Monetary Policy Roundtable

On 24 June, the Bank of England and the Centre for Economic Policy Research hosted the sixth Monetary Policy Roundtable. These events are intended to provide a forum for economists to discuss key issues affecting the design and operation of monetary policy in the United Kingdom.(1) As always, participants included a range of economists from private sector financial institutions, academia and public sector bodies. At this sixth Roundtable there were two discussion topics:

- will the protracted period of above-target inflation lead to further upward pressure on prices?; and
- how will the contrasting fortunes of the household and corporate sectors play out?

This note summarises the main points made by participants.(2) Since the Roundtable was conducted under the 'Chatham House Rule', none of the opinions expressed at the meeting are attributed to individuals. The views expressed in this summary do not represent the views of the Bank of England, the Monetary Policy Committee (MPC) or the Centre for Economic Policy Research.

Will the protracted period of above-target inflation lead to further upward pressure on prices?

Inflation, measured by the annual change in the consumer prices index (CPI), has exceeded the 2% target set by the Government for much of the past three years. The elevated rate of inflation reflects the temporary effects from a number of factors, including: increases in commodity prices; higher import prices following the substantial depreciation of sterling since the onset of the financial crisis; and increases in the standard rate of VAT.

As the temporary effects from those factors wane, the path of inflation in the medium term will be shaped by substantial, but opposing, pressures on inflation. On the one hand, there is a risk that the protracted period of above-target inflation might make high inflation more persistent. For example, inflation expectations might drift up and that may lead companies to increase wages and/or prices by more than they otherwise would. Or the recent and prospective squeeze on households' real income may result in some upward pressure on nominal wages. On the other hand, the reduction in households' real income and the continued existence of a margin of spare capacity are likely to weigh on wages and prices, creating a risk that inflation might fall well below the target.

Participants discussed the likelihood that these pressures on inflation might arise and what that might imply for the balance of risks to inflation in the medium term.

Participants suggested that clear communication by the MPC of the factors underlying the recent rise in inflation and an assessment of when inflation was likely to return to target might help to keep inflation expectations stable. That was consistent with the results from a model presented by one participant, in which monetary policy makers may at times choose not to respond to current deviations of inflation from target. In that model, if the policymakers were unable to communicate credibly that they remained committed to responding to deviations of inflation from target in the medium term, then a prolonged period of policy inaction could cause inflation expectations to de-anchor from the target.

It was widely recognised that the United Kingdom's monetary policy remit allowed the MPC to respond flexibly to deviations of inflation from target, setting policy so that inflation could be brought back to target within a reasonable period of time without causing undesirable volatility in the economy. But some thought that the Committee could better communicate what was meant by a 'reasonable' amount of time. Alternatively, one participant suggested that responsibility for defining 'reasonable' should rest with the Government, given that the trade-off between returning inflation to target more quickly and reducing volatility in output might have welfare implications. But some noted that writing such a remit would be infeasible in practice, since it could not cover every possible scenario in which inflation might deviate from target.

Some participants felt that there was a fair chance that the risk to inflation from higher nominal wage growth would materialise. It seemed likely that households would resist further reductions in their real income and perhaps even push to 'catch up' some of the past reduction in real earnings. A fall in unemployment might also provide a fillip to nominal wage

(1) Roundtables are held twice a year. The next Roundtable is scheduled for December 2011.
(2) This summary was originally published on the Bank of England's website on 22 July 2011. For both this and previous summaries, see www.bankofengland.co.uk/publications/other/monetary/roundtable/index.htm.

growth. But a rise in nominal wage growth might generate less upward pressure on inflation if it was accompanied by a rise in productivity, as that would increase companies' scope to grant larger pay increases without the need to raise prices too. One participant suggested that households' real income would continue to be squeezed: the depreciation of sterling since the onset of the financial crisis should, other things being equal, lead to a fall in the price of UK exports relative to the price of UK imports — the United Kingdom's terms of trade — and that would necessitate a corresponding decline in UK households' real purchasing power.

There was some discussion of whether the pass-through of higher import prices following sterling's depreciation might generate additional inflationary pressures in the medium term. One participant noted that it would take time for a relative price shock, such as an exchange rate depreciation, to propagate through the economy because of nominal rigidities. For example, not all companies are able to adjust their prices immediately in response to the shock. And businesses competing against those companies may adjust their prices more slowly than they are able to. But a range of evidence, including a comparison of consumer price levels in the United Kingdom, United States and euro area, suggested that there had already been substantial pass-through of the rise in import prices caused by the depreciation. Some participants contrasted that with the depreciation of sterling in 1992, when there was little evidence to suggest that substantial pass-through occurred.

Many participants thought that there would be substantial downward pressures on inflation in the medium term. For example, one participant stressed that the outlook for demand remained unusually weak. Historical experience suggested that the recovery from a financial crisis, and the recession that accompanied it, would be slow. And the fiscal consolidation was likely to weigh further on demand. Moreover, money growth remained subdued.

Some participants also emphasised that the current stance of monetary policy was likely to be tighter than implied by Bank Rate or the yields on government bonds. The onset of the financial crisis had been accompanied by a tightening of credit conditions, which had not yet fully unwound. As a result, the spreads of loan rates faced by households and businesses over Bank Rate were much higher than before the crisis, and the availability of credit for some borrowers remained limited.

