HOUSE OF LORDS

Select Committee on Economic Affairs

Corrected oral evidence: Quantitative easing

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4 pm

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Members present: Lord Forsyth of Drumlean (The Chair); Lord Bridges of Headley; Viscount Chandos; Lord Haskel; Lord King of Lothbury; Baroness Kingsmill; Baroness Kramer; Lord Livingston of Parkhead; Lord Monks; Lord Skidelsky.

Evidence Session No. 10 Virtual Proceeding Questions 94 - 100

Witnesses

I: Lord Turner of Ecchinswell, Senior Fellow and Grantee, Institute for New Economic Thinking; Charles Goodhart, CBE, FBA, Emeritus Professor of Banking and Finance with the Financial Markets Group, London School of Economics.

Examination of witnesses

Lord Turner of Ecchinswell and Charles Goodhart.

Q94 **The Chair:** For our second session we have two very distinguished witnesses: a colleague in the House of Lords, Lord Turner, senior fellow at the Institute of New Economic Thinking, and Charles Goodhart, already advertised by our previous witnesses, who is Emeritus Professor of Economics at the London School of Economics.

May I begin by asking you about the different phases of QE and how they differ from one another, and to what extent the QE undertaken during the pandemic marks a change in direction?

Charles Goodhart: The previous two speakers were absolutely correct. QE was a marvellous instrument for dealing with liquidity problems and acted enormously efficiently in 2009. It was used again, in effect, when there was a liquidity crisis in the American bond market last winter. It is much less effective when there is full or even excessive liquidity, and, as I think both earlier witnesses suggested, it was of fairly marginal importance after QE1 with QE2, QE3, QE4 and subsequently.

Lord Turner of Ecchinswell: It is a pleasure to be with you all. In answering this question, I think that it is useful to start with the description of the transmission mechanism of QE on the Bank of England's website, where it says, "How does quantitative easing work?" It says two things: first, that the large-scale purchase of government bonds lowers the interest rates or yields on those bonds and potentially has a knock-on effect on some other bonds, such as corporate ones, and because it pushes down the interest rate on loans it stimulates the economy. It also says that there is a second transmission mechanism, which is that it boosts a wide range of financial asset prices and, therefore, in some way produces a wealth effect with wealthier people spending more money.

My perception is that the first of those transmission mechanisms may have played a role in the early stages of QE when we were starting with gilt rates of about 3% and that was brought down to 1%. I think that it is credible that when you are reducing interest rates over that range via the corporate bond market and the rates on long-term lending from banks you could stimulate people to borrow more money. I do not think that was the primary transmission mechanism then. It is certainly not a credible transmission mechanism now, and I do not think that it has been for about five years. Once you already have long-term yields down at 0.5% or 0.75%, marginal decreases in those yields just do not have an impact on either corporate or personal borrower behaviour.

Instead, what QE is doing now is what it has been doing for many years in Japan. It is lubricating a fiscal expansion and making it easy for the Government to run large fiscal deficits without the danger of setting a rise in interest rates. The direct impetus to stimulating the economy is coming through the fiscal deficit and QE is lubricating it.

It is essentially doing what the monetary policy of the Fed did between 1942 and 1951. The commitment of the Federal Reserve to buy whatever level of bonds was needed to fund the fiscal deficit required for war enabled those fiscal deficits to occur without a rise in bond yields.

That is effectively the transmission mechanism today, and it is certainly different from what is described on the Bank of England’s website and is somewhat clearer in that form than when it was initially introduced and there were higher bond yields.

The Chair: To what extent is that policy mix of loose monetary policy and expansionary fiscal policy creating instability in the UK’s general macroeconomic framework?

Lord Turner of Ecchinswell: I do not think that it is, because the issue is: is this appropriate at this particular macroeconomic conjuncture? The difficult thing is to distinguish where we were before the Covid crisis, but even before it many thoughtful economists, who came from a very traditional central banking environment, had pointed out that it was possible for us to get into such a deflationary trap and the only way out of it might be to co-ordinate monetary and fiscal policy and have some element of overtly monetarily financed fiscal stimulus.

