QE and the inflation dogma
Does it work and does it make sense?

Richard Silveira PhD

06 November 2017

Agenda

- Does the current mandate make sense?
- Is monetary policy a suitable tool?
- What did QE bring us?
- How will QE unwind?
- Monetary policy and pensions

- Is there another way?

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Does the current mandate make sense?

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Does the current mandate make sense?

- Why does the BoE exist?

To promote the good of the people of the United Kingdom

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Does the current mandate make sense?

- Mandate is via monetary (price) and financial stability

The remit recognises the role of price stability in achieving economic stability more generally, and in providing the right conditions for sustainable growth in output and employment

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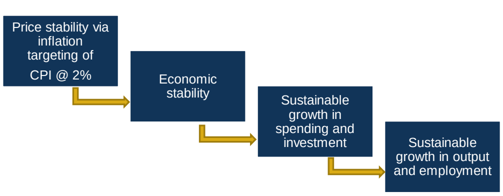
Does the current mandate make sense?



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Does the current mandate make sense?

- Why a single metric?
- Why 2%?

Is a single metric sensible?

Consumer price ***inflation***

Is a single metric sensible?

Necessary ***but not sufficient*** to achieve sustainable economic growth

Consumer price ***inflation***

Is a single metric sensible?

Consumer
price
inflation

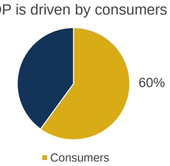
Necessary ***but not sufficient*** to achieve sustainable economic growth

So what else matters?

Is a single metric sensible?

Consumer
price
inflation

GDP is driven by consumers



Is a single metric sensible?

Consumer
price
inflation

Necessary ***but not sufficient*** to achieve sustainable economic growth

So what else matters for consumers?

Is a single metric sensible?

Consumer price *inflation*

Wage ***inflation***?

House price ***inflation***?

Rental ***inflation***?

Pension ***inflation***?

Why 2%?

- The sweet spot – not too high, not too low
- Is 2% relevant now? Is a monetary supply issue?
  - Ageing population
  - Technology
- Behavioural factors – why it's still 2%
  - Status quo bias, experts' opinion, fear of regret, anchoring

Is monetary policy a suitable tool?

The central banker's toolbox

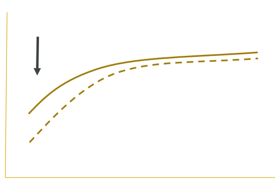
Setting base rates

Macro-prudential regulation

Quantitative Easing (QE)

Open market operations

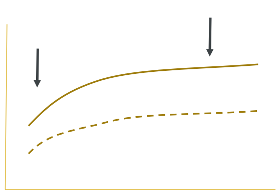
The central banker's toolbox



Set the base rate

Longer terms affected through expectation

The central banker's toolbox



Set the base rate

Longer terms affected through expectation

Add QE for direct influence

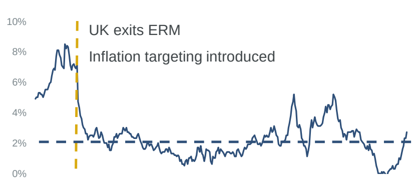
The central banker's toolbox

- Different tools, same intention
- Monetary policy is about
  - the yield curve i.e. the cost of credit
  - the relative value of risk-free and risky assets
- Lower rates to …..
  - increase aggregate demand through credit expansion
  - push capital into riskier assets

Is monetary policy a suitable tool to ***lower*** inflation?

- Yes
- Effective since 1992
- Basis for current mandate
- Can raise rates to arbitrary level

UK CPI 1989 - 2017



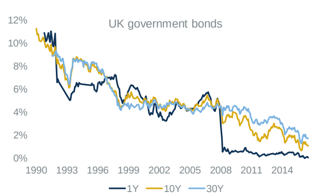
Is monetary policy a suitable tool to ***raise*** inflation?

