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Quantitative easing: a dangerous addiction?

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See Appendix 1.

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Committee staff

The staff who worked on this inquiry were Adrian Hitchins (Clerk), Dr William Harvey (Policy Analyst) and Mithula Parayoganathan (Committee Operations Officer). Professor Rosa M Lastra was the Committee's specialist adviser for this inquiry.

Contact details

All correspondence should be addressed to the Economic Affairs Committee, Committee Office, House of Lords, SW1A 0PW. Telephone: 020 7219 5358.
Email: economicaffairs@parliament.uk

Twitter

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Evidence is published online at https://committees.parliament.uk/work/993/quantitative-easing/ and available for inspection at the Parliamentary Archives (020 7219 3074).

Q in footnotes refers to a question in oral evidence.

SUMMARY

Quantitative easing

In 2009, with the economy suffering from a severe fall in aggregate demand following the global financial crisis, the Bank of England introduced a new monetary policy tool called 'quantitative easing'. The policy involves the Bank of England creating new money to purchase Government bonds on the open market. Its aim is to inject liquidity into the economy, which the Bank believes will have beneficial effects. These include lowering interest rates, increasing lending, and boosting investment.

Since March 2020, the Bank of England has doubled the size of the quantitative easing programme. Between March and November 2020, the Bank of England announced it would buy £450 billion of Government bonds and £10 billion in non-financial investment-grade corporate bonds. In total, by the end of 2021, the Bank will own £875 billion of Government bonds and £20 billion in corporate bonds. This is equivalent to around 40% of UK GDP.

Therefore, the scale and persistence of the quantitative easing programme are substantially larger than the Bank envisaged in 2009. Once considered unconventional, more than a decade after its introduction, quantitative easing is now the Bank of England's main tool for responding to a range of economic problems. These problems are quite different from those of 2009.

We recognise that both the global financial crisis and the economic crisis following the COVID-19 pandemic have involved shocks and great uncertainty of the kind outside standard models and, inevitably, the Bank had to both feel its way and take quick decisions that involved a great deal of judgement.

Inflation

Despite a growing economy and expansionary monetary and fiscal policy, central banks in advanced economies appear to see the risks of inflation in terms of a transitory, rather than a more long-lasting, problem. At the time that this report was published, the Bank of England's policy was to follow through with its decision to continue purchasing bonds until the end of 2021, contrary to the view of its outgoing chief economist.

Quantitative easing's precise effect on inflation is unclear. However, we heard the latest round of quantitative easing could be inflationary as it coincides with a growing economy, substantial Government spending, bottlenecks in supply, very high levels of personal savings available to spend, and a recovery in demand after the COVID-19 pandemic. The official inflation rate is already higher than the Bank of England's previous forecasts. The Bank of England forecasts that any rise in inflation will be "transitory"; others disagree.

We call upon the Bank of England to set out in more detail why it believes higher inflation will be a short-term phenomenon, and why continuing with asset purchases is the right course of action. If the Bank does not respond to the inflation threat sufficiently early, it may be substantially more difficult to curb later. The Bank should clarify what it means by "transitory" inflation, share its analyses, and demonstrate that it has a plan to keep inflation in check.

Risk to the public finances

If inflation is sustained and economic growth stalls, there is a risk that the cost of servicing Government debt would increase significantly. On 3 March 2021, the Office for Budget Responsibility said that "if short- and long-term interest rates were both 1 percentage point higher than the rates used in our forecast–a level that would still be very low by historical standards–it would increase debt interest spending by £20.8 billion (0.8 per cent of GDP) in 2025–26." Quantitative easing hastens the increase in the cost of Government debt because interest on Government bonds purchased under quantitative easing is paid at Bank Rate, which could be much higher than it is now (0.1%) if the Bank of England had to increase Bank Rate to control inflation. As a result, we are concerned that if inflation continues to rise, the Bank may come under political pressure not to take the necessary action to maintain price stability.

We heard proposals setting out how the Bank of England and HM Treasury could reduce the effect of potential interest rate rises on the public debt. These included an option to not pay interest on commercial bank reserves. We recommend that HM Treasury review such proposals and set out clearly who would be responsible for implementing them, as they would effectively be a tax on the banking system. HM Treasury's response to us on this question was ambiguous. It needs to clarify and put beyond doubt whether any decision to cease paying interest on reserves would be taken by Ministers, not the Bank of England.

The contractual document (the 'Deed of Indemnity') between HM Treasury and the Bank of England which commits the taxpayer to paying any financial losses suffered by the Bank of England that might result from the quantitative easing programme has not been published and is hidden from public scrutiny. The document was described as uncontroversial by the Governor of the Bank of England and by the former Permanent Secretary to HM Treasury who was in post at the time that the document was drawn up. Nevertheless, the Chancellor refused to make the document public without explaining why. We believe this is extraordinary and we call for its publication.

Allegations of deficit financing

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.

While the Bank has retained the confidence of the financial markets, it became apparent during our inquiry that there is a widespread perception, including among large institutional investors in Government debt, that financing the Government's deficit spending was a significant reason for quantitative easing during the COVID-19 pandemic.

These perceptions were entrenched because the Bank of England's bond 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. We recognise that it is not easy to distinguish actions aiming to stabilise bond prices

and the economy from actions oriented to funding the deficit. Nevertheless, if negative perceptions continue to spread, the Bank of England's ability to control inflation and maintain financial stability could be undermined significantly.

The level of detail published by the Bank on how quantitative easing affects 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, analyse the breakdown of the effect of quantitative easing at each stage of the programme and examine the extent to which it has achieved the Bank's stated targets.

Impact of quantitative easing

We took evidence from a wide range of prominent monetary policy experts and practitioners from around the world. We concluded that the use of quantitative easing 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 are exacerbated in economic downturns. It has also been particularly effective at stabilising financial markets during periods of economic turmoil.

However, quantitative easing is an imperfect policy tool. We found that the available evidence shows that quantitative easing has had a limited impact on growth and aggregate demand over the last decade. There is limited evidence that quantitative easing had increased bank lending, investment, or that it had increased consumer spending by asset holders.

Furthermore, the policy has also had the effect of inflating asset prices artificially, and this has benefited those who own them disproportionately, exacerbating wealth inequalities. The Bank of England has not engaged sufficiently with debate on trade-offs created by the sustained use of quantitative easing. It should publish an accessible overview of the distributional effects of the policy, which includes a clear outline of the range of views as well as the Bank's view.

More effective countervailing policies can be introduced by Government if these negative distributional effects are better understood. We therefore recommend that HM Treasury respond to research produced by the Bank on the distributional effects of quantitative easing.

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. We also note that the central bank research which does exist, tends to show quantitative easing in a more positive light than the academic literature. 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 to meet its inflation target; and
- the impact that quantitative easing has had on economic growth and employment.

Unwinding quantitative easing

No central bank has managed successfully to reverse quantitative easing over the medium to long term. In practice, central banks have engaged in quantitative easing in response to adverse events but have not reversed the policy subsequently. This has had a ratchet effect and it has only served to exacerbate the challenges involved in unwinding the policy. The key issue facing central banks as they look to halt or reverse quantitative easing is whether it will trigger panic in financial markets, with effects that might spill over into the real economy.

The Bank of England is unclear on whether it intends to raise interest rates or unwind quantitative easing first when it decides to tighten monetary policy. In 2018, the Bank suggested that tightening would first come in the form of higher Bank Rate; more recently, the Governor has suggested unwinding quantitative easing might be the first move in any tightening. 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. This is concerning considering the renewed debate about inflationary pressures.

The Governor told us that the Bank of England is reviewing the order in which it would tighten policy. It should expedite the review and we recommend that it sets out a plan for restoring policy to sustainable levels. The Bank should outline a roadmap which demonstrates how it intends to unwind quantitative easing in different economic scenarios.

Update to the Bank's mandate

During our inquiry, the Chancellor updated the Bank of England's mandate to confirm that the Monetary Policy Committee is required to support the Government's economic policy to achieve balanced, sustainable growth consistent with a transition to net zero carbon emissions. The Monetary Policy Committee is required to support the Government's economic policy as a secondary objective. Its primary objective is to control inflation.

We conclude that any changes to the Bank's mandate must be considered carefully. Environmental sustainability and the transition to net zero are important issues, but HM Treasury's instruction is ambiguous, and its interpretation has been left to the discretion of the Bank. We believe that without some clarification from the Government, the Bank risks being forced into the political arena, exposing it to criticism unnecessarily. The Chancellor should write to the Governor to clarify the Government's expectations.

Quantitative easing: a dangerous addiction?

CHAPTER 1: INTRODUCTION

Bank of England independence

1. The Bank of England was granted operational independence in 1997. This followed periods of high inflation in the 1970s and 1980s. By the 1980s, controlling inflation had become the overriding objective of UK monetary policy.[1] Departure from the Exchange Rate Mechanism in September 1992 meant that a new domestic policy framework to control inflation was required, and the inflation target was announced in October 1992. After independence, the Bank of England's Monetary Policy Committee—the body in the Bank of England tasked with setting monetary policy—was given a mandate, consisting of a primary objective to meet an inflation target of 2% in the medium term set by the Chancellor,[2] and a secondary objective to support the Government's general economic policy. The inflation target is symmetric, which means the Bank of England is responsible for returning inflation to target from below 2% as well as from above. If the rate of inflation moves away from the 2% target by more than one percentage point in either direction, the Governor of the Bank of England is required to write to the Chancellor to explain what action the Monetary Policy Committee will take in response.[3]

2. Power to set the official interest rate (known as Bank Rate)—which is used to meet the inflation target—was transferred from the Chancellor to the Monetary Policy Committee. Independence from political concerns, combined with clear and widely understood objectives, is thought to lead to more effective monetary policy.[4]

3. The independence of the Bank of England contributed to an economy characterised by moderate inflation and consistent expansionary growth. However, that period of stability ended with the global financial crisis in 2007–08, which shocked the financial systems of Europe and the US and led to a global recession along with sustained low inflation and weak economic growth. In many countries, the challenge for central banks shifted from reducing inflation to raising it. Central banks across the world, including the Bank of England, responded by cutting interest rates to record low levels and introducing an unconventional monetary policy called 'quantitative easing'.

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1 Prices rose by 750% in the 25 years to 1992, more than over the previous 250 years. See Mark Carney, speech on Independence – 20 years on, 28 September 2017: https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/opening-remarks-at-the-boe-independence-20-years-on-conference.pdf [accessed: 5 July 2021]

2 The inflation target was originally 2.5% measured by RPIX. It was changed to 2% measured by CPI in 2003.

3 The Governor is also required to explain the outlook for inflation and the reasons why inflation has moved away from the target; the policy action the committee is taking in response; the horizon over which the committee 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; how this approach meets the government's monetary policy objectives.

4 Written evidence from the Bank of England (QEI0015)

What is quantitative easing?

4. Quantitative easing is a monetary policy tool that central banks can use to inject money into the economy through the purchase of 'financial assets', usually government bonds.[5] Quantitative easing is also known as 'asset purchasing'.[6]

5. Usually, when an economy is slowing down or entering a recession, central banks will cut interest rates to make borrowing and investment—which help to create economic growth—cheaper. However, in circumstances in which a central bank has already lowered interest rates close to 0% (known as the 'zero lower bound'), quantitative easing has been used with the intention of stimulating spending, investment and growth.

6. Whenever the Monetary Policy Committee decides that it needs to undertake additional quantitative easing, the Bank of England creates new money to purchase Government or corporate bonds from private sector entities, such as pension funds or insurance companies. Once the Bank of England has purchased bonds from, for example, a pension fund, the pension fund receives new money in the form of a deposit in a commercial bank. The commercial bank has the deposit (a liability to the pension fund) and additional interest-paying reserves—a type of money that commercial banks use to pay each other—in the Bank of England (an asset).[7]

7. The Bank of England expects these actions to have effects that will boost the economy. These effects are sometimes referred to as 'transmission mechanisms' and they include:

    - **Portfolio rebalancing**: by buying large amounts of Government bonds, quantitative easing pushes up their price and lowers their interest rate for investors. Because interest rates on Government bonds tend to affect other interest rates in the economy, the Bank of England hopes that this will lower long-term interest rates offered on other loans, such as mortgages or business loans, making it cheaper for businesses and households to borrow and spend money. When investors sell assets to the Bank of England, their bank accounts are credited with the proceeds which provides liquidity. Some, or all, of that new money will be spent on purchasing a range of financial or real assets, such as shares or property, thus raising their price. Those higher asset prices should stimulate spending, either directly or by lowering the cost of financing new investment.

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5 In the UK, the overwhelming majority of assets bought by the Bank of England are Government bonds. By the end of 2021, the Bank has said it will have purchased £875 billion in Government bonds compared to £20 billion in corporate bonds.

6 Bonds are a type of investment whereby investors lend money to the Government (UK Government bonds are also called 'gilts') or to a private company in return for interest. The bond issuer (for example, the Government) pays the holder of the bond a rate of interest, known as the 'coupon', until the 'maturity' date when the issuer is obliged to repay the value of the bond to the bond holder. The return that a bondholder receives on their investment is called the yield. Bonds can be resold to other investors on the 'secondary market'. If the price of a bond has increased then the yield will be lower, as investors are paying more for a given bond to receive the same coupon price. Correspondingly, if a bond price falls the yield rises.

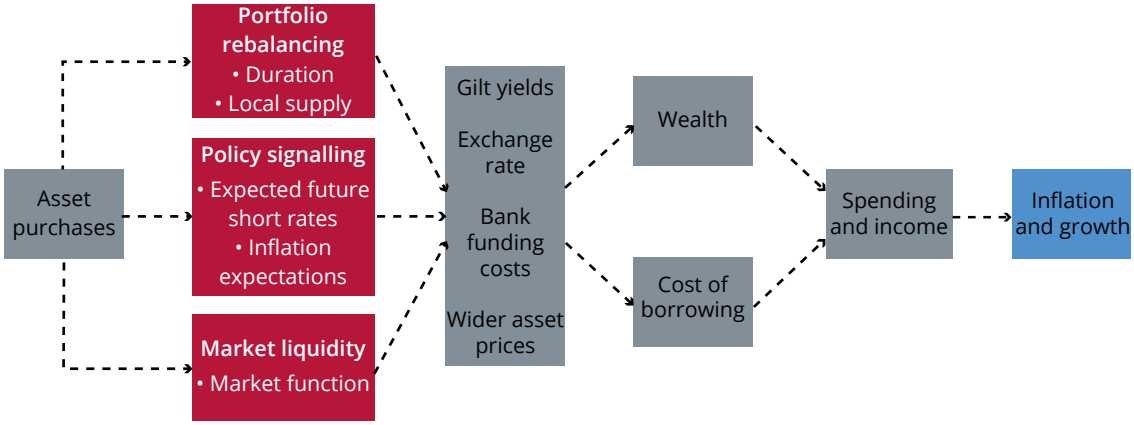
7 New Economics Foundation, *Strategic quantitative easing: Stimulating investment to rebalance the economy* (1 July 2013): https://neweconomics.org/uploads/files/e79789e1e31f261e95_ypm6b49z7.pdf [accessed 5 July 2021]

- **Signalling**: by purchasing bonds, the Bank of England in effect signals to the financial markets and lenders that it will keep interest rates low for a longer period of time. This reduces long-term interest rates in the economy and provides some certainty to banks that people can afford to borrow money.

