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Monetary Policy Roundtable

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Monetary Policy Roundtable

On 29 November 2017, the Bank of England and the Centre for Economic Policy Research (CEPR) hosted their 16th Monetary Policy Roundtable. These events provide a forum for economists to discuss key issues relevant to monetary policy in the United Kingdom.(1) As with previous Roundtable discussions, participants included a range of economists from private sector financial institutions, academia, public sector bodies and industry associations. There were two topics of discussion:

- **wage growth and the labour market:** the factors contributing to weak wage growth in recent years; and
- **monetary policy normalisation and communication:** the challenges to central bank communication in the context of a potential normalisation of monetary policy.

This report summarises the main issues raised by participants.

Wage growth and the labour market

Wage growth slowed during the financial crisis while unemployment rose sharply. Despite initially picking back up somewhat towards the end of 2014 as unemployment began to fall, pay growth has remained subdued, even as the unemployment rate has fallen to its lowest level since 1975. In the past, lower unemployment had tended to be associated with higher wage growth. In that context, participants discussed the factors that might explain why the recovery in wage growth had not been stronger and what that meant for the outlook.

One potential cause discussed was that changes in the structure of the economy might mean that it could operate at a lower rate of unemployment than in the past before it led to excess upward pressure on pay growth as firms sought to attract and retain workers. If this equilibrium rate had fallen it would mean that for a given rate of unemployment there was more spare capacity available in the economy. Participants noted that a decline in the ratio of out-of-work welfare support relative to earnings could have contributed to such a change, as well as the increasing share in the labour force of older and more highly educated workers, who tend to have lower rates of unemployment.

While the pool of those looking for a job was one source of slack, other forms of slack in the labour market may also have been relevant for wage growth. The proportion of workers working part-time had remained elevated, for example, although this measure had also been falling.

While measures of slack had pointed to a steady decline in spare capacity over recent years, workers' experiences of job insecurity during the financial crisis may have reduced the extent to which they demanded higher pay rises. Workers may instead have been attaching greater importance to job security than in the past. And many young workers had never experienced the kind of rates of pay growth seen before the financial crisis, which some participants thought could have reduced wage expectations.

Even if workers were minded to demand higher pay rises, some attendees highlighted that their bargaining power may have diminished over time, perhaps in part associated with the decline in unionisation since the 1970s. That was also likely to explain why there had been a decline in the extent to which wage settlements were linked to inflation. But some participants noted that historically low inflation in 2015 and 2016 did appear to have allowed firms not to raise pay more quickly, even as recruitment difficulties intensified, and it remained to be seen whether the recent rise in inflation would feed through to pay in 2018.

If workers' bargaining power had declined, however, it would be expected to show up in a lower share of national income accruing to workers. In contrast to other countries, the labour share in the UK had been relatively stable, which seemed to partly reflect an increase in non-wage labour costs. Firms had increased contributions to pension schemes since the early 2000s, which had helped to maintain the labour share. There was some evidence that this had reduced pay for some workers, but only modestly. More recently, auto-enrolment of employees into workplace pension schemes had boosted non-wage labour costs.

While workers' share of national income had been fairly stable in recent years, growth in that income, and therefore the revenue available for firms to pay their workers, had been slower than in the past due to weak productivity growth. While the causes of weak productivity growth were complex and the subject of much debate, participants highlighted several contributory factors.

(1) This report was prepared by Saugata Sen and Carleton Webb of the Monetary Analysis Directorate of the Bank. The Roundtables are conducted under the 'Chatham House Rule' and so opinions expressed at the meeting are not attributed to individuals. This summary does not represent the views of the Bank of England, the Monetary Policy Committee or the CEPR.

Despite the UK having many highly productive frontier firms, it also had a higher share of low-productivity firms than some of its international peers, including France and Germany. While that might explain differentials in productivity levels across countries, employment growth in recent years in the UK had also been concentrated in industries with lower levels of productivity. That could have provided a transitory — but perhaps ongoing — drag on pay growth.

Participants also highlighted the role of weak investment since the financial crisis in reducing productivity growth. Investment had recovered much less strongly following the 2008–09 recession than after previous recessions, which over time was likely to have weighed on growth in the UK's capital stock.

