COORDINATING MONETARY, FISCAL AND FINANCIAL POLICY

A Submission To The Treasury Committee Of The UK Parliament

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Abstract

UK monetary policy, following the 2008 recession, was effective at preventing the crisis from having a bigger effect than it otherwise might have done. As a result of experimenting with quantitative easing (an expansion in the Bank's balance sheet) and qualitative easing (a change in the risk composition of its balance sheet) we learned some important lessons. This submission to the ***Treasury Select Committee*** summarizes my understanding of what those lessons were and what they teach us about the future conduct of monetary, fiscal and financial policy. Whenever my recommendations differ from the existing dominant macroeconomic paradigm, I explain why.

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By

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1. UK monetary policy, following the 2008 recession, was effective at preventing the crisis from having a bigger effect than it otherwise might have done. As a result of experimenting with quantitative easing (an expansion in the Bank's balance sheet) and qualitative easing (a change in the risk composition of its balance sheet) we learned some important lessons. This submission to the ***Treasury Select Committee*** summarizes my understanding of what those lessons were and what they teach us about the future conduct of monetary, fiscal and financial policy. Whenever my recommendations differ from the existing dominant macroeconomic paradigm, I explain why.

I. Recommendations for Policy

A. The existing mandate for the MPC of maintaining 2% inflation is appropriate and should be maintained. The MPC should, however, reconsider the methods it uses to achieve that target.

B. Monetary, fiscal and financial policy should be coordinated. In the absence of an increase in confidence, an expansion in fiscal policy, or a recovery in the world economy, the UK may continue to fail to meet the 2% inflation target for a protracted period.

C. If the inflation rate does not increase in the absence of additional policy actions, the MPC should *increase* the interest rate to hit the inflation target. To be effective, a policy of this kind must be coordinated either with a fiscal expansion or with an intervention in the asset markets through open market purchases of risky assets.

D. A coordinated policy of higher interest rates, combined with a fiscal and or financial stimulus is inconsistent with an independent exchange rate target. It will likely cause an initial appreciation of the exchange rate as foreign investors take advantage of higher UK interest rates.

E. As a permanent component of future financial policy, the FPC should actively intervene in the asset markets by buying and selling assets that alter the risk composition of the Bank's balance sheet. There should be no presumption that the financial markets know best. They don't. The FPC can and should maintain a price for the average value of publicly traded equities that is consistent with full employment.

II. Executive Summary

2. The MPC is guided by a set of principles*, the dominant paradigm*, inherited from the economics profession. The dominant paradigm provides a framework that most, if not all, MPC members use to interpret their roles as public servants.
3. At the core of the dominant paradigm, are two concepts, the Non-Accelerating Inflation Rate of Unemployment, also known as the NAIRU:[1] And the natural rate of interest, also known

[1] The NAIRU is sometimes referred to as the Natural Rate of Unemployment. Here, I use these terms interchangeably.

as r-star. According to the dominant paradigm, the MPC cannot alter the NAIRU or r-star; they are, possibly time-varying, numbers.

4. Because the NAIRU and r-star are unobservable and time-varying, the dominant paradigm is irrefutable. Any set of observable facts can be interpreted through the lens of the dominant paradigm. It is religion: not science. A failure of the expectations of the members of the MPC, to conform with the ex-post facts, is explained by a change in the NAIRU or in a change in unobservable r-star.

5. The NAIRU was introduced by Milton Friedman in his 1968 Presidential Address to the *American Economic Association*. In that address, Friedman overturned two decades of economics that followed from the ideas of John Maynard Keynes.

6. There is increasing evidence that the dominant paradigm is wrong.[2] Evidence against the NAIRU comes from the persistence of low growth and high unemployment that lasted for years rather than months after the end of the last recession. Evidence against r-star comes from the persistence of permanently lower real interest rates. Evidence against both the NAIRU and r-star comes from the inability of the MPC to hit its 2% inflation target even as unemployment continues to fall.

