

Needed – MPC members who understand the monetary process to oversee the monetary easing



making business sense

The Bank of England announced a further (and possibly last in this cycle) fall in the Bank Rate today with another 50 basis point cut, taking interest rates to another record low in 315 years of history. There is also one further giant step into the unknown: a programme of asset purchases worth £75 billion – roughly 5.2 per cent of gross domestic product through the creation of new sterling reserves. Now that the interest rate policy tool has been deployed to its upmost extent, quantitative easing has arrived. Quantitative easing, or printing money, has elicited an emotive response from the popular press, with cautionary tales from the Weimar Republic and Zimbabwe rolled out, along with prophecies of economic collapse and hyper-inflation. Clearly the set of circumstances afflicting Britain today and hence the rationale for printing money is fundamentally different to these examples. A more reasonable comparison is the quantitative easing experiment begun by Japan in 2001, as an effort to combat deflation and kick start the economy. Whilst there is some debate on whether this episode achieved its objectives, it certainly did not lead to economic disaster.

In essence, just as the interest rate affects the price of money, quantitative easing is another policy tool that can be deployed by Central Banks, to affect the volume of cash. In addition printing money does not suffer from the core limitation of the interest rate, which is that it can't go negative and therefore can only be used up to a point. Therefore at times when an economy is threatened with deflation and depression, quantitative easing is one of the few options available for monetary easing. We see four key issues with the United Kingdom entering these uncharted monetary policy waters.

Firstly, how exactly is quantitative easing being conducted? There are two sensible ways: buying up corporate bonds or buying gilts. The Bank of England has opted for the latter: buying medium and long maturity conventional gilts. The second key point is how much the Bank should inject. The Bank has announced a £75 billion injection but that it could take three months to make the purchases. Back of the envelope calculations suggest as much as £150 billion could be needed but the crucial point should be to monitor the impact on markets weekly.

Third and especially crucial, is the exit strategy. How and when does the Bank know to turn off the tap? This will be an important judgement and will require careful monitoring of credit flows. When there is enough of a hint of improvement in credit conditions, so that the gap between what is being produced and the productive potential of the economy starts to close, the Bank will quickly need to reduce the volume of money in circulation. This is critical – if the timing is delayed inflation could rocket but if it is too fast it would likely impair the effectiveness of the intervention. The mechanism through which the new money is removed is fairly simple; the Bank sells the gilts and takes the money raised out of circulation.

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The difficulties surrounding the third point bring us onto the final point: it is essential to have the right team of heavyweight, credible monetary economists that are capable of making the very sensitive judgements on exactly how much easing is required and when it should stop. So, attention focuses on the Monetary Policy Committee. Mervyn King as Bank of England Governor is an economic heavyweight, though no monetary specialist. I do not feel that any of the members of the MPC provide an overwhelming level of confidence with their expertise in this area. Can I suggest therefore that for the duration of the crisis some serious monetary experts like Tim Congdon or Sir Charles Goodhart are coopted to help ensure that the MPC has sufficient monetary competence. This would undoubtedly calm financial markets, which are liable to be jumpy when printing money starts.

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