Bank of England response to the Lords Economic Affairs Committee's report on Quantitative Easing

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Contents

Chapter 1	Introduction	3
Chapter 2	Bank of England independence	5
Chapter 3	The effects of Quantitative Easing	9
Chapter 4	Communicating Quantitative Easing decisions	14
Chapter 5	The Monetary Policy Committee’s Strategy for tightening monetary policy	16

Chapter 1

Introduction

1.1 The Bank of England sets monetary policy to maintain price stability and, subject to that, to support the economic policy of Her Majesty's Government (HMG), including its objectives for growth and employment. This objective is set by Parliament and the Bank was granted operational independence to meet it in the Bank of England Act 1998 (the Act).[1] As required in statute, all monetary policy decisions are taken with that objective in mind.

1.2 Underpinning the United Kingdom's monetary policy regime is public accountability. For monetary policy to be effective in promoting the good of the people of the United Kingdom, it is important that the policies of the Bank are, and are seen to be, independent and credible. Parliamentary scrutiny plays a central role in maintaining that credibility.

1.3 In response to the financial crisis of 2007-08, the MPC cut rates sharply, bringing them close to their effective lower bound. By early 2009, with additional monetary support needed and little scope to reduce short-term interest rates further to stimulate demand in the economy, the Bank introduced asset purchases, financed by the creation of central bank reserves, commonly known as quantitative easing or QE. These asset purchases have since become part of the Bank's monetary policy toolkit.

1.4 The Bank has launched several further rounds of asset purchases over the past decade as the UK economy has faced new shocks – the euro-area crisis in 2011, the vote to leave the European Union in 2016 and Covid-19 in 2020 (Figure 1). In November 2020, the Monetary Policy Committee (MPC) announced that it would expand its programme of asset purchases by a further £150 billion. This latest programme of purchases is expected to be completed later this year, by which time the total stock of purchased assets will reach £895 billion, around 40% of annual UK GDP. This will comprise £875 billion of government bonds and £20 billion of corporate bonds.

1.5 QE has become larger in size and been used more frequently than initially expected when it was introduced in 2009. This has been true elsewhere in the world, too. Asset-purchase programmes have been extensively used in the US, euro area and Japan in the past decade – currently totalling around 30%, 32% and 106% of GDP respectively. And several other advanced and developing economies have also used QE in response to Covid (IMF (2021)).

[1] Under the Act, the Chancellor of the Exchequer is required to write to the Bank, at least annually, specifying, for the purposes of its monetary policy objective, what price stability is to be taken to consist of, and what the economic policy of HMG is to be taken to be.

1.6 QE has become a more established part of the MPC's monetary toolkit for several reasons. First, and as detailed above, subsequent shocks have necessitated additional monetary stimulus to prevent these otherwise deflationary events from causing a greater degree of economic instability and resulting in inflation that is too low to be consistent with price stability targets. In support of this, and in contrast to Bank Rate which typically has its greatest effect on short-term interest rates, QE has played an important role in reducing longer-term interest rates and thus reducing borrowing costs for household and companies. Second, the MPC has been limited in its ability to provide the necessary monetary stimulus via its more conventional control of Bank Rate. This reflects the proximity of Bank Rate to what has been considered to be its lower bound and, more fundamentally, a decline in the so-called "equilibrium" rate of interest (the rate at which inflation is stable). With the equilibrium interest rate expected to remain low, the MPC is more likely to need to use QE to impart stimulus when Bank Rate falls close to its lower bound. And third, QE has proven particularly effective as a tool for calming the market disruption that has accompanied some of the shocks faced by the UK economy since 2009. In doing so, it has helped to avoid an impairing of the monetary transmission mechanism that might otherwise have made meeting the Bank's inflation target more difficult.

1.7 The Economic Affairs Committee (EAC)'s report raises a number of observations and recommendations with respect to the Bank's Quantitative Easing policy. For the purposes of this response, these have been grouped under the headings of Bank of England Independence, the effects of Quantitative Easing, Communicating Quantitative Easing decisions, and the Monetary Policy Committee's strategy for tightening monetary policy. Each of these is addressed in turn over the sections that follow. HM Treasury will respond separately to the EAC's conclusions.