- **Market liquidity**: by buying Government bonds, the Bank of England reassures investors that they can sell these bonds if they wish. That makes them a safe asset to hold and reassures investors that they will be able to access liquidity by selling them even when financial markets are in distress.

- **Wealth effects**: quantitative easing can boost a range of financial asset prices, such as bonds and shares. This increases the value of these assets, which makes businesses and households holding them wealthier. The Bank of England hopes that this makes them more likely to spend money on goods and services, which would boost economic activity.

Figure 1: Quantitative easing transmission mechanisms



Source: Bank of England, Staff Working Paper No. 899, The central bank balance sheet as a policy tool: past, present and future, (December 2020): https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2020/the-central-bank-balance-sheet-as-a-policy-tool-past-present-and-future.pdf [accessed 6 July 2021]

Global context

8. In the 1980s and early 1990s, Japan experienced a stock and land market bubble which burst, leading to a financial crisis culminating in a threat to the solvency of the banking system in the late 1990s. Japan then experienced a period of economic stagnation and deflation (falling prices which may harm growth and employment), which led the Bank of Japan to cut interest rates.

9. In 2001, the Bank of Japan announced its first round of quantitative easing, which was intended to tackle deflationary pressures and to boost the amount of money held by commercial banks to help them to absorb losses from bad loans following the financial crisis in the 1990s. The Bank of Japan launched further rounds of quantitative easing over the last decade, initially in response to the global financial crisis, and most recently to support the economy through the COVID-19 pandemic.

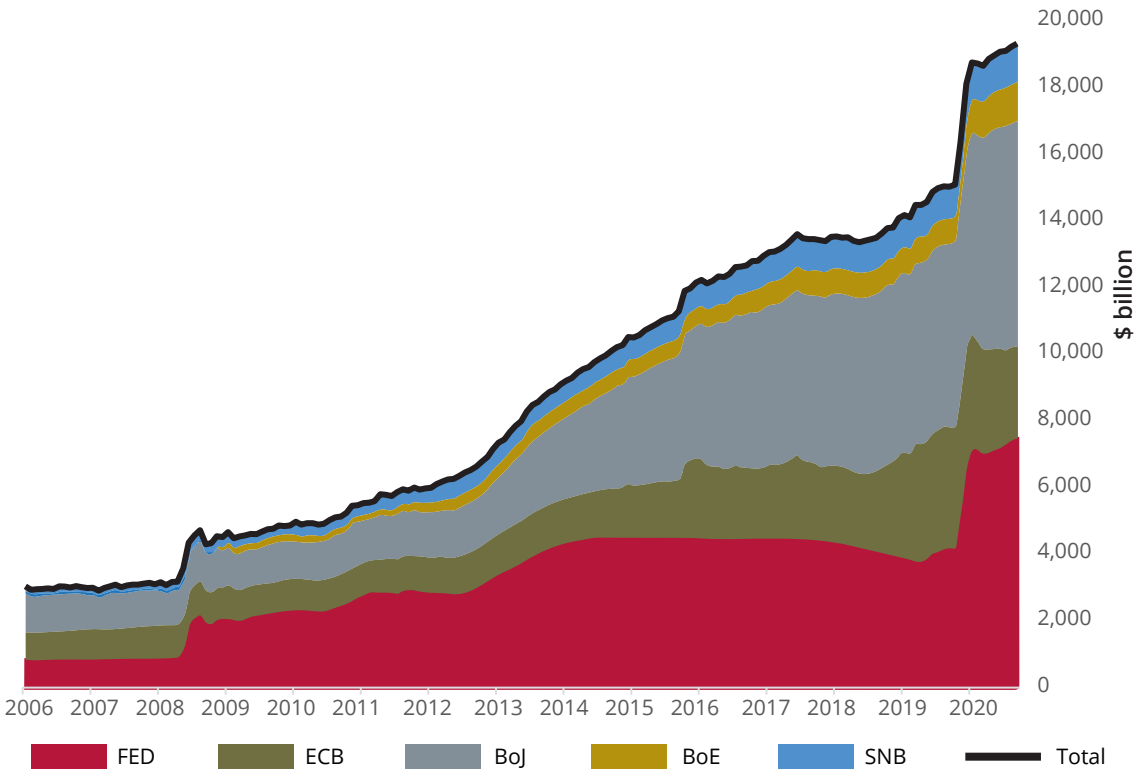
10. The Bank of Japan was an outlier in its use of quantitative easing until the 2007–08 global financial crisis. It still is in terms of the total value and type of assets that it has purchased. Nevertheless, since the global financial crisis,

quantitative easing has been used in many other large economies, including the US and the Eurozone. The US Federal Reserve introduced asset purchasing in response to the financial crisis in 2008, which it expanded in 2010 and 2012 to support economic stabilisation and recovery. In 2013, the Federal Reserve announced a 'tapering' of asset purchases, which were eventually stopped in 2014. It reduced its asset holdings again in 2017 but this ended in 2019. In 2020, in response to the economic crisis that resulted from the COVID-19 pandemic, the Federal Reserve announced 'open-ended' asset purchases, including corporate bonds.

11. The European Central Bank started purchasing assets in response to the 2008–2012 financial and sovereign debt crises. Between 2014 and 2019, it continued to purchase a range of assets to support monetary policy objectives and to provide additional stimulus. In 2020, in response to the COVID-19 economic crisis, it launched a temporary Pandemic Emergency Purchase Programme, which expanded the eligibility criteria for asset purchases.

12. On 26 February 2021, Andy Haldane, the Bank of England's outgoing Chief Economist, said central banks have expanded their balance sheets by $10 trillion, or 13% of global GDP, since the financial crisis and by approximately $5.5 trillion since 2020, in response to the economic crisis that resulted from the COVID-19 pandemic. Figure 2 sets out the expansion of the balance sheets of several central banks since 2006.

Figure 2: Selected central bank balance sheets (US Federal Reserve, European Central Bank, Bank of Japan, Bank of England and Swiss National Bank)



Source: Andy Haldane, speech on Inflation: A Tiger by the Tail?, 26 February 2021, p 9: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/february/inflation-a-tiger-by-the-tail-speech-by-andy-haldane.pdf [accessed 5 July 2021]

Quantitative easing in the UK

13. In the UK, quantitative easing was envisaged, at the point of introduction in 2009, as a short-term measure to support the economy through the global financial crisis. However, over the last decade or so, the programme has expanded substantially, and it has become the Bank of England's main monetary policy tool.

14. The Bank's quantitative easing programme can be split into three broad phases. The aim of the first phase, between 2009 and 2012, was to boost nominal spending and to provide liquidity to banks and financial institutions during the financial crisis.[8] In this period, the Bank conducted seven rounds of quantitative easing, totalling £375 billion by July 2012.[9]

15. The second phase, from August 2016, was a response to market uncertainty following the UK's vote to leave the European Union. Bank Rate was cut to 0.25% and the Bank of England expanded its quantitative easing programme with a further £70 billion of asset purchases, including £10 billion of corporate bonds. The Bank of England said that asset purchases would trigger market participants to "rebalance" their investments into riskier assets, and this would lower "the real cost of borrowing for households and companies." Its corporate bond purchases were designed to encourage those selling corporate debt to reinvest in other corporate assets.[10]

16. The third phase of quantitative easing, which was by far the largest, was launched in response to the COVID-19 pandemic. The Bank of England announced three rounds of asset purchases in March, June and November 2020, totalling £450 billion in Government bonds and a further £10 billion in non-financial investment-grade corporate bonds—around double the number of assets purchased in the first two phases of quantitative easing combined. The Bank expects to complete bond purchases by the end of 2021. It said that all three rounds were designed to help it to meet its inflation target. It said to meet this objective, the March 2020 round of quantitative easing was designed to support the gilt market and the subsequent two rounds were to support the economy.[11] Not only has the Bank of England purchased substantially more assets in this phase, it has done so against a highly expansionist fiscal policy.

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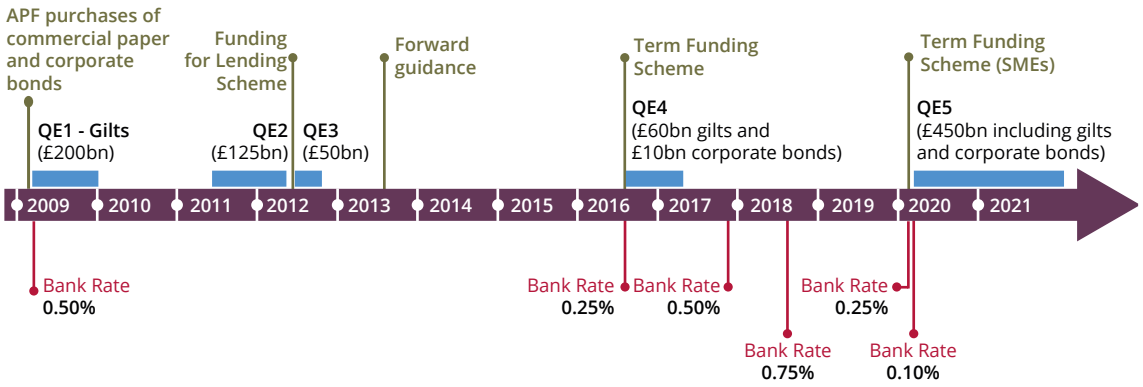
8 For example, Bank of England, *Minutes of the Monetary Policy Committee meeting, 4 and 5 March 2009*, (18 March 2009): https://www.bankofengland.co.uk/-/media/boe/files/minutes/2009/minutes-march-2009.pdf [accessed 5 July 2021]

9 House of Commons Library, Quantitative Easing, Debate Pack, CDP 2016/0166, 14 September 2016, p 4 [accessed 5 July 2021]

10 Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 3 August 2016* (4 August 2016): https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2016/august-2016.pdf [accessed 5 July 2021]

11 Bank of England, *Minutes of the special Monetary Policy Committee meeting on 19 March 2020 and the Monetary Policy Committee meeting ending on 25 March 2020* (26 March 2020): https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2020/march-2020.pdf [accessed 5 July 2021], see also Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 17 June 2020* (18 June 2020): https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2020/june-2020.pdf [accessed 5 July 2021] and Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 4 November 2020* (5 November 2020): https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2020/november-2020.pdf [accessed 5 July 2021]

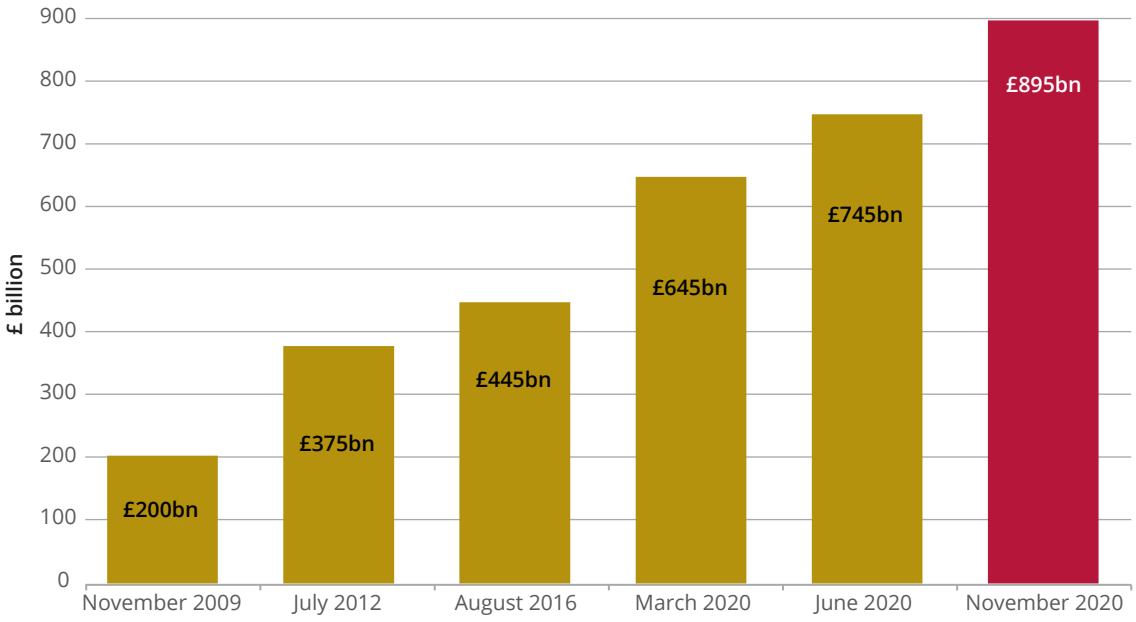
Figure 3: Bank of England QE programmes and selected policy interventions since 2009



Source: Bank of England, 'IEO Evaluation of the Bank of England's approach to quantitative easing', 13 January 2021: https://www.bankofengland.co.uk/independent-evaluation-office/ieo-report-january-2021/ieo-evaluation-of-the-bank-of-englands-approach-to-quantitative-easing [accessed 6 July 2021]

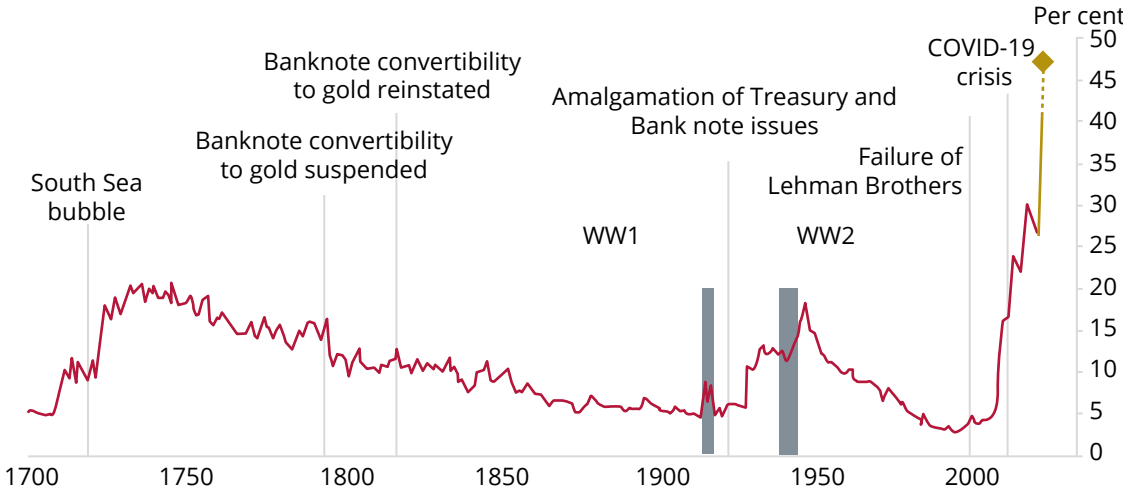
17. In total, the Bank of England will have bought £875 billion of Government bonds and £20 billion of corporate bonds, totalling £895 billion in assets by the end of 2021. Figure 4 sets out how the value of assets purchased by the Bank of England has grown since 2009.

