Pointmaker

QUANTITATIVE EASING

LESSONS FROM HISTORY

GEORGE TREFGARNE

SUMMARY

- One of the biggest policies undertaken in the 12 years of the Labour Government has been printing money, some £170 billion to date.
- There are signs that Quantitative Easing, as the policy is known, has so far been a success, reducing long-term interest rates, lifting the stock market and improving company balance sheets.
- However, the policy carries many significant risks. It has already had a serious impact on pension deficits and annuities, and is likely to be undermining the pound. It could also be very expensive. How and when will it end? Will it cause inflation? What criteria should we use to judge how it is working?
- The policy has also received little scrutiny by Parliament. There has been no primary legislation on QE. The only secondary legislation on QE has been a statutory instrument, exempting the policy from the FSA's authorization regime.
- The Bank of England now controls QE policy. It claims as its authority its independent right to control interest rates. This is a very thin justification for such an important role.
- There are useful lessons to be learned from history. On two out of three previous occasions that printing money has been used, it resulted in high inflation. The worst resulted in inflation reaching a record 36.5%.
- The political and legislative process for printing money was superior in the past. In 1810 the Bullion Committee was formed by Parliament to scrutinise the policy. Similarly, today a special Select Committee of Parliament should be formed to:
  - scrutinize QE on an ongoing basis;
  - report on progress and the risks on an at least quarterly basis; and,
  - consider the timing and method by which QE can be safely brought to an end.

INTRODUCTION

> *There can be few fields of human endeavour in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present.*[1]
> **J K Galbraith**

> *The four most dangerous words in investing are 'This time, it's different'.*
> **Sir John Templeton**

We have become so used to the enormous sums of public money tossed around during the credit crunch that one of Labour's biggest ever policy actions – the decision to print money – has been largely overlooked.

Yet this policy, known by its technical name, Quantitative Easing (QE), exceeds even the sums injected into RBS and Lloyds; or the debts the Government has assumed from Northern Rock and Bradford & Bingley.[2]

So far, the Bank of England has printed around £170 billion and spent that staggering sum on buying up Government debt. As the Bank is itself owned by the Government and its liabilities are underwritten by the Exchequer, this is an oddly circular scheme, equivalent to an individual taking out new credit cards to pay off their debts.

That £170 billion, a sum bigger even than the NHS budget, is being held by an obscure company registered at Companies House called "Bank of England Asset Purchase Fund Facility", or BEAPFF Ltd. This entity is owned by the Bank of England and has two Bank employees as its sole directors.[3] But its accounts are not consolidated, making it one of the largest of the UK Government's famed off balance-sheet liabilities.[4]

BEAPFF's assets are so big that if it listed on the stock market, it would probably be the biggest member of the FTSE 100, bigger even than BP or Shell.

The future of BEAPFF Ltd is not only fundamental to assessing the authorities' success in tackling the recession; it also has profound political and constitutional implications. Yet, if current form is anything to go by, its existence will hardly feature in the debate running up to the next election. Few people know about BEAPFF Ltd, or the policy of printing money and fewer still understand the issues involved. None of the major parties has said what it plans to do about BEAPFF Ltd.

Overall, there has been a lamentable lack of Parliamentary debate on this subject. It is time that the policy received proper scrutiny and it was put on a more transparent and secure legal footing.

IT HAS WORKED, SORT OF

Not even the Bank of England is entirely sure about the precise effects of QE. This is partly because it has coincided with massive stimulus policies elsewhere, notably by the US Federal Reserve, which is also printing money.

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1 *A Short History of Financial Euphoria,* Penguin, 1994.

2 According to the ONS, the bank interventions have totalled £141 billion.

3 Chief economist Spencer Dale and Markets Director Paul Fisher.

4 According to Note 15a) Bank of England Accounts 2009, the Bank holds 100 £1 ordinary shares in BEAPFF Ltd. This investment is held at cost on the Bank's balance sheet. HM Treasury have indemnified BEAPFF and the Bank against any loss arising from the activities of BEAPFF and will receive any surplus arising. The Bank has not consolidated BEAPFF in its financial statements as it has no economic interest in its activities.

But there are nonetheless signs that QE is working much better than Gordon Brown's many critics[5] have hitherto been prepared to concede. A 1930s-style Depression has been avoided (at least, so far). Indeed, if the policy does not go wrong, it may one day be seen as the most significant achievement of the Brown administration, alongside the decision to recapitalize the banks.

According to both the CBI and the Bank of England, Britain is slowly moving out of recession. There is evidence to suggest that QE has reduced long term interest rates, helped fuel the record-breaking rise in the stock market since March, kick-started the corporate bond market and enhanced confidence.

In fact, the real risk may not be that the policy is failing, but that it is working too well. For the benefits it has brought have come with some serious long-term risks and the longer it goes on, the worse those risks become.

Questions about where we go from here abound. How long should QE go on for? How exactly should it be ended? If QE has boosted asset prices, will it set off a bout of inflation? Who is in control, Parliament, the Treasury or the Bank of England? Why is the intervention taking place off balance sheet?[6] Is it right that the policy has, in effect, enabled Labour to continue funding its entire spending programme, much of which is politically contentious? The Opposition parties have been slow in asking these questions. And none of them have been answered by the Government or the Bank of England.

