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DEBATE PACK

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Quantitative Easing

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Contents

Summary

This debate pack has been prepared ahead of the Backbench Business Committee debate on Quantitative Easing, which will take place on Thursday 15 September in the Commons Chamber.

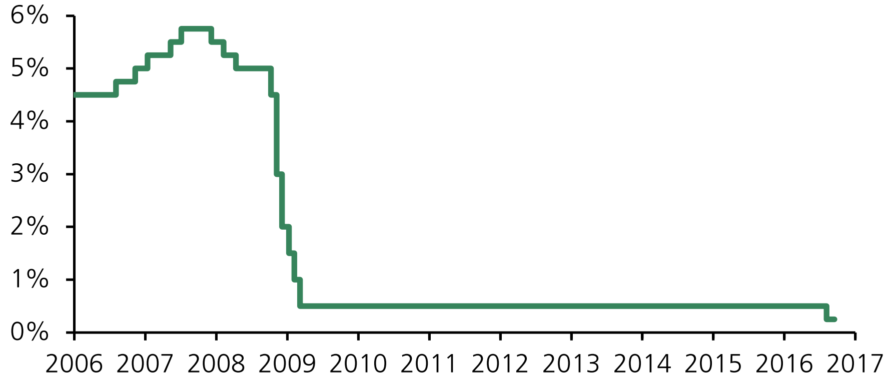
The House of Commons Library prepares a briefing in hard copy and/or online for most non-legislative debates in the Chamber and Westminster Hall other than half-hour debates. Debate Packs are produced quickly after the announcement of parliamentary business. They are intended to provide a summary or overview of the issue being debated and identify relevant briefings and useful documents, including press and parliamentary material. More detailed briefing can be prepared for Members on request to the Library.

1. Overview of quantitative easing (QE) and its impact

1.1 When was QE introduced and why?

As a result of the 2008-2009 financial crisis and recession, the Bank of England's Monetary Policy Committee (MPC) lowered interest rates at a rapid pace from 4.5% in October 2008 to a record low of 0.5% in March 2009 (where they remained for over seven years until early August).[1]

UK official interest rates



QE was introduced in March 2009 after interest rates were cut to 0.5%

At the same March 2009 meeting, the MPC also announced it was introducing a policy of quantitative easing (QE).[2] The MPC felt that additional stimulus to the economy was required given the ongoing severe economic recession and, with interest rates close to 0%, unconventional monetary policy was required to do that.

Box 1: Government's role

In January 2009. the then Chancellor, Alistair Darling, authorised the Bank of England to create a new fund called the Asset Purchase Facility (APF) and authorised the Bank's Monetary Policy Committee to use it for purchases of government debt (gilts) and corporate debt. [3]

The conditions associated with the use of the APF, particularly the total amount that can be purchased with it, are set by the Chancellor after a request by the Bank's Governor. For example, the upper limit of QE rose from £150 billion originally to £375 billion in July 2012, followed by a further increase in August 2016 (see below).

The Chancellor must sanction these changes as the government compensates the Bank and the APF should any financial losses occur from the APF's holdings of financial assets.[4]

[1] Bank of England, Official Bank Rate History

[2] Bank of England press release, "Bank of England Reduces Bank Rate by 0.5 Percentage Points to 0.5% and Announces £75 Billion Asset Purchase Programme", 5 March 2009

1.2 What is QE and how does it work?

To conduct QE, the Bank electronically creates new money which it then uses to buy assets (mostly gilts). These are not purchased directly from the government but from other parties such as banks, insurance companies and pension funds in the secondary market (explained in box below).[5]

QE involves the Bank of England creating new money electronically to buy assets, mostly government bonds

QE therefore provides these financial companies with extra money. The Bank expects this to boost the economy via a variety of different channels including:[6]

(i) Increasing asset prices, providing a **'wealth effect'** to firms and consumers as their assets increase in value, potentially leading them to spend more

(ii) Reducing borrowing costs by **driving down interest rates** on gilts (increased demand for gilts, pushes up their price, which reduces their yield, or interest, on them)

(iii) As interest rates on gilts fall, financial institutions **buy other assets** like shares (which would increase wealth) or corporate debt (which would reduce borrowing costs for companies); this is also known as the portfolio balancing channel

(iv) **Increased lending** from banks to companies and households (increasing incomes and spending in the economy)

Not everyone agrees that these arguments in favour of QE work in practice, with some arguing that lower interest rates are bad for savers, and that QE may have increased inequality, particularly wealth inequality.[7]

Box 2: Financing public sector debt

To finance public sector debt the UK government, via the Debt Management Office (DMO), sells bonds (known as gilts in the UK) to financial institutions. A buyer of a gilt is loaning the government money for a fixed amount of time and receives interest in return.

