COMMENTARY: MONETARY POLICY IN TROUBLED TIMES

Jagjit S. Chadha*

The blissful world of the 'Great Moderation' might return. But for now it has gone. We do not yet fully understand its fast-changing successor. Monetary policy needs to be guided by principles, above all the principle that Hippocrates' oath nearly stated – "do no harm".

Peter Sinclair and William Allen (2017).

1. Introduction

The *Commentary* in this *Review* has touched on the mix of monetary and fiscal policies regularly since the Brexit referendum.[1] The timeless issues relating to the framework for monetary and fiscal policy and their appropriate degree of co-ordination have been exposed by the Covid-19 crisis. We have previously argued that the sequence of arbitrary fiscal rules that have been formulated by successive governments in the past decade do not make much economic sense as they do not match a well-defined social welfare criterion.[2] We have also argued that the framework for monetary policy needs a close examination after the experiences of the global financial crisis and nearly 23 years of operational independence of the Bank of England.[3]

The economy is now engulfed in a crisis almost without parallel in peacetime, and we can anticipate a fall in activity in the region of 15–25 per cent in the initial period of lockdowns. We are on the cusp of what may prove to be the first of several severe contractions in output as the authorities are forced to shut down society to limit the death toll from the Covid-19 strain of the coronavirus. Should the duration of lockdowns get longer, the impact on the economy and the scarring they will leave will increase. The case for fiscal response and extensive monetary support is clear.

As this *Review* makes clear, the economic and social crisis we face is grave and this Commentary argues that it is possible for the Bank of England to provide space for fiscal policy to support economic activity without succumbing to a permanent regime shift towards fiscal dominance. But the monetary policy response should not simply be defined as a direct crisis management. It is essential that the Governor and the Chancellor reflect on a sensible exit strategy for monetary policy from any further extraordinary operations. Many of the measures must be temporary and clearly designed as such: they should be state-dependent and be able to be withdrawn once the crisis is over.

* Director, National Institute of Economic and Social Research. E-mail: j.chadha@niesr.ac.uk. In memoriam: Peter Sinclair. This paper is closely related to a recent Occasional Paper written with Richard Barwell and Michael Grady and I am grateful for their permission to draw on that work. Also for comments on the paper from Kate Barker, Charles Goodhart, Sean Holly, Mervyn King, Huw Pill, Manoj Pradhan, Paul Tucker, Philip Turner, Tony Yates and Garry Young. They share no responsibility and any errors are mine alone.

As such, the Bank of England faces a formidable challenge. From the first day in office on 16 March 2020, the new Governor has been confronted with an imbalance between the demands on his institution to support the economy and its apparent capacity to meet that challenge. While the main responsibility to manage this economic crisis lies with fiscal policy, monetary policy should provide as much support as it can without undermining prospects for long-run price and financial stability. The problem is that with limited orthodox monetary space, given the size of the shock, there is an increasing pressure for the Bank to go further along the spectrum of choices towards even greater levels of unorthodoxy, which run a greater risk of undermining stability should institutional safeguards not be clearly established.

Unfortunately, at face value the Bank seems limited in its available response in conventional terms. Unlike in previous economic downturns, the Bank cannot cut Bank Rate by several hundred basis points. Indeed, it has been clear for many years now that the Bank's capacity to support the economy through conventional monetary stimulus is much diminished. And whatever remained of the conventional monetary ammunition may have been exhausted over the past month, with rates seemingly at the floor and asset purchases resumed.

But there will now be pressure to do more. The Bank will have to explore every nook and cranny of the monetary armoury to find new ways to nurse the economy through the crisis. And with the Chancellor pressing ahead with a 'whatever it costs' strategy there will be a call on the Bank to do 'whatever it takes' to support that effort, which in practice means closer monetary-fiscal coordination and indeed a period of potential fiscal domination of the monetary economy.

