SUBMISSION TO THE TREASURY COMMITTEE
FOR THE INQUIRY INTO QUANTITATIVE EASING

12th January 2013 (2913 words)

Positive Money is a not-for-profit research and campaign organisation that works to increase understanding of the current monetary system and the need for reform. We will focus on three of the points raised in the call for evidence:

1. The effectiveness of QE so far undertaken by the Bank of England, and how effective it would be if the programme were to be further extended in the future.
2. Should other unconventional policy measures have been used by the Bank of England?
3. Should unconventional policy measures be used from now on?

We have also suggested some questions that the Committee may wish to ask Dr Carney on February 7th.

1. THE EFFECTIVENESS OF QE SO FAR

The purpose of QE

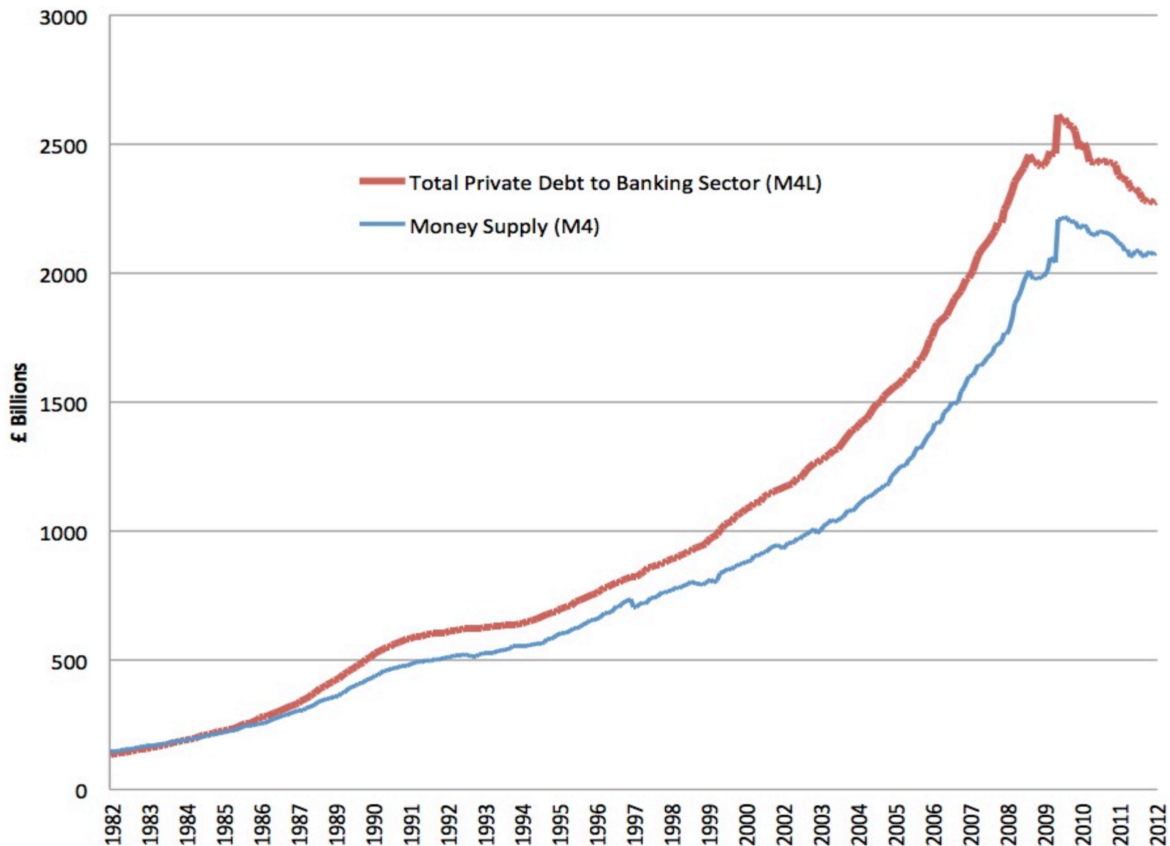
To understand why QE has had limited effectiveness to date it is necessary to understand the process by which money is created (and destroyed) in the economy. Today over 97% of all the money used in the economy is created by banks, in the form of electronic bank deposits, with just 3% being created by the state in the form of notes and coins[1]. Banks are able to create money through the accounting process they use when they make loans. In the words of Sir Mervyn King, “When banks extend loans to their customers, they create money by crediting their customers’ accounts.”[2] Conversely, when a loan is repaid to a bank, the bank deposits (number in an account) that were used to repay the loan disappear from the economy, as a result of the accounting process used.