A number of factors may have held back investment growth. An impaired financial system and economic uncertainty may have initially reduced businesses' appetite and ability to invest in the aftermath of the financial crisis, but the economy and financial conditions had improved since then. It was possible that strong labour supply growth and the costs of reversing investments in the event of a shock had made hiring workers a more attractive option for firms, reducing the incentive to make labour-saving investments that could boost productivity. And businesses had cited uncertainty over the UK's future trading relationship with the European Union and access to labour as a new source of uncertainty affecting investment.

Going forward, there was significant uncertainty over the prospects for productivity growth. On the one hand, increases in the National Living Wage could provide an incentive to train low-paid workers to raise productivity levels. Skills shortages as the labour market tightened might also encourage more capital investment. And a pickup in international trade might allow further specialisation. But on the other hand, the factors that had held global productivity growth back more generally since the financial crisis could persist.

Overall, participants generally agreed that there were likely to be a number of factors that had held back pay growth. Falls in unemployment were already likely to have reduced the drag from slack on pay growth. But this was probably being masked by other factors, most prominently the continued weak growth in productivity. Pressure from non-wage labour costs and past falls in inflation might also have played a role.

On average, participants expected pay growth to be slightly stronger in 2018 than in 2017, reflecting the easing of some of the downward pressures on pay. But pay growth was expected to remain modest by historical standards, reflecting the prospects for productivity growth.

Monetary policy normalisation and communication

Central banks loosened monetary policy during the global financial crisis, in the face of sharp falls in output and rising unemployment. As growth has recovered, and much of the slack within economies has been absorbed, some central banks have begun to withdraw that policy stimulus. Market interest rate paths imply a gradual policy tightening across a broader set of advanced economies in coming years. Against this backdrop, the second session focused on the challenges the process of policy normalisation posed to central bank communications.

Speakers first addressed what policy normalisation meant in the context of the current economic outlook, including for headline policy rates. Participants agreed that policy rates would need to rise from historically low levels as inflationary pressures gathered momentum. Policy rates were not expected to return to their pre-crisis levels, however. In particular, the 'natural rate of interest' consistent with stable inflation and sustainable growth had probably fallen across many advanced economies over past decades, and hence policy rates would probably settle below historical average levels.(2) Some participants referred to this as a 'new normal' for monetary policy.

This 'new normal' also applied to other policy tools. The set of instruments used by central banks widened following the onset of the financial crisis. In particular, less conventional policies were pursued to achieve stable inflation as policy interest rates reached their 'effective lower bound'. A primary tool of choice was quantitative easing, which involves central banks buying assets such as government and corporate bonds. One consequence of quantitative easing has been a significant expansion of central bank balance sheets, and issues for policy normalisation therefore include deciding the appropriate size and composition of central bank balance sheets as monetary policy is tightened. In addition, some central banks' remits had broadened following the crisis, and their policy toolkits had widened to meet those new remits. Some new tools, to meet financial stability objectives for example, were likely to be permanent features.

Within the context of monetary policy normalisation, discussions turned towards the role of central bank communications. Some participants noted that the sheer volume of communications had grown considerably following the crisis. One likely reason for this was greater transparency by central banks to promote better public understanding behind its discussions, processes and subsequent policy decisions. Another likely reason would have been the global

(2) For further detail on the factors that may have driven this, see the box on pages 8–9 of the November 2016 *Inflation Report*.

economic environment becoming more challenging for policymakers, and more frequent communications were needed to support the rationale behind policy decisions. Perhaps reflecting this, readability scores in official communications had gradually been declining, suggesting they had become more complex.

Central bank communications serve a number of purposes, many of which may be particularly evident during the process of policy normalisation. For example, central bank communications can affect households' and businesses' expectations of future policy, which in turn influence their respective saving and borrowing decisions. Communications also help financial market participants shape their expectations for future interest rates, which have an impact on longer-term interest rates and other financial asset prices. Some attendees suggested announcements of asset purchases, following sharp reductions in policy rates during the crisis, helped ease financial conditions in part by signalling those policy rates would remain low.

More broadly, communications help people to understand policymakers' 'reaction functions', by setting out how they may respond to changes in economic circumstances. While policymakers can set out their central view of the outlook, there are always significant risks and uncertainties around it. By discussing plausible paths, how policy would respond to different economic developments and some of the key uncertainties, policymakers can help households, businesses and financial market participants make informed decisions.

Overall, participants generally agreed that context, clarity and consistency were important guiding principles that should underpin all central bank communications. While those principles applied at all times, they may carry greater significance during a period of policy normalisation.