III. Take Away Points

A. **There is no NAIRU. Any unemployment rate between 0 and 100% is consistent with the MPC's inflation target of 2%.**

B. **There is no r-star. The long-run real interest rate is influenced by fiscal and monetary policy.**

C. **There is a socially optimal unemployment rate. Too much unemployment is a waste of social resources. Too little unemployment is also a waste of resources.**

D. **In the absence of intervention by government, there is no natural tendency for a market economy quickly to gravitate to the socially optimal unemployment rate.**

E. **The actual unemployment rate at a point in time is determined by four factors;**

   a. **Confidence in the financial markets, (so called animal spirits of investors)**
   b. **Fiscal policy**
   c. **Monetary policy**
   d. **Financial Policy**

F. **Because confidence is reflected in stock market valuations, it is directly influenced by the asset composition of the Bank's portfolio.**

G. **Maintaining financial stability is central to preventing a recurrence of the Great Recession.**[3]

IV. Some Questions Raised by the Treasury Committee

Interest rates are currently 'stuck near zero'. Can they be raised soon without choking off the recovery and causing a new recession?

7. Yes. As long as the increase in the interest rate is accompanied either by a fiscal expansion in the form of a tax cut or increase in government purchases: or by an asset market intervention that counteracts any possible fall in the value of the stock market.

8. If the MPC were to raise the interest rate, in the absence of any other policy change, historical experience suggests that the outcome would be a recession. Unemployment would increase and growth would fall, possibly by a substantial amount. But, if an interest

[2] Farmer R.E., 2010. Farmer R. E., 2013.
[3] Farmer R. E., *Prosperity for All: How to Prevent Financial Crises*, 2016.

rate increase were to be coordinated with a substantial fiscal expansion, or by an asset market intervention to prevent a market crash, the combined effect of these policies would increase the inflation rate without triggering a recession.

9. Is it plausible that inflationary expectations could be reversed overnight? Yes: There have been many historical episodes in which inflationary expectations have been rapidly reversed, for example, Austria, Hungary, Poland and Germany in the 1920s.[4] In each of these cases, inflationary expectations were quickly turned around by the combination of a tightening of monetary policy in conjunction with a fiscal consolidation.

Should the Bank maintain a large balance sheet moving forwards? What would be the effects of doing so?[5]

10. Yes. The risk composition of the bank's balance sheet should become a permanent component of future financial policy.
11. Many economists believe that, although it matters a lot whether government expenditure is funded by borrowing or by printing money, it doesn't matter at all if government borrows by issuing three-month bonds, five-year bonds, or thirty-year bonds. This perception is mistaken.
12. The *size* of the central bank balance sheet matters because it forms the base for the money supply. In normal times, when the interest rate is positive, there is a strong, positive correlation between the inflation rate and the rate of money creation. That correlation led Milton Friedman to argue that inflation is "always and everywhere a monetary phenomenon."
13. The *composition* of the central bank balance sheet matters because there is incomplete participation in the asset markets. An exchange of short-term debt for long-term debt or other risky assets in the central bank's portfolio transfers nominal income risk from current taxpayers to future taxpayers. The composition of the portfolio matters because our unborn children and grandchildren cannot trade in the financial markets.
14. A policy of managing the risk composition of the Bank's balance sheet can and should, become a permanent component of future financial policy.

Does the Risk-Composition of the Bank's balance sheet matter?

15. Yes. Following the 2008 financial crisis, in the UK, the MPC intervened in the bond markets by purchasing longer duration assets. In the U.S. the Fed intervened in the MBS market. Figure 1 plots the size of the Fed balance sheet, and its composition, measured on the left axis in millions of dollars; and the value of the S&P 500, measured on the right axis as an index number. This figure shows that the Fed purchase of risky mortgage backed securities, represented by the horizontal shading, was closely correlated with the increase in the stock market.
16. Why is this important? Because if an increase in the value of the stock market is persistent, it is followed by a fall in the unemployment rate three months later. This effect is persistent and has been stable in the United States, in Germany and in the UK for the entire post-war period.[6] Confidence, reflected in the asset markets, does not just reflect technology and government policy; it is an independent driver of the real economy.

