Monetary policy and asset purchases

Since the February *Report*, the Monetary Policy Committee has begun a programme to purchase £125 billion of assets, financed by the issuance of central bank reserves, including an extension by a further £50 billion announced on 7 May. The objective of this policy is to boost the supply of money in the economy, ease conditions in corporate credit markets and, ultimately, to raise the rate of growth of nominal demand and keep inflation on track to meet the 2% target in the medium term. The MPC is pursuing a twin-track approach by purchasing both government and high-quality corporate debt. This box discusses the impact of such asset purchases, some influences on their effectiveness, and the range of indicators the MPC is monitoring to judge their impact.

The impact of asset purchases

Purchases of gilts and corporate debt financed by the issuance of central bank reserves influence nominal spending through a number of channels (**Chart A**).

Purchases of assets financed by central bank reserves should push up the prices of assets and lower yields. That boosts wealth and reduces the cost of borrowing for households and companies, both of which should boost their spending.

The Bank's asset purchases can boost prices, and reduce yields, in a number of ways. For example, when investors sell assets to the Bank, their money holdings increase. If that leaves their holdings of money above their desired levels, they may buy other assets to rebalance their portfolios. Moreover, to the extent that the Bank's purchases depress yields on gilts and corporate debt relative to those on other assets, households and companies may respond to those lower yields by switching into assets with higher returns. The higher demand for a wide range of assets that might result from these effects is likely to raise prices and reduce yields.

Some investors, particularly those based overseas, may choose to invest the money in overseas rather than UK assets. But to do that they would need to exchange their sterling holdings for foreign currency. That would pass the money on to someone else, who may then decide to use it to buy sterling assets. And selling sterling for foreign currency may put downward pressure on the exchange rate (Section 1.3).

In addition, the purchases of corporate bonds and commercial paper should reduce the cost of borrowing for companies by improving the functioning of corporate debt markets. The cost of borrowing in capital markets has been pushed up by elevated liquidity premia (Section 1.2), as low market activity has left potential investors concerned that they will be unable to find buyers for corporate debt if they need to sell quickly. The Bank's offer to be a ready buyer, if required, should give investors greater confidence to hold such assets.

As well as their influence via prices, asset purchases financed by the issuance of central bank reserves increase commercial banks' reserve balances at the Bank of England. That increases the supply, and therefore reduces the cost, of liquidity. As their stock of liquid assets increases, banks may be more willing to lend to companies and households. More generally, as money balances rise, companies and households may increase their spending. For example, some companies may currently be holding on to cash due to worries about their ability to access working capital. Higher money balances may therefore encourage them to expand spending.

Finally, as with conventional monetary policy, expectations play a key role. Without the stimulus from asset purchases, households and companies might have expected a protracted period of below-target inflation. But the asset purchase programme means that the risk of that is diminished. And, for a given level of nominal interest rates, the resulting increase in inflation expectations, by pushing down on real interest rates, may provide a further boost to spending and inflation. Expectations also influence the price-setting behaviour of companies, so could lead to a more direct impact on inflation.

Factors influencing the effectiveness of purchases

Asset purchases should raise nominal spending and inflation over time, but a number of factors will determine the size and speed of that effect.

If the Bank buys assets from non-banks, it credits their account at a commercial bank. Therefore asset purchases from non-banks will lead directly to a rise in bank deposits. But the ultimate impact on nominal spending depends on how investors subsequently rebalance their portfolios. The impact is likely to be greater if investors switch into UK corporate bonds or equities, boosting demand for those assets and raising their price. On the other hand, the impact will be smaller if sellers leave the cash on deposit.

Another factor influencing the effectiveness of purchases is the extent to which banks choose to hoard the extra liquidity, or increase lending. That may depend on the form the new bank deposits take — for example, banks may be less willing to increase lending if deposits are placed with them in very short-term accounts. Banks are also less likely to expand lending if they remain capital constrained. Section 1.2 discusses banking sector developments.

