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News release

29 April 2014

Slack, pricing pressure and the outlook for policy - speech by Ian McCafferty

In a text issued today, based on remarks given to group of business contacts in Northern Ireland earlier in the month, Ian McCafferty sets out how he assesses the degree of spare capacity in the UK economy.

He argues that “while quantitative estimates of the amount of slack are a useful guide to the direction of travel of spare capacity in the economy, the high degree of uncertainty associated with those estimates also necessitates close and direct monitoring pf the pricing pressures they give rise to. As we steer the economy back towards full capacity operation, it is crucial we watch out for incipient upward pressures in price- and wage-setting behaviour.”

As examples of the uncertainty around how much spare capacity there is in the economy, Ian McCafferty points out that equilibrium estimates of potential supply are not directly observable, and that current estimates of slack “in some cases are currently at odds with more qualitative evidence – the Bank of England Agents’ reports of recruitment difficulty and skills shortages already points to tightening in some parts of the labour market”. He notes that the MPC’s most recent estimate of spare capacity, which was 1 to 1½ % of GDP, was a “central estimate not in any sense a statistical confidence range”. A one standard deviation range of each of the components of slack would generate “a range estimate of the level of slack between nought and 2.5%”.

Ian McCafferty suggests that the price pressures to watch, to complement estimates of slack, include “wage bid and wage settlement activity; firms’ pricing behaviour and movements in profit margins; and signs of firming prices early in the supply chain”.

On wage settlements, he notes that “the pickup in January settlements reported by a number of data providers certainly suggests that nominal pay is finally on the rise”. And the “sharp pickup in the proportion of REC survey respondents reporting higher salaries for permanent new recruits suggests that broader nominal pay is on the cusp of a strong recovery”. But he also notes that “pay pressures must be considered alongside movements in productivity” as any pickup in pay growth could be mitigated by a recovery in productivity. On profit margins, he notes that manufacturers’ margins have “picked up in some sectors since the turn of the year”. He argues that “services that underpin the wide range of activities across the economy, such as transport and distribution, are early indicators of diminishing slack, and rising price pressures.” He thinks that “at present these indicators, by and large, are still showing little sign of upward price pressure”.

Overall he concludes that “it appears that the early supply chain pricing environment remains benign.” But he warns that “turning points are hard to predict and can be quite abrupt….as demand recovers and slack is eroded, price pressures might pick up relatively quickly, a fact we must be alert to."

Turning to the implications for monetary policy, Ian McCafferty explains that "keeping a close eye on …early stage price and pay pressures should give us greater precision as to the timing of necessary increases in interest rates". He notes that the "three elements of policy normalisation – the timing of the first rise, the pace of tightening thereafter, and the longer term equilibrium level of Bank Rate – are inextricably linked, and there are potential trade-offs between them. To the extent that the endpoint of our normalisation journey – the level of the 'neutral' rate – is materially lower than before the crisis, we clearly have less far to travel, which might make the first rate rise appear less pressing than if we had to return to a neutral rate of 5%. On the other hand, a gradual trajectory for rates can be ensured only if the first rate rise is not held back, such that we start the normalisation process before the economy reaches effective capacity constraints, so that inflation expectations and pressures are kept well in check."