- A blunt tool
- With costs
- And limitations

Limitations of monetary policy

- No guarantee cheaper credit is used
- No guarantee it's used for intended purpose
- The lower bound and diminishing returns
- Postpones the issue, doesn't fix it

A 30-year decline in interest rates



What are the alternatives to monetary policy?

What are the alternatives to monetary policy?

- Fiscal policy – tax, investment, spending
- Stimulates economy directly
- Not credit-driven -> upfront cost -> politically unpopular

What did QE bring us?

Background – March 2009

…the MPC judged at its March meeting that a further monetary loosening was required. In particular, it was concerned that nominal spending in the economy would otherwise be too weak to meet the inflation target in the medium term

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Background – March 2009

The aim of quantitative easing is to inject money into the economy in order to revive nominal spending

It should ultimately lead to an increase in asset prices and spending and therefore bring inflation back to target

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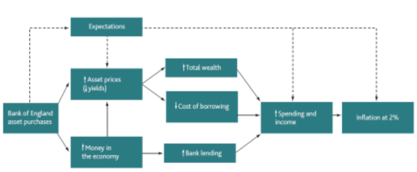
Mechanism



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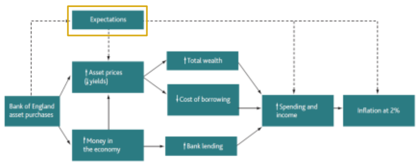
Mechanism

Asset purchases could have an important impact on expectations



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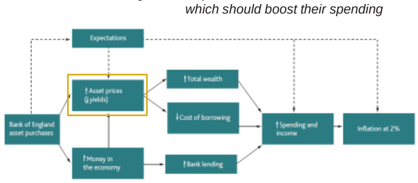
Mechanism

…higher asset prices increase the wealth of asset holders, which should boost their spending



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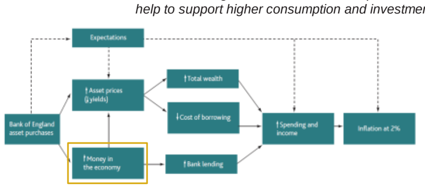
Mechanism

More bank lending to households and companies should help to support higher consumption and investment



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What does QE look like?

- What's happening to….
  - The gilt curve
  - The amount of bonds purchased
  - Asset prices
  - GDP
  - Inflation

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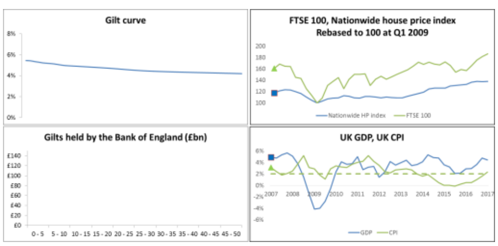

Q1 2007

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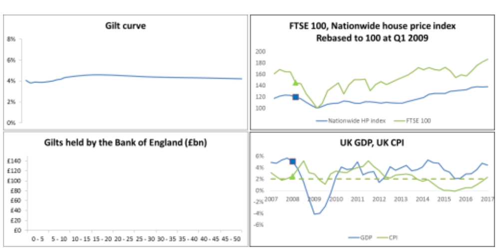

Q1 2008

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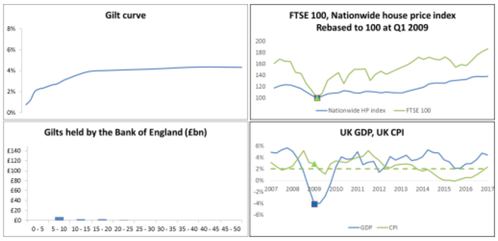

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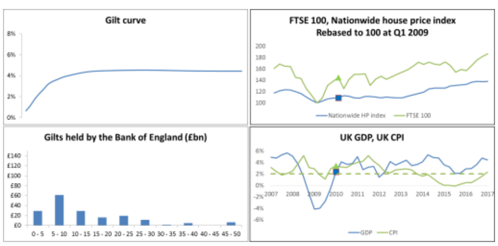

