BBC BUSINESS NEWS

WHAT IS QUANTITATIVE EASING?

by

Unknown

03 Oct 2012

http://www.bbc.co.uk/news/business-15198789

CMG Archives
http://www.campbellmgold.com

(2012)

--()--

What is quantitative easing and will it help Western economies?

Since the global financial crisis, both the Bank of England and the Federal Reserve have used the policy of quantitative easing (QE) to try to revive consumer spending and economic growth.

As of September 2012, the Bank of England had committed a total of £375bn to QE, while on 14 September the Fed said it would spend a further $40bn (£35bn) per month. This was on top of the $2.3tn (£1.4tn) the Fed had already put into QE since 2008.

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 assets - usually government bonds - using money it has simply created out of thin air.

The institutions selling those bonds (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.

Prior to 2008, QE had never been tried before in the UK.

Is this printing money?

These days the Bank of England does not have to literally print money - it is all done electronically.

However, economists still argue 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?

Under QE a central bank purchases government bonds from private sector companies or institutions, typically insurance companies, pension funds and High Street banks.

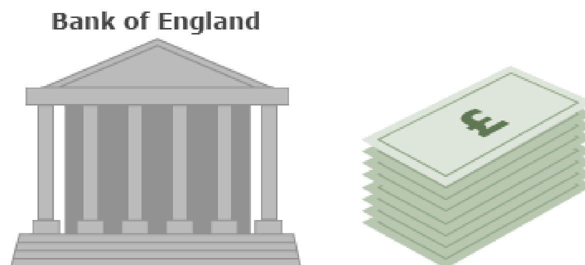
This increased demand for the government bonds pushes up their value, thereby making them more expensive to buy, and so they become a less attractive investment.

This means that the companies who sold the bonds may use the proceeds to invest in other companies or lend to individuals, rather than buying any more of the bonds.

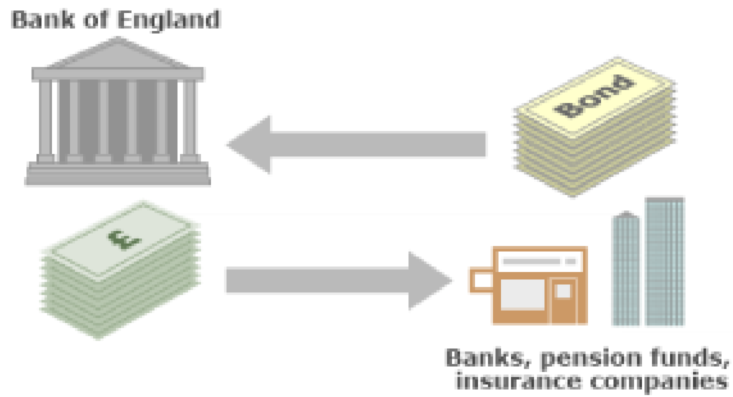
The hope is that with banks, pension funds and insurance firms now more enthusiastic about lending to companies and individuals, the interest rates they charge fall, so more money is spent and the economy is boosted.

