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News release

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Monetary policy in an uncertain economy

Speaking to a breakfast event organised by the Institute of Directors, Ian McCafferty explains his view of the competing risks that he thinks about when setting monetary policy. Between August and November, unlike most Monetary Policy Committee (MPC) members, he has voted for a rate rise. He explains that his voting reflects a different assessment of the risks facing the economy, compared with most other MPC members. But he also stresses that his vote in the December meeting will be revealed on 17 December – his comments today reflect his thinking up to the November *Inflation Report* and not necessarily December.

On the demand side, Ian suggests that uncertainties about the sustainability of domestic demand … have resurfaced. But although "latest evidence from output surveys suggests that some … momentum is waning in some sectors, these surveys remain consistent with healthy growth rates in the vicinity of 0.6% – 0.7% in the current and coming quarters".

He goes on to say that "considerable though uncertainties are on the demand side, they are small compared with those concerning supply". He focuses on four questions on supply:

1) What is the current level of slack? Ian notes that "business surveys suggest that companies are operating at close to 'normal' levels of capacity utilisation". But he suggests that the degree of slack in the labour market is a "more complex concept", requiring an assessment of equilibrium levels of unemployment, participation and hours, which cannot be observed directly. He considers that "recent weaker data on participation may well be telling us that the recent upward trend is coming to an end at a somewhat lower level than previously thought". He also thinks that "caution is needed in interpreting estimates of people's 'desired' hours worked." These considerations make him conclude that "the risks around our central estimate of slack in the November *Inflation Report* are probably skewed to the downside, and that in practice there may not be that much spare capacity left in the labour market."

2) How quickly is slack being absorbed? Ian notes that this depends on economic growth – growth will need to remain no faster than its average rate in coming years for slack to be absorbed less quickly. While he finds that "plausible" he warns that if growth ends up being slightly higher that could "materially change the date by which slack would be fully absorbed." He also notes that the speed with which slack is absorbed will depend on future productivity growth and that "with a substantial part of the weakness of productivity likely unrelated

to cyclical factors, it may take some time to see a solid recovery in productivity growth, and the timing is very uncertain". So in his view, "we may well see the economy return to full capacity somewhat earlier than implied by our central forecast in the November *Inflation Report".*

3) What are pay measures telling us? Ian explains that "here too policy makers have had to grapple with heightened uncertainty, relating to the interpretation of divergences in pay measures". "The main puzzle has been the recent weakness of average weekly earnings which has been at odds with the strength of the survey indicators". But Ian notes that survey measures have reasonably good leading indicator properties, and that the most recent private sector pay data suggest a pickup, so he concludes that "domestic pricing pressures may be less dormant than we think, and might surprise us faster than we expect".

4) How far should current low inflation influence our policy decisions? Ian argues that there are "some good reasons to justify looking through the recent sharp fall of inflation, at least partially." He explains that policy has to be forward looking. That the source of the weakness in inflation is largely external reflecting "falling food and energy prices, as well as the 10% appreciation of sterling". That "there is little evidence of …disinflationary second round effects emerging". And that, when looking through current levels of inflation "it is not only the current level of spare capacity that is important. Whether that spare capacity is diminishing or growing, and whether that output gap moves from negative to positive over the forecast horizon, are also important considerations".

Ian spells out how his analysis affected his vote in August through November for interest rates to rise. Given his views on supply he is concerned that there is "a risk that pay and unit cost growth will begin to rise faster than is consistent with our inflation target". He also thinks that there is a case for raising interest rates to reduce the risks to financial stability of encouraging excessive 'search for yield'.

Ian believes that "gradualism is a critical element of our policy armoury". This is important to minimise "the likely disruption to consumers and businesses" "as well as allowing us to assess the impact of a policy change after a long period of stability – whether, for example, consumers are more sensitive to changes in interest rates currently than they were before the crisis". He argues that gradualism "is more likely to be delivered if we start [to raise interest rates] sooner rather than later". These arguments led him to conclude, between August and November, that a small rise in Bank Rate was the best way of supporting and sustaining economic expansion.

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