



Perspectives by Ruth Lea

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Do not rule out more Quantitative Easing

The Bank of England's Monetary Policy Committee will meet this week and the usual announcement will be made on Thursday, 7 January, on their decisions. It is almost universally expected that the Bank Rate will remain at 0.5% and there will be no announcement concerning any further Quantitative Easing. The current plan is to achieve £200bn of QE by the end of January.^{1,2} But the MPC could well discuss the merits and demerits of a further tranche of QE with the distinct possibility that, if there is to be one, this will be announced at the February meeting.

QE has undoubtedly had a beneficial effect on the economy – though not in the way many had expected at the time of the Bank's initial announcement of QE in March 2009. It was widely assumed then that QE was being introduced in order to boost money supply and facilitate bank lending. Yet the money supply figures have remained disappointing. As the minutes of the MPC's December meeting noted:

- "M4, adjusted to exclude the money holdings of institutions that intermediate funds between banks, had declined by 5.3% on a 3-month annualised basis in October, weaker than in earlier months. That fall in money balances was a source of concern."³

Bank lending too has been weak – though the Bank's latest *Credit Conditions Survey* for 2009Q4 suggested some improvement. Lending to households and businesses continued to pick up in 2009Q4 and was expected to rise further in 2010Q1.⁴ Of note was the observation that demand for credit by private non-financial corporations (PNFCs) was weaker than anticipated, driven by reduced demand from larger firms as they sought other sources of finance. Access to finance was reported to be more difficult for smaller businesses. An improvement in mortgage availability, especially for higher loan-to-value mortgages, was also reported.

It would, however, be wrong to dismiss QE as ineffectual because of the continued weakness of money supply and bank lending data. The counterfactual should be considered. Without QE these data would surely have been even weaker. But, as we have discussed before, the real impact of QE has probably been to act as a major factor in the recovery of financial markets.⁵ The scale of asset purchases has been so large that it has led to a huge injection of liquidity. £200bn QE amounts to 14% of GDP. Bond yields have come down quite sharply for both government debt and riskier corporate debt. And equity prices have risen. The rise in asset prices and fall in yields has allowed large corporates, including banks, to refinance themselves in the capital markets. Given weak fixed investment expenditures and continued de-stocking, funds thus raised have facilitated the repayment of bank loans. It is one of the ironies of QE that rather than stimulating bank lending, it may have acted to reduce it.

More QE?

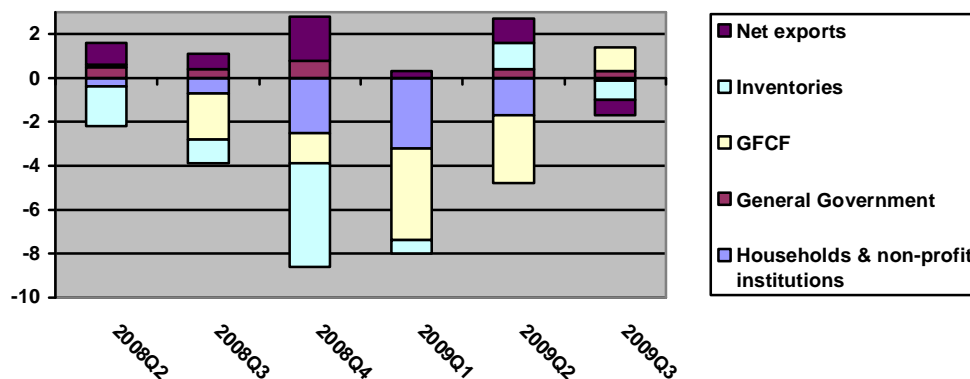
As the current programme of QE is due to run out by the end of January, speculation is already mounting as to whether the Bank will extend the programme. Arguably political considerations, with a General Election in the offing by 3 June 2010, may have a bearing on the nature and the timing of the Bank's decision. But the Bank will focus its analysis on the possibility of undershooting or overshooting its 2% CPI target in the medium term. In the Bank's November Inflation Report, its elegant fan charts showed that, on market interest rate expectations and given £200bn asset purchases, the 2% target would indeed be met – despite the jump in the CPI annual inflation rate towards 3% at the beginning of 2010. This does not seem unreasonable, given the undoubted economic problems ahead and the chance of a weak recovery.

Indeed there was more adverse commentary on the Bank's GDP forecasts which showed growth bouncing back to 4% by the end of 2010 and into 2011 – much in line with the Treasury's PBR forecast. One factor to note is that the Bank's forecasts necessarily assume current fiscal policy and, if a new government implements swingeing fiscal tightening soon after the General Election, these forecasts could be undershot by a considerable margin. But even allowing for this, the Bank's forecasts still look optimistic.

Key to any decision on further QE will be the MPC's assessment of whether the economic recovery is "on track". We will, of course, have to wait until the release of the minutes of January's meeting (due 20 January) to get an idea of the MPC's thinking on this issue. But the chances are that the recovery will disappoint rather than run to plan (or even run ahead of plan). Under these circumstances the MPC could take the view that they will undershoot their inflation target and recommend further QE in February – say another £25bn as already speculated about – though we will wait for the minutes of the January meeting before making our own speculation.

