



**IPPR Commission on Economic Justice**

# **Just About Managing Demand**

**Reforming the UK's  
macroeconomic  
policy framework**

*Policy Paper*

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Launched in November 2016, the Commission brings together leading figures from across society – from business and trade unions, civil society organisations and academia – to examine the challenges facing the UK economy and make practical recommendations for reform.

The Commission is undertaking a wide-ranging programme of research and policy consultation on issues including industrial strategy, macroeconomic policy, taxation, work and labour markets, wealth and ownership, sub-national economic policy and technological change. Through a major programme of communications, events and stakeholder engagement it aims to contribute to both public debate and public policy on the economy. Non-partisan, it has been welcomed by both government and opposition parties.

The Commission's Interim Report, *Time for Change: A New Vision for the British Economy*, was published in September 2017. Its Final Report will be published in autumn 2018.

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# Summary

## 60-SECOND SUMMARY

UK macroeconomic policy needs reform. When interest rates are effectively as low as they can go, monetary policymakers no longer have reliable tools to stabilise the economy in the event of a recession. Quantitative easing (QE) – the purchase of government and corporate bonds by the Bank of England to try and increase spending in the economy – has been an unreliable form of stimulus by its very nature. Normally, fiscal policy (government tax and spending) might be expected to pick up the slack. But over the past 10 years, successive governments have sought to reduce the budget deficit, despite damaging consequences for incomes and living standards. To increase the number of tools at the disposal of policy makers, we propose changes to the macroeconomic policy framework in three areas. First, new fiscal rules should be brought in that support governments to not overspend in the good times, but equally to not underspend during a downturn. Second, the Bank of England’s mandate should be revised to help interest rates rise faster in time for the next recession. Third, a new mechanism should be introduced under which, when interest rates cannot be cut sufficiently, the Bank of England would delegate an economic stimulus to a new National Investment Bank (NIB), and would purchase its bonds as necessary to ensure sufficient demand is injected directly into the economy.

## EXECUTIVE SUMMARY

Since the global financial crisis of 2008, policymakers in control of the UK’s two main macroeconomic policy levers have essentially been engaged in a tug of war – pulling simultaneously in opposing directions.

On the one hand, the Bank of England has been testing the limits of monetary policy to stimulate demand in the economy. Interest rates have now been held at 0.5 per cent or less for more than eight years, and £445 billion has been injected into the economy through the unconventional – and largely experimental – policy of quantitative easing (QE). UK monetary policy has essentially been set to ‘recession mode’ for the best part of a decade.

On the other hand, governmental fiscal policy has seemingly been set as if to deal with permanent economic boom, drawing demand out of the economy. The policy of discretionary fiscal contraction (‘austerity’) has seen public spending cut from around 45.1 per cent of gross domestic product (GDP) in 2009/10 – the high it reached in the wake of the financial crisis – to around 38.9 per cent in 2016/17 and a forecast 37.7 per cent by 2022/23. Total government borrowing has been cut from 9.9 per cent of GDP in 2009/10 to 2.2 per cent for 2017/18.

To have the two major macroeconomic policy instruments working in direct opposition to one another for such a prolonged period points to deep weaknesses in the UK’s policy framework. Two structural weaknesses have been revealed since the financial crisis.

1. Conventional monetary policy loses its effectiveness when interest rates are very low. Nominal interest rates have an ‘effective lower bound’, a minimum beyond which further reductions have little or no positive effect on spending in the economy. Interest rates in the UK have been at their effective lower bound for much of the past eight years.
2. Governments do not always act as mainstream political economy expects. A key assumption underpinning the Bank of England’s independence in 1997 was that governments tend towards overspending – they exhibit ‘deficit bias’. But

since 2010, governments in the UK have in fact done the opposite, favouring excessive underspending, or ‘surplus bias’.

Quantitative easing has been the main policy experiment to find a solution to these structural weaknesses. But the effects of QE are unreliable and inherently uncertain. They have led to significant winners and losers, without any democratic or public accountability. By increasing asset prices, QE has benefited equity investors and owner-occupiers, who tend already to be better off, while hurting pensioners dependent on retirement income and young people seeking to get on the housing ladder.

The combination of these two structural weaknesses in the UK’s macroeconomic framework has almost certainly meant that incomes and living standards are significantly lower than they should otherwise have been. This has also meant that interest rates have been unable to rise, leaving policymakers even less well equipped to combat the next recession than they were in 2008. Given that the UK experiences an economic downturn on average once every 10 to 15 years, the next recession may not be far away.

In this context, we propose three areas of structural reform to UK macroeconomic policymaking.

1. We propose new fiscal rules to guide government policy, mitigating against both deficit bias *and* surplus bias. These include the separation of borrowing for current spending from borrowing for investment. Borrowing for current spending should be balanced over a rolling five-year period. Public investment (which supports long-term growth) should have a separate target as a percentage of GDP. Overall debt should be determined on the basis of its long-term impact on the economy. The proposed rules would provide stronger protection of government investment during recessions and increased flexibility to increase overall spending temporarily if interest rates are at the effective lower bound.
2. We propose that the Treasury considers revising the Bank of England monetary policy mandate. The Bank’s Monetary Policy Committee (MPC) should be asked to target one or both of unemployment and the level of nominal GDP, either alongside inflation or as intermediate guides to a primary inflation target. This would reduce the risk of monetary policy being over-tightened during a recession when inflation was the result of an external price shock.
3. We propose a significant institutional reform of the UK’s macroeconomic framework in order to provide an alternative means of delivering a spending stimulus when interest rates are very low. This would be superior to QE in terms of economic reliability and democratic accountability.

We recommend the creation of an NIB, which under normal circumstances can help to provide countercyclical lending to support socially and economically productive investment in line with the priorities of the elected government. In addition, and to reduce reliance on QE, **we recommend that the Bank of England is given the power to ‘delegate’ an economic stimulus to the new NIB when interest rates are at the effective lower bound and government fiscal policy is believed to be overly restrictive.** This stimulus could take the form of increased lending for business growth, housing, innovation, and social and physical infrastructure. To ensure the extra lending can always be funded, we propose that the Bank of England is able to coordinate any delegated stimulus with additional purchases of NIB bonds from private investors.

Together, these proposed reforms to the UK’s macroeconomic framework would significantly increase the chances of effective policymaking in response to the next recession, while also retaining – and in some cases improving on – the balance between democratic accountability and economic effectiveness.

## Introduction

Since the global financial crisis of 2008, policymakers in control of the UK's two main levers in the macroeconomy have essentially been engaged in a tug of war – pulling simultaneously in two opposing directions.

More than at any other time in its history, the Bank of England has been testing the limits of its monetary policy levers to stimulate demand in the economy. Interest rates have now been held at 0.5 per cent or less for more than eight years, a period without precedent in UK policymaking. Over the same period, the Bank of England has also injected £445 billion into the economy through the unconventional – and largely experimental – policy of 'quantitative easing' (QE), through which it purchases government (and some corporate) bonds from the private sector. Interest rates were inched back up to 0.5 per cent in October 2017, but now nearly 10 years on from the financial crisis, and after eight consecutive years of growth (albeit slow), it is remarkable that UK monetary policy is essentially still set to 'recession mode'.

Meanwhile, the UK's other macro lever – fiscal policy – has seemingly been set as if to deal with permanent economic boom. Since 2010, when the country had still not fully escaped recession, fiscal policy has drawn demand out of the economy. Governments have been focused on reducing the public budget deficit (the difference between annual public expenditure and receipts), with the ultimate goal of 'balancing the books' of the state. This policy of discretionary contraction ('austerity') has seen public spending cut from around 45.1 per cent of GDP in 2009/10 – the high it reached in the wake of the financial crisis – to around 38.9 per cent in 2016/17. Current forecasts see government spending falling further to 37.7 per cent of GDP by 2022/23. Total government borrowing has been cut from 9.9 per cent of GDP in 2009/10 to 2.2 per cent for 2017/18 (OBR 2018a).

Monetary and fiscal policy have therefore been effectively acting against each other, one injecting demand into the economy while the other withdraws it. This might have worked if the UK economy had seen strong demand from business investment or exports. But business investment has been weak, with the UK corporate sector now a net saver in the economy: in 2016, private sector investment began to contract again (OBR 2017a). And we have had a persistently high trade deficit. The result is that growth has been largely dependent on household spending, fuelled by rising levels of consumer debt. The Office for Budget Responsibility (OBR) estimates that, for 2017, household consumption will have driven nine-tenths of the estimated 2 per cent of GDP growth (OBR 2017a). Average household debt has risen by over 15 per cent since 2010, and now stands at 142 per cent of disposable income. A continuation of this trend would take household debt beyond its 2008 peak (160 per cent) in under three years (House of Commons Library 2017). The Bank of England has already warned of the dangers (Brazier 2017).

None of this, however, should have been unexpected. One of two often overlooked reasons why fiscal consolidation has not worked well is that, across the economy as a whole, all saving and borrowing must mathematically balance. So if the government deficit declines, other sectors of the economy (households, firms and the 'rest of the world') have to make up the difference.

As long as the UK continues to run a high current account deficit (which equates to net lending by the rest of the world) and the corporate sector

remains a net lender, government and households must be net borrowers. It should therefore not come as a surprise that the budget deficit has not fallen as fast as governments sought, or that household debt has been rising.