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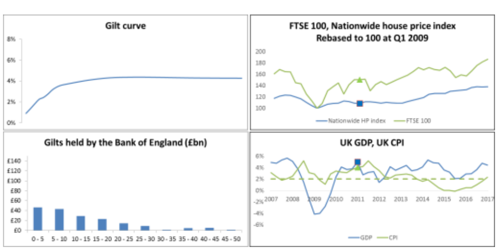

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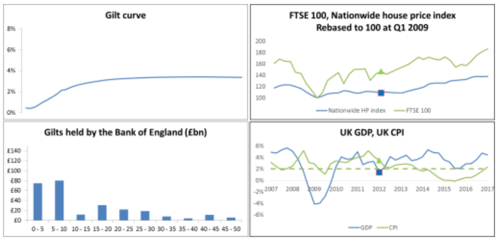

Q1 2012

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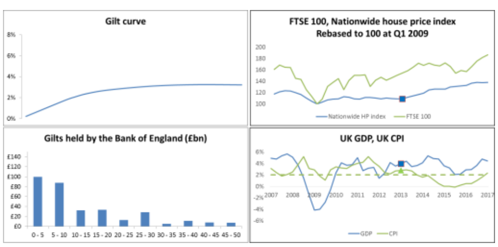

Q1 2013

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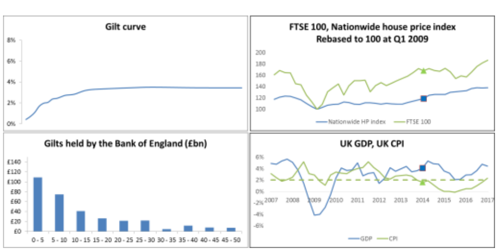
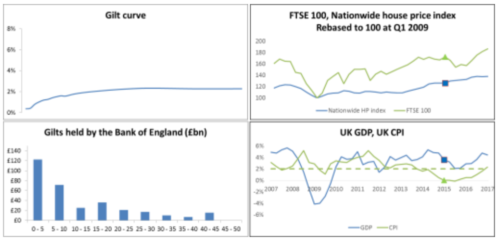


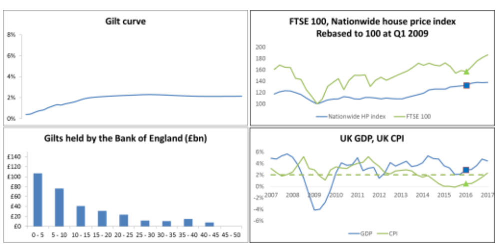
Q1 2014

06 November 2017 42



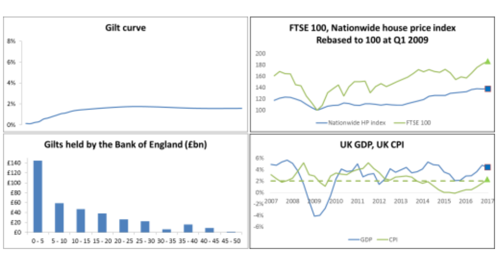
Q1 2015

06 November 2017 43



Q1 2016

06 November 2017 44



Q1 2017

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Q1 2009 – Q1 2017

30-year spot rate	4.2% -> 1.7%
FTSE 100	+ 87%
Nationwide Housing Index	+ 38%
Real GDP	3.5%
Average CPI	2.2%

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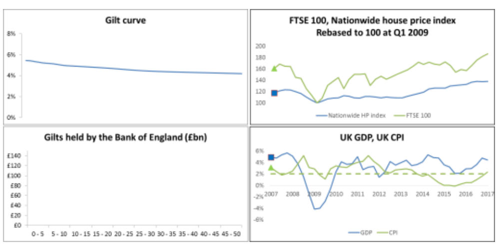

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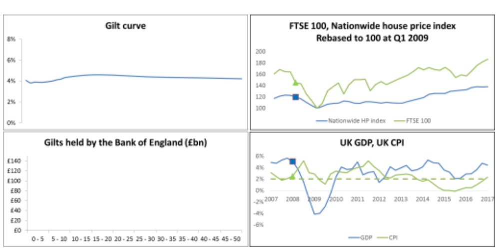