After originally being purchased from the DMO, gilts can then be bought and sold on the 'secondary market'. For example, say, an investment bank purchases £50 million of a gilt from the DMO. It may decide to keep that gilt or sell it on to another party, say a pension fund, at a price that is determined in the secondary market.

For more see Commons Library blogpost, "Public sector debt: a Q&A" (Jan 2016)

[5] For more on the specifics of purchasing gilts from non-banks see "Did Quantitative Easing boost bank lending?", Nick Butt, Rohan Churm and Michael McMahon, Bank Underground (Bank of England staff blog; views do not necessarily represent those of the Bank of England), 17 July 2015

[6] Bank of England, Quantitative Easing Explained, Quarterly Bulletin Q3 2011, and Quantitative Easing - frequently asked questions

[7] For example see "Wealth inequality and monetary policy",Dietrich Domanski, Michela Scatigna and Anna Zabai, Bank for International Settlements, BIS Quarterly Review, March 2016 and Liam Halligan comment, "History will surely see QE as a major mistake", Daily Telegraph, 1 November 2014

1.3 August 2016 expansion of QE

In August 2016, the Bank of England's Monetary Policy Committee voted to expand its QE programme by purchasing an additional £70 billion (£60 billion of gilts and £10 billion of corporate debt), taking the total to £445 billion.[8] The table below shows the evolution of the Bank's QE programme since its inception in 2009.

Quantitative easing
£ billion

	Asset purchases	Cumulative total
March 2009	75	75
May 2009	50	125
August 2009	50	175
November 2009	25	200
October 2011	75	275
February 2012	50	325
July 2012	50	375
August 2016	70 *	445

* includes £10bn of corporate debt
Source: Bank of England

At the August meeting the MPC also cut its benchmark interest rate from 0.5% to 0.25% and introduced a new Term Funding Scheme, up to £100 billion funded from newly-printed money, designed to ensure banks pass on the interest rate cut by giving banks access to cheap loans linked to the amount they lend firms and households.[9]

1.4 Impact of QE

There are a number of ways in which QE may affected economic and financial conditions. Some evidence as to its impact is presented below.

GDP growth, inflation and interest rates

Research by Bank of England staff in 2011 found that the first wave of QE from March 2009 to January 2010 of £200 billion (14% of annual GDP) increased GDP and inflation [emphasis added]:

> QE1 could have **boosted real GDP by as much as 1.5% to 2% and increased inflation by between 0.75 and 1.5 percentage points**. Using a ready-reckoner from the Bank of England's forecasting model suggests that this would be equivalent to a 150 to 300 basis-point cut in the Bank Rate, a significant reduction. Of course, there are large uncertainties even with this range and it is possible that the effects could have been larger or smaller.[10]

[8] Bank of England press release, "Bank of England cuts Bank Rate to 0.25% and introduces a package of measures designed to provide additional monetary stimulus", 4 August 2016
[9] Commons Library, *Interest Rates and Monetary Policy: Key Economic Indicators*
[10] Michael Joyce, Matthew Tong, Robert Woods, "The economic impact of QE: Lessons from the UK", VoxEU, November 2011 summarising research, "The United

A subsequent 2014 Bank of England paper also found that QE boosted real GDP and inflation, with an asset purchase equivalent to 1% of GDP leading to a 0.18% rise in real GDP and a 0.3% increase in the CPI measure of inflation.[11]

In its May 2014 *Inflation Report* the MPC also discussed QE's impact on the economy and GDP in particular [emphasis added]:

> Bank staff analysis suggests that **the peak cumulative impact of the MPC's asset purchases on the level of real GDP was around 2½%**. As purchases are assumed to take around two years to feed through fully to activity, that peak impact probably occurred during 2013.[12]