The second overlooked reason involves a deeper Keynesian insight. The state can provide stabilisation and stimulus in the economy, not only through the demand it generates directly and indirectly through government expenditure (its 'size') but also through the coordination provided by its institutions (its 'scope'). In both cases, the state can help to give assurance against risk for the private sector, either through the predictability of (public) demand in the economy or through the predictability of the private investment environment. Both of these roles were especially critical when the private economy was still reeling from the damage of 'unknowable risk', following the 2008 financial crisis (Leijonhufvud 2009). But from 2010, when markets needed further stabilisation policy and signalling from government to more accurately understand and price economic risks, government deliberately diminished its own role through reduced taxation, spending and coordination in labour and capital markets.

The consequence is that the combination of macroeconomic policies has not yielded strong growth. The UK's recovery from the crisis has been one of the slowest of all developed countries: lower than both the European Union (EU) and Organisation for Economic Development (OECD) averages, and well behind Germany and the US (IPPR 2017).

It is in the prospects for the immediate future, however, that most concern perhaps lies. The occasional tug of war between monetary and fiscal policy is always possible in a democracy. But for it to remain in place for the best part of a decade is a symptom of a failing macroeconomic framework. On average, the UK faces recession once every 10 to 15 years. Now, nearly 10 years on from the last recession, a new framework is required to ensure that policymakers can respond properly when the need next arises.

# 1. Running out of road: Macroeconomic policy in the UK

In mainstream theory, the policy objectives of macroeconomic management centre around targeting and controlling aggregate demand and inflation in order to optimise welfare in society. Since the 1970s, and the collapse of the Bretton Woods system of fixed exchange rates, consensus in western economics has broadly settled on a particular set of arrangements for how best to deliver against these goals. These have been adopted to a greater or lesser extent by most developed countries.

This arrangement hinges on a division of labour in both institutions and policy. During the ebb and flow of the normal economic cycle, responsibility for managing demand and inflation is the near exclusive preserve of monetary policy, administered by a central bank which is, in most cases and respects, independent from government. The central bank fulfils this role by actively setting the ‘base rate’: the rate of interest charged on short-term loans from the central bank to the private sector. This in turn affects the affordability of credit and the returns on savings in the wider economy, which also shapes the spending power of firms and households and therefore aggregates demand and inflation. In the right circumstances, lower rates can boost consumption and inflation, while higher rates suppress both. Discretionary fiscal policy, on the other hand, is not used primarily for demand management. At the macro level at least, it is limited to managing government debt and borrowing. Fiscal surpluses and deficits invariably have a significant impact on aggregate consumption, but policy is normally set with reference to debt and borrowing targets rather than targets of aggregate demand, such as inflation or employment in the economy.

Due to the commonality of this arrangement across both theory and practice, the economists Tatiana Kirsanova, Campbell Leith and Simon Wren-Lewis (2009) call this division of labour the ‘consensus assignment’: ‘assignment’ in the sense of allocating institutional roles for government and its central banks; and ‘consensus’ due to its prevailing support across policymakers and academia.

Within this consensus, there remains some role for *non-discretionary* fiscal policy in demand management in the form of automatic ‘fiscal stabilisers’. These are the increases in state social security payments, such as jobseeker’s allowance and tax credits in the UK,<sup>1</sup> which are activated when unemployment rises and incomes fall and thereby help to prop up household spending (Wren-Lewis and Portes 2014). In these cases, fiscal policy can become a temporary, limited and passive stabiliser which operates as a function of prevailing labour market conditions (the stabiliser is automatically reflationary during a recession and deflationary during a recovery, as people move on and off social security payments).

## THE UK’S POLICY ASSIGNMENT

In the UK, the consensus assignment is embedded in the institutional relationship between the government, in particular the Treasury, and the UK’s independent central bank, the Bank of England, in the form of its nine-member

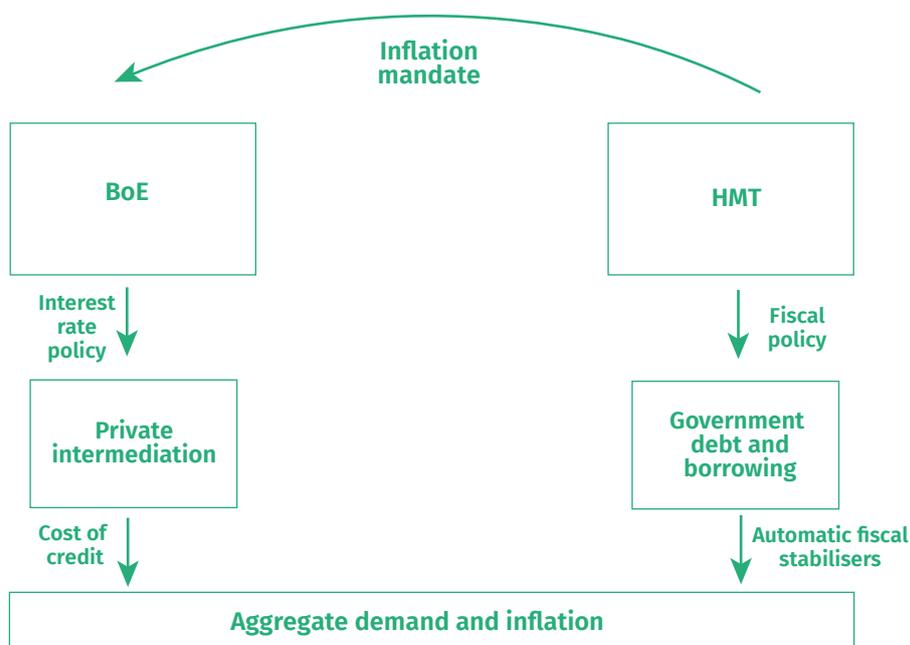
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1 These are currently being subsumed into Universal Credit.

Monetary Policy Committee (MPC).<sup>2</sup> The Treasury is responsible for setting fiscal policy and defining the government’s fiscal rules. It is subject to some independent assessment against these rules from the government’s fiscal watchdog, the Office for Budget Responsibility (OBR). The Treasury also sets the monetary policy mandate for the MPC, in the form of a target for inflation.<sup>3</sup> However, the MPC has full independence in setting nominal interest rates in order to meet the inflation target. They also have some leeway in being able to ‘look through’ short-term volatility in order to meet the inflation target over a two-year rolling time horizon, in line with their assessment of the drivers and outlook for aggregate demand and inflation.<sup>4</sup> For example, the MPC opted not to raise interest rates during 2011 and 2012 despite inflation being more than twice as high as the formal target. This was partly because under the particular circumstances at the time, they did not believe inflation to be an indicator of excessive aggregate demand.<sup>5</sup>

**FIGURE 1.1**

**The UK’s consensus assignment before 2009: institutional and policy arrangement of macroeconomic management**



Source: Author’s analysis.

The reasons for this particular division of responsibility are drawn from observations in practical policymaking, macroeconomics and political economy. From a practical perspective, active monetary policy using nominal interest rates can be implemented much more quickly and precisely than government

- 2 Technically, management of the automatic fiscal stabiliser is shared between the Treasury and the Department for Work & Pensions. However this is a relatively small, if non-trivial, element of the consensus assignment.
- 3 The inflation target in the UK was set at 2 per cent in 1997 by the then Chancellor, Gordon Brown. It has remained unchanged since.
- 4 The target is thought to be satisfied as long as inflation is forecast to reach 2 per cent within a reasonable time period.
- 5 The MPC’s view was that rising costs were primarily being driven by higher import prices – caused by a weak pound following the financial crisis added to rising oil prices – as well as the Government’s decision to raise VAT.

tax and spending (fiscal policy), allowing for a more immediate response and greater fine-tuning. This relative speed and precision also lends itself to more accurate and timely post-hoc review of policy outcomes. Monetary policy is also said to have ‘dominance’ over fiscal policy in terms of economy efficiency. While both monetary and fiscal policy can be effective at adjusting aggregate demand, monetary policy is thought to have complementary supply side effects: for example, a cut in interest rates may increase consumption (aggregate demand) while also reducing labour supply, both of which will affect inflation in the same direction (Kirsanova, Leith and Wren-Lewis 2009).

Many of the perceived advantages of monetary policy over discretionary fiscal policy lie in political economy. These arise from the likely trade-offs that might occur with other fiscal considerations; whether based in politics (for example, governments may seek to benefit particular electoral constituencies) or related to other policy considerations (for example, the size, reach and shape of the state).<sup>6</sup> A commonly cited critique is that political imperatives might make elected governments more willing to cut taxes and spend more when aggregate demand needs boosting than they would be to raise taxes and cut spending when demand is too high – characterised in some literature as ‘deficit bias’ (see for example Alesina and Tabellini 1990). According to the mainstream economic view, any trading-off of demand management goals against other fiscal priorities implies a net cost to aggregate welfare in the economy (Wren-Lewis and Portes 2014).

### **CONVENTIONAL MONETARY POLICY IN THE UK: NO LONGER FIT FOR PURPOSE**

Despite broad convergence around the consensus assignment, macroeconomic theory does not consider the arrangement to be infallible. In particular, the effectiveness of the assignment is contingent on monetary policy being unconstrained in its capacity to stabilise the business cycle.

