

A guide to quantitative easing

March 2009

During the first week of March, the Bank of England cut the base rate of interest in the UK to 0.5% and, having all but exhausted the full extent of ‘conventional’ monetary policy, it announced the start of ‘quantitative easing’. In this guide, we explain what quantitative easing is and how the Bank of England will implement it. We examine whether it will work and the investment implications of its operation. In summary, we believe it is uncertain whether the policy will bring about a dramatic change in economic and financial conditions and that further attempts to ease those conditions by the reduction of government bond yields are likely.

What is quantitative easing?

Quantitative easing entails the recognition by a central bank that the ‘normal’ operation of its monetary policy via the lowering of interest rates has ceased to have any significant effect. It shifts the emphasis of a central bank’s operations from influencing the price of money to changing the quantity of money in the financial system.

As with many areas of economics, there is much arcane debate about what constitutes quantitative easing. Ben Bernanke, chairman of the Federal Reserve, has indicated specifically that he does not believe that the tools being used by the US central bank constitute quantitative easing; he has identified those tools instead as being ‘credit easing’. Bernanke argues that it is the acquisition of a range of assets by the Federal Reserve that is causing the balance sheet of the US central bank to expand and that US monetary policymakers are attempting directly to bring about an improvement in underlying credit markets. By contrast, the quantitative easing that was announced on 5 March by Mervyn King, governor of the Bank of England, is intended (like the approach of the Bank of Japan from 2001 to 2006) more directly to increase the quantity of money in the economy. Ultimately, both approaches aim to improve the availability of credit and to reduce its cost but, unlike the policy of the Federal Reserve, the UK approach

involves the expansion of the ‘liability side’ of the Bank of England’s balance sheet.

What did the Bank of England announce?

The Bank of England announced its intention to acquire £75 billion of medium-dated and long-dated gilts, as well as a range of (highly rated) corporate securities; at present index-linked gilts are not included in the programme. In his letter of 17 February to the chancellor of the exchequer, Mervyn King, governor of the Bank of England, sought permission to start quantitative easing and to make acquisitions of up to £150 billion. With this permission granted, the scale of the Bank’s asset purchases can be doubled without further recourse to the chancellor.

Importantly, and in contrast with the terms of the Asset Purchase Facility (APF) announced in January (through which it was intended that £50 billion of corporate securities be acquired), the asset purchases taking place under the quantitative easing initiative will be financed ‘by the issuance of central bank reserves’ (i.e. by the printing of money). The purchases proposed under the APF will now be rolled into the broader implementation of quantitative easing.

The Bank of England believes that it will take up to three months to complete its first instalment of £75 billion of purchases. The majority of purchases are likely to be in the form of gilts owing to the additional complexity involved in the selection of appropriate corporate securities; no mechanism is yet in place to make such purchases. In granting permission to the Bank to spend up to £150 billion, the chancellor stipulated that £50 billion must be in the form of corporate bonds, but there is no indication that this requirement affects the first (£75 billion) instalment.

The UK’s central bankers will judge the success of their policy by the increases in the supply of money and credit that are achieved (and, in the longer run, by the rate of growth in nominal spending). In interviews following his

5 March announcement, Mervyn King indicated that he did not expect to see any significant signs of improvement in monetary and credit-market conditions in the next several months and that economic stabilisation was unlikely to take place for several quarters.

The Bank began twice-weekly (Monday and Wednesday) purchases of gilts on 11 March, via which it will buy £2 billion of gilts in the open market at each auction; £10.5 billion of gilts were tendered at the initial auction. The programme will focus initially on purchases of gilts with maturities of five to 25 years, with one further requirement being that there must be at least £4 billion of each purchased security still in issue.

How significant is the move to quantitative easing?

The table below shows the scale of the measures announced in relation to the overall gilt market, the debt issuance expected in the 2009 financial year, GDP and money supply (both notes and coins in circulation and the broader M4¹ definition of money).

