FRANCES COPPOLA – WRITTEN EVIDENCE (QEI0010)

QUANTITATIVE EASING INQUIRY

<u>Author's credentials</u>

I am the author of "The Case for People's Quantitative Easing", published by Polity Books in 2019 and currently available in the UK, Europe, the United States and Korea. This was Bloomberg's Book of the Month in September 2019, and featured on Martin Wolf's Summer Reading List at the Financial Times. My book reviews in detail the way in which QE has been conducted worldwide since the financial crisis and discusses its economic effects. It proposes an extension to current QE programmes which would direct money more explicitly into the real economy.

I also run the Coppola Comment financial blog, which has covered QE extensively over the course of ten years and hosts a widely-referenced discussion site about QE called "The QE Debate". My writing on financial and economic matters has featured in a wide range of publications including the Financial Times, Forbes magazine, The Economist, Open Democracy and CapX. I present frequently at conferences and workshops on central banking, finance and economics, and am a commentator for various media outlets including the BBC.

Perception of QE has been clouded by misunderstandings over a long time now. My objective in writing my blog and my book was to correct these misunderstandings as far as I could, and try to establish a clear view of QE's strengths and its problems, so that improvements can be made and, even, better tools identified. QE can perhaps be summarised as an effective tool for arresting a deflationary collapse, but an extremely weak economic stimulus with unfortunate distributional effects. It has been much over-used in the course of the last decade, largely in my view because of unwarranted fears about the effects of more direct central bank intervention in the economy. There is a desperate need to widen the range of tools available to central banks, as I have outlined in my book. And there is also a desperate need to recognise the limits of central bank responsibility and restore to fiscal authorities their primary responsibility for ensuring the wellbeing of their populations. This is why I have contributed this evidence to their Lordships' debate.

My comments below stem from the extensive research into QE that I have necessarily done over the last decade, and follow the structure outlined in the Call for Evidence.

<u>Governance and accountability</u>

1. **Has the expansion of the Bank of England's Quantitative Easing programme undermined the independence of the Bank, or the perception of its independence? What are the implications of this?**

1.1 The original QE programme that commenced in March 2009 was widely seen as the Bank's decision even though it was backstopped by the Treasury. However, subsequent rounds of QE have been perceived as much more politically-driven. For example, in his Mansion House speech of June 2013, the then Chancellor, George Osborne, gave a public direction to the incoming Governor, Mark Carney, that he was to pursue an "active monetary policy to support demand and help keep lending rates low."[1] The short round of QE that started in August 2016 was criticised by pro-Brexit politicians as being driven by anti-Brexit sentiment at the Bank.[2]

1.2 There remains considerable public anger about the Bank's support for banks and financial institutions in the 2008 crisis. The Bank's efforts to explain its actions have so far proved largely ineffective.

1.3 The behaviour of some Members of Parliament after the Brexit vote was in my view irresponsible and has caused significant damage to public perception of the Bank's independence.

1.4 As a result, trust in the Bank of England as an independent, neutral operator has been considerably eroded over the last decade. The Government and the Bank now need to act to reinforce the Bank's operational independence from the political process.

2. **How well has the Bank of England communicated its decisions on Quantitative Easing? Is the programme transparent enough?**

2.1 QE is widely misunderstood. Many people perceive it as some form of bank bailout, and are angry that banks haven't "lent out" this money. The Bank has overseen important academic work into the way banks work and the reasons why banks don't "lend out" QE money, but has failed to inform the public effectively about how QE works.

2.2 Particularly since the pandemic, public perception of Bank of England bond-buying is increasingly that it is financing the government's growing deficit. The Bank has done little to dispel this impression.

2.3 The Bank's efforts to communicate the reality of QE to the public are seriously hampered by persistent media misrepresentation of QE as "money printing", often accompanied by references to the Weimar Republic and Venezuela.

3. **Should the Bank of England's mandate be altered?**

3.1 There are good arguments for altering the Bank of England's mandate to ensure that it takes climate change issues into account in the design of its LSAP programmes. LSAPs that include corporate bonds have been tilted towards companies with dubious environmental credentials, including companies that extract, process and distribute fossil fuels. As the government has committed to

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[1] https://www.gov.uk/government/speeches/speech-by-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-mansion-house-2013

[2] https://www.bloomberg.com/news/articles/2016-09-06/carney-s-brexit-tormentor-says-boe-acted-too-early-on-rates?sref=3roVJZZ4

achieving net zero carbon emissions by 2050, for the Bank of England to openly support fossil fuel companies through its LSAPs would seem to place it unnecessarily at odds with the government. Of course, the Bank of England needs to have freedom to conduct monetary policy as it sees fit, but since there are green alternatives to fossil fuel assets, purchasing fossil fuel assets need not have any place in monetary policy. The argument that the Bank of England is limiting its credit risk by buying these assets will not stand, since the government ultimately backstops any losses that the Bank of England suffers from QE.

