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QUANTITATIVE EASING INQUIRY

Quantitative Easing Re-examined: Devising a Holistic Accountability Framework to fit the Unfathomable Issue of Monetary Policy Independence in a New Crisis Era of Lower for Longer / Quasi-permanent Q.E.

I am glad to have the opportunity to contribute to what may well be the most significant macro-economic question of this time. This mini-paper will take the form of a discussion document to hopefully shed some light on what is at once a deeply technical, incomplete and politically divisive matter – yet one which very much influences society, politics and prosperity at the same time.

The well-worn Bernanke quote about Q.E. and how it works in practice but not on paper, remains salient in a contemporary context. Central banks intervening in financial markets is nothing new and represents one of their core duties in a standardised inflation-targetting world now present for some thirty years. Factor in the advent of political independence, hard-won as it was – and we realise that large-scale bond-buying became almost inevitable in the aftermath of serious, existential crises.

Now, old friends of mine from my LSE FMG days Goodhart and Lastra have very eloquently described some of the problem areas of Q.E. in terms of 3 D's – distributional, directional, duration effects[1].

To this I shall add my very own personal D – Distortionary. The main difficulty I have with the practice of Q.E. as currently constituted in mature economies from the US to the UK to the Euro Area, is that it ought to be viewed merely as a complement to a range of measures and <u>expressly not</u> as a magic wand capable of righting all market disturbances good, bad or indifferent. In other words, it must be time-limited, specific, deployed with ultimate prudence – and subject to rigorous real-time and ex-post review. Notwithstanding the fairly well-proven evidence to suggest that it appears to offset disinflationary trends and prevent interest rate overshooting – in other words it does exactly what it says on the tin – we remain ignorant as to the scale and breadth of the distortions it creates. So, this segues neatly into the first key observation I would make – our lack of complete knowledge on the effects of Q.E., on the financial system, on economic agents, on markets and capital allocation / investment.

Now I am aware that the Bank of England is monitoring just these sorts of issues and that is a welcome development for sure. Any robust empirical data, together with more macro-financial findings is as worthy as it is necessary. As far as I am concerned I will focus now on what I perceive to be the main relevant components of distortion that we ought to be considering more fully in any

[1] 'Populism and Central Bank Independence', Charles Goodhart & Rosa Lastra, Published online: 26 September 2017

informed discussion of the merits / demerits of quantitative easing, before moving onto remedies further on in this essay.

Distortions / Unintended Consequences

If you want to see a very current example of why Q.E. is not quite the saviour that some would have us believe, there was a recent announcement by Nat West Group to close off a subsidiary based in Ireland and active here since the 1860s. Whilst the official corporate reasons are several – cost savings, profit squeeze and inefficient use of parent capital, the inconvenient truth is that traditional banking is being hammered out of existence because of artificially low central banks interest rates together with addictive Q.E. doses. Now, truth be told there is a vast separate debate to be had on bank regulation, supervision and economic growth and the role of central banks such as the BoE in same – however this is clearly not the stage to do so.

Suffice to say that the existing monetary stance – even pre-covid – is responsible for creating conditions whereby banking ceases to be profitable. One only has to glance to the Euro Area to see that mid-sized players are being, well, crucified by the ECB. With rates at the lower bound and forecast to go negative in some quarters, this situation will only worsen in the near-term.

There are an accompanying array of inter-related micro- and indeed macro-economic woes around savings, pensions, asset allocation and financial markets themselves. A very brief mention here would have to postulate the pretty well-accepted position that there are several losers as well as winners from a welfare point of view. Savers, people with defined contribution pensions, younger folk wishing to acquire their first property are all adversely affected by the embedded, low Bank Rate and ongoing round after round of Q.E. This tendency has to be front and centre of policymakers' minds because it is absolutely disastrous for economic integration, not to mention political fragmentation / social unrest.

Be that as it may, the chief macro-economic distortion in my eyes is the indivisible connect between industrial-size bond-buying and the signalling effect this has at the central exchequer level on fiscal discipline over the medium to long-term horizon.