1.8 Earlier this year, the Bank's Independent Evaluation Office (IEO) published its own report on Quantitative Easing. That report considered many of the issues raised by the EAC. The chapters that follow draw from the IEO report where appropriate, as well as the Bank's response to it.

Chapter 2

Bank of England independence

Page 55 paragraph 1: While the UK can be proud of the economic credibility of the Bank of England, this credibility rests on the strength of the Bank's reputation for operational independence from political decision-making in the pursuit of price stability. This reputation is fragile, and it will be difficult to regain if lost. So far, the Bank – and indeed other central banks which have used quantitative easing – have retained the confidence of international markets.

Page 56 paragraph 9: There is a widespread perception, including among large institutional investors in Government debt, that financing the Government's deficit was a significant reason for quantitative easing during the Covid-19 pandemic. By its nature, quantitative easing lowers the cost of Government borrowing; this makes it difficult to disentangle monetary policy and deficit financing.

Page 56 paragraph 10: Perceptions that the Bank of England had acted primarily to finance the Government's deficit were entrenched because the Bank of England's gilt purchases aligned closely with the speed of issuance by HM Treasury. Furthermore, statements made by the Governor in May and June 2020 on how quantitative easing helped the Government to borrow lacked clarity and were likely to have added to the perception that recent rounds of asset purchases were at least partially motivated to finance the Government's fiscal policy. If this perception continues to spread, the Bank of England's ability to control inflation and maintain financial stability could be undermined significantly.

Page 57 paragraph 15: The growth of quantitative easing has increased the sensitivity of debt interest spending to changes in short-term interest rates. We are concerned that if inflation rises, the Bank may come under political pressure to not raise interest rates to control inflation because the risk to the public finances and debt sustainability would have increased significantly.

2.1 The independence of the central bank is of paramount importance to the effectiveness of the monetary regime. Monetary policy is at its most effective when its objectives are clear and widely understood and when monetary policy decisions are – and perceived to be – independent of political influence.

2.2 Consistent with this, considerable safeguards were built into the UK's monetary policy framework when the Bank was granted operational independence in 1997/8. These include the following:

a. Legislation that enshrines the Bank's operational independence and stipulates in law that the primary objective of monetary policy is to achieve price stability.

b. A remit given to the Bank in public each year by the Chancellor describing what is meant by price stability and setting out the inflation target in more detail.

c. That monetary policy is formulated by a nine-member Committee, including four 'external' MPC members appointed for their expertise in the subject, with each member having a single vote.

d. Individual accountability to Parliament and the public of each member for their decisions, involving frequent public communications and public appearances of MPC members before both the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee

e. A legal requirement to publish a statement of what the MPC has decided and minutes of the MPC meeting, including the votes of each member at each MPC meeting.

f. A legal requirement for the Bank to publish a quarterly report, approved by the MPC, containing a review of the monetary policy decisions, an assessment of developments in inflation in the economy and an indication of the expected approach to meeting the Bank's monetary policy objective. This is satisfied by the *Monetary Policy Report* and before it the *Inflation Report.*

g. As specified in the MPC remit, an open letter procedure, in the event of inflation moving more than one percentage point away from its target, requiring the Governor to explain in writing why inflation has moved away from the target, the policy action that the MPC is taking in response, the horizon over which the MPC judges it is appropriate to return inflation to the target, the trade-off that has been made with regard to inflation and output variability in determining the scale and duration of any expected deviation of inflation from the target and how that proposed action is consistent with the monetary policy objective set out in the MPC's remit and legislation.

2.3 These arrangements provide the same safeguards today as they did in 1997. They protect the independence of all monetary policy decisions – whether regarding Bank Rate or the asset purchase programme. And they legally mandate that monetary policy actions must be carried out only in pursuit of the objectives set out in the Act 1998 and MPC remit. That is every bit as binding on asset purchase decisions as it is on Bank Rate decisions.

