Tomorrow's Company Response to Treasury Committee on UK Monetary Policy

Written evidence submitted by Tomorrow's Company in response to the Treasury Committee inquiry – Effectiveness and impact of post-2008 UK monetary policy.

1 About Tomorrow's Company

1.1 Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good in society. It believes that business can create more value for shareholders and society by adopting an approach that focuses on purpose, values, relationships and the long term. It succeeds in its goal by convening business leaders, investors, policymakers and NGOs to develop practical solutions. See more detail at tomorrowscompany.com.

2 Opening comments

2.1 We welcome the inquiry by the Treasury Select Committee. We agree that the efficacy of UK monetary policy in the aftermath of the financial crisis should be scrutinised, particularly at a time when conventional economics is struggling to provide all the answers. Our focus has been to better understand how money has been flowing through the UK financial system and through the activities of its companies, and how such flows have been affected by rising inequality and shifting business models.

2.2 Our argument is not that the actions taken by the Bank of England (BoE) post-2008 were wrong given the predicament it faced. Indeed, Quantitative Easing (QE) was effective in supporting the economy and financial sector in very difficult circumstances. Instead, our concern is why this was needed, how it was effective and what this means for the sustainability of future growth.

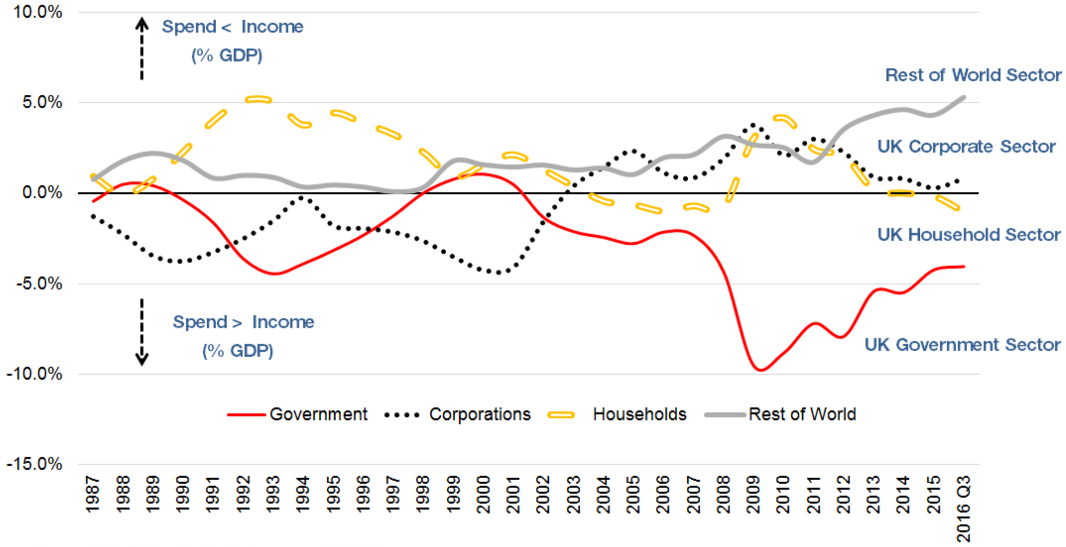
2.3 Over the last thirty years there has been a shift in income towards those less likely to spend it. This phenomenon has been described as secular stagnation; this captures trends such as a rising share of income going towards rich households with a high propensity to save, or the increasing profits of some businesses that have little or no investment requirements. These trends are not unique to the UK, but they have been compounded by its widening current account deficit. Either through trade or income transfers from the UK to foreigners, this current account deficit acts to reduce spending domestically.

2.4 In order to compensate, the UK has required ever more expansionary fiscal and monetary policy to maintain economic growth, not just since the crisis, but over the decades before. Over this period of time, economic growth in the UK became increasingly reliant on borrowing by lower-income households or the sale of their assets (that were increasing in value) or deficit spending by Government. We therefore argue that monetary policy post-2008 is an acceleration of a pre-existing pattern, rather than an entirely distinct phase of policy.

2.5 The effect of the financial crisis was to significantly exacerbate an already weak structural demand picture – with a sharp cyclical downturn further reducing the incentive to spend. Several years have passed since the crisis, yet monetary and fiscal policy levers are still pushed hard forward to keep the economy growing. After years of asset price gains, the UK household's net wealth to disposable income is higher than that of Japan in 1989 before its land and equity bubble burst.