3.2 There is a case for adding an unemployment or underemployment target to the Bank of England's mandate, similar to that of the Federal Reserve, or replacing the inflation target with an NGDP target. The principle behind a single inflation-targeting mandate is that the Phillips Curve trade-off between inflation and unemployment ensures that targeting inflation keeps unemployment at its optimal level for price stability. But it is no longer clear that the Phillips Curve relationship holds in any meaningful way, while output gaps have been significant and stubborn. The Bank may therefore do better to target the output gap rather than inflation.

3.4 Some have proposed that the Bank of England should target productivity. I do not think this is wise, since productivity is hard to measure and to some degree residual.

3.4 Others have proposed that the Bank of England should be required to direct credit into particular parts of the economy in accordance with the Government's industrial policy. For me this would unacceptably compromise both the Bank's independence and the politically neutral nature of monetary policy. Monetary policy is not neutral in its effects, but there is an important difference between monetary policy that is intended to lift all boats but lifts some more than others, and monetary policy that intentionally only lifts certain boats as decided by the political authority. I believe this difference should be respected. In my view explicitly supporting particular sectors of the economy is the job of the fiscal authority, not the central bank.

Effects of QE

4. How should Quantitative Easing be defined?

4.1 QE is an asset swap. It exchanges longer-dated financial assets for money. The idea is that those who exchange their assets for money will spend that money, either on goods and services or, more likely, on riskier assets. The effect of this is to depress the yields on assets and hence, since yield is the inverse of price, raise their price.

5. What were the original objectives of Quantitative Easing and have they changed?

5.1 QE has always been intended to depress market interest rates below the effective lower bound on the policy rate. The Bank has resisted cutting Bank Rate below zero, firstly because zero-yielding physical cash is an alternative to bank deposits, and secondly because the effect of negative rates on the economy is untested and unpredictable. So, at the lower bound, the Bank of England uses LSAPs to depress market interest rates and influence the shape of the yield curve.

5.2 The idea was that depressing market interest rates below the policy rate would reduce the cost of finance for corporations, encouraging them to invest and hire, thus bringing down unemployment and increasing GDP.

5.3. Raising asset prices was also thought to encourage spending by asset holders through wealth effects. If people feel richer, they will spend more.

5.4 It was also originally thought that QE would stimulate bank lending by providing banks with copious quantities of reserves, and this remains public perception of the principal purpose of QE. However, the MPC of March 2009 said that this effect would be weak after the financial crisis.[3]

5.5 The ultimate objective of QE was, and remains, to raise inflation back to the Bank of England's target.

6. Has Quantitative Easing been successful and how should success be measured?

6.1 Measuring QE's success is problematic, because we have to measure it in relation to what "would have happened" without it. Counterfactual analysis of the whole economy is inevitably imprecise and subjective. Unsurprisingly, the Bank of England's research shows that QE was successful, while critics of QE equally show that it was not.

6.2. My view is that QE is effective at preventing disastrous debt deflationary spirals such as that in the early 1930s, but is ineffective at kickstarting growth, particularly when there is active fiscal consolidation. It also has unfortunate negative externalities.

6.3 The different rounds of QE have had different effects. By supporting asset prices, the first round of QE in 2009 prevented a 1930s-style asset price collapse. However, the second round was largely devoted to offsetting the Chancellor's fiscal consolidation, and the third round was similarly devoted to offsetting the consequences of the UK's decision to leave the EU. The current QE programme is probably alleviating the worst effects of the pandemic slump, but without significant fiscal stimulus, in my view it will not succeed in restoring growth.

7. What trade-offs does the Bank of England's Quantitative Easing programme entail? What effect might it have on inflation?

7.1 QE has been much over-used over the last decade. There was a general expectation that it would by itself, or in conjunction with other Bank of England policy actions, restore growth. It was even expected to offset the disinflationary effect of fiscal consolidation. These expectations were far too high. The reality is that QE is a weak stimulus: the Bank has to do an awful lot to have much effect

[3] https://www.bankofengland.co.uk/-/media/boe/files/minutes/2009/minutes-march-2009.pdf

on the economy, and any beneficial effect is largely negated by sustained fiscal austerity.

