

Supplement

Quantitative easing – injecting money into the economy

The Monetary Policy Committee announced in March 2009 that it would start to inject money directly into the economy to boost spending – a policy often known as quantitative easing. The Committee continues to set Bank Rate each month, and the objective of monetary policy is unchanged – to meet the inflation target.

What is it?

In March 2009, the Bank's Monetary Policy Committee (MPC) began purchasing assets financed by new money that the Bank creates electronically in the accounts held with it by the commercial banks.

Often known as quantitative easing, the Bank's asset purchases are designed to inject money directly into the economy to boost spending and so keep inflation on track to meet the 2% target. As the economy has weakened, there is a risk that too little money is circulating. The money supply needs to grow for the economy to expand. Quantitative easing boosts the supply of money in the economy to raise the rate of growth of demand consistent with meeting the inflation target. Alongside its decisions on asset purchases, the MPC continues to vote on Bank Rate each month.

The Bank is injecting money into the economy to boost spending to meet the inflation target.

The Bank buys assets from private sector businesses – including insurance companies, pension funds, banks and non-financial firms – and credits the seller's bank account. Most of the assets purchased are government bonds. There is a large market available so the Bank can buy large quantities of these assets fairly quickly.

The Bank is also buying smaller amounts of private debt – such as corporate bonds – to improve conditions in corporate credit markets and boost the flow of funds to companies.

Why is it needed?

Spending in the economy slowed very sharply in the latter part of 2008 as the global downturn gathered pace. The MPC cut Bank Rate substantially to reduce the risk of inflation falling well below target further ahead. But as Bank Rate got closer to zero, further reductions were likely to be less effective in boosting demand and inflation. So the MPC needed to provide a further stimulus to support spending by directly injecting money into the economy through a new programme of asset purchases.

Money is not growing quickly enough to keep inflation close to the 2% target.

How does it work?

There are a number of ways in which the MPC's asset purchases could boost spending in the economy to bring inflation back to the 2% target.

The sellers of assets to the Bank have more money which they can spend directly on goods and services. That will help to boost growth. Or, they may buy other financial assets such as shares or company bonds. That will push up the prices of those assets, making the people who own them better off, and they may increase their spending as a result. Higher asset prices also mean lower yields – the percentage return. That brings down the cost of borrowing for businesses and households. This should provide a further boost to spending.

Those selling assets to the Bank of England have more money in their bank accounts. This means the commercial banks have more reserves at the Bank of England. That might lead them to boost their lending to consumers and

businesses, which in turn would help to increase spending in the economy. That said, if banks are concerned about their financial health, they may prefer to hold the extra reserves without expanding lending. For this reason, the Bank of England is buying most of the assets from the wider economy rather than the banks.

It is very difficult to be sure in what way asset purchases will have most impact on spending and inflation, and over what time scale. But the large amount of extra money injected into the economy is substantial. Over time, that should increase spending and help keep inflation on track to meet the 2% target.

How much?

In March 2009, the Chancellor authorised the MPC to purchase up to £150 billion of assets financed by new money created by the Bank. In August, the Chancellor raised the limit on the Bank's asset purchases to £175 billion.

There is a high degree of uncertainty over the appropriate scale of asset purchases necessary to keep inflation at target in the medium term. When the MPC initially discussed the scale of asset purchases in March, it noted that nominal GDP had grown each year by around 5% since 1997 and, over that period, inflation had been close to target.

That suggested asset purchases needed to be large enough to make up for the shortfall between projected growth in the economy and nominal GDP growth of around 5% a year, bearing in mind reductions in Bank Rate and other factors influencing the economic outlook. Strains in the financial system and particularly the pressure on banks to reduce the size of their balance sheets meant banks might not increase their lending substantially following an increase in banks deposits. So that would reduce the extent to which the money injected through asset purchases would generate a larger rise in the stock of broad money and credit. And it was also possible that the eventual increase in spending might be smaller than the increase in broad money – people might save more or reduce their borrowings. These considerations suggested to the MPC that the increase in the amount of money injected into the economy should be of a similar magnitude to the required increase in nominal GDP (MPC minutes, 4–5 March meeting).

At its meeting in March 2009, the MPC voted to reduce Bank Rate to 0.5% and to spend £75 billion on asset purchases. Subsequently, at its meeting in May, the MPC voted to keep Bank Rate at 0.5% and to undertake a

further £50 billion of asset purchases – bringing total purchases to £125 billion.

At its meeting in August 2009, the Committee voted again to keep Bank Rate at 0.5% and to make another £50 billion of asset purchases so that total purchases increase to £175 billion.

