

EBB AND FLOW

Following considerable efforts to ease the price of credit, the government is seeking new ways to kick-start the UK economy. The focus has now turned to quantity.

Despite the substantial policy easing by the authorities in recent months – including reducing Bank Rate to a 315-year low of 0.5 per cent, an unprecedented rise in fiscal easing and a depreciation of the currency – further steps have now been taken to revive economic activity. To improve liquidity in, and flow of, corporate credit, the Bank of England established in January an Asset Purchase Facility Fund. This was authorised to purchase up to

a total of £50bn of high-quality private sector assets, to be financed by issuing treasury bills. The facility also gave the Monetary Policy Committee (MPC) the option to finance purchases by issuing central bank reserves and the range of eligible assets included UK government debt in the secondary market. Having cut the price of credit, the Bank is now easing its quantity and has moved on to purchasing assets using central bank reserves. In total, £150bn is available for asset purchases, of which up to £50bn is to be used to buy private sector assets. In March, the MPC voted to go ahead with the first £75bn,



£50bn will be used to buy quality private sector assets

This comes from a total £150bn from central bank reserves. Given the pressures on the financial sector, the need is clear.

Points of caution

It is clear, however, that there are two major risks to all of this. The first is that it might simply not work because the recipients of the cash hang onto it rather than risk lending it on. The small reward in terms of interest received might be preferable to lending with the risk of not getting it back – the recent experience in Japan being one example.

There is also a risk that it will work far too well, that bank lending grows too quickly and inflation takes off again. However, there is a widely held, and probably justified, view that the current risks from deflation taking hold outweigh those associated with a build-up of inflationary pressures.

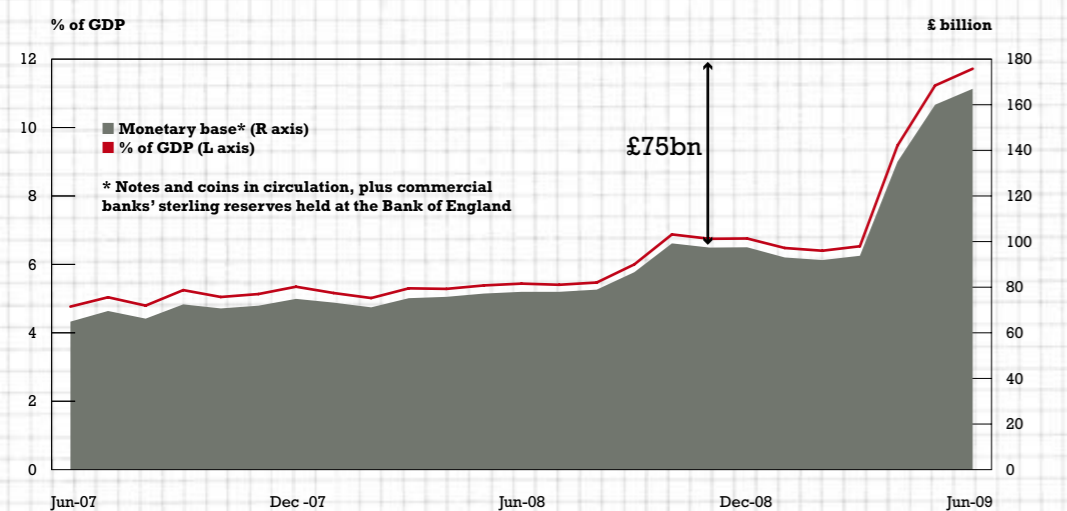
The initial results, very early in the process, appear to be encouraging. While longer-term bond yields have risen, they are still remarkably low considering the future gilt issuance spelled out by the recent budget.

Inflation expectations have risen, household and business confidence appears to be edging up, credit conditions seem to be easing slowly and asset markets look healthier. Consequently, the Bank of England may not feel the need to increase the Asset Purchase Programme.

In any event, the trick is for the Bank of England to keep the process going until it does work – there is no limit to the amount of money it can create – but also to know when to stop and, more importantly, when to reverse the process. Knowing when to sell back the assets it has acquired will require the Wisdom of Solomon.

Over the past decade, the Bank of England has been largely successful in weighing the evidence when setting interest rates. The coming months will see that ability stretched to the limit.

£75bn of quantitative easing



The Bank of England hopes that with an increase in the supply of money and lending to companies and households, nominal spending will rise.

Source: Bank of England, ONS

aiming to boost the supply of money and credit, and raise the rate of growth of nominal spending to a level consistent with the inflation target. At the time of the May MPC meeting, £46.5bn had been spent, £44.5bn on government bonds. At the current rate of £6.5bn of government bond purchases per week, this stage of the programme could be completed by early June.

Given the pressures on the financial sector, moreover, the need for such a step is even more apparent. Banks have been trying to restructure their balance sheets, by injecting new capital, selling assets and reining in lending.

Although necessary to improve the longer-term health of the sector, this adjustment risks exacerbating the recession if it also restricts the amount of lending available for creditworthy businesses and households. While demand for credit would naturally be expected to fall in periods of weaker activity, some feel a reduction in the supply of credit, reflected in a rise in spreads on lending, is contributing to the economic slowdown.

The multiplier effect

The Bank sees the process of quantitative easing as part of its normal open market operations. It expects that by increasing the supply of money and increasing the flow of bank lending to companies and households, nominal spending will rise. If the Bank of England buys directly from a commercial bank, for instance, that bank will see its reserves at the central bank expand. With Bank Rate at just 0.5 per cent, the rate of return on this extra cash will be extremely low, and so the hope is that the bank would use the funds to increase its lending. Any loans would then be spent and deposited elsewhere in the banking system, so providing the basis for another round of lending – in economic jargon, the so-called “money multiplier”. If the Bank buys from a non-bank financial institution such as an

insurance company, that institution may buy a further asset or leave the money on deposit with a bank, but it does provide the basis for the money multiplier to work its magic.

There should also be a beneficial impact on longer-term interest rates. Buying these assets should push their price up and, therefore, their yield down. Not only will it then be cheaper for the government and, more importantly, companies to issue further debt, but it should also be easier, given the squeeze on the supply of existing assets. And there would be an additional benefit if corporate yields can be reduced relative to gilt yields.

Yet, whether companies are convinced that this is a route they wish to take is less clear and is one of the big unknowns in deciding whether quantitative easing will be successful.

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