2.4 While monetary policy operations have always involved to some extent transactions in government bonds, QE is different because it involves outright purchases of government bonds. This necessitated additional governance arrangements – again intended to safeguard the independence of monetary policy

decisions – established in 2009 through an exchange of letters between the Chancellor and Governor:[2]

a. The Bank conducts QE purchases through the Bank of England Asset Purchase Facility Fund Limited (BEAPFF), a subsidiary of the Bank, which is fully indemnified by HM Treasury (HMT). The indemnity is there to guarantee the integrity of the Bank of England's balance sheet.

b. The exchange of letters expressly acknowledges that the Bank's QE purchases in secondary government bond (gilt) markets should not directly affect the gilt issuance strategy pursued by the Debt Management Office (DMO) in primary bond markets.

2.5 As required in statute, all monetary policy decisions are taken with the objective of price stability in mind, and no other – regardless of developments in government bond issuance.

2.6 Notwithstanding this, as the EAC has noted, there has been some commentary that the objective of the Bank's asset purchases has been to ensure that financing conditions remain favourable for the government specifically. This is incorrect. The concurrent easing of monetary policy and increased debt issuance by the government is entirely consistent with fiscal and monetary policymakers independently pursuing their objectives in response to a weaker economy. It is precisely what one would have expected to observe given the prevailing economic conditions.

2.7 The suggestion that there is a 'widespread perception' that the MPC's asset purchases have been aimed at financing the government deficit is unsubstantiated. Were there a widespread perception that the MPC was seeking to lower the government's financing costs by maintaining a more accommodative stance of monetary policy than warranted by its inflation target, then expectations of future inflation would begin to drift upwards, and inflation risk premia in sterling assets would increase causing gilt yields to rise. This has not happened, and as discussed in the 'In Focus' section of the *August Monetary Policy Report,* indicators of medium-term expectations of future inflation have remained well anchored.

[2] See https://www.bankofengland.co.uk/letter/2009/apf-letter-march-2009

Chapter 3

The effects of quantitative easing

Page 55 paragraph 2: Quantitative easing is particularly effective as a tool to stabilise financial markets. There is strong evidence that shows it is an effective monetary policy tool when it is deployed at times of crises, when financial markets are dysfunctional or in distress.

Page 55 paragraph 3: While the evidence on quantitative easing's economic impact is mixed, we note that central bank research tends to show quantitative easing in a more positive light than the academic literature. We conclude, on balance, that the evidence shows quantitative easing has had a limited impact on growth and aggregate demand over the last decade. To stimulate economic growth and aggregate demand, quantitative easing is reliant on a series of transmission mechanisms that operate primarily in and through financial markets. There is limited evidence to suggest that these increase bank lending or investment, or boost consumer spending by wealthy asset holders.

Page 55 paragraphs 4-6: The Bank of England's understanding of quantitative easing's effects and its transmission mechanisms are far from complete more than a decade on from the policy's introduction. Given that quantitative easing has increasingly become a conventional monetary policy tool, we recommend that the Bank of England prioritises research on:

- **The effectiveness of quantitative easing's transmission mechanisms into the real economy;**
- **The effect of quantitative easing on inflation and how it helps the Bank of England to meet its inflation target; and**
- **The impact that quantitative easing has had on economic growth and employment.**

Quantitative easing is an imperfect policy tool. Its use in 2009, in conjunction with expansionary fiscal policy, prevented a recurrence of the Great Depression and in so doing mitigated the growth of inequalities that evidence shows are exacerbated and deepened during economic downturns.

However, the mechanisms through which quantitative easing effectively stabilised the financial system following the global financial crisis have benefited wealth asset holders disproportionately by artificially inflating asset prices. On balance we conclude that the evidence shows that quantitative easing has exacerbated wealth inequalities.

Page 58 paragraph 22: Trade-offs that may have been acceptable in a policy designed as a temporary measure have become increasingly controversial as the programme has persisted. While the scale of quantitative easing has increased substantially over the last decade, there has not been a corresponding increase in the Bank of England's understanding of the policy's effects on the economy in the short, medium and long term. While we recognise that quantitative easing has prevented economic crises from spiralling downward, its effect on inflation and output is uncertain, and it may also have increased wealth inequality by raising the price of certain assets, benefitting those who own them. The Bank of England and HM Treasury must do more to acknowledge these effects.