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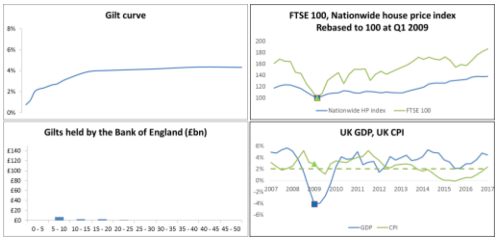

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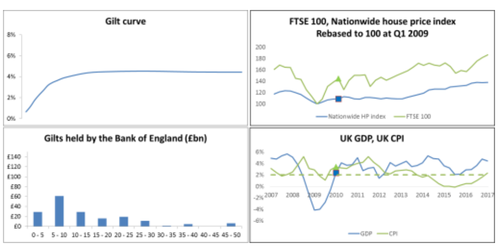

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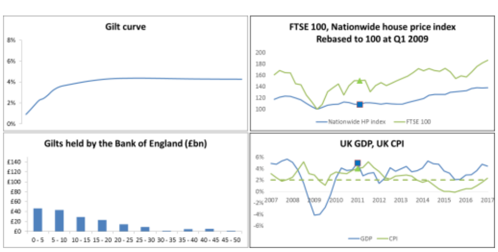

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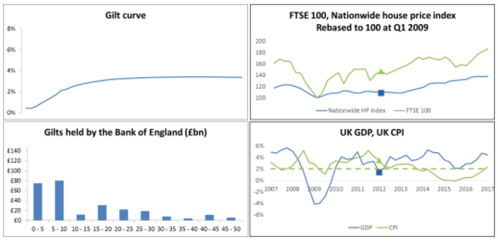

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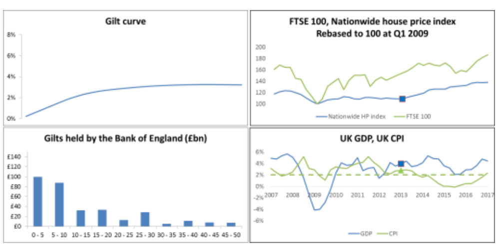

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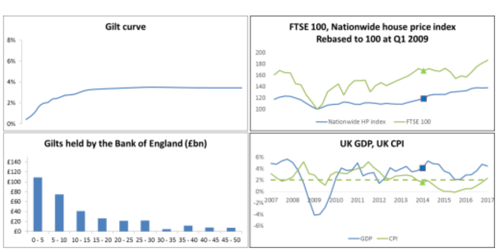

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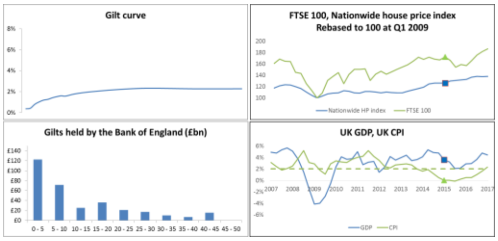

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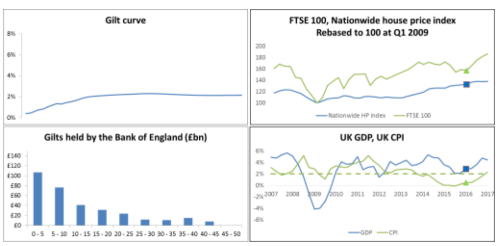

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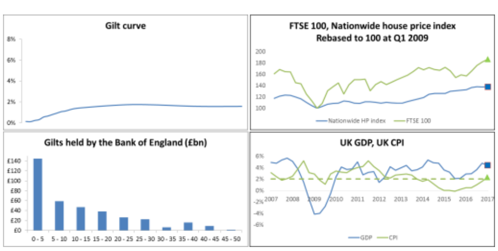

Q1 2017

QE did what it promised

It should ultimately lead to an increase in asset prices and spending and therefore bring inflation back to target

QE did what it promised

It should ultimately lead to an increase in asset prices and spending and therefore bring inflation back to target

But what else did it bring us?