Participants also discussed whether there would be merit in changing the measure of inflation specified in the MPC's remit from CPI to one that excluded the volatile prices of 'non-core' items, such as food and energy. Some thought that switching to a measure of core inflation, while desirable in theory, would be impractical in the current environment, since there was a risk that changing the measure would destroy confidence in the MPC's commitment to the inflation target. Others argued that such a change was not even desirable, for example because there was little justification for targeting a price index that did not include every item consumed by the typical household. Indeed, the flexibility in the current monetary policy remit already enables the MPC to look through volatility in inflation caused by one-off shocks to the price of any item. But that flexibility did not allow the MPC to disregard the price of non-core items completely, as it would do if it were to target core inflation, because it has to take into account any trends in non-core prices when setting policy.

How will the contrasting fortunes of the household and corporate sectors play out?

One participant set the scene by arguing that the *Inflation Report* forecasts for GDP growth in the past three years had been too optimistic. The current projection is based on a rebalancing of the UK economy, away from consumer and government spending, towards net trade and business investment. Such a large switch would be historically unusual. The speaker noted that this recession had been deep compared to previous ones, though judging the scale of the slowdown and recovery in GDP relative to trend was sensitive to the estimate of potential output.

The 'domestically orientated' service sector recovery was much less pronounced than the more 'internationally focused' manufacturing rebound, following the latter's sharp decline during the recession. Meanwhile, service sector productivity growth was weak. One interpretation was that firms had found that they could adjust flexibly to the shocks, and in such a way that they were better able to retain labour. Alternatively, sluggish productivity growth could reflect weaker potential growth. One participant questioned why companies had hoarded labour if they were not investing. It was suggested that productivity might be incorrectly measured, or there might have been a switch from capital to labour in production processes.

Domestic demand in the United Kingdom had fallen more than in the euro area and the United States in the recession, and had recovered less sharply. The largest component of domestic demand, consumption, was restrained by uncertainty, tight credit, taxes and inflation. But others noted that nominal retail sales and consumer credit were buoyant, however. One participant noted the regional dimension of the public sector consolidation, with relatively low income areas disproportionately affected. But the impact on disposable income should wane, since tax increases and benefit reductions had been front-loaded. Given weak incomes, household savings had remained low, rather than picking up sharply. One participant thought that this reflected households running down financial assets to fund consumption.

As discussed in the first session, inflation had been high, had consistently surprised on the upside, and was a key factor in eroding real incomes. There was a risk of a much more prolonged productivity growth slowdown, or that additional external price shocks would erode disposable income further. One participant noted that the transfer of income from the household to the corporate sector reflected underlying global forces, which were difficult for policy to lean against.

By contrast, private non-financial corporations had continued to accumulate resources. Given that, and the recovery in global demand, it was perhaps surprising that business investment had not been stronger. Perhaps that reflected heightened uncertainty, a weak outlook for domestic demand and/or tight credit conditions.

One speaker focused on the outlook for business investment, in the context of both a recent slowing in GDP growth and external shocks (such as developments in the euro area and in the Middle East and North Africa), as well as further expected weakness in public and housing investment. That speaker argued for a cautiously positive outlook, but that growth would remain more muted than in previous recoveries.

The decline in business investment in the first quarter of 2011 had been exaggerated by large movements in aircraft imports, in part due to impending changes to indirect taxes. Inventories had increased, but were doing so at a slower rate, providing a drag on GDP growth. Firms' operating profits had recently increased, resulting in a build-up of cash, although they were concentrated in large firms and could reflect risk-averse behaviour. Indeed, there were several candidate explanations for why it had not translated into stronger investment.

For instance, the BCC survey showed that business confidence was relatively weak, that investment intentions in plant and machinery were broadly flat, and that there was little evidence that firms were running against capacity constraints. The CBI surveys revealed a mixed outlook across sectors with relatively upbeat investment plans in some subsectors, such as business, professional and financial services, and manufacturing. But more consumer-facing sectors such as retail and consumer services did not plan to expand investment. The speaker thought that business investment was more likely to occur overseas than in the United Kingdom, given that more rapid growth was expected in many emerging markets. By contrast, there was significant uncertainty surrounding the prospects for the euro area (the United Kingdom's main export market), as well as the sterling-euro exchange rate. One participant observed that measured business investment does not take into account intangible assets, which have grown strongly in recent decades.

Set against these factors, the level of business investment was extremely weak, implying that postponed investment would need to occur at some stage. And the user cost of capital was consistent with robust investment growth.

Another speaker analysed the unprecedented movements in household income in recent years and their implications for the future. From 2002 to 2007, mean and median household incomes had grown more slowly than GDP. But during 2008–10, incomes had continued to grow even as GDP shrank. Over this period growth had been largely accounted for by an increase in benefits.

The top 1% of earners had seen their incomes grow relatively rapidly over the past decade or so. But between the 10th and 90th percentiles of the distribution, income had grown roughly the same amount. This contrasted with the 1979–97 period, when income inequality had widened across the distribution.

Although the period of the recession saw rising incomes, since then a squeeze had been experienced. In 2010–11 (for which data are not yet available), real incomes were expected to have fallen substantially. Looking ahead, the Office for Budget Responsibility forecasts falls in real earnings growth until 2013–14. It was suggested that average living standards in 2013–14 might still be around 2002 levels — following the longest/largest squeeze in real incomes since at least the 1970s.

Set against these changes in income, it was perhaps not surprising that consumption had been so weak. The weakness in incomes could also help explain low consumer confidence. Thinking ahead, one participant noted that there might be a relatively large impact on consumption when Bank Rate was raised, as households had become used to the current long period of low rates and because some households were heavily indebted. However, interest rates faced by many households were already a lot higher than Bank Rate, so it was less clear that such a rise would entail a large rise in the effective rate.