5 See for example, John Redwood MP on 30 September wrote on his blog "What is the point of QE?"

6 Despite the off-balance sheet approach, the Bank of England's disclosure and openness has been exemplary. The front page of its website has a counter proclaiming how much it has spent on QE and the results of the auctions are announced daily.

SOME LESSONS FROM HISTORY

QE is not a new idea. It was originally pioneered in this country by a Tory administration over 200 years ago, which in response to a banking crisis, flooded the system with funds, by printing money. QE is merely a fancy expression to describe the modern, technical aspects of that process. There have been three major precedents for QE.

1. The Restriction Period

The first example of printing money is 1797, the so-called Restriction Period. In February of that year, a 2,000-strong brigade of Frenchman undertook the last invasion of Britain, landing in Pembrokeshire. The banking system was already in a skittish state, as the Government had made continuous demands on the Bank of England for gold bullion in order to fund the war against France and to subsidise Britain's Continental allies. But the invasion – which was widely expected after a botched landing in Bantry Bay, Ireland, the previous year – was the last straw. Even though the French were swiftly defeated and rounded up by the Welsh gentry, the news triggered a widespread run first on the county banks, and then in the City.

The Prime Minister, William Pitt the younger, responded swiftly to a request by two Bank of England directors and used an Order in Council to authorise the Bank to stop redeeming paper notes in gold. Until that time, members of the public could take, say, a five pound note to the Bank and demand gold instead. That is why, to this day, pound notes have "I promise to pay the bearer on demand" printed on them and are signed by the cashier.

Instead, during the Restriction, the Bank was able to conserve its dwindling stocks of bullion by issuing more paper in the form of new £1 and £2 notes. It also issued silver dollars which had been captured from Spanish ships in the past and

clumsily stamped them with a tiny image of George III over that of the Bourbon Charles IV. This caused some wit to compose a couplet:

The Bank, to make their Spanish dollars pass
Stamped the head of a fool on the neck of an ass.

The issue, at 4s 9d, was not popular and numerous forgeries appeared. The Birmingham entrepreneur Matthew Boulton and his business partner James Watt were subsequently commissioned to overstrike the coins properly using their new steam press[7]. The Lord Mayor of London gathered City merchants at the Mansion House. 4,000 merchants signed a petition promising to honour the Bank's new notes.

The Restriction measure was supposed to be temporary but lasted 21 years and is the origin of Britain's paper money system. By 1819 the House of Commons was becoming impatient with the policy which, by common consent, had ultimately led to inflation.

Chart One shows that inflation hit an all-time record for Britain of 36.5% in 1800, three years after the Bank began printing money, before falling back, sometimes tipping into deflation.

Inflation and the high price of food provided the economic backdrop to a series of disturbances, notably the Peterloo Massacre in 1819. An Act was passed ordering the Bank to get Parliamentary authority for buying up British Government bonds, or gilts, and the policy was abandoned soon after.

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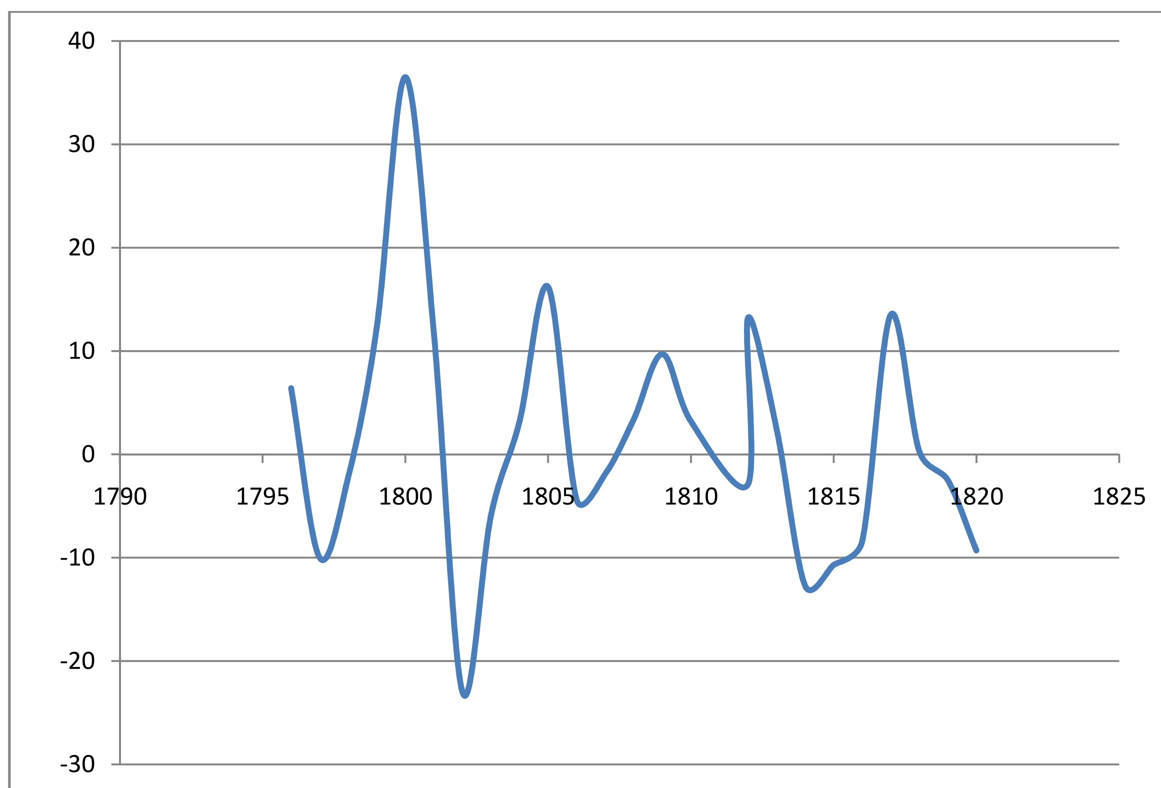
[7] See speech by Mervyn King at Birmingham Museum & Art Gallery, 29 May 2009.