Teams will need to monitor MPC announcements to check the MPC's latest decisions on Bank Rate and asset purchases.

What to watch?

The MPC is assessing how firms and households respond to the extra money injected into the economy. It will pay close attention to the growth of broad money, the cost and availability of bank borrowing, measures of inflation and inflation expectations, and developments in nominal spending growth.

What matters is the degree to which the cash injection boosts the growth of spending by households and businesses to ensure that inflation stays on track to meet the 2% target.

Key resources on quantitative easing

- Quantitative easing explained – the Bank's main web page on QE.
www.bankofengland.co.uk/monetarypolicy/assetpurchases.htm
- 'Quantitative easing explained' – the Bank's pamphlet on QE.
www.bankofengland.co.uk/monetarypolicy/pdf/qe-pamphlet.pdf
- Watch the Governor's BBC TV interview on injecting money into the economy.
www.bankofengland.co.uk/monetarypolicy/assetpurchases_stream.htm
- 'Quantitative easing' – a comprehensive survey article in the Bank's Quarterly Bulletin – 2009 Q2.
www.bankofengland.co.uk/publications/quarterlybulletin/qb090201.pdf
- *Asset Purchase Facility Quarterly Report*. A regular report from the Bank summarising its asset purchases over the previous quarter.
www.bankofengland.co.uk/publications/other/markets/apf/quarterlyreport.htm

When to stop?

The Bank's asset purchases are working through the economy to stimulate spending and inflation in a number of ways. It is difficult to be sure over what time scale these will boost spending and inflation. But the Bank's Monetary Policy Committee will continue to be guided when it sets policy by the outlook for inflation relative to the Government's 2% target.

If the Bank thinks inflation looks set to rise above 2%, the MPC could put downward pressure on spending and inflation through some combination of raising Bank Rate and selling assets back to the market.

Asset sales would remove the extra cash that the Bank had previously put into the economy.

The team's decision

In each round, the team should take the MPC's interest rate on the day of its presentation as its starting point, and decide whether to change Bank Rate and, if so, whether to increase it or decrease it, and by how much.

In addition to setting Bank Rate, teams may – like the MPC – wish to consider the option of injecting or withdrawing money from the economy to meet the inflation target.

Teams may vote on Bank Rate and the level of asset purchases.

Taking the MPC's current plan for asset purchases as its starting point, the team can decide to maintain or increase the stock of asset purchases, or to make asset sales.

It is difficult to offer precise guidelines about how much money needs to be injected into – or withdrawn from – the economy to keep inflation on track to meet the target. Teams will have to judge whether they think the amount of money injected is appropriate given their views about the outlook for the economy and inflation, and how the extra money might impact on spending and, in turn, inflation. For instance, if you think that growth in the economy could be very low, you might decide that justifies more asset purchases; if you think economic recovery is more likely to be strong, that might suggest less. And you need to decide whether you prefer to change Bank Rate or the amount of asset purchases, or both. You will need to watch the MPC's decisions in relation to their projections and judgements about the economy. Like your team's decisions on Bank Rate, the decision on asset

purchases will be whether to do 'more' or 'less' than the MPC – and if so what amount – or 'the same'.

This is very uncertain so there are no simple rules. But that is not very different to deciding on the level of Bank Rate. There is no right answer. Deciding on the level of asset purchases or of Bank Rate is a matter of judgement and, like the real policymakers, team members may disagree.

Even if team members agreed that rates should change, they may disagree about whether rates should go up or down, or about the extent of the change, say, 0.25% or 0.5%. Likewise, team members may have differences of view on the appropriate level of asset purchases, or of asset sales.

During the preparation stage, the team may choose to vote on Bank Rate and on the level of asset purchases. If this results in a tie, the team captain will have the casting vote. If there is a split decision, both sides of the argument must be explained in the presentation to the judges.

Key resources for the team's decision

- *Minutes of the MPC meeting, 4 and 5 March 2009* – see the section on 'The immediate policy decision' where the Committee attempted to quantify the scale of the boost to spending required to meet the inflation target, and decided to make asset purchases of £75 billion.
www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0903.pdf
- *Minutes of the MPC meeting, 6 and 7 May 2009* – see again the section on 'The immediate policy decision' where the Committee explained its decision to boost the level of total asset purchases to £125 billion.
www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0905.pdf
- Teams can check the MPC's latest plans for asset purchases in the most recently published MPC minutes.
www.bankofengland.co.uk/publications/minutes/mpc/index.htm
- The level of asset purchases so far undertaken by the Bank can be found in the data table on the home page of the Bank's website.
www.bankofengland.co.uk