However, other research finds less of an impact from QE on the real economy after the first wave of QE conducted in the midst and immediate aftermath of the financial crisis. Research by Professors Chris Martin and Costas Milas published in 2012 found there is "little evidence" that subsequent QE programmes had much effect on economic growth.[13]

Others also remain sceptical of the effectiveness of QE.[14] For instance, by driving interest rates lower savers have seen their savings incomes reduced. In addition, it now appears that QE did not lead to increased bank lending to companies; a July 2015 Bank of England staff blog found that "we find no evidence to suggest that QE boosted bank lending in the UK through a bank lending channel".[15]

Asset prices and inequality

It is generally agreed that the Bank's QE programme – and similarly schemes around the world – have had the effect of boosting asset prices in the financial markets (such as shares and bonds).[16]

Another issue raised by QE is the effect on savers and pensioners through the effect on annuity rates. This was highlighted by the Treasury Select Committee in its report on the 2012 Budget. The Committee's report said:

> Loose monetary policy, achieved through quantitative easing and low interest rates, has redistributional effects, particularly penalising savers, those with 'drawdown pensions' and those retiring now. The Bank of England has argued that some of those effects may be mitigated by the increase in asset prices stimulated by quantitative easing. While the aggregate of savers and

Kingdom's quantitative easing policy: design, operation and impact", published in Bank of England Quarterly Bulletin 2011 Q3

[11] Martin Weale and Tomasz Wieladek, "What are the macroeconomic effects of asset purchases?", External MPC Unit Discussion Paper No. 42, April 2014

[12] Bank of England, Inflation Report, May 2014, p41

[13] Christopher Martin and Costas Milas, "Quantitative Easing: a Sceptical Survey", Oxford Review of Economic Policy, Vol 28, No.4, 2012, pp750-64

[14] For example, see Buttonwood columnist's blog in The Economist, "QE was not about saving the banks", 28 September 2015

[15] "Did Quantitative Easing boost bank lending?", Nick Butt, Rohan Churm and Michael McMahon, Bank Underground (Bank of England staff blog; views do not necessarily represent those of the Bank of England), 17 July 2015

[16] Nick Butt, Rohan Churm, Michael McMahon, Arpad Morotz and Jochen Schanz, "QE and the bank lending channel in the United Kingdom", Bank of England Working Paper no. 511, September 2014

> pensioners may have received some benefit from higher asset prices, there will be many individuals who will not have benefited.[17]

As mentioned previously, research by the Bank for International Settlements also found that wealth inequality widened as a result of QE (as equity prices rise, which are mostly owned by people higher up the wealth distribution). The ratings agency Standard & Poor's also stated in a February 2016 report that QE exacerbated increasing wealth inequality in the UK.[18]

1.5 How QE and fiscal policy interact

While QE sees the Bank of England purchase gilts, it explicitly does not do this directly from government. Instead it purchases gilts on the secondary market from financial institutions that already own them, thereby providing QE's newly-created money to them rather than government.

In addition, at some point, the Bank is meant to reduce the amount of gilts it owns when economic stimulus is not required. In other words, QE is not meant to be permanent.

Purchasing gilts on the secondary market and the plan for QE to be temporary, are intended to avoid the perception that the Bank's independent monetary policy is monetising the government's debt (printing money to fund government spending).

However, the Bank now owns around one quarter of all outstanding government debt and there is very little prospect of the Bank unwinding QE anytime soon.[19] This has somewhat blurred the lines between monetary and fiscal policy. For instance, Andy Haldane, chief economist at the Bank of England, has noted the potential impact of QE on fiscal policy.[20] Nevertheless, bond markets do not seem particular concerned about this, with demand for UK debt still strong despite low interest rates.

As QE has helped lower the cost of borrowing for the UK government (this seems to be general agreement that this has been the case since 2009), QE can be said to have saved the government money in terms of debt interest paid.

