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Prospects for monetary policy: learning the lessons from 2011 – Speech by Spencer Dale

In a speech given at the London headquarters of Bloomberg, Spencer Dale – Bank of England Chief Economist and member of the Monetary Policy Committee (MPC) – asks what lessons monetary policymakers can draw from developments over the past year, addresses some concerns and criticisms often levelled at Quantitative Easing, and looks ahead to challenges for 2012.

Spencer Dale argues that, contrary to a common perception, the support to growth over the past year provided by the lower level of sterling has not disappointed. Net trade has responded broadly in line with previous large exchange rate movements. Instead spending by companies has been surprisingly weak and, more importantly, household consumption fell sharply. He contends that “the surprising weakness in consumption stemmed largely from the sharp pickup in inflation over the past year, driven by increases in VAT, energy prices...and other import prices.” Therefore, not all of our disappointing growth performance over the past year can be laid at the door of the Euro crisis: other factors have been important.

However, in Spencer Dale’s view, fallout from events in the Euro area seem the most likely reason for the material weakening in the outlook for the UK economy over the past few months. He cites three potential channels through which this impact may be felt: net exports; funding difficulties facing UK banks leading to a tightening of domestic credit conditions; and a reduction in household and business confidence. “How deep and persistent this slowing in growth is likely to be is very hard to know.” Spencer Dale acknowledges.

With the deterioration in the economic outlook having led the MPC to undertake a further round of asset purchases in October, Spencer Dale takes aim at a few often repeated myths about how quantitative easing (QE) is supposed to work, and how effective it might be:

- He strongly refutes that undertaking QE signals a reduced commitment by the Committee to hitting their 2% inflation target. The MPC’s fear in 2009 – as it is now – was that “if the recovery faltered and our economy fell into a further prolonged recession...there would be a risk that inflation would materially undershoot the inflation target in the medium term”.

- Mr Dale has “the utmost sympathy for the hardships faced by many pensioners and other households dependent on the flow of income from their savings”, though he does not believe that their hardship would be any less the case had monetary policy responded less aggressively.
- He argues that historically low gilt yields do not imply that there is little scope for QE to be effective. The aim of QE is not to reduce government borrowing costs, but to reduce the borrowing costs faced by UK companies and households. The spread of these costs over gilt yields has increased in recent months. The asset purchases should encourage investors to reallocate their portfolio towards more risk assets, including UK corporate bonds and equities.
- Nor, Mr Dale explains, will the money just sit in banks as is often claimed. QE is designed to go around the banking system. A vast majority of the gilts that were purchased would otherwise have been held by UK institutional investors and the resulting portfolio reallocation should increase their demand for other types of assets, including UK corporate bonds and equities.
- Finally, Spencer Dale does not believe that the MPC should have purchased a greater range of private sector assets in order to provide more support to small and medium sized enterprises. Complimentary policies to QE are better suited to this.

Looking ahead, Spencer Dale sees that “2012 should...be remembered as the year in which inflation fell sharply.” When considering the outlook for inflation over the next year or so, Mr Dale finds it helpful to separate it into two distinct phases. During the first phase, between now and next March or so, CPI inflation should fall rapidly as the price level increases seen around this time last year – from the VAT rise and the increase in petrol prices – drop out of the twelve month inflation rate so that “Barring some large and unanticipated price increases, CPI inflation looks set to come down to the low 3’s by March next year.”

But what is more uncertain and more important for monetary policy, argues Mr Dale, is the issue of how persistent inflation will be thereafter. While he expects inflation to continue to fall back, he sees that the chances of inflation being above or below the target towards the end of 2012 and into 2013 are more balanced than those embodied in the fan chart from the November Inflation Report. Inflation could fall further below target if demand is surprisingly weak. But set against this, companies’ and households’ price expectations may be sticky, productivity growth may continue to disappoint, businesses may attempt to rebuild their margins by raising prices and the upward impetus from import prices may persist.

“One thing I know for sure”, Mr Dale says of next year, “is that...we will be surprised”. He is confident that the MPC have scope to increase their programme of asset purchases if required, with material impacts on output and inflation. Likewise, he sees no major obstacles to exiting from the current period of exceptional policy, as and when the Committee judge it to be appropriate.

Key Resources

Prospects for monetary policy: learning the lessons from 2011 – Full speech