Economic and financial market impact of QE

3.1 QE provides monetary stimulus to help the MPC meet its inflation target. In practice, QE involves purchasing assets from the private sector, financed by the creation of central bank reserves. Central bank purchases push up the price of these assets which in turn reduce the yield or 'interest rate' that holders of these assets receive. The lower interest rates on UK government and corporate bonds then feed through to lower interest rates on loans for households and businesses. Lower interest rates are intended to encourage consumption and investment, boosting economic activity and employment and putting upward pressure on prices.

3.2 As the EAC notes, the first stage of transmission for QE, as with all monetary policies, operates through financial markets. A number of transmission channels through which QE operates have been identified in the literature. There is a range of opinions, however, about which channels are most important, and indeed their relative importance is likely to vary over time. These channels include:

a. Portfolio rebalancing: this captures channels that work through imperfect asset substitutability, including scarcity and duration, both of which are likely to operate by influencing term premia.

    i. Scarcity effects emerge because central bank purchases may create a shortage in the asset being purchased, for example, if investors have a preferred habitat in that particular asset. By creating scarcity in an asset, central bank purchases push up its price. While in theory other investors might arbitrage these markets, in practice their ability or willingness to do so is limited by capital and other constraints, particularly in conditions of heightened risk aversion.

    ii. Duration effects emerge as central bank purchases reduce the amount of outstanding bond duration in the market. In general the additional interest rate risk implied by holding additional duration leads to investors requiring a higher term premium in

compensation. By reducing the amount of outstanding duration, central bank purchases should lower the term premium and in the process flatten the yield curve. This effect will again depend on arbitrageurs being risk averse or capital constrained, and so the effects through this channel are likely to be larger in stressed market conditions.

b. Signalling: wherein quantitative easing is seen to provide information that the central bank intends to maintain an accommodative monetary policy stance for some time. This lowers expected future policy rates and thereby flattens the yield curve.

c. Liquidity premia: the presence of a large purchaser such as the central bank can enhance market liquidity and thereby lower any liquidity premia demanded by investors. This is likely to be particularly important when markets are at risk of becoming impaired and when liquidity would otherwise deteriorate.

3.3 The impact of QE has been the subject of extensive and growing academic and central bank literature, to which the Bank has made significant contributions. The most recent review of the evidence base by Bank staff was published in an accompanying paper alongside Governor Andrew Bailey's speech at the Jackson Hole Policy Symposium in August 2020 (Bailey et al (2020)).

3.4 Before turning to this evidence base, it should be noted that there are inherent difficulties in measuring the effects of QE and its transmission channels. There is unavoidably a smaller body of evidence than for changes in the short-term interest rate. Despite this, the Bank is committed to continuing to invest in its understanding of QE. The Bank of England Agenda for Research includes specific priority topics relevant to QE, consistent with the EAC's recommendation to prioritise further research into the impact and effectiveness of QE.

3.5 The empirical literature covers two main areas: the impact of QE on financial conditions, and its impact on macro-economic variables like GDP and inflation.

3.6 Consistent with the EAC's conclusion that QE is particularly effective as a tool for stabilising financial markets, there is a broad consensus in the literature that QE programmes have successfully lowered longer-term bond yields and eased financial conditions, in line with the intended transmission mechanisms of the policy, although its impact has varied. Collating results from 28 studies across the US, UK, euro area, Japan and Sweden, Gagnon (2016) finds that a QE intervention normalised to 10 per cent of GDP is associated with a median reduction in 10-year government bond yields of around 50 basis points. For the UK, the impact of the first quantitative easing programme announced in 2009 (QE1) on gilt yields was estimated to be around 100 basis points (Joyce et al (2012)), while estimates of the second (QE2, announced in 2011) and third (QE3, announced in 2012) programmes were thought

to be somewhat lower. A later study (Haldane *et al* (2016)) found that for the August 2016 package (QE4), the response of gilt yields was stronger than in QE2 and QE3, and closer to those of the first phase of purchases (QE1).

