



Perspectives by Ruth Lea

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More Quantitative Easing: a calculated gamble

Introduction

Sir Mervyn King was in apocalyptic mood last Thursday, 6 October, as he described our circumstances as “...the most serious financial crisis we have seen, at least since the 1930s, if not ever.” Though voices were raised to denounce such “scaremongering”, there are significant risks that Sir Mervyn’s comments may prove to be only too right given the deepening Eurozone crisis. The deep malaise in western economies, which erupted in 2007 when the global money markets froze over, has not gone away. It has morphed with concern currently centring on the Eurozone’s banks. Franco-Belgian Dexia was bailed out last week amid Eurozone leaders’ discussions over recapitalising the banking sector, as well as further discussions over Greece’s economic plight.

The Governor uttered his warnings after the MPC had voted for further £75bn of quantitative easing, along with keeping the Bank Rate at 0.5%. Perhaps the timing was a bit of a surprise, though the September MPC minutes had softened us up for more QE, and the amount was certainly more than expected. But given the economic softness, underlined by the ONS’s downward revisions to recent GDP data, and the Government’s adherence to fiscal retrenchment further monetary easing was expected.

The ONS GDP revisions

The latest ONS GDP revisions were extensive. They indicated that growth in the run-up to the recession was greater than previously estimated, but the peak-trough fall in GDP in the recession was 7.1% rather than the previously estimated 6.4%. The recovery began in 2009Q3 rather than 2009Q4. They also showed that the economy grew by only 0.4% in 2011Q1 (down from 0.5%) and 0.1% in 2011Q2 (down from 0.2%). The pattern of the revisions from 2008Q1 is shown in chart 1 (below).

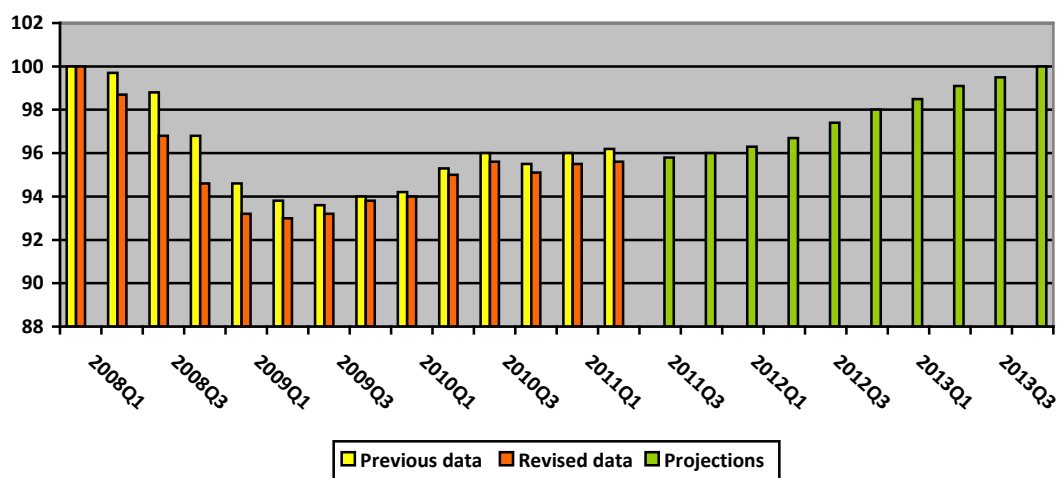
The extensiveness of these revisions underlines how difficult it was in 2008 for policy makers to make the correct policy responses to the economic developments. GDP is now estimated to have fallen by over 1% in 2008Q2, yet the ONS's initial estimate was for a 0.2% rise, amidst much confidence that a recession would be avoided. The Bank had raised rates in February 2008 (from 5% to 5.25%) and then hesitated to reduce them, given the rising CPI inflation rate and the seemingly "not-so-bad" GDP data. Yet we now know, or at least according to the ONS's latest figures, the economy was dropping like a stone throughout 2008 and into 2009. If the Bank had been aware of these numbers at the time, the likelihood is that they would have eased policy earlier despite the high inflation rate (CPI inflation was nearly 5% in 2008Q3).

