



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



There are signs that Quantitative Easing is “working”

The MPC surprised the markets with their decisions at their last two meetings. At their July meeting they appeared to call a halt to further Quantitative Easing (QE), when the markets were expecting them to announce they would proceed with the further, permitted, £25bn of asset purchases through the Asset Purchase Facility (APF).¹ And at their August meeting they announced not just the extra £25bn – but an extra £25bn on top, making total planned asset purchases of £175bn.²

By 13 August 2009 the quantity of assets purchased by the Bank stood at £129.2bn.³ The breakdown of the assets purchased was as follows:

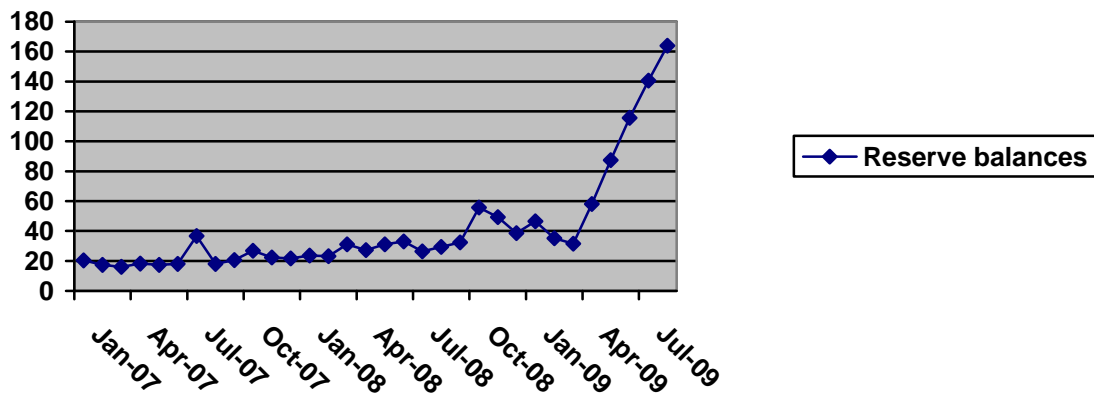
- Gilts: £126.6bn, 98% of the total. It is estimated that the Bank is holding about 15% of the gilts market and half the outstanding issuance (excluding the recent scheme extension).⁴
- Corporate bonds: £0.9bn, 0.7% of the total.
- Commercial paper: £1.7bn, 1.3% of the total.

The APF is, of course, one of the Bank’s major policies for stimulating the economy along with keeping interest rates very low. Given that the Bank Rate has been 0.5% since March 2009 and there is effectively no further room for manoeuvre on this score, the Bank is now depending on asset purchases to provide further stimulus to the economy. The procedure does not, however, involve the Bank printing more banknotes and metaphorically dropping them from helicopters on the beleaguered economy below, as of popular imagination.

Instead the Bank buys assets from private sector institutions – insurance companies, pension funds, banks or non-financial firms – and credits the seller’s bank account. The sellers then have more money in their commercial bank accounts, to spend or save as they please, while the banks hold a corresponding claim against the Bank of England by way of their operational deposits at the Bank - known as the reserves.⁵ The banks’ extra reserves can then enable the commercial banks to increase their lending to the private sector.

Reflecting the huge scale of the asset purchases programme the Bank’s reserve balances, a major item of its balance sheet, have exploded since early 2009, as the following chart shows.

