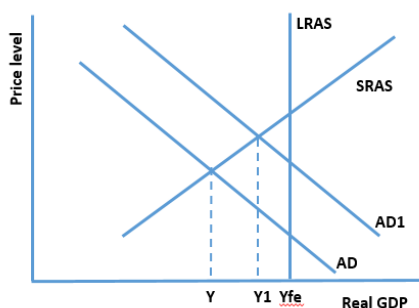


## Evaluate the effectiveness of the UK's monetary policy in improving the UK's economic performance in recent years.

UK monetary policy involves altering interest rates and/or the supply of money in the economy (not the exchange rate in the UK due to the free-float system). In discussing the effectiveness of monetary policy on the UK's economic performance three different aspects of policy will be evaluated: the use of interest rates, quantitative easing, and funding for lending.

One way of assessing the effectiveness of monetary policy in general is to examine the number of letters written by the Governor of the Bank of England to the Chancellor. The Bank of England has "operational independence" although it must work to an inflation target set by the government ( $2\% \pm 1\%$  as measured by the CPI) and generally support the government's economic policy on growth and employment. If inflation moves away from the target range, the Governor is required to send an open letter to the Chancellor explaining the reasons why and also what action the Bank is taking to bring inflation back to target. Since 2007 the Governor has written many letters to the Chancellor as the inflation target has been missed numerous times e.g. inflation reached 5% in 2008, was well over 3% over the 2010-2012 period and was 0% in 2015. Despite these fluctuations, for most of that period interest rates were held at 0.5%. This could suggest policy failure. However, this was a period of significant economic turbulence triggered by the financial crisis in 2008-09. In addition, the above target inflation rate was beyond the control of the central bank with rises in VAT, energy costs and import prices pushing up the UK price level. Furthermore, increases in the interest rate were inappropriate in a period of great economic uncertainty. Therefore, the failure by the Bank to hit its inflation target should not be regarded as resulting from ineffectual monetary policy, but rather because they were focusing their attention on their other objective of supporting government policy on growth and employment.

That said, it could be argued that the Bank's failure to cut interest rates quickly as the financial crisis unfolded, and then the failure of record low interest rates to stimulate the economy as expected, could be seen as policy failure. The 'interest rate transmission mechanism' assumes that interest rates affect aggregate demand; low rates should stimulate consumer spending and investment (by affecting incentives to save and borrow), and stimulate net exports by causing a currency depreciation – as the diagram shows, this should cause an increase in real GDP from Y to Y1, and move the economy closer to full employment by reducing the size of the negative output gap. However, the interest rate elasticity was very low due to a lack of confidence, and the 'Credit Crunch' meant that despite low interest rates the supply of loanable funds was diminished, therefore the effectiveness of conventional monetary policy was limited. This has therefore meant that the use of more unconventional monetary policy, such as forward guidance and quantitative easing has had to be used. Arguably, the use of forward guidance (which attempts to influence the financial decisions of households and businesses by indicating whether to expect interest rates changes in the months ahead) has been effective in increasing confidence and stimulating growth.



Quantitative easing (QE) is another unconventional form of monetary policy in which a Central Bank creates new money electronically to buy financial assets such as corporate and government bonds (or gilts) from financial institutions such as pension funds as well as commercial banks. This process means that commercial banks and other financial institutions will have greater liquidity, which should increase lending and lead to a rise in private sector

*Immediate demonstration that the nature of monetary policy in the UK is understood.*

*A good opening sentence that shows exactly what the focus of the paragraph is going to be.*

*Excellent use of data that is integrated to support the analysis.*

*Good connectives e.g. "however", "in addition", "furthermore" and "therefore".*

*Very clear concluding sentence that carefully answers the question.*

*Again, a very clear opening sentence setting the tone for the paragraph.*

*A succinct but effective analytical chain on the transmission mechanism. Specific points from the diagram are referred to in the written analysis – this is useful.*

*Good use of knowledge about the UK economy – this supports the evaluation.*

*Another good analytical chain using accurate terminology and examples.*

spending in the economy. QE has been used in the UK, US, Japan and the euro zone in response to the financial crisis of 2007-09, to prevent deflation and support consumption and investment as a period of uncertainty and pessimism continue to affect the global economy. The UK created £375bn of new money in its QE programme between 2009 and 2012, with a further purchase of £60bn of UK government bonds and £10bn of corporate bonds in 2016, amid uncertainty following the Brexit vote and worries about productivity. A 2014 paper published by the Bank of England said that asset purchases equal to 1% of UK GDP, raised growth by 0.18%, implying that the Bank's £375bn of asset purchases boosted UK real GDP by around £50bn. Furthermore, the report noted that QE had pushed inflation up by 4.2%; in other words, it had helped to significantly reduce the risk of deflation. Therefore, QE has produced a positive outcome for the UK economy.

*The addition of some **data** really helps to support the quality of the argument.*

*A strong final sentence, showing a **judgement**, gives structure to the essay.*

However, in theory an increase in the amount of money in the economy, as a result of QE, should cause inflation via the Quantity Theory of Money ( $MV=PT$ ). Others argue that the extra money in the economy has simply just increased the price of some assets such as shares and property creating destabilising asset bubbles, and worsening wealth inequality. In addition, QE has depressed the yields on government bonds (because bond prices and yields are inversely related) and this has meant that long term interest rates are very low. Whilst this is helpful for borrowers, it has disincentivised saving; this is a worry in the UK where the savings ratio is already low. Nonetheless the feeling among many economists is that QE has been on balance a valuable extra monetary policy tool in extraordinary economic circumstances.

*There are lots of great **synoptic links** in this paragraph – causes of inflation, asset bubbles, the bond market etc.*

A third aspect of monetary policy to consider is the Funding for Lending Scheme (FLS) which started in 2012 and was designed to boost the economy by increasing bank lending to households and companies after the credit crunch. The FLS was designed to incentivise banks and building societies to increase lending by providing funds / liquidity to banks and building societies for an extended period, with both the price and quantity of funding provided linked to their lending performance. Basically, the Bank of England was allowing commercial banks to borrow funds from it cheaply, which were passed on in the form of cheap loans to firms to stimulate investment and therefore economic growth. In principle, the idea of FLS is simple and should be effective. However, many commercial banks are quite risk averse and continued to be unwilling to lend unless the loans were secured. Furthermore, despite the low cost of finance, businesses in an uncertain economic climate have been unwilling to take on new debt. The FLS has also been the victim of the law of unintended consequences. The availability of cheap funds from the Bank of England has meant that commercial banks are less incentivised to attract savings from the general public as a source of their funds e.g. it is almost impossible to find a savings account offering more than 2% interest. Following the base rate cut to 0.25% in 2016 the Bank of England launched the Term Funding Scheme to try and counteract this, by lending directly to banks at rates close to the new 0.25% base rate to encourage them to pass on the lower interest rates to businesses and households. There is no compulsion for banks to do so, though. Overall, it is difficult to assess the effectiveness of FLS, because it is not possible to compare current economic performance with performance if FLS had not been used.

*It is very pleasing to see students recognising that monetary policy is about much more than changes in the interest rate in the current economic climate – breadth of knowledge is important.*

Overall, in extraordinary economic times the economy's position would arguably have been much worse without the use of innovative monetary policy. The main problem in the UK is that monetary policy alone cannot directly address the key growth constraints in the economy such as low productivity, skill shortages, poor infrastructure, low investment and a lack of competitiveness. These supply side problems require direct action by government and business and are beyond the scope of monetary policy.

*This is a **tidy conclusion** that neatly follows on from points made in the essay. A **judgment is reached** about the effectiveness of monetary policy.*

