Charles Bean: Quantitative easing and the economic outlook

Speech by Mr Charles Bean, Deputy Governor for Monetary Policy of the Bank of England, to the Scottish Council for Development and Industry, Glasgow, 21 February 2012.

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Good evening! I doubt that many of you will be aware that the Bank of England was actually founded, in 1694, by a Scotsman named William Paterson. Our original purpose was to raise the funds to enable the King to finance his foreign military adventures. But Paterson soon parted company with his fellow directors, leaving the Bank the following year.

Rather more of you may be aware that same William Paterson became the financial brains behind the Darien scheme, a project to establish a Scottish colony in Panama that could act as trading post between the Atlantic and the Pacific. Unfortunately, just about everything that could go wrong with the project did, resulting in not only the deaths of many of the colonists, but also substantial financial losses for the many Scottish people who had backed the scheme. According to historians, the Darien disaster and its financial consequences contributed directly to the pressures leading to the 1707 Act of Union between England and Scotland.

The possible dissolution of that union is, of course, now on the agenda. Whether or not Scotland becomes an independent country once again is a matter for the Scottish people to decide. If the referendum should result in a vote in favour of an independent Scotland, the associated monetary arrangements would then be one of many matters needing to be settled. But the exact form of those arrangements would be for the Westminster and Scottish parliaments to decide, not the Bank of England.

Until asked to do otherwise, the Bank will continue to use the powers delegated to us by the UK Parliament to try to deliver, to the best of our ability, monetary and financial stability for the United Kingdom as it stands, including being represented here through our Agency in Scotland. In keeping with that, my remarks tonight will focus not on what may, or may not, happen to the UK's monetary arrangements some years down the road, but rather on our more immediate economic prospects and the actions that the Bank's Monetary Policy Committee has taken to try to sustain the recovery.

As you will be aware, last October the Monetary Policy Committee resumed its purchases of government debt, financed by the issuance of additional claims on the Bank of England – so-called quantitative easing. At our most recent policy meeting less than a fortnight ago, we voted to make a further £50 billion of purchases, which will take the total sum bought to £325 billion. To give you some context, that represents about a fifth of the annual output of the United Kingdom and around a third of the total stock of UK government debt in issue.

Why did we decide to inject further monetary stimulus into the economy? And how likely is it to be effective? We started quantitative easing in March 2009 in the aftermath of the collapse of Lehman Brothers, as the UK economy was undergoing its deepest post-war contraction. Bank Rate was almost as low as it could go and further stimulus was necessary to put a floor under demand and get the economy growing again. All told we bought £200 billion of gilts during that initial phase of quantitative easing.

Quantitative easing essentially involves trading one liability of the state – gilts – for another – monetary claims on the Bank of England. We aim to buy mainly from non-bank private financial institutions, such as pension funds and insurance companies, not from the banks, as is sometimes erroneously claimed[1]. When we buy a gilt, we simply credit the bank account of the seller with an appropriate sum. If the seller were indifferent between holding the gilt and holding the associated bank deposit, that is where things would stop. But because deposits tend to yield less than gilts and assets such as corporate bonds and equities, the seller is likely to want to buy some other asset instead. The consequence is upward pressure on the prices of a whole range of assets, including corporate bonds and equities. That increases the availability, and reduces the cost, of finance to corporates. It also boosts the value of people's wealth, which should encourage more spending.

As I noted a moment ago, we aim to acquire the gilts from institutions other than banks. But as a by-product of the purchase, banks will find that they have both more customer deposits and an increase in their claims on us (what are known as bank reserves). That may encourage them to increase their lending, though in the particular circumstances prevailing during and after the financial crisis, we expected this effect to be quite weak. That is in line with the observed weakness in bank lending over the past three years.

Our analysis of the first phase of quantitative easing suggests bond yields were around one percentage point lower than they would otherwise have been. And UK equity prices rose 50% during the programme, though only a small part of that is likely to be down to quantitative easing. That made it cheaper for companies to access finance through the capital markets and issuance was indeed strong during 2009. But the ultimate aim was to sustain demand. Though we cannot be sure what would have happened in the absence of our asset purchases, our internal work suggests that the first phase of quantitative easing boosted the level of activity by around 1½–2%.