7.2 However, QE has been shown to reduce unemployment and raise wages relative to the counterfactual.[4] The principal trade-off involved is thus that the reduction in unemployment and increase in wages justifies the asset price increases that widen wealth inequality.

7.3 The ultimate objective of QE is to raise inflation to the Bank of England's target. The evidence of the last decade is that in this, it has not been wholly successful. Inflation expectations rise when QE is announced, but fall back when it is ended. The underlying disinflationary trend that has been in evidence since the mid-1990s remains unaffected. There is no reason to suppose that the current round of QE is likely to reverse this trend.

8. What have been its distributional effects?

8.1 QE intentionally raises asset prices. As assets are disproportionately held by the wealthy, this increases wealth inequality. When QE is sustained over a long period of time, as it has been, it also increases intergenerational inequality, since older people benefit from asset price increases while young people are priced out. This is particularly unfortunate when the assets in question are houses: not only are young people priced out of property purchases, but they also face higher rents, because rents relate to house prices.

8.2 On global markets, the QE money that went into commodities raised the world prices of oil and essential foodstuffs to the detriment of developing countries. The Arab Spring is thought to have been triggered by rising food prices in the Middle East.[5]

9. How does the Bank of England's Quantitative Easing programme compare to other programmes internationally?

9.1 The Bank of England's QE is of moderate scale compared to other countries, both in absolute terms and relative to the size of the economy.

9.2 The Bank of England has been innovative in its approach to QE. It recognised earlier than any other central bank that the bank lending channel didn't work, and therefore targeted purchases at investors rather than banks. It also experimented with other tools, for example the Funding for Lending scheme which eased collateral pressures caused by government bond LSAPs.

Future of QE

10. Could the expansion of Quantitative Easing in the UK create the possibility of economic stability being undermined in the future? If so, how?

10.1 The evidence from Japan is that QE can be done in very large amounts without threatening either financial or economic stability.

[4] https://www.resolutionfoundation.org/publications/quantitative-displeasing/
[5] https://www.theguardian.com/business/2011/jun/29/how-world-paid-hidden-cost-america-quantitative-easing

10.2 However, if markets perceived that the Bank of England was effectively monetising the government deficit on anything more than a very short-term basis, there would be a risk of a run on sterling, potentially triggering out-of-control inflation and widespread economic distress.

11. What evidence is there for any upper limits to the Bank of England's Quantitative Easing programme?

11.1 External evidence suggests that the effective limit to the Bank of England's QE programme is the availability of assets for purchase. For example, the ECB's QE is hampered by limited supply of German government bonds.

11.2 Bonds issued by governments in good standing such as the UK government are important safe assets in financial markets, being used as collateral and portfolio hedges. If their supply is reduced too much, there is a risk to financial stability.

11.3 The Bank can relieve supply pressures in government bond markets by buying longer-term bonds. However, this is also potentially risky for financial stability, since it flattens the yield curve, making it difficult for banks to earn money from maturity transformation and therefore threatening their profitability.

11.4 The Bank could do more corporate LSAPs, but this is a potential cost to taxpayers since the Bank would be taking credit risk backstopped by the Treasury. Also, as already noted, corporate LSAPs involve the Bank making decisions about which sorts of corporation to support. More corporate LSAPs should in my view be ruled out unless climate change is explicitly included in the Bank's mandate.

11.5 The Japanese central bank also buys stocks. In large quantities this amounts to creeping nationalisation and therefore threatens the capitalist free-market model of Western economies. As with corporate LSAPs, it also involves the Bank deciding which companies to support and taking balance sheet risk at a potential cost to taxpayers. I do not think the Bank should go down this road. Taxpayers taking stakes in companies, whether directly or indirectly, should be subject to democratic agreement via the ballot box.

11.6 The size of QE is also limited by the behaviour of inflation. Since the purpose of QE is to raise inflation, once inflation is rising towards target there will be no reason to continue QE.

12. Will Quantitative Easing be unwound in full, and if so how? Is it likely that the Bank of England's balance sheet will be permanently, and structurally, larger going forwards?

12.1 Because the excess reserves created by QE have existed for over a decade, the financial system has now adapted to them. Furthermore, regulatory requirements imposed on banks presuppose a reserve-rich environment. The repo market disruptions in September 2019 revealed just how dependent financial markets have become on larger central bank balance sheets.[6]

[6] https://www.coppolacomment.com/2019/12/the-blind-federal-reserve.html

Significantly reducing bank reserves would threaten the Bank's financial stability mandate. It is therefore unlikely that QE will ever be unwound in full. The Bank of England's balance sheet will remain considerably larger than it was before the 2008 crisis.

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