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

18 January 2013

Monetary policy in a changing economy - speech by Ian McCafferty

Speaking to an audience of economists and financial experts at Bloomberg on 18 January, Ian McCafferty gives his first speech as a member of the Monetary Policy Committee (MPC). He highlights the challenges for monetary policy and sets out his personal views on some of the key issues.

He notes that "one of the key legacies of the crisis is that some of the fundamental relationships that define the UK economy appear to be in a state of flux". "Perhaps the most unusual feature of this cycle has been the behaviour of the labour market...Employment has not fallen as much as we might have expected given the size of the fall in output". He suggests that part of the puzzle relates to "changes in the way companies manage their labour force...To achieve productivity gain through process innovation...requires employees to possess a high level of firm-specific skills... Even when faced with weak demand, firms are reluctant to lose experienced workers as they are hard to replace and their firm specific skills take time to replicate."

He cites various pieces of evidence to support this explanation, including his conversations with business managers, detailed labour market data, and business responses to surveys. He also notes that various features of the recession have allowed firms to be able to afford to hold on to their skilled employees. These include "greater wage flexibility....more prudent financial management...bank forbearance on existing loans.....and sterling's depreciation...which has lifted exporters' margins."

He sees "little evidence to suggest that our long-run productive capacity has so far been eroded to any meaningful extent." "One intuitive policy conclusion ...might be that the MPC should provide even more policy stimulus. [But] in the current environment, it is not clear if...current monetary policy instruments can easily generate a substantial increase in demand, [or that] such demand stimulus would have no inflationary consequences."

Elaborating on those concerns, he notes that "there are good reasons to think that the impact of Quantitative Easing (QE) on both financial markets and the broader economy varies significantly under different economic conditions, adding a further complexity to the policy decision". "Companies have yet to increase their intention to invest" despite a substantial fall in the cost of credit. "For households, faced with heightened uncertainty about the future, monetary stimulus may have only a limited influence in bringing forward expenditure". "The ability of QE to easily stimulate additional demand in the current climate is less clear than for earlier episodes. That does not mean that the scope for monetary easing to boost demand has been exhausted. QE still works, but it is important to consider carefully the timing of further flows and to be mindful of when any further policy stimulus, which is not costless, would be likely to have the greatest impact."

On the inflationary consequences of any further demand stimulus, Ian McCafferty sees "a risk that as the economy recovers, companies will feel obliged to reward their staff for their forbearance of recent years and compensate them for the recent squeeze in living standards with more generous pay increases". He hears this regularly when talking with companies. "The longer inflation remains elevated, and hence the greater the cumulative squeeze on real incomes, the greater the risk of such generosity". "There are reasons to think that inflation may come back to the target only slowly over the next two years, thus influencing both the 2013 and 2014 rounds of wage settlement". "Higher university tuition fees will add to inflation in each of the next three years, while on the face of it the recent increases in utility and rail prices, driven by regulatory and investment targets, will also remain a feature in coming years." There are also "upside risks to domestic food prices in coming months" due to poor harvests. Overall, "the upward pressure on both administered and food prices place a high burden of adjustment on other categories of the CPI basket, if, on average, prices are to rise in line with the 2% target".

Ian McCafferty suggests that his analysis of these issues illustrates the complexity of decision making for the MPC. "The crisis has changed the way that the economy works in ways that make the impact of monetary policy less obvious and decisions more challenging than before the crisis."