Rules need to be agreed around the operational framework and regime for the Bank of England, so that it will be able to respond to the next crisis, or even the next lockdown, but also a play a role in nurturing the economy back to health. This framework must then be endorsed and backed by elected politicians to allow the Bank to go back to the business of delivering monetary and financial stability.

In this short essay I outline the guiding principles for monetary and fiscal policy in this crisis, the case for a dominant and substantial role for fiscal policy, a sliding scale of choices for the Bank of England that may have implications for the monetary settlement, and a discussion of the case for helicopter money. I conclude by re-iterating the case for retaining not only a clear nominal anchor consistent with price stability but also for a careful withdrawal of monetary policy from the arena of political choices over resource allocations in the presence of market failures.

2. Guiding principles

The economy is being used as an instrument to control the spread of Covid-19. Mass lockdowns across the world have been deployed as a way of limiting the spread of this virus and the UK started its lockdown on 23 March. The Covid-19 economic crisis introduces what has been called radical uncertainty,[4] as we do not know that much about its incidence or duration, but we are assuming that it is likely to be temporary but persistent. Accordingly, our analysis is based on that narrative. Unlike the 'usual' causes of economic fluctuations, this contraction does not result directly from monetary-fiscal-regulatory laxity and so providing more complete insurance from public policy is not subject to the problem of extensive moral hazard. Indeed, in large part the economic crisis is the objective of policy in guarding the nation's health. The implication then is that large-scale temporary monetary and fiscal support must be supplied. But who does what?

The Chancellor's fiscal policy has to decide upon the quantum of risk that the economy faces that it cannot insure itself from, and then the overall level of resources to be transferred across the private sector by taxes and to future generations by debt issuance. It is not so much a question of whether there is a discretionary fiscal response but how much. The key point is that fiscal policy has to consider an actual transfer of resources across households and time that are either backed by current and/or future taxes. Our current estimates suggest that around a quarter of the economic loss might be met by the current strategy at HMT and there is room to do more. But some remaining space might be conserved should further lockdowns be required to deal with the return of the virus or a mutation.

It is then a question for the Bank of England to decide whether that quantum of risk and resource transfer from fiscal policy requires any changes in the stance of monetary and financial policies. To that, as ever, there is the question of using short-run flexibility subject to the constraint of maintaining credibility or reputation, which is a critical intangible public sector asset. Indeed, it is typically found that aligning policies to people's long-run expectations of that institution's behaviour make short-run polices more effective as they avoid problems associated with time inconsistency.

In confronting economic risk and radical uncertainty, of the manner in which Covid-19 has revealed it, fiscal policy must be prepared to revise its plans regularly in light of news about the spread of the virus and the economic impact here and overseas. It is also a sensible moment to establish more clearly a long-run objective to build up the net worth of public sector balance sheet, alongside a commitment to sustainable levels of public debt within an institutional structure that provides regular scheduled policy planning and projections on the path of the primary fiscal surplus and the debt stock.

3. Fiscal policy

In recent times, following a shock, in order to support the economy's adjustment to its long-run equilibrium, the main lever to stabilise economic fluctuations has been monetary policy. This has relied on deploying movements in Bank Rate or operations in the money market to influence longer-term interest rates to bring forward or defer expenditure. But this Covid-19 crisis has brought fiscal policy to the forefront of the policy imperative. There are broadly five reasons why we ought to focus mainly on fiscal policy in the first instance and deploy it in an active manner:

1. The lockdown is an economic instrument that is directed at controlling the spread of Covid-19. Much of the market economy has thus been placed in a state of near suspended animation to allow a more smoothed progression of the virus through the domestic and global population, subject to the availability of health care services;

2. The lockdown reduces the overall labour supply but while there is excess labour supply in some areas such as the recreation, travel and restaurant sectors, there is a shortage in others, for example in healthcare, agriculture and childcare. The state, as in wartime, could help divert labour to areas where required and provide basic training for necessary skills development;

3. The economic shock more obviously affects those households who cannot work on a sustained basis in a remote manner, many of those who are self-employed and those without sufficient savings to sustain expenditure patterns for necessities. This will tend to affect those in the lower income deciles, and this argues for a considerable effort on re-distributive policies;

4. Using the list of identified projects at the National Infrastructure Commission, we should be aiming to bring forward public investment as soon as lockdowns are eased. If we are heading for a sequence of lockdowns, then any projects that can be completed quickly, at the local authority level or for social housing, should be deployed;

5. Finally, when the monetary policy space is constrained and when demand falls so rapidly it seems very likely that fiscal multipliers are quite large – that is for every pound spent the impact on the economy will not be crowding private sector activity out.