For countries operating macroeconomic policy from within a monetary union, such as the EU, monetary policy is inevitably constrained. Interest rate policy is set according to a weighted average of all member countries’ inflationary outlooks. Therefore, the more an individual country’s inflation outlook differs from the average, the less good a fit conventional monetary policy will be. This means nominal interest rates are a sub-optimal tool to stabilise asymmetric shocks which affect particular countries more than others. In responding to such shocks, changing the base rate will affect all members of a union, and therefore requires trade-offs which imply costs to welfare within at least one country.

Constrained monetary policy has also come to affect far more countries since the financial crisis, whether inside or outside a monetary union. The reason for this is that in 2009 nominal interest rates quickly reached their ‘effective lower bound’ (ELB): a value at or close to zero, such that further rate cuts are impossible without turning negative or else bring little marginal benefit to the wider economy.<sup>7</sup> Under these circumstances, conventional monetary policy is unable to respond effectively to a deflationary price shock, such as a recession.

Present macroeconomic conditions in the UK are an exemplary case of constrained monetary policy due to nominal interest rates being at their ELB since 2009. Indeed, a striking trend of the last 40 years has been the secular decline in the base rate. This presents UK policymakers with a serious problem. Following periods of recession or slow growth, rates have been lowered

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6 This argument has also been made from the perspective of macroeconomic efficiency. Assuming the average level of public goods produced in an economy is optimal, any deviations from this balance to affect demand imply an economic cost (for example see Kirsanova, Leith and Wren-Lewis 2009).

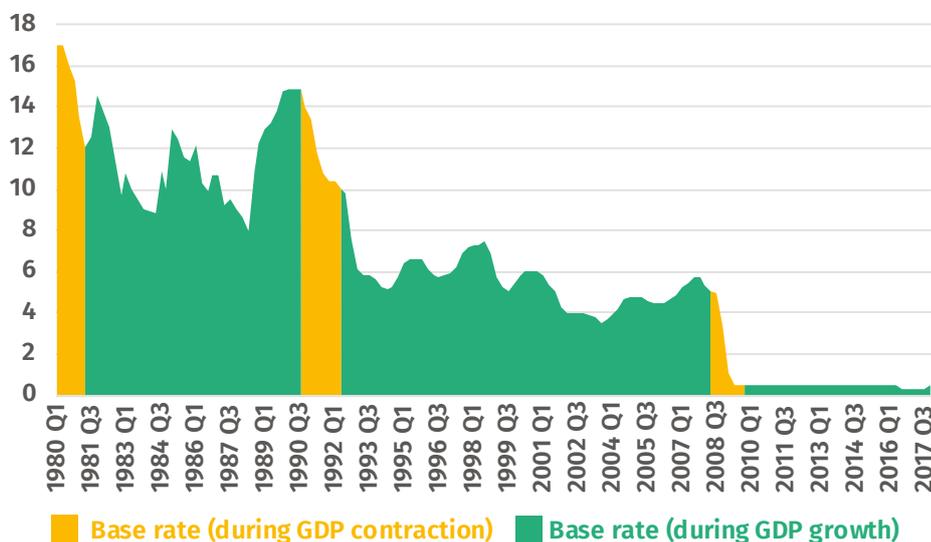
7 See section below headed ‘Alternative options in monetary policy’ for a brief discussion of negative interest rates.

significantly in order to reflate demand, prices and investment in the economy. But following major recessions, the base rate has tended not to recover its pre-recession level before being cut again in response to the next significant downturn (see figure 1.2). As a result, the economy has successively adjusted to ever cheaper credit, with each subsequent downturn requiring looser monetary policy while starting from an ever lower base. The base rate today stands at 0.5 per cent, which outside the period August 2016 to November 2017 (when it dropped to 0.25 per cent), is the lowest in the Bank of England’s history.

**FIGURE 1.2**

**The scope for conventional monetary policy to reflate demand is currently limited**

*Bank of England base rate (quarterly average) colourcoded to denote whether values coincide with quarters of GDP contraction or growth (compared with the same quarter the previous year, Q1 1980 to Q3 2017)*



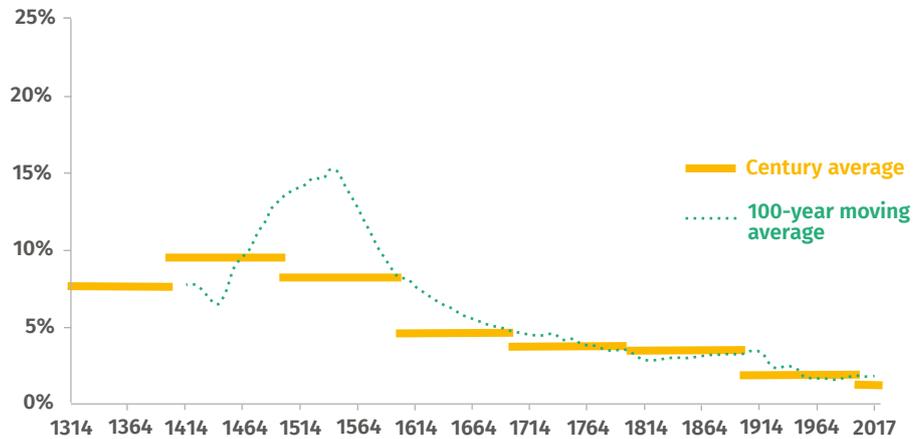
Source: Bank of England 2018 and ONS 2018.

The underlying causes of this pattern are not unique to the UK, nor are they thought to be short term. In western economies, the real ‘risk-free’ rate of interest – nominal interest on the safest long-term debt minus the rate of inflation – has been on a consistently downward path over decades, if not centuries (see figure 1.3). This observation is a key feature of the revived ‘secular stagnation’ thesis – that advanced economies have reached a period of semi-permanent low or negligible growth in aggregate demand. This has been advanced in recent years, most notably by Larry Summers (2013 and 2016) and Paul Krugman (2013). The causes of low aggregate demand growth are contested. Demographic shifts, overhanging debt, a slowing of the rate of technological innovation and increased financialisation of the private sector have all been put forward as candidates (Teulings and Baldwin 2014). Yet even sceptics of the secular stagnation hypothesis agree that falling real interest rates are a serious symptom of changing economy dynamics (for example see Bernanke 2015), and even those who question the extent to which the origins are structural agree that the causes are nonetheless likely to be long term (see for example Rogoff 2015).

**FIGURE 1.3**

**Long-run analysis suggests that the average ‘risk-free’ interest rate has been falling for at least five and a half centuries**

*International real ‘risk-free’ interest rates, 1314 to 2017*



Source: Reproduced from Schmelzing 2017

In the UK, the base rate is expected to remain well below the average for the previous decade for the entirety of the present OBR forecast period, remaining close to the ELB well into the 2020s (see figure 1.4). This means monetary policy is likely to remain constrained in its ability to stabilise demand following significant recessionary shocks for years, if not decades, to come. IPPR’s own projection using OBR data suggests that if the base rate continues to rise by the average percentage point increase expected over the coming five years then rates won’t return to 2007 levels until 2048 (IPPR analysis of OBR 2018b)<sup>8</sup>. This presents a problem. On average, the UK experiences a recession once every 10 to 15 years (Whittaker 2016). The previous two recessions before the financial crisis when monetary policy wasn’t constrained saw rates drop by at least eight percentage points to stabilise demand. If the next recession is comparable in size to any of the previous three, then conventional monetary policy will be entirely insufficient to stabilise the business cycle. There simply won’t be room for interest rates to be lowered sufficiently. Unless a solution is found, the economic and social costs are likely to be considerable.

<sup>8</sup> IPPR projection is extrapolated from the rate of increase in the base rate over the OBR forecast period. In the absence of another serious recession, the base rate may be expected to rise more quickly. Nonetheless, it is unlikely to return close to pre-2008 levels before the next recession.

**FIGURE 1.4**

**Nominal interest rates are unlikely to return to anything close to pre-recession norms by 2022 (the Office for Budget Responsibility's forecasting period)**

Bank of England base rate (quarterly average) decade average for the base rate and OBR forecast, Q1 1980 to Q1 2022



Source: Bank of England 2018 and OBR 2018b.

In the UK, the base rate is expected to remain well below the average for the previous decade for the entirety of the present OBR forecast period, remaining close to the ELB well into the 2020s (see figure 1.4). This means monetary policy is likely to remain constrained in its ability to stabilise demand following significant recessionary shocks for years, if not decades, to come. IPPR's own projection using OBR data suggests that if the base rate continues to rise by the average percentage point increase expected over the coming five years then rates won't return to 2007 levels until 2048 (IPPR analysis of OBR 2018b)<sup>9</sup>. This presents a problem. On average, the UK experiences a recession once every 10 to 15 years (Whittaker 2016). The previous two recessions before the financial crisis when monetary policy wasn't constrained saw rates drop by at least eight percentage points to stabilise demand. If the next recession is comparable in size to any of the previous three, then conventional monetary policy will be entirely insufficient to stabilise the business cycle. There simply won't be room for interest rates to be lowered sufficiently. Unless a solution is found, the economic and social costs are likely to be considerable.

