BIRMINGHAM CITY University Centre for Brexit Studies

Centre for Brexit Studies
Working Paper

QE or not QE? Was that the question…..for the MPC?

I agree with CBS Director Alex De Ruyter's initial analysis of the Bank of England's decision last week to raise interest rates. In particular, the sense that, had they not done so, they might have found themselves in a reputationally hazardous position - with a concern that the MPC's various audiences and 'the market' might have sensed they had no stomach for the fight, as it were.

That was no reason to act.

I would judge that the MPC jumped the gun. Perhaps August is the best time to do so. Will there be a rather ignominious reversal next April, to suggest a date? We will have to see.

There were, however, two other widely unremarked upon (though bearing in mind the interest rate decision, actually very much remarkable) decisions made by the Monetary Policy Committee (the MPC). On the same day, and recommended for approval in the same report which led to the decision to raise rates, the MPC voted to maintain the current level and amount of Quantitative Easing (QE). This was specifically in respect of continuing purchases of both the government's own Bonds (Gilts) and those in the corporate bond market.

Had they voted otherwise, then the interest rate decision would have been both consistent and tenable. So the rise seems odd (as indeed was the last one). Notwithstanding, QE is still, if not in full metronomic swing, ticking over with quite some rhythm.

This was covered in more detail just this Monday with the Bank of England's QE report for Quarter 2 which gives the full figures. The 'Asset Purchase Facility Q2 report' gives us an idea of where QE is. And it is very much with us.

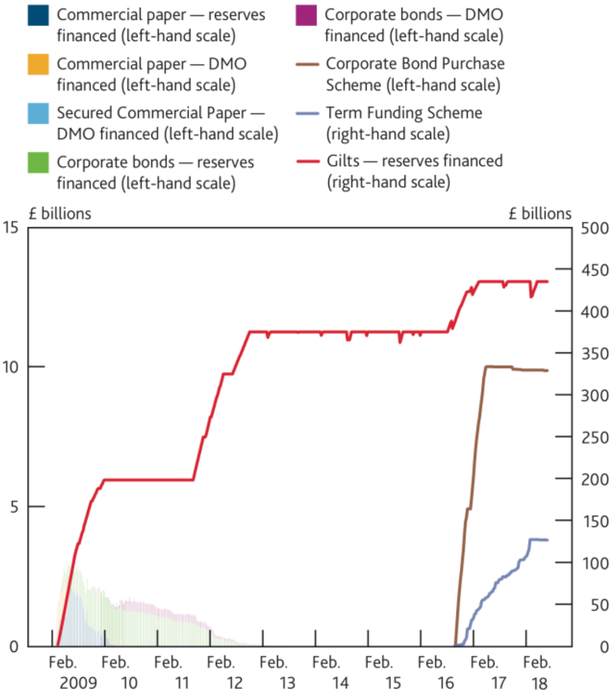
The Treasury through the Bank of England has, since the crash of 2008/2009, operated a number of schemes which ultimately equate to what we know as Quantitative Easing. The biggest was the buying of the government's own stock of IOUs to others in the form of Bonds.

In the early days of the crisis the Bank bought 'back' £200Billion of them. As we left 2012 it had bought £370Billion, and during 2016 it totalled £435Billion.

During 2016 it also started buying Bonds issued by big business to try to get liquidity cash into the sector at the £10Billion level to promote business activity. It instituted a (now closed) term funding scheme to banks (to try to get them to lend cash direct into the economy – households and small businesses) in the form of cash loan swaps for illiquid or less liquid assets at the £125Billion level. This ended at the end of February 2018.

As the various Asset Purchase Facility schemes are regarded to be functions of monetary policy, it was (as with the interest rate decision) a voted-upon decision by the 9 members of the MPC.

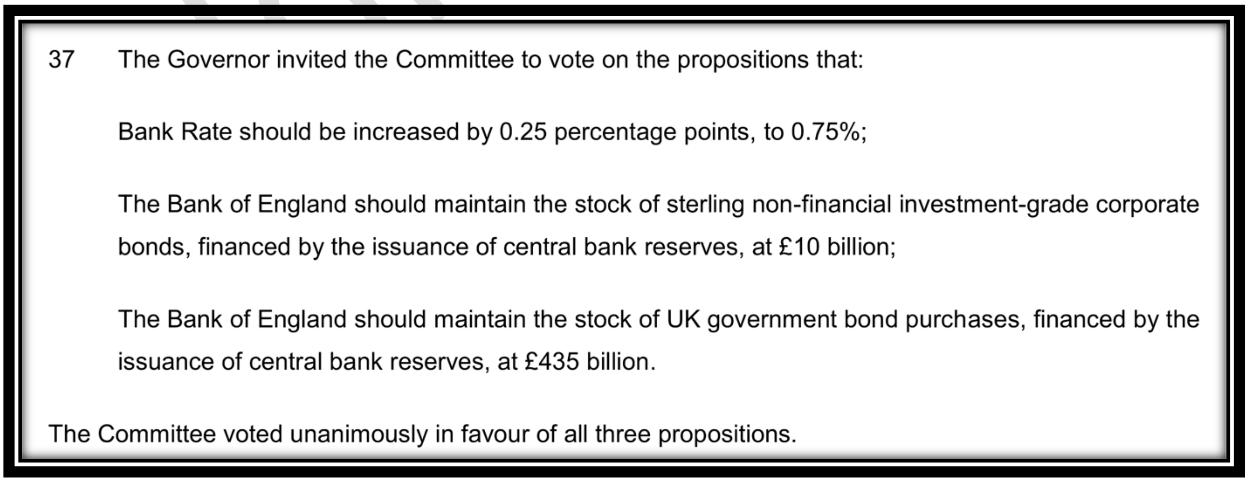
Chart 1 Cumulative net value of APF transactions by type, including TFS drawings[a]