3.7 While the macro-economic effects of QE are of key interest to policymakers, they have been less extensively studied in the literature. This is unsurprising. Because there are lags involved, as the effects almost certainly depend on the prevailing state of the economy (they are "state-contingent") and as the counterfactual – ie the level of interest rates in the absence of QE – is hard to establish, it is not possible to measure the macro-economic impacts with any great precision. That said, what literature there is does not support the EAC's conclusion that quantitative easing has had a limited impact on growth and aggregate demand over the last decade. Indeed, were it true that the impact of QE on growth and aggregate demand had been limited, then QE could not have served to prevent a recurrence of the Great Depression as the EAC has separately concluded.

3.8 In a survey of 25 studies of the macroeconomic impact of QE across countries, CGFS (2019) finds positive effects overall on both output and inflation, in the range of 0-4 percentage points. For the UK, work by Bank of England economists suggested that the initial £200 billion of QE in the UK may have pushed up on the level of GDP by a peak of 1.5%-2% and on inflation by 0.75%-1.5% (Joyce, Tong and Woods (2011)). Later work by Weale and Wieladek (2016) found that both the US and UK's QE programmes raised GDP materially. Haldane *et al* (2016) found that QE programmes in the US and UK appear to have had both a positive and significant impact on activity and inflation.

3.9 The experience of QE1-4, and the latest round of QE since 2020, has reiterated the state contingent impact of QE. In line with the EAC's conclusion, QE may be particularly effective as a monetary policy tool when deployed at a time of fragile economic conditions and market dysfunction, such as that seen in 2020, and has helped to prevent a recurrence of the market instability that has accompanied earlier economic crises such as the global financial crisis of 2007-08.

3.10 The Bank's Independent Evaluation Office has separately recommended that the Bank provide an update on its latest collective thinking on QE and proactively foster external engagement with that. The Bank intends to publish a document summarising its latest thinking on QE, taking the impact of the latest round of asset purchases in response to Covid into account.

<u>Distributional effects of QE</u>

3.11 Turning to the potential distributional effects of QE, the Bank acknowledges that this has been an area of contention in the public debate. Given the multiple channels of transmission for QE, its effects will generally differ between individuals depending on their asset holdings, debt position and employment. These distributional effects are inherently difficult to measure and to disentangle from other

factors. QE has also been implemented against the backdrop of certain longer-term structural changes in the economy, which have lowered the equilibrium interest rate. These trends also have implications for asset prices and distributional outcomes.

3.12 It is important that in any discussion of the distributional effects of QE, the asset price effects are weighed up against the effects of monetary policy on employment outcomes and wages in the economy. The public commentary on the distributional effects of QE has tended to focus more on the potential asset price effects, without considering the extent to which the policy may have improved incomes and employment outcomes.

3.13 Standard measures of the distribution of income and wealth have been broadly stable in the recent past. For example, the Gini coefficient of income inequality has seen little change over the past two decades in the UK, having fallen since the 2009 financial crisis (Chart 1). The Gini coefficient of total wealth inequality has also been broadly unchanged over the past decade.

3.14 A number of studies have sought to quantify the distributional effects of QE more precisely. The results of these studies are mixed (IMF IEO (2019)). For the UK, previous Bank staff analysis has found the impact of monetary policy on wealth and income inequality to have been limited, with similar percentage impacts on measured household income and wealth across the distributions (Bunn, Pugh and Yeates (2018)).

3.15 Some commentators have drawn attention to the unequal absolute impact, in cash terms, of quantitative easing on households across the wealth distribution. The Bank acknowledges that, consistent with monetary policy having a similar relative impact on households across the income and wealth distributions, the absolute impact will have been more varied.

3.16 For example, if asset prices rose uniformly by 10% in response to central bank purchases, a bondholder with £100 of bonds would see the value of those assets increase by £10, whereas a bondholder with £1000 of bonds would see the value of their assets increase by £100. This is the same for movements in Bank rate, where an increase in interest rates will see larger cash returns for those with more savings. So this does not mean that QE has benefited asset holders disproportionately as the EAC conclude; rather it has benefited them in proportion to their asset holdings. Such effects reflect the pre-existing disparities in the distribution of wealth and income across households.

Chapter 4

Communicating Quantitative Easing decisions

Page 56 paragraph 7: The Bank has not adequately engaged with the debate about the trade-offs created by sustained quantitative easing. We heard that it has been "defensive" about the extent to which quantitative easing has exacerbated inequalities. The Bank should publish an accessible overview of the distributional effects of quantitative easing which includes a clear outline of the range of views as well as the Bank's view.