Chart One: Inflation 1796 to 1820



Note: Finding reliable and comparable data for inflation 200 years ago is difficult. However, this chart is derived from data known as the Phelps Brown-Hopkins index, based on numbers from records from local markets, the accounts of colleges and hospitals and the Naval Victualling Service.

2. The Panic of 1825

The second precedent for QE occurred only a few years later in 1825, during Lord Liverpool's Liberal Tory administration. Interest rates were kept low after the end of Restriction and a great speculation in South American bond and share issues began. Investors were flush with cash and were seeking new opportunities after the Treasury converted a portion of its post-war debts and reduced the coupon from 5% to 4%.

1825 was a typical stock market bubble, featuring various useless and phoney schemes. A fraudster named Gregor MacGregor took advantage of the mania and issued a bond and sold land on behalf of a fictitious Latin American country called Poyais. When the scheme was exposed and collapsed, it contributed to a run on the banks and, for the first time, the Bank of England had to use its lender of last resort facility. Lord Liverpool resisted requests to suspend gold payments, but there is some evidence that he gave the Bank unofficial permission to print money beyond the legal minimum and it certainly reissued £1 and £2 notes from a box in its vaults. The crisis passed within a few months.[8]

3. The First World War

The third and final precedent for QE was in 1914 when the City took the declaration of war on Germany very badly. The Stock Exchange was closed for several days and when it was re-opened the Liberal administration announced a series of capital controls in order to steer investment into the war effort. In order to restore confidence, the Treasury – and not the Bank – issued £1 and shilling notes. The Bank also suspended gold payments again. Yet again there was a bout of inflation, which peaked at 25% in 1917.[9]

Britain went back on the gold standard briefly in 1925, but came off again in 1931 and the Bank of England has not redeemed pound notes for gold since.

BACK IN FASHION

Printing money in response to a financial crisis therefore has a long and, if not exactly respectable pedigree, then certainly a well-understood one. However, it was not until 1933 that the policy was first given an eloquent rationale. In that year, the economist Irving Fisher coined the expression "debt deflation" to describe the effects of a violent financial crisis, which can lead to fire-sales of assets and a total collapse in demand. It was this, according to Fisher, which led to the 1930s Depression. And the remedy he suggested was the one used in the past: central banks should keep prices rising by printing money.

Fisher's conclusions were endorsed by Milton Friedman in his *Monetary History of the United States* (1963) and his work is much admired by Bank of England Governor Mervyn King, which perhaps explains why he is in the driving seat of this powerful policy in 2009. Fisher was also quoted by Ben Bernanke, now the chairman the US Federal Reserve, in November 2002:[10]

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8 Bizzarely, the best source for the crisis is E M Forster in *Marianne Thornton: A Domestic Biography 1797-1887.* Marianne was the great aunt who brought the novelist up and her brother, Henry, was a partner in Pole, Thornton – a bank at the centre of the crisis. Although just 25 years old, Henry miraculously arranged a £400,000 loan on a Saturday to keep Pole, Thornton going. Sadly, Pole, Thornton sank in the end but the incident is perhaps the origin of modern central banking.

9 Jim O'Donoghue and Louise Goulding, "Consumer Price Inflation Since 1750", *Economic Trends*, ONS, March 2004.

10 www.federalreserve.gov/BOARDDOCS/SPEECHES/2002 /20021121/default.htm

The US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost.

He argued that it should do this to head off a potential depression. Indeed, for Bernanke, Friedman, Fisher et al, the big policy mistake of the 1930s was the failure to print money.

Printing money in 2009

The QE process is essentially circular and goes like this. The Government, via its Debt Management Office, borrows by selling gilts to investors, typically pension funds. The pension funds then sell those gilts, or their existing gilt holdings, to the Bank of England. Only instead of paying cash, the Bank simply credits electronically the reserve accounts the big banks must have deposited with it. So if pension fund A banks at Barclays and sells £50m of gilts, the Barclays account at the Bank of England is credited with the sum and, hey presto! £50m of new money has been printed, at the press of a button. The consequence has been a massive expansion of the Bank's balance sheet, both in terms of liabilities and assets.