Figure 4: Bank of England bond purchases by the month that new purchases were announced



Source: Bank of England, 'What is quantitative easing?': https://www.bankofengland.co.uk/monetary-policy/quantitative-easing [accessed 6 July 2021]

Figure 5: Bank of England balance sheet as a percentage of GDP



Source: Dave Ramsden, speech on QE as an economic policy tool - what does it do and how should we use it?, 17 February 2021: https://www.bis.org/review/r210303k.pdf [accessed 6 July 2021]

18. Quantitative easing in the UK now totals around 40% of GDP. The Bank of England is not alone in substantially increasing its rate of quantitative easing. The quantitative easing programmes in the US, Eurozone and Japan now total around 30%, 32% and 106% of GDP respectively.[12]

Our inquiry

19. The role and economic influence of the Bank of England has grown substantially since the global financial crisis, as have expectations that it will intervene in periods of economic uncertainty.[13] The trend for interventionist monetary policy continued during the COVID-19 pandemic, and led to the doubling of the UK's quantitative easing programme.

20. We launched this inquiry at this juncture for several reasons. First, the quantitative easing programme has not been subject to sufficient scrutiny, including in Parliament, given its size, longevity and economic importance. The increased role of the Bank of England in the economy merits enhanced accountability by Parliament.

21. Second, the substantial escalation of quantitative easing during the COVID-19 pandemic was unprecedented. While we recognise that the Bank of England was acting quickly in response to an economic emergency, it is imperative that the Bank is held accountable and asked to explain the reasons for its decisions openly and in sufficient detail. The importance of this was emphasised during the inquiry as it became apparent that there was a widespread perception that the Bank of England had conducted quantitative easing primarily to support Government borrowing rather than for monetary policy purposes, and that this perception might have been strengthened as a result of poor communications.

12 Written evidence from the Bank of England (QEI0015) and Bank of England, 'IEO evaluation of the Bank of England's approach to quantitative easing' (13 January 2021) : https://www.bankofengland.co.uk/independent-evaluation-office/ieo-report-january-2021/ieo-evaluation-of-the-bank-of-englands-approach-to-quantitative-easing [accessed 5 July 2021]

13 Q 166 (Ed Balls) and Q 172 (Otmar Issing)

22. Third, we wished to examine the extent to which quantitative easing has achieved its stated objectives, along with its effects on the real economy, growth and inflation. Quantitative easing is widely considered to have exacerbated wealth inequalities as it raises the price of certain assets, benefiting those who own them. Some consider this effect on asset prices to be responsible for risky behaviour in the financial markets and for inflating speculative bubbles. Moreover, the scale of the increase in asset purchases by the Bank in 2020–21, and the consequent rapid increase in broad money, has fuelled concerns that inflation may start to pick up faster than the Bank currently expects.

23. Fourth, we wanted to examine the most significant risks to the public finances that might result from quantitative easing, given that the Bank of England now holds a substantial portion of the debt issued by the Government. We heard that the threat of rising inflation, as the economy starts to recover, exposes Government debt to higher servicing costs if the Bank of England were to raise interest rates. We were told that this could expose the Bank of England to political pressure.

24. Fifth, we wanted to find out the Bank of England's plans for quantitative easing in the future. The programme has become significantly larger and more persistent than the Bank envisaged in 2009 when it was introduced, and it has taken no steps to reduce the size of its balance sheet. We therefore wished to hear from the Bank of England on its plan for unwinding quantitative easing and its preparations for the next economic crisis.

25. Many of our motives for this inquiry stem from a concern that quantitative easing is eroding the operational independence of the Bank of England or is at least creating the perception of this. Before we launched our inquiry, Andy Haldane, the Bank of England's outgoing Chief Economist, recognised many of the same issues that are growing in importance as the Bank's balance sheet grows. He said:

> "Recent quantitative easing has placed central banks in deep, and uncharted, waters. My view is that these quantitative easing actions have been necessary to support the economy and hit the inflation target. But they pose rising challenges to public understanding of the purposes of quantitative easing and, ultimately, perceptions of independence."[14]

26. If the perception that the Bank of England has lost its operational independence takes hold, or that it is taking decisions on the basis of political considerations, we heard that the effectiveness of its monetary and financial stability policies would be undermined.

27. This would reduce the Bank of England's ability to influence inflation and maintain financial stability, which would have negative consequences for all of us.[15]

28. **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**

14 Andy Haldane, speech on What Has Central Bank Independence Ever Done for Us?, 28 November 2020: https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/what-has-central-bank-independence-ever-done-for-us-speech-by-andy-haldane.pdf [accessed 5 July 2021]

15 Written evidence from Dr Jim Buller, Dr John Evemy and Dr Ben Whisker (QEI0013)

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.

Witnesses and evidence

29. In this inquiry we took oral evidence from prominent monetary policy practitioners and experts. We would like to thank in particular those witnesses from overseas who gave us the benefit of their knowledge and experience, including Masaaki Shirakawa, the former Governor of the Bank of Japan, Otmar Issing and Peter Praet, former Chief Economists of the European Central Bank, Kenneth Rogoff, Professor of Economics and Thomas D. Cabot Professor of Public Policy at Harvard University, Adam Posen, President at Peterson Institute for International Economics, Stephen G. Cecchetti, Rosen Family Chair in International Finance at Brandeis International Business School, and Christina Parajon Skinner, Assistant Professor of Legal Studies & Business Ethics at The Wharton School of the University of Pennsylvania, along with many others.

30. We took evidence on quantitative easing from academics and think tanks from the UK, Europe and the US, as well as evidence from representatives of the UK financial sector. We are also grateful to those members of the current and former leadership of the Bank of England and HM Treasury who contributed to our inquiry. A full list of witnesses and authors of written submissions is available in Appendix 2.

31. Finally, we would like to thank our Specialist Adviser for this inquiry, Professor Rosa M Lastra, Sir John Lubbock Chair in Banking Law at Queen Mary University of London.

CHAPTER 2: IMPACT OF QUANTITATIVE EASING

32. This chapter assesses the overall effect of quantitative easing on financial conditions and wider economic effects such as GDP and inflation. The evidence that we set out in this chapter examines the rounds of quantitative easing that were conducted between 2009–12 and in 2016. It does not examine the most recent rounds of quantitative easing that were announced between March and November 2020, in response to the COVID-19 pandemic. These are examined in Chapter 3.

Effectiveness of quantitative easing

33. The impact of quantitative easing has been subject to growing academic and central bank research. However, there is a recognition across the literature that measuring the effectiveness of quantitative easing is difficult to do with precision. The use of quantitative easing at scale is still relatively new and there are long lags between its deployment and the ability to assess its precise effect. Furthermore, the counterfactual—what would the effect have been if quantitative easing had not been deployed—is difficult to establish.

34. To date, empirical literature has covered two main issues: the impact of quantitative easing on financial conditions, and its effect on macro-economic variables like GDP and inflation. The Bank of England said that, of the two, the fundamental objective of quantitative easing "is to provide monetary stimulus to help the Monetary Policy Committee meet its inflation target."[16] The Bank of England's understanding is that quantitative easing helps it to meet its inflation target by lowering long-term borrowing costs, which it hopes will encourage spending on goods and services and put an upward pressure on prices.[17]

35. The Bank of England has said that the effectiveness of quantitative easing is largely state-contingent and depends on the prevailing economic and financial conditions. For instance, quantitative easing may be "particularly effective as a monetary policy tool when deployed at a time of market dysfunction."[18] While this is not the primary objective of quantitative easing, the Bank said that by restoring market functioning, quantitative easing supports financial stability when markets are in distress.[19]

36. Daniel Gros, Distinguished Fellow at the Centre for European Policy Studies, told us that there is evidence which shows that quantitative easing is "very important" in a crisis when markets are dysfunctional.[20] However,

16 Written evidence from the Bank of England (QEI0015)
17 Written evidence from the Bank of England (QEI0015). Research by Bank staff studying the initial £200 billion of quantitative easing suggests that it may have resulted in GDP increasing by around 1.5–2%, whilst it estimates that inflation rose by around 0.75–1.5% as a result. See Bank of England, *The United Kingdom's quantitative easing policy: design, operation and impact* (2011) pp 200–212: https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2011/the-uks-quantitative-easing-policy-design-operation-and-impact.pdf [accessed 5 July 2021]. Similarly, research by Bank staff in 2016 found that quantitative easing programmes in the US and UK appear to have had a positive and significant impact on economic activity and inflation. See Bank of England, *Staff Working Paper No 624, QE: the story so far* (October 2016): https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2016/qe-the-story-so-far.pdf [accessed 5 July 2021]
18 Written evidence from the Bank of England (QEI0015)
19 *Ibid.*
20 Q 104 (Daniel Gros)

he argued that the overall impact of quantitative easing on the real economy and inflation has been "vastly overestimated."[21]

37. Several witnesses provided similar assessments. Professor Özlem Onaran, from the University of Greenwich, said that while quantitative easing has helped to stabilise financial markets, its effectiveness as a tool to address stagnant or low rates of investment and growth appears to be negligible.[22] Frances Coppola, an author and economics commentator, said that quantitative easing can "be summarised as an effective tool for arresting a deflationary collapse, but an extremely weak economic stimulus with unfortunate distributional effects."[23] Fran Boait, Executive Director of Positive Money, told us that quantitative easing is reliant on "trickle-down economics" through both the wealth channel and the bank lending and portfolio rebalancing channel, neither of which are proven to stimulate spending and investment which results in economic growth.[24]

38. Professor Tim Congdon, Founder and Chairman of the Institute of International Monetary Research, told us that the use of quantitative easing in 2009 prevented a deflationary spiral from taking place. He said that without quantitative easing, "the quantity of money would have fallen very rapidly".[25] Adam Posen, President of the Peterson Institute for International Economics, said that quantitative easing "tends to work most powerfully when a financial panic is under way", but its ability to stimulate spending and investment in stable economic conditions is like "pushing on a string." He continued: "part of the reason that there is so much confusion and frustration about quantitative easing is that … it [can move] credit market spreads and liquidity conditions without … having the desired … or expected effects on inflation outlook and growth."[26]

39. We heard that quantitative easing has, in some cases, resulted in significant increases in pension fund deficits and it has led to investment in high-risk assets as part of a 'search for yield'. The Pensions and Lifetime Savings Association told us that, on balance, it believed quantitative easing had benefitted pension funds due to the support it had provided to the economy, which it said helped businesses which sponsor and contribute to pension schemes. However, it said that because quantitative easing had pushed up the price of gilts, it had "increased asset values for defined benefit schemes holding gilts but also reduced the expected yield." The combination of low yields and low long-term interest rates used to discount future obligations resulted in liabilities being increased. For defined benefit schemes, we heard that quantitative easing had resulted in "significant increases in deficits" that have had to be filled through higher employer contributions or greater investment returns.[27]

40. Professor Philip Davis, Professor of Banking and Finance at Brunel University and a Fellow at the National Institute of Economic and Social Research (NIESR), said that one of the consequences of reducing the yield on government bonds through quantitative easing is a "countervailing risk

21 Q 101 (Daniel Gros)
22 Written evidence from Professor Özlem Onaran (QEI0005)
23 Written evidence from Frances Coppola (QEI0010)
24 Q 22 (Fran Boait)
25 Q 24 (Prof Tim Congdon)
26 Q 86 (Adam Posen)
27 Written evidence from the Pensions and Lifetime Savings Association (QEI0020)

that pension funds are seeking to invest in high-risk assets going forward to obtain [the] required rate of return in [the] context of low long rates and the shift to bonds." There is "some evidence" of pension funds engaging in a "search for yield" through investment in leveraged alternative assets, structured products, private equity and derivatives.[28]

41. Aberdeen Standard Investments, an asset management company, thought it difficult to identify the effects of quantitative easing in isolation from other economic trends. It said that the effectiveness of quantitative easing on inflation and measures of economic growth appears in large part to depend on whether fiscal policy is concurrently expansive or contractionary. In contrast to the initial phases of quantitative easing, which were conducted in a contractionary fiscal environment, Aberdeen Standard Investments said that the 2020 rounds of quantitative easing "may be more powerful than previous rounds" because of an expansionary fiscal policy.[29]

42. Other witnesses made a similar point. Frances Coppola said that quantitative easing would have a greater impact on macroeconomic variables such as growth and GDP if it were implemented alongside a more significant package of fiscal policies that aimed to stimulate the economy.[30]

43. Nigel Wilson, Chief Executive Officer at Legal & General, said that quantitative easing is not the right policy tool for stimulating sustainable economic growth. He said that quantitative easing had boosted asset prices and stabilised financial markets successfully, but that it cannot be expected to create sustainable economic growth, for which an active fiscal policy was needed instead.[31]

44. Lord Turner of Ecchinswell, former Chairman of the Financial Services Authority and a former member of the Court of the Bank of England, characterised one of the effects of quantitative easing as "lubricating a fiscal expansion". He told us quantitative easing is currently providing the impetus for the Government's active fiscal policy, arguing that this is quantitative easing's most effective transmission mechanism.[32] Dr Will Bateman, Associate Professor at the Australian National University, made a similar point: "The main fiscal policy effect of [quantitative easing] is to maintain the UK Government's access to debt finance in large volumes and low cost in the face of sustained budget deficits." In so doing, quantitative easing provides "critical support during economic emergencies when fiscal receipts fall significantly behind public expenditure."[33]

45. Lord Macpherson of Earl's Court, former Permanent Secretary at HM Treasury, told us that the effectiveness of quantitative easing had diminished over time. When it was first deployed in 2009—after interest rates were cut from 4.5% in October 2008 to 0.5% in March 2009—it "had a real impact". However, he argued that when long-term interest rates are close to the zero lower bound the Bank of England must "buy a great deal of debt to have any impact at all."[34]

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28 Written evidence from E Philip Davis (QEI0019)
29 Written evidence from Aberdeen Standard Investments (QEI0009)
30 Written evidence from Frances Coppola (QEI0010)
31 Q 52 (Nigel Wilson)
32 Q 94 (Lord Turner of Ecchinswell)
33 Written evidence from Dr Will Bateman (QEI0017)
34 Q 164 (Lord Macpherson of Earl's Court)

46. We heard that central banks take a more positive view of quantitative easing than independent analysts. Chris Giles told us that the Bank of England's analysis of how quantitative easing works had been inconsistent—with stress put on different transmission mechanisms in different rounds. He said that despite its inconsistencies, the Bank of England "never has any doubt that it is working" although "it has often changed the way in which it says it is working."[35]

