An occasional paper from Fiscal Engineers

Quantitative Easing - what is it and how does it work?

Quantitative Easing in the UK

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In normal times, central banks attempt to influence the level of demand within an economy by adjusting the price of money (interest rates). If economic activity is deemed to be too weak to deliver the government's policy objectives (usually a target rate for inflation), central banks will cut interest rates in order to encourage spending at the expense of saving and/or increases in borrowing. However, in exceptional circumstances, particularly when, as now, interest rates are already close to zero, they may instead engage in policies aimed at directly changing the *quantity of money*. This, in essence, is Quantitative Easing (QE).

Since March 2009, the Bank of England has pumped some £745 billion into the UK economy through QE. £375 billion of this occurred between November 2009 and July 2012 in the wake of the Financial Crisis, an additonal £60 billion was injected following the EU Referendum in June 2016, with a further £310 billion added in response to the Covid-19 lockdown of the economy since March 2020. Although QE is often associated with 'printing money', there are no giant printing presses in Threadneedle Street churning out vast quantities of £50 notes. This is because the amount of notes and coin in circulation is tiny when compared with private sector bank deposits, which are what are mainly used for financial transactions in a modern, dynamic economy. Indeed, today bank deposits comprise almost 97% of the total stock of money.

QE therefore works by directly increasing the quantity of money held in the bank accounts of the private sector. Faster rates of monetary growth should, all other things being equal, translate into an acceleration in economic activity.

So how does the Bank of England set about doing this? The process begins with the Bank of England issuing new reserves—created digitally—to the commercial banks, who in return place a credit in the central bank's accounts with them. These funds are then used to purchase longer-dated government bonds (gilts) from the (non-bank) private sector—largely institutional investors such as life assurance and pension funds—with the sale proceeds increasing the amount of money held in their bank accounts. However, as this will take the amount of cash they wish to hold relative to other assets above desired levels, institutional investors will seek to reduce this by purchasing other assets, most notably equities. Asset prices duly rise, with the resulting positive wealth effects improving corporate sector balance sheets and eventually corporate spending. Nominal national income and employment both rise. Everybody is better off, albeit some more than others.

Keen-eyed readers will have noted that I have made no mention of bank lending in this description of QE. In normal times, most of the growth in the quantity of money occurs when a bank grants a new loan to an individual or company and then credits the funds to their bank account. This 'creates' new money. Unfortunately, immediately following the financial crisis the banks were required by the regulatory authorities to substantially increase the amount of capital they held relative to their assets (mostly their loan books). In addition to directly raising huge amounts of new capital, the banks responded by slashing new loan advances and, in some cases, calling in existing loans. Both practices, however laudible in terms of making the banking system 'safe', actually destroyed money. Consequently, the purpose of QE then was not, in contrast to what you may have read at the time, to stimulate bank lending but was instead to compensate for its weakness. Had it not been for QE, the quantity of money in the UK economy by the end of 2010 would have been around 25% lower than it actually was with nominal national income down by a similar amount. Without it, the 'Great Recession of 2008-09' would have undoubtedly become the 'Great Depression of the early 21st Century'.[1]

[1] Had the objective of QE really been to increase bank lending, the MPC would have targetted its asset purchases on shorter dated gilts as liability matching considerations prevent the banks from holding longer-dated issues.

So if QE has been such an unbridled success in countering deflationary forces, are there any downside risks? Any process that can create money out of thin air clearly has inherent dangers. Just as excessive bank lending can cause, as we saw in the late 1980s, economic overheating and rising inflation, so too can QE if economic conditions are not right. In the five years to March 2014, net bank lending was in almost continuous decline as banks sought to rebuild their capital bases following the financial crisis. QE was therefore necessary to maintain monetary growth at around the 4-5% a year rate that is consistent with 2% inflation. However, today with their financial positions substantially improved, banks are no longer reticent about lending, with total net lending to the private sector up 6.6% in the year to June. Although this isn't by itself a cause for concern, adding this to the £310 billion of additional asset purchases made by the Bank of England since the lockdown started in March has resulted in the overall stock of money increasing substantially. Indeed, the annual rate of growth in the total quantity of money was around 12% in August, the highest since this particular data series began in June 2007. Whilst this hasn't prevented the recession caused by the physical shutting down of the vast majority of the economy since 23rd March, it should mean that the subsequent recovery will be sharp and robust. In fact monthly data shows that the recovery got underway almost six months ago in May, with Bank of England Chief Economist, Andy Haldane reckoning the economy has already regained more than 90% of its lost output.

The bigger worry is that whilst UK monetary growth is only around half that currently being seen in the US, such rates are consistent with a pronounced pick up in inflationary pressures further down the line. Inflation could be the big investment theme in 2021-22. Given this, Fiscal Engineers recognises it is more important than ever for our clients to continue with the current well diversified portfolio strategy we have in place, with significant exposure to assets that provide protection against inflation such as equities, real estate and index-linked bond.

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23 October 2020