Bank of England: reserve balances, £bn, monthly data

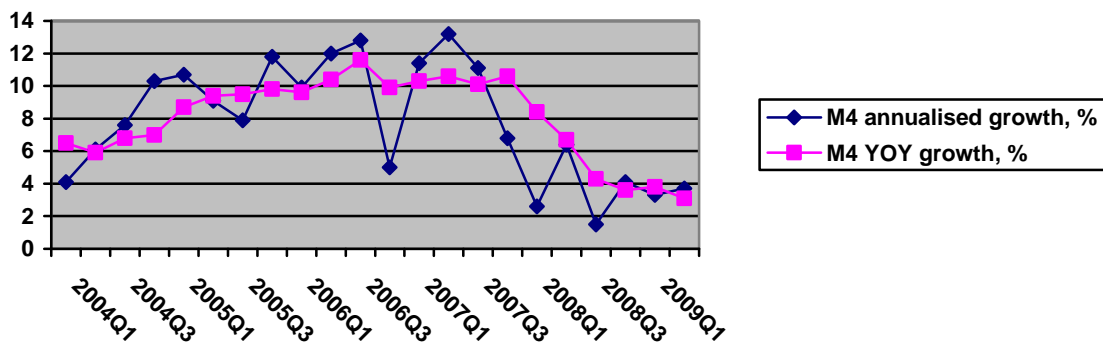


Source: Bank of England database, amounts outstanding of Central Bank sterling reserve balance liabilities, not seasonally adjusted data, 1st week's data taken for each month

Is QE working?

When QE was first announced in March, there were high hopes that the asset purchases would act to stimulate bank lending and increase money supply growth, then considered inadequate to sustain growth. Perhaps too much was expected, too soon. Monetary policy can act with long lags and the banks' balance sheets remain severely impaired. As we discussed in a recent Perspective bank lending remains depressed and lending to private non-financial corporations (PNFCs) has actually fallen in recent months.⁶ And money supply growth has remained disappointingly weak, as the following chart shows.

M4 growth, (excluding intermediate OFCs), quarterly data, seasonally adjusted, %



Source: Bank of England database, OFC = other financial corporations.

M4 broad money, excluding the distortions from within the financial sector, grew by only 3.7% in 2009Q2 (annualised), barely more than the 3.3% growth recorded for 2009Q1. As the Governor of the Bank made clear in his opening remarks to last week's conference for the Bank's August *Inflation Report*, this rate of money supply growth is inadequate, implying that it should be nearer to 8%. Specifically on the MPC's recent decision to increase QE he said:

"The aim is simple: to raise the supply of money and so boost nominal spending in order to meet the 2% inflation target."⁷

Otherwise, growth will be inadequate and the 2% CPI target will be undershot.

It should not, however, be concluded from these disappointing bank lending and the M4 numbers that QE has been ineffective in stimulating the economy. The yardstick of QE's success or failure is not the apparent sluggishness of some indicators, albeit some key ones, to respond to the programme but in the overall assessment as to whether QE is helping the economy. It is also relevant to consider possible reasons for the apparent sluggishness of M4 growth. The following points are relevant.^{8,9}

Firstly, as the *Inflation Report* pointed out, two processes in particular may have depressed money supply growth recently. The first was the use of the proceeds of net equity and bond issuance by PNFCs to pay off bank loans rather than increase deposits. The second was the banks' attempts to strengthen their capital positions, which can have the effect of reducing M4.

According to the Bank this balance sheet restructuring by PNFCs and banks had "most likely" been aided by the Bank's asset purchases. This was because the purchases had increased the funds that investors had available and reduced the returns on gilts relative to those on riskier assets (including equities and corporate bonds) making the latter more attractive to buy. Increased demand for corporate equity and bonds may have helped to reduce the cost of companies' finance (see below) and pushed up equity prices. And debt issuance by banks could strengthen their financial positions and, over time, support an expansion in lending growth. So, even though money growth had remained weak as companies and banks had restructured their balance sheets, the Bank's asset purchases were still likely to boost nominal spending over time. As the Bank pointed out, money growth therefore needed "to be taken together with a range of other indicators in order to assess the efficacy of the Bank's asset purchase programme."

Secondly, there are the general "counterfactual" arguments. In essence, what would have happened if QE hadn't happened? Money supply growth could well have turned negative and bond yields would have been higher than they are today.

Thirdly, even though gilt yields have risen since QE began, this has generally reflected market expectations of a rising Bank Rate. According to the IMF long-term bond yields may have been suppressed by about 40bp to 100bp as a result of the Bank's unorthodox monetary policies. The Bank's "big bond intervention" has probably been a major factor explaining how the UK had managed to keep 10-year gilt yields below 4% in the past 3 months, even though UK debt and issuance spiralled.¹⁰

And specifically on corporate debt, corporate bond yields have fallen since the start of 2009, reducing the cost of borrowing for some companies. Since March the Bank (via the APF) has acted as a backstop in the sterling corporate bond market, with the aim of reducing the cost of borrowing through improving market liquidity.

