Reflections on my first four votes on the MPC

In this speech, \(^{(1)}\) Professor David Blanchflower, \(^{(2)}\) member of the Monetary Policy Committee (MPC), sets out his reasons for voting against the August 2006 rise in interest rates. He explains that in his opinion the data available at the time of the decision were not indicative of a reduction in spare capacity in the economy, in contrast to the opinions of some of the other members of the MPC. He also sets out his belief that the risk to near-term spending growth from a weakening labour market outweighed the chance of greater spending growth stemming from too loose a policy stance.

I am particularly pleased to be in Wales for my first speech. The family on my mother’s side came from Swansea. I have happy childhood memories of summers spent on the Gower coast particularly swimming in the cold sea at Oxwich, Caswell and Horton. My parents lived here for 40 years until they moved a month ago, much to my surprise as I had planned on staying with them tonight! I went to school in Cardiff at what was then Canton High School for Boys, now Cantonian High School, and had an inspiring teacher, John Kitchker, who first introduced me to the joys of economics at A-level. I returned to University College, Cardiff for my Masters degree in Economics some years later and even taught some classes at the Export Credits Guarantee Department across the road from the Economics Department. I also recall with pleasure several years as a junior member of Wenvoe Castle Golf Club where I first became addicted to golf. I am now a member of Royal Dornoch Golf Club in the north — Scotland to be precise! Anyway, I have many happy memories of South Wales and am pleased to be here today.

I have now been a member of the MPC for nearly four months and voted four times. In the first two votes in June and July of 2006, I went along with the majority of other Committee members in voting for no change. But in August I was the sole dissenting vote in what the Governor of the Bank, Mervyn King, described at the August Inflation Report press conference as a ‘knife-edge vote’. I believe that is an appropriate characterisation: the vote for me was a very close-cut call, and principally came down to differences in views on the level of spare capacity in the economy. In this speech I aim to set out how I came to make my August decision, and my subsequent view of the economy.

The remit of the MPC is to control inflation — hitting the inflation target is our primary purpose. Subject to this goal, the Committee is also responsible for supporting ‘the economic policy of Her Majesty’s Government, including its objectives for growth and stability’.

The inflation target of 2% is expressed in terms of an annual rate of inflation based on the consumer prices index (CPI). The remit is not to achieve the lowest possible inflation rate. Inflation below the target of 2% is judged to be just as bad as inflation above the target. The inflation target is therefore symmetrical. Furthermore, a target of 2% does not mean that inflation will be held at this rate constantly. The MPC’s aim is to set interest rates so that inflation can be brought back to target within a reasonable time period, without creating undue instability in the economy.

In order to achieve this goal, the MPC, along with the Bank’s staff, spends a lot of time analysing and interpreting data. So, the big question is what was there in the data back in August that made the MPC move from a unanimous vote for no change in July to a six to one vote for an increase? The answer is principally twofold, reflecting concerns about the medium-term profile for inflation and the degree of spare capacity in the economy. I intend to talk about both these issues, starting with spare capacity.

Policymakers often gauge the extent of inflationary pressures in the economy by looking at the balance between the level of demand in the economy against the supply potential of the economy — the output gap, or the degree of spare capacity in the economy. The output gap is related to the unemployment gap, the difference between the natural rate of unemployment and the rate of unemployment itself. When unemployment is at its natural rate, there is neither upward nor downward pressure on inflation. Let’s take an example where unemployment is at its natural rate, but firms put extra pressure on their workers to work longer hours or be more

\(^{(1)}\) Given at a breakfast with contacts of the Bank’s Agency for Wales on 27 September 2006. This speech can be found on the Bank’s website at www.bankofengland.co.uk/publications/speeches/2006/speech283.pdf.