2.6 Our analysis will draw heavily on the UK flow of funds data to disaggregate how monetary policy is affecting the UK economy. One can see from a sector-by-sector analysis (the government, corporate, household and rest of world sectors) which have spent more than their income and which have spent less than their income through time. In aggregate, we know these net flows must balance. But the question is whether balance is achieved through economic growth or recession, and whether these flow dynamics can be sustained.

2.7 UK Flow of Funds Data – How has the UK economy balanced?



Source: ONS (Rolling 12 Month Average ex 2016 Q3)

2.8 We find little evidence that looser monetary policy has transmitted through increased investment spending by UK **companies** since the crisis. In fact, the sector has continuously returned cash to its owners (through dividends and buybacks) while paying down debt. The effects of low interest rates appear to have been undermined by stubbornly high investment hurdle rates – perhaps due to economic uncertainty or the disconcerting pace of technological progress. This lack of investment not only damages the long-term prospects of these companies, but it is contributing to a lack of economic demand and falling productivity.

2.9 We find even less evidence that monetary policy has been effective in improving the current account deficit with the **rest of the world**. We attribute this failure to the BoE's, seemingly contradictory, policy of publicly supporting the value of sterling. This has deferred the necessary adjustment.

2.10 Loose monetary policy has helped **the Government** run a larger deficit than it otherwise would. Total QE equates to around 40% of the increase in government debt since the financial crisis. We wish to emphasise the thin line between the current approach and overt monetary financing (OMF). The distinguishing feature is whether the QE is eventually reversed. In the next recession, the paucity of other policy options could make OMF inevitable.

2.11 **Household** spending has increased significantly as a result of loose monetary policy – including the effect of transferring income to borrowers, higher consumer credit and confidence. But our concern is that a significant part of increased household spending is the result of a wealth effect. We are worried that this reliance on rising asset prices is becoming increasingly unsustainable and poses systemic risk. It has also manifested in substantially increasing wealth inequalities, both intra and intergenerational. We are concerned that while this has delivered growth for 30 years, it cannot continue. Interest rates are near zero, asset prices are at all-time highs and there appears to be little flexibility on fiscal policy. When the next recession comes, there seem to be few conventional policy levers left available.

2.12 It is ultimately in companies that real wealth is created and sustainable growth achieved. The government must take steps to create the optimal entrepreneurial conditions in which companies can be started, nurtured, developed, enabled to invest and so thrive in the domestic and global marketplace.

2.13 To reduce the reliance on an unsustainable monetary policy we need, in particular, to encourage companies to tackle inequality, increase investment and exports. Sustainable economic growth requires a sustainable flow of funds in the economy, where there are no perpetual imbalances that build through time, either between the rich and poor, or between companies and the government. This can best be achieved by encouraging companies to focus on purpose, values, relationships and the long-term – for their own benefit and that of the wider economy.

2.14 Accordingly, we encourage the Treasury Select Committee to consider the connections between the sustainability of monetary policy and the Government's wider agenda on reforming business so that it works for everyone. In this regard, we highlight our two reports, Promoting long-term wealth and UK Business: What's Wrong? What's Next?

3 Responses to questions raised by Treasury Select Committee:

3.1 We have concentrated our answers in this submission on 'the effectiveness of holding Bank rate near zero and whether extremely low rates' [...and QE since 2009, have encouraged...] 'more, rather than less, saving' by each sector - companies, government, the rest of world or households:

4 UK Companies – limited impact due to pressures to not invest

4.1 Conventional economic thinking assumes that low interest rates and QE will lower the cost of borrowing for companies, and so encourage them to spend more on investment. However, we find little evidence that post-crisis monetary policy directly achieved this goal. At most, a case can be made that a general increase in confidence encouraged companies to maintain spending levels rather than cut them.

4.2 While headline UK corporate saving has reduced from £65bn in 2009 to £6bn in 2015, most of this was due to a collapse in the foreign earnings of UK multi-national corporations (MNCs) rather than an increase in spending domestically (UK FDI retained earnings fell from £40bn in 2008 to -£4bn in 2015[1]). Therefore, looking at only their domestic operations, UK companies are spending little more of their income than they did even at the height of the financial crisis. In 2015, business investment was £177bn, which in real terms is no more than the level reached in 2007 (£161bn) and only £33bn higher than the trough in 2009.