QE as currently executed in Britain differs from the equivalent policy in America. The Bank of England (like the Bank of Japan in 2001) has mostly bought up gilts, whereas the US Federal Reserve has also made significant purchases of corporate bonds and other private assets. Adam Posen, the newest member of the Bank's Monetary Policy Committee, says this is because UK markets for corporate bonds, commercial paper and other corporate securities issued by non-banks are "relatively thin", and this limitation "reveals a major long-term structural problem in UK financial markets which could be of potential harm as the UK economy begins to recover."[11]

Chart 2 shows the huge increase in the reserves held at the Bank of England by high street banks while Chart 3 shows the £160 billion loan the Bank of England has made to BEAPFF Ltd to fund QE and its impact on the Bank's balance sheet.

WHAT HAVE BEEN ITS EFFECTS?

There has been little independent analysis of how effective the policy has been. The most authoritative piece has come from the International Monetary Fund.[12] It estimates that QE has reduced the benchmark 10-year interest rate on British Government debt – the yield – by between 40 and 100 basis points or 0.4% to 1%, lowering it to 3.5%.

If anything, this could be an underestimate. In October last year, before the QE policy was being actively discussed, the Government was paying about 2.5% to 3.0% to borrow for two years or so, rising to 5% for 20 years.

But since QE was introduced, the Government pays less than 1% to borrow for two years, rising to just under 4% for 20 years (see Chart 4).

The reduction in gilt yields may not sound like much, but they are now at a near record-low. That means it is currently cheaper for the British Government to borrow than any time for the 300 years for which we have data.

The stock market has moved in tandem with gilts, as investors have reinvested their gains from selling gilts to the Bank in shares. So the yield on the FTSE-100 index, (from company dividends, expressed as a percentage of the total value of the index) is also about 3.5%. By mid-October, that positive move alone had probably added between 600 and 1000 points to the FTSE 100.

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11 "Getting Credit Moving", a speech by Adam Posen, Cass Business School, 26 October 2009.

12 André Meier, *Panacea, curse, or non-event? Unconventional policy in the United Kingdom*, IMF, August 2009.

Chart Two: Bank of England balance sheet liabilities

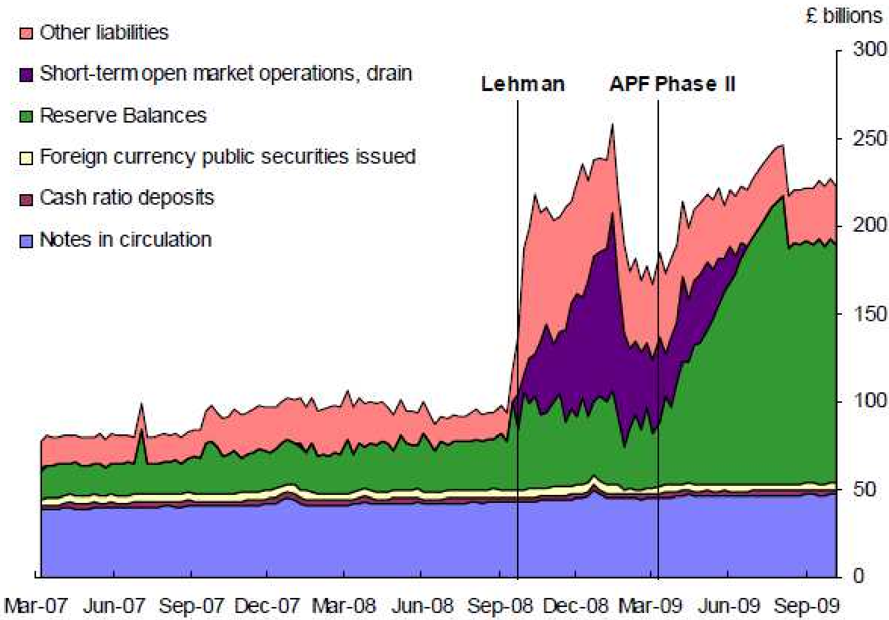
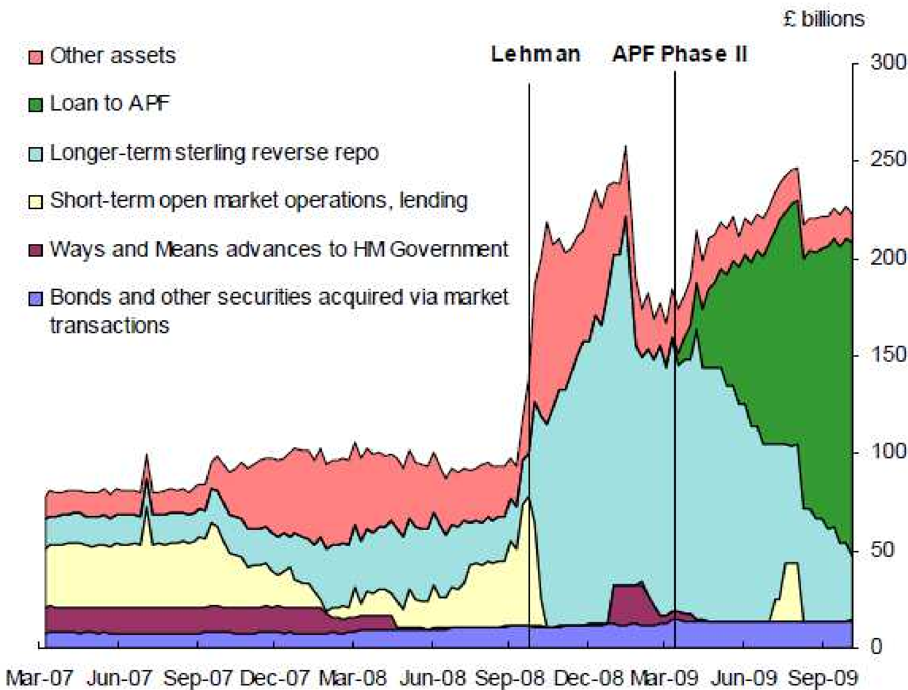


