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What to do when we don't know: policy-making when spare capacity is uncertain - speech by Martin Weale

In the annual JSG Wilson Lecture, at the University of Hull, Martin Weale – External Member of the Monetary Policy Committee (MPC) – explores what he calls "the practical problem" of setting policy while being uncertain about the margin of spare capacity in the economy, and thus the implications of future economic growth for future inflationary pressures.
Martin begins by warning of "the perils of thinking that we know too much". He explains that there are number of factors which are "inherently unknowable" such as what is going to happen to inflation in two years' time and how much the economy is going to grow in the future. Using modelling techniques, Martin suggests ways in which policymakers could adapt to these uncertainties, so that even "if we cannot be sure what is going on, we can at least do our level best to think about ways of alleviating the risks associated with getting things wrong."

He focuses his analysis on two key underlying areas of uncertainty that are particularly pertinent to the MPC today.

The first is around the degree of spare capacity in the economy, particularly in the labour market, as well as uncertainty about what components of spare capacity have a material influence on inflation and thus should be taking into account by the MPC. There are a wide range of views on the MPC as to the degree of spare capacity, and the "uncertainties surrounding the likely margin of spare capacity are now large relative to the best estimate of its actual magnitude."

Secondly, there is uncertainty as to the normal or equilibrium rate of interest – the rate at which supply and demand are in balance with inflation close to target. This is one reason why the MPC has been clear that its guidance – that interest rate rises, when they come, are likely limited and gradual – is an expectation and not a promise.

Given these uncertainties, Martin illustrates, using the Bank's economic model, how there can be benefits to setting policy with reference to the change in, rather than the level of the margin of spare capacity. The framework also avoids the need to know the normal rate of interest.

Turning to the practical implications of his analysis for current policy making, Martin argues that given the unusually rapid fall in unemployment over the past year, it is clear that the margin of excess capacity in the labour market is being used up rapidly, and "all logic suggests that that ought to lead to an increase in inflationary pressures over the two to three year horizon which concerns the Committee."

And despite the fact that wage growth, as measured by Average Weekly Earnings (AWE), has been very weak, suggesting more spare capacity to begin with, Martin argues that there may be other factors influencing these figures. He cites the divergence between AWE and other indicators of pay growth, and suggests as possible explanations that those recently entering the workforce are being paid less than average, and that rapid employment growth has depressed the rate of average pay growth.

He makes clear that "this is not to say that I think underlying pay is already growing faster than is compatible with the inflation target. Rather it is that, the tightening of the labour market means that, instead of waiting to see wage growth pick up, I think it is appropriate to anticipate that wage growth."

Martin also discusses the some of the factors influencing current inflation, noting that "the current inflation rate has been significantly depressed by the recent rise of the exchange rate and falling commodity prices." With respect to these influences, Martin recounts that the MPC rightly looked through the first-round effects of the fall in the exchange rate in the 2007-08 period and the subsequent rises in commodity prices. He explores whether they should be doing the same in response to recent movements. Given that monetary policy is operating at the effective lower bound, Martin suggests that, if inflation falls to very low levels, "it might be necessary to look through price changes less than fully on the downside" and suggests that the effects of exchange rate and commodity price movements will be explored more fully in the November forecast round.

He concludes his speech by summing up his analysis:

"No one would want to follow the signal from a policy rule of the sort that I have presented here to the exclusion of all other considerations and I am not proposing that... The point I do want to make, however, is that, when forming my view on the appropriate setting of Bank Rate, I am looking at, among other indicators, the speed with which the margin of spare capacity is declining as a guide to prospects for wage pressures in the second half of next year. The best indicator of this is probably the rate at which unemployment is falling."