As already mentioned GDP growth for 2011Q2 has been revised down to 0.1%. Household consumption fell 0.8% and there was, very disappointingly, a deterioration in the net trade balance. "Export-led" growth is not happening and given that the Eurozone and the US, our major export markets, are stuttering it is not likely to happen for some time. The economy has almost flat-lined since autumn last year.

There is not much direct ONS evidence for 2011Q3 yet - retail sales were subdued in July and August and production fell in July. Surveys have been mixed. The most recent Markit/CIPS PMI surveys, for example, painted a patchy picture. The manufacturing PMI was just 51.5 in September, the services PMI picked up to 52.9, but the construction PMI fell to 50.1, suggesting stagnation. The first estimate of 2011Q3 GDP is due on 1 November and may only show an increase of around 0.2%.

Even though the ONS's revisions have rewritten history, their implications for when we will get back to the pre-recession peak are not very significant. Assuming growth of 0.2% for the next two quarters of 2011, and growth of 1.5% in 2012 and 2.25% in 2013, the pre-recession peak should still be met by the end of 2013 (chart 1).

Chart 1: GDP, 2008Q1=100



Sources: (i) previous data: ONS, "GDP, 2nd estimate, 2011Q2", 26 August 2011; (ii) revised data: ONS, "Quarterly National Accounts, 2011Q2", 5 October 2011.

More quantitative easing

The Bank's News Release concerning further QE made for interesting reading. The key sentences were:¹

- "The Committee (MPC)...voted to increase the size of its asset purchase programme, financed by the issuance of central bank reserves, by £75bn to a total of £275bn".
- "The pace of global expansion has slackened, especially in the United Kingdom's main export markets. Vulnerabilities associated with the indebtedness of some euro-area sovereigns and banks have resulted in severe strains in bank funding markets and financial markets more generally.² These tensions in the world economy threaten the UK economy."
- "...while the strains in the bank funding markets also inhibit the availability of credit to consumers and businesses."
- "The deterioration in the outlook has made it more likely that inflation will undershoot the 2% target in the medium term. In the light of that shift in the balance of risks, and in order to keep inflation on track to meet the target over the medium term, the Committee judged that it was necessary to inject further monetary stimulus into the economy."

Two inferences can be drawn from these statements.

Firstly, the Bank's main concern was (arguably) the deteriorating state of the global financial markets, generally, and the knock-on effects for the UK banking system more specifically. Sir Mervyn King's comment about the severest financial crisis since the 1930s, if not ever, should be read in this light. And even though the key objective of further QE is not explicitly stated in terms of supporting the banking system it is reasonable to conclude that one of the main reasons for the action, if not the main reason, is to do just that.

QE directly increases commercial banks' reserve deposits at the Bank of England enabling them to lend more than otherwise be the case, other things being equal.^{3,4} And, significantly, QE should boost the capital markets and thereby create more favourable conditions for the banks to increase their capital at a time when they are cutting back on their assets because they are under pressure from the regulators to meet tougher capital requirements. The hope therefore is that QE will make it easier for the banks to meet their increased capital requirements. And, if the MPC's most important objective in extending QE is indeed to help relieve capital pressures on the banks, gilt purchases are probably the most effective way of delivering this objective rather than trying other avenues such as buying corporate bonds.

Secondly, the Bank was nevertheless keen to justify the extension of QE in macro-economic terms and, specifically, in terms of "undershooting" the 2% CPI target. The Bank still feels committed to justifying QE in terms of the inflation target. It could be argued that the MPC's problem is how to take necessary action to support the banking system while seeming to pursue the inflation target as its primary objective.

The Bank has announced the latest tranche of QE will last four months, starting on 10 October, and gilts will be purchased evenly across the three gilt maturity sectors (with residual maturities of 3-10 years, 10-25 years and over 25 years).⁵ Further QE has not been ruled out.