That was what Ben Bernanke said in April 2017, when the worry was that we were stuck and out of ammunition. He asked in his Brookings Institution blog, “What tools does the Fed have left?” More surprisingly, perhaps, two very traditional central bankers—Stanley Fischer of the Central Bank of Israel and Philipp Hildebrand of the Swiss National Bank—argued in autumn 2019 before the crisis that we ought to equip ourselves for the crisis by creating mechanisms by which we could have quite overt monetary finance of fiscal deficits.

You would want to deploy those things only if you believed that without them the inflation rate would fall significantly below your target, but I think that we are in those circumstances today.

We are also in the very particular and strange circumstance of Covid-19. We have the additional strange feature of a whole load of people earning income and accumulating money balances who cannot spend them in the hospitality and leisure sector, with the Government running large fiscal deficits on furlough to support the hospitality and leisure sector. This is a specific circumstance that we did not anticipate, but in that specific circumstance it is also appropriate to run very large fiscal deficits and quite reasonable for the Bank to buy those bonds to lubricate that.

There is a separate issue about whether you should ever say that that purchase is permanent. The dividing line between an accommodation of a fiscal deficit and overt long-term monetary finance is whether you ever say that bond purchases are permanent and for ever, rather than an exercise that you intend to reverse at some time.

The Chair: Charles Goodhart, do you want to come back on this?

Charles Goodhart: The policy measures that you indicated are in effect based on a massive gamble that inflation—and, therefore, interest rates—will remain low for a very long time.

Otherwise, one of the issues that I thought was not properly raised by my colleagues Ken and Adam was that the decline in the duration of debt, which QE brings about directly, means that, should inflation and interest rates rise relatively soon, that immediately impacts on the amount of interest payments that have to be made from the fiscal purse and immediately impacts on the private sector if it takes on a lot of debt.

It is a massive gamble at a time when policies are being applied in such a way that many of the indicators and factors leading to inflation are inevitably rising. The money supply as a result of QE and these purchases has been rising at rates in America that were equalled only during wartime. It is rising far faster in Japan now than virtually ever before, and very fast elsewhere.

Adair said that the difference is whether you say that you will reverse QE at some time. My expectation is that central bankers will go on saying that at some time they will reverse QE—but when? On the likelihood that it will be done, an overt sale rather than allowing a run-off of the existing portfolio would do enormous reputational and market damage, so the speed of run-off is effectively limited by the degree that the holdings within the central bank mature. Admittedly, they are big enough, so this could be quite fast.

Q95 **Lord Haskel:** Both Adair and Charles are questioning the effects of QE. It is difficult to separate out the effects of the pandemic and QE on the economy. Even so, to what extent has QE distorted market incentives and enhanced inequality? The pandemic has certainly thrown these matters into sharp relief.

Charles Goodhart: It is a slightly complicated issue. I think that Ken got this wrong. Central banks have studied the effects on income inequality. There have been many papers on it. The point that they make correctly on income inequality is that the expansionary effects countering the effects of Covid and the great financial crisis have their greatest impact on the poorest and those most likely to be unemployed and, therefore, do not increase income inequality. I think that they are right.

However, the issue is different when you look at wealth inequality, because clearly one of the major effects of such expansion is to raise asset prices, and the rich own assets. Again, the issue is slightly complicated because it also raises housing prices, in many cases quite dramatically. Housing is held by a much larger section of the population. If you look at things such as the Gini coefficient, it becomes quite a complicated issue, but as a generality I would say that it does not increase income inequality, it increases wealth inequality—although the measurement issues are quite technical and complicated.

Lord Turner of Ecchinswell: The first question is whether it has distorted market incentives. I think that we have to accept that the process of ending up over the past 10 years and looking forward for many years with nominal interest rates at a very low level and real interest rates at negative is a major disruption from some of the normal processes of capitalism, because, for instance, it allows many companies with debt, provided they can roll it over, to exist in a permanent state of indebtedness. It is at least possible that that enables some companies to survive that, in what we used to think were more normal times, might have gone to the wall and been replaced by other, more productive companies.

I think that this issue is overstated. It is sometimes called the zombie company debate and goes back to the discussions people had about the long period where Japan has been in this. We have to remember that for about 25 years Japan has been in the situation that we have been in for the past 10—so the issue is overstated but not nil.