**UNCONVENTIONAL MONETARY POLICY: A POOR SUBSTITUTE FOR INTEREST RATES**

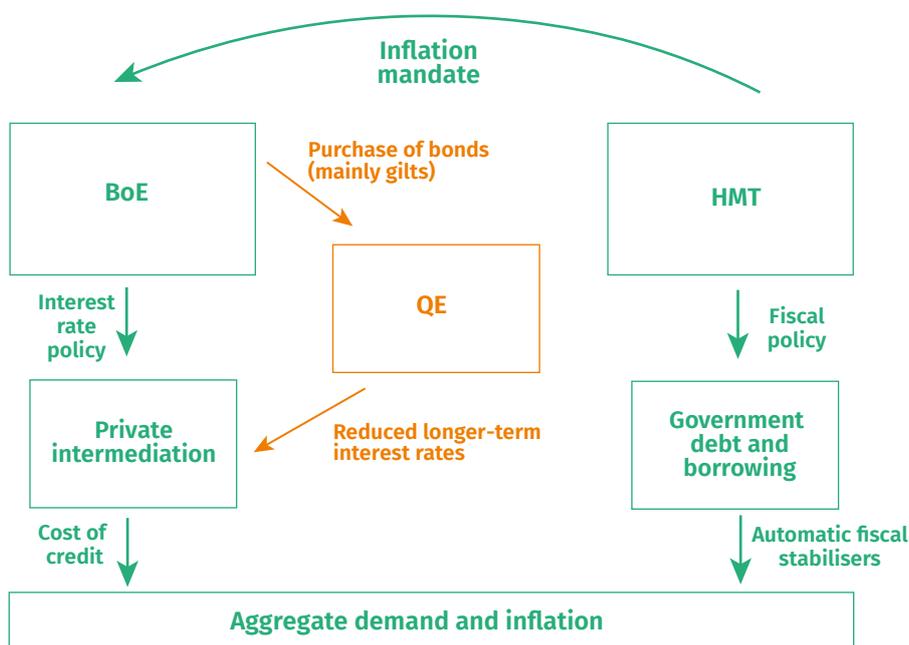
Perhaps the most conclusive evidence that the UK has entered a period of constrained monetary policy comes from the actions taken by the Bank of England since 2009. The significant use of alternative measures shows that the Bank of England did not believe its rate cut to 0.5 per cent was sufficient to stabilise demand following the financial crisis. Targeted support for bank lending – such as the Funding for Lending Scheme and more recently the Term Funding Scheme (TFS) – has been used extensively to improve the transmission

<sup>9</sup> IPPR projection is extrapolated from the rate of increase in the base rate over the OBR forecast period. In the absence of another serious recession, the base rate may be expected to rise more quickly. Nonetheless, it is unlikely to return close to pre-2008 levels before the next recession.

mechanisms between the base rate and commercial lending to the non-financial economy. ‘Forward guidance’ has been experimented with to manage the expectations of commercial banks, in order to eke out further stimulus beyond that achieved by the rate cuts themselves. Above all, the Bank of England has used the significant expansion of its balance sheet – otherwise known as ‘quantitative easing’ (QE) – to try to change the relative price of assets and thereby reduce longer term interest rates further down the chain of market transactions. In total, this has seen the Bank of England purchase £435 billion of government bonds and £10 billion of corporate bonds from private institutional investors and some banks.

QE represents a significant experiment in monetary policy, and a radical departure from the conventional consensus assignment, which conceived of monetary policy being carried largely through bank rate changes. It involves monetary financing by the Bank of England – a process by which the Bank of England creates electronic reserves from nothing – to purchase assets from the private sector. The hope is that the increased liquidity will improve lending conditions from commercial banks to the non-financial sector. However, both the effects of QE, and the mechanisms by which it is thought to work, are not well understood and remain contested (Harrison 2017).

**FIGURE 1.5**  
Quantitative easing in UK macroeconomic management



Source: Author's analysis.

Having initially, and famously, remarked that ‘the trouble with QE is that it works in practice but not in theory’, the former head of the US Federal Reserve Ben Bernanke has since argued that the policy primarily works through the so-called ‘portfolio balance channel’ (2010). This explanation holds that purchasing long-term bonds (debt) held by the private sector increases the

price of these assets, since aggregate demand for them has risen. With more buyers of long-term debt in the market, the interest rate charged on the assets is then expected to fall. Several other transmission mechanisms have also been suggested, including through signalling (Bauer and Rudebusch 2014), reducing commercial bank risk exposure (Farmer and Zabczyk 2016) and expansion of the central bank's reserves (Aksoy and Basso 2014, and Reis 2015). However, the view that the portfolio balance channel is the most important is now widely accepted, at least among monetary policymakers (Harrison 2017).

Nonetheless, the consensus view remains that QE is a poor substitute for conventional monetary policy. The extent to which QE is an effective instrument, whether through the portfolio balance channel or any other transmission mechanism, is unknown. A growing number of studies support the argument that QE does lower long-term interest rates (see for example D'Amico and King 2013, and Greenwood and Vayanos 2010),<sup>10</sup> and that overall this has a net positive effect on demand and prices (see for example Pesaran and Smith 2016, and Weale and Wieladek 2016). But if QE has had a positive effect, policymakers do not know what volume of QE equates to what percentage point change in inflation, or what the rate of diminishing returns on QE might be, or what the long-term outcomes are, or the extent to which its effects are time and place contingent (Joyce, Miles, Scott and Vayanos 2012, and Haldane 2015). In 2015, the chief economist of the Bank of England, Andy Haldane, argued: 'QE's effectiveness as a monetary instrument seems likely to be highly state-contingent, and hence uncertain, at least relative to interest rates. This uncertainty is not just the result of the more limited evidence base on QE than on interest rates. Rather, it is an intrinsic feature of the transmission mechanism of QE.'

Econometric research has shown that the optimal strategy for macroeconomic policy is always to prioritise the use of more reliable tools over more uncertain ones. The economist Simon Wren-Lewis uses the analogy of healthcare to describe why uncertainty is such an undesirable characteristic of a macroeconomic policy tool: doctors would always seek to avoid any medicine where the correct dosage is inherently unknowable for any given patient, and can only be discovered on a case-by-case basis through trial and error (Wren-Lewis 2013).

Beyond the effectiveness of QE as an instrument for demand management, there are also two further critiques that are important here: one from the perspective of effective finance and one from political economy. The first concerns the allocative efficiency of financial markets in terms of moving capital from savers to debtors, and from the future to the present. While the financial system displays great efficiency in some respects, most economists agree there are also systematic failures: for example, excessive short-termism (Haldane and Davies 2011), mispricing of risk (Kay 2015) and disproportionate preference for perceived value over fundamental value (Davis, Lukomnik and Pitt-Watson 2016). These issues mean the Bank of England has recently queried whether UK finance is under-performing in its role to support productive investment in the non-financial economy (Bank of England 2016). Because QE mainly works by adding liquidity to the existing financial system, it does little to improve the quality of investments made, and may instead make things worse (IMF 2013). Given that the funds used for QE are publicly created and (at least to start with) publicly allocated, failure to deploy the funds in a way that tries to improve or add value to private sector activity may be seen as a wasted opportunity. Detailed proposals to address this specific problem have been put forward in recent years by the New Economics Foundation (see for example NEF 2013).

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10 Although there remains a body of empirical research that also disagrees, for example see Thornton 2014.

The second issue is related, but also raises a question of democracy and Bank of England independence. QE works by suppressing yields on long-term debt, which has resulted in some investors moving their money into land and equity instead. While the aggregate effect might be to increase output and demand (albeit that the rate and mechanism is uncertain), beneath this there are significant winners and losers. The value of pension annuities erodes as the yields on bonds fall and rising house prices see home owners benefit at the expense of renters. Asymmetric distributional effects are not unique to QE in monetary policy (Bunn et al 2018). Changing the base rate also leads to winners and losers. But with QE, the Bank of England executive makes an active decision on which assets to buy and where in the market they buy from (Yates 2017). This makes the Bank of England far more accountable for the precise shape of distributional effects than with interest rate changes. This is especially true when the MPC buys corporate bonds of particular companies, as seen from August 2016. The issue this raises is one of democracy: unelected officials are essentially deploying government resources in a manner that lends itself to particular distributional results. Yet as long as the MPC is meeting its inflation mandate, there is no mechanism by which the public can hold the Bank of England to account politically for these choices. Normally, this is one of the perceived strengths of the consensus assignment, since it means monetary decisions are unaffected by political considerations or the electoral cycle. But in this case, it raises a fundamental question of democratic legitimacy.

This leaves the goal of improving QE with an internal tension: the extent of discretionary and unaccountable choices is already a source of democratic concern, yet the job of utilising public resources better, such that they correct and add value to private sector activities, would require the amount of discretionary interventions to increase, rather than diminish.

QE may well continue to be of use as an option of last resort, but its true effects, both in the present and over the long term, remain unclear. For this reason, it would be prudent for policymakers to attempt to find better options to turn to first. Given that conventional monetary policy will likely remain constrained for at least the medium term, if not beyond, finding additional solutions should become a priority for today's policymakers.