Assessment of quantitative easing to date

Between March 2009 and January 2010 the Bank purchased nearly £200bn of assets. Over £198bn were gilts, of mainly 5-15 years maturity, which represented nearly 30% of the outstanding gilts held by the private sector at the time and around 14% of GDP. Corporate bonds, around £1bn, were also purchased.

The Bank has recently published an assessment of this QE operation, analysing the various transmission channels from asset purchases to economic impact.⁶ The following channels were identified:

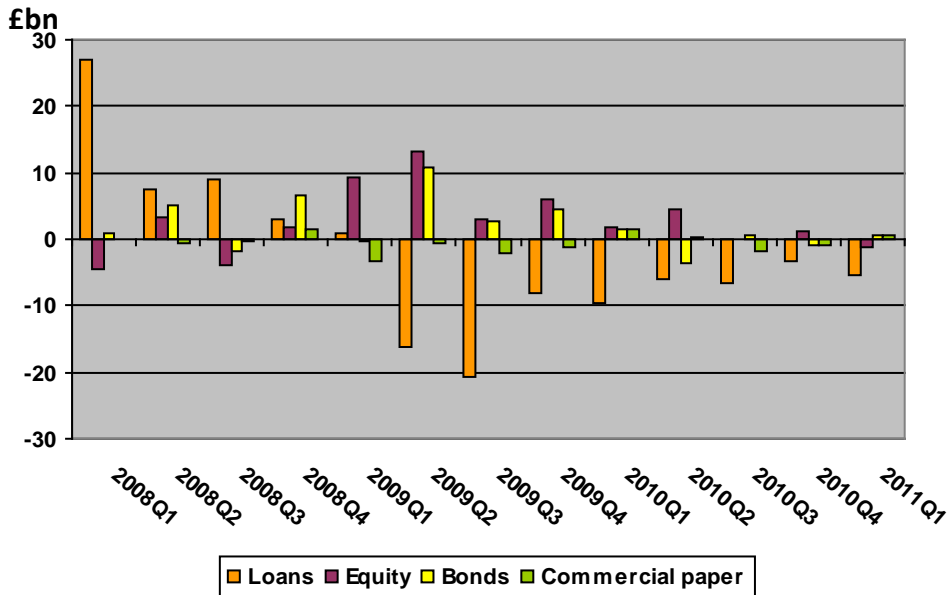
- Policy signalling effects: which include anything “economic agents” learn about the likely path of future monetary policy from the asset purchases.
- Portfolio balance effects: when the Bank buys gilts (say), the price of gilts (and complementary assets) will rise and the money holdings of the sellers will rise. The sellers may (or are likely to) rebalance their portfolios by buying other assets. Higher asset prices reduce yields and lower borrowing costs, which should stimulate spending. Higher asset prices also increase the wealth of the holders. The Bank of England’s asset purchase programme attached particular importance to this channel.⁷ Purchases were targeted towards medium to long-dated gilts from the non-bank financial sector (like insurers and pension funds) who were expected to use the funds from selling the gilts to invest in other, riskier assets like corporate bonds and equities.
- Liquidity premia effects: the Bank’s purchases can actively encourage trading.
- Confidence effects: intended to boost consumer confidence (for example).
- Bank lending effects: when assets are purchased from non-banks (for example) the banking sector gains both new reserves at the Bank and a corresponding increase in consumer deposits. This may encourage lending, but the Bank claims that little impact was expected through this channel given the strains in the financial system at the time and the resultant pressures on banks to reduce the size of their balance sheets. And it is true that bank lending has remained very subdued – though this also reflects demand pressures.⁸

The Bank concluded that QE had the following financial and economic impacts:

- The most clear-cut evidence concerned higher asset prices and, inversely, lower yields for a range of assets. Gilt yields were depressed by about 100 basis points by QE. The positive effects for other assets (corporate bonds, equities) were more difficult to calculate.
- There was evidence that corporates increased their use of the capital markets to raise funds, by-passing the banks. Net equity issuance by UK private non-financial corporations (PNFCs) was especially strong in 2009. Net corporate bond issuance was also stronger in 2009 than in 2003-08. (See chart 2 below.) Whilst it was not possible to know what would have happened in the absence of QE, there was strong institutional investor demand for corporate bonds in 2009H2.
- In addition, there was a net issuance of equity and long-term debt by banks, as they sought to deleverage and rebuild their capital bases.
- The Sterling ERI depreciated 4%, but note that the major fall in sterling occurred in 2008 before QE.

