

Quantitative easing explained



Putting more money
into our economy
to boost spending



BANK OF ENGLAND

Quantitative easing explained

Stable inflation promotes a healthy economy

Low and stable inflation is crucial to a thriving and prosperous economy. The Bank of England aims to keep inflation at the 2% target set by the Government.

The Bank uses interest rates to control inflation. It sets an interest rate at which it lends to financial institutions – Bank Rate. That influences many other rates available to savers and borrowers, so movements in Bank Rate affect spending by companies and their customers and, over time, the rate of inflation.

Changes in Bank Rate can take up to two years to have their full impact on inflation. So the Bank has to look ahead when deciding on the appropriate monetary policy.

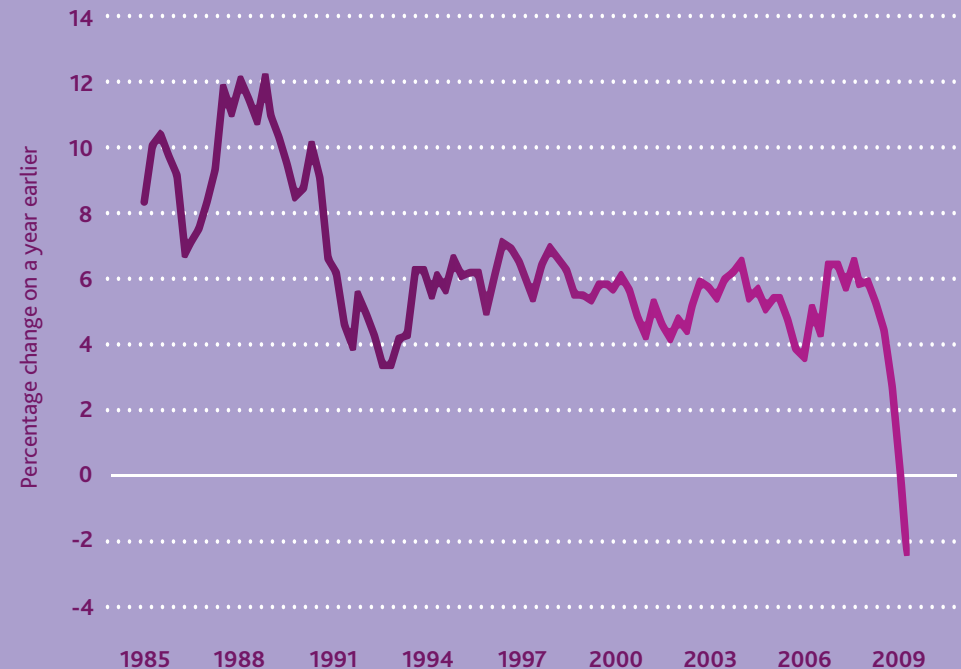
If inflation looks set to rise above target, then the Bank raises rates to slow spending and reduce inflation. Similarly, if inflation looks set to fall below 2%, it reduces Bank Rate to boost spending and inflation.

Q. Why is low and stable inflation good?

A. Unstable rates of inflation are costly to households and companies. They make it hard to see how prices of individual goods are changing compared with one another. And uncertainty over future prices makes it more difficult to enter into long-term contracts.

Historically, high inflation has tended to be more unstable.

UK money spending



Spending in the United Kingdom slowed sharply in late 2008 as the global slowdown gathered pace. So the Bank cut Bank Rate substantially to reduce the risk of inflation falling well below target further ahead.



Quantitative easing explained

Same target a new tool

When the Bank is concerned about the risks of very low inflation, it cuts Bank Rate – that is, it reduces the price of central bank money. But interest rates cannot fall below zero.

So if they are almost at zero, and there is still a significant risk of very low inflation, the Bank can increase the quantity of money – in other words, inject money directly into the economy. That process is sometimes known as 'quantitative easing'.

The Bank's Monetary Policy Committee (MPC) meets each month to discuss economic developments and the outlook for inflation. At that meeting, the MPC votes on Bank Rate. It may also decide whether to inject money directly into the economy, and if so, how much.

The MPC makes its decision independently of government.

Q. What is the MPC?

A. It is a committee of nine experts that meets every month at the Bank. It discusses the economy and decides how to set monetary policy to achieve the 2% inflation target.



Quantitative easing explained

Supplying more money why it is needed

Money in a modern economy comprises both cash and bank deposits. Normally, the amount of money grows each year. In the past, there have been periods when money has expanded too rapidly. Too much money circulating in the economy eventually resulted in too much inflation.

But if the economy weakens sharply, as it did in the final months of 2008, the problem is different. There is a risk of too little money circulating, not too much.

The money supply needs to keep growing at a steady rate to keep pace with the expansion of the economy, and to ensure inflation remains close to the Government's 2% target.

Quantitative easing explained

Supplying more money how it happens



The MPC's decision to inject money directly into the economy does not involve printing more banknotes. Instead, the Bank buys assets from private sector institutions – that could be insurance companies, pension funds, banks or non-financial firms – and credits the seller's bank account. So the seller has more money in their bank account, while their bank holds a corresponding claim against the Bank of England (known as reserves). The end result is more money out in the wider economy.