So, all in all, there are some encouraging signs that the Bank's huge asset purchases programme has helped to reduce the price of credit and raise the value of some assets, which will support economic recovery. So, to a degree, QE is "working".

Inflation expectations

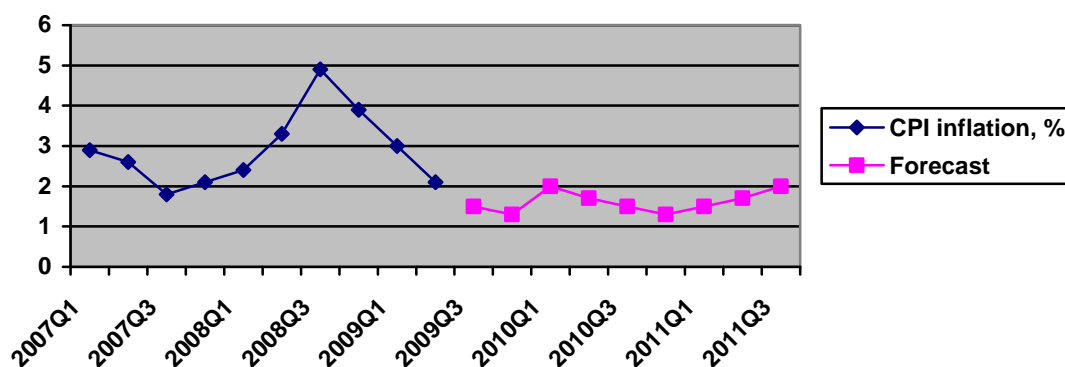
Whilst the decision to extend QE was a key part of the Bank's *Inflation Report* conference last week, the Bank's overall assessment of the economy and inflation expectations were also extensively discussed. The Governor was generally downbeat about the economy's prospects for recovery, citing the banking sector's impaired balance sheets as a depressing factor.^{11, 12}

The Bank was more sanguine about inflationary pressures, believing that the very sizeable output gap (the difference between potential and actual output), in general, and rising unemployment, in particular, will continue to put downward pressure on wage and price increases and prevent the emergence of a "wage-price" spiral.

Indeed the Bank's inflation projection on the basis of market expectations of interest rates at the time of August's *Inflation Report*, suggested that the 2% CPI target would be undershot in mid-2011. According to the Bank, the mean expectation was for a rise in Bank Rate to 2½% to 3% by the end of 2010 and 4% by end 2011 – but the clear implication was that these expected rises in market rates were far too aggressive. The Bank was therefore giving a clear message that interest rates would probably be significantly lower than this – perhaps staying at 0.5% until the first half of next year and then rising modestly. The Bank appears to be in no hurry to raise rates. Given the likely tough fiscal retrenchment over the short to medium-term a very slack monetary policy, including a weakish pound, seems all but inevitable.

The Bank also prepared a projection based on no change in nominal interest rates. On this basis the target would be met by mid-2011, though inflation would be on a rising trajectory. The chart below is broadly in line with the Bank's "no change" projection. Please note that the latest available CPI inflation estimate is 1.8% (for June).

CPI annual inflation projection, %



Sources: ONS for back data, forecast broadly in line with Bank's projection based on constant nominal interest rates and £175bn asset purchases (*Inflation Report*, August 2009).

The Bank expects inflation rates to fall further in the second half of 2009 as last year's energy price hikes continue to fall out of the year-on-year comparison, and then pick up at the start of 2010 when the standard VAT rate returns to 17.5%. The aforementioned output gap, "spare capacity", is expected to dampen inflation rates in 2010 but economic recovery, albeit subdued, will underpin modestly rising inflation in early 2011.

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**Ruth Lea, Economic Adviser, Director,
Arbuthnot Banking Group,
ruthlea@arbuthnot.co.uk,
Tel: 07800 608 674**