The fact that the vast majority of the UK’s money supply is created by private commercial banks, when they make loans, means that there are certain simple rules that determine the amount of money (the money supply) in the economy:

1. If banks are making new loans faster than old loans are paid off, the money supply will increase.
2. If the public pay down old loans faster than they take out new loans, the money supply will shrink.

In short, as debt increases, money supply increases, and as debt is reduced, the money supply shrinks, as shown in the chart overleaf.

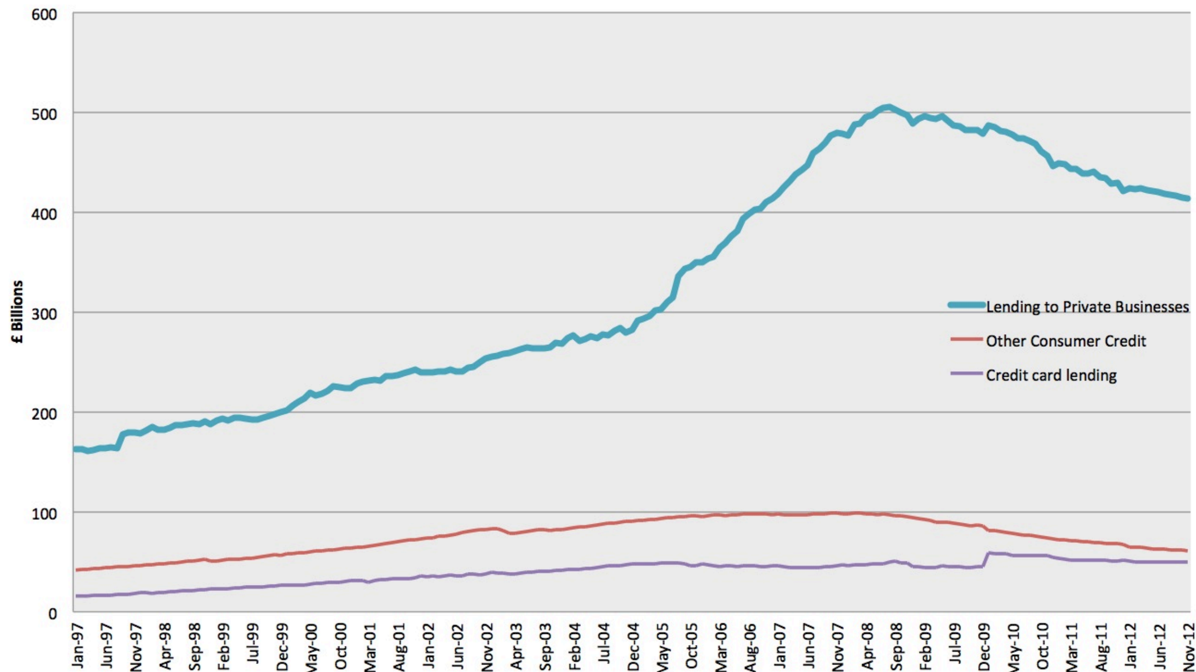
[1] Source: Bank of England statistical database, figures for M4 and “Notes & Coin”
[2] Speech by Mervyn King presented at the South Wales Chamber of Commerce at the Millennium Centre, Cardiff, 23rd October.



For most of the last 40 years case 1, above, has applied, and the money supply (and level of debt) increased consistently from 1970 until late 2008.