Fiscal Sub-optimisation

Why be prudent when you can borrow at historically-low rates to maintain or at least smooth out the business cycle? What elected politician could possibly refuse!

Due to the heavy-handed nature of the Q.E. programmes allied to the indefensibly-low rates or Lower for Longer, in the vernacular, bond yields are miniscule hence bond prices are trading at rather high levels. The rush of central bank money into gilts, sovereign debt and to a lesser extent corporate debt creates ideal conditions for an overheated market to take hold. How about a bond bubble next to the stock market over-valuations? And that's not forgetting the

impacts on foreign exchange markets, which is much too complex to detail here, yet deserves a quick word in the scheme of things.

Generally, the monetary transmission channel on sovereign debt is very direct, potent and easily measurable. Since Q.E. is now a consensus activity, markets anticipate and have re-priced risks accordingly. Governments can borrow at alarmingly low rates which pushes up the national debt and gives a false sense of security to all participants. Have we still not learned our ABC of financial market crashes, I wonder[2].

There is yet an additional layer of complexity – and relevance – here because we can establish an indirect opportunity cost *via* the fiscal expediency of central governments who may become accustomed to a stream of cheap largesse made available to them. This is a 'social bad' because it involves wildly incompatible budgetary incentives with respect to excess liquidity and easy monetary re-financing conditions. In other words, *in extremis* national governments can lose perspective on the standard mid-term revenue / expenditure model and may be tempted to act more recklessly. Fortunately, the UK along with several other mature economies has an independent fiscal oversight body prepared to issue warnings; nevertheless, the fact that the central bank is buying government debt at a steady rate, does slightly compromise the spirit of the term 'independence' and could perhaps lead to sub-optimum outcomes down the road between the central bank and government, either during crisis times or just as imaginable, whilst withdrawing stimulus.

Diagnosis-Outlook-Remedies

Now, I know there are some esteemed commentators on the other side of the Atlantic – such as Blanchard, *inter alias*, who contend that this is a new paradigm and that governments do not need to be afraid and are right to borrow and spend in the present circumstances. And I do get that point; indeed, I would do likewise were the choice mine to make, with some caveats, I hasten to add.

My main gripe then is with the period *after the financial crisis* and the mistakes in broader framework of monetary policy execution which were made in several jurisdictions – in decreasing scale of culpability starting with the worst offender: Euro Area, UK, US.

Essentially, the crime was leaving rates at *too low* a level for *too long*; for the UK, the decisions around repeat doses of Q.E. after the Brexit vote in 2016, seems like a bridge too far, although the Bank of England's judgment in gradually raising Bank Rate and tolerating a small inflation overshoot middle of last decade was a brave – and correct – thing to do.

The statistics are widely available and show that the extent of bond / gilt ownership among principal central banks including the Bank of England is extremely elevated – at 40% national income. This poses significant risks to these

[2] This handbook 'Manias, Panics, and Crashes: A History of Financial Crises', by Charles P. Kindleberger, has been around quite some time now.

central banks in terms of how they unwind the stimulus measures. For more detail on the UK angle, see the paper by William Allen, NIESR, January 2017. The US Federal Reserve dilemma is well treated by Cavallo, Del Negro, et al. (2019)[3].

Now many amongst us presume that this will all end in an inflationary upswing of some velocity and force – and probably quite soon. I know that Mr Goodhart himself would be of this view from speaking to him and based on what he has written on this aspect also.

There are very good reasons to believe that this might well materialise. And there are some reasons whereby it may not come to pass – or just not in the text-book interpretation of unbridled general price hikes, similar to previous inflationary episodes.

In fact, in some respects, an alternative scenario of persistently low inflation together with deeply embedded low rates could continue indefinitely, if we are unlucky enough in terms of for instance, *inter alias*, the pace of recovery from the health and economic emergency underway. As a yardstick, this corresponds loosely to the secular stagnation debate.

