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Monetary Policy: Beyond QE

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Policy Issue

Two decades after the granting of independence to the Bank of England to determine its own monetary policy, the doctrine which formed the basis for this policy has been discredited by the financial crisis of 2007-2010 and its aftermath. This doctrine was the New Consensus on Monetary Policy, that monetary policy, principally varying the interest rate at which the central bank provides funds to the money market, can effectively regulate the rate of inflation and the business cycle.

With QE discredited, what principles should guide the practice of UK monetary policy?

Analysis

Since the global financial crisis at the end of the 2000s, inflation has slumped despite the so-called 'extraordinary measure' of quantitative easing, which in any case has not worked in accordance with the mainstream ideology. Inflation in the UK has been reignited not by monetary policy but by the political shock to the exchange rate of the EU referendum. There are increasing concerns about so-called secular stagnation and the effect on financial stability of continuing the buying by the central bank of long-term securities, QE. The blame for the failure of the 1990s policy doctrine has been placed on the monetary transmission mechanism from central bank purchases to private lending, widely acknowledged to be ineffective. No alternative doctrine or theory has emerged to guide central bank operations.

The monetary transmission mechanism is a fluid rather than a mechanical transmitter. It does not as much 'break down' as alter with the changing structure of the financial markets. A structural examination of the financial markets, as opposed to an examination of financial indicators, shows why QE monetary policy has ceased to work. The money markets have been internationalised by development of dollar swaps market. With the exception of the Federal Reserve, no central bank in a country without capital controls has any money market that it can use as the starting point of a transmission mechanism of that central bank's monetary policy.

Monetary policy, as we now see with quantitative easing, operates on the capital market for long-term securities rather than on short term money markets and the real economy. Failure in capital markets turned the financial crash of 2008 into a financial depression. Large industrial corporations were unable to refinance short-term debts into long-term bonds and equity and responded to this illiquidity in the capital market by cutting back their fixed capital investment.

The growing awareness of the threats posed to financial stability of continuing quantitative easing has not led to a development of a sound alternative. Instead, discussion of monetary of policy is dominated by the question of how QE may be discontinued so consensus monetary policy framework may resume. However, such a return to the *status quo ante* would be wrong. Abandoning the open market operations of quantitative easing would render the capital market illiquid, creating problems for government finances and corporate finance, both of which need to be mobilised in order to overcome the slow economic growth.

Policy Framework

The new policy framework should regulate liquidity in the capital markets by building on QE open market operations. Capital market liquidity is needed to support bond markets, including the government bond market, and to regulate corporate liquidity. Regulating capital market liquidity requires reinforcement through taxing holdings of financial assets to discourage hoarding of excess liquidity. Such a framework would not be ‘monetising’ fiscal deficits, but drawing off the excess liquidity created by deficit spending of the government.

Taxation of holdings of financial assets and drawing off of excess liquidity implies that monetary policy must to coordinate with fiscal policy. This need not mean eliminating the independence of the central bank, and subordinating the monetary policy of the Bank of England to the government. Fiscal policy coordination could be achieved by making the Bank of England more accountable to Parliament for financial stability in the capital market. Parliament would assign the Bank of England responsibility for adequate liquidity in the capital market, this to be measured by stock market indices and the ease of issue of new securities by the government and by corporations based in England.

The Bank of England could regulate the liquidity in a globalised capital market by setting as its target a stable yield curve for UK government bonds and for liabilities of British corporations that are willing to have the market for their long-term securities regulated by the Bank. This would also give the Bank control over those corporations’ merger and acquisition activities. This policy framework was used informally in the nineteenth century when capital markets were internationalized under the gold standard. Central banks then made a market in bonds issued by their governments and had formal and informal lists of corporate securities that they would accept for discount. This framework also featured in the Chicago Plan for Banking Reform in the 1930s.

This framework would provide a tool to implement the industrial policy in the Labour Manifesto. In return for benefiting from the Bank of England’s liquidity umbrella, British corporations could be expected to show a greater commitment to investment in Britain. The stabilisation of the yield curve and the regulation of merger and takeover activity would also discourage speculation and trading on capital market instability.

The stabilisation of the capital market would complement and make more effective bank capital adequacy regimes: banks lending to businesses with access to more stable long-term funding would improve the quality of their loan books.

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