Page 56 paragraph 11: The level of detail published by the Bank of England on how quantitative easing will affect the economy is not sufficient to enable Parliament and the public to hold it to account. This has bred distrust. The Bank of England should be more open about its "assessment processes" for calculating the amount of asset purchases needed to achieve a stated objective. In its public communications, including Monetary Policy Committee minutes, the Bank should publish its assumptions, along with its assessment processes and analyse the effect of quantitative easing at each stage of the programme and examine the extent to which it has achieved the Bank of England's stated targets.

Page 58 paragraph 21: When quantitative easing was introduced it was envisaged that it would support the UK economy after a sharp fall in aggregate demand following the 2008-09 financial crisis. However, over the last decade it has been deployed in various circumstances quite different from those of 2009 to tackle a range of different problems. This has had a ratchet effect, whereby the scale of quantitative easing has been increased repeatedly, with no subsequent attempts to reverse it. This has only served to exacerbate the challenges involved in unwinding the policy. The Bank insists that quantitative easing has been an essential response to extraordinary and fast-moving events and always in line with its price stability mandate. However, the effects of quantitative easing remain poorly understood and in recent years, particularly during the Covid-19 pandemic, the Bank has struggled to explain why it was the appropriate response to particular economic circumstances.

Page 58 paragraph 23: Quantitative easing has also made Bank of England and HM Treasury policymaking more interdependent, blurring monetary and fiscal policy, and this has started to erode the perception that the Bank has acted wholly independently of political considerations. We are concerned that scepticism of the Bank's started reasons for quantitative easing grew significantly during the Covid-19 pandemic, when many market participants said that they believed the Bank of England had used quantitative easing

primarily to finance the government's deficit spending. If such sentiments continue to spread, the effectiveness of the Bank's policies will be threatened severely. A reappraisal of how the Bank communicates its reasons for quantitative easing is needed urgently, as is the need for the Bank to provide a way for the public and Parliament to judge the success of the programme to ensure that it can be held properly to account for its decisions.

4.1 The Bank's policy transparency and communications to explain its policy decisions are critical to ensure public accountability. The Bank fully recognises that given QE's role as a core part of the monetary policy toolkit, building the public's trust and understanding of the tool is important for its mission.

4.2 The Bank acknowledges that QE is a complicated policy instrument, and one which presents a greater communications challenge than movements in Bank Rate. The volatile economic environment, including the unprecedented reduction in activity, that followed the outbreak of Covid-19 made this challenge even greater.

4.3 Decisions on quantitative easing are made with reference to the inflation target. In determining the appropriate amount of quantitative easing, the MPC reviews the quarterly *Monetary Policy Report* forecast and considers what level of asset purchases may be necessary to take inflation to target over the course of the forecast horizon. As noted earlier, the Bank intends to publish a document summarising its latest thinking on QE, taking the impact of the latest round of asset purchases in response to Covid into account.

4.4 Moreover, it is the MPC, rather than the Bank of England, that is responsible for monetary policy decisions. And as set out in Chapter 2, a host of safeguards govern the UK's monetary policy framework with members of the MPC individually accountable to Parliament and the public for their decisions. Monetary policy decisions are made with reference to the inflation target. The efficacy of these decisions is best judged, therefore, by the extent to which they have succeeded in delivering at target inflation.

4.5 As noted and discussed in more detail in Chapter 3, the Bank recognises that the potential distributional effects of QE have been a contentious issue. And the Bank acknowledges that there are a range of views on this topic, without a clear consensus. The Bank's view is set out in Chapter 3. This view will be updated as new evidence becomes available.

4.6 The Bank's Independent Evaluation Office has separately recommended that the Bank develop more accessible communications on QE. In response, the Bank has committed to publishing a set of responses to frequently asked questions on QE to support the Bank's public understanding work. The Bank has also committed to expanding the set of communications on QE.

4.7 More broadly, drawing lessons from its experience with QE, the Bank has committed to taking a more structured approach to explaining any new monetary policy tool to stakeholders. This will include communications to support the launch of any new tool.

