

## Written evidence submitted by Anthony J Evans (MON0008)

**About the author: Anthony J. Evans** is associate professor of economics at ESCP Europe Business School. He has published in a range of academic and trade journals and is the author of *Sound Money: An Austrian proposal for free banking, NGDP targets, and OMO reforms* (Adam Smith Institute, 2016). His work has been covered by most broadsheet newspapers, and he has appeared on Newsnight and the BBC World Service. He is a member of the Institute of Economic Affairs' Shadow Monetary Policy Committee.

This submission is made in a personal capacity.

### Executive Summary

- Conventional monetary policy (i.e. One Target One Tool) has serious flaws and contributed to the 2008 financial crisis. Since then, emergency monetary policy (i.e. Unknown Targets and Multiple Tools) has been reasonably successful but lacks clarity. The opportunity should be taken to reform monetary policy such that the same rules are applied in good times and bad.
- Open Market Operations (OMO) should be reformed to meet the following criteria:<sup>1</sup>
  1. They should be tied to a specified nominal target – preferably nominal income.
  2. They should be open access (i.e. allow a diversification of counterparties).
  3. They should be standalone (central bank intervention should be restricted purely to managing the money supply).
  4. They should be as neutral as possible (and focus on gilts first).

### *The effectiveness of monetary policy in meeting the inflation target*

1. It's possible that low rates cause some people to increase rather than decrease their savings. So called "target savers" have a fixed financial goal and respond to lower returns by having to save more of their income. Draghi (2016) contests that this applies to the Eurozone by pointing out that savings rates have generally fallen, and Carney (2016) shows that the UK savings rate has returned to pre-crisis levels. However this implicitly acknowledges a prior *increase* in the savings rate during the implementation of emergency monetary policy, which may well have undermined previous policy decisions.
2. It seems likely that any loss of fixed income due to low policy rates have been offset by increased asset prices, however a McKinsey Global Institute report pointed out that this ignores a worsening of people's cash flow; gives people a bigger stake in any bubble activity; and is non-voluntary (and therefore makes people subjectively worse off).<sup>2</sup>
3. The consensus evidence on the impact of QE seems to be positive, albeit with marked differences between countries. Haldane et al (2016) show that QE is more effective when used as a form of monetary policy rather than liquidity provision. As they say,

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<sup>1</sup> A fuller justification for these recommendations are made in Evans (2016a).

<sup>2</sup> "QE and ultra-low interest rates: Distributional effects and risks" McKinsey Global Institute Discussion Paper, November 2013

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“it is not the balance sheet expansions per se, but their purpose and, prospectively, method of execution that matters for determining their impact on nominal spending”. Indeed given that open market operations are the main instrument of monetary policy regardless of the intermediate target (be it broad money growth or inflation targets), it should be treated as standard policy rather than an emergency tool. Indeed I believe QE would have been even more effective had it been tied to a clear nominal income target. The discretionary and ad hoc nature limited its effectiveness.

4. There are many options to extend OMO in different directions. They can be used to buy more assets (quantitative easing); private sector/lower quality assets (credit or qualitative easing); longer dated assets (operation twist); or from a broader range of counter parties. The critical issue is that market participants know in advance which margins would be exploited, and under which circumstance. For example if the Bank of England own more than a certain percentage of gilts of a specified maturity, they extend asset purchases to a pre announced basket of investment grade bonds.
5. Forward Guidance can be Odyssean (i.e. publicly committing the central bank to future action) or Delphic (i.e. provide a forecast about where the economy is moving). The Bank’s use of a 7% unemployment threshold backfired because markets took that to be an Odyssean commitment rather than part of a Delphic claim. When the threshold was breached earlier than expected, instead of following through the goalposts were shifted. So although the communication strategy will be more effective if it extends into future time periods, it also becomes more complex and could increase uncertainty. The solution is to remove as much discretion as possible from the decisions being made.

