Helicopters on standby?

With rates at all-time lows, the Bank of England needs a different playbook for this crisis

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With a big recession on the way, the Bank of England's Monetary Policy Committee would normally be unveiling measures to support the economy today, and this piece would be discussing what they've done. But we are not in normal times. Instead, the Bank of England does not have the option of cutting rates in the way it has done in past recessions. So, what should it be doing, and more importantly what is its role, in the face of economic threat from coronavirus? Quite a big change from previous recessions is underway - rather than being the key provider of support to the economy, the Bank's main role is now a supporting one: making sure the necessary fiscal measures can happen. This is particularly important because financial markets – which are the key source of funding for the Government – have been extremely volatile in response to the outbreak, raising questions about whether they can provide the eye wateringly large increase in the government's need to raise cash.

In practice this role means continuing Quantitative Easing, buying government bonds in the secondary market to calm markets and ensure funding costs remain low. But it is crucial that we plan for what happens if the situation deteriorates and the Government is unable to borrow direct from markets to fund measures on the scale required to support the economy. In that case, the Bank of England will need to provide direct monetary financing to avoid a prolonged and painful recession. Such a scenario seemed only a distant prospect a few weeks back but the risk of it taking place have now risen substantially. The Bank would be right to engage in such exceptional action as a last resort, but it should be done in such a way as to avoid lasting damage to either the Bank's reputation for independence or inflation expectations in the years ahead. The Government and the Bank of England should be explicit in advance that it will only take such measures if they are temporary, transparent and accountable.

The Bank of England cannot provide the support to the economy it normally would during a recession

Remember Autumn 2008? Financial markets were in meltdown and there were signs everywhere that the UK economy was about to enter a deep recession. For those involved in policy for more than a decade, there is a clear sense of déjà vu. Whereas in 2008 the financial system was collapsing, this time the threat of economic crisis comes from a viral outbreak.

Back then, the Bank of England came to came to the rescue, slashing rates by more than five percentage points and launching Quantitative Easing (QE) to provide vital support to the economy. This is what central banks *normally* do: when the outlook deteriorates they are the key source of broad support for the economy as a whole.

So you might have been forgiven for expecting the Bank of England's Monetary Policy Committee to have announced something similar today at their meeting, given signs that we are slipping into a major recession – indeed, based on the experience of past viral outbreaks, there is a risk of high single, or even double-digit, percentage falls in GDP.

But the problem for the Bank of England is that it has reached the limit of its playbook from past recessions. Indeed, it has already cut rates to all-time lows and sees no net benefit in cutting them further, and doing so much QE that it's hard to see much more making a huge difference. In short, monetary policy is, not quite, but close to being maxed out.

So, if it can't do what it would normally do, what should the Bank's role be in this crisis?

There are other tools the Bank can use to support the economy, but they won't allow it to be the key provider of support to the economy

If the Bank of England can't simply pull its existing levers harder, can it find a new lever to pull instead? Here, there are essentially three options.

First, negative rates. Unfortunately the reality here is that, despite the column inches devoted to this, cutting policy rates below zero simply won't achieve much right now. Because cuts in rates aren't passed on to borrowers when they are at near-zero levels, further cuts will have a smaller effect. And while the previous decision to cut its main policy rate to just 0.1 per cent (Figure 1) is slightly lower than the Bank has gone before, it doesn't think there would be much to gain from going further. While in years to come digital currencies could mean rates can be cut meaningfully into negative territory, for now there is little scope to provide further support this way.

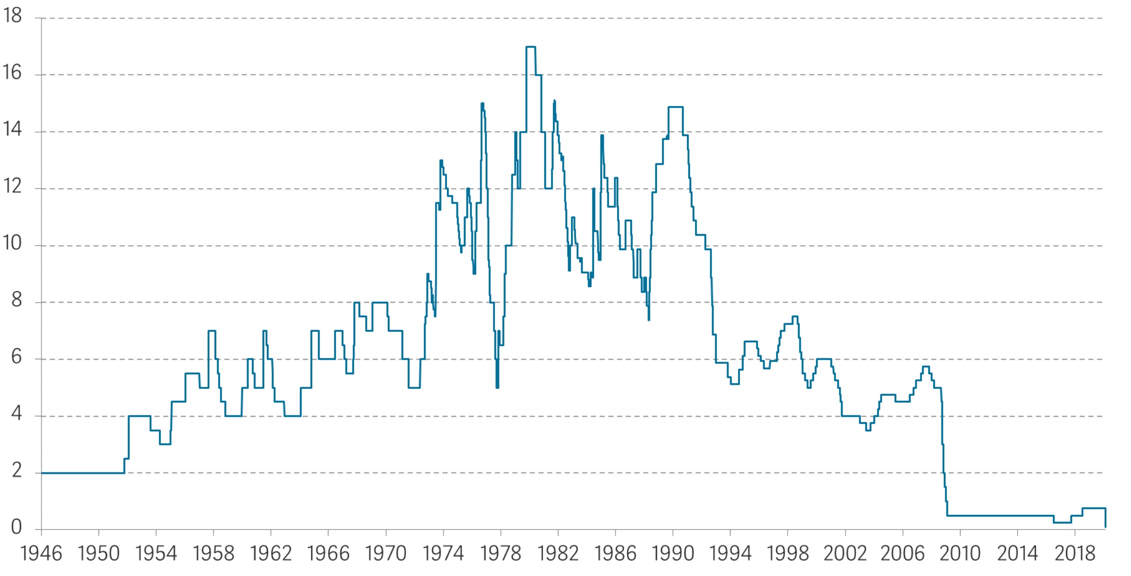
Second, the Bank of England could provide more stimulus by promising to keep rates close to zero even as the economy recovers and inflation picks up. This approach is darling of monetary-policy wonks the world over owing to the traction it gets in certain theoretical models. But this approach relies on families and firms trusting that central banks will keep rates low even when faced with powerful incentives to renege on their promises. So here again the real-world scope for additional stimulus is very limited.