- According to model simulations, the level of GDP was 1½% to 2% higher than it otherwise would have been and CPI inflation was ¾% to 1½% higher than it otherwise would have been. The Bank emphasised that these estimates were “highly uncertain.”
- The overall effect of QE was equivalent to 150-300bp cut in the Bank Rate.

Chart 2: Net funds raised by UK businesses (PNFCs), quarterly, 2008Q1 to 2011Q1,



Bank of England, *Trends in Lending*, July 2011, www.bankofengland.co.uk. Monthly data are available up to May 2011. Loans data are seasonally adjusted; bond, equity & commercial paper data are not seasonally adjusted.

More QE: a calculated gamble

The Bank’s estimates were met with considerable scepticism, even though the Bank was cautious in presenting their conclusions. And there has been a steady stream of claims that, because the economy is still struggling and bank lending has remained weak, QE “didn’t work”. Granted bank lending remains weak (though see the Bank’s caveat above about the banking sector’s restraints) and the corporate sector has invested less than hoped, piling up cash instead. But without QE the situation would surely have been worse. Consider the counterfactual. The fact that the British economy has not fully recovered following previous rounds of QE is not evidence that it failed to “work” and was a waste of time. One could also come to a similar conclusion about the Bank’s unprecedented cuts in interest rates.

At this stage of the proceedings we can only speculate as to the economic impact of this latest tranche of QE. The impact on gilt yields and the effect on the real economy may indeed be modest. The Bank may be reaching the limits of the effectiveness of monetary stimulus. If the impact on the economy is modest, the impact on inflation will also be modest. The notion that QE can trigger Weimar-style hyperinflation when other indicators, including weakish money supply growth, are so depressed hardly rings true. Similarly there are huge uncertainties as to how much QE will boost the capital markets and thereby create more favourable conditions for the banks to increase their capital. If a fully-fledged financial crisis does blow up, further Government injections of funds into the banks cannot be ruled out.

Credit easing

It is not just quantitative easing that has been in the news recently. Reflecting the concerns that QE had done little to help SMEs directly, the Chancellor announced that the Treasury was exploring options for improving credit to smaller businesses on 3 October. Such credit easing policies will probably be fleshed out in the Autumn Statement (29 November). One suggestion is for the Bank to buy up securitised bank loans made to SMEs.

MPC member Adam Posen has also expressed concern that some of the economy's weakness is down to a shortfall of small business investment linked to a dearth of credit. Small firms find it hard to get loans. In order to address the "credit and investment gap", as he calls it, for SMEs and new firms he has recommended that the government should set up two new public institutions:⁹

- An entity which he provisionally calls the "British Enterprise Investment Equity" ("Bennie") which would bundle up and securitise loans made to SMEs. This idea is related to the suggestion above.
- A public bank or authority to lend to small businesses, as already exists in many other countries, e.g. the Small Business Administration (in the USA) and the Kreditanstalt für Wiederaufbau (in Germany).

Potential credit help for SMEs has been discussed many times before. For example Chris Rowlands compiled a report for BIS in 2009, which seems to be gathering dust.¹⁰ He found a "permanent funding gap for smaller businesses wanting to raise between £2-10m, with neither banks nor private equity interested in making money available". He recommended a privately financed fund to make loans available. And irrespective of how much the Government would stand behind the fund, he believed that institutions would subscribe to it readily, since their exposure would be spread.

Given the pressures on the banks and the state of the economy, any measures to improve credit availability to SMEs and backed by the Authorities should be given a fair hearing.