Source: Bank of England.

(a) Data based on settled transactions.

So last week the hands were raised unanimously in relation to QE, and then reported in the minutes of the MPC in the immediately following sub-paragraphs to the interest rate decision:



37 The Governor invited the Committee to vote on the propositions that:

Bank Rate should be increased by 0.25 percentage points, to 0.75%;

The Bank of England should maintain the stock of sterling non-financial investment-grade corporate bonds, financed by the issuance of central bank reserves, at £10 billion;

The Bank of England should maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

The Committee voted unanimously in favour of all three propositions.

Perhaps one of the reasons why the two other votes went unremarked upon is that they appear on the face of it to be neutral, no-change decisions. They are not. The MPC made a decision that the Bank of England would continue effectively to buy (through the magical issuance of Bank of England reserves) further tens of £billions of UK government bonds out of the marketplace, and £billions of corporate bonds too. That is not insignificant. It suggests that the MPC believes there is neither a fully functioning sovereign and corporate bond market out there nor (more importantly) enough liquidity out there either, to let full QE go. You'd have thought raising interest rates wouldn't have helped with this.

Whilst the Asset Purchasing credit card limit was reached and breached quite a few times some time ago, the problem is that some of the Gilts now in the possession of the Bank of England's subsidiary, The Bank of England Asset Purchase Facility Fund (where the printing of electronic money actually went), have started to mature.

In other words some gilts owned have expired, and effectively, in QE Land, evaporated. So the decision is actually to max out the credit card again, not pay it down. Of course this is all funded by creating Bank of England reserves in the first place which then get pumped into the BOEAPFF to buy up the 'assets'.

So when each bit of the bonds held by the BOEAPFF expires, the Bank is formally authorised as a matter of now agreed monetary policy to buy more to replace them. So the bank does and has. In March this year £10Billion in gilts evaporated. So in April the BOE's subsidiary bought £10Billion more. The decision last week authorises this to continue.

The interest rate decision seems not yet to have been adequately explained by the MPC in the context of the decision to continue pump-priming QE. Indeed no reference as to the reasoning is given in the minutes, just the fact of the decision.

But earlier this year (in the June Monetary Policy Summary) the committee indicated that it would start to stop QE when rates went to 1.5%. So QE is very much here to stay in the near future. This was even though it had in 2015 suggested an interest rate at 2% was the level when unwinding QE would start. It really is quite a mess.

The reason given now and reiterated by Ben Broadbent (the Bank of England's Deputy Governor of Monetary Policy and member of the MPC) in a speech a few weeks ago on 23rd July is that rates needed to be at such a rate so that (effectively) if things start to go wrong there could be a response to "materially" cut them, for fear just a slight reverse would be completely ineffective.

The reason suggested for this was that it believed traditional monetary policy levers should be returned to, rather than all this fiddling about with QE.

Is it the fear of an immediately negative impact of the actual reality of Brexit next 31st March that prompts this? The need to keep at hand some monetary policy levers which it trusts more to work? Is it the fear of a possible No Deal Brexit that means we toddle along assuming all will be well, but prepare for the worst? Again, it really is quite a mess.

If everything really is so relatively rosy in the garden such that interest rates should rise twice on the one hand, and the MPC is not really sure about whether QE works (if it ever did) why on earth are £Billions being spent on creating reserves to buy up £10Billion of Gilts? They did it in April 2018 and will no doubt do it again before the year is out.

The reason I believe this is misguided is because the MPC has missed one of the major unintended consequences of QE which has created an impact on the economy that the MPC is not factoring into its monetary policy decisions. The effect of all of the QE above, and in particular the buying of the £435Billion of the government's own bonds was to drive down the yields on those bonds to historic low levels. This then caused Pension Funds actuaries, who base their annual accounting figures on the yields on those bonds, to calculate ever-soaring liabilities for the pension funds using ever-bizarre, and ultimately artificial discount rates. The lower went the bonds yields the higher went the liabilities. And real discount rates fell to next to zero – a place where exponential effects on liabilities calculations mean they go into orbit - and in some cases into negative territory.