What else did QE bring us?

- Debt

What else did QE bring us?

- Debt
- Dependency

What else did QE bring us?

- Debt
- Dependency
- Market distortion

The (extreme) search for yield

- In 2016 Austria sold 2bn Euros of 70-year debt at 1.5%
- Consider the risks:
  - Long term, very high duration
  - Will the Euro exist in 70 years' time?
- For context, for SII, EIOPA deem the last liquid point for the Euro to be 20 years

The (extreme) search for yield

- In 2016 Austria sold 2bn Euros of 70-year debt at 1.5%
- **In 2017 Austria sold 3.5bn Euros of 100-year debt at 2.1%**
- Consider the risks:
  - Long term, very high duration
  - Will the Euro exist in 70 years' time?

- For context, for SII, EIOPA deem the last liquid point for the Euro to be 20 years

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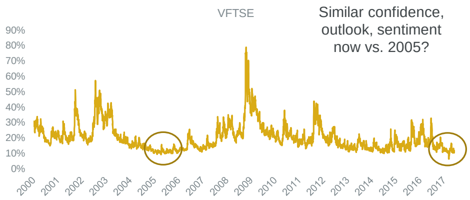
Yet the market is (implied) calm



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What else did QE bring us?

- Debt
- Dependency
- Market distortion
- Pension deficits

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What else did QE bring us?

- Debt
- Dependency
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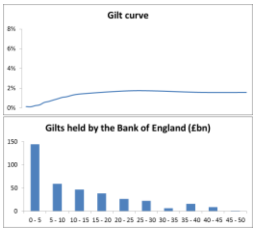
- Pension deficits
- A new predicament

What else did QE bring us?

- Debt
- Dependency
- Market distortion
- Pension deficits
- A new predicament
  - Central bank cannot walk away
  - Nor can it stay there forever
  - How does it extract itself?

How will QE unwind?

Q1 2017



The options

- Sell bonds, reduce balance sheet
- Let bonds mature, with no repurchase
- Repurchase such that maturity and/or notional reduce over time
- Rollover indefinitely i.e. no unwind

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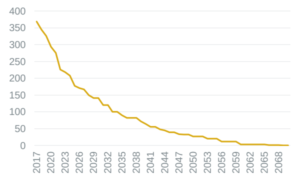
- +……when should rates rise?

Balance of gilts if QE left to run off (£bn)



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What the Bank of England has said

- Q1 2009

The MPC will decide on the most appropriate way to withdraw the policy stimulus based on the circumstances prevailing at the time

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What the Bank of England has said

- Q1 2014

We're not going to sell £375 billion of gilts.

That's a hypothetical question, purely hypothetical

Mark Carney to the Treasury Select Committee

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What the Bank of England has said

- Q2 2014

The MPC's preference is to use Bank Rate as the active marginal instrument for monetary policy

What the Bank of England has said

- Q4 2015

The MPC expects to maintain the stock of purchased assets at £375 billion until Bank Rate has reached a level from which it can be cut materially

What the Bank of England has done

- Q3 2017
- **Base rate 0.25% ->0.50%**

The Committee also voted unanimously to maintain the stock of UK government bond purchase

Monetary policy and pensions

What does the Bank of England think about pensions?

Andy Halldane

Bank of England chief economist

Next governor?

What does the Bank of England think about pensions?

- May 2016

I confess to not being able to make the remotest sense of pensions

What does the Bank of England think about pensions?

- August 2016, on the best option for retirement

It ought to be pensions but it's almost certainly property

What does the Bank of England think about pensions?

- Assets matter…..
- Liabilities don't?

What does the Bank of England think about pensions?

Publication	Word count on *asset*	Word count on *liability*
Quantitative easing Quarterly Bulletin Q2 2009		
The United Kingdom's quantitative easing policy: design, operation and impact Quarterly Bulletin Q3 2011		

What does the Bank of England think about pensions?