Chapter 5

The Monetary Policy Committee’s Strategy for tightening monetary policy

Page 57 paragraph 13: Quantitative easing’s precise effect on inflation is unclear, and the magnitude of recent quantitative easing on future inflation has not yet been established. However, we heard that the latest round of quantitative easing could have an inflationary effect as it coincides with substantial Government spending, bottlenecks in supply, and a recovery in demand after the Covid-19 pandemic.

Page 57 paragraph 14: There is a debate about the extent to which renewed inflationary pressures will be sustained over the medium to long term. We heard that the Bank’s response to sustained inflationary pressure will be a test of its independence. While the evidence is mixed, there appear to be short-term price rises across a series of indicators. Central banks in advanced economies appear to see the risks of inflation in terms of a transitory, rather than a more long-lasting problem. We recommend that the Bank of England clarify what it means by ‘transitory’ inflation, share its analyses, and demonstrates that it has a plan to keep inflation in check if its forecasts prove to be incorrect.

Page 58 paragraph 18: There is an increasing risk that central banks are facing a “no-exit paradigm” from quantitative easing. No central bank has managed successfully to reverse its asset purchases over the medium to long-term, and the key issue facing central banks as they look to halt or reverse quantitative easing is whether it will trigger panic in financial markets that spills over into the real economy.

Page 58 paragraph 19: It is not clear whether the Bank of England intends to raise interest rates or unwind quantitative easing first when policy is tightened. The Governor told us that the Bank of England is reviewing the order in which it intends to tighten policy but would not commit to publishing a roadmap. The rationale for reversing the order in which policy is tightened is yet to be fully explained, and we are concerned that the Bank does not appear to have a clear plan for tightening policy. This is concerning considering the renewed debate about inflationary pressures.

Page 58 paragraph 20: The Bank of England needs to set out a short-term plan for restoring policy to sustainable levels. We recommend that it expedites the review as a matter of urgency. As part of the review, the Bank should outline a roadmap which demonstrates how it intends to unwind quantitative easing in different economic scenarios.

Page 59 paragraph 24: Finally, we are concerned that the scale of quantitative easing exposes the Bank of England to political pressure not to raise interest rates if rising inflation does not prove to be short-term as is forecast by the Bank. The Bank must define more clearly what it means when it states that rising inflation will be 'transitory'; and it must explain in more detail why it is appropriate to continue with previously announced asset purchases when the economy is growing and inflation is rising at a faster rate than the Bank expected. The design of the quantitative easing programme and the size of the Bank's balance sheet – now equivalent to 40% of GDP – has increased the sensitivity of the public finances to a substantial rise in debt servicing costs if the Bank needs to raise interest rates to control inflation. This will test the Bank's independence. If it does not respond to the inflation threat early enough, it may be substantially more difficult for the Bank to curb it later. Failure to pass this test would damage hard won trust in the Bank of England's ability to achieve its mandate.

Developments in inflation

5.1 The MPC routinely and regularly sets out its view of inflation prospects in its quarterly Monetary Policy Report and in speeches by individual MPC members. As set out in the August *Monetary Policy Report*, CPI inflation has risen markedly in recent months, and as of August 2021 stands at 3.2%, above the MPC's target. A detailed exposition of the Bank's view of the developments in, and trajectory for, inflation was set out in the 'In focus' section of the August report. And as explained in the minutes of its August meeting, the MPC's view is that the recent rise in inflation, while likely to continue over the short term, is likely to be transitory.

5.2 Some of the recent rise in inflation reflects base effects as prices are compared against the low levels that prevailed early in the pandemic, as well as subsequent increases in energy prices. But it also reflects strong global demand for goods, supply shortages for some specific products, and increases in shipping costs.

5.3 Reflecting these price pressures, CPI inflation is expected to rise materially further in the near term to around 4%. Around half of this increase is accounted for by the direct effects of higher energy prices. Goods inflation is also expected to rise further. And as the spare capacity opened up by the pandemic is eroded, a small margin of excess demand is expected to emerge adding a further degree of upward pressure on CPI inflation.

