



Treasury Committee

Oral evidence: [Re-appointment of Ian McCafferty to the Monetary Policy Committee hearing, HC 498](#) Tuesday 13 October 2015

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Members present: Andrew Tyrie (Chair); Helen Goodman, Stephen Hammond, Mr Jacob Rees-Mogg,

Questions 1-21

Examination of Witnesses

Witness: **Ian McCafferty**, External Member of the Monetary Policy Committee, gave evidence.

Q1 Chair: Thank you very much for coming to see us. You are a familiar face before this Committee and we are grateful to you for giving evidence in the way you do. Can I just begin with a quote from the October MPC minutes? “For one member, the likely prospective increase in domestic costs was sufficient to justify an immediate increase in Bank Rate.” Was that you?

Ian McCafferty: It was, yes, Chairman.

Q2 Chair: In his speech in September, Andy Haldane gave a big speech. Andy Haldane often gives big speeches. He said, “The balance of risks to UK growth, and to UK inflation at the two-year horizon, is skewed squarely and significantly to the downside.” This is quite a big gap between you two. Could you say something about it and how you succeed in coming to such a different conclusion from him?

Ian McCafferty: Certainly. Clearly there is a balance of risks to inflation around the central forecast that we published in August. Those to the downside, which I think are the ones that Andy is referring to when he sees the balance of risk to the downside, primarily come from the outlook for the international economy and the weight that he

would give to the potential damage to the sustainability of UK growth from a further slowdown in China and a further slowdown in other emerging markets. While I do not discount such risks, I do not think that they are necessarily yet part of the central forecast for the UK economy. We already have quite conservative forecasts for China and for other emerging markets built into our expectations, such that, although there is always a risk of further deceleration in China or of disruption through financial markets, I do not see that as necessarily, as yet, critical to the outlook for the UK economy.

On the other hand, I place more weight on some of the upside domestic risks to inflation over the three-year horizon. It is clear that we have seen UK wages pick up relatively smartly, in nominal terms, over the course of the last six months to a rate that is higher than the MPC would have expected six or nine months ago. I do think that, given the tightening of the labour market that we are now seeing, which at the rate of growth that we expect for the UK over 2016 and 2017, is likely to continue, we are going to see further acceleration in nominal wage growth over the course of 2016 and 2017. That, to some extent, will be offset by a pickup in productivity growth over that period, but I am not a huge optimist in terms of the pickup in productivity growth, such that unit labour cost growth, by 2016 and certainly by 2017, is going to be in excess of that which would be consistent with the inflation target.

We therefore get to a position in which we have, in my view at least, domestic costs running rather faster than is consistent with the target, offset by potential weakness from the international side and from the feed-through from the recent appreciation in sterling. I find that a somewhat uncomfortable combination of underlying domestic inflation being faster than target, and the target only being reached because of weakness in international prices and, in particular, as a result of recent sterling appreciation.

Q3 Chair: You are saying that the international downward pressure on inflation might be transitory.

Ian McCafferty: Some of it is definitely transitory, and the other may prove to be slightly longer term, if it is due to slow growth in the world economy for a longer period, but I am not necessarily clear that that fully offsets what we see on the domestic front.

Q4 Chair: The upward pressure might be more enduring if, for example, a measure of inflation becomes embedded in the private sector wage round.

Ian McCafferty: That is true, yes.

Q5 Chair: That is what you are looking at particularly, by the sound of it, from what you have just said.

Ian McCafferty: Yes.

Q6 Chair: You are seeing the very slight pickup we have had as being a harbinger of something that could be more serious.

Ian McCafferty: It is more than a very slight pickup.

Chair: I will take out the word “very”, but in historical terms against previous cycles.

Ian McCafferty: Yes, private sector nominal wage growth is now running close to 3.5%. Productivity growth has picked up somewhat over the first half of the year, but that already leaves unit labour costs running at somewhere close to 2%. If anything, that juxtaposition will deteriorate slightly, as we see the labour market tighten further.

Q7 Chair: Just one question: you were also clear, in response to my first question, not only that it was you felt policy might benefit from some tightening, but that we should use Bank Rate to achieve it, rather than reversing QE in some way; there are several ways in which that could be accomplished. Could you just explain why that is? If we put the counter-argument, interest rates at a very low level are not operating in a conventional way, arguably, whether up or down. Going to 0.25% or going to 0.75% is not the same environment as moving from 2.5% to 3%. You see the point I am making. That is one of the reasons we have been experimenting with QE. We need to unwind it somehow or other, or eventually address the increase in the debt stock that is accumulated there, which is sitting on the Bank balance sheet. Why did you not consider raising the use of QE for the purposes you wanted?