4.3 One reason that lower interest rates did not have a stronger effect on UK companies' investment is that their target 'hurdle rates' did not adjust downwards in line with the fall in interest rates (i.e. the required level of profitability of any investment). A recent survey by the Bank of England found that the average hurdle rate across UK companies was 12%. This is well above the cost of equity capital and of debt[2]. The survey also found that companies infrequently update their hurdle rates, suggesting why they have not fallen with interest rates. This contradicts the idea that lower interest rates stimulate investment through a lower cost of borrowing.

4.4 This is further evidenced by UK companies paying back debt during this period. Despite their incomes holding up surprisingly well post the crisis (UK Corporate Gross Balance of Primary Incomes in 2015 was 12.5% of GDP versus 13.4% in 2006-08), UK companies have instead paid back bank debt and capital market issues almost continuously since the crisis. Between the initiation and conclusion of the first £375bn of QE, UK non-financial companies actually paid back over £90bn of bank debt and financial companies repaid over £330bn.[3] A similar picture can be seen in capital markets over this period – UK resident companies' monthly gross issuance of debt, equity and commercial paper fell from a figure of £55bn in February 2009 to just £35bn in October 2012, while between these dates *net* monthly issuance collapsed from £12bn to £-7bn.[4] Far from utilising lower interest rates to take on more debt, UK companies were paying it back.

4.5 The lack of a transmission mechanism from lower interest rates to increased investment is symptomatic of a wider problem. UK companies are underinvesting due to a variety of reasons from short-term pressure from shareholders to technological disruption, economic uncertainty, high hurdle rates and many more. This is not only damaging the prospects of companies, employees and shareholders, but it is also contributing to dangerous macroeconomic imbalances that have necessitated an unsustainable monetary policy. For more detail see pages 11-18 of our report UK Business: What's Wrong? What's Next?.

[1] Reinvested earnings on foreign direct investment (ONS)
[2] 'The financial system and productive investment' BoE
[3] Bank of England, Sectoral analysis of M4
[4] See UK Resident Capital Issuance statistics. BOE

5 Rest of world – benefits mitigated by BoE's support of a strong currency

5.1 One effect of post-crisis monetary policy could have been to weaken the exchange rate, and through this to boost to UK spending directly (through international trade) and indirectly (by increasing the incomes from assets UK residents held abroad, which may then be spent domestically).

5.2 However, between March 2009 and October 2012 (spanning the first £375bn of QE), the trade-weighted value of the exchange rate did not fall and it has only been since the Brexit vote that this value has fallen below that level seen in December 2008. Perhaps as a result, the UK's net export position has not really improved since its pre-crisis level (i.e. £-39bn in 2015 vs -£40bn in 2007). Worse still, when we include international income payments, the UK current account has now risen to a record – both harming domestic spending and also channelling income away from UK residents. This means that the Government, and UK households and companies must spend more than their income to keep the economy from falling into recession.

5.3 Through its public pronouncements over recent years, the BoE appears to have had an agenda of promoting the 'safe-haven' status of the UK, as well as its currency. This has encouraged foreigners to purchase UK assets to fund the UK's widening current account deficit. But this had the effect of keeping the value of sterling higher than otherwise. Without the necessary adjustment, the problem is simply getting larger through time.

5.4 Government – supported a larger deficit (as OMF in disguise?)

5.5 By lowering the cost of government finance, post-crisis monetary policy has undoubtedly helped finance the Government's deficit. Total QE of £425bn represents approximately 40% of the increase in the Government's gross debt position since the financial crisis. Without QE, the Government would have struggled to run such a large deficit.

5.6 Combining QE with a large budget deficit is not that different to overt monetary financing (OMF), where money is printed to directly finance government expenditure. The key distinguishing feature is that at some point QE is expected to be reversed – the debt the Bank of England (BoE) has purchased through QE will mature and the £425bn injection of credit will be withdrawn. However, we believe that the forces of secular stagnation will make it hard to ever implement this reversal.