### **DISCRETIONARY FISCAL POLICY: AN UNRELIABLE SOLUTION**

Due to the uncertainty of QE, fiscal policy remains a more reliable tool for demand management. Though (for the most part) government spending and taxation is considered a less targeted form of intervention compared with adjustments to the base rate, unlike QE their effects are reasonably well understood by economists and policymakers. Discretionary fiscal policy can affect spending in the economy both directly – such as through increased government spending on goods and services purchased from the private sector – and indirectly, such as through income tax cuts which raise disposable incomes, or VAT cuts which reduce prices (IMF 2014).

The long-term goal of debt management need not be compromised by the use of fiscal policy to stabilise the business cycle. Research by staff at the International Monetary Fund (Ostry et al 2015) suggests that the UK has ample 'fiscal space' before public debt reaches a level where the negative effects on growth are likely to become acute. Given this, and given constraints on conventional monetary policy, UK governments since 2010 could and should have done far more to use

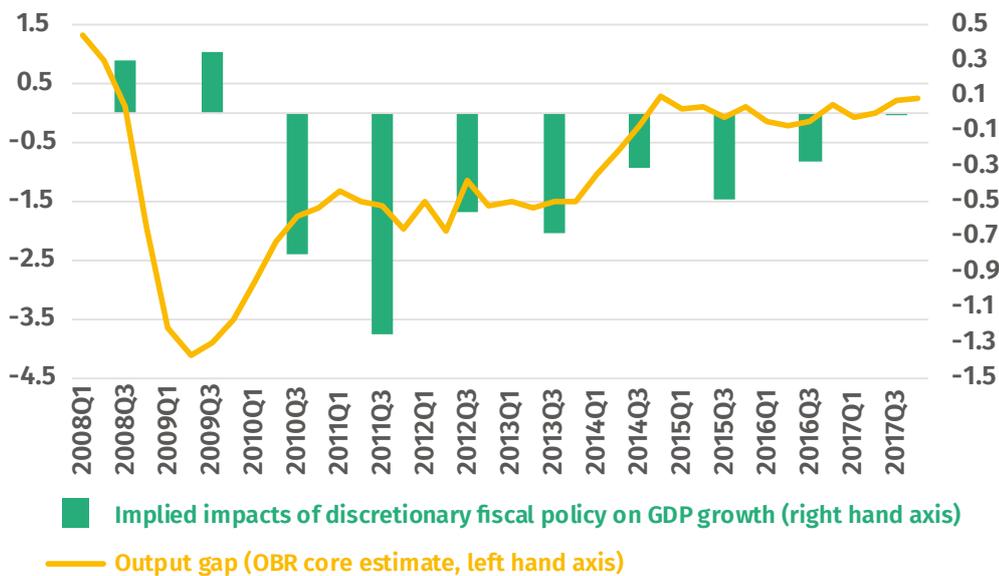
discretionary fiscal policy to help stabilise demand – not least to allow interest rates to rise faster above the ELB in time for the next recession.<sup>11</sup>

Nevertheless, it is a common opinion among economists that, from the point of view of economic efficiency, governments cannot always be relied upon to use fiscal policy in the right ways, or at the right times. As described above, one of the key observations of the UK’s present macroeconomic framework is that elected Chancellors are prone to ‘deficit bias’. This insight was key to the design of Bank of England independence and the current macroeconomic assignment as a whole. But recent history has shown that fiscal bias can also work in the opposite direction: governments can make a political virtue out of fiscal consolidation and display a bias towards fiscal *surplus*. Despite the deepest and most damaging recession since the second world war, interest rates reaching their effective lower bound and the chief economist of the Bank of England declaring inherent limitations with QE, consecutive governments in the UK have nonetheless pursued discretionary fiscal *contraction* since 2010/11. They have exhibited ‘surplus bias’.

**FIGURE 1.6**

**Government fiscal policy has the effect of suppressing GDP growth**

*Isolated impacts of discretionary fiscal policy on GDP growth and the OBR’s estimate of the output gap in the UK, Q1 2008 to Q3 2017*



Source: OBR 2017b and 2018b.

Pursued at the wrong time, the effects of such actions are likely to be at least as harmful as those amounting from deficit bias, and possibly far more so. The OBR’s own estimates suggest that, isolated out, the impact of discretionary fiscal consolidation since 2010 was to suppress the level of GDP in 2017/18 by more than four percentage points (OBR 2017b). At current growth rates, this is equal to more than a year of lost GDP growth. This serious cost to aggregate welfare can only be

11 If the secular stagnation thesis is correct, it is possible that even this may not have been enough to return demand growth to pre-2007 levels. However, given the failure to sufficiently utilise discretionary fiscal policy across almost all advanced economies since 2007, this counterfactual is not yet available to us. The argument that it should have at least been tried still holds.

assumed away in the OBR's model if it is held that unconventional monetary policy did not limit the Bank of England's ability to stabilise GDP and prices. However, it is striking that closing the output gap – the difference between what the economy is producing and its potential given available technology and people's willingness to work – stalled in the UK after discretionary fiscal policy became contractionary in 2010/11 (see figure 1.6). Monetary policy, constrained as it was by the ELB and largely having to rely on QE, was not able to close the output gap until late 2014. This would suggest that monetary policy was in fact not able to offset the negative impacts on GDP caused by fiscal consolidation. If this is the case, it would mean government's surplus bias did in fact slow the economic recovery, suppressing incomes and living standards relative to what they might otherwise have been.

### ALTERNATIVE OPTIONS IN MONETARY POLICY

The problems of the effective lower bound for conventional monetary policy have not gone unnoticed. A number of innovations have been put forward, from both inside and outside government. Three proposals in particular – negative nominal interest rates, helicopter money and revising or adding to the targets under the MPC's mandate for price stability – have received particularly serious engagement from policymakers in the UK and internationally. We discuss the first two here and return to a discussion and recommendations on the Bank of England's mandate in the next chapter.

A policy of negative nominal interest rates allows the central bank to set one or more of its interest rates below zero. Despite having already been implemented to varying degrees by a number of central banks (for example in Japan, Switzerland and Sweden), the mechanisms and effects of the policy remain hotly contested. Like QE, the impacts of negative rates are uncertain and, depending on the behavioural response from banks and savers, could actually reduce spending in the economy, or else increase the number of risky loans (see for example Eggertsson, Juelsrud and Wold 2017). Either way, at best, negative nominal rates can provide further headroom and breathing space above the ELB, but they do not escape the problem entirely. Negative interest rates too have a lower bound, which in effect is the point at which the costs to financial actors of moving to cash as a means to store and exchange value becomes lower than the cost of paying negative interest rates.<sup>12</sup> This is thought to be between around minus 0.75 per cent and minus 2 per cent (Viñals et al 2016). If aggregate demand continues to fall structurally, even if negative interest rates are successful in staying the final sentence, they too will eventually reach a lower bound.

Interest rate policy aside, one further proposal in particular has received attention in academic circles, albeit less so from policymakers: so-called 'helicopter money'. With multiple theoretical variations, and a number of different academic proponents since its 1960s origins, the distinctive characteristic of helicopter money is that it involves the creation of money by the central bank to be given away for nothing.<sup>13</sup> Money could be given to the state to distribute as it chooses (via fiscal policy) or else dropped directly into people's bank accounts for free. In other words, spending power, and therefore demand, is created without a counterbalancing liability. As long as there is spare capacity in the economy (such as under-employment or unused

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12 The costs to moving to cash are likely to mainly come upfront: such as expanding vaults and systems of transportation. Once these investments have been made, the extent to which the base rates can go negative in the future may be reduced. One way round this could be to implement a form of charge on holding cash, such as through an exchange rate between physical and electronic cash (see Haldane 2015).

13 This is not the same as quantitative easing, where bank reserves are given in exchange for an asset, normally a Treasury bond or gilt.

capital), the increased spending power need not become inflationary. Instead, and assuming the supply side of the economy is working efficiently, unused capacity will simply become utilised to create more goods and services in order to meet demand, keeping prices down and improving overall welfare. If there is insufficient spare capacity such that the stimulus does become inflationary and the inflation target is exceeded, then the central bank can increase rates or sell QE assets to reduce inflation.

While the arguments in favour of helicopter money are powerful, there remain reasons for caution. On the one hand, if the central bank (in the UK's case, the Bank of England) allocated new money unilaterally, this would be acutely undemocratic. On the other, cooperation with government over the distribution of a money-financed stimulus could undermine the Bank of England's independence. (Though it should be noted that to some extent this has already happened in the collaboration between the Treasury and the MPC in the design of QE.) To take an example: helicopter money could be used to finance a cut in VAT. But the Bank of England has no democratic mandate to oblige government to alter tax rates. And if government could oblige the Bank of England to money-finance a VAT cut whenever it liked, this would undermine the Bank of England's independence and the benefits of managing demand outside the political cycle.

In practice, some of these issues could be overcome through institutional and constitutional reforms (see chapter 2). The larger question is perhaps the perceived political cost: first, on the part of government in being seen to (further) contravene central bank independence; and second, on the part of the central bank in being seen to go beyond its democratic mandate.

