



Perspectives by Ruth Lea

Economic Adviser to Arbuthnot Banking Group



The Bank looks ready for “unconventional” measures

During last Wednesday’s press conference on the Bank’s February Inflation Report, Governor Mervyn King hinted strongly that the Monetary Policy Committee would be discussing “unconventional” monetary policy instruments at its next meeting in March (4-5 March). Moreover, there was a good chance that the discussion would lead to their implementation.

Mr King has, of course, discussed unconventional measures already, most recently in a speech to the CBI in January¹ to which I referred in my last Perspective.² On that occasion he distinguished between the “conventional” monetary instruments, including the Bank Rate, which were not as effective as they could be given the impaired functioning of the financial system, and “unconventional” monetary instruments, involving the direct expansion of the money supply by purchasing assets. Concerning the unconventional measures, commonly referred to as “quantitative easing”, he further made the distinction between:

- “Conventional, unconventional measures”, involving the purchase of assets such as government securities or gilts, to boost the supply of money.
- “Unconventional, unconventional measures”, involving the purchase of commercial assets.

The following could be concluded from the Governor’s comments at the press conference:

- Firstly, the Bank Rate does not have to go to zero before quantitative easing can start. This may be interpreted as meaning that the Bank will not cut interest rates further – and I see no point – even though it is widely expected that it will.
- Secondly, he placed considerable emphasis on the money supply. Indeed he sounded like an old-fashioned monetarist. He said “the problem we face at the moment is that the supply of money is not rising quickly enough. For many decades we had the opposite problem. The problem now is that the supply of money is growing too slowly.” He went on to say “what we now will be moving to is a world in which we’d be buying a range of assets, certainly including gilts, to ensure that the money supply will grow at an adequate rate to keep inflation at the target so that normal growth can resume.” The implication is that, even without formal money supply targets, the Bank has in mind estimates of money supply growth that are consistent with economic stabilization and recovery – as well as hitting the inflation target. And they are clearly higher than currently is the case.
- Finally, the MPC’s future monetary policy deliberations will concentrate on quantitative easing and that gilts as well as commercial assets will be purchased by the Bank in order to stimulate the money supply. Any further cut in the Bank Rate, if it occurs, will be a side-show.

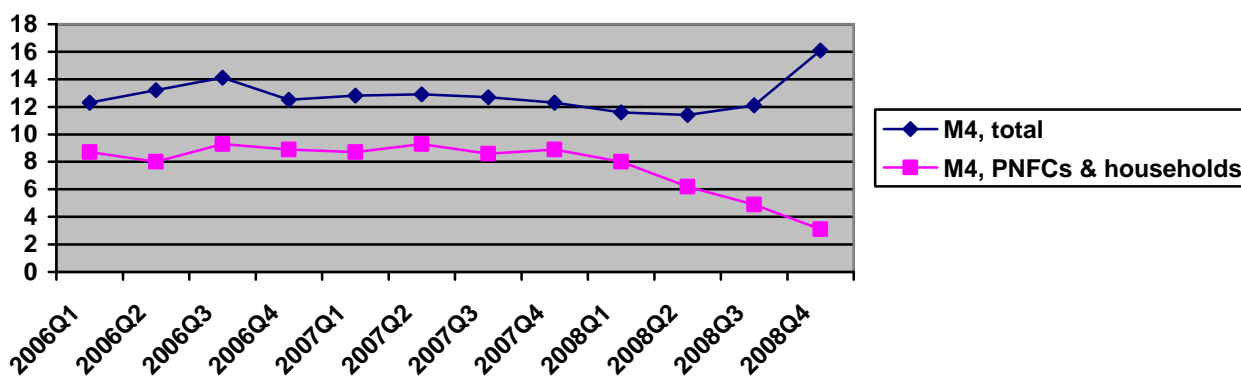
What is happening to the money supply?

