PROFESSOR DAVID MCMILLAN – WRITTEN EVIDENCE (QEI0006)

QUANTITATIVE EASING INQUIRY

1. My name is David McMillan, I am a Professor of Finance at the University of Stirling. This evidence is submitted given concerns that current QE may have on the future course of the UK economy, its impact on inflation and whether the Bank of England Monetary Policy Committee should alter its inflation targeting interest rate setting behaviour to ensure continue growth.

2. As the Committee is conducting a wide-ranging enquiry, this evidence, in a desire to be concise, focuses upon only part of this, notably issues concerning the success of QE (and the ways it can be measured) and the potential effects on future inflation. These points do also lead to issues around the future of the Bank of England, its mandate and operational independence.

3. As a brief overview. QE, as initially introduced in 2009 and subsequently repeated in 2012 and 2016, was partially successful overall. Notably, QE ensured the recapitalisation of the banking sector, but had a muted effect on macroeconomic conditions (both in regard of increasing growth and reducing long-term interest rates). The current round of QE differs from previous ones and directly injects money into the economy. While inflation will remain low in the immediate period, there is a reasonable likelihood that the Bank of England (monetary policy committee) may be confronted with the prospect (over the next 2/3-year period) of interest rate increases to keep inflation within its target range, while overall economic growth remains historically low. There may be a need to relax the inflation target to ensure continued recovery.

4. The original purpose of QE (in 2009) was to recapitalise the banking sector and to prevent a severe depression. Bank liquidity was low, the interbank market had ceased to function, and banks were withholding loans to the private sector. This would lead to a deflationary spiral and substantial increases in unemployment resulting from declining economic activity, with all the attendant societal problems that would result.

5. In recapitalising the banks through QE, this would have two additional effects. First, akin to more traditional open market operations (which target short-term interest rates), through the purchase on longer-dated Treasury bonds, long-term interest rates would be reduced. Second, as bank liquidity eased, there would be an increase in lending to the private sector and an increase in economic growth. The extent to which QE was successful is not clear. At a basic level, banks were recapitalised and there were no large-scale banks failures. But whether long-term interest rates declined, and whether money reached the private sector to improve economic conditions is less clear. Long-term interest rates were in secular decline (globally) since the highs of the early 1980s (and a small peak in 1990). The decline had levelled off in the 2000s with an average rate of approx. 4.8% between 2000-2007. This compares to an average rate of approx. 3.1% between 2009-2012 and 2.2% between 2009-2019. Thus, long-term rates declined. However, they did not decline as much as they should done given that short-term rates were near zero. The difference (term structure) between 10-year Treasury bonds and 3-month Treasury bills was approx. 0.17 between 2000-2007 and 2.62 between

2009-2012 and 1.79 between 2009-2019. Thus, the spread between short- and long-term rates increased over the QE period. The effect being that the cost of long-term borrowing remained high, which means less long-term borrowing (and capital investment) by firms as well as less household borrowing than might have otherwise occurred. A simple illustration of this is through the GDP annual growth figures, which averaged 2.8% in the period 2000-2007 and subsequently 0.15% over 2009-2012 and 1.28% over 2009-2019. Thus, QE prevented the worse possible outcome of the financial crisis but did not foster a recovery and leaves open the question of whether any alternatives may have led to the same outcome.

6. Subsequent to the QE of 2009, it has been repeated in 2012 and 2016. While the purpose of these QE events is less clear cut in terms of bank liquidity, an argument can be made that they ensured confidence within the banking system and functioning of the interbank market.

7. A recurring question is whether the increase in money injected into the economy is inflationary. Inflation between 2000-2007 averaged 1.7% and then 2.7% and 2.1% over the periods 2009-2012 and 2009-2019 respectively. Within the context of an inflation target of 2% and historical average rates of over 6% in the 1980s and approx. 3.5% in the 1990s, the inflation rates that have followed QE periods have been muted.