However, some economists have claimed that central banks are already practising a form of opaque helicopter money in some of their seemingly more orthodox functions. The Bank of England's Term Funding Scheme uses money-financing to subsidise commercial banks' loans to the rest of the economy in the form of reduced interest rates (Wren-Lewis 2016). Meanwhile the European Central Bank (ECB) has been practising something similar for even longer through its 'targeted longer-term refinancing operations' (Loneragan 2016). These practices have received minimal attention from most commentators, perhaps partly because in each case they are described by the central bank as a means of simply improving the transmission mechanism of the base rate, rather than as a significant innovation in their own right (*ibid*). However, each could be described as a form of helicopter money in the sense that public money is created out of nothing and given away (in the form of a subsidised interest rate) without anything being received by the central bank in return.

## 2. Laying new road: Reforming the UK's macroeconomic policy assignment

In the preceding chapter, we have argued that the UK macroeconomic policy assignment is sub-optimal, particularly when the ability of the Bank of England to conduct conventional monetary policy is constrained. We have also shown that the Bank of England's base rate in the UK is likely to remain close to its effective lower bound for at least the medium term. In such circumstances, fiscal policy should be the tool of first resort to stimulate demand. Quantitative easing is a much less desirable substitute. But the risk of governments exhibiting 'surplus bias' means that fiscal policy cannot always be relied upon. With an economic downturn likely to occur at some point over the next few years, more options are required.

It is in this context that we argue for a strengthening of the UK's macroeconomic framework with three areas of reform:

- new fiscal rules
- a revised mandate for the MPC
- a new mechanism to get around the effective lower bound.

### NEW FISCAL RULES

Fiscal rules need to be designed to minimise the risks and potential harm from government biases towards either deficits or surpluses. Collectively, they need to be tight enough to help government increase 'fiscal space' – room for emergency manoeuvre – during periods of growth in the economy, but flexible enough to allow discretionary expansion during and following recession.

Recent fiscal rules introduced by successive governments have generated perverse outcomes. The Coalition Government's rules included a fixed date for debt to fall as a proportion of GDP. This was particularly harmful, pushing government into reducing spending and raising taxes too quickly during periods of slow growth when previous forecasts were wrong. This fiscal rule was ultimately abandoned, but the same mistake was made by the succeeding Conservative Government, which adopted a single target year in which net debt would have to fall as a proportion of GDP and a specific target for the total deficit (including investment spending) would have to be achieved.

It is particularly unhelpful to set fiscal targets that make no distinction between borrowing and debt used to finance assets, and borrowing and debt used to meet day-to-day consumption. These have fundamentally different economic effects. Such a rule incentivises disproportionate cuts to investment, since it is politically much easier to cut investment (which will benefit future voters) than current spending. This is exactly what happened in the UK during the Coalition Government – even though its early targets for the deficit actually excluded borrowing for investment. In just five years between 2009/10 and 2013/14, net public investment was halved from 3.4 per cent of GDP to 1.7 per cent of GDP (OBR 2018a). Since then, annual public investment has averaged less than 2 per cent of GDP. This almost certainly damaged the long run productive potential of the economy, thereby reducing long-term tax revenues and slowing the rate of debt reduction.

In the decade up to the financial crisis, the Labour Government deployed fiscal rules that allowed for net borrowing to fund investment spending, with separate targets for overall debt providing a theoretical upper ceiling to total investment. However, because targets were defined relative to the inherently imprecise concept of the ‘economic cycle’, there was regular ambiguity over whether goals had been met or not (King 2015). This ambiguity also meant targets were vulnerable to ‘gaming’ through reinterpretations of when the business cycle started and finished (Wren-Lewis and Portes 2014).

**We propose the following fiscal rules** to provide the right balance between precision and flexibility within a framework designed to mitigate both deficit bias and surplus bias.

- **A current spending rule:** a rolling five-year target to balance overall day-to-day government spending with government revenue. This would allow borrowing for investment outside the current spending target.
- **A total debt rule:** a rolling five-year target for government debt as a proportion of GDP. This relatively short-term target for debt would be an operational target aimed at achieving a longer term target level for debt based on an assessment of the UK’s ‘fiscal space’ and a cost benefit analysis of lower levels of debt against higher taxes or lower levels of spending. Such a rolling five-year rule could aim for debt to rise, remain constant or fall depending on this assessment, and the external economic environment. A target for total debt applies a constraint on the level of total borrowing for investment spending. But it would also allow the maximum level of borrowing to vary, depending on the extent to which investments were expected to contribute to higher future GDP. The OBR should be given the independent authority to assess both fiscal space and the long-term impacts of different investment projects on GDP, in line with methodologies agreed with government and independent economists.
- **An investment spending rule:** a separate target for an average minimum level of annual public net investment over a rolling five-year period, subject to meeting the debt target above. Since investment spending is excluded from the borrowing target, our fiscal rules allow governments to borrow either to produce a future revenue stream or to spread the cost of a long-term asset over multiple generations. Our target for total debt provides a ceiling that guards against deficit bias, while this separate target for a minimum level of investment spending helps to guard against surplus bias.
- **A fiscal and monetary policy coordination rule:** these fiscal rules should be allowed to be temporarily suspended at the request of the Bank of England when its MPC judges that monetary policy is constrained by the effective lower bound. This would free fiscal policy for discretionary demand management when monetary policy is less reliable.<sup>14</sup>

Getting the right definition of what constitutes an ‘asset’ or ‘investment’ is critical to the operation of the investment spending rule. There is a good case to make that the conventional definition of physical assets (like infrastructure, buildings and equipment) is too limited (for example see Goodridge et al 2016, and Haskel and Westlake 2017). In a modern economy it is not only physical infrastructure which increases productive capacity and therefore supports higher future growth. This is also true of intangible investments; for example so-called ‘social infrastructure’ spending (such as vocational education or skills training) can boost future wages or employment, as can improvements in software or organisational methods. These may also generate an increased future revenue stream to government in terms of tax receipts. Clearly, governments should not

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14 This is similar to a provision in the Labour Party’s current Fiscal Credibility Rule (Labour 2016).

be able to alter the definition of investment arbitrarily in the future in order to get round the fiscal rules. **We therefore propose that the Office for Budget Responsibility conducts an independent review of public sector accountancy practices**, in consultation with the Office for National Statistics (ONS) and independent economists, with a view to broadening the current definition of investment and economic assets. As part of this process, **we would also propose aligning the definition of government debt with that used by most other European countries so that borrowing by independent public corporations is not scored by government debt or borrowing.**

These fiscal rules would provide for a much more sensible approach to macroeconomic policy than the current arrangements. However, it is important to note that even if future governments were to adopt them, the risks of either surplus bias or deficit bias cannot be removed entirely. In a democracy it is right that elected government can make the final decision over the size of the state. Improved fiscal rules are therefore an important contribution to the UK's macroeconomic framework, but are not in themselves sufficient to ensure policy makers can respond adequately to the next recession.

### **A REVISED MANDATE FOR THE MONETARY POLICY COMMITTEE**

From the point of view of reducing the risks of monetary policy being constrained by the ELB, the choice of targets under the MPC's mandate from the Treasury should reflect two priorities. First, ensuring that the 'natural' resting point for the base rate of interest is high enough to provide for sufficient rate cuts in the event of recession. Second, that recovery in economic output following a recession is as permanent and sustained as possible, in order to allow interest rates to return to their natural resting point quickly and sustainably.

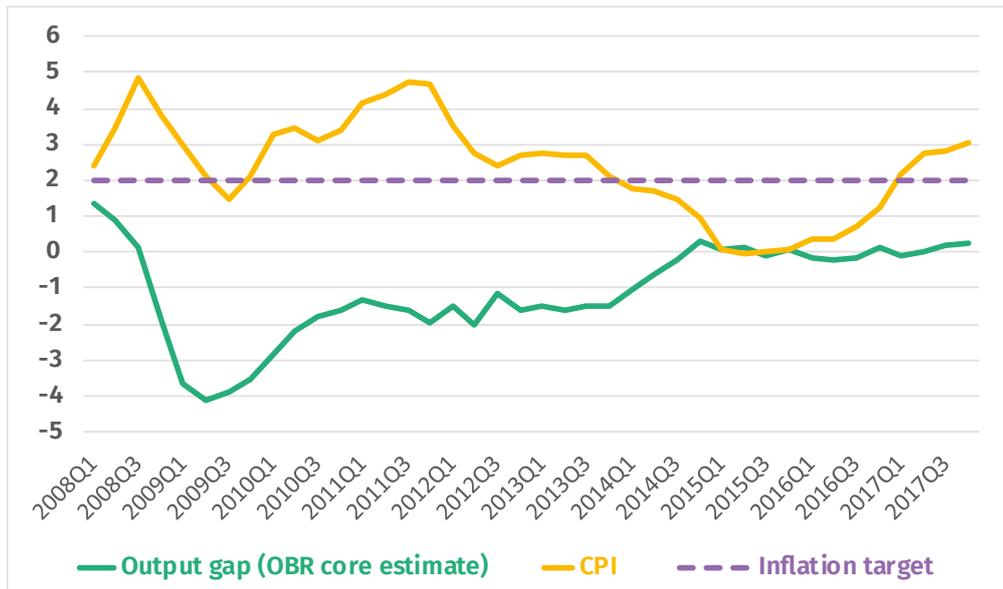
The lessons of the recent recovery have served as a reminder that the 'divine coincidence' (Blanchard and Galí 2005) from macroeconomic theory – the idea that inflation and output are good proxies for one another, so you do not need to target both – does not always hold. Between 2008 and 2014, inflation remained almost exclusively at or above the 2 per cent target, implying an economy that was running hot. At the same time, however, output was significantly below potential for the entire period (see figure 2.1). The reasons for this are well understood. Cost push factors on inflation that are external to domestic production costs, such as rises in oil prices or VAT, can drive up inflation despite economic underperformance. In practice, the MPC is able to 'look through' short-term inflation and informally consider wider economic indicators in coming to their decision over monetary policy intervention. That is why they didn't raise interest rates in 2011. Nonetheless, things could have been very different. During that year, the MPC was in fact two votes short of raising interest rates on a number of occasions (for example see Bank of England 2011). Given that even without a rate increase, output took so long to recover after 2011, this would have been a very costly mistake. Indeed, on the continent, the ECB did raise interest rates and recession followed shortly afterwards. The close vote shows, therefore, that an informal understanding to consider more than one indicator may not be sufficient.