Having finished the first programme of purchases in early 2010, why then did we deem it necessary to restart the programme last October and extend it at our February meeting?

During late 2009 and through 2010, a recovery of sorts appeared to be taking hold and, by the beginning of last year, some of us were starting to think that the time to begin withdrawing some of the monetary stimulus might be starting to draw near. As the year wore on, though, it became increasingly clear that the underlying growth rate was moderating.

To begin with, that reflected a continuing squeeze on household real incomes, and thus on spending, resulting from the increase in the standard rate of VAT in January and the impact of higher energy and import prices. In fact, real household income declined a total of 2½% in the two years after output troughed, whereas in normal conditions it might have been expected to rise about 5% in that time. But since last August, the deterioration also seems to have reflected heightened concerns about the prospects for the euro area. That was reflected in much tighter funding conditions for European banks, including those in the United Kingdom, and increased caution on the part of businesses both in regards to hiring and capital spending. Output is reported to have contracted by 0.2% in the final quarter, though some of the business surveys at the start of this year suggest that the economy may again be expanding.

It was that deterioration in the outlook that led us to restart our asset purchases in October. Despite the recent more encouraging signs, we continue to expect underlying growth to remain sluggish in the first half of the year (the actual data are likely to move somewhat erratically because of the extra holiday associated with the Queen's Diamond Jubilee). But inflation has been falling sharply, down from its peak of 5.2% in September to 3.6% in January and is likely to continue declining as increases in energy prices a year ago drop out of the calculation. That means that the long-lasting squeeze on household real incomes is also starting to ease. In turn, that should facilitate a modest pickup in household spending;

[1] Banks do act as intermediaries in the transactions, but it is the behaviour of the ultimate seller that matters for the economic impact.

the upbeat retail sales figures announced at the end of last week may be a sign this is already starting to happen. But while growth should gradually strengthen, the continuing headwinds from the unwinding of excessive debt and the Government's continuing fiscal consolidation mean that the pace of recovery is likely to remain moderate by historical standards.

As a consequence, a margin of unused capacity and labour in the economy is likely to persist for some while yet, helping to ensure that domestically generated inflation – presently running around 1½%, depending on exactly how one chooses to measure it – should stay subdued. Indeed, in the absence of the extra £50 billion of gilt purchases announced two weeks ago, we judged that inflation would be rather more likely than not to undershoot our 2% target in the medium term. That was why we decided that it was necessary to do more.

Moreover, the longer capacity lies idle, the more likely it is to be scrapped completely. And the longer people are out of work, the more likely they are to become disconnected from the labour market altogether. So there is an added incentive to getting the recovery back on track quickly.

The euro area represents the biggest single downside risk to this picture. Greece is the country in the headlines right now, but several countries of the euro-area periphery face, in varying degrees, a challenging mixture of unsustainably high public and/or private indebtedness and weak competitiveness. Correcting those problems requires: fiscal consolidation; bank recapitalisation; and a rebalancing of demand towards net exports. The first two are under way, but the third is harder to achieve in a monetary union where no exchange rate movement is possible to bring about the necessary improvement in international competitiveness. At best, these countries face an extended period of very low growth while the necessary adjustments take place. And while this morning's agreement between the Greek government and the euro-area authorities is certainly welcome, there still remains a possibility that events could unfold in a disorderly and damaging fashion at some stage in the future.

The linkages to the United Kingdom from such a disorderly outcome would be threefold. First, and most obviously, almost half our exports go the euro area, so weak growth there has a rather direct spillover on to us. Second, although UK banks' exposures to governments, households and businesses in the affected countries are generally manageable, they do have exposures to, and get finance from, euro-area banks which are more heavily exposed. A disorderly outcome in the euro area could then result in a tightening of the availability of funds to UK banks as a result of this interconnectedness and thus also in the credit extended to UK households and businesses. Third, a bad outcome would probably knock confidence and lead UK households and businesses to hunker down and postpone spending.

