Monetary Policy Roundtable

On 10 July, the Bank of England and the Centre for Economic Policy Research hosted the tenth 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 discussion topics:

- understanding recent developments in the UK labour market; and
- what can we say about the trade-offs currently facing monetary policy makers in the United Kingdom?

This note summarises the main points made by participants.(2) The Roundtables are conducted under 'Chatham House Rule' so opinions expressed at the meeting are not 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.

Understanding recent developments in the UK labour market

The behaviour of the UK labour market since the financial crisis has been a key area of interest for monetary policy makers. Following the significant fall in GDP in 2008–09, output growth has been weak, while employment growth and labour force participation have been relatively resilient. Taken together, these developments have meant a prolonged period of unusually weak productivity growth. At the same time, wage growth has been subdued in a historical context. The first session of the Monetary Policy Roundtable explored the reasons for, and implications of, these recent developments in the labour market.

Roundtable participants discussed the causes of the relative strength of employment in the United Kingdom. It was suggested that one factor contributing to robust employment growth was a positive shock to labour supply. That largely appeared to reflect participation rates among older age groups — particularly in the over 50s — rising strongly, both in the years leading up to, and since, the crisis. Roundtable speakers pointed to several potential factors behind that increased participation: the removal of the compulsory retirement age; the increase in the age at which women are eligible for a state pension; and expected future increases in the age of eligibility for state pensions for both men and women.

There were differing views among participants as to the extent to which the relative strength of employment reflected stronger job creation than would have been expected. On the one hand, the low level of vacancies since the crisis, together with a historically low share of employment of duration less than one year, were cited as evidence that the strength of employment growth had not reflected unusually strong hiring by companies. On the other hand, elevated flows from unemployment to employment were cited as evidence of strong job creation. One participant reconciled these views by suggesting that job-to-job flows had fallen in the recession, and remained subdued.

Discussing the weakness in measured labour productivity over the past few years, one speaker considered the evidence that some companies had retained employees even though they were working well below full capacity. The speaker concluded that the evidence for such behaviour was thin on two grounds. First, one might have expected companies to have adjusted labour input through natural employee turnover given the length of time since the crisis. Second, companies may have chosen to increase the amount of labour used relative to capital in their production processes, given the fall in the relative cost of labour. That would be consistent with both weak investment and subdued labour productivity. Others noted that the modest fall in average hours in the recession seemed inconsistent with significant underutilisation of employees.

The ability of companies to increase output without hiring more staff, were demand to pick up, was therefore highly uncertain. By contrast, most participants considered the high level of unemployment as indicative of considerable slack in the labour market. Some participants also pointed to measures of underemployment, which they thought suggested an even greater degree of slack. Set against that view, one speaker argued that demographic trends were likely to mean that, unless participation and employment rates continued to

(1) This report was prepared by Venetia Bell, Chris Duffy and Alice Pugh of the Monetary Analysis area of the Bank. Roundtables are held twice a year. The next Roundtable is scheduled for Winter 2013.
(2) For both this and previous summaries, see www.bankofengland.co.uk/publications/Pages/other/monetary/roundtable/default.aspx.

rise within older age groups, there might not be a large amount of labour to call on during the recovery.

Participants noted that since the crisis there had been a large fall in real wages. It was suggested that this reflected weak labour productivity growth, high unemployment and an increase in labour supply. One speaker presented evidence that wages had become more sensitive to both national and regional unemployment since 2002. For that speaker, the level of unemployment was important for the level, rather than the growth rate, of wages (as suggested by the Phillips curve relationship in economic theory), and there was little evidence that wage growth responds to shocks to CPI inflation. His conclusion was that the evidence did not support the usefulness of 'non-accelerating inflation rate of unemployment' concepts for explaining wage growth and that, even in an environment of low and stable unemployment, underlying pressures on wage growth were likely to be weak.

The discussion touched on the role of migration in explaining recent labour market dynamics. It was noted that while migration had been important for developments over a longer time frame, most participants did not believe it could explain many of the features of the labour market since the financial crisis.

There was some discussion of the differences between the UK experience and those of other countries. The behaviour of UK unemployment appeared broadly similar to that in the United States, notwithstanding the greater initial increase in unemployment there, while movements in employment had differed due to distinct trends in labour force participation. The UK experience appeared to be different to the euro area in both respects. A variety of explanations were put forward for these differences, including: different financial systems; experiences with welfare-to-work policies; and legislative changes in relation to retirement. But there was no consensus on the relative importance of each factor.