On inequality, I entirely agree with what Charles has said. It was better to do QE than not to do it all the way along. It had some stimulative effect on the economy, most powerfully when combined with fiscal. I think that stimulating income growth was probably good, if anything, for income equality, but quite clearly, if you read that second transmission mechanism as defined by the Bank of England on its website, it works by increasing asset values and, hopefully, by those with asset values, either companies or individuals, choosing to spend more. If you increase asset values, given that wealth is much more unequally distributed than income, you will tend to increase some aspects of inequality. You will increase the wealth-to-income ratio, which has some very important impacts on, for instance, opportunity. The higher housing prices go relative to income, the more difficult it is for people from poorer parts of the country to move to richer parts of the country, because there is a bigger barrier in the form of high prices.

Broadly speaking, I agree that if you have a transmission mechanism that works partly through a wealth effect, it is almost bound to increase elements of wealth inequality.

Lord Haskel: Bearing in mind Adair's response, could QE be a form of his helicopter money?

The Chair: I think that we will come to helicopter money. If Lord Haskel does not mind, I will move on to Viscount Chandos.

Q96 **Viscount Chandos:** I want to come back to inflation, which Professor Goodhart has already mentioned. How powerful are the inflationary forces, whether monetary or non-monetary, such as demographic or technology-related ones, and what does that mean for the Bank's conduct of QE from here?

Charles Goodhart: In the short run, the honest answer is that we do not know. We have a weird situation, as Adair has said, where people have been effectively prevented from doing much of the spending that they would normally do. The savings ratios in all our economies have shot up to levels unlike anything except in wartime, and monetary growth has shot up again. If they returned to normal within a short time, which they will not, we would get a massive boost in spending relatively quickly and that would be inflationary.

We really do not know how quickly and how much the monetary expansion and the savings build-up will revert to normal. It is anybody's guess. It would be very unwise for anyone to change policies now, because we really do not know how the world and economies will behave once normality returns after the vaccines have given us herd immunity.

Lord Turner of Ecchinswell: I agree with that. There are some things where we do not know precisely what will occur in the future. That is why we have a Monetary Policy Committee that meets each month and looks at the situation as it then is and responds to the emerging facts, which tell us about the future as it emerges.

If I were to guess, I think that the balance of factors is against a major take-off of inflation on a sustained basis. The first of the factors that could lead to significant inflation is the one that Charles mentioned. We have had a very big increase in monetary balances. I do not believe that in itself an increase in the money supply must feed through to inflation. We saw in the 1980s and 1990s a significant fall in the velocity of circulation of money.

On the whole, to make sense of this you have to look at the asset side rather than liability side of bank balance sheets. You have to realise that there was big lending against property, which drove up property prices. Sellers had large bank balances as a form of savings but did not rush out and spend it on everything else, so you had an increase in house prices but not in the generalised price level.

Therefore, I do not think that all increases in the money supply necessarily produce an inflationary surge—but this one might. Indeed, I think it is certain that it will produce at least temporary effects. I would be willing to bet that, if everybody is allowed to travel to Greece and Spain in May and June, the price of easyJet and Ryanair flights will shoot up. When you have prices set in an extreme market fashion by pricing algorithms responding to people going on the internet, you will get a price effect from that pent-up demand.

We will see that temporary effect across many areas of the economy. We might see a more generalised impact simply because, after years when we were not expanding fiscal policy all that much, we now have massive fiscal expansion in all countries. In America, we have a fiscal expansion that has gone beyond that which is naturally required to deal with the Covid-19 crisis by way of a huge discretionary overt choice to give a big stimulus to the economy.

It is possible that that together will bring us into a period where for the first time we have central banks worried about how to keep the inflation rate down to target rather than up to target.

On balance, I do not think that will occur, because of some structural features of our economy—in particular, technology and the relentless progress of our ability to automate functions. We have effectively a kind of reserve army of robots rather than a reserve army of labour. That is so deep and will continue to be deep that I suspect that, when we look back from 2030, we will still be talking about a period of sustained low inflation—but that is a judgment and not one that we need to make to guide monetary policy today. Monetary policy today can stay on its present setting and then observe information as it becomes available over time.

Viscount Chandos: Charles Goodhart, do you feel that, setting technology aside, other factors such as demographics, which you highlight in your book, counteract that? Would you be less optimistic about the secular direction of inflation than Lord Turner?