47. Daniel Gros said that there is "a certain bias in the available evidence", highlighting a recent paper for the National Bureau of Economic Research that set out how central bank research tended to show quantitative easing has a stronger impact on output and inflation than independent academic research.[36] Pointing to the same research, Blonde Money, an independent macroeconomic research consultancy, said, "with central banks marking their own homework, the jury is still out on the success of quantitative easing."[37]

48. Andrew Bailey, the Governor of the Bank of England, told us that quantitative easing is most effective "in a situation where there is impaired market liquidity." He disagreed that its effect is diminished over time: "it is not surprising … that the effects of quantitative easing vary over time, but I would not subscribe to the view that there is some sort of linear progression of [quantitative easing] and it becomes either more or less effective."[38]

49. **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 crisis, when financial markets are dysfunctional or in distress.**

50. **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 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.**

'Knowledge gaps'

51. We were told that the Bank of England produced several pieces of research between 2009 and 2013 that contributed significantly to early conclusions on the effectiveness of quantitative easing.[39] However, when the Bank of

35 Q 8 (Chris Giles)
36 Q 104 (Daniel Gros). See National Bureau of Economic Research, *Fifty Shades of QE: Comparing Findings of Central Bankers and Academics* (April 2021): https://www.nber.org/system/files/working_papers/w27849/w27849.pdf [accessed 5 July 2021]
37 Written evidence from Blonde Money (QEI0012)
38 Q 180 (Andrew Bailey)
39 See for instance Michael Joyce, Ana Lasaosa, Ibrahim Stevens, and Matthew Tong 'The Financial Market Impact of Quantitative Easing in the United Kingdom', *International Journal of Central Banking*, vol. 7 (2011): https://www.ijcb.org/journal/ijcb11q3a5.pdf and Bank of England, *The United Kingdom's quantitative easing policy: design, operation and impact* (2011) pp 200–12: https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2011/the-uks-quantitative-easing-policy-design-operation-and-impact.pdf [accessed 5 July 2021]

England was not conducting quantitative easing between 2013 and 2016, research on it was limited. Melissa Davey, Director of the Bank of England's Independent Evaluation Office, told us that the Bank should have "spent more time in investing in its understanding and thinking about its policy toolkit".[40]

52. While the number of Bank of England publications assessing the impact of quantitative easing has increased in recent years,[41] we were told that there are still significant "knowledge gaps" in the Bank of England's understanding of quantitative easing. Melissa Davey told us that its most significant knowledge gaps were:

- which transmission mechanisms—portfolio rebalancing, market liquidity, signalling and wealth effects—are most effective;
- the effect of quantitative easing on growth and inflation; and
- how the prevailing economic and financial conditions in which quantitative easing is deployed is expected to affect its impact.[42]

53. Professor Daniela Gabor said that the Bank of England does not have a sufficient theoretical understanding of the effects of quantitative easing. In particular, she highlighted its lack of knowledge of the links and interactions between monetary and fiscal policy. She said, "We have had five rounds of quantitative easing and we have a central bank that does not quite clearly understand the transmission mechanism of monetary policy."[43]

54. The Bank of England has acknowledged that the evidence on quantitative easing is still evolving.[44]

55. **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,**

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40 Q 41 (Melissa Davey)

41 See for instance Bank of England, *Staff Working Paper No. 720, The distributional impact of monetary policy easing in the UK between 2008 and 2014* (March 2020): https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/the-distributional-impact-of-monetary-policy-easing-in-the-uk-between-2008-and-2014.pdf [accessed 5 July 2021]. See also Bank of England, *The central bank balance sheet as a policy tool: past, present and future, Paper prepared for Jackson Hole Economic Policy Symposium, 27–28 August 2020 (2020):* https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/the-central-bank-balance-sheet-as-a-policy-tool-past-present-and-future.pdf [accessed 5 July 2021] and Dave Ramsden, speech on QE as an economic policy tool – what does it do and how should we use it?, 17 February 2021: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/february/qe-as-an-economic-policy-tool-what-does-it-do-and-how-should-we-use-it-speech-by-dave-ramsden.pdf [accessed 5 July 2021]

42 Q 41 (Melissa Davey). The 2021 Independent Evaluation Office report on quantitative easing identified several other knowledge gaps in the Bank's understanding, including the interlinkages between quantitative easing and financial stability, and consideration of potential monetary–fiscal interlinkages. It identified several long-term issues that it said the Bank lacked clarity on, such as: the potential limits of quantitative easing, how those limits might interact with very low long-term interest rates and the implications of unwinding quantitative easing. See Bank of England, 'IEO evaluation of the Bank of England's approach to quantitative easing': https://www.bankofengland.co.uk/independent-evaluation-office/ieo-report-january-2021/ieo-evaluation-of-the-bank-of-englands-approach-to-quantitative-easing [accessed 5 July 2021]

43 Q 8 (Prof Daniela Gabor)

44 Written evidence from the Bank of England (QEI0015)

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.**

Distributional effects

56. The distributional effects of quantitative easing—meaning the redistributive impact of the policy—are difficult to measure separately from other economic events and so should be considered alongside its effect on employment, incomes and growth. In other words, the extent to which quantitative easing has a positive effect on employment and incomes should be taken into consideration when assessing whether it has led to any negative distributional outcomes.

57. One of the deliberate consequences of quantitative easing is to raise asset prices. There is a body of evidence that perceives this to have increased wealth inequalities.[45] However, when we asked the Governor whether quantitative easing had increased wealth inequality in the UK, he said that he "would not agree."[46]

58. The Bank of England said that the overall effect of quantitative easing on standard measures of income and wealth inequality had been relatively small.[47] The Bank of England said that if it had not deployed quantitative easing in response to a series of economic shocks, the impact on income and unemployment would have been significantly worse. It said that the positive support that quantitative easing provided for jobs and wages in the economy outweighed any increase in asset prices and wealth inequality.[48] Dr Ben Broadbent, Deputy Governor for Monetary Policy at the Bank of England, told us that by supporting the economy, quantitative easing reduced income inequality "at the margin" by mitigating the loss of employment in groups who are less well paid.[49]

59. Aberdeen Standard Investments made a similar point. It said that by easing financial conditions quantitative easing "tends to put upward pressure on growth, wage growth and inflation and downward pressure on unemployment … given that we know that downturns especially negatively affect the poor in

45 For instance BIS, *Wealth inequality and monetary policy* (March 2016): https://www.bis.org/publ/qtrpdf/r_qt1603f.pdf [accessed 5 July 2021]. See also Haroon Mumtaz and Angeliki Theophilopoulou, 'The impact of monetary policy on inequality in the UK: an empirical analysis', *European Economic Review*, vol. 98, (2017), pp 410–423: available at https://www.sciencedirect.com/science/article/abs/pii/S0014292117301332 and Resolution Foundation, *Quantitative (displ)easing? Does QE work and how should it be used next time?* (September 2019): https://www.resolutionfoundation.org/app/uploads/2019/09/Quantitative-displeasing-FINAL-VERSION.pdf [accessed 5 July 2021]

46 Q 181 (Andrew Bailey)

47 A 2018 paper by Bank of England staff found that the overall effect of monetary policy on standard measures of income and wealth inequality has been small. The paper estimates that households close to retirement age gained the most from quantitative easing, but that the support it provided to incomes disproportionately benefited younger people and households. See Bank of England, *Staff Working Paper No. 720, The distributional impact of monetary policy easing in the UK between 2008 and 2014*

48 Written evidence from the Bank of England (QEI0015)

49 Q 181 (Dr Ben Broadbent)

terms of wage growth and employment, this impact is likely to be especially beneficial in terms of reducing inequality."[50]

60. The Bank of England said that it is important to consider a broader range of indicators when assessing the impact of quantitative easing on inequality. Drawing on recent research,[51] it said that looser monetary policy and quantitative easing has resulted in "substantial welfare benefits" which had helped to "mitigate the fall in overall well-being after the financial crisis."[52] Through this lens, the Bank said that while older households had benefited from the effect of quantitative easing on asset prices (by increasing the value of assets), younger households have, on average, "benefited the most from the support that [quantitative easing], and monetary policy, has given to incomes and employment." Moreover, it said that younger households had also benefited from "an erosion in the real value of debt since they are more likely to be borrowers than savers."[53]

61. However, Melissa Davey, Director of the Independent Evaluation Office of the Bank of England, told us, "The Bank's engagement in the debate [on quantitative easing exacerbating inequality] was often described… as quite defensive".[54]

62. Nigel Wilson said that, by inflating asset prices without a corresponding increase in productivity or real wages, quantitative easing had caused wealthy households to benefit more than less wealthy households: "Rich people in rich countries and poor countries have done really well out of quantitative easing, but poor people relatively have not done well in any of the economies."[55] Similarly, Frances Coppola said that the use of quantitative easing over a sustained period had increased intergenerational inequalities. She said that by raising asset prices intentionally, quantitative easing benefits older generations, who are disproportionately more likely to hold assets.[56]

63. Professor Özlem Onaran told us that the positive effects of quantitative easing are "higher for the top of the distribution and lower for the bottom of the wealth and income distribution."[57] James Smith, Research Director at the Resolution Foundation, referred to research by the Resolution Foundation which showed that "40% of the impact [of quantitative easing] on asset prices accrued to … the top 10% of people" in the distribution of wealth. Fran Boait also told us that "the richest 10% of households benefited by £350,000 during the first round of quantitative easing, which was more than 100 times the benefit for the poorest."[58]

64. Chris Giles, while accepting the Bank of England's position that quantitative easing had mitigated inequalities of income by supporting employment, said that the increase in asset prices since the financial crisis made the Bank of England's position on wealth and intergenerational inequalities "much

50 Written evidence from Aberdeen Standard Investments (QEI0009)
51 See Bank of England, *Staff Working Paper No. 720, The distributional impact of monetary policy easing in the UK between 2008 and 2014*
52 Written evidence from the Bank of England (QEI0015)
53 *Ibid.*
54 Q 44 (Melissa Davey)
55 Q 55 (Nigel Wilson)
56 Written evidence from Frances Coppola (QEI0010)
57 Written evidence from Professor Özlem Onaran (QEI0005)
58 Q 23 (Fran Boait)

less convincing".[59] Charles Goodhart, Emeritus Professor of Banking and Finance at the London School of Economics, made a similar point. He said that the Bank of England was right to say that quantitative easing does not increase income inequality, but the effect of raising asset prices had resulted in an increase in wealth inequality.[60]

65. Other witnesses told us that the more persistent than expected use of quantitative easing over the last decade had led to excessive and potentially destabilising risk-taking in markets. Dr Mohamed El-Erian, President of Queens' College Cambridge and Chief Economic Adviser at Allianz, told us that markets are in a bubble in which "financial assets are totally decoupled from [economic] fundamentals."[61] He said that the decoupling of assets from the real economy was a rational process because consistent central bank intervention through quantitative easing means that financial markets can take excessive risks in the knowledge that central banks will provide support if financial stability is threatened. He told us that the major risk is that this develops into an unhealthy co-dependency between central banks and markets.[62] He added: "Not only do markets expect central banks to come in and repress any volatility, regardless of the source of that volatility, but they require it. They feel entitled to central bank support."[63]

66. Lee Buchheit, Visiting Professorial Fellow at Queen Mary University of London, also told us that the global scale of quantitative easing could potentially compromise financial stability. The extra liquidity in the global system from quantitative easing "means that you have an investor community flush with liquidity that must be re-deployed in some fashion … This is the kindling for the proverbial search for yield." One of the consequences is that "the normal risk aversion of private sector lenders has not been eclipsed, but it has been anaesthetised by the fact that they are stuffed with liquidity that they must re-deploy and, therefore, they have implicitly revisited their normal risk aversion."[64]

67. **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.**

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

69. **The Bank has not adequately engaged with 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**

59 Q 9 (Chris Giles)
60 Q 95 (Charles Goodhart)
61 Q 62 (Dr Mohamed El-Erian)
62 Q 63 (Dr Mohamed El-Erian)
63 Q 64 (Dr Mohamed El-Erian)
64 Q 158 (Lee Buchheit)

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.

70. **The extent to which, and how, quantitative easing interacts with fiscal policy is still poorly understood. What is clear is that quantitative easing has distributional outcomes that exacerbate wealth inequalities that can be mitigated only through fiscal policy. We do not believe this is a reason for the Bank of England not to use quantitative easing as a monetary policy tool. Rather, more effective countervailing policies can be introduced by Government if these negative distributional effects are better understood. We therefore invite HM Treasury to reply to any research that the Bank produces on the distributional effects of quantitative easing.**

CHAPTER 3: QE AND THE COVID-19 PANDEMIC

Independence and accountability

71. The COVID-19 pandemic caused an economic shock that was unprecedented in peacetime. Between April and June 2020, when many businesses were closed as part of a UK-wide lockdown, GDP contracted by 19.5%. In response, the Bank of England cut interest rates to 0.1% and announced several rounds of quantitative easing.[65] We heard that the rapid enlargement of the quantitative easing programme, and the Bank of England's growing role and influence in the economy, had reopened debates over whether the policy had compromised the Bank's operational independence, and whether adequate accountability mechanisms are in place, commensurate with the expanded mandate of the Bank.[66]

Allegations of deficit financing

72. In 2020, the Bank of England conducted three rounds of quantitative easing, which raised the total amount of Government debt owned by the Bank from £425 billion to £875 billion (an increase of £450 billion). Minutes published by the Monetary Policy Committee set out the Bank of England's explanations for each round of quantitative easing since March 2020:

    - In March 2020, £200 billion of gilts were bought to "help improve the functioning of the gilt market and help to counteract a tightening of monetary and financial conditions that would put at risk the Monetary Policy Committee's statutory objectives".[67]

    - In June 2020, the Monetary Policy Committee voted to purchase an additional £100 billion of gilts. This was "warranted to meet [the Bank of England's] statutory objectives."[68]

    - In November 2020, the Monetary Policy Committee voted to purchase an additional £150 billion of gilts to "support the economy and help to ensure that the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target."[69]

73. Some witnesses said that quantitative easing was not an appropriate tool for supporting the economy and employment through sector specific

65 See Figure 4 in introduction for indication of scale of new asset prices.

66 Lord Tyrie submitted a proposal for enhanced Parliamentary scrutiny body to examine the work and policies of the Bank of England and other regulators in written evidence. See written evidence from Lord Tyrie (QEI0022). See also, European Parliament, *Accountability Mechanisms of the Bank of England and of the European Central Bank* (September 2020): https://www.europarl.europa.eu/cmsdata/211623/1_LASTRA-final.pdf [accessed 5 July 2021]

67 Minutes were published on 26 March 2020, alongside those of the regularly scheduled meeting ending on 25 March 2020. See, Bank of England, *Minutes of the special Monetary Policy Committee meeting on 19 March 2020 and the Monetary Policy Committee meeting ending on 25 March 2020*