Finally, as with any economic policy, households' and companies' decisions will affect the efficacy of asset purchases. It is possible that households and companies may not wish to spend out of higher wealth, if they are aiming to rebuild their

balance sheets. Or their demand for credit may remain subdued, so that lending does not rise even if banks are more willing to extend credit.

Assessing the impact of purchases

As with changes in Bank Rate, it will take time to assess the extent to which the MPC's asset purchases have stimulated nominal spending. The first leg of the transmission mechanism is the resulting changes in yields and asset prices, and the Asset Purchase Facility does appear to have borne down on gilt yields (Section 1.1). Further asset price impacts may occur as the Bank makes further purchases, investors rebalance their portfolios, and market participants assess the impact of purchases on the outlook for the UK economy. But it will continue to be difficult to isolate the impact of the APF.

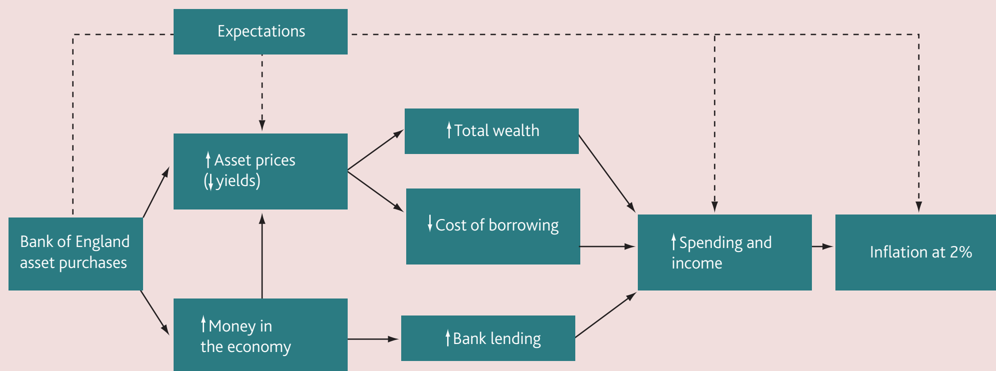
To the extent that assets are bought from non-banks, measures of the broad money stock will rise. But it will take time for this effect to become visible in the data. The purchases in March — the latest month for which broad money data are available — amount to around 1% of M4 excluding intermediate OFCs. The box on page 13 examines some issues around the measurement of money.

A key aspect of the policy is to ease credit conditions, especially those facing companies. The purchases of corporate debt are designed to improve the functioning of those markets, and so this impact needs to be judged by developments in those markets, not by the size of the stock of purchased assets. The MPC will continue to monitor the cost of corporate borrowing, and in particular evidence whether the liquidity premium on corporate debt is declining. The extent to which the corporate sector as a whole is credit constrained will continue to be assessed using survey evidence and intelligence from the banks, the Bank's regional Agents, and financial market participants. Section 1.2 examines evidence on recent developments in credit.

The MPC will also continue to pay close attention to measures of inflation expectations, and in particular whether expectations in the medium term remain consistent with the 2% inflation target. Section 4 describes recent movements in measures of inflation expectations.

Finally, the MPC will be monitoring developments in nominal demand growth closely. But it will be many months before the policy stimulus would be likely to appear in published estimates of final expenditure.

Chart A Stylised transmission mechanism for asset purchases



with a rating of BB or below has issued bonds since the onset of the financial crisis.

The cost of borrowing in capital markets provides another indicator of corporate credit conditions. Although companies issuing bonds generally have to offer a higher yield than those on government bonds of the same maturity, the difference between these corporate and government yields rose over 2008 (**Chart 1.11**). That rise in corporate bond spreads in part reflected the need for greater compensation for the risk of default as the economy slowed. But, on top of that, reduced activity in bond markets since the onset of the financial crisis increased the compensation demanded by buyers against the possibility that it might be difficult to sell those bonds on in the future. In other words, liquidity premia rose.