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Treading carefully – speech by Minouche Shafik

In a speech at the Institute of Directors, Minouche Shafik, Deputy Governor for Markets and Banking and member of the Monetary Policy Committee, sets out her views on approaching monetary policy decisions as we learn about how the economy operates in the wake of the Great Recession.

Proceed with caution

Minouche notes that there are good reasons for Bank Rate to have remained lower for longer than in the aftermath of previous recessions. First is that the size and nature of the shocks that accompanied the financial crisis meant that the equilibrium level of Bank Rate fell dramatically in 2008-09. Second is that there is residual uncertainty about the relationship between the real economy and inflation.

Much of the weakness in inflation, Minouche observes, is due to movements in commodity prices and the exchange rate. But a portion of the current deviation from target is due to weakness in domestically generated inflation. In turn, the most important driver of domestically generated inflation is how quickly wages grow relative to productivity, which determines labour costs per unit of output. A puzzle started to emerge in 2014 when – despite a significant narrowing of slack in the labour market – wage growth seemed slow to pick up. The early signs were that 2015 would be more promising, but "*the rate of wage growth seems to have levelled off again in the most recent data*". Plausible explanations include: that the number of hours worked per person per week may have started to decline; there are compositional effects pushing down on starting salaries; and that the low level of headline inflation may be limiting upward pressure on pay.

Minouche judges that "*the most likely outcome is that wage growth will soon resume its recovery, but there are alternative states of the world in which it takes longer for that to happen. So I judge it prudent to tread carefully, and refrain from voting for an increase in Bank Rate until I am convinced that wage growth will be sustained at a level consistent with inflation returning to target".*

Consider all the outcomes

In the presence of uncertainty, it is wise to hedge against undesirable states of the world. This means that financial asset prices reflect not only what is thought to be the most likely outcome, but also the full range of other possible outcomes and the probabilities attached to them.

For example, at the time the MPC was producing the November *Inflation Report*, the market yield curve implied the first increase in Bank Rate would come in March 2017, and that it would reach 1¼% by the end of 2018. It is possible that the true expectation of market participants is for Bank Rate to increase more quickly than that, but that they are particularly worried about downside risks and are happy to accept a lower expected return in exchange for insurance against bad outcomes. This would be consistent with the risks to the world economy that have come to the fore over the past year.

Minouche believes "*the yield curve could be weighed down by worries about the world"*. She explains that "*should the downside risks from the world economy fail to materialise, and absent further shocks, once wage growth has returned to a level consistent with inflation returning to target I would expect the economy to warrant a path for Bank Rate that increases more quickly than implied by the market yield curve used to condition the November Inflation Report. I think it is interesting to note that surveys of economic forecasters – a more direct measure of the expected future path of interest rates – show expectations for a faster pace of increases in Bank Rate. Having said that, I think all agents, and all members of the MPC, expect the future path to be gradual and limited".*

Retain flexibility

When the time does come to raise Bank Rate, "*it will be important to retain the flexibility to change course if needs be, either by tightening policy more quickly than originally envisaged or by being prepared to loosen again*". Were it required to respond to unforeseen events, the MPC would have two tools at its immediate disposal: Bank Rate and Quantitative Easing (QE). In light of the uncertainty about the transmission of unconventional monetary policies, the MPC has expressed a preference to use Bank Rate as the marginal instrument for monetary policy when the time comes to tighten.

Minouche believes that this "*will be more likely to give us the ability to respond to an adverse shock using Bank Rate rather than tools which are inherently less flexible and with which we are less familiar*".

Minouche goes on to make the broader point that the flexibility the MPC has had to pursue its target independently since 1997 has brought "*great economic benefit in the form of lower and more stable inflation - a result that has stood the test of the financial crisis and is something we should treasure"*. She notes that "d*ecisions on the stock of gilts held in the APF have always been made solely by the MPC in the sole pursuit of its monetary policy objectives mandated by Parliament and that should always remain the case*".

Conclusion

We are still learning how the post-crisis economy behaves, and some relationships in the data have proven slow to reassert themselves or may have changed. The recent plateau in wage growth despite the ongoing recovery is one example.

Minouche sums up: "*I will wait until I am convinced that wage growth will be sustained at a level consistent with inflation returning to target before voting for an increase in Bank Rate. In this sense, I will proceed with caution. But once I am convinced, absent further shocks, I can see Bank Rate rising more quickly than the path implied by the market curve at the time of the last Inflation Report…Whatever the outcome, it will be important to maintain flexibility to respond to new data and events*".

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