Now if we consider that central bank balance sheets are dangerously over-stretched, financial market discipline is somewhat compromised, earnings growth subdued and economic prospects mediocre at best – at least in overall terms, on global trade perspectives, you might be looking at a situation where the Q.E. card retains its appeal. Therefore, instead of withdrawing the stimulus of continuous monthly investment in government bonds and select corporate debt, it is plausible that this programme might actually be ramped up again – for a sixth time in little over a decade!

Due to the fact that unconventional monetary policy is not all that transparent by its nature, the level of democratic oversight and accountability expected of central bankers fall short. This area is close to my heart as I am preparing advanced studies on same – accountability under present day frameworks with respect to the monetary wing and the executive. Therefore, we are inadvertently creating a climate whereby Q.E. becomes a quasi-permanent feature of monetary policy – which would be an appalling vista.

My controversial bent says that this would be the politico-economic equivalent of a no-deal Brexit, i.e. it must not be allowed to happen under any circumstance. It is commonly accepted that removing the stimulus of Q.E. is the hardest part of the exercise and one only has to recall the trouble the Federal Reserve experienced under Mr Bernanke in the shape of the market "taper tantrum" some years back to get a flavour of what conceivably lies ahead.

Accordingly, we could be nearing the end of the road of the usefulness of Q.E. as it is currently interpreted. That would leave economic experts and policy officials very constrained in terms of how to respond effectively to crises. For every problem there lies a solution and I can see an avenue as follows.

[3] Cavallo M., M. Del Negro, W.S. Frame, J. Grasing, B. A. Malin and C. Rosa (2019), "Fiscal Implications of the Federal Reserve's Balance Sheet Normalization", International Journal of Central Banking December 2019

Although deeply misunderstood and virtually a taboo subject, there is a compelling case to be made to radically alter the goals, delivery and methodology of our standard, beloved Q.E. model.

Cukierman, a renowned authority on central banking going back to his seminal paper 30 years ago on independence which delightfully measured the main rubriques on governance and independence, has written a paper entitled "COVID-19, helicopter money and the fiscal-monetary nexus". This appears in a summarised format on VOX / CEPR[4]. Some refer to these kind of co-ordinated fiscal-monetary programmes as helicopter money; others including Bernanke label them as "Money Financed Fiscal Programs". Irrespective of the terminology used, the main upside to this kind of initiative is that they tend to avoid some of the more odious issues around standard Q.E. which I have spoken of already such as market distortion, wrong incentives and asset / investment bubbles.

Additionally, since the stimulus delivered can be more targeted than conventional Q.E., there is less scope for adverse welfare effects which magnify the gap between the have's and the used-to-be-able-to-afford-housing lot. If we assumed that the overriding goal is to push up consumption and counteract either entrenched disinflation, actual deflation, stagnation – or a combination thereof, then this is policy option *could* have merit.

Practically, it requires great dexterity as there are obvious implications for the Bank, on inflationary aspects as well as operational independence. Would it not be better to get prior approval between the Bank of England and the Finance Ministry that under a limited, pre-defined list of conditions a temporary stop on the independence of the Bank may be sought? This could be intended for rare, extraordinary and emergency measures only, mind. A global pandemic and an anaemic recovery might fit the bill here.

In a paper he wrote a few years ago[5] in his capacity as a member of the MPC at the Bank, Dr Gertjan Vlieghe enunciates how this might work in practice:

" as a credible commitment to pay no interest on reserves, the central bank would have no control over whether reserve market balance is restored via a lot of inflation and a little real growth, or the other way around. Such a policy would therefore also effectively suspend, for a period, the inflation target of the central bank. Suspending both the instrument and the target of the central bank effectively suspends central bank operational independence…"

Essentially, as we try to charter a safe passage through the unprecedented economic collapse precipitated by the pandemic, we will be faced with extremely testing decisions which will call for flexibility and imagination to solve previously unheard of economic challenges. The headline figures on the underlying health of the UK economy make for grim reading – no-one can be under any illusions that this is about to get savagely tough for many small businesses and others at the margins.