5.7 That being said, if the Government were to explicitly carry out OMF this may have a significant impact due to the symbolic change. This is because currently the possibility of the BoE reversing QE in the future holds down long-term inflation expectations. The BoE's primary target is inflation. It must balance the stimulative effect the announcement of OMF can deliver to spending with the need to credibly constrain the government's use of this tool into the far future.

5.8 In the event of the next crisis, even the non-conventional policy of QE might not be able to deliver a strong enough impact on confidence and asset prices to stimulate spending to reverse any downswing. In this environment, we believe the BoE may have to implement a policy of OMF as the only way to fulfil its mandate of stable inflation.

6 Households – a powerful wealth effect, but how long can it last?

6.1 The final group for which lower interest rates could increase spending is the UK household sector. Alongside supporting the Government deficit, this is the most effective transmission channel for increasing spending. This acts in a variety of ways from lower mortgage payments to higher consumer borrowing to a wealth effect. However, there are reasons to be concerned around the impact on inequality and the reliance on asset prices rises, both of which appear unsustainable.

6.2 UK households have dramatically increased spending since a post-crisis low in 2010 (when they saved £71bn) to net spending in 2015 to the tune of £3bn. Indeed, now on the latest Q3 2016 run-rate households are spending £20bn per annum more than their income (i.e. a £90bn swing from trough to peak). The OBR points out that this level of household spending is 'unprecedented in the latest available historical data, which extends back to 1987'[5]. It is this powerful swing back in household spending that helped propel the UK economy back into growth.

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5 Quote from OBR March 16 "...Other datasets extending back to 1963 also suggest little evidence of a large, persistent household deficit, with the household surplus moving into negative territory in only one year between 1963 and 1987".

6.3 One of the central mechanisms the BoE identifies in transmitting looser monetary policy into higher spending is through a wealth effect. As the value of household assets increase due to lower interest rates (or through the added liquidity of QE) it is argued that households will spend at least some of this gain. This can happen through a number of channels: Some households release equity from their home by re-mortgaging while others simply choose to save less; continually rising asset prices have enabled lower pension fund contributions; some asset gains are constantly being released back into the economy via financial fees (such as estate agent costs, stamp duty, or annual charges on portfolio performance), while banks can also lend against greater collateral values. Alongside such effects, higher asset prices may also work through simply increasing confidence. Most economic literature assumes a wealth effect of approximately 5% (depending on the type of asset and the type of owner) in that for every £1 increase in assets, 5p will be spent on additional consumption[6].

6.4 Since the depths of the economic crisis, loose monetary policy has helped engineer a large increase in wealth. Since QE was introduced in March 2009, the net worth of UK households increased by a half, or £3.5tn, to £10.2tn in 2015.