[4] "The Ends of Four Big Inflations", (Sargent, 1986)
[5] Paragraphs 11—13 paraphrase an excerpt from my book *Prosperity for All*, Oxford University Press, 2016.
[6] Farmer, 2013 finds that in U.S. data, there is a strong and stable correlation between the stock market and the unemployment rate. Studies by Corp, (2014), at the Bank of England and by Fritsche & Pierdzioch, (2016), have succesfully replicated the findings of my original study on UK and German data.

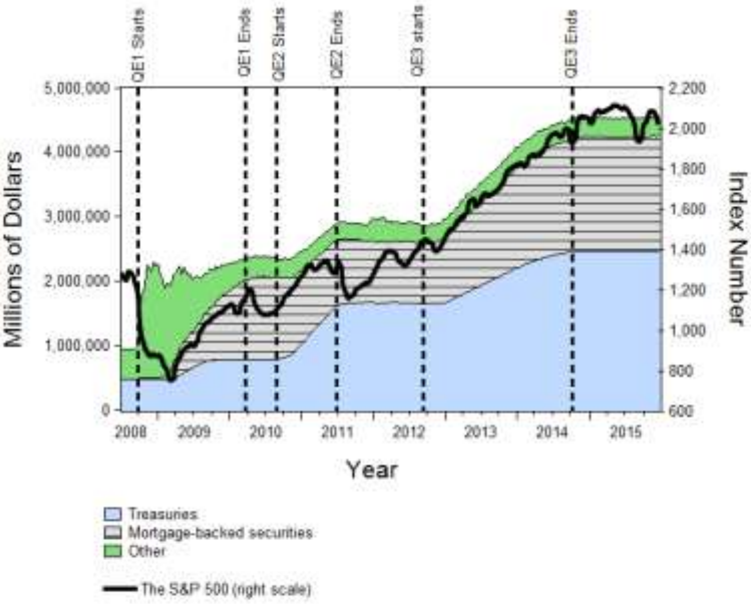

Figure 1: The Stock Market and the Fed Balance Sheet in the U.S.[7]

Are the Financial Markets Efficient?

17. No. According to a widely held view of financial markets; the markets know best. This idea, *the efficient markets hypothesis*, was formalized by Eugene Fama of the University of Chicago.[8] It has two parts. *Informational efficiency*, means that you can't make money playing the market. That idea is right. The second, *Pareto efficiency*, asserts that government can't make us all better off. That idea is wrong.
18. Government has an advantage in the financial markets because it can trade on behalf of the unborn. If you are born in a recession, your job prospects will be dim. If you had been given the opportunity to insure against the circumstances of your birth you probably would have done so. And the asset market trades you would have made would have smoothed the stock market moves that caused a recession. The FPC can, and should, make those trades on our behalf.[9]
19. The idea that the government should fix asset prices will sound radical to some. It's not. The government already fixes one asset price, the interest rate on overnight loans. It should fix two. I make that assertion because, like Keynes, I do not believe that the labour market is typically able to maintain the socially optimal unemployment rate. Aggregate demand is often too low, or too high, as a consequence of mercurial beliefs about wealth. Confidence is an independent fundamental variable. When we feel rich, we are rich![10]

Does Forward Guidance Make Sense?

20. No. And it has been widely discredited amongst economists largely because the theory of forward guidance is based on an incorrect model that attributes far too much knowledge to private agents and to policy makers.

[7] Source: *Prosperity for All*, Farmer, 2016.
[8] Fama, 1970.
[9] Farmer, "Qualitative Easing; a New Tool for the Stabilization of Financial Markets", 2013.
[10] Farmer, *The Macroeconomics of Self-Fulfilling Prophecies*, 1993. Farmer, *How the Economy Works: Confidence, Crashes and Self-fulfilling Prophecies*, 2010. Farmer, *Expectations, Employment and Prices*, 2010.