In summary, Roundtable participants were largely in agreement that the United Kingdom had experienced a substantial increase in labour supply, although it remained unclear how persistent that increase would prove to be. This was thought to be an important driver of developments in both employment and wages. While there were mixed views on the degree of underused labour in employment, most saw the elevated unemployment rate as a sign of slack in the labour market more generally.

What can we say about the trade-offs currently facing monetary policy makers in the United Kingdom?

With inflation well above the 2% target and a sizable margin of spare capacity in the economy, the MPC faces a trade-off when judging how quickly it intends to return inflation to target. If it attempts to lower inflation too quickly, that would reduce the support it can provide to output and employment, and so may endanger the recovery. But if it does so too slowly, people may doubt the Committee's commitment to the inflation target, making it more costly to keep inflation close to the 2% target in the future. The second session of the Roundtable explored the nature of the trade-off between output and inflation, and the consequent implications for monetary policy.

A key aspect of this trade-off is the extent to which productivity can pick up as demand recovers. That will depend in part upon the degree of slack currently in the economy, over which Roundtable speakers expressed a range of views. One speaker argued that the output gap was relatively small, in large part reflecting a reduction in the rate of growth of potential output since the crisis. A sustained period of low interest rates was also thought to have discouraged the reallocation of resources within the economy towards their most productive uses. The speaker presented empirical estimates that suggested that accommodative policy during the post-crisis period might have permanently reduced the level of productivity by nearly 1%.

In contrast, another speaker argued that there was no strong reason for a decline in potential output growth since the crisis, and thus the output gap might be reasonably large. Productivity growth had been relatively strong in the three decades preceding the crisis, without being driven predominately by the financial sector, and there was no clear evidence to expect that to have changed.

Another dimension of the trade-off currently facing monetary policy is the way in which inflation expectations respond to policy changes. One speaker argued that a rise in inflation expectations may be an important part of the monetary transmission mechanism with nominal interest rates at the zero lower bound: a rise in inflation expectations should reduce real interest rates and hence stimulate demand. Another noted, however, that a rise in inflation expectations could cause a rise in nominal rates rather than a reduction in real rates, in part offsetting the impact of the highly accommodative stance of policy. Others argued that if inflation expectations were to become less well anchored by the inflation target, a future monetary policy tightening that would prove costly in terms of output and employment might be required in order to regain control of inflation expectations.

Participants discussed the difficulties inherent in assessing how inflation expectations are likely to evolve. For example, one speaker used chaos theory to illustrate how, when feedback mechanisms between outcomes and expectations are complex, expectations can be extremely sensitive to small changes in conditions in the economy.

Some participants noted a potential trade-off between monetary policy and financial stability concerns. Participants discussed whether quantitative easing might risk an inappropriately large increase in asset prices. One Roundtable participant noted that lower nominal deposit rates discourage households from building up bank deposits, which puts pressure on banks to raise funds through other means.

The speakers discussed various policy options in light of these trade-offs facing monetary policy. There were mixed views on whether further monetary policy stimulus was warranted and, if so, how much.

Participants also discussed possible actions that the MPC could take in order to communicate how it views these trade-offs. One speaker argued that recent MPC policy decisions appeared more consistent with 'strict' rather than 'flexible' inflation targeting, on the grounds that the Committee had persistently forecast inflation to return to the target over the two-year horizon, despite apparently not expecting the output gap to close. The speaker argued that the MPC should signal to the public that it is prepared to tolerate a forecast of above-target inflation at the two-year horizon in order to achieve a smaller output gap, consistent with a flexible rather than a strict approach to inflation targeting.

Participants discussed other ways in which the MPC might conduct and communicate policy in view of the trade-offs it faces. Some argued in favour of forward guidance, although it was noted that this might constitute a limited change given an alleged reluctance of central banks to forecast a prolonged period of high inflation. An alternative suggestion was an intermediate target for the path of nominal GDP, although some participants expressed concerns over this idea. For example, difficulties in assessing the growth rate of potential output might result in an overambitious target for nominal GDP, which could in turn result in unexpectedly high inflation.

In summary, there was a range of views on both the nature of the trade-off facing monetary policy makers and the appropriate response.