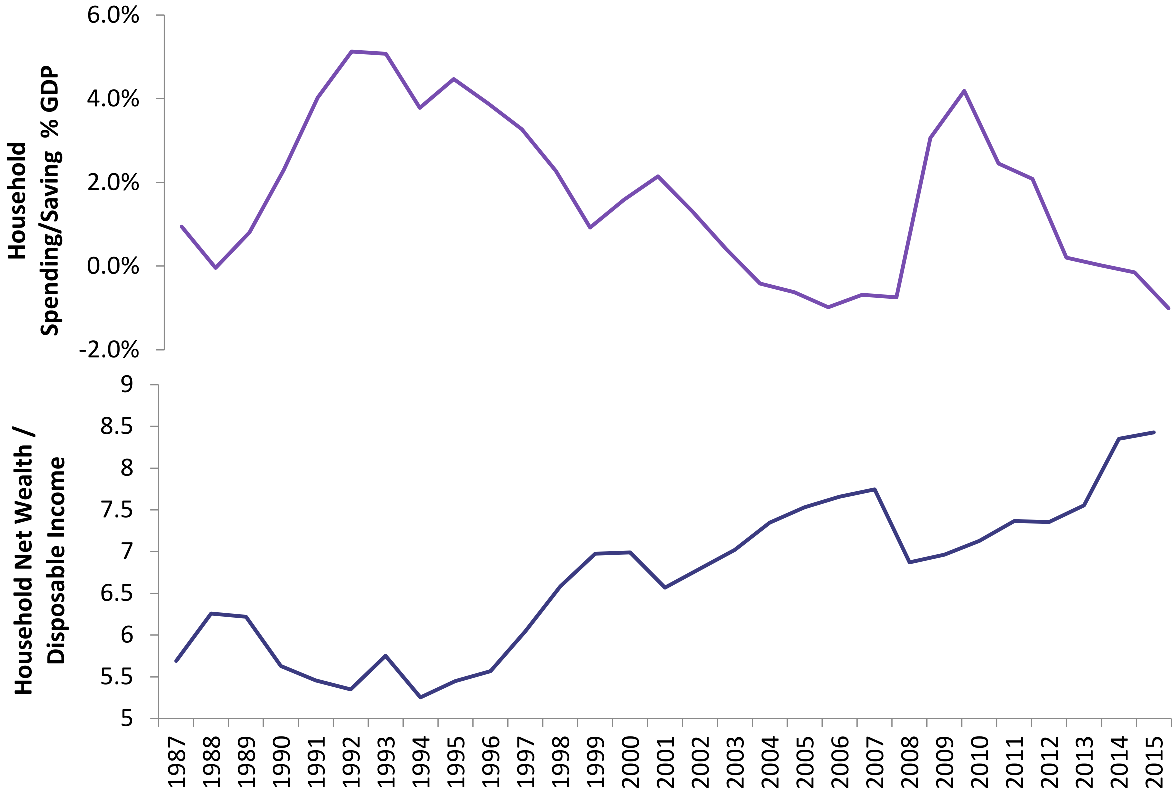
6.5 Using these two figures above, we can estimate how much of the swing in household spending, from trough to peak of £90bn, can be explained by rising wealth over the period. This suggests that post-crisis monetary policy has transmitted a wealth effect that has boosted annual household spending by £35bn per annum (£3.5tn wealth swing * 5% = £175bn/ 5 years).

6.6 By comparison, other ways in which looser monetary policy might have boosted household spending look less significant. One such mechanism would have worked through shifting income towards borrowers (who are more likely to spend) and away from savers. Since the value of mortgages and bank consumer credit is roughly matched by the £1.5tn bank deposits a 2% fall in interest rates since 2009 would have shifted £30bn pa into the hands of borrowers (e.g. mortgage holders) rather than savers. The BoE estimates a different willingness to spend between borrowers and savers of approximately 0.4x income[7] and so the positive uplift of spending would at most have been £12bn per annum (£30bn*0.4 = £12bn). Also, lower interest rates may explain some portion of the swing in new consumer credit of £25bn per annum since its 2009 nadir. The wealth effect therefore seems to have been the dominant transmission of monetary policy to increase household spending since the financial crisis.

[6] The housing wealth effect has been estimated at up to 9% in 'How Large Are Housing and Financial Wealth Effects? A New Approach' Christopher Carroll. In 'How do house prices affect consumption? Evidence from UK micro data' the same author point to particularly large effects for older house owners.

7 The potential impact of higher interest rates and further fiscal consolidation on households: evidence from the 2015 NMG Consulting survey

