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Monetary policy one year on - speech by Sir Jon Cunliffe

In a speech to the Cambridge Society for Economic Pluralism. on Tuesday, Jon Cunliffe reviews developments in the UK economy during his first year in office and looks ahead at the judgements and uncertainties faced by the Monetary Policy Committee.

The recovery has remained strong. Growth in the four quarters to September now stands at 3%, a quarter of a percentage point stronger than the MPC forecast in November 2013. The burst of pent-up demand that propelled the initial recovery was stronger and lasted longer than the MPC had forecast last November, Jon notes, but it now, as anticipated then, seems to be fading. Still, the recovery has been made more sustainable by a marked pick-up in business investment, which has driven around a third of the increase in GDP over the past year.

However, as unemployment has fallen sharply as output has grown, productivity has not made even the modest recovery to half of its pre-crisis trend that the MPC forecast last November. The productivity puzzle remains a puzzle. “And there is now a new puzzle: why, despite this rapid fall in unemployment to 6%, have we seen such weak pay growth in the official data?”

Jon observes that even adjusting for low productivity by looking at pay relative to the output of the average employee, the picture is weak. Growth in unit labour costs has been negative over the past year.

“The big surprise, therefore, for the MPC … has been the extent to which employment has been able to grow without generating more inflationary pressure through higher pay increases. Understanding why that has happened and how long it will persist is, in my view, now key to deciding policy.”

One possible explanation may be a longer-than-usual lag between falls in unemployment and pay pressure emerging, which could mean that inflationary pressure is building in the pipeline that will be more difficult to curtail if the Bank does not act now. However, another is that a combination of factors has caused labour supply – the amount of hours of labour available to the economy – to be much stronger than in previous recoveries, for example due to the increase in women’s state pension age and changes to the incapacity benefits regime. And the fall in unemployment has included a high number of long-term unemployed, who probably act as less of a drag on pay.

Yet despite the biggest squeeze on real incomes for nearly a century, there appears to be little evidence that workers are demanding a catch-up in pay, Jon observes, possibly due to a shift in the psychology of UK workers resulting from the sharpness of the recession and the years of austerity that have followed it.

The MPC is therefore left with a judgement whether falls in unemployment presage an imminent and possibly inflationary sharp pick-up in pay growth, or whether the continued weakness in labour costs means it can afford to let falls in unemployment continue to run for some time yet.

“But there are grounds to continue to suspect that labour supply may be behaving differently to the past, to be cautious about moving to tighten monetary policy on the basis of falling unemployment alone and to wait for clearer signs of strength in pay growth.”

The instinct to be cautious about tightening monetary policy too early is reinforced by the constraints that come with Bank Rate remaining close to its effective lower bound.

“We’ve now seen evidence of a slowing in UK growth, and prospects for the global economy have deteriorated. With the scope for tightening monetary policy substantial, but the scope for loosening it much more limited, the risk of a surprising pick-up in inflationary pressure may be more manageable than the risk of the expansion stalling and inflation dropping further.”

Jon concludes that some of what the MPC thought would happen when he joined the committee last year has happened. The economy has gone from recovery to expansion. Growth is slowing to something close to its pre-crisis average. Investment is making an increasing contribution to growth. But the behaviour of unemployment, productivity and, most recently, pay continue to surprise and puzzle.

"The softening in the pay and inflation data, together with the weaker external environment, for me implies that we can afford to maintain the current degree of monetary stimulus for a longer period than previously thought. That of course will be a subject for the MPC to debate in the coming weeks."