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News release

18 June 2014

Spare capacity and inflation - speech by Martin Weale

In a speech given to the Northern Ireland CBI in Belfast, Martin Weale outlined the factors he believes are most important for assessing inflationary pressure in the economy. He focussed on two areas of the economy where inflationary pressure can build and which MPC action can influence. First, pressures within firms, affecting how they set prices. Secondly – and more important in Weale's view – pressures in the labour market, which affect wage growth.

Using data from the CBI's Industrial Trends Survey, Weale found that measures of firms' capacity utilisation – how intensively they use their existing physical capacity and labour – are poor predictors of how firms intend to change their prices over the next twelve months. Developments in wage costs, he found, are a far more accurate indicator for how firms will set prices and are the most important component of inflation in the economy overall: "An analysis of inflation without the labour market would be akin to a performance of Hamlet without the Prince".

Weale turned therefore to focus on the impact of labour market slack on wage growth. Taking the unemployment gap, or the difference between the current rate of unemployment and its medium-term equilibrium, Weale found that for every one percentage point that unemployment is above its equilibrium, quarterly pay growth is 0.3 per cent lower than it would otherwise be.

Breaking this down further, Weale found that the sensitivity of regular pay is about three times more sensitive to movements in the unemployment gap than discretionary pay or 'bonuses'. Nevertheless, the flexibility in bonuses suggests that they may have been a helpful factor behind overall wage flexibility during the crisis. A cost of this, however, is that bonuses can discourage equity finance and make firms reliant on debt.

Combining this analysis of wage pressures with the projections in the Bank's Inflation Report, Weale notes that falling unemployment and recovering productivity should result in wage growth picking up to around 4 per cent per annum. However, if as he believes "there is less spare capacity than was assumed in the Inflation Report, then the growth rate projected in the Inflation Report could lead to undesirable inflationary pressures developing in the labour market".

Actual outturns for wage growth, Weale noted, have been weaker than forecast over the past six quarters. He said that one explanation for this may be that the medium-term equilibrium level of unemployment is lower than the MPC believes, in which case the actual level of unemployment will bear down more strongly on wage inflation. Weale added: “If I put all of the weakness in wages over the past year down to the unemployment gap being larger than we currently believe, this points to extra spare capacity of over half a per cent of GDP. This is consistent with a medium-term unemployment rate closer to 5% than our current range of 6%-6½%.”

Turning to the policy decision the MPC faces, Weale said that it is becoming more balanced, with two opposing forces of uncertain magnitude pushing in different directions.

On one side, existing measures of underemployment may be overstating the underlying amount of spare capacity in the labour market. Weale said: “One factor is that people who have been recently unemployed are less productive than average. If this is the case, then as the economy continues to grow, unemployment could fall more quickly than the MPC expects. That on its own certainly points to a need for a policy profile tighter than in our May forecast.”

On the other, there is the question of what lesson should be drawn from a continuing and unusual weakness in wages, which may indicate there is more spare capacity in the economy than the MPC has assumed. He added: “Should wage growth fail to revive, that will, on its own, tip the scales further in favour of maintaining a strong monetary stimulus.”

Weale concluded by noting that, even after interest rates start to rise, monetary policy will still be providing considerable support for the economy. The key to any decisions made by the MPC would be how data develops – and how individual members interpret it.