By including proxy targets for output or potential output, such as unemployment (which is used by the US Federal Reserve) or the level of nominal GDP, the importance of metrics outside inflation is formalised, making it less likely that the central bank will underestimate the economy's underlying dynamics. This makes expansionary policy more likely during and after recession in the event of positive external price shocks. In the medium term, this could help to ensure that interest rates are able to rise above the ELB more sustainably by avoiding premature rate increases that risk reducing consumption unnecessarily.

**FIGURE 2.1**

**The so-called ‘divine coincidence’ – that output and inflation are good proxies for one another – does not appear to have held following the financial crisis**

*Inflation (CPI), the Bank of England’s inflation target and the OBR’s estimate of the output gap in the UK, Q1 2008 to Q3 2017*



Source: OBR 2018b.

A further reform to central bank mandates that has received some discussion in recent years, including from the Bank of England and US Federal Reserve, is a higher inflation target. The idea is that if the economy is allowed to adjust permanently to a higher rate of inflation, then interest rates will also be able to settle at a higher resting point; giving greater space for a rate cut in response to recession. The argument is that, up to a point, permanent but marginal economic costs in terms of higher inflation may be a price worth paying to enable faster and more complete recoveries from recession.

We therefore propose that the Treasury revises the MPC’s mandate to include targets for one or both of unemployment or the level of nominal GDP, either alongside inflation or as intermediate guides to a primary inflation target. In addition, we propose the Treasury considers raising the inflation target, such as to 3 or 4 per cent, to create more space for interest rate cuts above the ELB.

Increasing the inflation target and including formal proxy targets for output in the MPC’s mandate could help mitigate the risks of the ELB, but they do not get around the problem entirely. At some point, the costs of higher inflation will outweigh the advantages of a higher resting point for nominal interest rates. This means that in theory this idea too has an *upper bound* in terms of raising the inflation target, which means the ELB could still be reached if the secular decline in demand and real interest rates continues. Similarly, although including targets for output may reduce the risk of unnecessary monetary tightening, they do not provide an immediate solution if further monetary loosening is required when the ELB has already been reached.

## A NEW MECHANISM TO GET AROUND THE EFFECTIVE LOWER BOUND

In this section we propose an alternative to QE for monetary policymakers to get around the effective lower bound of nominal interest rates. Our aim is to establish a policy mechanism that:

- can deliver a stimulus in a more targeted, certain and measurable way than QE as currently practised. This means delivering or overseeing direct investment or spending in the non-financial sectors of the economy
- protects the size and timing of any stimulus from government fiscal bias – either towards deficit or surplus
- also ensures that distributional or allocative decisions over the stimulus are more democratically accountable than QE.

### Delegating economic stimulus

Economists such as Tony Yates, Simon Wren-Lewis and Jonathan Portes have suggested that one mechanism to get around the effective lower bound of interest rates would be for the MPC to temporarily ‘delegate’ output stability to fiscal policy and government (see for example Yates 2017). At the effective lower bound, the MPC could calculate the value of a ‘missing’ stimulus, perhaps in terms of the size of an interest rate cut that would otherwise have taken place, and ask government to deliver an equivalent stimulus through fiscal policy (ibid).

This would almost certainly be a much more targeted and economically reliable mechanism than QE. Tax policy can provide an efficient economic stimulus, such as through changing the cost of household and business consumption (via VAT and duties) or household disposable incomes (via income and profit taxes). These mechanisms have been used successfully by governments in the past, and their effects are better understood and almost certainly better targeted than QE. For example, an OBR review found that around two-thirds of a change in the rate of VAT will be passed on directly into a change in prices, with the remainder borne through company profits (OBR 2010). Public spending can also raise output and demand in the economy. Like tax policy, the effects of public spending on demand are better understood and can be far better targeted than QE. Public spending that leads to increased capital formation (for example, either in the public sector or via private business investment) is thought to have a particularly high multiplier effect on GDP, largely through the increased wages and consumption generated by employing people to produce assets (IMF 2014). If investment is productivity enhancing, it also has complementary supply side effects in terms of improving output potential in the economy.

However, there are also limitations to this approach. For example, it does not provide a reliable answer to surplus bias. If the Bank of England had the power to ask government to expand discretionary fiscal policy, it could make surplus bias less likely, but ultimately a government could always refuse. The alternative, which would be to prevent government from refusing, would be fundamentally undemocratic. The resulting effects of a ‘forced’ stimulus on the size of government and public debt, as well as any distributional impacts, would have no democratic legitimacy.

### A third ‘pillar’ in the UK policy assignment

There is, however, an alternative means of deploying a delegated stimulus which is both less vulnerable to surplus bias while still being democratic and at the same time more targeted and effective than QE. This would be through the use of a National Investment Bank (NIB) with the power to borrow to finance economically and socially productive lending. State investment banks exist in many countries, including Germany, France, Brazil, Italy, China, the Nordic economic bloc and the

European Union. Previous discussion papers for the IPPR Commission on Economic Justice have already made the case for the creation of a UK NIB on the grounds that it would significantly improve the effectiveness of UK industrial strategy (Jacobs et al 2017) and financial intermediation as a whole (Stirling and King 2017). There has also been increasing political recognition of the potential of such banks, including from the Scottish Government<sup>15</sup> and UK Labour Party (Labour Party 2017).

We propose that the NIB receives its high-level investment mandate from the Department for Business, Energy & Industrial Strategy (BEIS) through legislation governing its Articles of Association. Government would therefore be able to provide parameters to NIB activities, such as through exclusion criteria that prohibit certain forms of investment activity that are judged to be socially or environmentally harmful. We would also recommend more active stewardship from BEIS in the form of high-level ‘missions’ to steer the NIB’s activity in support of government industrial strategy. We would recommend that the governing model of the NIB is similar to that of state investment banks in other countries, with a formal division between a governing body and the executive team responsible for day-to-day management (Macfarlane and Mazzucato 2018). For example, a similar structure could be adopted to that of KfW, the German government-owned development bank, with the governing body made up of representatives from government, along with individuals drawn from business and trade unions. This would help to strike the right balance between democratic legitimacy and alignment with government policy on the one hand, and credible independent expertise on the other.

The additional macroeconomic policy innovation we propose is that a UK NIB should provide a means of delivering a delegated stimulus when interest rates are at the ELB. We propose that in such circumstances the MPC be given the power to ask the NIB to expand lending in the real economy – for example, either by expanding existing projects or bringing planned projects forward – at a volume estimated to equate to all or part of the interest rate cut that the MPC would otherwise have wished to make.

Because state investment banks can develop expertise in supporting the production of real economic assets in a way that is additive to private sector finance (see Griffith-Jones and Cozzi 2016, OECD 2016, and Mazzucato and Macfarlane 2017), additional activity from a NIB is likely to be much more targeted and effective than QE. The common economic role for all state investment banks is countercyclical lending, providing finance to small and medium-sized enterprises, technology and innovation, housing and advanced infrastructure projects. Such banks are also significant economic entities. For example, annual investment spending by KfW is worth more than 2.5 per cent of German GDP (ibid). This would be equivalent to more than £50 billion in the UK, around a third of the value of all VAT receipts. The economic effects of such spending are also better understood than QE from a macroeconomic point of view. Increased lending to firms brings forward investment and consumption, which in turn leads to the production of goods or services, while increasing wages and employment that contribute to a further rise in household consumption. The Bank of England also already holds extensive comparative advantage in understanding and assessing the effects of different forms of finance for investment on the economy as a whole.

To ensure that the NIB would always be able to finance countercyclical lending, it should also be possible to fund a delegated stimulus indirectly through the creation of new reserves at the Bank of England, in the same way that the MPC

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15 See <https://www.theguardian.com/uk-news/2018/feb/28/scottish-government-to-launch-national-investment-bank>

currently funds bond purchases under QE. In normal times, bond issuances are the main source of funding for state banks such as KfW and the European and Nordic Investment Banks (Macfarlane and Mazzucato 2018). However, Article 123 of the Treaty on the Functioning of the European Union prohibits the purchase of state investment bank bonds by a central bank on the primary bond markets (ECB 2017). Nonetheless, the ECB is allowed to purchase bonds issued by state investment banks on secondary markets, including those of KfW, the European Investment Bank and the Italian state investment bank CDP, among others, as part of its QE programme (Macfarlane and Mazzucato 2018). The MPC could therefore coordinate its request for a delegated stimulus from the NIB with a programme of NIB corporate bond purchases in secondary markets. This would mean investors would always know there was a demand for NIB bonds, and in effect would be a means of indirectly money-financing a delegated stimulus from the NIB if alternative financing could not be found.