Chart Three: Bank of England balance sheet assets



The buoyancy of the stock market has in turn enhanced confidence and allowed many companies to put their finances on a sounder footing by having rights issues (selling new shares to help pay off their debts). Other companies are also floating on the stock market for the first time or issuing bonds. So far this year, companies have raised £60 billion of capital, compared to £40 billion in 2008.[14]

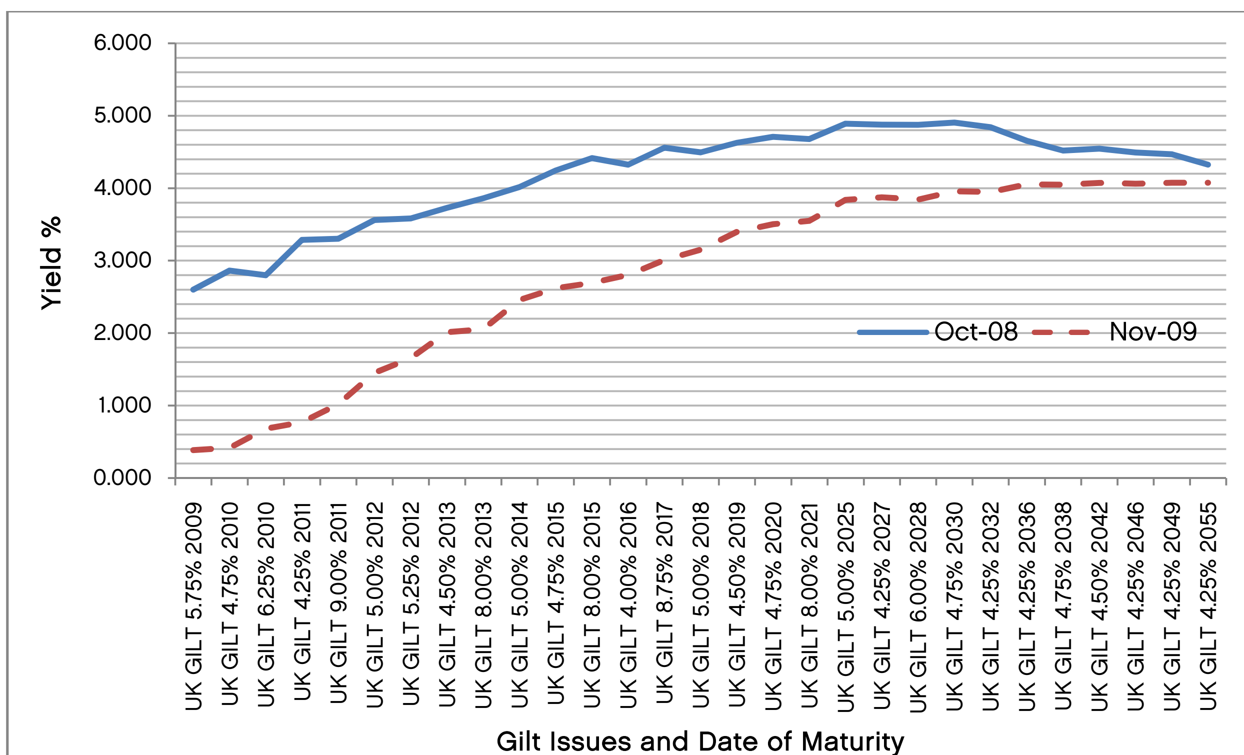
The 10-year gilt yield is perhaps one of the most important numbers in finance as it is used as the benchmark for valuing many projects. Investors know they will get that return at a minimum – assuming the British Government does not default – and therefore use it as the "hurdle rate" for testing whether other projects are worthwhile. A 3.5% yield is extremely low by historical standards and thereby encourages investors who are considering putting money into new investments, whether they be infrastructure, shares or property.

However, on the negative side, actuaries use the 10-year gilt yield as the benchmark for measuring the potential return of assets held by pension funds. So one unfortunate side-effect of the low gilt yields from QE has been a theoretical ballooning of pension deficits. The actuary Lane Clarke and Peacock estimates that cumulative pension deficits for FTSE-100 companies are now a record £96 billion. The return of large pension deficits is a reminder of the distorting effects of QE and has probably contributed to a number of companies closing their final salary pension schemes.