Charles Goodhart: Yes, indeed. One of the points that we make in our book is that the world saw the most enormous positive supply shock of labour and a huge shift of manufacturing, particularly from high-wage to low-wage economies with globalisation, and this is now rapidly reversing. Therefore, the underlying context in which central banks will have to operate over the next few decades will shift from deflationary to inflationary.

One of the points of the book is that this massive upsurge in the availability of labour to anyone who could move production to low-wage economies so weakened trade unions that private sector trade union membership declined very sharply in virtually all countries, and labour is much harder to organise in the service sector than in manufacturing. The bargaining power of labour really got trashed and was sharply reduced, and it will be a time before this turns around. Although we think that the underlying context is shifting from disinflationary to much more inflationary, how quickly this will shift is very difficult to ascertain.

We think that the blip in inflation that will come for the reasons Adair and others have said will possibly be strong enough, combined with the underlying shift in labour, particularly in the UK, to raise inflation to uncomfortable levels. Given that of the order of over 1 million migrants from Europe are returning to their home countries as a result of Covid, this could very sharply change the labour bargaining balance of power between supply and demand as we come out of the Covid pandemic.

Q97 **Lord Bridges of Headley:** May we turn to alternative versions of QE? May I start with Lord Turner and then turn to Charles Goodhart? Should the Bank be actively considering alternative versions of QE? If so, which ones?

Lord Turner of Ecchinswell: As for what instruments it should buy, broadly, no. Broadly, a central bank should stick to the macroaggregates and its influence on the overall level of monetary demand in the economy and be very cautious about intervening in ways that get into the specifics of the precise pricing of companies in their equities or bonds. I have never been a supporter of the fact that the Bank of Japan has a non-trivial equity-buying programme alongside its bond-buying programme.

In relation to corporate bonds, there is a legitimate role for QE to operate alongside other mechanisms of liquidity provision when you face a short-term liquidity crisis in a shock that has driven spreads on corporate bonds up to levels that you think are reflecting a short-term illiquidity crisis. In those environments, which we saw back in 2008-09, it is reasonable to have a corporate bond element within your bond-buying programme, but it should be small and used only in those circumstances. If you think that the spread relationship between corporate bonds and gilts is reasonably reflecting expectations of future default, you should leave those markets alone.

Therefore, I do believe that QE should operate essentially through the purchase of government bonds. That is the neutral mechanism. The crucial issue is the scale and whether some element of that purchase should be considered permanent. That latter issue, however, takes us straight on to the issue of overt money finance or helicopter money, and since that is the next question I will leave it until then. If we are talking about buying alternative forms of instrument other than gilts, I think that it should be only in exceptional circumstances.

The Chair: If you dealt with the "helicopter money" point now, that would be quite helpful.

Lord Turner of Ecchinswell: First, it is important to define terms: whether you are talking about the way in which a stimulus is delivered or how you finance it. Some people using the expression "helicopter money" think that literally it has to mean sending a cheque to every individual, so it is the nearest equivalent of Milton Friedman's scattering of money from a helicopter and people picking it up and spending it.

That is a subset of a more general case, which is: should you ever have an element of overt monetary finance? Should you ever run a fiscal deficit? The Government issue debt; the bank buys it and the bank makes it plain that that is permanent and, indeed, that in its purest form it intends in future to finance it with reserves that are not remunerated, remembering that it is possible to have a policy for the future remuneration of reserves that distinguishes tiers between an element that is remunerated at zero rate and an element that is remunerated at the marginal policy interest rate.

That is what we mean when we talk about overt monetary finance. The benefits of that versus a purely monetary transmission mechanism go back to what I said earlier, which is that when interest rates are already close to zero or lower bound, you are helping to finance a fiscal stimulus that produces a direct stimulus through to the economy where the purely monetary mechanism will not work.

The benefit versus a straightforward funded fiscal deficit, if there is a benefit, is that it overcomes what is called a Ricardian equivalence effect. It overcomes the fact that when you issue a whole load of debt people might worry about the fact that they will have to pay back in future, so it might not be as stimulative as it would otherwise be.

