implied by the shortfall in productivity."

Turning to monetary policy, Spencer Dale explains the reasons that he stopped voting to raise interest rates at the MPC's August meeting. "The outlook for demand over the past few months has weakened quite materially", he says, attributing this primarily to developments outside of the UK. "Growth in the world economy … has slowed. Concerns about the fiscal positions of some countries, particularly within the euro area, have intensified. This in turn has fuelled worries and uncertainties about the resilience of the international banking system. And perhaps most fundamentally of all, confidence that the authorities have the ability to respond to these challenges in a decisive and timely manner has diminished. These four factors have fed on each other, leading to a pronounced downward spiral. The UK has been caught in the fallout from these external developments". Spencer Dale concludes by noting that monetary policy remains highly supportive of the economy.

**Key Resources**

**Productivity and monetary policy – Full speech**