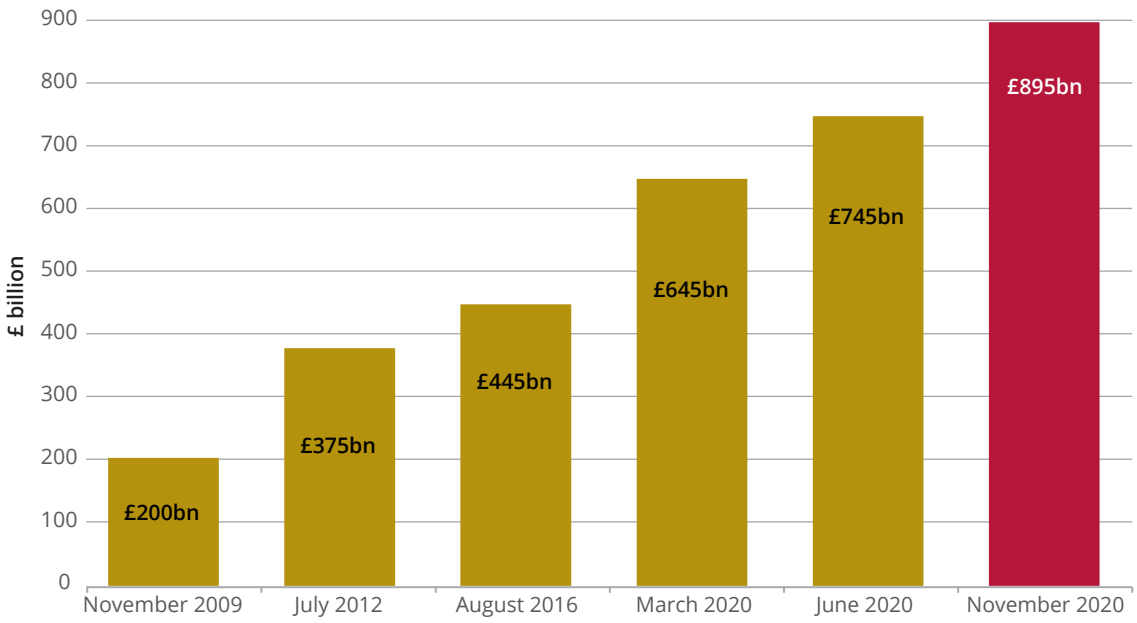
68 Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 17 June 2020*

69 Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 4 November 2020*. At subsequent meetings of the Monetary Policy Committee, it voted to continue with asset purchases previously announced. For example, on 17 March 2021 it confirmed that it expected it to complete asset purchases "by around the end of 2021." See, Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 17 March 2021* (18 March 2021): https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2021/march-2021.pdf [accessed 5 July 2021]

lockdowns. Professor Tim Congdon, Founder and Chairman of the Institute of International Monetary Research, said, "In my view, you should not use a general macroeconomic demand instrument or approach to deal with sectoral-specific issues".[70] Sir Paul Tucker, Research Fellow at Harvard Kennedy School and former Deputy Governor of the Bank of England, said he had questioned why the Bank of England wished to "stimulate aggregate demand just as aggregate supply is closing down".[71]

74. On 5 January 2021, the *Financial Times* published a survey which found the "overwhelming majority" of the 18 largest investors in Government debt believed that the Bank of England had bought gilts to keep the Government's borrowing costs down. The article reported that many investors were sceptical of the Bank of England's stated motivations for quantitative easing because of a correlation between the amount of gilts the Government had issued and the amount that the Bank of England had bought during the pandemic.[72] We were told that such market sentiments, if sufficiently widespread, could be a danger to financial stability. Frances Coppola, an author and economics commentator, wrote, "if markets perceived that the Bank of England was effectively monetising the government deficit on anything more than a very short-term basis, there would be a risk of a run on sterling, potentially triggering out-of-control inflation and widespread economic distress."[73]

Figure 6: Bank of England quantitative easing and Government borrowing requirements



Source: 'Investors sceptical over Bank of England's QE programme', Financial Times (5 January 2021): available at https://www.ft.com/content/f92b6c67-15ef-460f-8655-e458f2fe2487

75. Liam Halligan, Senior Economics Commentator at the Telegraph Media Group, referred to the *Financial Times* survey, telling us that quantitative easing "is now almost entirely about buying government debt. The Bank

70 Q 33 (Prof Tim Congdon)
71 Q 12 (Sir Paul Tucker)
72 'Investors sceptical over Bank of England's QE programme', *Financial Times* (5 January 2021): available at https://www.ft.com/content/f92b6c67-15ef-460f-8655-e458f2fe2487
73 Written evidence from Frances Coppola (QEI0010)

tries to portray the idea that quantitative easing is about increasing inflation to stave off deflation, but no one in the market believes that."[74]

76. Other witnesses said the use of quantitative easing during the COVID-19 pandemic was consistent with the Bank of England's mandate. Lord Darling of Roulanish, a former Chancellor of the Exchequer, said, "You can perfectly argue that what the Bank is doing now is entirely in keeping with the mandate that it has at present."[75] Rupert Harrison, Portfolio Manager and Chief Macro-Strategist at BlackRock, said the independence of the external members of the Monetary Policy Committee was a protection against the Bank acting beyond its mandate. He said, "I am absolutely confident that decisions of the Bank are made by the Bank in the context of its inflation remit."[76]

77. We heard that, while the latest rounds of quantitative easing did not constitute direct monetary financing, the result was effectively the same. Lord Turner of Ecchinswell, Senior Fellow and Grantee at the Institute for New Economic Thinking, said:

> "The quantitative easing that we are seeing is de facto financing the fiscal deficits that the Government are running, but the decision to do that quantitative easing was made by the Monetary Policy Committee in its independent judgment that, given that the Government would run this larger fiscal deficit, it would be more stimulative if it also did a quantitative easing operation to finance it, and that without that quantitative easing operation, inflation would have fallen further below target."[77]

78. Anjalika Bardalai, Chief Economist for TheCityUK, said that the rounds of quantitative easing since March 2020 had not constituted direct monetary financing as there had been no intention from the Bank of England to take such action. However, "notwithstanding the importance of the intention, the end result, you could argue, has been the same. That end result, as we have discussed, is a lowering of the cost of sovereign borrowing."[78]

79. The Governor of the Bank of England rejected suggestions that the Bank of England had acted beyond its mandate and denied that the correlation between debt issued and debt bought was significant. He said:

> "Take yourself back to 19 March last year. Nobody knew at that point what the fiscal deficit was going to be. I do not think the Chancellor knew what it was going to be. I do not think the Treasury knew what it was going to be. The Bank of England certainly did not know what it was going to be. So, it is just impossible for us to have fixed [quantitative easing] at that point to have matched fiscal deficits and the borrowing requirement. Nobody knew what it was, because the major economic effects of COVID had not happened at that point."[79]

80. The Governor said that the Bank of England's judgment on the number of gilts to purchase was made through its "assessment processes" and

74 Q 22 (Liam Halligan)
75 Q 75 (Lord Darling of Roulanish)
76 Q 56 (Rupert Harrison)
77 Q 98 (Lord Turner of Ecchinswell)
78 Q 137 (Anjalika Bardalai)
79 Q 197 (Andrew Bailey)

deciding which number would best support the inflation target up to a three-year horizon. In addition, he said that decisions were based on how much "headroom"—the amount of gilts the Bank of England can purchase without exceeding its self-imposed limits—remained for asset purchases. He observed that for these reasons the Bank of England could not in November 2020 have purchased significantly more than £150 billion of gilts, although he acknowledged that these self-imposed limits could be reviewed.[80]

Clarity of communications

81. The Monetary Policy Committee minutes from March 2020 noted that quantitative easing was aimed to bring stability to the gilt market. Subsequent announcements on quantitative easing were intended to bring inflation to target and to support the economy. The Governor of the Bank of England made several statements to the media after the March 2020 announcement, some of which attracted public attention:

- On 13 May 2020, he said that gilt purchases had been intended partly to "spread, over time, the cost of this thing to society, and that to me is important."[81]
- On 14 May 2020, he was reported to have said that the expansion of quantitative easing was not only intended to calm financial markets and keep inflation on track, but also for "smoothing the profile of Government borrowing and the impact that might have on financial markets."[82]
- On 22 June 2020, the Governor was reported to have said, "I think we would have [had] a situation where, in the worst element, the Government would have struggled to fund itself in the short run".[83]

82. Dr Ben Broadbent, Deputy Governor for Monetary Policy at the Bank of England, delivered a speech on quantitative easing in September 2020 which set out its purpose and how it meets monetary policy objectives.[84] Andrew Bailey and Sir Dave Ramsden, Deputy Governor for Markets and Banking at the Bank of England, also made speeches on quantitative easing in February 2021.[85] Sir Dave Ramsden said:

> "Some commentary that I have seen has suggested that in addressing market disorder the Monetary Policy Committee somehow broadened its objectives and used a monetary policy tool for financial stability purposes. I don't see it like that at all. The Monetary Policy Committee took action in pursuit of its objectives, because further market dysfunction triggered by the COVID shock would have led to even worse outcomes for GDP

80 QQ 184, 190 (Andrew Bailey)
81 ITV, 'Bank of England's Andrew Bailey explains how he is helping the government avoid austerity' (13 May 2020): https://www.itv.com/news/2020–05-13/governor-of-bank-of-england-andrew-bailey-robert-peston
82 'BoE is financing UK's coronavirus measures, Bailey acknowledges', *Financial Times* (14 May 2020): available at https://www.ft.com/content/ad63e45c-ad55-41a2-ae2e-8d550ff0ac92
83 'UK government almost ran out of funds, says BoE governor', *Financial Times* (22 June 2020): available at https://www.ft.com/content/1945b708-a1d0-4960-9cb2-7238a3c8cd89
84 Ben Broadbent, speech on Government debt and inflation, 2 September 2020: https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/government-debt-and-inflation-speech-by-ben-broadbent.pdf [accessed 5 July 2021]
85 Andrew Bailey, speech on Modern challenges for the modern central bank: perspectives from the Bank of England, 5 February 2021: https://www.bankofengland.co.uk/speech/2021/february/andrew-bailey-lse-event-german-symposium [accessed 5 July 2021]

> and inflation. Their action had the welcome side effect of supporting financial stability, but it was taken for monetary policy purposes."[86]

83. As a result we heard that the Bank of England's communications since March 2020 had been "poor".[87] Philip Aldrick, Economics Editor of *The Times*, told us that communications had become "increasingly confused" and that it was unclear initially how the March 2020 market stability intervention fed into monetary policy objectives: "Understandably, the initial phases were not very transparent. I think that there was confusion in the Monetary Policy Committee, and that led to a lack of clarity … which then helped to spur the concerns about whether this is monetary financing."[88] Blonde Money said, "the very fact that [Sir Dave] Ramsden had to make such a speech almost a year after the programme began suggests a recognition that communication needs to be improved."[89]

84. Chris Giles, Economics Editor at the *Financial Times*, said that the Bank had not been transparent about the size of gilt purchases, and referred to the announcement in November 2020 that there would be an additional £150 billion of quantitative easing:

> "When we asked the senior officials at the Bank of England, "Why £150 billion? Why not £200 billion? Why not £100 billion? Why not zero? What is the effect of different amounts of quantitative easing?", in the same way as you would normally ask the Bank those questions about interest rates, there was no reply … there is very little transparency over what the Bank of England thinks additional quantitative easing actually achieves."[90]

85. Sir Paul Tucker, Research Fellow at Harvard Kennedy School and former Deputy Governor of the Bank of England, said the best way to dispel accusations of deficit financing would be for the Bank of England to publish a forecast which set out the difference that it expected each round of quantitative easing to make to growth and inflation over two to three years.[91] Similarly, Adrian Grey, Global Chief Investment Officer at Insight Investment, said, "it would be helpful if in the whole communication strategy there was a little bit more about how the amount of quantitative easing mapped on to a growth or inflation target in the forecast period."[92] Blonde Money said in written evidence that the Bank of England should produce a "quantitative model" which sets out the extent to which quantitative easing programme had met its stated objectives.[93]

86. We heard that it would be challenging to create such a model. Blonde Money said, "such a model is only as good as its assumptions" and Lord Macpherson of Earl's Court said, "there is not a huge amount of science yet in quantitative easing. It is very difficult to know the precise impact of an

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86 Dave Ramsden, speech on QE as an economic policy tool - what does it do and how should we use it?, 17 February 2021: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/february/qe-as-an-economic-policy-tool-what-does-it-do-and-how-should-we-use-it-speech-by-dave-ramsden.pdf [accessed 5 July 2021]
87 Written evidence from Blonde Money (QEI0012)
88 Q 2 (Philip Aldrick)
89 Written evidence from Blonde Money (QEI0012)
90 Q 2 (Chris Giles)
91 Q 14 (Sir Paul Tucker)
92 Q 50 (Adrian Grey)
93 Written evidence from Blonde Money (QEI0012)

extra £10 billion or £20 billion of asset purchases."[94] Nevertheless, Chris Giles said, "We know that we cannot have accuracy in these things, but a little bit of additional transparency over what exactly they are thinking about and their judgment is entirely appropriate."[95]

87. The Governor of the Bank of England told us that communicating effectively about quantitative easing in 2020 had been a challenge: "It was a most extreme challenge for us, unsurprisingly, during the second quarter of last year when activity in the economy was falling by 20% … [Communicating] quantitative easing is a challenge to us, and it is one we have to take on and maintain, but I am under no illusions that in explaining monetary policy in a world where quantitative easing is a tool it is harder to communicate."[96]

88. **There is a widespread perception, including among large institutional investors in Government debt, that financing the Government's deficit spending 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.**

89. **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.**

90. **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 breakdown 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. We recognise that the quality of data on the effects of quantitative easing is limited but we believe that greater transparency will lead to improvements over time.**

Bank of England mandate

91. On 3 March 2021, the Chancellor updated the Bank of England's mandate so that it reflected the Government's "economic strategy for achieving strong, sustainable and balanced growth that is also environmentally sustainable and consistent with the transition to a net zero economy."[97] The update

94 Q 165 (Lord Macpherson of Earl's Court)
95 Q 2 (Chris Giles)
96 Q 184 (Andrew Bailey)
97 Letter from the Chancellor of the Exchequer to the Governor of the Bank of England (3 March 2021): https://committees.parliament.uk/publications/3958/documents/39777/default/

confirmed that the economic policy of the Government, which the Monetary Policy Committee is required to support as a secondary objective, includes supporting the transition to net zero emissions.[98]

92. For several years, central banks have been conducting work on managing climate risk to the financial sector and exploring their role in the transition to net zero. For example, in December 2017 eight central banks, including the Bank of England, and supervisors established the Network of Central Banks and Supervisors for Greening the Financial System. It now has 92 members.[99]

93. One of the implications of the update is that the Bank of England will need to change its approach to buying corporate bonds as part of its Corporate Bond Purchase Scheme. Under the Scheme, the Bank of England has purchased £20 billion of corporate bonds, which accounts for 6.5% of the sterling corporate bond market.[100] As Andrew Hauser, Executive Director for Markets at the Bank of England, said in a speech on 21 May 2021, large companies which use the bond market for finance are more likely on average to have large carbon footprints. To fulfil its updated mandate, the Bank of England will need to adjust the composition of the Corporate Bond Purchase Scheme, without compromising its monetary policy objectives.