However, it is case 2, above, that is central to the issue of Quantitative Easing. Following the onset of the financial crisis, banks panicked and severely restricted the amount of new loans they made to members of the public and businesses. However, people and businesses with existing loans had to continue making repayments on these loans. Banks were not creating enough *new* money by making new loans to compensate for the money that was disappearing from the economy as it was used to pay down old loans. This would lead to a shrinking of the money supply, a fall in spending in the economy, and a more severe recession.

The chart below shows this withdrawal of money from the real economy; from September 2008 (considered to be the starting point of the financial crisis period) and November 2012, £89 billion of money was withdrawn from the economy (and effectively 'destroyed', in Mervyn King's words) as businesses paid off debts and were unable to refinance existing loans. In addition, £35 billion of money was destroyed as consumers paid down existing personal loans (mortgages not included).



Quantative Easing was a means of injecting new money into the economy to replace the money that was disappearing as old loans were repaid. With banks unwilling to create money through their lending, and customers unwilling to take on significant levels of debt (after a crisis caused by over-indebtedness), the state, via the Bank of England, had to start creating money in place of the banks. Mervyn King explained this point to the Treasury Committee on 25th October 2011 [our additions for clarity in brackets]:

> "What we were doing [through Quantitative Easing] is injecting money into the economy, and what the banking sector has been doing is destroying money [as existing loans were repaid]. As they reduce the size of their balance sheet and deleverage, they're reducing not just the size of their assets but also the size of their liabilities. And most of the money in our economy comprises liabilities of banks in the form of bank deposits. So what we were doing was partially to offset what would otherwise have been an even bigger contraction."[3]

So whilst QE was seen in the press as being the start of reckless creation of money by the state, in reality it was simply a case of the state taking over the (often reckless) creation of money that is normally undertaken by private commercial banks through their lending.

The flaws in this approach to QE

There was a critical flaw in the implementation of QE. The money created via QE was intended to replace the money that was disappearing from the real (non-financial) economy, as individuals and businesses paid down their existing debts. But instead of re-creating the money and injecting it into this part of the economy, the Bank of England injected the money into the **financial** part of the economy. By buying bonds from pension funds and insurance companies, the Bank of England increase the quantity of money (bank deposits) in the hands of these financial sector firms and investment companies, and therefore increase the amount of money circulating in the financial markets. Activity and spending by these

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[3] Available at http://www.bbc.co.uk/news/business-15446545

companies is not included in GDP figures, and so this initial money creation could not have had any impact on economic growth or inflation (although it could artificially inflate financial markets).

In order for the money creation to lead to an increase in spending (i.e. growth) in the *real economy,* the deposits created through QE would need to move from the financial markets (where they were injected) across to the real economy. But it is difficult to see how this would have taken place. Pension funds could not simply pay all this newly created money to their beneficiaries (pensioners), as to do so would have run down the value of the fund and left insufficient assets for future beneficiaries. In fact, the Bank of England itself seemed to be unclear and hazy about how exactly the money created through QE was supposed to reach the real economy, as evidenced by further comments by Mervyn King (our additions in square brackets):

> "When the Bank buys assets [i.e. government bonds via QE], the people [pension funds] who sell the assets to us receive money which can then be used to buy other assets. In turn, the sellers become buyers of other assets, and so on indefinitely as the money is transferred from one account to another. The prices of assets that investors choose to buy go up, raising wealth and pushing down on yields. Those yields are the opposite side of the coin to the borrowing costs of companies. In these ways, the Bank's purchases of assets increase demand in the economy." 18th October 2011[4]

This convoluted explanation of the intended process highlights the fact that there was no clarity about how or indeed *whether* the money created via QE would actually reach the real economy.

In short, by using newly created money to buy financial assets (bonds), QE has pumped new money into the financial markets, where it has stayed circulating and inflating prices of financial assets (stocks, bonds etc.). But it was not realistic to think that this newly created money would ever reach the real economy or have an effect on employment, economic growth or inflation. The lack of any significant improvement in economic growth, despite the creation of such huge sums of money, shows that the money created has not reached the real economy.