--()--

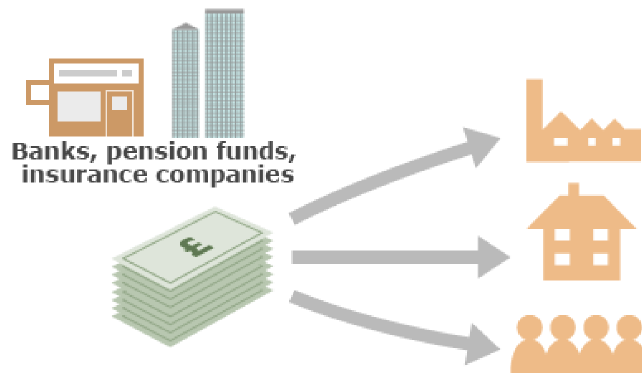
Quantitative Easing: Step by step



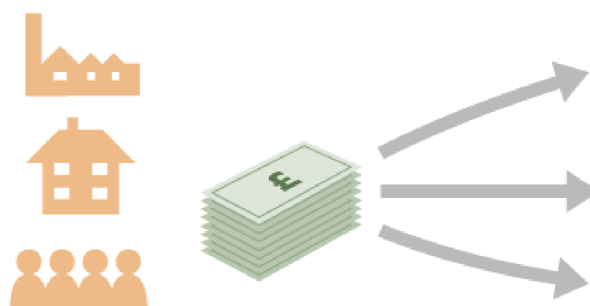
First, with the permission of the Treasury, the Bank of England creates lots of money. It does this by just crediting its own bank account.



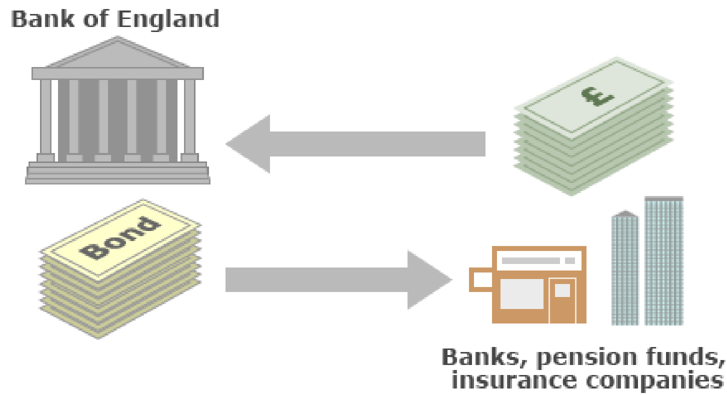
The Bank of England wants to use that cash to increase spending and boost the economy so it spends it, mainly on buying government bonds from financial firms such as banks, insurance companies and pension funds.



The Bank buying bonds makes them more expensive, so they are a less attractive investment. That means companies that have sold bonds may use the proceeds to invest in other companies or lend to individuals.



If banks, pension funds and insurance companies are more enthusiastic about lending to companies and individuals, the interest rates they charge should fall, so more money is spent and the economy is boosted.



Theoretically, when the economy has recovered, the Bank of England sells the bonds it has bought and destroys the cash it receives. That means in the long term there has been no extra cash created.

--()--

How do you know if it has worked?

A Bank of England report into the effect of its first round of QE suggested that the measure had helped to increase the UK's annual economic output by between, 1.5% and 2%, indicating that the effects of the programme had been "economically significant".

Yet some analysts have complained that since QE started in the UK in 2008 lending to businesses and individuals has remained sluggish.

The simple fact is, no-one knows how bad the UK economy would have been without QE.

As BBC economics editor Stephanie Flanders said: "Quantitative easing may well have saved the economy from a credit-led depression. We will never know."

Has anyone suffered?

One of the effects of QE is to push up the market price of government bonds and consequently to push down the yield they give investors. This has two very important effects.

Firstly, QE has being cited as a major reason why UK company pension scheme deficits, calculated monthly by the Pension Protection Fund, have ballooned.

That is because the cost of paying pensions from final-salary schemes is calculated on the assumption that all their assets are invested in bonds.

As the yield on bonds has dropped, so the stock of assets needed to generate the same level of pension income has gone up.

In May 2012 this collective UK pension scheme deficit reached a record high of £312bn. If this persists then it will have to be paid off by employers, presenting them with a very large bill.

Meanwhile the fall in bond yields has driven down the annual income someone can obtain, by buying an annual pension (an annuity) with their accumulated pension pot.

So, anyone retiring and trying to buy a private pension in the past year or two has lost potential income that they will never get back.

Why are the UK and US'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 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 has been buying government bonds from financial institutions, not directly from the government.

The Bank believes this form of QE is different because it is "printing money" as part of monetary policy - to prevent deflation. It is 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.

http://www.bbc.co.uk/news/business-15198789

End

http://www.campbellmgold.com

27112012