8. However, the question is whether the current round of QE will also have the same muted influence. The current round of QE differs from previous. In the current QE programme, there is no requirement to recapitalise banks, which are well provisioned. The current QE money is instead directly entering the economy. This can be seen in the trajectory of monetary aggregates. The time series plot of the UK monetary base reveals the QE injections. Over the year 2009, the UK monetary based increased annually by approx. 7.7%. In other QE years this was approx. 4.5% (2012) and 9% (2016). In 2020, this figure is again approx. 9% and with double-digit figures for the year between early 2020 and 2021. Thus, there has been a substantial increase in the UK monetary base. We can then compare this figure to other monetary measures that indicate whether the QE related monetary injections reach the economy. Over the year 2009, M4 increased by approx. 5.4%, for 5.3% for 2012 and 3% for 2016. In contrast, the value for 2020 is approx. 13.4%. A similar effect can be seen in other monetary aggregates for the UK. Thus, there is clear evidence that the current QE injections are entering the wider economy, rather than being absorbed by banks. This is a clear distinction from previous QE periods.

9. Of course, while there are varying schools of economic thought, money supply by itself does not lead to higher inflation. The money needs to be spent and so the velocity of circulation can be considered. The period of lockdown has led to lower spending and the velocity has fallen. Moreover, throughout the period of QE, beginning in 2009, the velocity of circulations has fallen almost continuously. The ratio of Nominal GDP to broad money (M4) has moved from an approx. average of 1.7 over the period 2000-2007 to 1.3 over the 2009-2019 period and now at or even below 1. This suggests a historically low level of velocity and whereby an increase in the circulation of the additional QE money is likely to become inflationary. Against, this there are deflationary factors, this includes an aging population, technological advancement and falling commodity prices. Equally, uncertainty of employment results in consumers deferring expenditure, with UK (Gfk survey) consumer confidence in the -20 territory for almost the whole

of 2020 (the Deloitte measure is at -17%). This means that demand is low, and wile confidence is likely to only return slowly, it would be expected to return over the next 2 years. Thus, there is pent up demand and deferred consumption that will ultimately lead to an increase in spending and when combined with the injection of money into the economy, can be inflationary.

10. It should also be noted that while real pay inevitably fell during the majority of 2020 following repeated lockdowns, it has picked up to end the year 2.8% higher than the previous year. Again, this suggests the potential for repressed demand that could lead to future inflation. On the supply side, while lockdown has inevitably meant a lower supply of goods, it might be expected that the ending of lockdown should allow manufacturing etc to return to pre-covid levels. UK manufacturing PMI (purchasing managers index) remains above 50 (above 50 indicates future growth and below 50 indicates a contraction) suggesting confidence in regard of future output levels. However, service PMI is currently below 40 and has been below 50 for the past three months. Equally, the composite PMI is currently approx. 40. This suggests an overall contraction is UK output and a negative output shock going forward could be combined with an increase (previously pent up) demand.

11. The initial QE was designed to prevent a severe economic recession (and potentially a depression) and while it achieved this, it also failed to significantly lower long-term interest rates and increase GDP growth. Initial QE money went to recapitalise the banking sector and did not trickle into the wider economy. 2020 QE is different with more direct monetary funding into the economy. Current inflation is low, largely a result of low demand. Consumer confidence is low, money is circulating around the economy (velocity of circulate) slowly. However, real wages are increasing, confidence and spending is likely to significantly increase with the vaccination programme and the phased opening of the economy. Meanwhile, supply may not recover as quickly, with confidence low (and this is without considering Brexit related supply interruptions), leading to a recovery in demand before supply and rising inflation.

12. There is a realistic possibility that inflation over the next two/three years could present a test to the Bank of England Monetary Policy Committee (MPC) by pushing above the 2% target rate. As such the MPC may need to make a decision regarding interest rates and to increase rates in order to meet the 2% target, while general economic recovery from the covid related downturn may still be muted. The higher inflation could require tighter monetary policy, putting it odds with fiscal policy, which may remain looser. This could test the resolve and independence of the Bank of England.

13. Given the potential for higher inflation, while economic recovery is ongoing, as recovery in demand may outstrip supply. The Bank of England may need to relax its inflation target or combine it with an output (or employment) target to ensure interest rate rises do not cut off a nascent economic recovery. Noting the recent announcement of the US Federal Reserve in allowing or tolerating inflation to (moderately) exceed its 2% target for a period of time, this may serve as a potential steer.

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