In the next section we explain how an alternative approach to QE *could* have been much more effective.

2. Should other unconventional policy measures have been used?

Spending QE into the real (non-financial) economy

If the money that was created via QE had been injected into the real economy instead of the financial sector, then we would have been likely to see immediate economic growth. As an example, a total of £375 billion has been created as a result of QE. If, over the same period of time, this money had been spent directly into the real economy (which counts towards GDP and growth figures) rather than being

[4] Speech by Mervyn King to the Institute of Directors, 18th October 2011, available at http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech523.pdf

spent into the financial markets, then GDP would have been boosted by up to 6% a year above the level that it has been at[5].

Would this injection of newly created money into the real economy have been inflationary? Initially, no, because it would have first created new demand that would have 'soaked up' the large amount of spare capacity in the economy (the 2.5 million unemployed workers, under-worked staff, part-time workers who want to be full-time, half-empty restaurants, factories working four days per week instead of five, etc.). The impact of this extra spending would have been, quite simply, a recovery from the economic recession.

Eventually the creation of money in this way would have become inflationary. However, the very point of QE *is* to create inflation so that the Bank of England meets its inflation target. A rise of inflation in the real economy would have shown that QE *had* been successful (but also that it was time to halt further creation of money).

How could QE money be spent into the real (non-financial) economy?

There is a wide range of options for injecting QE-created money into the real economy. Three potential options are laid out below:

1. Through funding new government spending: for example, large planned infrastructure projects could have been brought forwards, schools could have been rebuilt, flood defences could have been built. All of these would lead to additional employment, further spending in the real economy and economic growth, as construction workers spend their salaries into the real economy and this money circulates.
2. By using money from QE to cover existing government spending and reducing taxes by an amount equal to the amount of QE. For example, VAT raises approximately £100bn a year. By suspending VAT for 3 years, at a cost of £300bn (to be met by money created by QE), an extra £300bn would have been left in the hands of consumers and businesses. Assuming this was split evenly between consumers and businesses (i.e. a 10% fall in prices, which translates to a similar rise in disposable income, and an additional 10% margin to the business), this would have increased disposable income, made businesses less dependent on bank financing to expand, and potentially led to job creation by the private sector.
3. By distributing the money directly to citizens, as a form of 'citizens' dividend'. This money would have been used for spending (leading to an increase in GDP i.e. growth) and also for debt-repayments (which would have helped the solvency of banks, reduced the burden of household debt and left those households with higher disposable income due to lower debt repayments).

Options (1) and (2) amount to financing the government explicitly through money creation. This will raise many eyebrows amongst orthodox economists[6]. However, the reality is that this is exactly what has been

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[5] £375 billion injected into the real economy over 4 years = £93.75 billion additional spending each year, equivalent to around 6% of 2011 GDP. Of course, the benefit to GDP may be higher than this as the money injected will be spent more than one as it circulates through the economy.

[6] The Bank of England may raise concerns that such an approach may contravene the Maastricht Treaty (Article 101), which states that a central bank may not provide loans or overdraft facilities to the government. However, the existing QE scheme is very clearly designed so as to circumvent this treaty (by buying bonds from pension funds, who will then go and lend the money they receive to government), and so the spirit of the treaty has already been disregarded. In addition, Article 101 is intended to prevent profligate governments borrowing excessive amounts cheaply from the central bank, but this risk can simply be avoided if the Bank of England is willing to halt its creation of money once its inflation target is reached again.

done, albeit it less explicitly, by the current form of QE. By buying government bonds, the government has withdrawn bonds from the market, allowing the government to issue new bonds (i.e. borrow more) without completely saturating the market for government debt. However, unlike options (1) and (2), the approach actually used by the Bank of England has not led to additional government spending; it has only financed existing government spending. It has also not left any extra money in the hands of consumers and businesses, and has not had any significant effect on GDP. The options outlined above would be in principle no more controversial than QE has been, but would actually have a beneficial effect on employment, GDP and eventually, inflation.