6.7 UK household spending versus household net wealth / disposable income



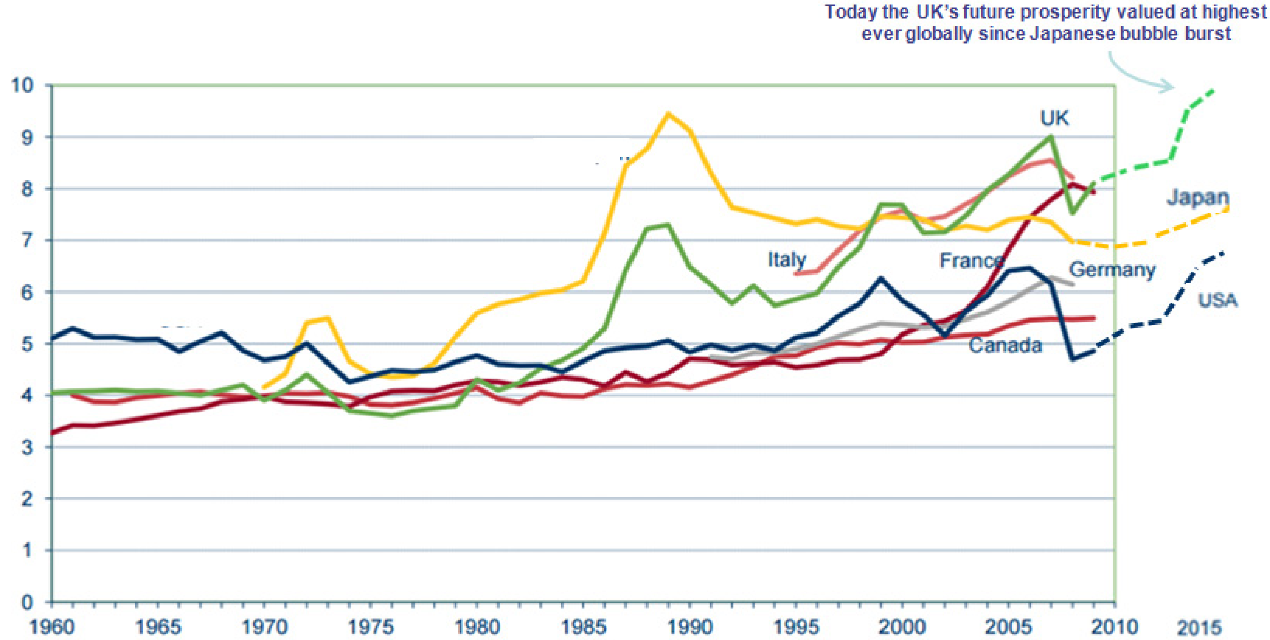
6.8 The use of the wealth effect to power consumer spending[8] is neither a new strategy, nor one that can be used indefinitely. This is the essential problem. There are clear limits to how far the BoE can help push up asset values. The level of UK household net wealth (houses, equities or bonds minus debts such as mortgages) has now risen to a record 8.4 x disposable income, higher than the 7.7x reached at the peak of the last boom.

6.9 We can see that the wealth effect has been employed to drive UK household spending, not just since the last crisis, but over the previous decades. QE should be seen as the culmination of a loosening of monetary policy since interest rates began falling from a peak of 17% in 1981. Since this date, household net wealth had risen from 3.8x disposable income to 7.7x just before the 2008/09 financial crisis. Put differently, over the period 1981 to 2015, UK households have enjoyed an average increase in their net worth equivalent to 30% GDP *every* year. This figure clearly dwarfs any figure that households have saved by spending less than their income in the economy.

6.10 Seen over a longer time period the UK household net worth to disposable income ratio has now reached a level higher than that for any developed economy, surpassing even that reached by Japan in 1989 at the very height of its land and equity bubble (note that the scale here is different – OECD methodology would report a 9.7x multiple in 2015 vs the ONS methodology reporting 8.4x).

[8] The OBR calculate that between Q2 2009 to Q4 2015 Private Consumption contributed for 6.7% out of the 13.4% real GDP expansion over the period. http://cdn.budgetresponsibility.org.uk/Nov2016EFO.pdf

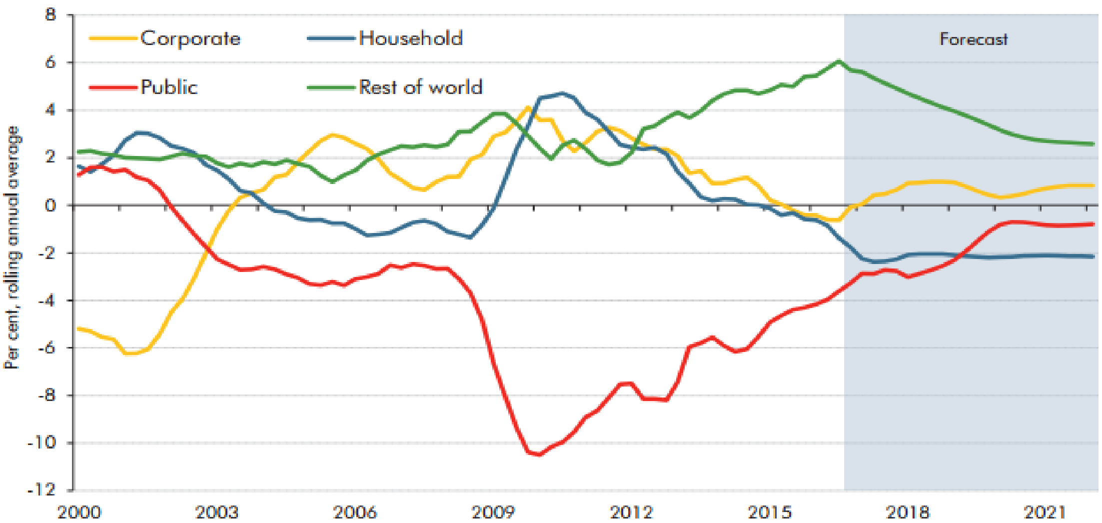
6.11 OECD Global Household Net Wealth / Disposable Income chart