It is because people are worried that there might be constraints on the amount of fiscal deficits that Governments are willing to run, which therefore might leave us in a liquidity trap, that a number of central bankers have argued that under certain circumstances we should have overt money finance. That was what Ben Bernanke, Stanley Fischer and Philipp Hildebrand argued should happen under certain circumstances. It is also a possibility that has been extensively discussed theoretically. It is essentially what Michael Woodford said in his Jackson Hole paper of 2012 and what Christopher Sims said in his Jackson Hole paper of 2016.

That is what it is. Is it required today? If what you are trying to do is to overcome the danger of Ricardian equivalence, you have to ask: is there any Ricardian equivalence? The alternative strategy is to get rid of the Ricardian equivalence by a commitment to continue buying bonds to keep the yield at a zero rate for ever. Therefore, you end up, in the case of the Bank of Japan, with no real difference between a permanent commitment to yield curve management at a zero rate and overt monetary finance that is permanent. I do believe that there are some circumstances in which it is possible to get stuck in a liquidity trap so deep that the ultimate instrument—which, Willem Buiter wrote in an article, is the one that will always work and should be deployed—is to run a fiscal deficit and finance it with pure central bank money.

Charles Goodhart: Under the Biden stimulus programme, every family will be sent a cheque for $1,400. If that is not helicopter money, I do not know what is.

The Fed is now arguing that it will not raise interest rates effectively until it sees inflation occurring. If that is not modern monetary theory, I do not know what is.

We are in a very weird world where we are actually undertaking helicopter money; we are following exactly the precepts of modern monetary theory, otherwise known as the magic money tree; and at the same time we are claiming that we are not doing it. We are doing what we claim we are not doing. I find this situation absolutely weird.

The Chair: I think that you want to come back on that. I can see that your helicopter has taken off.

Lord Turner of Ecchinswell: I do not entirely agree with Charles that you know from the fact that there is a distribution of a cheque that that is helicopter money. If that was a cheque that had been financed by the Treasury in the perfectly normal fashion of the issue of government debt without a simultaneous purchase of that government debt by the Federal Reserve, that is just a particular form of fiscal expansion.

What Milton Friedman meant by "helicopter money" was money financed by the central bank creation of money—but I absolutely agree with Charles that we are denying things that we are doing. This has become the case in the Bank of England and Federal Reserve, but I have believed for over 10 years that the Bank of Japan is doing permanent monetary finance. There are no believable circumstances in which the Bank of Japan will ever sell back the totality of this massive accumulation of JGBs—over 100% of Japanese GDP. There is none in which it will sell them back.

I believe that almost all future circumstances are ones in which there will be an almost continuous zero interest rate stretching hugely into the future. Although the central bank governor, if you ask him, will always deny that he is doing what Finance Minister Takahashi did in the 1930s, which was overt monetary finance, it is true that the first time I met Haruhiko San he had a great smile on his face and gave me the English language version of the biography of Takahashi. I asked him, "So, are you the modern Takahashi?", and he simply laughed. It is undoubtedly true that the Bank of Japan is doing permanent overt monetary finance and post facto we will realise that we have done an element of it here.

It is interesting to go back to the Federal Reserve story from 1942 to 1951. From 1942 it introduced the policy of buying whatever level of government bonds was required to finance the war effort. In 1951 it made the accord—which, as Mervyn pointed out recently, is an amazingly brief statement between the Federal Reserve and the Treasury—bringing an end to that process, but, if you look at the Federal Reserve's balance sheet, you see that the increase that occurred as a result of that monetary finance is never reversed. The Federal Reserve balance sheet as a percentage of GDP very slowly declines because nominal GDP declines, but it always stays there. I think that is de facto what we are almost certain to see with the balance sheets of both the Bank of England, Federal Reserve and probably the ECB as well.

The Chair: Lord Bridges, do you want to intervene in this discussion between our witnesses?

Lord Bridges of Headley: I see that Lord King does, but may I first ask Charles Goodhart about one point? Is there a strong case for returning to a system where commercial bank deposits held at the central bank pay zero interest? I know that you have been talking about this. Could you just explain that a little?

Charles Goodhart: I do not think that the commercial bank deposits at the Bank of England will go down all that much. It will be politically extraordinarily difficult should interest rates start to go up to have large payments out of the central bank to commercial banks. It would possibly even have the effect of driving the central bank into a loss that would have to be made up every year. If you have something of an indefinite period with a zero interest rate, it has no fiscal cost whatever. It is not only QE; it is the combination of QE and the payment of interest on excess reserves that makes the whole process so sensitive to any increase in interest rates. My view is that, should interest rates start to go up, it will become almost politically inevitable to return to paying zero interest on commercial bank deposits.

