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The UK productivity puzzle – a sectoral perspective - speech by Ian McCafferty

Speaking at a Market News Connect lunch, Ian McCafferty, a member of the Bank of England Monetary Policy Committee, spells out some new analysis of the UK's productivity performance. He notes that "a fuller understanding of why productivity has remained so weak, and to what extent it is therefore likely to recover, is critical for the path of interest rates as the expansion continues…..The faster the recovery in productivity, the slower the absorption of remaining spare capacity over the forecast horizon, which would allow a longer time before the first rise in interest rates and a more gradual trajectory thereafter."

He believes that "the behaviour of aggregate productivity in recent years has masked stark differences across sectors….sufficiently stark to suggest that the reasons behind the productivity weakness are likely to be more numerous, diverse and complex than sometimes assumed."

He then examines detailed productivity data across a wide range of business sectors, and identifies the sectors that have contributed most to the low level of productivity, relative to 2007. "To provide likely explanations of the cause of differential productivity performance across sectors…[he draws]…on a database of intelligence compiled by the Bank's Agency network from their company visits. This documents detailed discussions the Bank Agents have with about 5,500 company contacts each year, and provides direct evidence of the factors affecting their business performance both from the company itself and via the Agents' interpretation".
His analysis concludes that eight sectors "account for the entirety of the weakness in productivity over the past six years:….Mining and the extraction of crude petrol / gas (22%), Education (15%), Financial service activities (excluding insurance and pension funding) (13.5%) , Social work activities (12%), Activities of head offices; Management consultancy (11%), Services to buildings and landscape activities (10%), Warehousing and support activities for transportation (9%) and Postal and courier services (8%).

Based on Agents reports he finds that this weak productivity was driven by "a tough operating environment, labour retention and minimum operating scale [which] look to be primarily 'demand contingent', whereas drivers such as stricter regulation and changes in business mix can be deemed more 'non-cyclical'". He concludes that "the cumulative contribution to the shortfall (60%) of the divisions where the weakness of productivity is underpinned by predominantly non-cyclical drivers is slightly greater than that of the divisions where weak productivity primarily reflects demand-contingent drivers (40%)."

Ian concludes that his "sectoral analysis of the productivity puzzle broadly supports the MPC's central view of a gradual recovery in productivity as the economy recovers. Nevertheless, the fact that 60% appears to be unrelated to the cycle of

demand also suggests that some of the weakness may well be more persistent, and that a more rapid recovery in productivity than currently expected over the next couple of years is perhaps hoping for too much."

Turning to the policy decision, Ian notes that "faced with such uncertainties about the likely pace of absorption of slack, a prudent policy maker, in my view, would want to start to remove some of the current extraordinary level of monetary stimulus a little before the output gap is fully closed. But on this occasion, there is an additional reason not to hold back too long. Once the normalisation of monetary policy gets underway, I believe it will be critically important that rises in Bank Rate are delivered, as far as we are able, at only a modest, gradual pace…. The decision on when it will become appropriate to begin the normalisation of policy is becoming more balanced as the economy has strengthened through the early summer. As ever, our decisions on monetary policy will depend critically on the evolution of the data over the coming months."