Some also argue that QE complemented fiscal policy by providing a boost to demand in the economy to offset the impact of reductions in government spending and increases in taxation. For instance, the Adam Smith Institute, a think tank advocating free markets, has said that QE reduced the 'more baneful effects of austerity'.[21] If QE did boost

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[17] Treasury Committee, Budget 2012, HC 1910-I, 18 April 2012, paras 54-5
[18] "S&P: QE 'exacerbates' inequality" FT.com (FastFT), 10 February 2016 and "Bank of England's recovery policies have increased inequality, finds S&P", Guardian, 10 February 2016
[19] Commons Library blogpost, "Public sector debt: a Q&A" , 22 January 2016
[20] Speech given by Andrew Haldane, Chief Economist, Bank of England, "How low can you go?", 18 September 2015, pages 9-10
[21] Adam Smith Institute, "Economic nonsense: 49. Government was wrong to use austerity to deal with the 2008 financial crisis", 16 April 2016

economic activity then it will have led to increased revenues for the government (compared to an alternative reality where “austerity” happened but QE didn’t).

2. Press Articles

[Quantitative easing extension risks reopening ECB rifts]

Financial Times

Claire Jones, 7 September 2016

[The right kind of budget: The British economy and Brexit]

Economist

3 September 2016

[Forget QE. Theresa May should cut taxes if she wants to drive growth]

Fraser Nelson, Daily Telegraph

11 August 2016

[Bank of England to face 'real trial' to implement monetary stimulus, say analysts: Experts said pension funds would be reluctant to sell long-dated Gilts, even at the high prices offered by the Bank, because of regulatory requirements]

Ben Chu, The Independent

10 August 2016

[The BoE's stumbling QE operation: analysis and reaction]

Financial Times

10 August 2016

[Bank will need to conserve ammunition to win the war]

Ian McCafferty, The Times

9 August 2016

[The Bank of England: Treating the Hangover]

Economist

6 August 2016

[Carney's sledgehammer won't crack a thing]

Ed Conway, The Times

5 August 2016

I'm from the central bank and I'm here to help: Quantitative easing has prevented deflation and the policy is now ordinary

Dan McCrum, Financial Times

5 August 2016

Economists call for Bank of England cash handouts to prop up economy

Jake Cordell, City AM

4 August 2016

Quantitative easing: all you need to know

4 August 2016

Katie Allen and Julia Kollewe

Bank of England unveils four-pronged stimulus package in bid to avoid Brexit recession

Daily Telegraph, 4 August 2016

Szu Ping Chan

A post-Brexit economic policy reset for the UK is essential

The Guardian

3 August 2016

The Bank of England's response to Brexit

Financial Times

Chris Giles, 27 July 2016

Smoke, mirrors and helicopter money

Financial Times

John Kay, 17 May 2016

3. Press Releases

Monetary policy summary: Bank of England cuts Bank Rate to 0.25% and introduces a package of measures designed to provide additional monetary stimulus

Bank of England

4 August 2016

The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending 3 August 2016, the MPC voted for a package of measures designed to provide additional support to growth and to achieve a sustainable return of inflation to the target. This package comprises: a 25 basis point cut in Bank Rate to 0.25%; a new Term Funding Scheme to reinforce the pass-through of the cut in Bank Rate; the purchase of up to £10 billion of UK corporate bonds; and an expansion of the asset purchase scheme for UK government bonds of £60 billion, taking the total stock of these asset purchases to £435 billion. The last three elements will be financed by the issuance of central bank reserves.

Following the United Kingdom's vote to leave the European Union, the exchange rate has fallen and the outlook for growth in the short to medium term has weakened markedly. The fall in sterling is likely to push up on CPI inflation in the near term, hastening its return to the 2% target and probably causing it to rise above the target in the latter part of the MPC's forecast period, before the exchange rate effect dissipates thereafter. In the real economy, although the weaker medium-term outlook for activity largely reflects a downward revision to the economy's supply capacity, near-term weakness in demand is likely to open up a margin of spare capacity, including an eventual rise in unemployment. Consistent with this, recent surveys of business activity, confidence and optimism suggest that the United Kingdom is likely to see little growth in GDP in the second half of this year.