Gilt yields also underpin the annuity market. As a consequence, those retiring now find that their pension pots purchase perhaps the smallest incomes for a generation.

[14] "Quantitative Easing, an interim report", a speech by Charles Bean at the London Society of Chartered Accountants Annual Lunch, 13 October 2009.

Chart Four: How UK Gilt Curves have shifted



Finally, although large company balance sheets have improved, small businesses which cannot tap financial markets and instead rely on bank lending find that conditions remain exceptionally tight. This may be because banks are choosing to hoard their gains from QE in order to repair their balance sheets. The British Bankers Association says that lending to private non-financial corporations fell by £3.9 billion in September and has been contracting at an average £1.2 billion a month over the last six months. Adam Posen says this is one area where there is an uncomfortable parallel with Japan's situation in the 1990s. The Japanese banking system was so weak that banks failed to lend, despite the stimulus provided by the Bank of Japan. This was a problem economists described as "pushing on a string." However, a decade later, lending has recovered and the Bank of Japan now regards its experiment with QE as a qualified success.

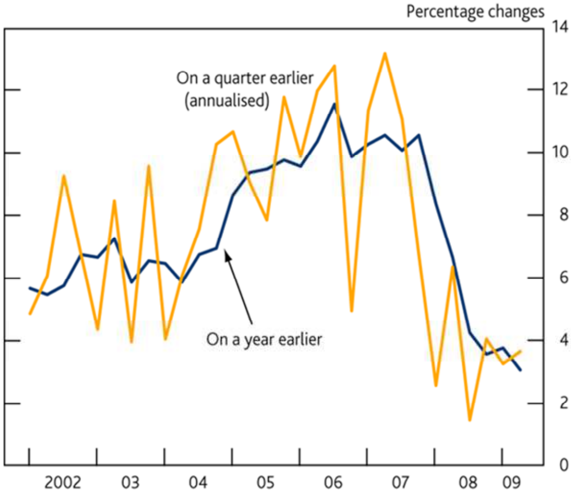
The situation here is serious enough for Posen to claim: "The relative limits in the UK on the availability of non-bank financing for smaller companies may constrain the emergence of a sustainable private-sector led recovery."[15] However, this issue is more correctly a failing of the banking system as opposed to QE itself.

Just how the Bank of England itself measures the effectiveness of the policy is a bit of a mystery, but judging by the minutes of the Monetary Policy Committee, it initially relied on examining the money supply, to see if it has grown or not.

The usual measure of the money supply used by the Bank is broad money, or M4. It is made up of bank accounts, deposits and notes and coins in circulation. However, about 18 months ago, the Bank started to use a new measure, M4X, which strips out "Other Financial Corporations"[16] – the off-balance sheet vehicles used by banks and hedge funds during the boom.

According to M4X, the money supply is hardly moving, growing at just 2% compared to the usual 8% to 10%. For this reason, the monetary policy committee said in August that it wants to expand QE from £150 billion to £175 billion and the Governor Mervyn King even voted for it to be expanded to £200 billion.

Chart 5 Money supply, M4X



But is M4X the right measure of money in these circumstances? Has it understated the true impact of QE? It is perfectly possible that the sums generated by QE have not found their way into the money supply at all, but gone straight into other instruments, such as equities and corporate bonds. After all, on the face of it, it seems pretty odd for the bank to print £170 billion and for none of it to find its way into the money supply.

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[15] Adam Posen, as above.

[16] Intermediate OFCs are: mortgage and housing credit corporations; non-bank credit grantors; bank holding companies; and those carrying out other activities auxiliary to financial intermediation. Banks' business with their related 'other financial intermediaries' is also excluded, based on anecdotal information provided to the Bank by several banks.

If it is true that the money supply has not budged, then maybe QE is not being conducted in the most efficient way. Perhaps, for instance, the Bank should be buying up more commercial bonds as opposed to mostly gilts.

The Bank itself now has misgivings about using the money supply to measure the effectiveness of QE. In September, David Miles, a member of the MPC, gave a speech in which he produced a host of different charts to measure QE's effectiveness.[17] Mr Miles said that the money supply "is not a good measure of success." Instead, he explained that by underpinning a rise in the stock market and in corporate bonds, QE has allowed companies to pay down their bank debts, or to "deleverage", in the jargon.

He said that portfolio managers are selling gilts to the Bank of England, but instead of leaving the proceeds on deposit at virtually zero interest, they look for "substitutes that are more natural places to invest," – that is, shares and corporate bonds. The resulting improvement in balance sheets means that companies are "creating more head room to respond quickly to future investment opportunities by paying down bank debt."