Ian McCafferty: There are two main reasons. The first is that we understand more about the impact on the real economy from moves in Bank Rate than we do in terms of QE. We have more experience of that and the multipliers through to the economy are better understood. As I said in my written submission to the Committee, there are some big issues about whether the multipliers of unwinding QE are going to be the same as those that we observed in the one experience we have, when QE was initially put into the market.

Q8 Chair: These are the behavioural effects that people initially perceive it to be an extremely important signal, but that wears off. It is like coats of paint going on a wall, where each successive coat changes the colour of the wall less.

Ian McCafferty: That is one of the impacts, yes. There are two impacts where the impact of QE might be slightly less going forward than it was initially. One is that signalling effect. The other is that, when QE was initiated, a number of financial markets were dysfunctional and I do think there was an element of liquidity assistance, which helped lower premia in those markets, which would not be the case now. From that point of view, as I say, the multipliers for QE may well be different and we are less confident of those. I therefore think that there is a lot of merit in using Bank Rate as the primary marginal instrument.

I also think there is merit in using Bank Rate initially, in terms of the tightening cycle, because it would be a very healthy development for the UK economy if we were able, over time and were economic circumstances to permit, to return Bank Rate to a position at which it became an active and effective marginal instrument in both directions. I would like to see, over time, Bank Rate get up to a point at which we could cut it again, were we to need to do so, if the economy were to slow or inflation to dip below target. I would rather use Bank Rate as that marginal instrument than restart QE, if possible.

Q9 Mr Jacob Rees-Mogg: May I follow up that answer? Do you think it is important to get interest rates back to a normal level so that capital will be allocated more efficiently? If you have endlessly very, very low interest rates, and essentially free capital, is that not likely to lead to capital being misallocated?

Ian McCafferty: Eventually that may be the case. The theory would say that, if the nominal interest rate that we set is lower than the neutral interest rate, then you will get some capital misallocation over time. It is not that obvious that that has been the case in the recent past. The neutral interest rate fell very sharply as a result of the crisis into serious negative territory. It has been gradually rising, I would argue, over the course of the recovery in the economy, but I do not think there is a serious mismatch between the neutral rate and the current Bank Rate. It would be the case that, were we to, as it were, get behind the curve and not raise Bank Rate in line with that neutral interest rate, then there could be some capital misallocation.

Q10 Mr Jacob Rees-Mogg: It is very important to bear in mind that we have a limited time before we begin to create long-term problems with the economy if interest rates are not normalised, beyond the immediate inflation issue.

Ian McCafferty: I would not want to suggest that it is somehow a factor for timing. I do think that, although we have seen some improvements in that neutral interest rate, it is clear that, as a result of the long-term legacies from the financial crisis, that neutral interest rate is likely to remain significantly below that which prevailed before the crisis for quite some time to come. We still have a number of those headwinds, in terms of slow world growth, in terms of fiscal consolidation and in terms of continued management and working-out of some of the debt issues that appeared as a result of the crisis. The rise in the neutral rate is likely to be relatively slow, so I do not think that, somehow, we have to hurry into this, but we do have to be mindful of the fact that, as the economy starts to normalise, we need to take that into consideration when setting policy.

Q11 Mr Jacob Rees-Mogg: You are currently concerned that, with interest rates at such a low level, there is very little ability to cut them in the event that things get worse, rather than getting better. Do you think the Bank has the tools it needs to deal with deflation, if that is what we are entering? I know that is not what you think we are entering.

Ian McCafferty: Just for the record, no, I do not think we are entering any form of deflation and, as I said earlier in the year, even though inflation has remained at zero, there is very little sign of changes in consumer behaviour or consumer inflation expectations over the medium term that would presage any concerns about a period of true deflation.