Suffice to say the latest real data have been, on balance, rather disappointing despite the better news from the labour market. Even though the ONS revised up the 2009Q3 GDP data from a quarterly decrease of 0.3%, the revision was only marginal – to a decline of 0.2% - and less than City expectations. As shown in the chart below a modest positive correction in fixed investment, after slumping in the first two quarters of 2009, offset a higher rate of de-stocking and a deterioration in net exports (mainly reflecting a rebound in imports) in the third quarter. Household consumption showed a very modest rise, despite a further improvement in the saving ratio to 8.6% as households continued to mend their balance sheets, and General Government consumption continued to contribute to GDP.

Contributions to quarterly changes in GDP, 2008Q2 to 2009Q3



Source: ONS, "Quarterly national accounts, 2009Q3", 23 December 2009. GFCF stands for Gross Fixed Capital Formation and house.

The data so far released for the fourth quarter tentatively suggest that a weak recovery should have got under way in the quarter. Services output (76% of GDP) rose by 0.1% in October, however production industries (17%) were flat. Britain's recovery continues to lag those in Germany, France and the US – to name but three. Britain will do well to achieve even the 1 ¼ % growth pencilled in, in the PBR forecast. ⁶

QE must eventually finish

Even if the MPC recommends a further tranche of QE in February this unconventional policy, in which the authorities are effectively acting as both a seller of new gilts and a buyer of existing stock, is likely to finish over the next 6 months. Indeed some would argue that there should be no further QE. Charles Goodhart, one-time MPC member, has written that the authorities should avoid pumping up the financial markets too much in order to prevent any further asset bubbles and, therefore, there should be no more QE.⁷

In a matter of months, if not weeks, therefore, the gilts market will bear sole responsibility for meeting the government's borrowing needs. The Bank will no longer be *de facto* supporting gilt prices. This development will almost certainly lead to lower prices, and higher yields, to ensure there is sufficient domestic and overseas demand for gilts.⁸ The increase in yields, which will inevitably prompt a generalised rise in borrowing costs and hamper growth, will depend on the credibility of the government's "road map" to fiscal sustainability.

Under these circumstances, the gilts market will become increasingly focused on the opinion polls running up to the General Election and the possible "shape" of the next government. The probability of a strong majority for the winning party should contain the increase in gilt yields as such a majority should hopefully produce a government that will deal with the soaring government debt in a timely manner. But a hung parliament would probably have the opposite effect, adding to the upward pressure on bond yields – not least as such an outcome would be deemed to raise the odds that the UK's "triple-A" sovereign rating will come under threat. Given the size of government borrowing, the road is likely to be a rocky one when QE ends even in the most favourable of circumstances.

When QE ends, other issues will come to the fore – not least of all how and when the Bank intends to unwind the QE scheme by selling their existing huge stockpile of government bonds. Such sales would inevitably risk flooding the market with gilts, spook the market, put even more strain on gilts prices and push up yields.

Our view is that the Bank will be holding on to much of its stock for a considerable time – some stock to maturity. Indeed Charles Bean, the Bank's Deputy Governor for monetary policy, has said as much:

- "We do not, however, expect to retain all the purchased assets in the Asset Purchase Facility to maturity. At some stage, as the recovery proceeds, the Monetary Policy Committee will need gradually to remove the large monetary stimulus that we have imparted to the economy; otherwise we will be in danger of overshooting our 2% inflation target. That monetary tightening will take the form of some combination of a higher level of Bank Rate and asset sales from the Asset Purchase Facility to the private sector. The process of selling off the gilts can then be expected to push gilt yields back up towards where they would have been in the absence of the Quantitative Easing programme."⁹

Indeed there is a fair chance that the Bank Rate will be increased before any assets are sold. And we expect Bank Rate to remain at 0.5% for much of this year, with perhaps a token increase to 1% in the second half of the year. In the meantime there will probably be monetary tightening in the form of higher gilt yields.

References

1. £75bn of QE was announced last March, with a further £50bn in May, another £50bn in August and £25bn in November, making a total of £200bn.
2. As of 24 December 2009, the quantity of assets purchased by the creation of central bank reserves was £190.2bn, £188.1bn (99% of the total) of which related to gilts. In addition £0.6bn of commercial paper and £1.5bn of corporate bonds had been purchased. Source: www.bankofengland.co.uk. Details are recorded in the Bank of England's latest Quarterly Bulletin.
3. BoE, Minutes of the Monetary Policy Committee meeting, 9 and 10 December 2009.
4. Bank of England, *Credit Conditions Survey*, Survey results, 2009Q4, 31 December 2009.
5. Ruth Lea, "There are signs that Quantitative Easing is 'working' " Arbutnot Banking Group Perspective, 17 August 2009.
6. See Ruth Lea, "The Pre-Budget Report: yet more irresponsible procrastination", Arbutnot Banking Group Perspective, 14 December 2009.
7. Charles Goodhart, "It is time to declare victory and withdraw from quantitative easing", *FT*, 1 December 2009.
8. The gilts market is already showing signs of strain, with the 10-year gilt paying over 4%.
9. "Quantitative Easing: An Interim Report" by Charles Bean, Deputy Governor for monetary policy, speech to the London Society of Chartered Accountants, 13 October 2009.