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[4] https://voxeu.org/article/quantitative-easing-and-helicopter-money-not-so-distant-cousins
[5] https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/monetary-policy-adapting-to-a-changed-world-speech-by-gertjan-vlieghe.pdf?la=en&hash=C6BBF869444DCE6FE402EFB031869578E4C4BF2F

These hard conversations are going to have to be had at some stage for there are grave dangers ahead and macro-economic safety is everyone's shared objective. The priority is designing monetary stimuli that maximise 'bang for the pound', without imperilling fiscal equilibrium unduly.

Summary / Recommendations

In this short paper, I have attempted to cover a large amount of ground on advanced monetary economics and the political science implications of same. Q.E. arrived on the scene to much fanfare and succeeded in the task which it was granted – alleviating pressure in credit markets and acting both as a robust monetary device as well as a more general counter-cyclical tool to underpin economic stability. So far, so good.

The great tragedy of Q.E. appears, however, to arise in understanding its related externalities on the wider financial community, on 'fiscal discipline' and to a certain extent on independent central banking viewed from the classic inflation-targetry perspective.

A few inescapable conclusions and by extension policy recommendations arise accordingly.

Firstly, the standard theoretical assumptions around Q.E. must be widened to take account of these unsatisfactory distortions. As a blunt instrument, unconventional monetary policy can be an effective remedy for short-term market disturbances but as has been documented in various literatures, it is less beneficial over repeated cycles / longer periods of time.

There also needs to be a more informed debate about the precise nature of the interactions at the lower bound – in other words the sequencing of Q.E. intervention and relationship with Bank Rate, just as much as the removal of the stimulus.

From an all-embracing perspective, it would certainly assist matters were the accountability frameworks to be revised to take into better account the new frameworks we are operating under. The prospect of repeated Q.E. manoeuvres which exacerbate second-round effects whilst not perfectly meeting inflation objectives, is a distinctly unappealing scenarios which must be resisted.

Broadening the argument still further, there are several justifiable concerns vis-à-vis banking sector profitability / risk-taking and macro-financial stability, for the longer-term independence of central banks whilst embarked on massive bond-buying programmes – especially pertinent for those who are charged with prudential supervisory duties as well as monetary mandates. However, the reservations on market dynamics also apply in the well-aired case of excessively low interest rates and their direct impact on banks.

Two further points are salient.

The act of unwinding the various Q.E. programmes and the effect this will have on market participants, as well as the net impact on the government's ability to fund itself adequately in the market, are especially relevant. These are points that ideally ought to be at least framed *ex-ante.* To my mind, it is not exactly evident that this is always the case, judging by the *ad hoc* nature of recent programmes.

Finally, the hoary old chestnut of overt monetary financing – helicopter money – money-financed fiscal programmes does need to be addressed in an honest, transparent and rigorous manner. These issues are among the most politically sensitive questions at any level, so real courage from policy officials and elected representatives are pre-requisites. We talk at great length of the inherent advantages of independence; however renewed emphasis on accountability both at the Bank level as well as the executive, would not go amiss.

About the author

Kevin Newman is an experienced Consultant, Academic and Analyst on EU / Global Financial Regulation and Supervision, with an accompanying long-established track-record from Brussels, Ireland and the UK across finance, policymaking and industry.

As an invited guest of Mr Charles Goodhart, he is actively involved with the London School of Economics 'Financial Markets Group' (FMG) for over ten years, whilst working in a range of areas as a Strategic Advisor, technical expert to the EU Institutions and Researcher on core Retail Banking issues affecting UK and global markets.

His speciality remains examining central bank policy both from a macro-stability perspective – prudential supervision, regulation and resolution, together with the monetary policy transmission mechanism and its interaction with industry and the wider economy.

Currently he is preparing Advanced Research at University College Cork (UCC) on the independence, governance and accountability of central banking – focussing particularly on the institutional design of modern-day central banks *vis-à-vis* central government / fiscal actors and the political economy aspects underpinning same.

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