These developments present a trade-off for the MPC between delivering inflation at the target and stabilising activity around potential. The MPC's remit requires it to explain how it has balanced that trade-off. Given the extent of the likely weakness in demand relative to supply, the MPC judges it appropriate to provide additional stimulus to the economy, thereby reducing the amount of spare capacity at the cost of a temporary period of above-target inflation. Not only will such action help to eliminate the degree of spare capacity over time, but because a persistent shortfall in aggregate demand would pull down on inflation in the medium term, it should also ensure that inflation does not fall back below the target beyond the forecast horizon. Thus, in tolerating a temporary period of above-target inflation, the Committee expects the eventual return of inflation to the target to be more sustainable.

The MPC's choice of instruments is based on a consideration of their likely impact on the real economy and inflation. The MPC has examined closely the interaction between monetary policy and the financial sector, both with regard to ensuring the effective transmission of monetary policy to households and businesses, and with consideration for the financial stability consequences of its policy actions.

The cut in Bank Rate will lower borrowing costs for households and businesses. However, as interest rates are close to zero, it is likely to be difficult for some banks and building societies to reduce deposit rates much further, which in turn might limit their ability to cut their lending rates. In order to mitigate this, the MPC is launching a Term Funding Scheme (TFS) that will provide funding for banks at interest rates close to Bank Rate. This monetary policy action should help reinforce the transmission of the reduction in Bank Rate to the real economy to ensure that households and firms benefit from the MPC's actions. In addition, the TFS provides participants with a cost effective source of funding to support additional lending to the real economy, providing insurance against the risk that conditions tighten in bank funding markets.

The expansion of the Bank of England's asset purchase programme for UK government bonds will impart monetary stimulus by lowering the yields on securities that are used to determine the cost of borrowing for households and businesses. It is also likely to trigger portfolio rebalancing into riskier assets by current holders of government bonds, further enhancing the supply of credit to the broader economy.

Purchases of corporate bonds could provide somewhat more stimulus than the same amount of gilt purchases. In particular, given that corporate bonds are higher-yielding instruments than government bonds, investors selling corporate debt to the Bank could be more likely to invest the money received in other corporate assets than those selling gilts. In addition, by increasing demand in secondary markets, purchases by the Bank could reduce liquidity premia; and such purchases could stimulate issuance in sterling corporate bond markets.

As set out in the August Inflation Report, conditional on this package of measures, the MPC expects that by the three-year forecast horizon unemployment will have begun to fall back and that much of the economy's spare capacity will have been re-absorbed, while inflation will be a little above the 2% target. In those projections the cumulative growth in output is still around 2½% less at the end of the forecast period than in the MPC's May projections. Much of this reflects a downward revision to potential supply that monetary policy cannot offset. However, monetary policy can provide support as the economy adjusts. Had it not taken the action announced today, the MPC judges it likely that output would be lower, unemployment higher and slack greater throughout the forecast period, jeopardising a sustainable return of inflation to the target.

This package contains a number of mutually reinforcing elements, all of which have scope for further action. The MPC can act further along each of the dimensions of the package by lowering Bank Rate, by expanding the TFS to reinforce further the monetary transmission mechanism, and by expanding the scale or variety of asset purchases. If the incoming data prove broadly consistent with the August Inflation Report forecast, a majority of members expect to support a further cut in Bank Rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of the year. The MPC currently judges this bound to be close to, but a little above, zero.

All members of the Committee agreed that policy stimulus was warranted at this time, and that Bank Rate should be reduced to 0.25% and be supported by a TFS. Eight members supported the introduction of a corporate bond scheme, and six members supported further purchases of UK government bonds.

These measures have been taken against a backdrop of other supportive actions taken by the Bank of England recently. The FPC has reduced the countercyclical capital buffer to support the provision of credit and has announced that it will exclude central bank reserves from the exposure measure in the current UK leverage ratio framework. This latter measure will enhance the effectiveness of the TFS and asset purchases by minimising the potential countervailing effects of regulatory requirements on monetary policy operations. The Bank has previously announced that it will continue to offer indexed long-term repo operations on a weekly basis until the end of September 2016 as a precautionary step to provide additional flexibility in the Bank's provision of liquidity insurance. The PRA will also smooth the transition to Solvency II for insurers.

Bank of England cuts interest rates and boosts quantitative easing after Brexit vote: The Bank of England has cut interest rates to record low levels of 0.25% and expanded its quantitative easing programme.