Interestingly, Mr Miles is sanguine about bringing QE to an end. He says that banks are accumulating large reserves at the Bank of England – without giving any figures – which is a good thing because banks must, in future, hold more liquid assets if another crisis is to be avoided. "Further down the road banks may well want to hold more of their liquid assets in gilts and rather less in reserves. This is one way in which QE can naturally roll-off as banks reduce their reserves by buying of gilts from the Bank of England," he said. The FSA has made such an outcome more likely by publishing new liquidity rules for banks,[18] requiring them to hold more liquid assets as a buffer against a future crisis. The FSA has stuck to a narrow definition of liquid assets and this essentially means that banks will have to hold billions of pounds of extra gilts.

The new liquidity rules have been attacked by the British Bankers Association, which said that the rules effectively forced banks to lend to the Government rather than individuals and companies. "These proposals would oblige banks to hold high amounts of government bonds, rather than allowing them to diversify their assets. And self-evidently any money held in these 'liquidity buffers' is money that banks cannot lend to individuals and businesses."

While the BBA is right to point out the risk of so-called crowding out, it misses the essential point that the we should all be extremely grateful if the new liquidity rules allow such a radical policy as QE to end painlessly.

THE RISKS

Despite the successes of QE, there are several identifiable risks. As a matter of logic, the longer the policy goes on, the bigger those risks get. After all, the Bank of England surely cannot buy up the entire national debt and hide it off balance sheet.

First, when QE finishes, it could be interpreted by the markets as an admission that the UK has used all its ammunition in the crisis. In this scenario, the most likely market response would be for investors to sell gilts, causing gilt yields to rise. As the gilt yield is a benchmark used for setting commercial interest rates, such a sell-off could cause long-term interest rates across the economy to rise sharply.

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[17] See David Miles Speech to 14th Northern Ireland Economic Conference in Belfast, September 2009.

[18] www.fsa.gov.uk/pages/Library/Policy/Policy/2009/09_16.shtml

Such a deterioration could be quite sudden, especially if it was accelerated by coinciding with an inflationary shock set off by a boost to demand from QE. There is no sign of this yet. Indeed, you could argue that with the RPI currently falling, the opposite problem, deflation, is more of a threat. But historical experience shows how easy it could be for the Bank to overshoot and to print too much money. The markets certainly believe that Britain is more at risk from an inflationary shock than other major countries.

Second, as the Bank of England is an agency of the Government and its liabilities are indemnified by the Treasury, any loss on the Bank's QE portfolio – potentially running into billions of pounds – will rebound on the National Debt. Indeed, the signs are this is already happening.

QE as a whole is regarded as off balance-sheet by the ONS, but any losses on the portfolio held by BEAPFF Ltd do have to be accounted for. Losses arise, for instance, when the Bank of England pays more than the market price for gilts and corporate bonds. So far, some £14.2 billion has been added to the National Debt in this way.[19]

Charles Bean, deputy Governor of the Bank, has said that these losses are merely notional, because the BEAPFF receives interest payments from the Government.[20]

Third, whatever the short-term economic benefits of QE, confusion over what happens next and growing alarm about the true state of the public finances is already undermining the pound. Some forecasters believe sterling could soon reach parity with the euro. Another big fall in sterling should ideally be avoided, as it could jeopardize the nation's credit rating, further adding to the cost of borrowing from foreign creditors.

The fourth and final risk is political. A side-effect of the policy has been vastly to enhance the power of the Bank of England, by effectively giving it control over fiscal policy. Some might say this is a good thing, given the record of politicians at running the public finances over the years. But we live in a democracy and central banks are not endowed with a monopoly on wisdom. The usual process for approving Government spending and borrowing is via Parliament. QE effectively circumvents that process by giving a generous interpretation to the terms of the Bank of England Act.

WHAT HAPPENED LAST TIME

The Bank is, by far, the nation's biggest creditor and QE gives the Governor and the monetary policy committee (which he chairs) a potential veto over every detail of fiscal policy and, by extension, over almost everything that the current or next Government says or does. This is an awesome power indeed and one which, so far, the Bank and the Treasury have preferred is mostly deployed out of the public eye.

Furthermore, it cannot be right that the Bank is the judge of how effective the policy is. In 1797, 1825 and 1914 the Government and Parliament were in the driving seat of the policy. In 2009, by contrast, there has simply been a couple of exchanges of letters between the Governor and the chancellor, Alistair Darling. Yet those exchanges have given the Bank huge powers, powers which were never mentioned explicitly in the Bank of England Act.

The decision to print money in 1797 was taken by the Government, the executive, via an Order in

[19] See ONS, *Public Sector Finances*, August 2009, background note 6,.

[20] See Charles Bean, above.

Council signed by the King who was expressly called back from Windsor to an emergency meeting of the Privy Council. It was followed by fierce Parliamentary debates, culminating in the Restriction Act. During these debates the Whig MP Richard Sheridan coined the term "old lady of Threadneedle Street" to describe the Bank of England and Gillray published a famous cartoon of it being ravished by Pitt.

There were also two Parliamentary inquiries. The first was in secret. The second, the so-called Bullion Committee, argued forcefully that printing money had devalued sterling and caused inflation. It was influenced by the economist David Ricardo and its members included the writer Francis Horner and Tory MP William Huskisson.