The reason this matters for the MPC is that this pension fund behaviour bizarrely impacted on the economy.

Ordinary households (whether in the state or private sector) were suddenly, as a result of the allegedly soaring liabilities, finding themselves with lower take-home pay because pension funds were suddenly demanding significant increases in monthly employee pension contributions.

As importantly, employers were also suddenly being asked to hike their contributions too. This meant that there was lower investment in jobs and capital investment. In addition to higher monthly employer contributions, the appearance of these bizarre pension fund liabilities on private companies and public bodies' own balance sheets meant deficit recovery programmes were drawing massive sums away from the businesses, or public services being provided.

While QE was busy saving banks and stock markets, with asset prices soaring due to moves away from low-yielding safer bonds, those in work with no assets found themselves considerably worse off. But the way the maths went was that the increase in assets owned by the pension funds couldn't keep pace with exponential increases in liabilities and a vicious cycle developed and continues to get worse.

The biggest funded pension scheme in the public sector is the over (£300billion in assets) Local Government workers' fund. The QE-led massive liabilities calculations prompted the funds to demand huge increases on a monthly basis from local council employees, and even bigger from the employer councils.

To make things worse, even further top-up payment demands running into billions of pounds were made of the local councils to close illusory deficits out of local councils' revenues and capital, and also set against assets. This meant more job losses and more cuts to their services, super-charging the austerity cuts to local government. In Birmingham, for example, the local pension fund demanded an extra £44million deficit top-up per year plus increases in employer contributions of 1% of salary. This was money which could have been spent on employment and local government services.

The liabilities of the funds get placed on the balance sheets of the local councils, leaving them less able to borrow to invest in housing and the local economy. The impression of councils going bust because pension fund liabilities get loaded onto the accounts creates another vicious cycle.

The same has happened right across the Private sector. The drain from businesses plugging deficits and paying extra on the payroll has impacted on business investment.

BT paid deficit funding contributions of £1.5Billion during March and April 2015, £250 million in March 2016 and £250 million in March 2017. During the same time it had to increase its employer contributions from 13.5% of salary to 16.9%. It’s got to find £4.5 Billion in cash by 2020 just for. The deficit.

Surely all of this should have been and should now instead be put into capital investment and jobs?

Carillion’s collapse was at the very least hastened by the ballooning deficits reported in its pension fund.

Unfunded pension funds (teachers, the NHS, military, EU, for example) followed suit on cutting discount rates so as to mirror the processes in funded pension funds. So employer and employee contributions rose and (notional) liabilities for accounting purposes ballooned. The treasury was probably very happy about this, though not the employers and employees.

I would argue that the very cause of all of this chaos is actually QE.

Nowhere in the MPC’s regular inflation reports is there evidence that they have considered this, either specifically in relation to broad money or in relation to business investment. Mr. Broadbent’s speech specifically on his assessment of the impact of QE mentioned it not at all. It has been looking the wrong way, or the other way. It should have monitored and reported on, and then factored into its decisions some time ago what the effect of massive QE was going to be on discount rates used in pension funds and elsewhere.

The MPC acknowledges that the slowing in aggregate ‘Broad Money’ growth (in particular since 2016) largely reflects slower growth in household deposits and cash holdings. Did they take into account pension contributions?

When assessing demand and output, costs and prices, the labour market and pay, and all of their components, did they even consider the impact of QE-led pensions fall out? Did they factor it into business investment decisions? On money growth or contraction? They may have, but there is no evidence of it.

We could be at the stage that monetary policy with the MPC at the helm is now simply pushing on a piece of string, to mix my metaphors. There was no recommended regulatory or policy response by the government, treasury or regulators when they saw this unintended consequence. The government should have intervened to set regulatory policy to counter the effects of QE on discount rates. Or the MPC should have warned of the consequences so such could happen.

A floor should have been placed on discount rates as QE began to bite. That would have been just as artificial as QE itself and just as justifiable when the most extreme dysfunction of markets occurred.

I believe history will show that last week's interest rate decision was a minor matter, which will probably be reversed, especially if a no deal Brexit hits. The decision to continue QE will actually have been a more significant and misguided decision. It will probably have a greater impact on the economy (though negatively) than the interest rate slight hike itself.

In assessing the impact of QE the MPC simply has not factored in its impact on pension funds and then the impact of pension funds decisions on the wider economy.

What will monetary policy in relation to QE be if real economic turbulence follows a no-deal Brexit? Perhaps the very serious and rapid unwind of QE would have a greater impact than cuts to the interest rate.

The MPC appeared to do nothing this month, but actually ramped back up QE.

It should no longer be dodged: QE or not QE? That is the question.