Josh May, Politics Home

4 August 2016

The decisions from the Monetary Policy Committee come after a series of negative economic data in the wake of the vote to leave the European Union in June.

The MPC was unanimous on the quarter-point cut to interest rates, but it was a split decision to expand the quantitative easing programme, which sees the Bank print money to buy government bonds, by a further £60bn to £435bn.

It will also buy £10bn in corporate bonds and has launched a new 'Term Funding Scheme' to make sure banks can pass on the rate cut to individuals and businesses.

It is the first time interest rates have changed since 2009.

Alongside the MPC's decision, the Bank has published its quarterly inflation report.

That includes drastic cuts to the UK's GDP forecasts, with the Bank now anticipating "little growth" in the economy through the rest of 2016.

"Following the United Kingdom's vote to leave the European Union, the exchange rate has fallen and the outlook for growth in the short to medium term has weakened markedly," today's MPC said.

"Recent surveys of business activity, confidence and optimism suggest that the United Kingdom is likely to see little growth in GDP in the second half of this year."

The Bank also warned that inflation was likely to be pushed up beyond the 2% target, and that unemployment would rise.

In a letter to Bank of England Governor Mark Carney, the Chancellor said he was ready to take "any necessary steps to support the economy and promote confidence".

Philip Hammond also released a statement welcoming the MPC's package of measures.

He said: "The vote to leave the EU has created a period of uncertainty, which will be followed by a period of adjustment as the shape of our new relationship with the EU becomes clear and the economy responds to that.

"It's right that monetary policy is used to support the economy through this period of adjustment. That's why I have authorised the Governor's request for an increase in asset purchases and a new lending scheme to support the economy, helping ensure that the benefit of low interest rates is passed on by the banks to households and businesses.

"As recent figures on jobs and growth have shown, we enter this period of adjustment from a position of economic strength. And the Governor and I have the tools we need to support the economy as we begin this new chapter and address the challenges ahead."

4. Parliamentary Material

4.1 Parliamentary Questions

Monetary Policy: Written question - 6776

Asked by Ian Blackford

To ask Mr Chancellor of the Exchequer, what assessment he has made of the effect of the quantitative easing programme on (a) bank lending generally and (b) M4 lending.

Answered by Harriett Baldwin

Answered on 30 July 2015

The UK's monetary policy framework, set out in the Bank of England Act 1998, gives operational responsibility for monetary policy to the independent Monetary Policy Committee (MPC).

The MPC's macroeconomic policy tools, including quantitative easing, are designed to affect the economy as a whole, in order to meet the 2 per cent inflation target over the medium term.

The Bank of England's paper, "The United Kingdom's quantitative easing policy: design, operation and impact", published in 2011, notes that, "Asset purchases may also have a stimulatory impact…by influencing bank lending, though this channel would not be expected to be material during times of financial crisis."

Monetary Policy: Written question - HL5483

Asked by Lord Myners

Asked on 05 March 2015

To ask Her Majesty's Government what oversight they exercise of the quantitative easing programme to manage its risk under the HM Treasury Indemnity.

Answered by Lord Deighton

Answered on 18 March 2015

The UK's monetary policy framework, set out in the Bank of England Act 1998, gives operational responsibility for monetary policy to the independent Monetary Policy Committee (MPC). The MPC makes decisions on its policy tools, including quantitative easing, in order to meet the 2% inflation target in the medium term.

The framework for the Asset Purchase Facility (APF), authorising it to be used as a monetary policy tool, was set out in the exchange of letters between the then Chancellor of the Exchequer and the then Governor of the Bank of England on 29 January and 5 March 2009. The framework requires the Chancellor to authorise the ceiling on total asset purchases by the APF, given the indemnity the Treasury provides for the facility.

4.2 Parliamentary Briefings

Interest Rates and Monetary Policy: Key Economic Indicators, House of Commons Library, 8 September 2016

Government borrowing, debt and debt interest: statistics, House of Commons Library, 19 August 2016

5. Further Reading

What is quantitative easing?

BBC, 4 August 2016

Quantitative Easing – Frequently Asked Questions

Bank of England

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DEBATE PACK
CDP 2016/0166 14
September 2016