Lord Turner of Ecchinswell: That was the point I made earlier. The logical concomitant of any permanent QE or monetary finance is that there is a tier of commercial bank reserves remunerated at zero—but you would not remunerate all commercial bank reserves at zero. You would want marginal reserves above a certain level to be remunerated at the policy rate, because that is part of the crucial transmission mechanisms of policy.

I agree with Charles that it is likely that, if we ever had a major rise in interest rates, which would automatically increase those payments from the Bank of England to the commercial banks, we might well then be forced to do what I think is the logical thing in any case, which is to have a tier of commercial bank deposits at the central bank that are zero remunerated, with the policy rate paid on the margin.

Lord King of Lothbury: Lord Turner, you said that in certain situations, if they were dire enough, permanent monetary financing would be the answer because ultimately it can work. You said that Japan had been doing this for quite a long time. Why has Japan not been a model of economic growth or inflation, even at target? It has always been below.

Lord Turner of Ecchinswell: It is almost a separate issue from that. Japan's real growth is not all that bad—its real growth per capita compares very well with the G7—but its nominal growth, which is affected by central bank impacts, has been low and its inflation has continued to be below target.

The issue here is, simply: what is the counterfactual? It is my belief that, if you had not had both continuous large fiscal deficits in Japan, which have been running at about 3% or 4% and are now up at 7% or 8% for the past 20 years, financed significantly by central bank money, we would have a still lower inflation rate and, therefore, nominal GDP rate. That is an issue that neither of us can prove either way because we do not have the power to see what that counterfactual is, but that is how I would square my assertion that under certain circumstances it is appropriate, and that Japan has been doing it appropriately with the undoubted fact that nominal GDP growth in Japan has been below the level required to hit the 2% inflation target.

Lord King of Lothbury: Do you think that the rest of the G7 are likely to go down this path in years to come?

Lord Turner of Ecchinswell: We may end up doing it de facto for the reasons Charles mentioned. If we come out of this crisis with what he perceives may be a more sudden increase in inflation than I anticipate, we may face a challenge in the remuneration of those commercial bank reserves at the Bank of England. We may choose to put a tier of them on to a zero-based remuneration, but you could argue that we could be reversing the QE in any case.

Therefore, I think that the most likely circumstances in which we will de facto in 30 years' time look back and say that this was permanent monetary finance are those in which the structural factors for disinflation continue to be strong. If they continue to be strong, as I believe they will, we will eventually look back on this period. We will get to 2030 and 2040 and see that interest rates are still very low; we will see that we still have very large holdings of government bonds at the central bank, and we will say, "This is de facto a form of monetary finance".

Even if it is reversed, it is to a small extent—the difference between the interest rate on the bank reserves and the gilt rate. The Bank of England has done close to £800 billion of QE. If that had been funded by 10-year gilts, that would be paying 7.55 basis points. It has been funded at 10 basis points. The difference between those is of the order of £5 billion a year. Within the OBR report, you can see that direct effect—a lower rate of interest—being of benefit to the PSNB. That is undoubted, but it is relatively at the margin. The issue is whether the balance sheet effect is ever reversed and whether it is a really big monetary finance.

The Chair: Lord Livingston, I hope we will have a brief question and answer and then we will move on to Lord Skidelsky.

Lord Livingston of Parkhead: It is a brief question; hopefully, it will be a brief answer.

Charles Goodhart, the question about banks paying zero on their reserves has come up. This is presented as being free money, as it were. But it is either a tax on shareholders or a cost to customers. Should we not be honest about it? If our public sector borrowing requirement is partially caused by rising short-term interest rates, that is a fiscal decision—it is almost a hidden tax.

Charles Goodhart: That is absolutely correct. To insist that there is a tranche or large part of commercial bank deposits in the central bank that have a zero interest rate would have to be done by the Chancellor of the Exchequer.

Q98 **Lord Skidelsky:** I am sorry I am invisible—it is a technical problem—but I hope I am audible.

