Q&A: Quantitative Easing

Thursday, 09 April 2009

UK interest rates are currently at 0.5% - the lowest level in the Bank of England's 315-year history.

The dramatic series of cuts in the Bank rate over the past few months has been aimed at easing the credit crunch and getting the banks to lend again.

But that has not happened, at least not to the extent that the Bank thinks is necessary to revive consumer spending and economic growth.

So the Bank is now expanding the amount of money in the system by £75bn - a process known as "quantitative easing".

What is quantitative easing?

Usually, central banks try to raise the amount of lending and activity in the economy indirectly, by cutting interest rates.

Lower interest rates encourage people to spend, not save. But when interest rates can go no lower, a central bank's only option is to pump money into the economy directly. That is quantitative easing (QE).

The way the central bank does this is by buying up assets - usually financial assets such as government and corporate bonds - using money it has simply created out of thin air.

The institutions selling those assets (either commercial banks or other financial businesses such as insurance companies) will then have "new" money in their accounts, which then boosts the money supply.

QE has never been tried previously in the UK.

Is this printing money?

Of course, these days the Bank doesn't have to literally print money to do QE. It's all done electronically.

However, economists would still argue however that QE is the same principle as printing money as it is a deliberate expansion of the central bank's balance sheet and the monetary base.

How does it work?

The Bank has initially said it will buy UK government bonds, or gilts, maturing between five and 25 years, though it could increase the maturities in the future.

It has been conducting reverse auctions - when the sellers compete in order to drive down prices - on Mondays and Wednesdays each week since 11 March.

The action by the Bank is supposed to have two effects. The first channel is through the direct effect on the banks' bank accounts. With more money sloshing about in their accounts, the banks may decide to lend more to businesses and individuals, and increase the amount of activity in the economy that way.

The second channel is through the effect on the cost of borrowing. When the Bank buys bonds, it reduces the supply of those bonds in the economy. That should increase the demand for new bonds and, at the same time, make it cheaper for businesses to borrow.

Having taken very short-term interest rates as low as possible, the idea would be for the Bank to push down longer-term rates as well (which are the rates that companies and individuals borrow at). These are used by companies making longer-term investments and banks setting mortgages, for example.

If QE works, credit growth will pick up and businesses will find it easier to get credit. That, in turn, should help to stimulate the economy.

Has it worked so far?

So far, the Bank has spent about £26.4bn on this new policy, or 35% of what it planned to spend initially.

There are some tentative signs that the credit markets - which have not been functioning in the way they normally do and

are the Bank's real concern - are showing signs of thawing.

But it is too early to say whether the policy is working.

Since the Bank started, the US Federal Reserve has also joined in.

With US rates close to zero, the Fed has said it will buy almost $1.2tn (£843bn) worth of debt to help boost lending and promote economic recovery. It will buy long-term government debt as well, and expand its purchases of mortgage-related debt.

Are there any risks?

QE is a high-risk strategy. If it is not done aggressively enough, banks will remain unwilling to lend and the crisis could drag on. To some extent that is what happened in Japan when this was tried 10 years ago.

Like old-fashioned money printing, QE also runs the risk of going too far: pumping too much money into the economy and causing high inflation - even hyperinflation - as seen in 1920s Weimar Germany and modern-day Zimbabwe.

Why are the UK's actions different from 1920s Germany and Zimbabwe?

Printing money can be defined as the central bank financing of government debts. This is what happened in both 1920s Weimar Germany and Zimbabwe and what the British government will insist it is not doing, although the short-term effect is similar.

According to the Maastricht Treaty, EU member states are not allowed to finance their public deficits by printing money. That is one reason why the Bank of England will buy government bonds from financial institutions, not directly from the government.

The Bank believes this form of QE is different because they are "printing money" as part of monetary policy - to prevent deflation. They are not printing money to help the government finance its deficit.

Also, unlike Zimbabwe, this is a temporary policy: the Bank expects to sell the government bonds back into the market when the economy recovers.

Published by the BBC Website 9th April 2009