94. Several witnesses said that the update to the mandate risked politicising the Bank of England. Christina Parajon Skinner, Assistant Professor of Legal Studies and Business Ethics at the Wharton School of the University of Pennsylvania, told us:

> "In connection with the green mandate, it puts the central bank in the position of choosing and making value judgments about green winners and losers. Deciding what is and is not in the green perimeter seems like a difficult task to take on with objectivity. The genie is out of the bottle at this point, but the discretion at least is a bit unhelpful to independence."[101]

95. Christina Skinner said that Parliament and the public would benefit from further insight as to why using the Asset Purchase Facility to make the financial system greener is monetary and not fiscal policy. "After all, that will have the direct effect of skewing the £20 billion programme towards certain kinds of green sectors, and potentially the secondary impact of raising the cost of credit for fossil fuel producers and similar corporates via a signalling channel."[102]

96. Some witnesses warned of the risks of giving central banks too many objectives which may bring them into conflict. Otmar Issing, President of the Center for Financial Studies and former Chief Economist at the European Central

98 The Bank of England has, for several years, considered the potential effects of climate change on the financial sector as part of its regulatory and financial stability responsibilities. See, Bank of England, 'Climate change': https://www.bankofengland.co.uk/climate-change [accessed 5 July 2021].

99 NGFS, 'Membership': https://www.ngfs.net/en/about-us/membership [accessed 5 July 2021]

100 Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 5 May 2021* (6 May 2021): https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2021/may-2021.pdf [accessed 5 July 2021] See also Andrew Hauser, speech on It's not easy being green – but that shouldn't stop us: how central banks can use their monetary policy portfolio to support orderly transition to net zero, 21 May 2021: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/may/its-not-easy-being-green-but-that-shouldnt-stop-us-speech-by-andrew-hauser.pdf [accessed 5 July 2021]

101 Q 145 (Christina Parajon Skinner)

102 Q 144 (Christina Parajon Skinner)

Bank, said, "Too many targets make it almost impossible to focus monetary policy on maintaining price stability."[103] Daniel Gros, Distinguished Fellow at the Centre for European Policy Studies, said, "The more independent a central bank is, the narrower its mandate has to be."[104] Lord Macpherson of Earl's Court thought that it was not clear whether the update to the mandate represented a significant change but said, "if we overload the Bank with objectives—bear in mind that it only has so many instruments—we risk dragging it into political areas where it will be criticised unnecessarily."[105]

97. Several witnesses said the Bank of England should largely limit climate change considerations to financial stability risks. Charles Goodhart said the Bank had a role in climate change policy because of its financial stability remit "but I would not go further".[106] Lord Turner of Ecchinswell said, "I would not like to see in the corporate bond portfolio a lot of playing around and saying, "I am going to buy the corporate bonds of this renewable energy company and not that".[107] Lord Darling of Roulanish said the Bank of England should consider financial stability risks from climate change but "where you get into difficulties is if the Government asks it to make decisions to lend to one person or one group of people or others when it does not really have the means of assessing whether something is carbon neutral".[108]

98. On 21 May 2021, Andrew Hauser, Executive Director for Markets at the Bank of England, launched a Discussion Paper setting out several challenges to 'greening' the Banks portfolio and how the Bank might overcome them. Challenges included the difficulty of not penalising carbon emitters with credible carbon reduction strategies and the risk of the Bank selling the bonds it currently holds to investors with the least interest in emissions reductions.[109] The Discussion Paper set out that changes to the Scheme:

    - cannot impede the ability of the Monetary Policy Committee to achieve its inflation target;
    - must have due regard to protecting public money; and
    - must be capable of clear and transparent explanation using robust and proven metrics.

    The Discussion Paper said the Bank was considering setting particular climate targets for the Bank's portfolio; making eligibility for the Corporate Bond Purchase Scheme conditional on climate-related actions by issuers; rebalancing bond purchases towards eligible issuers which have made stronger relative progress in achieving net zero; and implementing a strategy to make requirements for inclusion in the Corporate Bond Purchase Scheme progressively more stringent.[110]

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103 Q 173 (Otmar Issing)
104 Q 111 (Daniel Gros)
105 Q 166 (Lord Macpherson of Earl's Court)
106 Q 100 (Charles Goodhart)
107 Q 100 (Lord Turner of Ecchinswell)
108 QQ 76, 83 (Lord Darling of Roulanish)
109 Andrew Hauser, speech on It's not easy being green – but that shouldn't stop us: how central banks can use their monetary policy portfolio to support orderly transition to net zero, 21 May 2021: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/may/its-not-easy-being-green-but-that-shouldnt-stop-us-speech-by-andrew-hauser.pdf
110 Bank of England, *Options for greening the Bank of England's Corporate Bond Purchase Scheme* (May 2021): https://www.bankofengland.co.uk/-/media/boe/files/paper/2021/options-for-greening-the-bank-of-englands-corporate-bond-purchase-scheme-discussion-paper.pdf [accessed 5 July 2021]

99. The Governor of the Bank of England said the Bank's initial approach to greening the Corporate Bond Purchasing Scheme is to adapt the definition of market neutrality so that it takes "the direction of the change towards net zero" into account. He said that judging whether companies were adopting policies consistent with net zero was "not straightforward". The Governor said that the Bank of England aimed to have adapted the Corporate Bond Purchasing Scheme before it needed to rebalance its corporate bond portfolio in the autumn.[111]

100. On 26 May 2021, we wrote to the Chancellor to ask whether HM Treasury had provided any guidance or instructions to the Bank of England on how it should interpret and implement the update to its mandate. We asked how he expected the update to affect the Bank of England's Corporate Bond Purchasing Scheme. On 9 June 2021, he responded:

> "The Treasury gave no guidance or instruction to the Bank of England on how it should implement the update to the mandate, as it is for the independent MPC to judge how it can support the Government's green and other economic objectives whilst achieving its primary objective of price stability."

The Chancellor would not comment on how the update might affect the Corporate Bond Purchase Scheme and referred us to the Bank of England's 21 May 2021 Discussion Paper.[112] On 15 June 2021, we wrote to the Chancellor to request a fuller answer on the implications for the Corporate Bond Purchase Scheme.[113] In his response, the Chancellor declined to do so.[114]

101. **Any changes to the Bank of England's mandate must be considered carefully. HM Treasury has updated the mandate to reflect environmental sustainability and the transition to net zero. These are important issues, but HM Treasury's instruction is ambiguous, and its interpretation has been left to the discretion of the Bank of England. Without some clarification from the Government, the Bank risks being forced into the political arena, exposing it to criticism unnecessarily. The Chancellor should write to the Governor to clarify the Government's expectations.**

111 Q 198 (Andrew Bailey)
112 Letter from the Chancellor of the Exchequer to the Chair of the Economic Affairs Committee (10 June 2021): https://committees.parliament.uk/publications/6260/documents/69153/default/
113 Letter from the Chair of the Economic Affairs Committee to the Chancellor of the Exchequer (15 June 2021): https://committees.parliament.uk/publications/6608/documents/71317/default/
114 Letter from the Chancellor of the Exchequer to the Chair of the Economic Affairs Committee (2 July 2021): https://committees.parliament.uk/publications/6609/documents/71318/default/

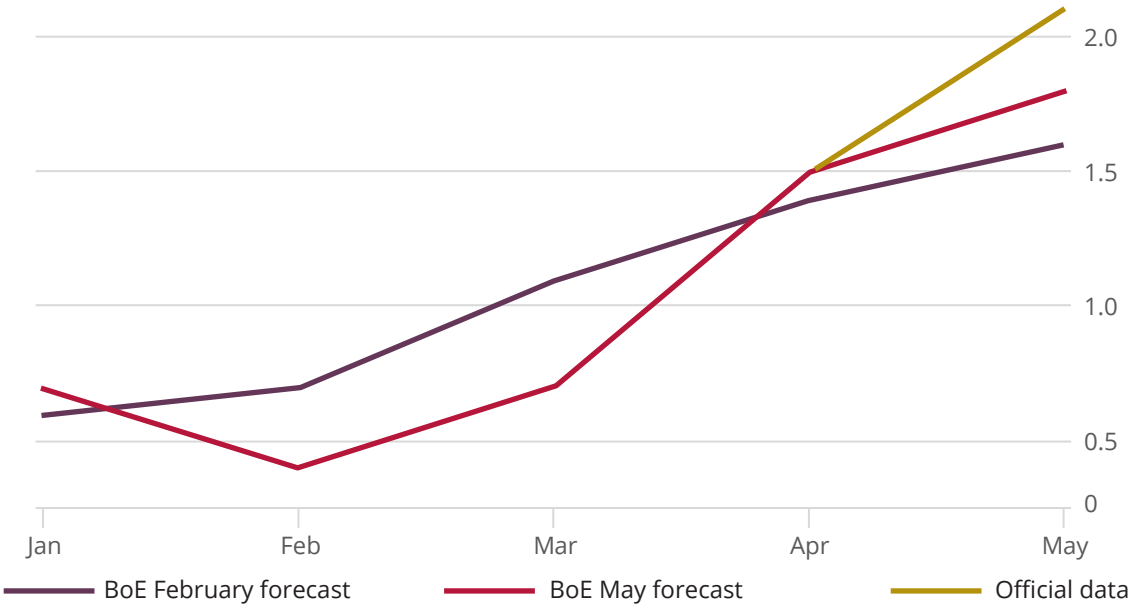
CHAPTER 4: THE FUTURE OF QUANTITATIVE EASING

102. We heard concern that central banks have not given adequate thought to the future of quantitative easing. Witnesses told us that the key risks facing central banks were the return of inflationary pressures, the risk that quantitative easing poses to debt sustainability and the lack of clarity on an exit strategy from quantitative easing.

Inflationary pressures

103. There is an active debate about renewed inflationary pressures facing advanced economies around the world, as economies start to recover from the COVID-19 pandemic and expansionary monetary policy is combined with expansionary fiscal policies.[115] There is rising concern that bottlenecks in supply chains, the release of pent up demand, and very high levels of personal savings available to spend once COVID-19 health restrictions are removed could result in a higher than expected rise in inflation. CPI inflation in the UK has risen from 0.4% in February 2021 to 2.1% in May 2021, slightly above the Bank of England's 2% inflation target. Figure 7 shows that the Bank's official inflation forecasts have underestimated the recent rise in inflation:

Figure 7: Bank of England inflation forecasts and CPI annual inflation rate, 2021 (%)



Source: 'Bank of England under pressure to show it can keep lid on inflation', Financial Times, (22 June 2021): available at https://www.ft.com/content/9c6487ac-4530-4df6-9dd4-a4b46a180734

115 Central to the renewed debate is the extent to which the Federal Reserve's loose monetary policy stance and the Biden administration's fiscal stimulus—the coronavirus relief package—will lead to sustained inflation. The Federal Reserve has said that it will tolerate a temporary overshoot of its 2% inflation target for some time so that the average inflation rate is 2% over the medium to longer-term. It expects to maintain an accommodative stance in monetary policy until it has achieved its dual goals of maximum employment and 2% average inflation over the longer run. See, Federal Reserve, Press Release, *Federal Reserve issues FOMC statement*, 17 March 2021: https://www.federalreserve.gov/newsevents/pressreleases/monetary20210317a.htm. For an overview of the debate about renewed inflationary pressures see, 'Fed meeting turns into a test of its inflation narrative', Mohamed El-Erian, *Financial Times* (14 June 2021): available at https://www.ft.com/content/46450be2-99dd-43ec-a9f3-9cf3c60d72e1 and 'The inflation risk is real', Lawrence Summers, *The Washington Post* (24 May 2021): available at https://www.washingtonpost.com/opinions/2021/05/24/inflation-risk-is-real/

104. However, the effect of quantitative easing on inflation, and the extent to which it has increased since the onset of the COVID-19 pandemic, is unclear.

105. Sir Paul Tucker, Research Fellow at Harvard Kennedy School and former Deputy Governor of the Bank of England, told us that quantitative easing "did not work on either side of the Atlantic to get inflation back to target, notwithstanding the scale of quantitative easing."[116] Otmar Issing, President of the Centre for Financial Studies and former Chief Economist of the European Central Bank, also said that the use of quantitative easing had not resulted in central banks being able to meet their inflation targets consistently.[117]

106. We heard from several witnesses who thought sustained inflation was unlikely. Fran Boait told us that the outlook in the UK appeared to be deflationary, pointing to long-term trends of declining real wages. She said that there is "less evidence to suggest a link between [quantitative easing] and consumer price inflation."[118] Professor Daniela Gabor said that deflation was a bigger risk than a sustained rise in inflation.[119]

107. Masaaki Shirakawa, former Governor of the Bank of Japan (2008–2013), told us that the risk of sustained inflation was "somewhat overblown." He said that, even accounting for the rollout of vaccination programmes and increases in demand, it is more likely that economies will return to their pre-pandemic level. He saw no convincing evidence that deflationary structural factors—such as globalisation and technological change—have been reversed.[120]

108. Lord Turner of Ecchinswell did not think sustained inflation was likely to occur because structural changes in the economy were pushing down long-term prices which made it more likely that advanced economies would experience a period of sustained low inflation. He saw no reason for central banks to tighten policy yet.[121]

109. Charles Goodhart said there is a long-term reversal of global low-wage manufacturing taking place, which makes it more likely that "the underlying context in which central banks will have to operate over the next few decades will shift from deflationary to inflationary."[122] However, he argued that in the short-term it would be "very unwise" for central banks to change their policy stance because it is still highly uncertain how economies will recover once the pandemic has fully receded.[123]

110. Dr Mohamed El-Erian thought "there will be a rise in measured inflation" but did not believe it would result in sustained inflation over the medium to

116 Q 15 (Sir Paul Tucker)
117 Q 174 (Otmar Issing)
118 Q 24 (Fran Boait)
119 Q 6 (Prof Daniela Gabor)
120 Q 149 (Masaaki Shirakawa)
121 Q 96 (Lord Turner of Ecchinswell)
122 Q 96 (Charles Goodhart). Charles Goodhart and Manoj Pradhan have said that long-term deflationary trends are beginning to reverse as demographic reversals and retreats from globalisation become more prominent. They argue that, in the long-term, this is likely to result in inflationary pressures returning. For an overview see, LSE blogs, 'The great demographic reversal and what it means for the economy': https://blogs.lse.ac.uk/businessreview/2020/09/18/the-great-demographic-reversal-and-what-it-means-for-the-economy/ [accessed 6 July 2021]
123 Q 96 (Charles Goodhart)

long term. [124] Lord Darling of Roulanish said that "it is by no means certain that we are bound to have higher inflation." Lord Darling said that the focus should still be on providing the necessary support to ensure that the economy will recover. Whilst he agreed that a sharp recovery could lead to some inflationary pressures, "it would be a mistake to think that suddenly we will go back to where we were 20 or 30 years ago, when structural problems caused very high levels of inflation. I do not think we are at that stage, but you have to be mindful of it."[125]