I do think the Bank has sufficient tools. Although it is clear that, at very low rates, we have some limitations in terms of cutting interest rates, relative to where the MPC was (prior to my taking my seat on the Committee back in 2009) where it was at that stage deemed that 0.5% was the effective low level for interest rates as a result of a number of complexities in the mortgage market and in terms of the functioning of the inter-bank market. Work that the Bank has done since then does suggest that some of those complexities have disappeared, such that I do think there is scope to cut interest rates a little further, were we to need to do so. As we are beginning to learn from a number of countries that have, in recent times, even moved to negative nominal policy rates, there is scope to cut rates to small levels below zero without causing major disruption, in terms of the holdings of cash, for example. The Bank has that tool still to use. We could cut Bank Rate were we to deem it necessary.

While I say that the multipliers into the economy from QE may be different now than they were back in 2009 through 2012—and it may also be that the multipliers are different if one is withdrawing QE than if one is pushing further QE into the market, which raises some uncertainty about the exact calibration of that policy tool—I do believe that further QE would have an impact to stimulate the economy, were it to be required.

Q12 Mr Jacob Rees-Mogg: You mentioned negative interest rates. You do think that they would be a possible tool that the Bank of England could use, but you would not go as far as Mr Haldane and take away the Bank of England's promise to pay the bearer on demand.

Ian McCafferty: Certainly not. Nor would I go along with Andy's suggestion, at the moment, of abolishing cash as a way of simplifying the policy. To me, certainly for small and irregular transactions, it seems the public gains a great benefit from the use of cash. As a result, I would not wish to take it away.

Q13 Mr Jacob Rees-Mogg: If it were threatened that they would have their money confiscated by their bank, even in small amounts, they might be very keen to hold much more of it in cash.

Ian McCafferty: As I say, the evidence is still accruing in terms of behaviour in other economies, but, at small negative interest rates, there is not as much sign of cash hoarding or withdrawal into cash as one might have thought before the event. Clearly, the further below zero interest rates get, the greater the incentive for that distortion of the cash market but, at small negatives, it does not necessarily appear to be a major risk.

Q14 Stephen Hammond: Good morning. Could I ask the same question as I just asked your colleague? In the August inflation report, the Governor spoke about the output gap and his view that it was around 0.5% of GDP, although he recognised there were a wide range of views on the Committee. I wonder if you would care to share your view of where it is at the moment and to what extent it is a useful tool for us to look at.

Ian McCafferty: It is a useful conceptual tool for monetary policymakers to use. Clearly, if the economy is operating at levels of slack, over the medium term, once short-term inflationary pressures and temporary pressures have come out of the system, that will determine to some extent whether one is moving sustainably to or in line with the inflation target or whether you are likely to move away, either in an upwards or downward direction. As a conceptual tool, it is invaluable.

The difficulty comes in measuring the output gap with any level of great precision. There is a risk in being over-precise, which is why I always talk in terms of fractions, rather than decimal points, because I think the measurement issue is important. Our August forecast suggested that, on the basis of a series of different methodologies, on average—and of course they do come up with slightly different numbers as individual methodologies—it looked as if the economy had about half a percentage point of GDP of slack remaining. That is a combination of looking top-down, through some filter methods such as the IMF uses, and the bottom-up measures of looking at the degree of slack in different elements of the labour market, and in terms of capacity utilisation, which the Bank has more traditionally used.

I have to say that, in terms of that measurement of slack, taking the bottom-up measurements, it is clear that capacity utilisation within firms is, according to the surveys at least, close to normal, so we can simply say that there is not a great deal of slack in terms of excess or spare capacity within existing firms. That leaves essentially the measurement within the labour market.

The difficulty with the measurement of course is that any measure of slack relies on underlying estimates of the equilibrium measures for unemployment, for hours worked and for participation. Those are difficult to judge. The work that I have done within the Bank does suggest that they may not even be constant through the course of the cycle. In particular, hours worked does have a strong correlation with real income growth, and it can be explained in terms of the work that people such as Steve Nickell have done, such that second earners in a household note that their primary earner is earning more in real terms, and therefore cut their hours as a result. It could well be that those who are on part-time income have an income target and, if they can meet that slightly more easily as a result of real income growth, then they do not need to seek extra hours to the same degree.

There are two issues. One is the measurement of the output gap as of this quarter, for which our estimate is 0.5%, but if anything my judgment is that the risk is it might be on the slightly smaller side of that, albeit there may well be a little slack still to go, between 0.25% and 0.5%, something of that sort of nature. Also, how quickly we absorb the remaining slack depends on whether you believe that the equilibrium estimates are constant through time and, therefore, we approach them slowly; or whether, if hours and participation are sensitive to

real income growth, then they are likely to decline over the course of the next couple of years, as a result of the strong real income growth that we are seeing. As a result, we would be absorbing what slack still exists slightly faster than in our central forecast, and that provides one of the upside risks to wages that we have talked about earlier.

