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Limits of monetary policy - speech by Spencer Dale

In this speech Spencer Dale, Chief Economist and member of the Monetary Policy Committee, looks at what role monetary policy can play in the recovery from the financial crisis and, in particular, the limits of monetary policy. He looks at two main aspects: limitations to stabilising the economy using monetary policy, and the potential costs and side effects of running extremely loose monetary policy for a sustained period.

Spencer Dale notes that a key limit to the use of monetary policy as a stabilisation tool is uncertainty and ignorance of how it works. "Beware confident economists" he warns. To illustrate the need for caution, Spencer Dale looks at how different judgements about the economy can lead to large differences in monetary policy prescriptions given by a simple 'Taylor rule'.

Relating that to issues facing the MPC, Spencer Dale notes that "a defining feature of the UK economy since the financial crisis is that the persistent weakness in output has been accompanied by a long-lasting period of very weak productivity growth, suggesting that the supply capacity of the economy may also have been impaired." Compared with the period before the financial crisis, "this makes judging the appropriate policy response to a slowdown in output growth far more complicated". He argues that "the Pavlovian-like response of some commentators to call for more monetary stimulus each time they observe weak output growth is not sensible. The extent to which policy should be eased depends crucially on the reasons why output is weak." "Ultimately, our job is to hit an inflation target not a growth target".

Spencer Dale then looks at the limits to running extremely loose monetary for a sustained period of time, noting "the financial crisis has taken monetary policy into uncharted waters" given very low Bank Rate and the scale of quantitative easing.

Spencer Dale argues strongly that, given the scale of headwinds that have faced the economy, weak growth does not imply that monetary policy actions have been ineffective as some commentators claim. He has "little doubt that without them our economy would be in a far worse state today". Dale also notes that the recently-announced Funding for Lending Scheme (FLS) is different from earlier bank lending schemes: "It is bigger and bolder than any scheme tried so far to get the banks lending". "The FLS takes off the table the constraint posed by high funding costs" and "stands a good chance of making a material difference".

But Dale notes that prolonged and aggressive monetary accommodation, combined with increasingly unconventional policy tools, also comes with potential costs and risks. Over longer periods of time, sustained loose monetary policy could lead to increases in the risk taking of investors and financial institutions in a way that could store up problems for the future. It may also delay some of the rebalancing and restructuring that our economy needs to undertake. Dale also notes risks associated with exiting, which, given the amount of gilts to be sold back to private sector investors, "will be a delicate task".

In addition, Dale worries about potential risks to the MPC's credibility from "the inevitable blurring between fiscal and monetary policy when interest rates are close to zero". He stresses that the only reason why QE was undertaken was to hit the inflation target in the medium term, but acknowledges that, to some, QE may look uncomfortably close to monetary financing, with the difference only becoming clear once the gilts bought are sold back to the private sector. "However unfounded, those perceptions need to be taken seriously" he argues. More generally, Dale worries that "unless the limits of monetary policy are well understood, a widening gap may develop between what is expected of central banks and what they can realistically deliver".

In concluding, Spencer Dale notes that the MPC's policy actions have played a critical role in stabilising our economy and, if needed, there is scope for monetary policy to do more. But there are limits to how much we should ask of monetary policy, given how little we truly know about how the economy works. If output growth remains weak, the MPC will need to assess carefully developments in potential supply as well as demand before deciding how to respond, and we need to consider the potential costs as well as benefits of further policy easing. '"Above all", Dale argues "we need to remain firmly focussed on hitting our inflation target."

Key Resources

http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech597.pdf
Full speech by Spencer Dale