Funding the Future

The QE process

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I was criticised by some commentators yesterday for what they thought to be a harsh comment by me on a comment by Neil Wilson [on a post.](#)

He claimed that the QE process simply involves an asset swap where a central bank reserve account balance is substituted for a bond.

I suggested that this was wholly untrue because it represented an incomplete understanding of the QE process. As a consequence, I wrote this glossary entry to explain what the QE process is. I am aware that I contradict some modern monetary theory exponents by doing so, but think what follows is economically correct, in my opinion:

The QE process describes the whole process of quantitative easing (QE). It ignores the fact that there are three apparent stages to this process and instead views them as a whole.

In the first stage of the QE process the government instructs its central bank to make a payment, as is its normal practice, day in and day out. Presume that the payment is for £100. The central bank records this by:

A) Increasing the value on the loan account that the government has with it by £100.

B) Increasing the value of the central bank reserve account that the commercial bank that will make payment to the intended recipient has with it by £100.

The commercial bank will then match its receipt of £100 from the government via the central bank reserve accounts by making the required payment to the account that the recipient maintains with it.

In summary, each of the following has increased by £100:

1) The sum owed by the government to the central bank.

2) The sum owed by the central bank to the commercial bank on its CBRA.

3) The sum owed by the commercial bank to the intended recipient.

Note that as a result the commercial bank is a neutral player in this. It only gets a sum on deposit because existing rules do not allow individuals to bank with most countries' central banks.

The process could end at this stage. It does not because by convention, backed in some countries by regulation, central banks cannot make loans to the governments that own them.

As a result, stage two happens. In this stage, the government sells a bond (which is just a form of deposit account) to someone other than the central bank. It does not matter who they are. The result is that the following payments are made:

A) The purchaser of the bond pays the commercial bank £100 for the bond by reducing the balance on their account with that commercial bank.
B) The commercial bank then pays the central bank £100 by reducing the balance on their central bank reserve account with the central bank.
C) The central bank pays the government by reducing the sum owed by the government to it.

The central bank reserve accounts are now back where they were before this process started.

So is the loan between the central bank and government back where it started.

But the recipient of the government's payment still has their money, and the government now owes someone else £100.

The process could be ended here, at stage 2. In fact, it is very often the case that it does.

However, when the QE process is in operation, the process was never intended to stop at stage one or two. Stage three was always intended.

In stage 3 the central bank buys the £100 bond that the government sold to someone in the private sector economy. To do this:

A) The central bank pays the commercial bank that holds the account of the person who owns the £100 bond by increasing the balance on that commercial bank's central bank reserve account.
B) The commercial bank in question then pays £100 to the owner of the bond.
C) The central bank now owns the bond. As a result, it is now owed £100 by the government. The previous bond owner has been repaid in full.

But note that the position now achieved is in substance identical to that achieved at the end of stage 1. The recipient has their money, the commercial bank central bank reserve account is up £100, and the government owes the central bank £100 as a result. All that has changed is the government now owes the central bank £100 in respect of a bond rather than £100 in respect of an overdraft. Everything else is the same as at the end of stage 1.

This now requires interpretation. First, note that to consider each of these stages in isolation is wrong when the QE process plans that all three be undertaken. It is a straightforward error to claim that they are separable if QE is planned. In particular, it cannot be claimed that stage 3, which some describe as QE, is independent of stages 1 and 2 when that clearly cannot be the case. Stage 3 is wholly dependent on stages 1 and 2 taking place.

What that then means is that stage 3, and so QE itself, is not, as some claim, a simple asset swap by a commercial bank that gives up a bond to hold a central bank reserve account balance instead. That is not true because the central bank reserve account balance already existed at the end of stage 1 of this process and is still there at the end of stage 3. So there was in effect no asset swap involving a central bank reserve account in stage 3: a balance was restored, not swapped.

Instead what there is instead is a wholly bogus or sham sale of a bond which the government always intended to repurchase. In fact, the only asset swap is that the government now owes the central bank on a bond and not on a bank overdraft account.

If QE is only stage 3 it would be correct to say that QE does not create new money because that stage does not involve new money creation.

But the QE process is stages 1, 2 and 3 together. As a result new money is created, and is the balance of £100 that exists at the end of stages 1 and 3 and which only disappeared at stage 2 because of the sham bond transaction that then took place.

As such QE does create money, albeit at stage 1, and those claiming otherwise have failed to view the transaction as a whole.

The unintended consequence of all this is that it is the government's spending at stage 1 (not the transactions at stage 3) that creates a central bank reserve account balance that a commercial bank has no role in creating except by acting as a conduit and yet, as a result, it is owed base rate interest on the resulting balance by the Bank of England. It is that outcome that makes almost no sense in all this.

Also note that if QE does create money for the reason noted then quantitative tightening does, when properly understood, destroy money by removing it from use.