

Why and how we can do something much better than quantitative easing

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Modern monetary theory (MMT) says the government creates all our money - either itself through its own spending, or indirectly through the banks that it licences.

In both cases the money is made by making a loan - and repayment of the loan cancels the money that is created.

The Bank of England currently manages the government's money creation programme. It does part of this through what is called the quantitative easing (QE) programme.

QE does, in effect, let the Bank of England lend money to the government. It can do so interest free. However, the problem is that the government ends up with little effective control of the money created for it by the Bank of England.

MMT argues that this is inefficient, and not just because of the cumbersome nature of the QE process described below. It says that the process in question is not required: if the government wants funding from the Bank of England it just has to ask for it (as it did until 2008 when it chose to use QE instead, but which it could still do on what is called its Ways and Means Account). Then the government could use the newly created funds any way they wished instead of relying on third parties to decide on their use.

Despite this the government persists with QE, supposedly to comply with international law. The arrangements are cumbersome. This is what happens:

- a) The Bank of England lends money to a company it owns - the Bank of England Asset Purchase Facility Fund Limited - which is known as the APF;
- b) The APF is owned by the Bank of England, but that is misleading: every aspect of its activities is undertaken for and on behalf of the Treasury, who provide a complete indemnity for its activities to the Bank of England. The Treasury is, of course, a part of the government, of which the APF is an effective part as a result. This interaction makes a mockery of Bank of England independence as a result;
- c) The APF buys bonds that the government has issued. It does not do so directly from

the government. It buys them from financial markets instead. Banks, buildings societies, pension funds and others sell them to the APF. It is very likely that they profit from doing so.

d) The money paid for the bonds is - by and large, but not entirely - used by the banks and building societies to whom it is paid to increase their own liquidity. This means that they actually deposit it back with the Bank of England on what are called their central bank reserve accounts. It is likely that these organisations hold more than £600bn in such accounts at present, which is most of the funds created via the QE process.

e) The Bank of England pays interest at its bank base rate of 0.1% on these balances. The advantage of this arrangement to the government is that it means it has considerable control over the short-term interest rates in use in the UK economy: if such large sums are subject to the Bank's chosen rate all other rates follow suit.

f) In effect, by using QE the gilts the government issues to collect money from the private sector are replaced by private sector bank deposit accounts held with the Bank of England of roughly equivalent amount. There is an approximate substitution of one form of government liability for another;

g) The advantage for the government of this arrangement include that fact that:

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* their gilts are effectively cancelled because of their ownership by the Treasury, which also issued them in the first place (even if this cancellation is publicly denied);

* the government still secures the cash funding that they want, but now through deposits from banks and building societies instead of via bonds;

* the overall interest cost of these funds is, however, reduced because bank base rate is paid upon them rather than the higher rates at which most reacquired gilts were originally issued;

* interest rates in the economy are controlled through this payment of bank base rate on deposits of more than £600bn;

* the central bank reserve accounts that are held by UK banks and building societies with the Bank of England are, in practice, very hard for them to redeem even if they are, in theory, repayable on demand. That is because if the government refuses to accept additional payment from the banks and buildings societies who hold these accounts in the form of either higher taxes or new bond sales not covered by additional quantitative easing activity (and neither looks likely at present) the banks and building societies have little chance to make any significant new payments to the government over and above the flows of new money that come to them as a result of government spending on a regular basis, meaning that these balances are likely to remain broadly static. The balances can, admittedly, be reallocated between those banks and building societies at their choosing, but redemption is effectively entirely under government

control, meaning that questions of so-called 'repayment' do not arise unless at the government's choice; and

- * banks and other organisations hold greater quantities of funds that may encourage them to lend or invest more, which may stimulate the economy and so improve its performance.

h) The advantage for the banks is that they tend to have enlarged balanced sheets with significantly more cash holdings on them, which makes them appear more robust. With luck, some money might also reach the real economy as a result, although the amounts in question are in doubt, and much that has been used seems to have flowed towards asset speculation.

The problems with this policy should be apparent. Firstly, it is a game of smoke and mirrors. It is fundamentally dishonest with the public as to its intention. The permission it gives to the government to claim that there is still debt in place, as they do in national debt calculations, when in practice that has been substituted with newly created money is intended to mislead, and does. That deception is part of the austerity narrative, long used to claim that the government cannot spend as it is suggested that it has not got the means to do so, when that is obviously untrue.

Secondly, the same cash injection could be achieved more effectively by the Bank of England lending newly created money directly to the Treasury for the latter to spend as it wished on whatever it thought might best stimulate the economy instead of relying on commercial banks to achieve this goal.

For these reasons MMT does not embrace QE, which it thinks unnecessary, and instead suggests direct lending from central banks to government. This could, however, be structured in the form of QE if that was really desired. But in that case the logical way to do this would be to use the funding in question for specific government directed purposes. So, for example:

- * The government could create a National Investment Bank (NIB);
- * The NIB could issue bonds;
- * The APF could use Bank of England created money to buy these NIB bonds;
- * The NIB could then invest directly into the economic transformation that the UK requires;
- * The holding of bonds in the NIB would, via the APF, be under the direct control of the Treasury, as would be appropriate;
- * The Bank of England would have then used its power to create money for specific

rather than random purpose;

- * Government borrowing through the NIB would still have been replaced by newly created money on the national balance sheet;
- * There would be no loss of control of interest rates: there are more than enough conventional QE funds in existence already to achieve that goal.

In 2010 [Colin Hines and I described such an arrangement as Green QE](#) because it would fund a Green New Deal. It still could, and is the use of a form of QE that is consistent with modern monetary theory that we still require.