The resulting Bullion Report is celebrated as one of the founding documents of monetary economics.[21] The Committee took evidence from 29 witnesses including a "a very eminent Continental Merchant" who declined to be named but was thought to be Nathan Meyer Rothschild. The Bullionists, as the authors became known, blamed the decline of sterling on foreign exchanges on the "excessive quantity of circulating medium". The report was reprinted many times and its arguments gained momentum in the subsequent decade. This proved decisive when Restriction was finally abandoned in 1819.

In 1825 it was Lord Liverpool who gave the Bank permission to use its lender of last resort facility. And in 1914, the Treasury itself printed the new notes, not the Bank, much to the chagrin of the then Governor, Lord Cunliffe.

[21] To give it its full name: The Select Committee to enquire into the cause of the high price of gold bullion, and to take into consideration the state of the circulating medium and of the exchanges between Great Britain and foreign parts.

BANK OF ENGLAND 1, PARLIAMENT 0

In 2009, there has been the smoothest possible co-operation between the Bank and the Treasury and almost no Parliamentary scrutiny. Furthermore, the policy is ultimately in the control of the Bank of England and neither ministers nor Parliament have had much say. In his party conference speech, David Cameron said that printing money could be inflationary and "will have to stop". But he may not have the power to do that, if he were Prime Minister. That authority apparently resides with the Bank of England.

There has not been any new primary legislation specifically to authorise QE. The only secondary legislation has been a statutory instrument, exempting BEAPFF Ltd from the Financial Services Authority's authorization regime. The instrument was rushed through on 29 January 2009, in less than the usual 21 days. As the House of Lords Statutory Instruments Committee subsequently commented:

> *We are disappointed that HM Treasury's failure to identify more promptly the need for this instrument has reduced the opportunity for pre-commencement Parliamentary scrutiny.*

Mervyn King told the Treasury Select Committee in November 2008 (before QE got underway), that the reason for the Bank's pre-eminence is that QE is really an aspect of monetary policy which is the special responsibility of the Bank's monetary policy committee. He said:

> *It is clear that the Bank of England Act gives the authority to set decisions on monetary policy to the MPC, and monetary policy includes the Bank Rate but is not restricted to it… .So there would need, if we got to that point [ie, QE], to be close co-operation between the Treasury and the Bank, but the decision-making power as to what the Bank would do would still rest with the MPC.*

In Mr King's eyes, therefore, it is up to him and the MPC when and how QE should end. His legal authority for saying this is the Bank of England Act. But it is not as clear as he claims. Nowhere does the Act mention QE or any policy like it and in practice, as the Bank is underwritten by the Treasury, the chancellor does have some influence, but the legal position is not entirely clear.

The scale of QE is also, we are told, almost exclusively a matter for the Bank and we only know of plans to increase its scale to £175 billion through the monthly minutes of the monetary policy committee. How unusual for Parliament, the arbiter of the nation's finances, not to have had a say.

One interesting detail is that the working capital for BEAPFF actually came in the form of a £810m loan from the Debt Management Office, the agency which issues debt on behalf of the Treasury[22] – a highly irregular arrangement. Was it Parliament's intention when it approved the Government's borrowing, that some of it should be used to fund an off-balance sheet vehicle to fund that very borrowing?

WHAT NEEDS TO BE DONE

Quantitative Easing must be thoroughly scrutinised by Parliament. Politicians of all parties need to do a better job of bringing it into the public domain. Far from rubber-stamping an increase in QE – as the Governor would apparently like – politicians have a common interest and a duty to examine QE, to bring it into the daylight and to consider the outlines of an exit strategy before the next election.

There are two reasons for this. First, the electorate needs to be able to make its choice at the next election with all the facts in front of it. One unfortunate consequence of QE has been the circumvention of the usual public spending scrutiny process, allowing politicians to escape – at least for the short term – the consequences of the true state of the public finances.

Second, a public debate on QE will have the effect of giving a democratic mandate for the policy which should, in the long term, improve market confidence. As it stands, there is a risk that voters will suddenly wake up to the effects of this important policy and turn against it when they realize the potential risks. That would almost certainly happen if the Bank overdoes things and sets off a bout of inflation or causes a spike in interest rates.

Parliament should therefore form a special Select Committee, of equivalent status to the Bullion Committee of 1810, whose remit would be to take evidence from experts, including the Bank of England, and to review the policy and its implementation. It should have the authority and capacity to do this regularly, on a quarterly basis. In addition, it should be able to convene on an *ad hoc* basis in order to respond quickly to signs of any emerging difficulty. The Bank of England already provides a quarterly review of QE on its website, but the Governor should be expected to report on any aspect of QE at the command of the Select Committee.

This would help to bring the facts into the public domain and to keep the Bank on its toes. It is, for instance, surprising that the Bank is paying above market prices for the gilts it purchases, thereby incurring a loss for the public finances.

Furthermore, by creating an orderly political process around QE, a Select Committee would be likely to ensure that this emergency policy is not inadvertently extended for 21 years, as happened in the past.

[22] Note 31, Bank of England Accounts 2009.

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THE AUTHOR

George Trefgarne was Economics Editor at *The Daily Telegraph* from 2000 to 2004 and now works in financial communications.

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