The MPC can opt to buy a variety of assets. For example, in March 2009, it decided to buy two types of asset – UK government bonds (known as gilts) and high-quality debt issued by private companies. Making the majority of purchases in gilts allows the Bank to increase the quantity of money in the economy rapidly. Targeted purchases of private sector assets should make it easier and cheaper for companies to raise finance by improving conditions in corporate credit markets.

This twin-track approach means spending may be boosted in a variety of ways.

Quantitative easing explained

Supplying more money how it works

Direct injections of money into the economy, primarily by buying gilts, can have a number of effects. The sellers of the assets have more money so may go out and spend it. That will help to boost growth. Or they may buy other assets instead, such as shares or company bonds. That will push up the prices of those assets, making the people who own them, either directly or through their pension funds, better off. So they may go out and spend more. And higher asset prices mean lower yields, which brings down the cost of borrowing for businesses and households. That should provide a further boost to spending.

In addition, banks will find themselves holding more reserves. That might lead them to boost their lending to consumers and businesses. So, once again, borrowing increases and so does spending. That said, if banks are concerned about their financial health, they may prefer to hold the extra reserves without expanding lending. For this reason, the Bank of England is buying most of the assets from the wider economy rather than the banks.

The extra money has worked its way through the economy, resulting in higher spending and therefore growth.

Normally, central banks do not intervene in private sector asset markets by buying or selling private sector debt. But in exceptional circumstances, such intervention may be warranted – for example, when corporate credit markets became blocked as the financial crisis intensified towards the end of 2008. Bank of England purchases of private sector debt can help to unblock corporate credit markets, by reassuring market participants that there is a ready buyer should they wish to sell. That should help bring down the cost of borrowing, making it easier and cheaper for companies to raise finance which they can then invest in their business.

More generally, the Bank of England's purchases of both government and corporate bonds also increase the total demand for those types of assets, pushing up their prices. This is another way in which the Bank's actions will make it cheaper for companies to raise finance.



Bank of England asset purchases

A direct cash injection
The Bank creates new money to buy assets from private sector institutions.

↑ **Asset prices increase**

Purchases of financial assets push up their price, as demand for those assets increases and corporate credit markets are unblocked.



↑ **Money in the economy increases**

More money means private sector institutions receive cash which they can spend on goods and services or other financial assets. Banks end up with more reserves as well as the money deposited with them.



↑ **Bank lending increases**



Increased reserves mean banks can increase their lending to households and businesses, making it easier to finance spending.

↑ **Total wealth increases**



Total wealth increases when higher asset prices make some people wealthier either directly or, for example, through pension funds.

The cost of borrowing reduces as higher asset prices mean lower yields, making it cheaper for households and businesses to finance spending.

↓ **Cost of borrowing decreases**

↑ **Spending and income increases**



With better financial conditions in place, households and businesses should be more willing to spend, improving employment prospects and raising incomes.

Increased spending and employment should help to keep inflation at the 2% target.

Inflation at 2% back to target



Quantitative easing explained

Monitoring what to watch

How will we know if the asset purchases are working? The MPC can monitor what sellers of assets are doing with the money they receive and what effect that is having on spending and inflation.

A critical issue will be the impact on the terms and conditions offered on loans – is it cheaper and easier for companies and households to borrow than it would otherwise have been? Are corporate debt markets functioning better, making it easier for companies to borrow direct from the market? The MPC can monitor a range of asset prices and can also draw upon information gathered by its network of regional Agents and from financial market participants to assess whether credit is indeed becoming cheaper and more widely available.

But borrowing costs are not the only measure of success. The MPC will continue to monitor flows of money and credit across the economy including bank lending. Ultimately, what matters is the degree to which the cash injection boosts the growth of money and spending by households and businesses and so helps to ensure that inflation is close to target.

Q. How will you know if quantitative easing is working?

A. Transparency is key to the success of monetary policy.

- Every month the MPC announces its decision and publishes details of its discussions.
- Every three months it publishes an *Inflation Report* that provides a more detailed assessment.
- The Bank regularly publishes statistics on money supply growth and bank lending. The amount of assets bought under the programme is also disclosed.





Quantitative easing explained

When to stop and how

The Bank of England is committed to low and stable inflation. Together, large cuts in Bank Rate and quantitative easing provide the economy with a substantial boost, and reduce the risks of inflation falling below the 2% target.

But the Bank will not let inflation get out of control.

Just as the Bank takes the steps necessary to contain the risks of below-target inflation, it also acts if it thinks inflation looks set to rise above 2%. In that case, the MPC could put downward pressure on spending and inflation by raising Bank Rate and removing the extra money by selling the assets it previously purchased.

Economic conditions can and do shift rapidly. The job of the MPC is to navigate through these changes and to take the steps necessary to keep inflation as close to the 2% target as practical. By delivering low and stable inflation, the Bank of England will play its part in fostering the climate of stability that is essential to the UK economy.

If you have any questions or enquiries about the Bank of England, you can write to:

Public Information & Enquiries Group
Bank of England
Threadneedle Street
London
EC2R 8AH

You can telephone the Bank's public enquiries team on **020 7601 4878**

or email us at
enquiries@bankofengland.co.uk

www.bankofengland.co.uk

ISBN 1 85730 114 5 (Print and on-line)



Mixed Sources

Product group from well-managed forests, controlled sources and recycled wood or fibre
www.fsc.org Cert no. TT-COC-002794
© 1996 Forest Stewardship Council