6.12 We are concerned that just as the Japanese Central Bank failed to identify the risk to demand in its economy from sky-high asset prices in 1989, the BoE might be doing the same in 2017. It's notable that in the minutes of the November 2016 meeting of the Financial Policy Committee, there was not one mention of any direct systemic risk from high asset prices.

6.13 But the possible danger may manifest in two ways. Firstly, the risk is that when the potential for asset gains is exhausted, the wealth effect can no longer help power UK household spending. In the OBR's five-year economic forecasts (see overleaf) they have projected UK households spending an unprecedented amount more than their income - not just next year but every year in the forecast period. On the basis of our above analysis, were the wealth effect to disappear, household spending could drop by £35bn pa. Without a compensating increase in spending by some other sector, this drop would risk pushing the UK economy into recession.

6.14 OBR Five-Year Forecasts Flow of Funds:



Source: ONS, OBR

6.15 The second risk is that using the wealth effect to drive up incomes is a highly reflexive process. Higher asset prices can boost spending and so help increase the incomes on which these same assets are priced. It has been described as 'using the tail to wag the dog'. But this feedback might work in reverse. In the event of another crisis, this virtuous cycle could become vicious, particularly from such elevated asset prices.

6.16 Finally, the unsustainable nature of continuing asset prices rises is further evidenced by the impact on pension funds. Higher asset prices have been achieved on the back of much lower yields across the asset spectrum. Therefore, individuals will now need to save a much higher proportion of their income to reach the same pot for retirement. The benefits of a wealth effect experienced today will through time be offset by higher required savings for pensions. We note that the reported widening of the DB pension deficit to £520bn likely captures just a small fraction of the total decline in future pension pots (only 1.6m workers are covered by a DB scheme relative to total workers of 30m).

7 Households – impact on equality

7.1 The distributional impact of post-crisis monetary policy cannot be overstated. If we just consider the impact of QE on wealth, a study by the BoE in 2011 linked £200bn of QE to a £600bn increase in household wealth[9] so we might imagine the total £425bn program to have generated something like £1tn. Given that the top 1% of households own 24% of wealth[10] this means they received ~£80k per household against just £2500 gained by households in the 99%. And given that over 45s own 80% of wealth this means that they will have enjoyed over twenty-five times as much of these gains as those from the younger generation.

7.2 But this is not just a problem of fairness, but a problem of economic efficiency. The wealth effect will only be maximised if gains in asset prices can be put into the hands of those most likely to spend them. Given the inequitable distribution in wealth, both rich versus poor and old versus young, it is likely that much of the gains in wealth over recent years will instead have accrued to those with low propensities to spend. In this way, it could be argued that the wealth effect might have been somewhat 'wasted'.

8 Key questions

8.1 Our analysis is intended to ask the right questions rather than provide definitive answers. It is the BoE's responsibility to be able to respond to the concerns we have raised over both sustainability and inequality.

- During the implementation of QE what assumptions were used about the extent of a wealth effect?
- How do they anticipate household spending to respond to a stabilisation in asset prices, or even a decline?
- Is the step-up in saving – now required to offset the effects of lower yields - assumed to dampen household and corporate spending in medium to long-term forecasts?
- Are economic models capturing the flow of funds between high and low income households and whether these are sustainable?
- Are there realistic fiscal solutions that can offset the effects of the intra and intergenerational inequality that has resulted from their actions?
- Are lower interest rates and increased liquidity leading to increased productive investment by UK companies?

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9 The United Kingdom's quantitative easing policy: design, operation and impact
10 CSFB wealth study in 2016