Funding the Future

PQE, gilts and the cost of borrowing

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Several questions have been asked about whether or not People's Quantitative Easing funding imposes a cost on the Bank of England because it is paid for with newly created Bank of England money. My argument was it does not because the Bank of England is not an entity separate from the Treasury and so all the interest flows are within the government sector.

It's a point Paul Krugman, in a sense, made in 2012 when he said:

David Beckworth has a good piece on a point I've also tried to make: the irrelevance of "helicopter money", and in particular the irrelevance of the decision to finance budget deficits by printing money as opposed to selling bonds.

Why is this an issue? Because a fair number of people have in fact argued that we can get extra bang for the stimulus buck if we pay for infrastructure investment and so on through the printing press rather than conventional finance. Now, the truth is that this would do no harm – but it would also do no good.

It doesn't take fancy analysis to make this point – just an acknowledgement that in financial terms, at least, the central bank is part of the government. The Fed, for example, remits the interest it earns on government debt to the government proper, keeping only that amount it needs for operations. So for the purpose of our analysis right now, we can use the term "the government" to include the central bank.

I added the italics.

First this piece makes my point: that the Bank of England should just be though of as part of the government and so, first of all PQE does not create debt per se, and does not create an interest cost per se on the debts created by a National Investment Bank (as Jeremy Corbyn would use for this purpose). But it does create an interest charge on reserves, which I accept, except that as the Bank of England has recently said in an email to a person who asked what the impact of this was, and which was shared with me:

Thank you for your email of 10 August. You are correct that the APF owes interest on the loan from the Bank of England at the prevailing Bank Rate, as well as any administrative costs.

To understand the flow of funds related to the interest payments on the loans made to the APF, we need to consider the impact of APF transactions on the Bank's balance sheet. When asset purchases are made through the APF, a corresponding liability is created on the Bank's balance sheet in the form of central bank reserves. Under the current sterling monetary framework, the Bank remunerates all reserves held at Bank Rate. As a result, interest payments by the APF to the Bank are broadly offset by interest payments made by the Bank to reserve account holders.

Thank you once again for writing to the Bank of England.

Yours sincerely

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To elaborate that, the APF owns the £375 billion of current QE assets. And the interest it pays is (plus or minus) born out of interest paid by the government on the bonds the APF owns. Except that as gilt rate is above bank rate right now (roughly 2% compared to 0.5%) there is a guaranteed imbalance: the government has profited from QE by markedly reducing its interest costs as a result. That is why a substantial return has been made by the Bank of England to the Treasury. That would only change, of course, if the effective fixed rate on the QE funds rose above bank rate. I am not seriously expecting bank rate above 2% for a long time to come. In other words, QE and so in turn PQE is, right now, the cheapest form of money the government can lay its hands on, and certainly cheaper than gilts. Krugman was not quite right on neutrality as a result. The trade off is some increased long term risk. The consequential incentive created is, however, for the government to keep interest rates low, which I would argue an essential feature of any economic policy the UK needs for decades to come, so there is nothing wrong with that.

But for those who want to take this issue a little further, ***can I recommend a 2012 response*** ***to Krugman from Prof Stephanie Kelton? This is important. Because some may not be able to access it I have turned it into a PDF, with Stephanie's permission. As Stephanie argues in the first instance:***

Some, however, still question [Krugman's] idea because they wrongly believe the Fed *and the Treasury to be two separate entities. While this may be the case on paper, in reality they represent more of a married couple with a joint account than two separate entities.*

And as she then says:

To help explain, we've done some balance sheet exercises to show how it is that the ultimate outcome of bond-funded spending, whether QE supported or pure money printing, is the same.

In other words: printing money is neutral from an economic perspective. And it makes not a jot of difference to a central bank, because in fact it does not change that central banks overall position. In the process Stephanie also shows that the ban on central banks lending direct to central treasuries is also absurd.

This though, is not the end of it. First, the difference can matter if broader issues are considered. All Krugman sought to show was that the Treasury / Central Bank split was just a facade, which it so obviously is. When that is accepted it is Modern Monetary Theory explains why there is a real choice to be amde between bonds and any form of QE. As Stephanie puts it, the question is:

When institutional formalities are removed and we look at the real mechanics of what's going on when the "the government" buys back its Treasury bills, it is as if it had never issued it in the first place.

Consequently, the fact that the government funds itself through bond sales serves a different purpose than one of pure financing.

I have, ***of course, shown that the net effect of QE in UK consolidation is cancellation.*** ***This confirms Stephanie's first point. So, the second is important. What are the reasons for bonds, or PQE come to that? Stephanie says (and I have anglicised, a bit):***

[Any] deficit creates reserves and deposits. Obviously this is an option available to a currency issuer without issuing debt first, whether via consolidation or via overdraft for the government's Treasury to the government's central bank if the government so allows.

But without [bank base rate] set at the targeted interbank rate, adding reserve balances causes the interbank rate to fall below the target rate, all the way to zero. The only alternative is to drain the reserve balances through sale of (in this case) [gilts] if the government (or central bank if we aren't consolidating) desires a positive interbank target rate. Thus, as Abba Lerner ***put it******, the purpose of bond sales for a currency issuer isn't "financing" but rather a desire that the public should hold bonds***

rather than reserve balances earning interest [at bank base rate].

To put it another way: this is about controlling rates, but has nothing to do with funding, which a government with its own currency can always do anyway, and at what will usually be lower rates than those set is gilts are issued. As Stephanie then concludes:

Of course, none of this means that a currency-issuing government ***should*** run large deficits, or that it always has an interest to do so. What it shows is that it can do so without worrying about bond vigilantes because the interest rate on the national debt for a currency-issuing government is either [bak base rate] –a policy rate–or the [gilt] rate, which arbitrages with the policy rate. Splitting up the central bank and Treasury doesn't change this, and neither does the self-imposed requirement that the Fed not provide the Treasury with overdrafts–which simply means that the Treasury can issue debt at ***roughly*** the Fed's target rate via [gilts].

But it does mean that co-ordination on these issues is vital, making a mockery of a supposedly independent central bank, as I have long argued.

So where does this leave PQE and interest cost? It leaves it in the mix as an option of choice. It is, effectively, a bank overdraft for the state rather than a gilt at the end of the day. And the choice as to which to use depends upon either target interest rates and other, non-financial, targets.

But the argument that PQE both works, and does not impose additional cost, and might usually be cheaper when there are long term very low bank base rates happily survives the analysis. As I always thought it would.

After which why political economic choices might suggest PQE is the proper choice becomes the question to consider, but that is for another blog.