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Briefing: rethinking the Bank of England's quantitative easing programme

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> *"Monetary policy – in the form of super-low interest rates and quantitative easing – has helped those on the property ladder at the expense of those who can't afford to own their own home."*
> ***Theresa May***

Summary of key points

- The Bank of England announced in August that it will create an additional £70bn of new money to finance bond purchases from private investors.
- Past rounds of QE have resulted in a **significant increase in wealth inequality** by boosting the value of property and financial assets. It has also contributed to a rise in household debt, which jeopardises financial stability.
- **The Bank's stimulus programme should be re-designed** in a way which avoids these adverse side effects and is more effective at boosting the real economy. Leading economists have outlined proposals including using newly-created money for infrastructure projects, a tax cut, or a cash transfer to citizens.
- **As Chancellor, Philip Hammond should carry out a review into the alternatives to QE**, and put in place a framework for alternative monetary policy tools to be used. This can be done without compromising the independence of the Bank of England.

Concerns over QE's effectiveness

QE involves the Bank of England using new electronically-created money to buy financial assets from private investors. In the UK, these financial assets have been mostly government bonds. In August, the Bank of England also announced plans to purchase up to £10bn of corporate bonds. The programme has three intended effects These are to:

- encourage financial institutions to lend more to the real economy
- push interest rates even lower across the banking sector, even when the Bank's own rates are nearly at zero,, allowing businesses and consumers to borrow more
- increase demand for financial assets, thereby increasing the price of these financial assets. This is meant to make wealthy asset-holders feel better off, which should encourage them to spend and consume more.

However, there is clear evidence to suggest that QE will not have these intended effects:

- Instead of encouraging investors to lend to the real economy, they are likely to channel money into financial assets instead. This is evidenced by the rapid increase in stock and bond prices during previous rounds of QE.[1]
- QE has not provided a funding boost to businesses. Bank lending to businesses actually fell over the course of the initial round of QE. Business aren't borrowing because they are not confident they will be able to sell their products – not because rates aren't low enough.[2]
- Investors, companies and richer households prefer holding on to the extra wealth that QE provides them with, rather than choosing to invest their money into the real economy.[3]

QE's negative consequences

Quantitative easing also has a number of worrying side-effects. The Prime Minister has joined a growing number of financial institutions and academics in recognising that QE has **increased inequality**. This was confirmed in a 2013 report by the Bank of England which showed that QE boosted asset prices and household financial wealth, which is "heavily skewed with the top 5 per cent of households holding 40 per cent of these assets".[4] The report estimated that QE has made the top 5% of households richer by an average of £128k each. More recently, a Standard and Poor's report found that the proportion of the nation's wealth in the hands of the top 10% of households rose nearly 10% in the six years from 2008[5]. The report attributed this rise to unconventional monetary policy including QE, which it says "exacerbated wealth disparity between rich and poor".

Another risk associated with QE is that in order to be effective, it relies on encouraging households to take on more debt. Referring to the underlying causes of the 2008 financial crisis, Lord Adair Turner has warned that QE risks fuelling the same "growth of private credit which got us into this mess in the first place". If QE is successful in stimulating bank lending, it is likely that most of the new money will be lent into the property and financial sectors. This reinforces the UK's dependence on household debt and jeopardises future financial stability.

Might the new government rethink its support for the policy?

Theresa May could adopt a more critical stance towards current monetary policy. The new Prime Minister said that ultra-loose monetary policy has contributed to inequality by benefiting homeowners over those who have yet to get on the property ladder.[6]

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[1] Ryan Collins et al (2013)
[2] Jackson (2013)
[3] Jackson (2013)
[4] http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb120306.pdf
[5] http://www.ft.com/fastft/2016/02/10/sp-qe-exacerbates-inequality/
[6] http://www.theresa2016.co.uk/we_can_make_britain_a_country_that_works_for_everyone

In authorising the latest round of asset purchases, Philip Hammond appears to be less than convinced by the case for QE, omitting to express his support for the programme.

George Osborne and Philip Hammond on QE: a change in tone?	
"I agree that an increase in the ceiling would provide the MPC with the scope […] it remains the primary tool for responding to changes in the economic outlook." *Letter from George Osborne to Mark Carney, 2012*	"I note that it is the MPC's view that in the absence of monetary policy stimulus there would be undesirable volatility in output." *Letter from Philip Hammond to Mark Carney, 2016*

The case for greater democratic control

There is a growing acceptance that monetary policy has significant political implications which must be subject to greater democratic scrutiny. As explained above, the QE programme has been shown to disproportionately benefit the richest households at the expense of the least well-off. The Bank's decision to purchase up to £10bn in corporate bonds also raises questions about the types of companies which will benefit from lower borrowing costs. The list of bonds eligible for corporate QE purchases, published in September, includes a tobacco company, several firms accused of tax-dodging, and a number of companies based overseas[7].

To ensure that monetary policy does a better job of stimulating the real economy, and to address this democratic deficit, it should be an urgent priority for the new government to undertake a review into the alternatives to QE. The Treasury should set in place the framework for a new tool to be used.

What are the alternatives?

The most commonly-cited proposals are summarised below. They each share two characteristics, which is that they target productive sectors of the economy, and do not rely on adding to the ever-increasing debt burden of UK households.

	How would newly-created money be used?	What would be the impact?	Who has proposed this option?
Sovereign Money Creation	To fund government spending e.g. on investment in infrastructure	Household spending would rise and private sector incomes would be boosted	Positive Money Lord Adair Turner proposes a similar model

[7] http://www.bankofengland.co.uk/markets/Pages/apf/corporatebondpurchases/default.aspx

Helicopter Money	To finance a tax cut or citizens dividend, thereby increasing disposable incomes	Household spending would rise and private sector incomes would be boosted	Ben Bernanke
Strategic QE	To directly finance lending for infrastructure and strategically important industries	Private sector incomes would be boosted. Business debt would rise but household debt would not	New Economics Foundation

Does a different form of QE mean ending Bank of England independence?

The models described above all rely on greater fiscal and monetary cooperation. Many economists agree that while the Bank should remain independent, its strategy must be more closely aligned with the Treasury. The decision about the timing and size of any new stimulus should remain a matter for the Monetary Policy Committee. Just as the Treasury gave the Bank of England permission to begin QE in 2011, any alternative monetary policy tool would require the Treasury's cooperation and consent. But the Bank would retain control over when and how much stimulus should be used.

Recommendations:

The Treasury should:

- retract permission for the current quantitative easing programme
- undertake a review into alternative monetary policy tools
- create the framework for newly created money to be transmitted directly into the real economy, with the Monetary Policy Committee left to determine the appropriate quantity and timescale of any stimulus.

For more information or to arrange a meeting to discuss the issues in this briefing, please contact:

David Clarke | david.clarke@positivemoney.org.uk | 0207 253 3235