### *The unintended consequences of monetary policy*

6. Although inflation is always and everywhere a monetary phenomenon, it is not necessarily always a consumer price one.
7. In the years prior to the financial crisis the Consumer Price Index (CPI) systematically underreported the inflationary pressure in the UK (Evans 2016c). More attention should be given to indices that include asset prices (including the housing market). Although such indices are harder to construct, the economic rationale for measures of inflation which include cash flows of future consumption purchases is strong (see Posen 2011).
8. Long-term implications of monetary policy are impossible to forecast. Haldane (2016) draws attention to the rise of Agent-Based Modelling (ABM) and it’s usefulness as a modelling device. For example, he provides convincing evidence that economic distributions aren’t normal (pp. 25-26.) This is valid, but we shouldn’t be looking for the “new normal”; we’re “post” normal. If we take radical uncertainty seriously (and we should), whilst ABM serves as a useful *microeconomic* input into policy considerations, macroeconomic policy decisions should be grounded in an alternative methodological terrain. Namely scenarios.<sup>3</sup> The difference is that whilst forecasts attempt to predict the future (and plan accordingly), scenarios imagine alternate ones

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<sup>3</sup> See Tables B and C in “The distributional effects of asset purchases” Bank of England, Quarterly Bulletin 2012 Q3.

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(and plan broadly). A 2012 Quarterly Bulletin utilises scenarios to consider the impact of QE on various alternative pension schemes. More attention should be given to these approaches.

9. Monetary policy has generated malinvestment. Although it can be hard to identify we have a strong theoretical basis for expecting easy money to generate various forms of capital misallocations. Vertical malinvestment is intertemporal, and a shift towards capital investment (for example housing and construction, white elephant infrastructure, export capacity, and reduced savings rates). Horizontal malinvestment occurs when capital is directed to the wrong sectors (e.g. construction, the financial industry, or renewable energy).<sup>4</sup>
10. The downsides of zombie firms are that they mask underlying problems and make future rate rises more painful.
11. Capital misallocations and zombie companies are not the only dangers of easy money. Also:
  - Destabilising capital flows
  - Pension deficits
  - Commodity price volatility
  - Dynamics of intervention
  - Regime uncertainty
  - Exit risks
12. The Bank of England's large balance sheet has generated concerns over the relationship between monetary policy and the Treasury. It diminishes the accountability of elected officials and reduces financing constraints. When the then Chancellor surprised markets by requesting £35bn of the Bank's interest payments in 2012, this exposed the extent of uncertainty over the exit strategy. I don't have a strong opinion on this matter, but there should be more coherency and clarity on the following questions: (i) should the Treasury take interest payments; (ii) should QE be unwound before raising interest rates; (iii) should the gilts be sold or written off. The fact that we are speculating about these questions demonstrates why QE had muted impact: when launched we simply didn't know if it constituted a permanent increase in the monetary base.
13. It is impossible to expect macro-prudential or fiscal policy to counteract unintended consequences of monetary policy. Indeed the manner in which banks are regulated should be changed – see the “Note on Prediction Markets” below.

### *The prospects for monetary policy*

14. The natural interest rate has probably fallen over time. My own estimate put it at 2.34% as of Q2 2016 (Evans 2016b).
15. As Draghi (2016) points out reasons include a secular slowdown in productivity; global savings imbalances; and a debt overhang. Undoubtedly there are structural problems that affect this, but previously inappropriate monetary policy (i.e. allowing nominal income to contract in 2008) is also a causal factor.

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<sup>4</sup> For more see White (2012).