111. However, other witnesses expressed concern that the rounds of quantitative easing conducted since March 2020 may prove to be inflationary. Professor Tim Congdon, Founder and Chairman of the Institute of International Monetary Research at University of Buckingham, and Liam Halligan, Senior Economics Commentator at The Telegraph Media Group, both said that rounds of quantitative easing since the start of the COVID-19 pandemic would be inflationary. Professor Tim Congdon said that the expansion of quantitative easing had rapidly increased the quantity of money in circulation. He warned that this could be inflationary if it coincided with excess demand and spending post-pandemic.[126] Liam Halligan agreed and said that a concurrent increase in quantitative easing and Government debt could cause inflationary pressures if increased savings that had accumulated throughout the pandemic led to excess demand.[127]

112. William Allen, Visitor at the National Institute of Economic and Social Research, saw "a clear risk of inflation taking off". He said that quantitative easing had increased the money supply and that there is a risk that inflation will rise if there is a release of pent up demand, in part driven by the increase in household savings over the COVID-19 pandemic.[128]

113. David McMillan, Professor of Finance at the University of Stirling, said that, unlike the initial round of quantitative easing in which there was a requirement to recapitalise the banking sector, the current round "is instead directly entering the economy." He said that an increase in the money supply is not inherently inflationary, but that the potential for higher inflation is realistic if it were to coincide with a strong economic recovery in which demand outstrips supply and real wages increase substantially. However, he said that there are still deflationary factors—such as an ageing population, technological advancements and falling commodity prices—that may mitigate a rise in inflation over the long-term.[129]

114. Andy Haldane, the outgoing Chief Economist of the Bank of England, has warned against complacency on inflation. In a speech delivered in February 2021, he argued that the UK may experience a "sharper and more sustained rise in inflation than expected." He warned that it could be difficult to get inflation under control if it was allowed to overshoot and become sustained.[130]

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124 Q 67 (Dr Mohamed El-Erian)
125 Q 74 (Lord Darling of Roulanish)
126 Q 24 (Prof Tim Congdon)
127 Q 24 (Liam Halligan)
128 Q 157 (William Allen)
129 Written evidence from Professor David McMillan (QEI0006)
130 Andy Haldane, Speech on Inflation: A Tiger by the Tail?, 26 February 2021, pp 22–23: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/february/inflation-a-tiger-by-the-tail-speech-by-andy-haldane.pdf [accessed 5 July 2021]. See also, 'The beast of inflation is stalking the land again', *New Statesman* (9 June 2021): https://www.newstatesman.com/2021/06/dangerous-moment

115. Witnesses agreed that the Bank of England's response to any sustained inflationary pressures would be a test of its operational independence. Chris Giles, Economics Editor of the *Financial Times*, said that taking action to keep inflation in check by raising interest rates may put the Bank into conflict with HM Treasury.[131] Otmar Issing said action needed to prevent sustained inflation will bring central banks into conflict with their governments. He said:

> "It will be a very hard test for the central bank to withstand political pressure and I see a great risk that exit, once needed to nip inflationary development in the bud, might be delayed because central banks have come closer to political decisions during the financial crisis and now in the context of the pandemic."[132]

116. The Bank of England's central projection is that inflation will continue to exceed 2% in the short-term having passed that rate in May 2021, before returning to around 2% in the medium-term.[133] The Bank said that the projected near term rise in inflation is due "mainly to developments in energy prices."[134] The Governor reaffirmed this view to us when he said that the Bank expected a short-term rise in inflation, partly due to strong shifts in energy prices and a potential increase in consumer spending, but it did not see evidence that inflationary pressures will persist.[135]

117. Sir Dave Ramsden, Deputy Governor for Markets and Banking, told us that the Bank of England was assessing the balance between demand and supply, and the extent to which there is excess demand building as the economy recovers. He said that the Bank of England did "not see that being sustained, because we think that momentum will slow in the economy through this year for a number of factors."[136]

118. In June 2021, the Monetary Policy Committee said that downside risks to the UK's economic outlook remained. It highlighted the risks of a resurgence of COVID-19 and said that it expected the boost to GDP provided by increased consumer spending, business investment, and strong Government spending to wane after 2021.[137] In June 2021, the Monetary Policy Committee were split by 8–1 in favour of continuing the Bank's existing programme of Government bond purchases. Andy Haldane, the Bank's outgoing Chief Economist, voted to reduce the stock of these purchases from £875 billion to £825 billion.[138]

119. **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**

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131 Q 3 (Chris Giles)
132 Q 172 (Otmar Issing)
133 Bank of England, Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 22 June 2021 (24 June 2021) p 1: https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2021/june-2021.pdf [accessed 6 July 2021]
134 Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 5 May 2021*, p 3
135 Q 192 (Andrew Bailey)
136 Q 192 (Sir David Ramsden)
137 Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 22 June 2021*, pp 7–9
138 *Ibid.*, p 11

with substantial Government spending, bottlenecks in supply, and a recovery in demand after the COVID-19 pandemic.

120. **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 pressures 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.**

Debt management

Asset Purchase Facility and the indemnity

121. In the UK, the Bank of England created a subsidiary company for conducting quantitative easing called the Bank of England Asset Purchase Facility Fund Limited (usually known as the Asset Purchase Facility). The Bank of England lends money to the Asset Purchase Facility to buy Government or occasionally corporate bonds. The purpose of the Asset Purchase Facility was to permit the Government to provide an indemnity to a ring-fenced entity that would conduct asset purchase operations.

122. When the Bank of England lends money to the Asset Purchase Facility, it increases the size of its balance sheet—the balance of assets and liabilities that it holds. The asset side of its balance sheet is increased in line with the size of its loan to the Asset Purchase Facility, on which it receives interest at Bank Rate. The liability side is increased in line with the increase in reserves, on which it pays interest to commercial banks, also at Bank Rate. Quantitative easing is not intended to lead to a permanent increase in the size of the Bank of England's balance sheet. When economic circumstances permit, the Bank of England has said that the Asset Purchase Facility will 'unwind' its asset purchases. This could, for example, be by allowing bonds to mature or by selling them back to the market.

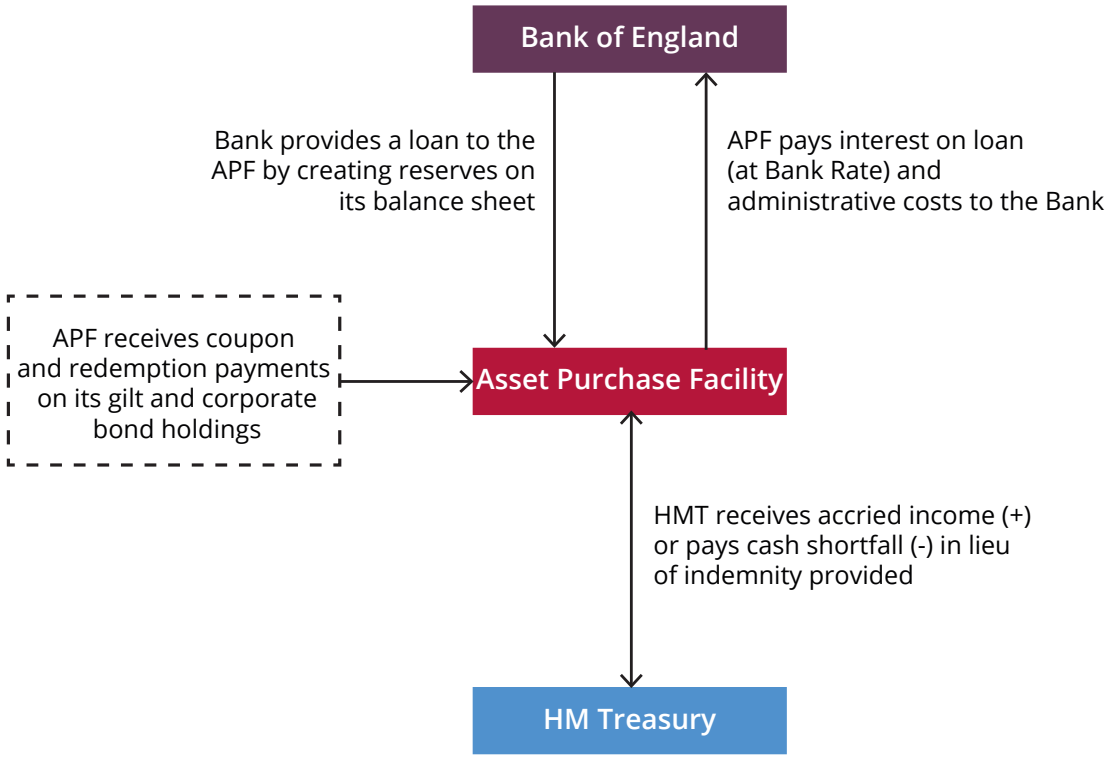
123. The Asset Purchase Facility receives income from the bonds that it holds through, for example, coupon payments from the Government. This income is used to fund the interest payments on the Asset Purchase Facility's loan from the Bank of England, along with any administrative costs. It is therefore possible for the Asset Purchase Facility to make a profit, as the money it receives from coupon payments can exceed the interest that it pays at Bank Rate on the loan from the Bank of England. It is also possible that the coupon rate is lower than Bank Rate, particularly if the Bank of England found it was necessary to raise Bank Rate to control inflation, which would lead to a loss.

124. However, the Asset Purchase Facility is fully indemnified by HM Treasury. This means that any loss that might result from purchasing bonds is borne by HM Treasury, and any profits that are gained are owed to HM Treasury. According to the Bank of England, the indemnity is there to guarantee the integrity of the Bank's balance sheet and to avoid any suspicion that monetary policy decisions "might be taken with a mind to their financial

implications for the Bank, rather than purely in pursuit of the monetary policy objectives."[139] When the Bank of England wishes to conduct additional quantitative easing, it is necessary for the Governor to write to the Chancellor to request permission to use the Asset Purchase Facility because of the risk to the public finances.

125. Figure 8 sets out the cash transfer arrangements between the Asset Purchase Facility, the Bank of England and HM Treasury as a result of the indemnity.

Figure 8: Stylised Asset Purchase Facility cash flows



Source: Bank of England, 'IEO Evaluation of the Bank of England's approach to quantitative easing', 13 January 2021: https://www.bankofengland.co.uk/independent-evaluation-office/ieo-report-january-2021/ieo-evaluation-of-the-bank-of-englands-approach-to-quantitative-easing [accessed 6 July 2021]

126. Since it was established, the Asset Purchase Facility has made an operating profit. Between 1 April 2013 and 28 February 2021, the Asset Purchase Facility made payments to HM Treasury which totalled £112.5 billion, with £13.7 billion of this transferred between 1 March 2020 and 28 February 2021.[140]

The effect on the public finances

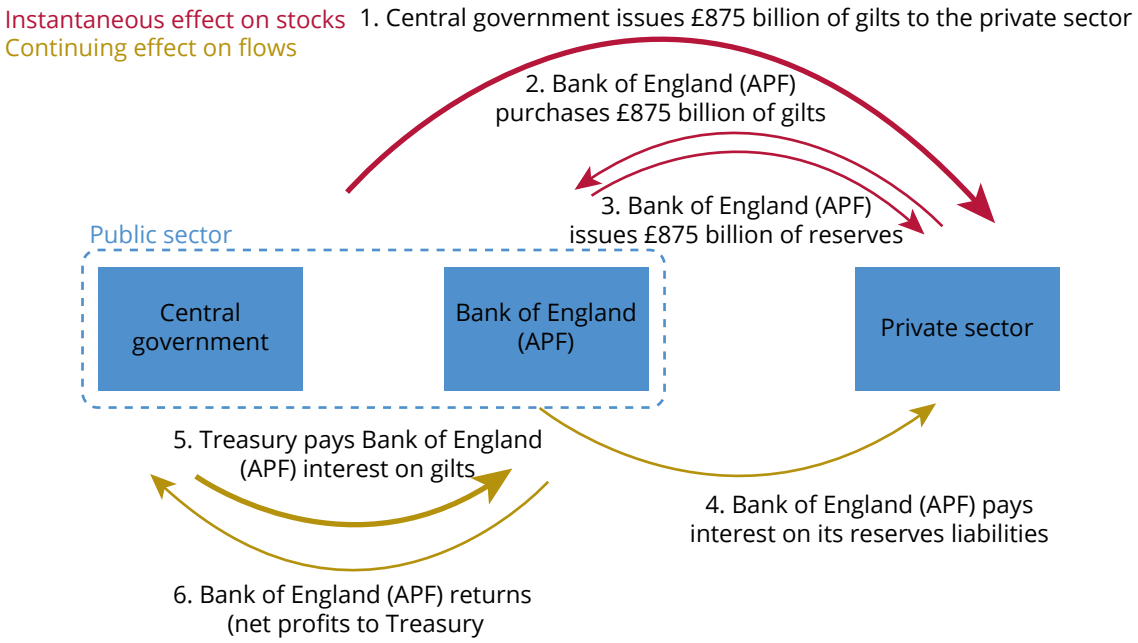
127. As described above, if the Bank Rate were to rise above the average rate of return on the assets held in the Asset Purchase Facility, the fund's interest costs would end up exceeding its receipts. In other words, the cashflow would turn negative and HM Treasury would have to reimburse the Asset Purchase Facility so that it does not make a loss.

139 Written evidence from the Bank of England (QEI0015)

140 Bank of England, *Bank of England Asset Purchase Facility Fund Limited Annual Report and Accounts, 1 March 2020–28 February 2021* (17 June 2021): https://www.bankofengland.co.uk/-/media/boe/files/asset-purchase-facility/2021/annual-report_2021.pdf [accessed 6 July 2021]. See also Q 185 (Andrew Bailey).