\(^{(2)}\) I am grateful to Lavan Mahadeva, Jumana Saleheen, Chris Shadforth and Nicola Dufty for their help in preparing this speech. I would also like to thank the Governor, Kate Barker, Charlie Bean, Martin Brooke, Andrew Holder, and Andrew Wardlow for their helpful comments.
productive. These firms may have to compensate workers for their extra hours and effort. This is an example of reduced spare capacity within firms, which can lead to inflationary pressures. So, one can think of the output gap as being the sum of two parts, the degree of spare capacity in the labour market (or the unemployment gap) and the degree of spare capacity within firms. I will use this simple framework to argue that I did not feel that there was any news in the data in August that convinced me that there was less spare capacity in the UK economy relative to July, in contrast to some of my colleagues.

Each summer, the Office for National Statistics (ONS) publishes revisions to its past estimations of national output, expenditure and income to reflect the receipt of less timely data. These latest estimates of annual economic growth show that the economy grew more strongly in 2003 and 2004 than estimated at the time of the May Inflation Report (Chart 1). The new data also imply that the slowdown in 2004–05 was more pronounced than previously reported, but that the recovery since then has been correspondingly stronger, although these data are subject to revision themselves. The revised level of output over the recent past could indicate that the economy is operating with less spare capacity than previously thought. Some external support for this view is provided by the upward revisions to both Oxford Economic Forecasting (OEF) and National Institute of Economic and Social Research (NIESR) output gaps between April and July (Chart 2).

A reduction in the output gap would be consistent with some tightening in the labour market or a decrease in the degree of spare capacity within firms — how hard firms work labour and capital. It could also be some combination of the two. So, what did these data say back in August?

Wage pressures and spare capacity in the labour market

Turning first to the labour market, the unemployment rate had been trended up for some time (Chart 3) — which is evidence of loosening rather than tightening. At the time of my August decision the unemployment rate was 5.4% for the month of May, up from a low of 4.7% in August 2005. I note also that the unemployment rate in Wales, which was below that of England in 2005 Q1 (4.6% and 4.7% respectively) was above it in 2006 Q2 (5.7% and 5.5%).

The claimant count had increased less dramatically, in part reflecting higher unemployment among more vulnerable workers who may not be entitled to unemployment benefits, for example younger workers, low-skilled workers and immigrants. This, together with some evidence of increasing durations of unemployment tended to suggest that the rise in unemployment was primarily cyclical in nature, rather than structural. The reason why I believe it is cyclical is that one would expect the vulnerable groups in the labour market to be hit first by weaker labour demand. And we know that the average duration of unemployment is higher in periods of softer

(1) Source: StatWales. However, the Welsh outturn for 2006 Q2 looks somewhat volatile having been 4.7% in 2006 Q1.
The degree of tightness in the labour market can be driven by factors affecting demand and/or supply. One explanation for the recent increase in unemployment might be the upward trend in oil prices over the past two years. An increase in the price of oil may lead firms to seek to rein in other costs, such as labour, or at least reduce their expectations of future recruitment. Chart 4 shows that since 1971, there have been five episodes during which the oil price has risen significantly (detailed in Chart 5). It shows that during the first three episodes, the oil price hike was followed by a recession: a sharp rise in the unemployment rate. But following episode IV, the unemployment rate was largely unaffected.

One could argue that the first three episodes were different because the oil price hikes were the result of disruptions in oil supply, whereas in episode IV and the current episode the oil price hike is more likely to be related to increased global demand. In that case, the observed rise in unemployment might remain modest going forward, or even fall, as it did during episode IV. But of course, there is always a risk that episode IV is the outlier; alerting us to the possibility that unemployment might rise more sharply should the demand for labour fall.

Consistent with muted labour demand, recruitment difficulties reported by contacts of the Bank’s Agents were down ahead of my August decision, while the Recruitment and Employment Confederation survey data (REC) showed that the demand for permanent staff was around its long-run average (Chart 6). The recruitment rate — defined as the proportion of individuals with tenure of less than three months — continued its steady decline (Chart 7). The survey measures of employers’ future employment intentions, reported by the Agents and the British Chambers of Commerce (BCC) had recently fallen (Chart 8). The number of vacancies had also risen.

