Written evidence submitted by Andre Clark

As someone whose been banging on from both inside and outside the tent about the supply side for many years, can I just make a plea for any quantitative tightening policies to take into account the following implications on productivity as I fear that these may otherwise be overlooked given that the relationship between this and deliberate quantitative tightening is a relatively poorly researched area, (relative to the demand side and issue to do with the effects of money on broad aggregates, including total output). That the effect of tightening money on productivity should not be overlooked is made more pertinent by the fact that in the UK we do have a pre-existing problem with productivity both in terms of historical comparisons and in comparison to some of our key international competitors.

The arguemnts on the effect of tightening on demand are horrendously complex, but well researched by -amongst others- Bank of England staff and I think that in what follows part of my motivation in keeping it simple is to cut through as I expect that you are probably already overloaded with theory and I also don't want to come across as challenging the primacy of the demand effects in this debate. The other element in my motivation is that having just completed a paper on the Weimar Republic and its money supply travails I was struck by two things. The first was how significant the output and productivity problems were in determining the ultimate effect of the monetary measures that were tried and, secondly, how well their monetary tightening worked in the end, which we might see as something of a triumph had we not already just acknowledged the significance of the supply side in this and were we not aware that the following years of strong non-inflationary growth would not save the Republic from the Great Depression or the subsequent rise of Fascism.

My reflection on this leads me now to suggest that the supply side of the real economy be likewise recognised in formulating policy today by at least factoring in some consideration of the productivity effects too. Ideally, I think it would be worth tasking a Bank of England economist to spend some time considering whether some of what follows can be added into the (largely demand orientated) macro econometric modelling used by the Bank, since without it I feel that supply side effects will tend to get overlooked again.

A limitation of what follows is that since such formal modelling has yet to be done some of what follows is speculative, although I have cited a bit of research where I can and there is, therefore, a reference list at the end of this document. Similarly, since the scaling of the effects listed below is unclear there is no order to the list, except that I've left what I consider to be the vaguer more general points until the end.

1. It seems rather obvious that money tightening can lead to lower investment, and since the UK housing market is highly dependent on mortgages, and large amounts of consumer spending are on borrowed money, the effect on demand can be huge, particularly if asset prices start decreasing, since there is a negative wealth effect to add into the mix. On the supply side things can go the other way, however, as the Bank of England itself reported in 2018 (Bunn *et al*) found Quantitative Easing to have had a negative effect on productivity as companies had to divert free funds into pension schemes as returns on bonds and 'cash' fell. It seems at least possible, therefore, that this diversion of money away from more productive investments will ease as tightening occurs, although whether this creates an incentive of sufficient magnitude in practice to draw funds in a noticeably more productive direction is an empirical issue.

2. Monetary tightening may reduce the rate of substitution of capital for labour, although it would be hard to distinguish this empirically from the effect of lower wage growth that may also result from the general anti-inflationary policy stance and the effect on long run total factor productivity is unclear.

3. For similar reasons companies may start using inputs more intensively, which would lead to higher productivity, although with the caveat that this can become too much of a burden on labour and reduce productivity at some point (Pencavel, 2021).

4. Lower productivity workers may tend to be pushed out, as might Zombie firms, unable to carry on without the support of Quantitative Easing, which might increase productivity in the long run as resources get allocated to better purposes, but which in the short run can destroy both human and physical capital.

5. Uncertainty affects stock markets and although traders are used to volatility recent events show that (as Liz Truss found), any withdrawal of liquidity from markets can easily trigger a crisis, which in turn affects both demand and supply sides of the real economy.

All of this is complicated by the fact that some of the drivers of productivity such as innovation are hard to predict and diffuse throughout the economy slowly and patchily. It should also be noted that while some effects (particularly on the demand side) are simply reversals of observations regarding Quantitative Easing on the growth and productivity side it would be a mistake to think that there are many simple symmetries here. For example while QE might have underpinned the continued existence of Zombie firms, even if tightening does no more than simply fail to continue such support any such symmetry is broken by the difference in timings since the negative effects are immediate, while the positive reallocation effects are not. Plus it is possible that many Zombie firms would attempt to cling on through overworking which may push productivity either way in the figures (Pencavel, 2021).

Many studies show that what does most damage in economics is uncertainty and unanticipated changes have been found to be the worst thing when it comes to money supply changes too (Peery Cover, 1992) and it is my hope that a better appreciation of the points made above will help reduce this in the case of monetary tightening now.

References.

Bunn, P., Mizen, P and P. Smietanka, (2018) ‘Growing Pension Deficits and the Expenditure Decisions of UK Companies.’ Bank of England Working Paper No. 714.

Pencavel, J. (2021) ‘Hours, Employment, and Earnings of American Manufacturing Workers from the 19th to the 21st Centuries.’ *Economica* 88 (351), pp. 601-623.

Peery Cover, J. (1992) ‘Asymmetric Effects of Positive and Negative Money-Supply Shocks, The Quarterly Journal of Economics,’ 107 (4), pp. 1261–1282.

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