5.4 Above-target CPI inflation is likely to be transitory. Unless energy prices continue to rise, their effect on inflation will fade after a year or so. Goods inflation is also expected to decline, as global demand rebalances and supply shortages ease. And although, as the EAC notes, the economy is growing, this is not expected to translate into significant excess demand as supply and demand are expected to

return broadly to balance over the MPC's 3-year forecast period. As a result inflation is expected to fall back later in the forecast period, close to the 2% target.

5.5 At its August meeting, MPC members reiterated that in judging the appropriate stance of monetary policy, the MPC would, as always, focus on the medium-term prospects for inflation, including medium-term inflation expectations, rather than factors that were likely to be transient. A majority of MPC members judged that the existing stance of monetary policy, which included the previously announced £150bn increase in the target stock of purchased assets, remained appropriate.

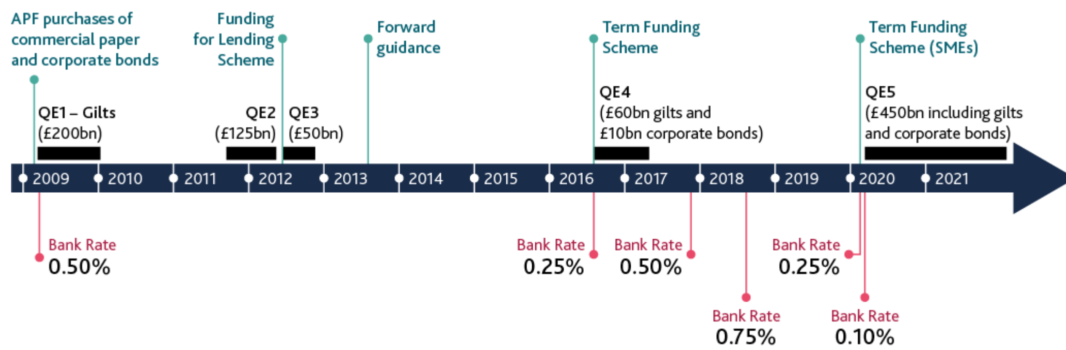
The strategy for tightening monetary policy

5.6 The August *Monetary Policy Report* set out in detail the MPC's strategy for the sequencing of monetary policy tools to deliver tighter policy, when necessary to meet its remit. The MPC intends to begin reducing the stock of purchased assets when Bank Rate has reached 0.5%, if appropriate given the economic circumstances. The MPC judges that the reduction in the stock of purchased assets should initially occur through ceasing the reinvestment of maturing assets, to allow the reduction to occur at a gradual and predictable pace.

5.7 The MPC will consider actively selling some of the stock of purchased assets only once Bank Rate has risen to at least 1%, depending on economic circumstances at the time. This reflects the MPC's judgement that there are advantages to reducing the stock of purchased assets initially by ceasing reinvestments.

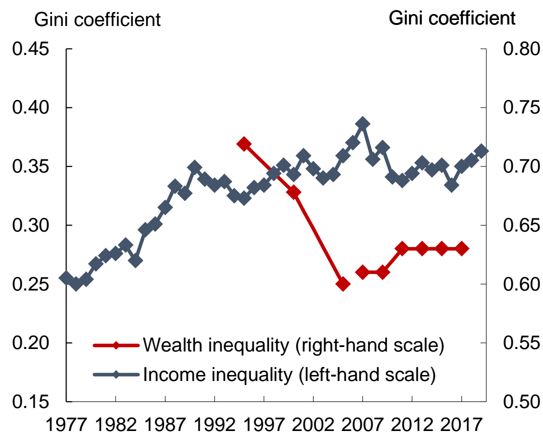
5.8 The MPC will monitor the impact of the reduction in the stock of purchased assets, and may amend or reverse the process if needed to meet its 2% inflation target. And the MPC intends to review the unwind process no later than two years after it has begun.

Figure 1: Bank of England QE programmes and selected policy interventions since 2009



Source: IEO (2021).

Chart 1: Measures of inequality[(a)]



Sources: ONS and British Household Panel Survey (BHPS).
(a) Income inequality data are ONS data from the Living Costs and Food Survey. Wealth inequality data from 1995 to 2005 are from the BHPS and cover financial and property wealth only. Wealth inequality from 2007 onwards are from the ONS Wealth and Assets survey and cover total wealth (including physical and pension wealth).

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