The story was a little different at a disaggregated level. KPMG data suggested that staff availability was more of a limiting factor to recruitment in the financial and professional service industries. This fitted with what the Bank’s Agents were being told about employment intentions in the Financial and Business services sectors. So it seemed that different sectors of the economy were probably experiencing different conditions at the time. But in my view, in aggregate, there seemed a high likelihood that unemployment had increased in part as a result of more muted labour demand.

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However, part of the explanation for the rise in unemployment is also that labour supply has increased, especially among older age groups, perhaps in part because of declining incomes from defined contribution plans. Economic theory tells us that the expected wage of workers is higher during booms than in recessions, encouraging a larger fraction of the workforce to participate during a boom. For this reason one would normally expect an increase in the unemployment rate to be followed by a fall in the participation rate. But recently there has been a continued rise both in participation and employment, in spite of the rise in unemployment. 

The continued rise in participation at present may in part reflect increasing migration to the United Kingdom; an increase in labour supply. There has been a notable increase in the inflow of migrants since the accession of the A8 countries (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) on 1 May 2004. Preliminary research shows that immigrants born in the A8 countries made up only around 0.6% of the stock of foreign-born individuals in the United Kingdom in 2005. But their share in terms of the immigrants who have arrived in the past two years is much bigger, now accounting for around one in four of new arrivals. This research also shows that, on average, immigrants who arrived in the United Kingdom in the past two years were somewhat less likely to be employed than the indigenous population. But within that group of immigrants there are differences. Those born in the A8 countries had higher employment rates compared to those born elsewhere. So, immigrants may have swelled the participation, employment and unemployment figures.

[1] The economic activity rate of those aged 16 and over increased from 63.0% in April-June 2004 to 63.6% in April-June 2006. The rates by age for the two years respectively were as follows: age 16–17 – 52.0% and 47.1%; age 18–24 – 74.7% and 74.5%; age 25–34 – 83.6% and 84.7%; age 35–49 – 84.7% and 85.3%; age 50–59 (women) – 68.4% and 70.2%; age 50–64 (men) – 74.5% and 75.1%; age 60+ (women) – 10.1% and 11.4%; age 65+ (men) – 8.8% and 10.0%. Source: First Release, Labour Market Statistics, August 2006, ONS, Table 12(1).


[3] I am grateful to Jumana Saleheen and Chris Shadforth for allowing me to draw on some of their work.
Pay pressures appear to have been constrained by the recent increases in labour supply, especially from increased immigration from Eastern Europe and rising participation of older workers and rising unemployment. Whole-economy twelve-month average earnings index (AEI) weighted settlements had been easing continuously since July 2005 at the time of my August decision (Chart 11). And regular pay growth had been flat or slowing on most measures since late 2004 (Chart 12 and Table A). Moreover, the wage of new immigrants (including those from the A8 countries) has been strikingly weaker in the recent past (Chart 13), and some of this weakness is likely to have helped to moderate wage pressures in some sectors. The National Institute in their July Economic Review noted that employers are likely keeping down pay raises as many firms are contributing large amounts of money to their pension funds. These payments, the NIESR estimate, together with higher National Insurance contributions have increased from 13% of total labour costs in 2001 to around 17% in the first quarter of 2006.

A particular problem with wage data based on sample surveys, such as the AEI, is that they exclude data from workers at the low end of the wage distribution. For example, the ONS calculates the AEI using survey data from firms that employ more than 19 people. Hence, the wages of workers employed in smaller firms, which are frequently non-union, and have lower and more flexible wages than those of bigger, unionised workplaces, are excluded. In addition, the 3.72 million self-employed are also excluded from the AEI wage series.

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**Table A** Annual regular pay growth

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<th>AEI(a)</th>
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<td>Q1</td>
<td>4.0</td>
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<tr>
<td>Q3</td>
<td>4.2</td>
<td>3.7</td>
<td>2.9</td>
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<tr>
<td>Q4</td>
<td>4.5</td>
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<td>2005</td>
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<td>Q1</td>
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<td>Q4</td>
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<tr>
<td>Q1</td>
<td>3.8</td>
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<td>Q2</td>
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(a) Average earnings index, excluding bonus payments. Measures are three-month averages and exclude arrears.