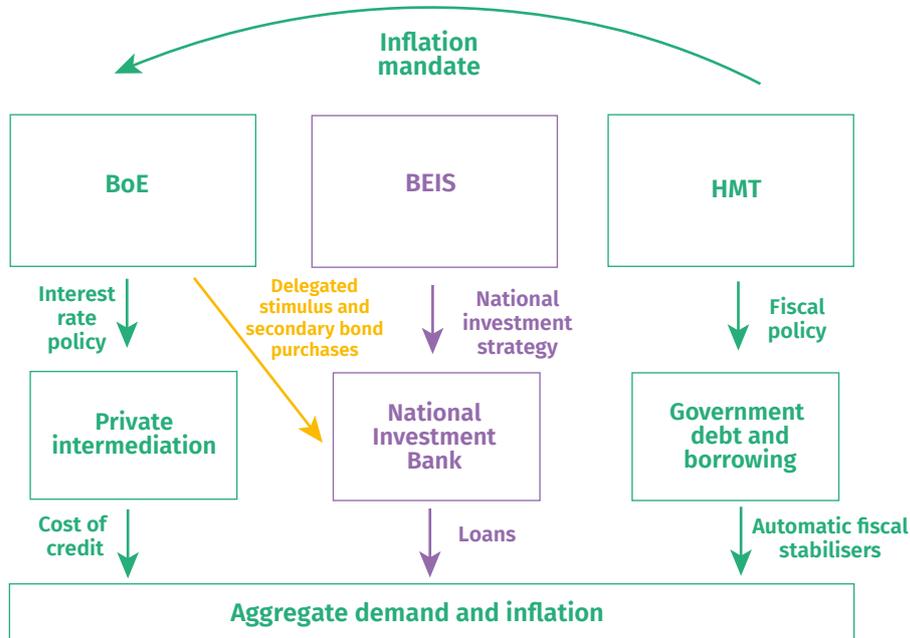
This mechanism for a delegated stimulus via an NIB would be a particularly robust policy lever in recessionary circumstances where governments exhibited acute ‘surplus bias’ and were reluctant to use fiscal policy. First, operational control of the NIB would be independent from government and therefore at least one step removed from concerns about the political cycle. Critically, the NIB would not rely on government to fund its projects and would be able to raise funds independently. Second, the accounts of the NIB could be excluded from the definition of public debt and borrowing in the government’s fiscal rules, under the accounting changes we recommended above (see section on new fiscal rules). In Germany, for example, the KfW is not included under the definition of ‘general government gross debt’ (ibid).

The distributional effects of NIB investment would nonetheless lie outside the Bank of England’s control and would ultimately be democratically accountable. Although the MPC would be able to ask for an increase in NIB activity when interest rates were at the ELB, any increase would have to fit within an investment mandate accountable to BEIS (see above). Were the MPC to include the NIB in funding schemes with an element of money-financed subsidy of interest rates such as the ECB’s targeted longer-term refinancing operations (see chapter 1), this would also provide a more democratic means with which to experiment with what is essentially a form of helicopter money.

Given the UK economy’s current prospects, there is a strong case for early establishment of an NIB. This would increase the chances that an effective, delegated stimulus is available in time for the next recession, which is likely to occur when interest rates are still very low and monetary policy remains constrained. We would propose that the NIB looks to secure independent finance by issuing bonds as soon as is practicably possible. One way to ensure early market confidence in a new NIB would be for the Bank of England to announce its intention to purchase a level of NIB bonds on secondary markets to coincide with early rounds of NIB bond issuances. This could be done without creating any new Bank of England reserves and could instead be paid for by reinvesting a small portion of the proceeds of bonds bought under QE once they mature. In most quarters, around £10 billion or more of bonds held under the Bank of England’s QE programme matures and is actively reinvested to keep the overall level of QE constant. Some or all of the proceeds from maturing bonds could be invested into NIB corporate bonds.

**FIGURE 2.2**

**IPPR’s proposed macroeconomic policy assignment including provisions for a delegated stimulus from the Bank of England to a new National Investment Bank**



Source: Author’s analysis.

### **MOVING BETWEEN MONETARY AND FISCAL POLICY: A NEW HIERARCHY OF POLICY RESPONSES**

The reforms to the UK’s macroeconomic framework set out in this chapter would imply a new hierarchy of policy responses in the event that price stability is threatened by stagnating economic growth or recession. In practice, different policy interventions may need to happen simultaneously, particularly in the event of an economic shock that is as deep and damaging as the 2008 financial crisis. For example, discretionary fiscal policy may form part of the first response, in coordination with the central bank and the automatic fiscal stabilisers. Nonetheless, the following hierarchy would broadly apply.

1. The MPC should adjust interest rates in view of its target(s) under its (new) mandate and given any discretionary fiscal response from government in line with the new fiscal rules. In theory, this could mean that interest rates might need to be reduced, raised or held constant, depending on the fiscal position taken by government.
2. If interest rates were constrained by the effective lower bound and the MPC would otherwise have wanted to cut interest rates, the MPC should have the power to temporarily suspend the government’s fiscal rules. This would provide a signal to government that monetary policy was constrained, and invite government to use further expansionary fiscal policy at its discretion.
3. If the MPC believes that any further government fiscal policy is insufficient to stabilise prices and output, it should request additional lending from the NIB at a volume designed to deliver a stimulus of equivalent magnitude to

at least part of the ‘missing’ interest rate cut. To ensure this countercyclical stimulus could always be funded, the MPC could announce a programme of money-financed NIB bond purchases on secondary markets, similar to the corporate bond purchases currently conducted under QE. As today, the MPC could still also use QE as a last resort or to supplement this ‘delegated stimulus’ from the NIB. In addition, the Bank of England could also include the NIB in targeted funding schemes, such as the TFS and Funding for Lending Scheme.

4. Once the economy has recovered sufficiently, the MPC would be able to stabilise any resulting inflation arising from the economy overheating by raising interest rates. Indeed, this would be the objective in order to ensure interest rates are able to rise above the ELB as fast as possible in time for the next recession. As soon as the MPC believes further stimulus is no longer required, it would also be able to restore the government’s fiscal rules. The MPC would also be able to ‘wind down’ the effects of any additional reserves created to fund bond purchases – either through QE or a delegated stimulus – by selling bonds back to the private sector.

**TABLE 2.1**

**Scorecard of responses under current and proposed policy assignment**

	<b>Current assignment</b>	<b>IPPR proposal</b>
Inflationary shock with non-constrained monetary policy.	MPC increases the base rate to keep inflation down.	MPC increases the base rate to keep inflation down.
Recessionary shock with non-constrained monetary policy.	MPC cuts the base rate to increase aggregate demand and inflation.	MPC cuts the base rate to increase aggregate demand and inflation.
Recessionary shock with monetary policy constrained by an effective lower bound.	Further interest rate cuts are insufficient to reflate aggregate demand. The government is under no obligation to use discretionary fiscal policy to reflate the economy. The MPC can choose to expand non-conventional tools such as QE or the TFS.	Further interest rate cuts are insufficient to reflate aggregate demand. Before any further monetary policy decisions are taken, the Bank of England must notify government that monetary policy is constrained and invite the use of discretionary fiscal policy to reflate demand. If fiscal policy is not sufficient, the MPC can delegate a stimulus through the NIB, in combination with other non-conventional policy devices such as QE or TFS, at the Bank of England’s discretion.
Above target inflation (including caused by excessive discretionary fiscal policy) following recovery and while monetary policy remains constrained.	MPC chooses to sell assets to reverse QE and/or increase interest rates.	MPC can choose to increase interest rates and/or reverse any QE or money-financed purchase of NIB bonds by selling assets back to private investors, depending on its judgment on how the economy is performing including against any other target under its (new) mandate.

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# **Just About Managing Demand**

## **Reforming the UK's macroeconomic policy framework**

### ***Policy Paper***

The IPPR Commission on Economic Justice is a landmark initiative to rethink economic policy for post-Brexit Britain. The Commission brings together leading figures from across society to examine the challenges facing the UK economy and make practical recommendations for reform.

This policy paper proposes a new framework for UK macroeconomic policy. Since the global financial crisis, monetary and fiscal policy have been pulling in opposite directions. On the one hand the government has been withdrawing demand from the economy through severe public spending cuts. On the other, with interest rates close to zero, the Bank of England has used quantitative easing (QE) to inject demand into the economy. The result has been the slowest recovery from recession in modern times, an inequitable and distorting rise in asset prices, and interest rates still close to zero. This has left policymakers without a reliable set of tools to combat the next recession. The paper sets out three areas for reform. First, it proposes new fiscal rules which would enable more active fiscal policy in a downturn, including greater public investment. Second, it proposes a revision of the Bank of England's mandate to help interest rates rise faster in time for the next recession. Third, it describes a new mechanism under which, when interest rates cannot be cut sufficiently, the Bank of England would delegate an economic stimulus to a new National Investment Bank, and would purchase its bonds as necessary to ensure a direct injection of demand. With the economy now likely to be closer to the next recession than the last, the paper argues that these reforms would enable a much more effective policy response.