Q15 Stephen Hammond: In your answers to Mr Rees-Mogg, you were pretty pessimistic about productivity, if I interpret you correctly.

Ian McCafferty: I am cautiously optimistic, rather than pessimistic. There is a difference between judging the rate of productivity growth going forward and whether there is any catch-up, in terms of the productivity loss that we have seen relative to 2007 that 14% to 15% gap relative to the pre-crisis trend.

It is quite unlikely that we will see material inroads into that productivity gap over the foreseeable future, and by that I mean a good number of years. On the other hand, I do think that some of the causes of the recent disappointing productivity growth will prove, in time, to have been somewhat cyclical. Some of the composition effects in the labour market that have depressed productivity growth over the course of the last couple of years or so, and some of the labour hoarding and some of the overhead labour issues whereby, as output falls, it is impossible to adjust labour *pari passu* with changes in output, as output continues to rise, will gradually fade and that will help boost the rate of growth.

However, I think some of the current issues to do with productivity growth are as a result of the sharp falls in capital investment that we saw earlier in the cycle, 2008 through 2012, what that has done to the existing capital stock and, as my colleague Martin Weale said in his speech yesterday, the fact that the recession has meant that many firms have not yet adopted some of the new technologies that have appeared in recent years in order to help gain productivity. Those causes of productivity loss tend to be a little bit more persistent. That is not to say that they will be there forever, but they do take a little longer to work through the system. There is scope for some pickup in productivity growth relative to what we saw in 2012 to 2014, where it was relatively parlous, but at the same time I think that improvement in the rate of growth will be relatively slow, such that we are not likely to see growth rates in line with pre-crisis trends for a little time yet.

Q16 Stephen Hammond: You picked up a number of things. Can I pick up three factors you have identified? One is labour hoarding. The second is the failure to move to new technology. The third is, as again, in your answer to Mr Rees-Mogg, you explored, because of the way that the banks are now lending capital, misallocation of capital, in that some of that is not moving as fast as some of the more productive sectors of the economy. Can you give us some balance between how you see those three factors?

Ian McCafferty: I think there are more than those three that explain the entire productivity puzzle. I have said in front of this Committee in the past that we have identified anything up to 10 to 12 different potential features, each of which seem to

contribute about one percentage point so, from that point of view, clearly these are not necessarily the only explanations.

Stephen Hammond: I accept that.

Ian McCafferty: I also think these have different impacts at different points in the cycle, and this is why it is quite difficult to give you a very simple rule of thumb. Labour hoarding was probably more to do with the weakness of productivity in the early part of the cycle, when output was falling, or in the early stage of output growth.

Q17 Stephen Hammond: It should be unwinding now, and unwinding at a faster rate.

Ian McCafferty: It is unwinding as we speak, if not already just about unwound, on the basis that we have seen significant employment creation and a fall in the unemployment rate in the more recent period. I do think labour hoarding in the early stage of the productivity puzzle probably had an important role.

The new technology is more a later-cycle issue. It takes time for the non-adoption of new technologies and for the deterioration in the capital stock, because of low levels or falls in capital investment, to feed through into total factor productivity. That is an issue that we are seeing now more.

In terms of misallocation of capital, there is some of that. I would not want to use that to explain a very large chunk of the productivity puzzle either, because I do think it is very easy to condemn all those companies that have benefitted from some form of forbearance as somehow being unviable. I am not sure that is necessarily true. If they are part of a cyclical industry, then it may well be true that they struggle to the extent that we had the depth of recession that we did, back in 2008 and through to 2010, but they can be viable in terms of their business model, even as interest rates rise. Forbearance does not necessarily mean that these companies are completely unviable and, therefore, represent a through-cycle of misallocation of resources.

At the same time, there will be some companies that are surviving as a result of very low interest rates, as a result of HMRC forbearance and the forbearance that some banks have been practising themselves. To that extent, they may well be, to the extent that it is a small contribution but it is a contribution nonetheless, lower-productivity-than-average companies and therefore dragging down the average rate of productivity growth, while they survive. To the extent that we see the economy normalising, as monetary policy normalises and as other forms of forbearance naturally fade away, then we will see some turnover in terms of that sector of the corporate sector, which will then have some benefit to productivity going forward.