References

1. "Bank of England maintains Bank Rate at 0.5% and increases size of Asset Purchase Programme by £75bn to £275bn", www.bankofengland.co.uk, 6 October 2011.
2. See Bank of England, "Minutes of the MPC, 7-8 September 2011", 21 September 2011. The minutes said "one consequence of the turbulence had been the virtual closure of the corporate bond and bank term funding markets to new issuance. Since May, there had been no senior unsecured debt issued by banks either in the UK or elsewhere in Europe...while UK banks had already met a significant proportion of their funding needs for the year, if they were unable to access unsecured term funding markets for much longer they might feel pressure to reduce lending."
3. See annex on quantitative easing for an explanation.
4. *FT*, "Old Lady delivers shock and awe", 7 October 2011.
5. Bank of England, "Asset Purchase Facility", Market Notice, 6 October 2011.
6. Bank of England, "The UK's quantitative easing policy: design, operation & impact", *Bank of England Quarterly Bulletin*, 2011Q3.
7. See the annex for more on this transmission channel.
8. Ruth Lea, "Weak bank lending: constrained by demand factors not just supply", *Arbuthnot Banking Group*, 9 August 2010.
9. Adam Posen's speech at Wotton-under-Edge, 13 September 2011, www.bankofengland.co.uk/publications/speeches/2011/speech517.pdf.
10. BIS, *The Provision of growth capital to UK small and medium sized enterprises*, November 2009, SO, chairman Chris Rowlands.

Annex on Quantitative Easing

Box: The Bank of England's explanation of Quantitative Easing

- The MPC's decision to inject money directly into the economy does not involve printing more banknotes.
- Instead the Bank buys assets from private sector institutions (including insurance companies, pension funds) and credits the seller's bank account (if the seller is a non-bank).
- Private sector institutions receive cash which they can spend on goods and services or other financial assets, which can stimulate the economy.
- Their commercial bank holds a corresponding claim against the Bank of England (known as reserves, or reserve deposits). Increased reserves mean that bank lending can increase to households and businesses, which can stimulate the economy.
- Asset prices increase which results in an increase in wealth for those holding these assets and reduced borrowing costs, which can stimulate the economy.

Source: Bank of England, "Quantitative Easing explained", www.bankofengland.co.uk

The tables below show the impact of QE (buying gilts) on the balance sheets of the Bank of England and a commercial bank.

Table 1: Bank of England buys gilts from non-bank financial institution

| Bank of England balance sheet | |
|---------------------------------------|---|
| Assets | Liabilities |
| Foreign currency securities | Monetary base: (i) Reserve deposits (+b) (ii) Banknotes & coin issued |
| Domestic securities or loans (+a) | Capital |
| | |
| Commercial bank balance sheet | |
| Assets | Liabilities |
| Vault cash | Deposits (+c) |
| Reserve deposits at central bank (+b) | Foreign liabilities |
| Loans & investments (assets) | Capital |
| Foreign assets | |
| | |

- Bank of England buys the bonds from an insurance company (say) increasing its assets (+a).
- The Bank of England pays for the bonds by crediting the reserve account of the seller's (or settlement) bank (+b).
- That commercial bank now has extra (excess) reserves in its balance sheet (+b) and can increase its lending, other things being equal.
- In addition, the deposit account of the original seller of the bond (the insurance company) will be credited for the value of the bond (+c). The investment company can then invest in other assets (property, equities or corporate bonds).

Table 2: Bank of England buys gilts from a commercial bank

| Bank of England balance sheet | |
|---------------------------------------|---|
| Assets | Liabilities |
| Foreign currency securities | Monetary base: (i) Reserve deposits (+b) (ii) Banknotes & coin issued |
| Domestic securities or loans (+a) | Capital |
| | |
| Commercial bank balance sheet | |
| Assets | Liabilities |
| Vault cash | Deposits |
| Reserve deposits at central bank (+b) | Foreign liabilities |
| Loans & investments (assets) (-a) | Capital |
| Foreign assets | |
| | |

- Bank of England buys the bonds from a commercial bank, increasing its assets (+a).
- The commercial bank's investments (assets) are decreased by the same amount (-a).
- The Bank of England pays for the bonds by crediting the reserve account of the commercial bank (+b).
- That bank now has extra (excess) reserves in its balance sheet (+b) and can increase its lending.

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