And third, the Bank of England could buy riskier assets, such as debt issued by large firms. Such purchases would act to reduce the spreads on such debt, making it cheaper for corporations to borrow, and so providing a boost to their spending. The problem with doing more here is that the market for corporate debt denominated in sterling is pretty small (there's only around £500 billion in issuance, compared to more than £2000 billion of

Government bonds). This makes it difficult for the Bank to intervene at scale without taking over the market completely. In any case, having bought around £10 billion of the outstanding stock in 2016, and said that it will make further purchases as part of the round of QE announced last week (albeit an unspecified amount) it is hard to see that much material difference could be made via this route.

An alternative would be for the Bank to buy equities, as has been tried in Japan. This would get around the problem of the size of the market, but would increase the credit risk taken onto the public sector balance sheet. So, once again, it would be difficult to do this in large scale – one of the reasons why purchases of equities have been a relatively small proportion of asset purchases in Japan.

Figure 1 **Policy rates have been cut to all-time lows and can be cut no further**
Bank of England policy rate



Notes: Bank Rate until 1972, Minimum Lending Rate 1972-1981, Minimum Band 1 Dealing Rate 1981-1997, Repo Rate 1997-2006, Bank Rate, 2006-2016.
Source: Bank of England.

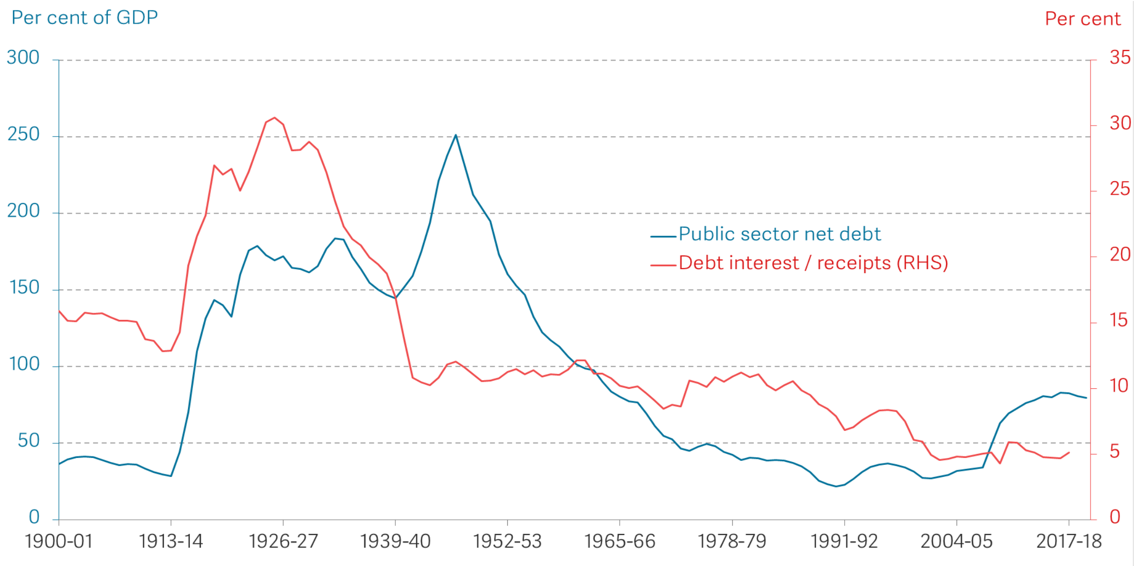
It is also worth noting that these generalised forms of stimulus are simply less effective given the nature of this crisis, which sees some households and firms not able to spend the money they do have, while others heavily affected by the social distancing measures put in place to contain the spread of the virus seeing very real income hits.