(b) Experimental average weekly earnings, excluding bonus payments. Measures are based on quarterly data.

(c) National Accounts wages and salaries per employee.

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(4) Source: Labour Market Statistics, August 2006, ONS, Table 3.
Their earnings are also likely to be flexible downwards in periods of rising unemployment and reduced work opportunities.\(^{(1)}\) Based on current estimates from the Labour Force Survey these two sample exclusions account for some 29% of workers, or over 8 million workers. Hence, the AEI and other similar measures tend to overestimate wage growth in the economy when there is slack in the labour market.\(^{(2)}\) This makes it more difficult to assess the current level of wage pressure. At present, I see no evidence of any second-round wage effects from the recent oil price increases.

I also believe we will see a decline in the employment rate and further rise in unemployment going forward because of the current composition of employment growth. Of the 1.5 million new jobs created since 2000 Q1, 38.1% were public sector employees, 30.3% were self-employed workers with the remaining 31.6% of the new jobs among private sector employees. In 2006 Q1, out of 28.9 million workers, 13.0% were self-employed, 20.3% were public sector workers and 66.8% private sector employees.\(^{(3)}\) This compares with 12.0% self-employed, 19.3% public sector employees and 68.7% private sector employees in 2000 Q1. It seems unlikely that there will be similar growth in employment in the future from the public sector or even from self-employment, which is cyclically rather volatile.\(^{(4)}\)

In summary, at the time of my August decision the labour market appeared to be loosening, consistent with increases in labour supply and muted labour demand. This is clearly not consistent with the reduction in spare capacity implied by the ONS’s upward revisions to the recent output data. As such, I now turn my attention to the alternative explanation, namely a decrease in spare capacity within firms. Is there any evidence of this having decreased? And more so, decreased enough to offset the looser labour market?

**Spare capacity within firms**

There are a number of pieces of information that can shed light on how hard firms are working their factors of production, although in my opinion there was no consistent story in August. The CBI measure of spare capacity jumped well above its long-run average in 2006 Q2, suggesting some modest reduction in manufacturers’ spare capacity (Chart 14). But the series is volatile, and I was unsure whether this increase was ‘real’ or simply volatility in the data. The BCC measures of spare capacity in the manufacturing and service sectors accorded with the CBI measure if the assumed long-run averages of the series are the appropriate gauges against which to compare the most recent outturns. However, the two measures are little changed from their post-1996 averages, my preferred metric (Chart 15). The Bank’s Agents scores showed a little more disparity between the manufacturing and service sectors: manufacturers believed their degree of spare capacity had fallen, but remained below normal levels. Service sector firms continued to consider themselves as working beyond normal capacity (Chart 16). Both measures, however, had changed little since our July meeting. Overall I took the view that spare capacity within firms may have fallen slightly in aggregate, but not enough to more than offset the weaker labour market.

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\(^{(1)}\) Weir found, using data from the Family Resources Survey, that, on average the earnings of the self-employed were higher than those of employees, but this was driven by earnings at the top end. Weir found that the first four fifths of self-employed people earned less than the first four fifths of employees but the highest one fifth earned more. Source: Weir, G (2003), Labour Market Trends, Vol. 111(9), pages 441–51.

\(^{(2)}\) Similarly, annual pay settlement data from large private sector firms or from the public sector tells us less about wage pressures in the economy than they did in the past when union bargaining coverage was more prevalent.

\(^{(3)}\) For more on the growth in public sector jobs see Hicks, S (2005), ‘Trends in public sector employment’, Labour Market Trends, Vol. 113(12), December.

In my judgement the evidence in August suggested that the level of spare capacity was the same as, or even greater than, it was at our July meeting. There remained plenty of spare capacity in the economy — this was also the position Steve Nickell took earlier in the year when he too was in a minority of one and voted for interest rate reductions when the rest of the Committee voted for no change. In my view there was insufficient empirical evidence of a lack of spare capacity, within or outside firms, although the majority of the Committee judged that the current margin of spare capacity in the economy as a whole was somewhat less than previously thought. I believe there to be more spare capacity in the economy than in the central projection contained in the August Inflation Report, implying lower output growth and lower inflationary risks down the road and a somewhat lower probability of having to write a letter to the Chancellor.