There is little doubt that M4 money supply (the broad money measure including the private sector’s cash in circulation and retail and wholesale deposits) is growing inadequately.³ But, at first glance at the data, this may seem a strange conclusion.

In 2008Q4 M4 was some 16% higher than a year earlier, compared with growth of around 12% in the first half of the year. But, as the Bank of England's February Inflation Report explains, the current data are significantly distorted by the activities of intermediate "Other Financial Corporations" (OFCs), such as mortgage and housing credit corporations, non-bank credit grantors, bank holding companies, and other activities auxiliary to financial intermediation. Transactions between banks and other financial intermediaries (some of which take place within the same banking group) have risen very sharply as inter-bank activity has fallen. But these transactions are unlikely to affect spending activity and therefore should be excluded in order to get to a measure of M4 which is related to spending activity.

The Bank provides data for M4 holdings by (i) OFCs, (ii) the private non-financial corporations (PNFCs) and (iii) the household sector. Removing OFCs from total M4 provides a more appropriate economic measure of M4. As can be seen from the chart below, the year-on-year growth of this measure of M4 was nearly 10% for much of 2006 and 2007. But it was 3% in 2008Q4. By any standards, this is a dramatic drop in the growth of the economically relevant money supply.

M4 year-on-year growth rates, seasonally adjusted quarterly data (%)

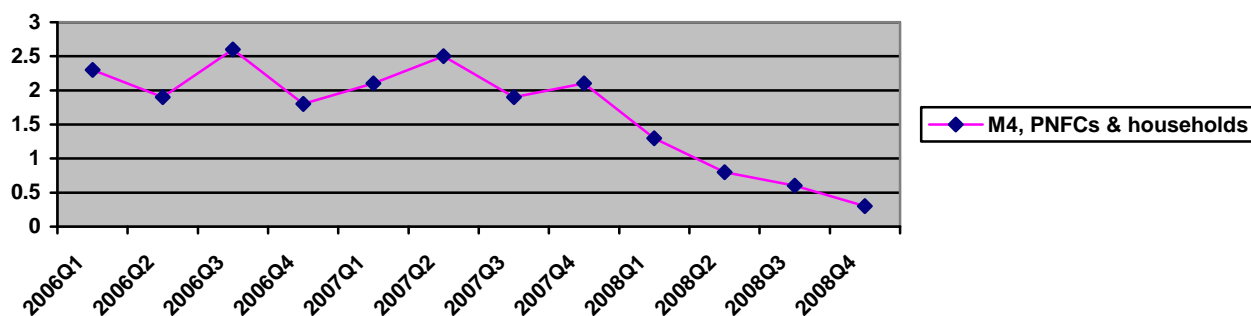


Source: www.bankofengland.co.uk

Two further points should, however, be made:

- The breakdown shows a very different picture for PNFCs and households. The YOY M4 growth of households was around 5% in 2008Q4 (compared with 8% in 2007 and early 2008). But the equivalent data for PNFCs shows a much sharper deterioration. In 2008Q4 M4 holdings of PNFCs were around 5% lower than a year earlier – compared with increases of 10-12% in 2007.
- YOY data tend to dampen the appreciation of the full degree and speed of the deteriorating developments. This is the case with current M4 growth. The next chart below shows quarterly M4 growth rates for PNFCs & households only. M4 growth in 2008Q4 was a mere 0.3% (QOQ, just over 1% annualised) compared with 2% to 2½% (8-10% annualised) in mid-2006. This is an inadequate level of growth to sustain recovering economic activity and is, in itself, a strong reason for quantitative easing. Mervyn King's comment that money supply is not rising quickly enough is entirely justified. Money supply growth is collapsing.