So the Bank of England must take on a different role to past recessions

So, while during the financial crisis the Bank of England was the key provider of support to the economy – with fiscal policy acting in a secondary supporting role, facilitating the Bank's stimulus measures (for example by providing an indemnity for losses on its QE purchases) - this time the roles are to a significant degree reversed. In short, as we have set out previously, with monetary policy at its limit, fiscal policy must do the heavy lifting. It does that against a backdrop of a relatively low deficit and the very low cost of funding borrowing (Figure 2). As long as the Government is able to finance its borrowing, this can continue. But this is not guaranteed, and we have already seen some jitters in financial markets that will provide pause for thought as the Treasury and Bank look to the months ahead. The danger here is that the government will need to raise simply colossal amounts of cash in the months ahead to pay for the economic and health care responses to this crisis, but will be doing so at exactly the time when everyone else wants to hold on to their cash.

Crucially, then, the Bank of England has a key role in making sure fiscal policy can continue to support the economy. It can do this by ensuring fiscal support does not need to be withdrawn because the Government loses access to funding markets. It is clear that the Bank of England recognises this role: in one of his first television interviews, Andrew Bailey, the new Governor, suggested that the Government should not be concerned about its ability to finance the extra borrowing that it would need to do to counter the crisis, as the Bank would be there to buy it.

Figure 2 **There is currently scope to use fiscal policy to support the economy**
Public sector net debt and debt interest payments as a proportion of tax receipts



Notes: Measurements are for central government debt interest and do not include that of local government or public sector corporations.
Source: RF analysis of OBR.

But pursuing such an important policy potentially comes with big risks and it is important that we prepare for those. By announcing that it will undertake substantial QE purchases of Government bonds, the Bank of England has already acted to make it easier to finance the necessary fiscal response – reducing volatility. It is important to recognise that this is the Bank buying government bonds in the open or secondary market. That approach requires market participants to continue to take up all new debt issued by government, in part reassured that the Bank is out there as a big source of demand for those bonds. But if this key requirement is no longer met and Government is unable to sell bonds on the scale that the current vital support for the economy requires, then more aggressive measures would be needed from the Bank.

This could include outright monetary financing of Government spending – that would see the Bank buying government bonds at the point of issue rather than in the secondary market. Such an approach should be adopted, if needed, in this crisis to enable the Government to do its job in supporting the economy. But such a policy would come with big risks for the overall policy framework in the UK, including eroding the credibility of the Bank of England if it is perceived that the Government is in some way taking over monetary policy. Indeed, a strong, independent Bank of England has been a cornerstone of the macroeconomic policy framework – so it is imperative that we find ways for the Bank to fulfil this crucial role without a destabilising loss of confidence.

The good news is the Bank and Government has some, albeit not much, time to set out how if needed it would approach this issue. The next government bond auction is not set to take place until 2 April. The risks would be reduced by setting out explicitly, in advance, the conditions under which the Bank of England could provide monetary finance to the Government. Those conditions should ensure such operations are:

- Temporary: any monetary financing should be explicitly temporary, with both the Bank and the Treasury able to call a halt to it at any time, and a commitment that the bonds purchased will be sold back into the open market when feasible;
- Transparent: such coordination should have the transparent objective of maintaining financial stability and achieving the Bank of England's inflation target in the medium term – ruling out using this mechanism to fund normal government expenditure outside of the crisis; and
- Accountable: the Bank and government should aim to maintain some private sector involvement in auctions to provide some elements of market pricing while the Government should retain all decisions on the nature of the spending financed by the Bank of England, to maintain democratic accountability.

In such circumstances, would we be seeing so-called 'helicopter money'? Well not in the normal sense of that phrase, which is taken to involve the Bank of England creating electronic money and then directly (or via the government) making payments to individuals to boost spending power and inflation. But it is within the spirit of discussions of helicopter money, with the creation of those bank reserves making possible the several different forms of fiscal support for the economy that the government is currently engaged in.

It is also important to be clear that this is also not the same as permanent funding of Government spending through unlimited creation of central bank reserves, which would undoubtedly create inflation – just think of the experience of Zimbabwe or Venezuela. The priority for both the Bank and Government is therefore to not only ensure the approach they might need to take is in practice very different to the experiences of these countries, but to communicate that fact very clearly indeed.

Providing any sort of monetary financing would clearly represent the crossing of a major Rubicon in terms of the interaction between fiscal and monetary policy, and would reflect the unprecedented situation that we find ourselves in.

So with today's policy announcement from the Bank of England signalling it has reached the limits of its ability to provide large-scale support to the economy, it is important to recognise that it still has a huge role to play in this crisis. While the Bank will not be the key provider of support for the economy that it was in 2008, it will nevertheless play a key role in allowing fiscal policy to stop the current crisis becoming deeper and more painful. In taking on this vital role, the Treasury and the Bank should be clear that any moves towards monetary financing of the Government deficit must be: temporary, transparent and accountable.