		Announced QE amount as a %	
		£bn	
Quantitative easing	Announced	75	
	Authorised	150	
Gilts	Issuance expected in FY09	120	62.5
	Amount outstanding ^a	544	13.8
	Amount outstanding (5-25y) maturity ^a	253	29.6
Nominal GDP		1,445	5.2
Notes and coins in circulation		53	140.8
Notes and coins in circulation plus bank reserves		93	80.9
M4 money supply		1,991	3.8

* At market prices; excludes index-linked

There is little doubt that, even at £75 billion, the scale of intervention being undertaken by the Bank of England is substantial; it is proportionately similar to the increase in the monetary base that was implemented by the Bank of Japan between 2001 and 2006. During this earlier period, the Bank of Japan injected funds directly into the reserve balances held by commercial banks with the central bank, which increased the monetary base (notes and coins plus bank reserves) by some 70% (from ¥65tn to ¥110tn). However, whereas the initial phase of policy

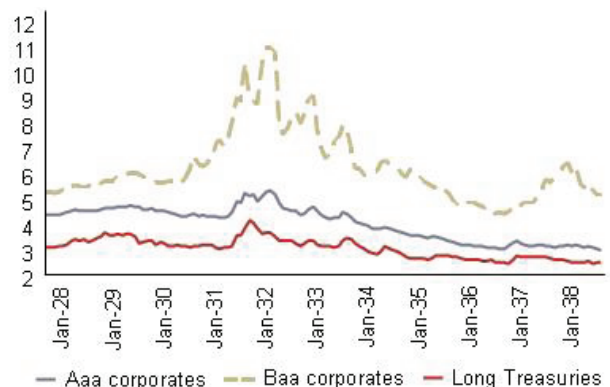
implementation in the UK is expected to take place within three months, the increase in Japan took place over the first four years of quantitative easing.²

Will quantitative easing work?

This is unclear and it depends in part upon how success is measured; does a short-term improvement in economic conditions (which is led by a further increase in the indebtedness of UK households) count as a success? While the Bank of England's actions are significant in the context of the UK economy, there is little doubt that the financial crisis is global in scale. £75 billion pales in a wider, global context and it is unlikely that the independent actions of a single authority will be sufficient to reverse global deflation trends.

Evidence that quantitative easing has been successful as a policy in the past is mixed. Given Japan's obvious reliance upon exports for much of the improvement in its economy this decade, it is debatable how important quantitative easing has been to Japanese economic wellbeing. However, the experience of the US in the 1930s appears to have been more successful. The US authorities introduced quantitative easing in April 1932 and, as the chart below shows, this coincided with the peak in corporate bond yields and was successful in keeping long Treasury yields near 3%.

US long Treasury, Aaa and Baa corporate bond yields



Source: Thomson Datastream

¹ M4 is defined as notes and coins in circulation with the public and non-bank firms plus private-sector retail bank and building society deposits plus private-sector wholesale bank and building society deposits and certificates of deposit.

² The Japanese economy operates with a much higher proportion of monetary base to broad money. At ¥190:£1 (the average exchange rate over the period), the Japanese monetary base expanded from c.£340 billion to c.£530 billion between 2001 and 2006. M2 money supply continued to increase at less than 3% per annum during this period, reaching the equivalent of £3.7 trillion in 2006. At ¥190:£1, Japanese GDP is equivalent to £2.6 trillion.

As in the 1930s, financial markets are likely to be the best barometer of the success of modern-day quantitative easing. Lower corporate borrowing costs and mortgage rates, together with the rising availability of credit, are likely to be the best indication that at least some temporary relief from the worst effects of the credit crunch has been achieved.

It is arguable that, for the US, the approach of acquiring Treasury securities would stand a greater chance of success than the current policy of credit easing, given the significant reliance on 30-year mortgages among home-owners and the relatively rapid pick-up in mortgage refinancing activity that occurs as long yields decline. Equally, given the uncertainties over the scale of intervention required, it is possible that the UK policy would have a greater impact if the Bank of England were to state a target yield for longer-dated gilts rather than a quantity of purchases that it intends to make.

Investment implications

The Bank of England has clearly demonstrated that the zero-interest-rate level does not act as a limit on its attempts at policy intervention to aid the recovery of the UK financial system and economy. The policy statement issued on 5 March stated that the speed and scale of quantitative easing would be adjusted as appropriate to meet the Bank's inflation target. With few indicators suggesting a rapid rebound in financial-market or economic activity, and with the Bank becoming much more concerned about the downside risks to growth and the 'substantial risk of undershooting the 2% inflation target in the medium term', a further expansion of quantitative easing is likely. As a result, government bond yields are likely to decline further.

While there is a significant chance that UK monetary policy stimulus will be left in place for too long (and therefore that inflation escalates), managing portfolios now to protect against the corrosive effects of inflation seems premature. Before inflation takes hold, however, risk assets should respond to improved liquidity conditions and a revaluation of corporate bonds, equities and property may well occur.

Important Information

Unless otherwise stated, all data is sourced from Bloomberg or Thomson Datastream.

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