21. Importantly, my recommendation is that the interest rate must be increased if inflation is to be brought back on target. This is opposite to the recommendation of economists who adhere to a theory based on the NAIRU. A policy of fiscal austerity has reduced the UK budget deficit from 7% of GDP in 2010 to less than 2% in 2016. This reduction in fiscal pressure has contributed to a reduction in aggregate demand and helped to sustain a low inflation environment.
22. There are some indications that world demand will increase following the stock market rally that followed the Trump presidency in the U.S. This has taken hold both in the U.S., where the S&P 500 has increased by 17% since the U.S. election and in the UK where the FTSE has increased by 8% over the same period. If the stock market rally is followed by a global increase in the demand for goods and services, as I am currently predicting, UK inflation may begin to move back towards the 2% target in the absence of any corrective action by the MPC. In this benign scenario, the theory that most MPC members subscribe to will direct them to increase the interest rate.
23. My recommendation, although different from established orthodoxy, is based on a coherent framework explained in my 2016 book, *Prosperity for All,* and on a body of empirical and theoretical research published in a series of books and articles, over the past twenty years.[11]

[11] Farmer, R.E. *The Macroeconomics of Self-Fulfilling Prophecies* 1993, "Animal Spirits, Persistent Unemployment and the Belief Function" 2010, "Confidence, Crashes and Animal Spirits" 2012, "Qualitative Easing: How it Works and Why it Matters" 2012, "The Stock Market Crash Really Did Cause the Great Recession" 2013. *Expectations, Employment and Prices*, 2010, *How the Economy Works: Confidence, Crashes and Self-fulfilling Prophecies*, 2010.

V. Appendix 1: The Dominant Paradigm

The following principles provide a guide to (what I believe to be) the majority opinion of the members of the MPC.

CORE PRINCIPLES (Likely to be held in common by all MPC members currently on the committee)

24. Inflation is governed by a `Phillips curve': The Phillips curve is a fundamental structural equation that relates current inflation to expected future inflation and to the unemployment rate.
25. Attempts to lower unemployment below the NAIRU through monetary or fiscal policy actions will cause prices to rise at an ever-increasing rate. Attempts to raise unemployment above the NAIRU through monetary or fiscal actions will cause prices to fall at an ever-decreasing rate.
26. The NAIRU is very hard to measure and is changing over time because of structural changes in the UK labour market.
27. Inflationary expectations are highly persistent. A primary goal of monetary policy is to `anchor' inflationary expectations.
28. In the long-run, a higher Bank Rate is associated with higher inflation. The gap between Bank Rate and the average inflation rate is called the real interest rate.
29. The long-run value of the real interest rate is referred to as 'r-star'. R-star, is determined by structural features of the economy, for example, the one-child policy in China or the invention of new technologies. It cannot be influenced by the actions of the MPC.

SECONDARY PRINCIPLES (Likely to be held by some members more strongly than others)

30. The UK economy is fundamentally self-stabilizing. In the absence of fiscal intervention by the Treasury or monetary intervention by the Bank of England, the unemployment rate would converge eventually to the NAIRU.
31. Views on the role of monetary policy in combatting unemployment.
    a. (DOVISH VIEW) The MPC should temporarily deviate from its inflation target to bring the unemployment rate back more quickly to the NAIRU.
    b. (HAWKISH VIEW) The inflation target is primary. MPC intervention to affect the unemployment rate will be counter-productive.
32. If inflation becomes too high, the MPC should raise the interest rate. This will cause unemployment to rise temporarily above the NAIRU and put downward pressure on wage and price inflation.
33. If inflation becomes too low, the MPC should lower the interest rate. This will cause unemployment to fall temporarily below the NAIRU and put upward pressure on wage and price inflation.

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