M4 quarterly growth rates, seasonally adjusted data (%)



Source: www.bankofengland.co.uk

Quantitative easing: definition

There are several approaches to the definition of “quantitative easing”. But basically it is a tool of monetary policy in which the central bank injects new money into the financial system, in order to increase the money supply. In the context of the current discussions in the UK it relates to the expansion of a central bank’s monetary base (“base money”, “central bank money”, M0) by purchasing assets in order to expand the money supply.⁴ M0 comprises banknotes and coin issued (in circulation and in banks) plus reserves which the commercial banks hold in their accounts with the central bank. M0 is a key component of a central bank’s balance sheet, as shown in the following table.

Central Bank and Commercial Bank balance sheets (simplified)

Central Bank balance sheet	
Assets	Liabilities
Foreign currency securities	Monetary base (M0): (i) Reserve deposits (commercial bank reserves) (ii) Banknotes & coin issued
Domestic securities or loans	Capital
Commercial bank balance sheet	
Assets	Liabilities
Vault cash	Deposits
Reserve deposits at central bank	Foreign liabilities
Loans & investments (assets)	Capital
Foreign assets	

Quantitative easing and the Asset Purchase Facility

The details of the Asset Purchase Facility (APF) have now been released by the Bank.⁵ The initial purpose of the APF is to help improve the availability of corporate credit through the targeted purchase of up to £50bn of high-quality assets (though relatively illiquid) such as corporate bonds, commercial paper and paper issued under the Credit Guarantee Scheme. These operations will be carried out by the Bank, and financed by the issuance of Treasury Bills. The APF as initially mooted is an example of “qualitative easing”, or “credit easing”, not “quantitative easing”. It does not result in an increase in the monetary base. And the Bank’s balance sheet does not expand, though its composition changes.

The APF arrangements announced by the Government do, however, provide a framework for quantitative easing - which looks very likely to be implemented. Under “APF quantitative easing” the Bank would, for example, pay for purchases of corporate bonds from commercial banks by crediting their reserve accounts at the Bank. The transactions would be implemented at the stroke of a computer key. M0, the monetary base, would therefore be increased and the Bank’s balance sheet would have been expanded. The commercial banks would then have additional resources, in the form of excess reserve deposits at the Bank, which they can lend. Assuming the banks do not hoard the increase in their Bank reserves the Bank’s action to increase the monetary base should boost M4 and stimulate the economy.

As the Bank acknowledges there are uncertainties over the potential efficacy of the policy. One risk is that, if banks are over-concerned about their financial health, they may choose to hoard the increase in Bank reserves rather than expand the supply of credit. This happened to some extent in Japan in the earlier part of this decade.⁶

As already stated, it seems likely that the Bank will be buying government securities (as well as the private sector assets targeted by the current APF) as part of its quantitative easing strategy. This represents a move to “under-funding” government borrowing and, concomitantly, a move away from the “full funding” rule which insists that all borrowing should be met by selling government debt.

References

1. Speech by Mervyn King to the CBI, 20 January 2009, www.bankofengland.co.uk
2. Ruth Lea, "Memo to the Bank: there's no point in further interest rate cuts", *Arbuthnot Banking Group Perspective*, 2 February 2009.
3. M4 is a key monetary statistic. M4 includes the non-financial private sector's (i.e. the UK private sector other than (MFIs)) holdings of cash in circulation, private-sector retail bank and building society deposits, private-sector wholesale bank and building society deposits, certificates of deposit and commercial paper, bonds, FRNs (floating rate notes) and other instruments of up to and including five years' original maturity issued by UK MFIs (monetary financial institutions).
4. Indeed the Bank has already been undertaking an increase in the monetary base (M0), though this has not been referred to as quantitative easing in recent months. See, for example, Willem Buiter, "Quantitative and qualitative easing again", *FT*, 11 January 2009, available on www.ft.com.
5. Bank of England, News Release, *Asset Purchase Facility*, 6 February 2009, available from www.bankofengland.co.uk. The APF started on 13 February instead of 2 February as originally announced in January.
6. Bank of England, *Inflation Report*, February 2009. See the section on unconventional monetary policy tools (page 45).

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