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16. Tightening policy in the near-term is appropriate even if there are short-term costs. A basic dashboard of monetary conditions (such as real interest rates; inflation expectations; the stock market; commodity prices; industrial production; and the exchange rate), collectively suggest that policy is too loose. Whilst nominal income growth is muted it is robust and consistent with less loose monetary policy.
17. Switching to a nominal income target (as opposed to an inflation target) would rectify the problem identified by Broadbent (2016). Current policy needs to distinguish between demand and supply shocks when choosing a policy response (the latter should be “seen through” but the former should not). Since nominal income *is* aggregate demand this avoids the problem and reduces the epistemic burden on policy makers.
18. Monetary policy is not out of ammunition provided a clear pathway for extending OMO are decided upon and communicated.
19. Draghi (2016) is right that although monetary policy can buy time, if the root cause of problems are fiscal and structural then central bankers can’t provide the answers. It is not the job of monetary policy to raise the natural rate of interest, but boosting potential growth should be a priority for any government. For the UK economy some critical issues are:
  - Greater competitiveness
  - Lower marginal tax rates
  - Fewer regulatory barriers
  - More liberal planning laws
  - Increased labour market flexibility

### *Note on Prediction Markets*

If there’s widespread acceptance that existing regulation has failed we need to stop and ask why. Harford (2016) provides an excellent account of the evolution of banking regulations, and how greater detail pushes risky behaviour into the same loopholes, which creates systemic danger. The more complex the regulations are, the harder it is to anticipate how they’ll be gamed and what the downside risks are. In Andrew Haldane’s speech at Jackson Hole (2012) he praised the use of heuristics (i.e. rules of thumb) rather than ever more complex regulatory measures. As he says, “you do not fight fire with fire, you do not fight complexity with complexity”.

Whilst stress tests provide an impression of resilience, they can be gamed (see Dowd 2015). Harford (2016) makes the link to the Volkswagen emissions scandal: if tests are predictable behaviour will change to pass the tests, but not necessarily remedy the underlying problems that the tests are supposed to prevent. Harford (2016) refers to “randomly times tests of arbitrarily chosen areas” and uses the analogy of an examination. If students don’t know what they’re going to be tested on, the best strategy is to cover all bases. Haldane (2012) likens this as a SWAT team rather than an army.

However there is a problem. Despite Haldane’s speech drawing upon FA Hayek, it doesn’t fully capture the knowledge problem that exists at the heart of Hayek’s work – it still suffers from an assumption that regulatory agencies know more than the banks. After all, in an examination the goal of the student is to demonstrate knowledge of the material. The

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examiner is expected to have superior knowledge, and so if there's a conflict we know who is "right". By contrast there's no reason to assume that regulators understand risk better than financial market participants. And when participants get too clever about dealing with the risk being checked for, they will inevitably introduce other types. A genuinely Hayekian approach would be to consider which institutional mechanisms will improve the flow of knowledge. Not between participants and regulators, but between participants and the *market*.

The source of the problem is that we don't know in advance who has the relevant information, therefore we need measures to encourage anyone and everyone to share information, and a system that aggregates that information. Relying on traditional communication between concerned insiders and the outside world (i.e. whistleblowing) is important but contains many problems. In particular, there are weak incentives to speak out, and no guarantee that the outsiders will agree with, or act upon the claims being made. An alternative to top down measures where regulators seek information is a bottom up approach where those holding information can act on it.

Many organisations use internal prediction markets as a way to understand complex, uncertain issues, and these could be deployed for regulatory uses (see Wolfers and Zitzewitz 2004, Dye 2008). Bank employees and members of the public could trade on an array of important issues. Stress test scenarios could be reworded to serve as questions, providing real time probability estimates based on the wisdom of the entire market.

I am neither a bank executive nor a regulatory agent, and I don't like to see a "game" being played between the two. This cat and mouse charade is destined to fail because it rests on an assumption that government knows best. In truth, the knowledge required to know what is excessive risk isn't given to anyone. I want market competition to penalise excessive risk taking, and the allure of long-term profitability to encourage sensible decisions. I also want freedom for banks to experiment with alternative business models, giving customers choice and reducing systemic danger. One way to move towards this is to supplement existing regulatory measures with Bank of England endorsed prediction markets.

*February 2017*

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