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QUANTITATIVE EASING INQUIRY

The Covid-19 economic crisis has illustrated several weaknesses in the structure of our monetary and fiscal frameworks. It has increasingly been the case, since the global financial crisis, that monetary, regulatory and fiscal policies have deepened the connection between the balance sheets of the central bank, commercial banks and the government and the response to Covid-19 deepened these connections. And, of course, nothing exemplifies this development more than the introduction, operation, and growth in the reliance on quantitative easing.

Public debt as a fraction of GDP has been ratcheted up over the past decade or so, first by the financial crisis and most recently by the Covid-19 crisis. It is, of course, entirely reasonable for public debt to rise following heightened calls on the public purse. Indeed, in the most recent period, fiscal policy has rightly taken the strain of macroeconomic stabilisation. This is in part because the MPC's cut in Bank Rate to 0.1% and the increase in the planned holdings of the Asset Purchase Facility (APF) to some 40% or more of outstanding public debt may mean that we are approaching the limits of the monetary instruments currently at its disposal. The MPC has, in effect, subject to the constraint of meeting its inflation target, acted to create fiscal space by influencing the costs of public debt issuance. But I argue that action has not carried with it a sufficient explanation of the exit strategy and return to more a normal operating procedure.

The attendant peacetime increase in public debt to some 100% or more of GDP would previously have led to many alarm bells ringing in the orthodox circles of those who support sound money. But funding costs are so low both for structural reasons, which reflect a large pool of global savings and a shortage of high-grade investment assets such as government bonds, as the more proximate cause that central banks are acting to reduce the effective net supply of those bonds. These low funding costs have given us the gift of time to deal with the burgeoning fiscal debt problem but also how to reduce the sensitivities of markets to any planned or announced reversal in QE. That time needs to be better spent.

Under the economic uncertainty we face, a correct response would be to address the gaps in the monetary and fiscal frameworks and provide more clarity on the principles likely to guide future policy, instead we seem to have dropped even the fiscal rules without replacement and monetary policy makers has been silent on the scope for negative interest rates, which may be a substitute for more QE, how and when QE will be reversed and what impact ever larger quantities of holdings by the APF mean for the efficacy of this instrument.

In the absence of addressing the framework, we have tended to focus on conjunctural issues and simple observations about Bank Rate. The national obsession with small movements in Bank Rate has removed focus from more important issues. And as a direct consequence, of this distortion, there has recently been a rather misleading debate about the sensitivity of debt stock to changes in debt funding costs. There are several quite separate aspects to this problem, but they do illustrate the need to work through the monetary-fiscal framework. The first, is that we cannot solely look at changes in funding costs without understanding the cause of those changes. An increase in funding costs related to a rapid return to normal economic activity will not pose anything like the problem that a rapid increase in global interest rates might cause us if our economic cycle did not merit it.

But there would be an even bigger problem if funding costs increased because we were not thought to have a credible monetary-fiscal settlement, as this may involve a loss of the anchor on inflation expectations. Such a loss of anchor may result from market expectations of unfunded debt issuance and some increase in term or risk premia without a corresponding increase in national income. Again, it is the framework that matters under the uncertainty we currently face about our economic prospects. Indeed, without more complete guidance, markets may even begin to expect a reduction in the holdings of public by the APF that may itself trigger increases in risk premia. To some extent we may witnessed that effect in the first half of this year. Perversely without a plan, both increases in debt or expectations of a reduction in debt holdings may either cause a dislocation in bond rates from that implied by Bank Rate alone.

The second is that funding costs do simply not rise immediately in line with Bank Rate. The debt stock has an average maturity of some 15 years, if we place the actions of the APF to one side for the moment. That means any increase in funding costs today only impacts on the small fraction of debt that has to be refinanced (rolled-over) or raised in that year. It is quite misleading to suggest that all debt will face an immediate increase in funding costs following a given change or expected change in Bank Rate. Again, the likely gradual increase in funding costs affords us time to act on developing sources of tax revenues rather than reducing fiscal support measures too rapidly. The actions of the APF would matter less if our revenue bases was more secure.

Thirdly, recall that the APF of the Bank of England looks likely over its lifetime to yield a positive return from its operations. But having passed some £110bn of profits to HMT so far, we might in the next few years be entering a period of losses were Bank Rate to rise sharply. That is because the APF is funded by reserves that are renumerated at Bank Rate. By itself that does not jeopardise the solvency of the Bank of England as it holds an indemnity from the HM Treasury as to any losses from APF operations. But the general understanding of how the indemnity would operate is poor and, as a result, may leave the Bank subject to the concern that the MPC may be reluctant to raise rates because it might lead a solvency problem. We do now need a clearer statement from H M Treasury on this indemnity and how it would operate.

Finally, the effective maturity of government debt, if we account for that large fraction of debt that now represented by reserves that receive Bank rate, is considerably lower than 15 years, as we and the OBR have pointed out. And that the quantum of debt is more sensitive to interest rate changes than is probably optimal. H M Treasury should therefore be thinking about how to reduce the sensitivity rather than waiting for a shock to limit fiscal space. It might, for example swap some of the reserves that will move one for one with Bank rate for less sensitive (short-term) T-Bills that will have the benefit of allowing some reduction in the quantum of QE, as the proceeds could be used to retire some of the debt held by the APF. Such a policy advocated by my colleague, William Allen, may allow some of these liquid T-Bills to both reduce interest rate sensitivity of debt and allow commercial banks that may need more or less liquidity from time to time to trade these bills with each other. There may, of course, be other solutions but we are waiting for an assessment of these from the monetary authorities.

As we can see from the taper tantrums in the bond markets, there is considerable skittishness about higher policy rates and the implications for the net supply of public debt. And this results from a nervousness about how the exit from QE will ultimately be managed. For that to nervousness to be allayed there needs to more guidance from the MPC as to what is the range of debt holdings the APF think have most efficacy for the control of longer-term interest rates and how and at what speed any debt stock held would fall as Bank Rate normalises. Indeed, the rapid recovery now in train gives the MPC a perfect opportunity to make a statement as to the need to reverse some of increase in QE announced in Spring 2020. They should take it. Some move away from the use of this blunt tool ought to allow market functioning and the price revelation process of information flows from bond prices to resume. And if properly managed would not act to limit future fiscal and monetary policies.

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