Option (2) would probably be the quickest and easiest to implement, requiring only an announcement from government. Option (1) is more challenging in that it is subject to the timescales of construction projects and capacity by government and the civil service to implement spending programmes. Option (3) is logistically challenging, given that the government would need to find mechanisms to pay every citizen their share of the money created, but once in place, such a mechanism could then quickly be used to add additional injections into the economy to cancel out the contractions caused by the banking sector's reluctant to lend.

Either of these three options would have a greater effect that the current approach of creating money, injecting it into the bond markets, and hoping that it will reach the real economy. Smaller sums of money would need to be created, because all of this money would go directly into the real economy and therefore contribute to growth and economic activity, whereas only a small proportion (if any) of the QE money will have reached the real economy.

It is worth stating the scale of the wasted opportunity of QE. Over the last 5 years we have had unemployment levels of over 2.5 million i.e. 2.5 million people looking for a useful way to spend their time. We have also had numerous cuts to infrastructure and construction projects (such as the schools rebuilding programme) because of a 'lack of money'. The £375bn created by the Bank of England was sufficient to employ 2.5 million people full time on the national average salary for approximately 5 years. Logistical issues aside, it should be clear that there were more effective ways of stimulating the economy through the creation of money than injecting new money into the financial markets and hoping this money would reach the real economy.

3. Should unconventional policy measures be used from now on?

Aside from the potential uses of QE outlined above, which are intended primarily to stimulate a recovery from a deep recession, there is a more fundamental issue with the current structure of the monetary system which has worrying implications for the future of the UK economy.

As discussed earlier, 97% of the money supply is in the form of deposits created by banks when they make loans. In order to increase the money supply, banks must increase their total lending, which means that the public (including businesses) must go further into debt.

Conversely any attempt by the public (and businesses) to reduce their overall levels of debt will cause the money supply to shrink/contract, because bank-created money is 'destroyed' when loans are repaid.

The current level of personal and household is close to its highest ever level, at £1,183 billion (a direct result of the banking sector's ability to provide loans by creating money). The costs of servicing this debt limits the disposable incomes of households, limiting the money available for spending in the real economy and therefore making significant growth in the economy very unlikely.

It is difficult to see how the economy can return to growth without some reduction in this personal and household debt. Yet within the current monetary system, any attempt to reduce household debt will simultaneously reduce the money supply. This contraction in the money supply will cause or exacerbate a recession.

The only way to reduce household debt without causing a simultaneous reduction in the money supply is for the central bank to inject new bank deposits into the system, via spending into the real economy. These new deposits would counteract the shrinking money supply as existing debts are paid down. This would allow debts to be reduced by an amount equivalent to the money created by the Bank of England, without any overall reduction in the money supply.

With lower household debt, households would have greater disposable income and more spending power. This is good for growth. Another positive side effect would be that the size of bank balance sheets would be reduced ('deleveraged'), meaning that the fiscal risk to the government of future bank failures would be reduced.

We do not have space here to give a detailed explanation of how this process could take place, but full details are given in a 300+ page book released by Positive Money on Jan 31st. We would be happy to provide copies to any members (or staff) of the Committee who are interested, and to provide a shorter overview of the process. We would also be happy to discuss this issue in person.

4. Questions the Committee could ask Dr Carney

We would suggest that the Committee should be concerned with whether Mr Carney understands a) the importance of stimulating the real economy rather than the financial sector, and b) the connections (and near equality) between the level of household and personal debt, and the money supply. In particular, we would suggest asking the following questions:

- How does he believe that the money created through Quantitative Easing and injected into the financial markets has reached the real economy and stimulated growth?
- Are there more effective ways of injecting money directly into the real economy, rather than into the financial markets?
- Is a fall in the level of personal and household debt likely to be necessary before the economy can return to positive growth?
- Is a fall in the level of personal and household debt possible without a commensurate fall in the money supply? (Loan repayments reduce the money supply).
- Is it possible to have economic growth whilst the money supply is falling?

5. For Further Information

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