The Gower Initiative for Modern Money Studies

Quantitative Easing

What is Quantitative Easing?

Quantitative Easing (or QE as it is more widely known) is a type of monetary policy, used by the Bank of England to purchase financial products, such as gilts and other bonds, on the open market in exchange for bank deposits. Since bank deposits generally pay less interest than gilts the economy receives less interest income overall.

The extra demand for gilts and bonds from the Bank of England increases their prices. In response, further activity in the financial markets increases the value of other assets in the economy.

The belief is that by increasing the price of assets that will somehow increase the amount of spending in the economy due to a "wealth effect".

There are two other effects associated with QE:

- The first is that because the interest rate on gilts and bonds is lower, and money supposedly cheaper, firms will be more likely to invest. This is the "signalling effect".
- The second is that by increasing the level of cheap bank deposits, banks will reduce the price of lending and will lend more. This is the "bank lending effect".

The Bank of England believes that any impact QE may have had has been due to the "wealth effect". They have been unable to detect any impact of the "signalling effect" or the "bank lending effect" in the UK.[1]

QE has failed to create any significant inflation, and even mainstream economists are beginning to wonder if it is capable of doing so.[2]

[1] See QE and the Bank Lending Channel in the United Kingdom and Does quantitative easing boost bank lending to the real economy or cause other bank asset reallocation? The case of the UK
[2] e.g. Reis, Ricardo, 2016. "Funding Quantitative Easing to Target Inflation," CEPR Discussion Papers 11505, C.E.P.R. Discussion Papers.

The Quantitative Easing Process

The Bank of England intervenes in the fixed income market and purchases gilts and corporate bonds at the market price in exchange for a bank deposit.

QE tries to purchase gilts and bonds that have a long time left before they mature. These are the ones held by entities like pension funds and insurance companies and the Bank of England wants them to hold the bank deposits initially, not banks. Banks tend to hold gilts that will mature within five years.

Pension fund sellers are unlikely to move into riskier assets, since they were selling for a reason (e.g. to fund a retiree's pension). Buyers in the market, outbid by the Bank of England, were looking for a safe investment[3] and, likely, will simply keep their money in the bank.

However, the Bank's purchases do raise the price of gilts, which increases the percentage of gilts held in portfolios in the wider market. Some portfolio managers running asset allocation strategies[4] will sell some gilts to push the value of gilts held back down before reinvesting the proceeds in different assets. The same applies to corporate bonds.

The result is an increase in the prices of riskier assets such as shares and a general increase in bank deposits, but not an awful lot of additional borrowing for investment[5]. In the UK the main impact appears to have been to drive up the price of domestic property and housing costs.

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[3] Gilts are normally purchased as lower yield, but lower risk, long-term assets, and therefore are of most interest to long-term investors such as pension funds seeking to fund pension payments. By contrast, the stock market offers higher risk at higher potential reward, and are usually purchased at the growth stage of a pension, prior to retirement. The lowest risk assets are cash and bank deposits.
[4] Many financial funds look to hold set percentages of different classes of assets and regularly rebalance between them as prices change.
[5] Again, see QE and the Bank Lending Channel in the United Kingdom and Does quantitative easing boost bank lending to the real economy or cause other bank asset reallocation? The case of the UK

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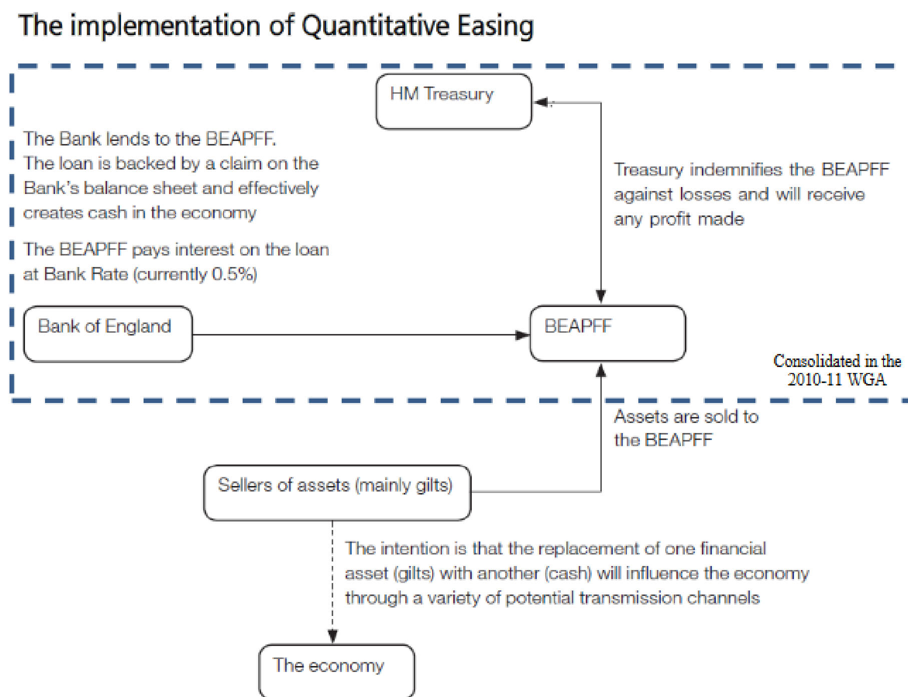
How is Quantitative Easing Implemented?

