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

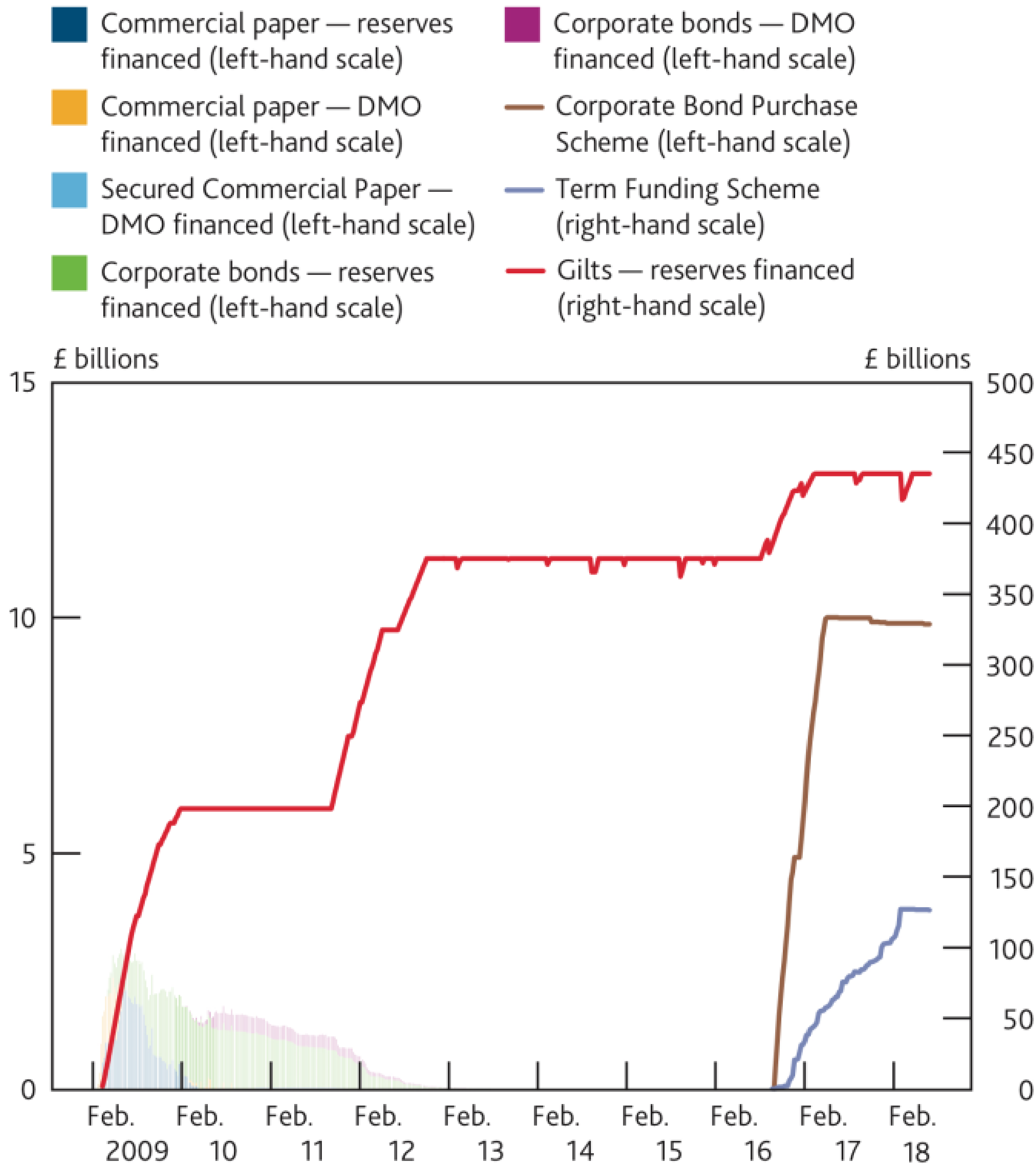
By Professor John Clancy, Centre for Brexit Studies

All the attention last week went on the Bank of England's Monetary Policy Committee (MPC) and its decision to raise interest rates again.

There were, however, two other widely unremarked upon (though actually very much remarkable) decisions made by the MPC. It also voted to maintain the current level and amount of Quantitative Easing (QE). So 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 Quantitative Easing (QE) report for Quarter 2 which gives the full figures of where QE is. And it is very much with us.

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



Source: Bank of England.

(a) Data based on settled transactions.

The biggest part of QE was the buying of the government's own stock of IOUs to others in the form of Bonds (Gilts). By 2016 it had hit £435Billion. These purchases paid for out of magically created reserves.

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.

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.

These 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 further tens of £billions of Gilts out of the marketplace, and £billions more of corporate bonds too. That is not insignificant. No reference as to the reasoning is given in the minutes, just the fact of the decision.

Because some of the government bonds now in the possession of the Bank of England have started to mature, action is required. In QE Land, the gilts have evaporated. So the decision is actually to max out the credit card again, not pay it down.

In March this year £10Billion in gilts evaporated. So in April the BoE bought £10Billion more. The decision last week authorises this to continue and will no doubt involve tens of £Billions of purchases 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 MPC is not factoring into its wider monetary policy decisions. The effect of all of the QE bond-buying spree from made-up reserves was to drive down the yields on Gilts to historic low levels.

This then caused Pension Funds' actuaries, who effectively base their annual accounting figures on Gilt yields, to calculate ever-soaring liabilities for the pension funds using ever-bizarre, and ultimately artificial 'discount rates'. The lower went the bonds, 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 discount rates went into (uncharted, *Alice in Wonderland*) negative territory.

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

Ordinary households 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. 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 investment in the businesses, or public services being provided. They also made the businesses and public bodies look considerably shakier than they were.

When combined, the biggest funded pension scheme in the country is the Local Government Workers Pension Fund at over £300billion in assets. The QE-led massive liabilities calculations in the local funds caused them to demand huge monthly increases from employees and employer councils.

But on top of that, top-up payment demands running into billions of pounds were made of the local councils to close illusory deficits. They

had to be paid out of local councils' revenues and capital, and also set against the councils' assets. This meant more job losses and more cuts to their services, super-charging the austerity cuts to local government.

In Birmingham the local pension fund demanded an extra £44million deficit top-up per year plus increases in employer contributions of another 1% of salary. This was money which could have been spent on employment and local government services. The liabilities of the funds now on the balance sheets of the local councils, leave them less able to borrow to invest in housing and the local economy.

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/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 plugging 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.

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

Nowhere is there evidence that the MPC has considered this.

The MPC has been looking the wrong way, or the other way. 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 the QE-led pensions fall out? Did they factor it into monitoring business investment decisions? On money growth or contraction?

The government should have intervened, on MPC advice, to set regulatory policy to counter the effects of QE on discount rates. A floor should have been placed on discount rates as QE began to bite. That would have been just as artificial as QE itself but 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.

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.

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

You can read the full working paper from Professor Clancy over on our website.