There has been little news on the degree of spare capacity within firms since my August decision. The only data that have subsequently become available are the Bank’s Agents scores for August. These show a further pickup in the extent to which service sector firms are working above normal capacity, although this figure remains below the most recent high of May 2005. Capacity utilisation within manufacturing firms continues to be (marginally) below normal.

Of course the questions surrounding the degree of spare capacity in the economy were not the only ones that were discussed during the round. The other main piece of news was on consumer prices. Importantly, CPI inflation rose to 2.5% in June (it subsequently fell back, but returned to 2.5% in August), its highest level since September 2005. That rise partly reflected the pass-through of previously announced increases in domestic energy prices into household bills. Looking ahead, higher university tuition fees and the continuing pass-through of higher energy prices are likely to push inflation further above the 2% target for a while. I saw little evidence of any pickup in domestically generated inflation in August.

### Prospects for inflation

If inflation persists above the 2% target for too long the worry is that agents will start to revise up their expectations for inflation going forward. This may lead workers to demand higher wage settlements to offset the expected fall in their real wage. Inflation expectations did rise early in 2006, perhaps reflecting the preannounced of energy price rises, but subsequently inflationary expectations appear to have levelled off (Chart 17).

If the monetary framework is credible, inflation expectations are less likely to be dislodged in the event of a cost shock. It seems to me that monetary policy in the United Kingdom does have credibility and inflationary expectations are well anchored on the inflationary target. In such a case a rise in

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2. The employment rate has been between 60.0% and 60.2% since 2004 Q1. Source: First Release, Labour Market Statistics, August 2006, ONS.
consumer price inflation generated by some relative price increase such as a rise in oil prices is less likely to feed through into pay settlements because of the general belief that inflation will return to target. As Nickell (2006) noted: ‘wage inflation has not responded significantly to the recent rise in oil prices so there have been no second-round effects and, consequently, the implications for monetary policy of the oil price increase are few’.

The Committee’s projection for the probability of various outcomes for CPI inflation in the future is given by Chart 18, based on market interest rate expectations. If economic circumstances identical to today’s were to prevail on 100 occasions, the MPC’s best judgement is that inflation over the subsequent three years would lie within the darkest central band on only ten of those occasions.

The inflation profile is a little higher than in the May Inflation Report, particularly in the near term. As usual, there are risks surrounding the central projection. In addition to those that I have already discussed, namely the outlook for energy prices and their interaction with domestic pricing pressures, and the margin of spare capacity within firms and in the labour market, prospects for world growth and the strength and duration of the recovery in consumer spending are also important considerations.

The world economy looks particularly uncertain going forward. The most recent FOMC decision (20 September) yielded a continuation of the pause in policy tightening first abated at their August meeting. According to the FOMC’s minutes, the August decision, like ours, had been a close call, although the United States faces a different set of challenges to the United Kingdom. Core and headline inflation have been high for some time and housing market activity has come off the boil much quicker than some commentators had expected. Both channels could imply weaker consumer demand ahead, with repercussions for UK exporters. In contrast, household spending in the euro area has continued to recover in recent quarters, underpinned by a strengthening labour market. And Japanese growth appears to remain robust.

At home, consumption looks to have recovered, but there remain risks. Looking ahead, I will be watching out for signs of building demand pressures. But should the labour market continue to weaken, as I suspect, then we might expect to see a slowdown in household’s income growth. Real incomes may also continue to be squeezed by higher energy prices, although we must also be cautious of potential second-round effects. In my opinion, the risks of a slowdown outweigh the chance that there may be more near-term momentum in spending growth. Overall, we are as a Committee unanimous in agreement that there is greater-than-usual uncertainty over the outlook for inflation, particularly in the near term. However, we will, as always, continue to take our decisions on the basis of the data that are available at the time of each decision.