The Bank of England operates QE via the Bank of England Asset Purchase Facility Fund Limited (BEAPFF). This is a wholly-owned subsidiary of the Bank. The Bank acts as agent for BEAPFF.

The Asset Purchase Facility operates within this subsidiary. The BEAPFF was established to "provide a clear, transparent mechanism for monitoring the operations conducted under the facility"[6] It is the legal counterparty to any market transactions rather than the Bank of England itself.

The following diagram[7] details the approach:



[6] https://www.bankofengland.co.uk/-/media/boe/files/letter/2009/governor-letter-290109.pdf
[7] WGA - Whole of Government Accounts

How Much Does it Cost?

The common view is that QE is “printing money” and “injecting money into the economy”. It is of course no such thing. MMT shows that QE is merely an adjustment of the liabilities of the government sector. A point made in the Whole of Government Accounts 2011[8]

> *Consolidating Quantitative Easing does not significantly reduce the overall liabilities of government but it does reduce the number reported as government borrowing. Once intra-government transactions are eliminated, the scheme represents an exchange of gilts (liabilities of the National Loans Fund) for central bank reserves (liabilities of the Bank of England).*

For every £100 of central bank reserves added, £100 of gilts are removed.

Since gilts tend to pay more interest than bank reserves, QE removes income from the economy overall. HM Treasury gets a rebate on its gilt interest bill from the Asset Purchase Facility of over 20%.

The result is that the economy gets less risk-free income after QE than it would before. The primary effect of QE is to tax the risk-free income of the economy. Mainstream economists hope that the wealth effect and extra borrowing will overcome this tax.

[8] Whole of Government Accounts 2010-2011; §7.54; pp65

What Quantitative Easing Changes

The assets purchased by the Asset Purchase Facility are either government gilts or high-grade corporate bonds. The overwhelming majority of the assets purchased are government gilts (over 97%)

Gilts

An MMT analysis of the spending cycle (Table 1) shows that QE purchases of gilts merely restores the position of the banking system to what it would have been if the government had just spent on an overdraft at the central bank in the first place.

While QE is progressing we have the ridiculous situation where the debt management part of HM Treasury is doing “anti-QE” and draining bank deposits due to the “full funding rule”[9], only for the bank part of HM Treasury to undertake QE and put those bank deposits back.

It truly is moving money from the left pocket to the right pocket and back again.

Table 1 - The Spending Cycle: The assets and liabilities of the private sector and HM Treasury at each point in the cycle.

	Private Sector				**HM Treasury**			
	Pension Fund/Insurance Co.		**Commercial Bank**		**Bank of England**		**National Loans Fund**	
After	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**	**Assets**	**Liabilities**
Government Spending	Bank Deposit	Future Pensions	Bank Reserves	Bank Deposit	Overdraft	Bank Reserves	Other Assets	Overdraft
Clearing	Bank Deposit	Future Pensions	Rev Repo Sale	Bank Deposit			Other Assets	Repo Buyback
Gilt Auction	Gilts	Future Pensions					Other Assets	Gilts
Quantitative Easing	Bank Deposit	Future Pensions	Bank Reserves	Bank Deposit	Gilts	Bank Reserves	Other Assets	Gilts

[9] The funding rule (to fund fully the public sector borrowing requirement, maturing debt and any foreign currency reserves) was originally set out in ‘Report of the Debt Management Review’, HM Treasury and the Bank of England, July 1995. https://www.dmo.gov.uk/media/2083/report95.pdf

Corporate Bonds

A small amount of QE (just over 2% so far) is directed at the corporate bond market. The effect here is to reduce the amount of income available to the wider market from corporate bonds[10]. The idea is that this will encourage more corporate bonds to be issued at a lower interest rate.

However, the corporations still have to pay the coupons[11] to the Bank of England on the corporate bonds purchased with QE. The Bank of England then pays that income to HM Treasury. In other words, overall, coupons on corporate bonds have incurred a tax increase, and increased tax tends to reduce activity, not stimulate it.

How Effective is QE from the MMT View?

> *MMT challenges whether the direct reduction of long-term rates via QE would be any more successful in stimulating these economies than the earlier cuts to official rates which indirectly reduced long-term rates. The main problem in many developed economies is sluggish growth and the consequent absence of large numbers of creditworthy firms seeking to borrow. Second, there may be some modest increases in spending from the wealth effects, but equally interest incomes from retirees are based on interest rates and will decline as rates fall. Third, MMT would reject the bank funding/lending channel since it is premised on reserves driving loans and deposits.*
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> Macroeconomics; Mitchell, Wray and Watts; §23.6; pp367

[10] Corporate Bonds are tradeable fixed interest loans to private businesses, issued by the business themselves They are an alternative fund-raiser to bank loans and share issues. Some of these are purchased on the secondary bond market by the Bank of England.
[11] A coupon is the interest rate paid periodically on the face value of a bond, e.g. 4% p.a. on a £100 bond pays £4 every year. Any corporate bonds held by the Bank of England will earn a coupon for the Bank of England who then pays that money over to its owner - HM Treasury.