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Conditional guidance as a response to supply uncertainty – speech by Ben Broadbent

In a speech at London Business School, Monetary Policy Committee member Ben Broadbent explains why, given the uncertainty surrounding productivity growth, it is appropriate for the MPC to condition monetary policy on the rate of unemployment.

Ben Broadbent observes that the economy has "clearly picked up significantly faster than the majority of forecasts" made last year. He notes that, against this backdrop, the guidance issued by the MPC in August "has a number of virtues, not least the reassurance to investing businesses that monetary policy will not rise until economic recovery has become firmly entrenched."

Equally important to the outlook for demand, he contends, is the outlook for potential output – the capacity of the economy to meet demand without generating inflationary pressure. That capacity depends in turn on how productivity evolves. And because productivity growth has been "unusually poor" in recent years, Ben Broadbent thinks it is hard to be sure how it will behave as the economy recovers. This is, he argues, "a central feature – perhaps the central feature – of the economic landscape in the UK and it is in this light…that we should see the policy of "conditional guidance" recently introduced by the MPC."

Ben Broadbent argues that labour hoarding and greater pay flexibility, often cited as explanations for the "productivity puzzle", cannot on their own explain all of the relative strength in employment and the associated weakness in productivity. He presents evidence to show that the economy has been slow to adapt to significant shifts in relative economic conditions, across different sectors and firms, thereby impairing effective supply. For example, and perhaps because of impairments in the financial system, investment growth has not responded to profitability as it has in the past.

This does not mean productivity won't recover as demand grows. After all, the health of the financial system itself depends on growth in the wider economy. So Ben Broadbent is "happy with the MPC's central forecast, in the latest Inflation Report, that foresees an acceleration in productivity – and a correspondingly gentle decline in the rate of unemployment – as the economy recovers." But because of the uncertainty around why productivity has been weak, he argues that: "Changes in unemployment are now a more reliable measure of what's happening to the degree of slack in the economy than economic growth alone" and therefore "as you become less confident about future supply, the unemployment data become more informative."

Ben Broadbent explains: "Suppose the policy maker sees strong growth. This may turn out to require extra resources, including higher employment, in which case it is likely to add to inflationary pressure. But it may not: it's also possible the upturn is being accompanied by faster productivity growth, in which case it would be wrong to tighten policy. What, under these circumstances, should one do? The answer is to respond less sensitively to output and more to developments in the labour market, even if you have to wait for a while to see them."

This is, in his view, a key rationale for conditioning policy on the rate of unemployment, as the MPC did in its policy announcement in August.

He notes, in closing, that some commentators have suggested it would be problematic for the policy if unemployment fell faster than the central forecast in the MPC's August Inflation Report and the Committee was thereby "forced" to consider an earlier rise in interest rates than it has "promised". But he points out that: "there is no promise unconditionally to keep interest rates fixed for a particular length of time. What we have pledged to do – and the clue is in the word "conditional" – is to examine the case for a withdrawal of monetary stimulus only after a significant fall in unemployment and as long as the inflation and financial stability "knock-outs" have not been breached."

Ben Broadbent concludes: "That is only reasonable…If unemployment falls faster than we're expecting either because productivity does less well than in our central projection, or because demand grows more strongly, it would be right to ask whether we should think about withdrawing some of the monetary stimulus currently in place. Nor would we be displeased with such an outcome (what's not to like about lower unemployment?). If unemployment declines more slowly it would be right to leave the monetary stance unchanged for that much longer."