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News release

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The Phillips curve: lower, flatter or in hiding?

In a speech to the Oxford Economics Society on Tuesday, Sir Jon Cunliffe, Deputy Governor for Financial Stability and member of the Monetary Policy Committee, discusses the debate around the relationship between pay and unemployment (the Phillips Curve), and explains why he voted against the 25 basis point increase in Bank Rate this month.

At its November policy meeting, the MPC judged that the effects of rising import prices on inflation would diminish over the next few years, and domestic inflationary pressures would gradually pick up as spare capacity is absorbed and wage growth recovers. It also judged that the steady erosion of spare capacity in the economy had reduced the degree to which it was appropriate for the MPC to accommodate an extended period of inflation above target.

Jon explains that his decision was not the result of his having a markedly different view to the majority of the right trade-off between output and inflation over the forecast period. Rather, it was because of the current uncertainty around the shape and slope of the Phillips Curve, which is an important guide to domestically generated inflation pressure.

“Given the uncertainties … and the serial disappointments we have had in recent years in forecasting the impact of unemployment on pay growth, there is, in my view, a not immaterial risk that the trade-off is not as it currently appears and that domestic inflation pressure will undershoot the Committee’s collective expectation,” Jon says.

“In my view, the low level of domestic pressure on inflation now, the absence of second round effects from the depreciation of sterling, and inflation expectations around their historical averages, make it possible to wait before tightening policy until there is clear evidence that pay growth is responding to the level of unemployment in line with our forecast.”

Jon notes that the apparent disappearance of the link between pay and unemployment is one of the key puzzles of the post recovery economy in the UK and in advanced economies. He highlights four main explanations for this - slack in the labour market has been under-measured; the curve has shifted

downwards; the curve has become flatter, and the curve is not there - and explores what that might mean for policy makers.

Jon also makes the point that expectations of Brexit – from the most optimistic to the most pessimistic – are affecting "to some degree" many of the economic decisions of businesses and households. But he emphasises that his policy decision does not anticipate any particular Brexit outcome.

However, the MPC cannot forecast what the outcome of Brexit will be or how it will measure against the diverse expectations in and between households, businesses and financial markets. Nor can the MPC forecast how the Brexit outcome will affect the adjustment of the paths of demand, supply and the exchange rate, relative to each other.

"It is that relative adjustment of these variables that will determine the path of inflation and hence whether - and in which direction - policy may need to respond to meet the Committee's primary objective. We can, in my view, only work on what we see in the economy now, and stand ready to respond as necessary as Brexit emerges."

To conclude, Jon says that monetary policy cannot simply wait until there is a clearer understanding of whether employment is being correctly measured, whether the Phillips curve has shifted down, tilted or both – or whether there is a better framework for understanding the relationship between supply, demand and inflation. However, the current level of uncertainty around the key assumptions on which the MPC models and understands the economy is different to uncertainties about the data or signals it receives, which are always mixed.

"Some of the relationships between economic variables that we depended on in the past appear to have gone on a longish leave of absence, but we are not sure why, or whether this is a temporary or more persistent departure.

"Against that background – and although it makes forward-looking monetary policy more difficult – I tend to put more weight on the evidence we can or cannot see in the data, and a little less on the un-observables and on how we think the economy works."

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