4. Monetary policy options[5]

The Bank of England faces a formidable challenge. The case for a powerful monetary stimulus to nurse the economy through the current crisis is overwhelming. This Monetary Policy Committee (MPC) cannot cut interest rates by several hundred basis points as predecessors might have done. There was relatively little conventional monetary ammunition before the outbreak of the Covid-19 crisis, and much of what remained has already been exhausted.

And yet monetary policy cannot sit this slump out and must do whatever it can in support of the Government's crisis response. There are three sets of issues to resolve: first, what can still be done within the conventional toolkit; second, what can be done in the space of formal monetary-fiscal coordination; and third, what must be done once the crisis is over, which I consider in section 5.

4.1 Exhausting what remains of conventional space

There are three basic options open to the Monetary Policy Committee to inject additional stimulus if it is required: further asset purchases, forward guidance and negative rates. None look particularly promising, in terms of delivering a sufficient level of stabilisation, but all may have to be explored.

There is scope to stimulate the economy further through large-scale asset purchases, although long-term risk-free rates are already low. Purchases of riskier assets offer the possibility of more leverage on aggregate demand and might prove powerful in a crisis in which credit and equity risk premia can widen significantly. However, clarity on objectives and a discussion on governance are paramount in the design of any asset purchase scheme. The questions to think about are how much government debt should be bought by the central bank, how large should its balance sheet grow and with what level of risk? Even though quantitative easing has been in place in the UK since 2009, we have still not developed good answers to these questions.

There is little additional monetary space to be found in what has become known as forward guidance – that is, communication that reflects an orthodox reaction to events or news. The only way to ease the stance through communication is via a clear commitment to change that reaction function. That in turn requires a credible and transparent commitment device, preferably a target path for the price level, or failing that an average inflation targeting regime. A published path for the policy instruments that explains likely responses in different states of the world, may also help.

There are valid concerns about whether maintaining negative rates for an extended period will ultimately prove counterproductive. But there is evidence from the Euro Area of some efficacy. Policymakers may need to examine the reversal rate – the rate at which lower interest rates lead to a contraction in bank lending rather than an increase – literature a little more carefully. But even if still not convinced, there may well be an argument for negative interest rates for reserves to deal with large shocks and disconnecting the one-to-one exchange rate between cash and deposits, so that holding cash becomes relatively costly.

4.2 Formal monetary–fiscal coordination

Whatever remains of the conventional monetary space is likely to prove insufficient. More will need to be done. The Chancellor is pursuing the right strategy of 'whatever it costs' to support the economy. But that in turn requires a significant, but so far quite sustainable, increase in government debt to finance critical support for the economy. In this crisis, greater coordination between the monetary and fiscal authorities is justified with the Bank taking the steps to create and preserve fiscal space. There are a range of options on the table.

Direct yield curve control would place a limit or target on bond yields. It provides a robust and transparent regime for preserving fiscal space, and has the added virtue of signalling the transition of responsibility for demand management to the fiscal authority. Ideally, the purpose of a yield cap would be to suppress any contractionary increase in bond yields given a shift in rate expectations or the term premium (due to higher net issuance), but in a crisis it may keep a lid on rising sovereign credit and inflation risk premia, providing long-run credibility is maintained. As ever the control of a price would rob it of its information content so it may become progressively harder to gauge financial risk and changes in inflation expectations.