Again, looking at these, there seem to be about 10 different factors, each giving a point or so, so it is very difficult to focus on one and say, if this changes, it is going to make a material difference to the outcome.

Q18 Stephen Hammond: I and probably others on the Committee are keen to understand where you see the balance of risk between those factors and their pertinence to where we are. It is helpful in that regard. I absolutely accept there are more than three or four factors. Indeed, your new colleague, Dr Vlieghe, talked about disaster risk or extreme event risk, as we call it. I do not know whether you saw his written evidence to us.

Ian McCafferty: I did not, no.

Q19 Stephen Hammond: It suggested that firms are failing to invest because of the continuing risk or the way they have been reminded of very sharp contractions. In terms of where we are in the cycle, is that not a rear-view mirror, rather than a windscreen event? Is that not something that actually was more pertinent previously in the cycle, rather than a risk now?

Ian McCafferty: To the extent that we have seen a recovery in business investment over the course of the recovery, clearly as an issue it is fading. At the time of the extreme dislocation and the extreme depths of the recession, where business investment was falling rapidly, then that factor was very material. To the extent that firms have been reminded of the potential for downside risk in the economy as a result of the upheaval in financial markets and renewed worries about China that emerged in August, that may well give them some pause for thought.

I am watching very closely the indicators of business intention, the investment intention indicators, as well as the confidence indicators to see whether that is going to have any material impact on the outlook for business investment over the course of the next year or so. So far, although as I say we have very little data since August as yet, my conversations with individual businesses suggest that their confidence remains reasonably robust to that financial upheaval of August.

Q20 Chair: I have one question on the CPI figure, which you will already know, which came out at 9.30, of minus 0.1%, so very low, lower than expectations, and we have had of course the IMF coming out with their rather pessimistic and downbeat assessment of the global economy too. Do these things in any way influence the set of judgments that led you to take that decision on interest rates recorded in the October MPC minutes, or do you take the view that these could well be transitory factors—food and drink, transport, things that have relative price effects that will work through?

Ian McCafferty: Let me take them separately and make a brief comment on the IMF, before going on to the CPI figures. In terms of the IMF, there is little difference between the narrative that they use and looking at the data, in that their downward revisions to world growth for 2016 and 2017 are of the order of half a percentage point or less. Yes, there is some downside risk, but they have added to this in terms of their narrative. While I think they are right to point out the risks of disruption to the world economy, and particularly the risks to financial markets in having a very desynchronised

global cycle, with the US and the European Union in particular starting to show some signs of picking up or accelerating, relative to the emerging markets having further problems, as I said at the August IR, I do not think those should be overstated in terms of the impact for the UK. In isolation, that would not make me change my judgments at present, subject to the potential second-round effects of emerging market slowdowns, through the financial markets and through business confidence here in the UK. As long as those second-round effects are not triggered, then I think the UK can continue to grow sustainably, in spite of slower growth in the emerging markets.

In terms of the CPI figures, my understanding—and I have not had a chance to examine that in enormous detail—is that much of the slightly lower-than-expected headline, as you say, is a result of food and drink and a result of transportation costs, both of which are driven by the falls in commodity prices. As such, they are relatively transitory effects in terms of the year-on-year impact on CPI. As such, although we have seen the dip in oil prices, from August into September, we have now seen a recovery in oil prices from September to October. These things are going to affect the month-by-month figure. Whether it is plus 0.1%, 0% or minus 0.1% in coming months is going to depend on short-term volatility in food prices and oil prices, as much as on small moves in the exchange rate, where those are passed through rapidly.

At the same time, I still think those commodity prices are one-off price effects. They will start to disappear from the CPI calculation soon after the turn of the year. I do not think that we will see a very sharp, quick pick-up in CPI. Our calculations are that CPI will still be of the order of 1% or so by the spring, so still, at that stage, materially lower than our target. The impacts on the most recent CPI figures I still think are largely due to those transitory impact of oil and commodities.

Q21 Chair: The short answer to my question is no.

Ian McCafferty: I am sorry.

Chair: No, I am very glad to have had the longer one, particularly since I provided the last question, which you rightly unpicked.

Ian McCafferty: In isolation, those things would not on their own change my views of the last few years.

Chair: Thank you very much for coming to give evidence to us this morning.