There is little that the Monetary Policy Committee – or, indeed, the Government – can do to influence the outcome of events beyond our shores. In particular, it would make little sense to set the level of asset purchases so as to try to counteract an extreme event whose likelihood, timing and magnitude we have no realistic way of assessing.

The latest extension of our asset purchase programme has proved controversial in some quarters. Some commentators have questioned its likely effectiveness in stimulating demand. Others have focussed on the undesirable distributional consequences.

As far as the effectiveness of the policy goes, the impact depends on what those who have sold the gilts do with the money we give them in return, and how banks, businesses and households respond to the resulting movements in asset prices and money holdings. It is quite possible that the impact of a given quantum of purchases will be different at different times and be sensitive to the prevailing economic conditions. But that is also the case with changes in Bank Rate, where the effects can be equally uncertain.

Tracking the impact of the new round of purchases is also harder than before. Market participants have increasingly come to anticipate our actions, so that asset prices tend to move ahead of our decisions. That makes it difficult to isolate the impact on asset prices of policy changes from the myriad of other things driving them. The fact that UK government bond yields have fallen about a quarter percentage point more than those in Germany and the United States since the late summer is, however, at least consistent with the effect we expected. In any case, so far we have seen little to suggest that the effect on nominal demand will be markedly at odds with that of our first round of purchases. But it is still rather early to draw firm conclusions one way or the other.

Turning to the distributional consequences of the asset purchases, attention has focussed on the downward impact on annuity rates, which have fallen about a percentage point over the past three years since we started our purchases. That means someone[2] with a £100,000 pension pot, who could have expected that to yield an annual pension of a little under £7,000 three years ago, would now get just under £6,000. That is a rather substantial income loss. But it is only part of the story. Those pension funds will typically have been invested in a mix of bonds and equities, with perhaps a bit of cash too. The rise in asset prices as a result of quantitative easing consequently also raises the value of the pension pot, providing an offset to the fall in annuity rates[3]. The impact of quantitative easing on those approaching retirement is thus more complex than it seems at first blush.

More generally, the current extended period of rock-bottom interest rates has impacted heavily on those holding most of their savings in deposit or short-term savings accounts, who have seen negative real returns. Savers have every right to feel aggrieved at losing out; after all, they did nothing to cause the financial crisis. But neither did most of those in work, who have also seen a substantial squeeze in their real incomes. And unemployment, particularly among the young, has risen as output has fallen. This is all a reflection of the hit to output from the financial crisis. Output is still some 4% below its previous peak and more than 10% below where it would have been if the economy had simply continued growing at its pre-crisis historical trend. There have been few winners over the past few years.

In a deep sense, the low level of real interest rates here and in the other advanced economies is a reflection of the impact on the financial crisis. Heightened uncertainty and, for some households, a desire to reduce their indebtedness have resulted in an increased propensity to save. And the same heightened uncertainty has reduced the appetite of businesses to invest and encouraged them to build up cash buffers. Substantial dissaving by the public sector could offset that initially, but there are limits to how long the markets will allow high deficits to be sustained. Fiscal consolidation was unavoidable at some juncture.

Given that, the stance of monetary policy needs to be loose in order to sustain demand. If we had chosen to run a substantially tighter monetary policy, then that would only have served to depress activity and raise unemployment even further. By slowing growth, it would also make the task of fiscal consolidation and de-leveraging even more challenging. And by providing a gloomier climate for business, it would also inhibit investment and slow the necessary re-balancing of our economy towards manufacturing and internationally tradable services.

Treating serious medical conditions often has unwanted side effects. But, unpleasant as those side effects sometimes are, treatment is invariably better than the alternative. So it is with the economic medicine of low interest rates and quantitative easing. The immediate consequences may be unpalatable, but the sooner we can get the economy on the mend,

[2] For a single male, aged 65.

[3] Indeed, if the savings were held in bonds of a maturity structure that matched the likely longevity of the individual, the two effects would cancel each other out.

the sooner we can return policy to more normal settings and the better it will be for all of us – savers, businesses and employees alike.

Thank you!