Alternatively, fiscal space can be secured by working directly on quantities – that is, the Bank could engage in some form of monetary financing. By committing to purchase government bonds in the magnitude issued, under strict conditions and only for a limited period, a central bank can support proper market functioning and prevent an unwarranted tightening in financial conditions. The announcement of extended use of Ways and Means on 9 April is simply the deployment of an overdraft facility that limits liquidity disruption in sterling money markets as unanticipated debt issuance is so large. So at face value the announcement does not constitute monetary financing, not least because it is being carried out within the Bank's inflation-targeting remit. But there are some missing parts: the absence of a statement on the overall quantity of the overdraft on this facility and for its duration. It would also be normal for an exchange of letters between the Chancellor and the Governor to set these out, as well as how decisions on future of use of the Ways and Means facility will work.[6]

Finally, there is the possibility of a mythical 'helicopter drop'. Governments, not central banks, have the experience, infrastructure and remit of distributing cash to the general public. But the Bank can engineer a helicopter drop through a credible commitment that monetary financing will be permanent. Purchases of government debt, whether made in the secondary market or in a more unorthodox manner via primary purchases, would remain on the Bank's balance sheet indefinitely. This is the most extreme of the three options, and carries the greatest risk to monetary stability as it states that the nominal anchor will drag. I will return to this question in the section below.

Within the range of these options, the obvious next step is yield curve control as it is close to quantitative easing in that a price is set rather than a quantity delivered but both intend to influence long-term bond prices. Indeed, a case can be made for yield curve set outside of a crisis on the grounds that it makes more sense to control bond prices than to control the quantity of purchases in the hope of influencing bond prices. However, if the commitment to a target were to be tested by market participants – in the same manner as a commitment to an exchange rate peg – then the policy may ultimately converge on monetary financing.

4.3 Quantitative easing, monetary financing and helicopter money

In an earlier generation of macroeconomic models, it was hard to find a direct role for money to affect the

economy as it provided a veil over real decisions to spend or invest.[7] Certainly in these models money, *per se*, did not constitute net wealth for the private sector. As models developed and incorporated financial frictions it was possible to show that the relaxation of lending conditions, which lead to the build-up of debt, might amplify economic fluctuations. And to the extent that the supply of funds was not well pinned down by movements in policy rates, there was a case for alternate operating procedures. Accordingly, when policy rates were constrained, other ways to influence monetary and financial conditions had to be found.

So we cannot very easily draw a distinction between changes in Bank Rate and the policies followed at the zero lower bound of bond purchases, in so far as bond or asset purchases are an attempt to alleviate monetary and financial conditions in the same manner as movements in Bank Rate. In this case, the steps are that the fiscal policymaker has made some decision to issue debt. Depending on the capacity of markets to absorb this debt, the resultant bond prices may not be quite where the central bank wants them to be, given the stance of monetary policy or constraints on policy rates. In this case government debt is bought from the non-bank financial sector on a temporary but probably long-term basis. But note that the debt is funded and future taxes are still expected to be remitted to pay these debts. Debt issuance that is not funded by taxes does not have a very promising history and Sargent (1982) tells the sorry tale of the causes of four hyperinflations.

Monetary financing, though, is the direct purchase of debt by the central bank. It bypasses the transmission mechanism in the real economy and simply hands unfunded resource allocation or tokens (money) to the Treasury, which compete with private sector allocations. There may be no intention of raising tax to meet these overdrafts. And the bonds are held permanently by the central bank with an increase in its balance sheet. If the private sector thought that these tokens were claims on real resources then they would have some stimulatory effect on the economy (see Buiter, 2014). Indeed if one took the view that households would always demand central bank money, were it issued in ever larger quantities, and placed a positive value on it related to the claims on output, then it could always be relied on to boost output, even in a helicopter drop. But the prospects for a stable demand for central bank money in the presence of a large or repeated deployment of this tool seem to be strictly limited. And the magnitude of any stimulatory effect seems unlikely to be much larger than a more standard form of debt issuance with QE.[8]