We have become terribly involved in people's QE and helicopter money. That issue has been very extensively explored, so I want to phrase my question slightly differently. To what extent does the use of the Bank to finance government spending, which is really what has been happening, undermine the accountability of the central bank as an independent actor?

It seems to me that what has happened—I do not know whether the witnesses agree—is that Governments have been so scared of fiscal policy that when the crunch has come and they have needed to use it they have simply outsourced it to an institution supposedly independent of political pressure.

Lord Turner, perhaps you could start the answer to this. You have said that you want central banks to decide how much government spending they are prepared to finance by monetary policy and that Governments should then decide how to spend it, but is that not another way of simply passing the buck? Surely, you cannot do that if you have a Government who are accountable to Parliament for their spending. You cannot tell the Bank, "This is how much we are prepared to finance". The Bank will have to finance whatever the Government want.

Lord Turner of Ecchinswell: I think it is both desirable and possible to use whatever you call it—people's QE, helicopter money or, using my preferred and more precise phrase, permanent explicit monetary finance—and still preserve the appropriate distinction between the role of elected officials and the fiscal function and the role of the Bank of England. I think that we have preserved it so far. The QE that we are seeing is de facto financing the fiscal deficits that the Government are running, but the decision to do that QE was made by the MPC in its independent judgment that, given that the Government would run this larger fiscal deficit, it would be more stimulative if it also did a QE operation to finance it, and that without that QE operation inflation would have fallen further below target.

I think that the MPC was completely appropriately following its inflation mandate when it made that decision. I do not think that there was a phone call from Rishi Sunak to Andrew Bailey of the sort that you undoubtedly get in Argentina and other places like that. I do not think that the MPC said, "We have to have a whole load of fiscal spending". It said, "Given the fact that the Government are running this large fiscal deficit, what is the action we will take that is most likely to bring us closer to the inflation target?"

I think that this is also true even if you go as far as making an element of it permanent and explicit. The proposals for that were explicitly set out by Ben Bernanke in his April 2016 paper and by Fischer and Hildebrand in their November 2019 paper, in which they described a process by which monetary policy, or FOMC, would have within its complete discretion the ability, if it believed it necessary, to say, "We think it would be a good idea now to spend more money, not in order to achieve some social purposes but to stimulate aggregate nominal demand. We therefore authorise £X billion, which the Treasury can spend if it wants and in the fashion it wants, and we will finance this tranche of fiscal expenditure with zero interest rate reserves in a permanent fashion".

That was what Bernanke, Fischer and Hildebrand proposed. Again, you have a perfect and clear separation between the decision of a monetary policy committee to use an instrument to bring it closer to the defined inflation target and the total amount of money spent by the fiscal authority—that may be many more times this particular slice, which is money financed—which is also deciding the precise form of that expenditure.

I do not think that there is a problem here. It is absolutely possible to enable us to have the degrees of flexibility that we want in the use of these instruments while preserving the appropriate roles of the fiscal and monetary authorities.

Lord Skidelsky: Charles, do you agree that we have this degree of clarity in the respective roles of the Bank and the Treasury that Adair Turner has described?

Charles Goodhart: I think that at the moment Adair is right, but I would add two points. First, in a fundamentally disinflationary context fiscal and monetary policies will always go hand in hand. Central bankers and Ministers of finance have been best buddies for decades. The problems arise when the situation shifts and you get into an inflationary setting and Ministers of finance and central bankers, each pursuing differing objectives, find that they come into more conflict.

The other point I will make is that the lags in the operation of fiscal policy, particularly the inside lag that Ken Rogoff was talking about—problems in getting Congress to act and all of that—mean that you can act much quicker with monetary policy than fiscal policy. You will remember Obama's complaint that there were no shovel-ready projects ready to go when he wanted to undertake fiscal expansion. Inevitably, the contracyclical policy of choice tends to be more monetary than fiscal because you can operate it quicker. One of the problems about the Biden stimulus is that it is likely to have its major effects just when the US is growing at its very fastest.

Lord Skidelsky: Do you agree that you will never have shovel-ready projects if you do not prepare them?

Charles Goodhart: You are absolutely correct, but that is another issue. It would be a very good idea if Governments around the world did have shovel-ready projects at hand for use under such circumstances, but I am afraid that is the exception rather than the norm.

