What is Next for Monetary Policy in a Post-Pandemic World?

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The well-known economist Professor Tim Congdon has attacked the Bank of England (BoE) in an op-ed in the Telegraph newspaper for letting inflation rise to the highest level since it was made independent 25 years – by the Labour government after the 1997 election victory of Tony Blair[i]. He argued, as the headline for the piece put it, that *' Labour created a Bank that doesn't understand inflatio*n' Congdon laments the fact that as he sees it, the BoE *"took the measures that have pushed money growth to its current excessive level"* and that the bank's analysis of inflation is "entirely non-monetary", ..and.."*could even be criticised as atheoretical, scrappy and ad hoc".*

His remarks seem to echo the conclusions of a House of Lords inquiry whose findings whose findings were published in July 2021[ii]:

'While the scale of quantitative easing[QE] has increased substantially over the last decade, there has not been a corresponding increase in the Bank of England's understanding of the policy's effects on the economy in the short, medium and long term. We also note that the central bank research which does exist, tends to show quantitative easing in a more positive light than the academic literature. We recommend that the Bank of England prioritises research on: • the effectiveness of quantitative easing's transmission mechanisms into the real economy; • the effect of quantitative easing on inflation and how it helps the Bank to meet its inflation target; and • the impact that quantitative easing has had on economic growth and employment.'

Harsh judgment maybe. But are they right? There have been legitimate worries that this 'modern' monetary behaviour by central banks which have, since the onset of the financial crisis deployed an expanded balance sheet to enhance liquidity in the markets in an unprecedented scale would lead to higher inflation and therefore, ultimately financial ruin. It still could of course though the direct links over the ages between money supply and growth and inflation are not as clear as many would like us to think. But there are legitimate concerns, as a 2021 paper by the National Institute for Economic and Social Research paper (NIESR) [iii] pointed out, that the simultaneous expansionary behaviour by reserve issuing central banks , having been magnified by global capital markets could be creating systemic risks which regulators would have to address. And it is also true that the record low interest rates that QE indirectly- and central banks through their own rate setting directly- encouraged has led to a rise in inequality. There is no doubt that the asset- rich have benefitted disproportionately during the pandemic . An OXFAM report published in advance of the virtual World Economic Forum meeting has highlighted the doubling of the net worth of the world's top ten billionaires since pre pandemic[iv]. And house prices have risen sharply in many arts of the world during the past year and a half helped by plentiful and cheap supply of mortgages [v].

But despite those concerns, it is not difficult to find studies from academics here and abroad , not only from the Bank of England but also from the US Fed and elsewhere which argue that the policy was nevertheless essential to reverse what would otherwise have been a dramatic and costly drop in demand . There is also evidence that financial institutions used this money to invest in riskier corporate bonds than they would otherwise have considered doing helping the recovery along[vi] both after the financial crisis of 2008/09 and now during the pandemic.

The context against which this monetary expansion took place matters hugely of course. If it is done to artificially boost growth for a short period to gain some political advantage when the economy is operating in or at near full capacity already, one may want to call that irresponsible. But even what is full capacity and how big the output gap may be at any one time is itself fluid if one is able, as Britain was until Brexit, to call on a seemingly unending supply of labour from Europe to meet any extra demand.

But this last period was by no means normal given the combined demand and supply shock and the urgent need to act. And the uncertainties both about the virus and the economy still linger nearly two years from the onset of the pandemic.

So what can we look forward to. The first is that the global inflationary tide may be about to turn as supply and demand imbalances start sorting themselves out as a recent IMF paper seems to suggest[vii]. In the UK the most recent labour statistics published on January 18 suggest that fears of sharp wages rises across the economy are overdone despite unemployment coming down to 4.1% and record staff shortages[viii]. Countries are beginning to reduce their fiscal and monetary stimulus and are embarking on a gentle hiking of interest rates. But even here we should be grateful for a good dose of pragmatism. As ECB board member Isabel Schnabel warned last week[ix] , raising interest rates too early carries with it the danger of stalling the economic recovery, adding that any tightening would only have an impact after a lag and so would not be able to deal with the immediate crisis as monetary policy "cannot push down oil and gas prices"

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