Funding the Future

Mythbuster: What is quantitative easing and how does it…

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I have been asked to explain how quantitative easing works, given how important it is within our economy and managing the coronavirus crisis right now. What follows is part of a larger piece of work that is in development, and is a bit technical in nature, but I hope it is of use to those who are looking for a bigger understanding of this issue. When I can find time I will do another Mythbuster to explain the economic consequences of this:

What is quantitative easing?

The Bank of England says that quantitative easing (QE) is***[1]*:**

Quantitative easing is a tool that central banks, like us, can use to inject money directly into the economy.

Money is either physical, like banknotes, or digital, like the money in your bank account. Quantitative easing involves us creating digital money. We then use it to buy things like government debt in the form of bonds. You may also hear it called 'QE' or 'asset purchase' — these are the same thing.

The aim of QE is simple: by creating this 'new' money, we aim to boost spending and investment in the economy.

There is nothing wrong with this simplistic explanation, but to make sure that it is properly understood, and that its consequences can be explained, it is important to break the QE process down into its relevant stages.

Accounting for quantitative easing

Quantitative easing is a process that involves the following operations:

* The Bank of England set up a new company, called Bank of England Asset Purchase Facility Fund Limited***[2]* (the 'APF') to manage this process. It had to do so because all money creation involves the making of loans, and the Bank of**

England cannot lend money to itself, and so had to lend it to this other company instead.

* ***The Bank of England lent money to the APF to provide it with the funds that it required to acquire government bonds, as well as a limited quantity of corporate bonds, under the QE programme. Those loans have now reached about £745 billion in total[3].***

* ***As is normal with regard to bank loans of any sort, new money was created as a consequence of this loan. The Bank of England acknowledge this in the statement noted previously. They explained this process in the Spring 2014 edition of their Quarterly Bulletin[4].***

* ***The vast majority of the money created in this way was used by the APF to buy government gilts from the financial institutions that owned them. These included banks, building societies, pension funds and life insurance companies as well as some overseas and private owners of these assets. The gilts in question were bought in an auction process. As a result, current market prices were paid at the time of the reacquisition of these gilts by the government. The price paid may not have been the price at which the gilts were originally issued by the government[5].***

* ***Once bought by the APF the reacquired gilts have sat on its balance sheet as assets. To date none have ever been sold back to the financial markets although some have been redeemed by HM Treasury at the end of their lives. In that case the proceeds have been reinvested in the purchase of replacement gilts acquired in exactly the same way as other reacquired gilts, as already noted. The objective has always been to keep the same value of gilts in ownership.***

* ***The loan from the Bank of England to fund the purchase of the reacquire gilts is a liability on the APF balance sheet.***

* ***That same loan is, of course, an asset on the balance sheet of the Bank of England, and the two sums do balance each other out.***

* *This netting off is not, however, shown in the accounts of the Bank of England because although the APF is nominally owned by the Bank of England all its profits and losses are under written by the Treasury in an agreement dating back to 2009 when the QE programme began[6]. As such it is under the effective control of the Treasury. The consequence of this Treasury control is that although it would appear that the APF is owned by the Bank of England, the substance of the transactions undertaken is that the Treasury has reacquired debt that it has issued to the financial markets in the form of gilts, and has done so with a loan from the Bank of England.*

* *Although the nature of this transaction would imply that the reacquired gilts are cancelled, because it is immediately apparent that the Treasury cannot owe itself money, the legal form in which the gilts were created, and the nature of the loan structure used for their repurchase has meant that legally the gilts have not been cancelled as a consequence of their repurchase. Whilst the economic substance of what has happened is that the gilt is cancelled, the legal form of their continued existence has been maintained.*

* *As a consequence of this continued legal existence of the reacquired gilts, technically the Treasury has to still pay itself interest on these gilts as those interest payments fall due for payment, and as a matter of fact, these payments have been made.*

* *Politically it has suited the government's narrative to maintain this pretence that interest is owing on these gilts. As a consequence of this pretence, successive governments have been able to claim that the cost of government debt servicing has been more onerous than has actually been the case, and have claimed that this has prevented it from undertaking other forms of spending. This claim has been disingenuous. In practice, the income received by the APF as a result of the payment of this interest belongs to the Treasury as a consequence of the management agreement reached between it and the Bank of England, previously noted. The result has been that the income in question has been returned to HM Treasury, as a matter of fact. The accounts of the APF make this clear. The refund has not, however, been used to cancel the interest charge recorded in the government's own accounts: it does, instead, appear to be shown as part of the 'other income' of the government. In accounting terms this might be called a*

misrepresentation. The two sums should be offset to present a true and fair view of the interest cost that the government actually incurs. The only possible explanation for this misrepresentation has been that it has suited government purposes to make it.

* ***Because the accounts of the Bank of England do not include a consolidation of the APF the Bank of England's accounts do not reflect the APF asset holding, and do instead show the loan account balance owing by the APF, which is actually effectively payable by HM Treasury as a consequence of the Treasury's agreement to indemnify the Bank of England with regards to the Bank's operation of the APF.***

* ***However, the UK government does prepare accounts on what is called a [Whole of Government basis](). In these accounts the gilts owned by the APF are shown as cancelling the liability owing by the Treasury with regard to those same gilts Because, as a matter of fact, no one outside the government is owed any money with regards to these gilts once they have been re-acquired this presentation does show an overall true and fair view of the position of the government with regard to the gilts in question. Because of the accounting requirement that the economic substance of a transaction must take precedence over the legal form in which it is undertaken the correct presentation of the liabilities of the government with regard to these debts is shown in the Whole of Government accounts as a consequence, with the gilts in question being shown to be cancelled. The political preference of the government to show that the debt still exists is overruled by the accounting requirements that a true and fair view be presented by its accounts.***

* ***The fact some separate accounts e.g. those of the APF, still show transactions being undertaken with regard to these gilts, does not alter this economic substance that the transactions in question net out on consolidation for the government as a whole, and as such have no real economic substance to them, clearly indicating that the gilts in question are effectively cancelled.***

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[1] https://www.bankofengland.co.uk/monetary-policy/quantitative-easing

[2] https://beta.companieshouse.gov.uk/company/06806063

[3] https://www.bankofengland.co.uk/monetary-policy/quantitative-easing

***[4]* https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/quarterly-bulletin-2014-q1.pdf**

***[5]* There is nothing surprising about this change in the price of gilts after their issue. As official interest rates have been reduced to almost nothing[5] over the period during which the quantitative easing programme has been in operation, and whilst the amount of interest actually paid on government bonds in issue remains a constant (which on all but index linked bonds it does, over the lifetime of a gilt, which can be for a period of up to fifty years), the price of bonds increases in the open market to equate the price of a bond already in issue with the current equivalent interest rate return expected upon it as if it had been issued now, taking into account the time expected to pass until redemption of the bond takes place. There is nothing untoward about this: this is how fixed interest bond markets work.**

***[6]* https://webarchive.nationalarchives.gov.uk/20091204191052/http:/www.hm-treasury.gov.uk/d/chxletter_boe050309.pdf**