Q99 **Lord Monks:** I have a question for Adair. When we were talking about the quantitative easing policies of the Bank, you said that there was a role for it in purchasing corporate bonds. Casting your mind back to your days at the CBI, how would you distinguish between which bonds could be bought and which could not, and how would you deal with the politics of all that in the Bank, making decisions about who is a worthy recipient and who should be turned down?

Lord Turner of Ecchinswell: That was why I said I was cautious about the idea of a large role for corporate bond purchase within QE operations. I think that the vast majority of QE operations ought to operate through the neutral instrument of the purchase of gilts, the impact on the gilt rate and the indirect impact, therefore, on all corporate yields at a spread above the gilt rate, and only in exceptional circumstances should one focus on the direct purchase of corporate bonds with the intent of reducing the spreads above gilt rates.

That is precisely because I am very wary of getting the Bank of England into microlevel allocations between different companies. I think that those corporate bond purchase schemes should not be a normal part of a QE operation. They may need to be in extremes, but I do not think that we are in that extreme now. If you go back to 2008-09, we had various bond rates and spreads going to incredibly high levels. I think that in those environments it is possible for the central bank to say, “We think that because of some dislocation in the market, some mispricing, some illiquidity crisis, the spreads are generally too high”. I think that in those circumstances it can buy corporate bonds, but it will be well advised to buy as broad and diversified a portfolio as possible, precisely to avoid the problem of being seen to choose between one and the other.

Broadly speaking, I am wary of making either corporate bonds or equities a significant or, in the case of equities, at all a part of a QE operation, because a central bank ought to stick to interventions in aggregate quantities that affect the generalised rate of money GDP, rather than the micro-allocation of credit between different agents.

The Chair: That is clear. Charles Goodhart, do you want to comment?

Charles Goodhart: I have nothing to add.

Q100 **Lord Livingston of Parkhead:** My question is related in a way to the previous one. I refer to the widening of the Bank’s remit that the Chancellor announced recently regarding climate and sustainability. First, do you think that is a good idea? Secondly, if you are to widen it, would you add any other areas to that list, albeit only if you think it is a good idea at all?

Charles Goodhart: I think that there is a role for a central bank in so far as the measures to deal with climate change might move sufficiently fast to cause financial instability in some areas. Because of its financial stability remit, I think that there is a role, but I would not go further than that.

Lord Turner of Ecchinswell: I think that any role of central banks in relation to climate change is very secondary to the fiscal and regulatory authorities. The way we will deal with climate change is by things such as carbon taxes, bans on the purchase of internal combustion engines and direct subsidies to help people insulate their homes better. Those are all much more powerful and direct instruments. I would not like to see in the corporate bond portfolio a lot of playing around and saying, “I am going to buy the corporate bonds of this renewable energy company and not that”.

Somewhat in line with Charles, I am still happy that there is a climate and environmental sustainability objective, because this is such a huge potential crisis that it is good to have all organs of the state paying some attention to it, but the focus where they operationalise that should be in the overlap, as Charles said, in relation to financial stability and the choices major banks have to make about how to make their lending compatible with net zero. As you will know, most of our major banks and asset managers are now making statements saying that they wish to be net-zero companies by 2050. All of them are trying to work out what to do to achieve that. If within the processes of the financial stability side of the bank—the PRI side—and the choices on capital ratio regulation, et cetera, there are things that the bank can do to enable it to meet those objectives without in any way interfering with the primary objective of financial stability, we can imagine the use of some instruments, but I think that we will see it primarily operationalised with things that the PRA does rather than the MPC does. I can imagine some useful ways it could provide support there.

Where it does usefully loop back to Charles's issue about financial stability is that it really is true that, if banks go on lending to coal companies, they may end up with stranded assets on which they will make a loss. That will be bad for their capital ratio. I think that it is reasonable for the PRA to set higher capital ratios for anybody who is still lending to coal.

Lord Livingston of Parkhead: To summarise it for the purpose of our inquiry, they should, but it is not really a QE instrument; it is a PRA instrument.

Lord Turner of Ecchinswell: It is a PRA instrument, not a QE instrument.

The Chair: That concludes this session. I thank Charles Goodhart and Lord Turner for their very considered answers, which will be very helpful to the Committee. We are extremely grateful to you for taking the time to be with us.