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What does the Bank of England think about pensions?

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Quantitative easing Quarterly Bulletin Q2 2009	173	0
The United Kingdom's quantitative easing policy: design, operation and impact Quarterly Bulletin Q3 2011	163	0

What does the Bank of England think about pensions?

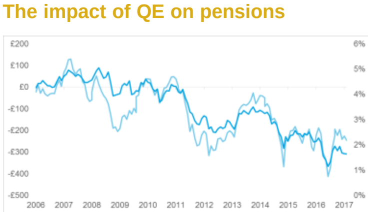
- Essentially ignored
- Not part of the mandate

The impact of QE on pensions

The impact of QE on pensions

PPF estimate of aggregate DB deficits (£bn)

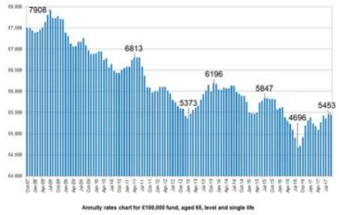
The impact of QE on pensions



PPF estimate of aggregate DB deficits (£bn)

+ 20Y gilt spot rate

The impact of QE on pensions



Falling annuity rates

Source: sharingpensions.co.uk

The impact of QE on pensions

- How sustainable and secure are DB schemes?
- Subject of recent government consultation

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  - Broadly affordable
  - Some schemes may struggle

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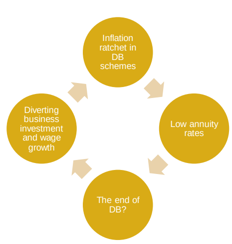
- **Affordable but at what cost?**

The impact of pension costs on Bank of England's aims

- An implicit assumption that it **doesn't** impact Bank's primary aims
  - *To promote the good of the people of the United Kingdom*
  - *(via) sustainable growth in output and employment*

The impact of pension costs on Bank of England's aims



Is there another way?

Is there another way?

Question	Answer
Does the current mandate make sense?	
Is monetary policy a suitable tool?	
What did QE bring us?	
How will QE unwind?	

Is there another way?

Question	Answer
Does the current mandate make sense?	In broad terms yes Necessary but not sufficient
Is monetary policy a suitable tool?	
What did QE bring us?	
How will QE unwind?	

Is there another way?

Question	Answer
Does the current mandate make sense?	In broad terms yes Necessary but not sufficient
Is monetary policy a suitable tool?	To lower inflation, yes To raise inflation, it's a blunt tool
What did QE bring us?	
How will QE unwind?	

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Is there another way?

Question	Answer
Does the current mandate make sense?	In broad terms yes Necessary but not sufficient
Is monetary policy a suitable tool?	To lower inflation, yes To raise inflation, it's a blunt tool
What did QE bring us?	Exactly what it promised. And more… Debt, dependency, distortion, new risks
How will QE unwind?	

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Is there another way?

Question	Answer
Does the current mandate make sense?	In broad terms yes Necessary but not sufficient
Is monetary policy a suitable tool?	To lower inflation, yes To raise inflation, it's a blunt tool
What did QE bring us?	Exactly what it promised. And more… Debt, dependency, distortion, new risks
How will QE unwind?	Rates then QE (maybe)

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The issues that central banks need to address

- Short-termism

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- Short-termism
- Narrow view

The issues that central banks need to address

- Short-termism
- Narrow view
- Denial that monetary policy has limitations and costs

The issues that central banks need to address

- Short-termism
- Narrow view
- Denial that monetary policy has limitations and costs
- Application of outdated economics

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What needs to be change?

- Genuine oversight and accountability

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- Better alignment of fiscal and monetary policy

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- Genuine oversight and accountability
- Better alignment of fiscal and monetary policy
- Wider mandate

What needs to be change?

- Genuine oversight and accountability
- Better alignment of fiscal and monetary policy
- Wider mandate
- Start to unwind QE – intention is key

Long term thinking is vital

Colin Wilson

Questions Comments

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