5. After the crisis – resuming normal service

Even this crisis will eventually pass. At that moment it is essential that the Governor and the Chancellor revisit the gaps that have been exposed in the fiscal and monetary framework. The first order of business is to devise and state a credible exit strategy from the extraordinary policy measures that will have been taken during the crisis.[9] Some measures are harder to exit than others. An orderly retreat from yield curve control – by slowly relaxing the grip and widening the tolerance band around the target – seems easier to engineer than scaling back the quantum of purchases. The device of making exit an extraordinary measure contingent on a return to normality – that is state dependent – is one such route. But we have not yet returned to the previous norm after the financial crisis. And this means the permanent and the temporary are very hard to disentangle.

In terms of initial conditions for this crisis, the fundamental problem the Bank faces is a lack of monetary space. There is one obvious solution: raise the inflation target to 4 per cent to offset the decline in equilibrium real interest rates. But that threatens normal notions of what constitutes price stability with prices then doubling every 17–18 years. And there is also a danger that any immediate shift in the nominal anchor may be misunderstood as an expedient device during a crisis, and as we do not want to dislodge stable price expectations and the contribution to regularised exchange that affords, any decision to move it must wait.

Finally, the Bank itself needs an exit strategy from the so-called 'only game in town' trap, in which the central bank and its balance sheet are the answers to every problem – from infrastructure to greening the economy. There must be a return to the narrow focus of monetary and financial stability. The pursuit of broader social objectives and the conduct of industrial and credit policy must be left to the politicians.

6. Conclusion

The modern, recent history of monetary policymaking in the UK has unfolded over three key events: exit from the European Exchange Rate Mechanism in September 1992, the election of 'New Labour' in 1997 with Gordon Brown as Chancellor, and the global financial crisis of 2007–8. The first led directly to the adoption of an explicit inflation target for monetary policy in October 1992; the second led to the adoption of operational independence for the Bank of England's Monetary Policy Committee (MPC) in pursuit of that target; and the third exposed the limitations of single-minded

inflation targeting pursued solely via manipulations in Bank Rate. With the terrible events associated with the spread of Covid-19, the UK monetary authorities have an opportunity to move the dial further on to adopt instruments that increase the space for monetary policy but also respect the boundary between the political choices of the state and the technical matters of ensuring monetary financial stability in the face of shocks.

But at the same time, we need to ensure sensible commitments about the long run are not lost. One way to frame the policy innovations over the past decade or so has been an attempt to nurture a fragile economy back to normal. The global financial crisis had the capacity to bring about a decade of prolonged depression. That it did not is a testament to extraordinary monetary policies. In time, the pressing issues will be to help the government redefine the numerical objective for monetary stability: being clearer about the links between the MPC and Financial Policy Committee as bodies both affecting monetary and financial conditions. Think hard about communication as part of the instrument tool kit and finally contribute to the measurement and understanding of the new economy. Indeed the best answer of all might be for the Governor to call for an external Review of the Bank's Remit and Objectives and use that to refocus on the bread and butter of central banking in the long run while managing the crisis in whatever it takes mode until then. Let's do no harm.

NOTES

1. See 'Fiscal policy after the Referendum', November 2016, 'Interest rate normalisation', August 2017 and 'Monetary and fiscal policy options in the event of a 'no-deal' Brexit, August 2019.
2. See "Time for the UK's 'budgetarians' to make way for some proper fiscal policy", Vox-EU CEPR, 9 March 2020.
3. See *Renewing our Monetary Vows: Open Letters to the Governor of the Bank of England*, NIESR Occasional Paper, 58.
4. See Kay and King (2020).
5. This section draws heavily on Barwell *et al*., 2020, Occasional Paper, 59.
6. At the time of writing on 20 April no such decision or letter had been exchanged.
7. Chadha *et al*. (2014) explore this decomposable property.
8. See Harrison and Thomas (2019) on this point.
9. By exit strategy here I mean strictly the monetary and financial measures and not what common discussion has linked to the exit from lockdowns, which is quite a different form of exit strategy.

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