BANK OF ENGLAND

News release

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Wages, inflation and current monetary policy – a speech by Ian McCafferty

In a speech given at the Bank of England, Ian McCafferty outlines how the world has changed since he last voted for a rise in Bank Rate – and what he now needs to see before voting for tighter monetary policy.
Ian outlines two broad themes that have emerged since the summer of 2015, when he began voting for a rise in Bank Rate. On the international side, he noted that the darkening outlook for emerging-market economies (EMEs) and further net falls in the price of oil were buffeting financial markets and pushing down on headline inflation rates around the world. On the domestic side, a modest slowdown in growth was being accompanied by disappointingly weak growth in nominal wages and other domestic prices.

For Ian, while global developments remain germane for the MPC, the main focus was the domestic picture, in particular the recent stuttering pick-up in wages. He said: “Last summer, in voting for an increase in Bank Rate, I had expected that the narrowing of slack would drive up wages through 2016 as firms competed for increasingly scarce labour. But it now appears that opposing factors are acting to hold wage growth down, for rather longer than I had thought.”

Ian noted that there are a number of factors that may have driven this development, including effects from the changing composition of the workforce as well as a possible anticipatory effect from the introduction of the National Living Wage. However, he believes that the most important factor is that the current low level of headline inflation has been having a material impact in reducing the pace of wage growth. He said: “[It] is this factor that has been paramount in the evolution of my thinking about the balance of risks around domestic cost pressures, and the appropriate policy stance.”

However, for Ian this is likely to be a temporary interruption to the expected wage growth. He argues that when CPI inflation starts to rise, wage-setting behaviour will likely normalise and “wage inflation may rise surprisingly quickly in response”.
Ian also underlined his belief that the path of interest rate normalisation should be as gradual as possible to allow businesses and households time to adjust to changes. He said he would like to see rates rise at a slower pace than in previous cycles, undershooting those historic norms – likely around 50bps per quarter – “with some margin to spare”.

Before voting for the normalisation of interest rates to begin, Ian concluded by saying he would need to see either the dissipation of the external forces holding down inflation or renewed domestic wage growth. The extent to which the recent depreciation in the exchange rate proves persistent also needs to be watched closely, a judgement made difficult at present by uncertainty around the referendum on EU membership.

Ian concluded: “I continue to expect the ongoing process of normalisation to proceed and for the economy to continue to recover, as well as for consumer price inflation to revert to our 2% target. But the time over which this is likely to occur has been delayed. This delay, combined with the current dynamic between current inflation and wage determination, has led me to suspend my call for an immediate increase in Bank Rate.”

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