128. Figure 9 shows the direct effects of the Asset Purchase Facility on the public finances.

Figure 9: Effects of the Asset Purchase Facility on the public finances



Source: Office for Budget Responsibility, Debt maturity, quantitative easing and interest rate sensitivity (3 March 2021): https://obr.uk/box/debt-maturity-quantitative-easing-and-interest-rate-sensitivity/ [accessed 6 July 2021]

129. In general, quantitative easing has lowered the cost of servicing Government debt by lowering long-term interest rates, which means that the Government can borrow money at low levels of interest. However, while the cost of servicing the Government's debt has diminished in recent years, this has come at the cost of greater sensitivity to changes in interest rates relative to if there had been no quantitative easing, because lower short-term rates are reflected more quickly in Government borrowing costs as quantitative easing shortens the overall duration of its liabilities.[141]

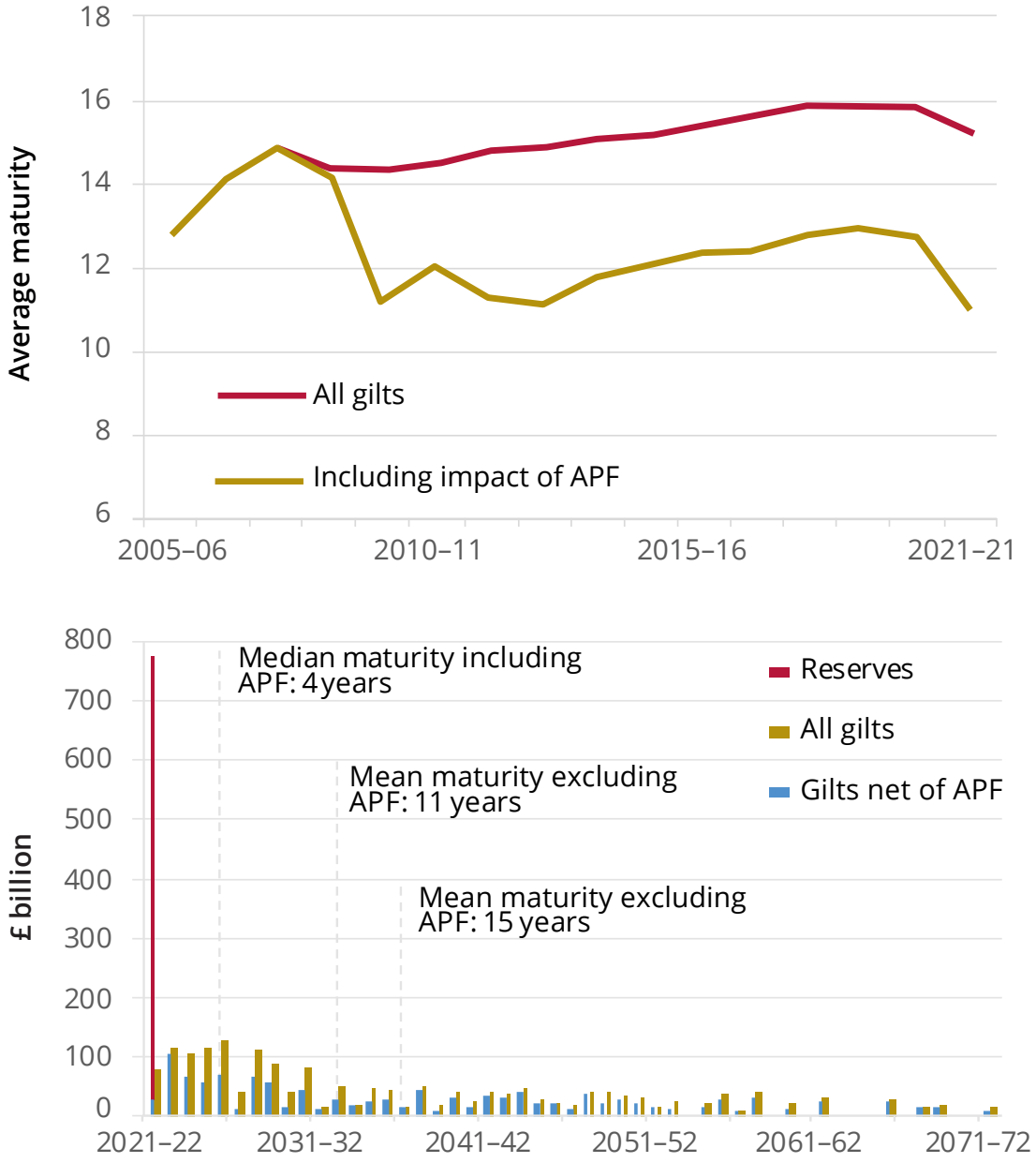
130. Dr Ben Broadbent, Deputy Governor for Monetary Policy at the Bank of England, explained that quantitative easing has an impact on the overall cost of Government debt by shortening the maturity of its liabilities. Dr Ben Broadbent told us that a shorter maturity means:

> "that (i) the government's overall debt costs (including any payments to the [Asset Purchase Facility]) are at the margin more sensitive to shorter-term rates, relative to longer-term yields, and (ii) the impact of any lasting change in short and long rates tends to come through more quickly."[142]

141 Office for Budget Responsibility, 'Debt maturity, quantitative easing and interest rate sensitivity': https://obr.uk/box/debt-maturity-quantitative-easing-and-interest-rate-sensitivity/ [accessed 6 July 2021]

142 Letter from the Deputy Governor for Monetary Policy at the Bank of England to the Chair of the Economic Affairs Committee (4 June 2021): https://committees.parliament.uk/publications/6259/documents/69152/default/

Figure 10: Mean maturity and redemption distribution of gilts



Source: Office for Budget Responsibility, 'Debt maturity, quantitative easing and interest rate sensitivity': https://obr.uk/box/debt-maturity-quantitative-easing-and-interest-rate-sensitivity/ [accessed 6 July 2021]

131. In other words, quantitative easing hastens the resulting increase in the cost of servicing the Government's debt if interest rates were to rise across the curve. On 6 July 2021, the Office for Budget Responsibility said that since 2008, the proportion of Government debt on which interest rates respond within the first year "has more than doubled", which "has made the first-year fiscal impact of a one percentage point rise in interest rates six times greater than it was just before the financial crisis, and almost twice what it was before the pandemic, just 18 months ago."[143] In terms of the impact on the overall cost of Government debt, the Office for Budget Responsibility has said:

143 Office for Budget Responsibility, *Fiscal risks report* (July 2021)p 17: https://obr.uk/docs/dlm_uploads/Fiscal_risks_report_July_2021.pdf [accessed 6 July 2021]

> "To illustrate the potential fiscal impact of an increase in interest rates, if short- and long-term interest rates were both 1 percentage point higher than the rates used in our forecast–a level that would still be very low by historical standards–it would increase debt interest spending by £20.8 billion (0.8% of GDP) in 2025–26. To put this into context, it is roughly equivalent to two-thirds of the medium-term fiscal tightening announced by the Chancellor in this Budget."[144]

132. However, Dr Ben Broadbent told us quantitative easing "has no bearing on the eventual cost" of any rise in servicing Government debt. He said that while quantitative easing had sped up the increase in the cost of Government debt, this should not be taken in isolation from the fact that the average maturity of the stock of gilts since quantitative easing began has lengthened to 15 years. This means that "the extra cost would come through more slowly than in other jurisdictions."[145]

133. Professor Jagjit S Chadha, Director of the National Institute of Economic and Social Research, explained that the cost of servicing Government debt does "not rise immediately in line with Bank Rate" because the average maturity of the stock of gilts is 15 year: "that means any increase in funding costs today only impacts on the small fraction of debt that has to be refinanced (rolled-over) or raised in that year." He told us that it is "misleading" to suggest that the total stock of Government debt will face an immediate increase in funding costs following a change in the Bank Rate. Instead, the "gradual increase in funding costs affords us time to act on developing sources of tax revenues rather than reducing fiscal support measures too rapidly."[146]

134. Professor Jagjit S Chadha stressed that the economic context in which the Bank Rate may rise is key to whether it has a negative impact on the Government's total stock of debt. He said, "we cannot solely look at changes in funding costs without understanding the cause of those changes. An increase in funding costs related to a rapid return to normal economic activity will not pose anything like the problem that a rapid increase in global interest rates might cause us if our economic cycle did not merit it."[147]

135. In other words, the risk to the Government's finances posed by greater interest rates needs to be contextualised by the likely reason for the increase in the interest rate. On 3 March 2021, the Office for Budget Responsibility set out two reasonable scenarios:

    - In a **benign scenario** where the increase in interest rates reflects higher economic growth, the debt stock could ultimately be lower and the Government's primary balance more favourable.

    - A **malign scenario** where interest rates rise because investors demand a higher risk premium. This would be more likely to be accompanied by a deteriorating economic and fiscal position. In such circumstances, the Office for Budget Responsibility said the Government may find it

144 Office for Budget Responsibility, 'Debt maturity, quantitative easing and interest rate sensitivity': https://obr.uk/box/debt-maturity-quantitative-easing-and-interest-rate-sensitivity/ [accessed 6 July 2021]

145 Letter from the Deputy Governor for Monetary Policy at the Bank of England to the Chair of the Economic Affairs Committee (4 June 2021): https://committees.parliament.uk/publications/6259/documents/69152/default/

146 Written evidence from Professor Jagjit Chadha (QEI0021)

147 *Ibid.*

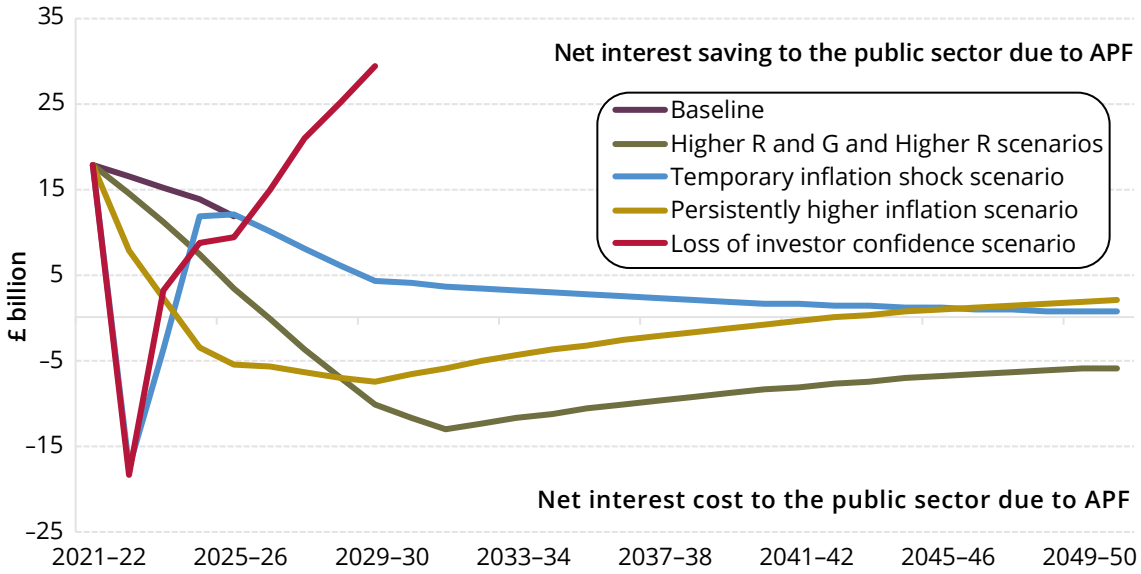
difficult to make the spending cuts and tax rises necessary to restore the debt trajectory to a sustainable path.[148]

136. We note that in a malign scenario there could also be supply chain issues and increasing wage demands which might result in investors seeking an inflation premium on Government debt.

137. In July 2021, the Office for Budget Responsibility modelled the fiscal impact of different inflation scenarios on the Asset Purchase Facility.[149]

- Under a '**persistently higher inflation'** scenario, a rising Bank Rate sharply increases payments on reserves, which eventually exceed the coupon income earned, resulting in a deficit in the Asset Purchase Facility.
- Under a '**temporary inflation shock'** scenario, a sharp increase in Bank Rate would quickly send the Asset Purchase Facility into deficit, but it would return to surplus relatively quickly when the rise in Bank Rate is reversed to reflect the temporary nature of the inflationary shock.
- In the most extreme scenario, a '**loss of investor confidence'**, the Asset Purchase Facility experiences a sharp fall into deficit to begin with. However, in this scenario the surplus in the Asset Purchase Facility rises sharply following the initial fall and keeps rising as the soaring gilt rate would rapidly increase earnings on rolled over gilts.

Figure 11: Net savings to the public sector of the APF based on the Office for Budget Responsibility's scenarios



Note: Loss of investor confidence scenario only shown to 2029–30

Source: Office for Budget Responsibility, Fiscal risks report (July 2021), p 204

148 Office for Budget Responsibility, 'Debt maturity, quantitative easing and interest rate sensitivity': https://obr.uk/box/debt-maturity-quantitative-easing-and-interest-rate-sensitivity/ [accessed 6 July 2021]

149 Office for Budget Responsibility, *Fiscal risks report* (July 2021), pp 203–205

138. William Allen, Visitor at the National Institute of Economic and Social Research, said that "in the UK context debt management will be extremely difficult in the coming few years."[150] He told us that "there is a risk that maintaining sustainability in the public finances can become inconsistent or at least difficult to reconcile with achieving the inflation target."[151] Masaaki Shirakawa made a similar point. He told us that, were inflationary pressures to increase and central banks tightened monetary policy significantly, this "could affect financial institutions and government finance."[152]

139. We heard several proposals for how the Government and the Bank of England might mitigate the impact that interest rate rises could pose to the cost of servicing the Government's overall stock of debt.

140. Charles Goodhart proposed that the Bank of England could return to paying zero interest on central bank reserves. He said that it will be politically difficult to maintain the policy of paying interest on reserves were interest rates to rise and the Bank of England were required to make large payments to commercial banks as a result. If there was a period of paying zero interest on reserves, he said that the fiscal cost of interest rate rises would be minimised.[153] Philip Aldrick, Economics Editor of *The Times*, set out the case for Charles Goodhart's proposal. He said that if interest rates on reserves were removed, the Bank of England would have no requirement to pay interest on its liabilities to the private sector, and the coupon on gilts would instead transfer "back and forth between the Government" and the Bank of England at no fiscal cost.[154] Both witnesses agreed that paying no interest on reserves would in effect operate as a tax on the commercial banking sector, whilst Charles Goodhart said that any decision to return to paying zero interest on reserves would have to be taken by the Chancellor.[155]

141. Sir Paul Tucker told us that in order to make the management of its debt more sustainable, "there must be a chance at some point that the Government will say to the Bank of England, "For God's sake, can you not stop paying interest on reserves?"" He said that if the Government and the Bank of England were to choose to do so, it would reduce the cost of servicing Government debt and transfer the costs to the banking sector.[156]

142. Lord Turner of Ecchinswell suggested that, rather than the Bank of England paying zero interest on all reserves, a tranche of reserves could be renumerated at zero interest, while marginal reserves above a certain level could be renumerated at Bank Rate.[157]

143. Anjalika Bardalai, Chief Economist at TheCityUK, expressed concern about the potential impact of paying zero interest on reserves on the banking sector. She told us that "the policy would be perceived as a form of off-balance sheet accounting" and that it would amount to "a financial penalty" on commercial banks "because they would be prevented from earning interest on the reserves and from increased lending, presumably at a profit."[158]

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150 Q 161 (William Allen)
151 Q 160 (William Allen)
152 Q 149 (Masaaki Shirakawa)
153 Q 97 (Charles Goodhart)
154 Q 5 (Philip Aldrick)
155 Q 97 (Charles Goodhart)
156 Q 17 (Sir Paul Tucker)
157 Q 97 (Lord Turner of Ecchinswell)
158 QQ 125, 126 (Anjalika Bardalai)

144. William Allen suggested an alternative approach. He proposed that there "should be a compulsory exchange of reserve balances held by the commercial banks for newly issued short and medium-term gilts by the Treasury, so that instead of having a floating interest rate liability the Treasury would have liabilities with interest rates fixed at least for a period ahead". He said that the benefits of this proposal would be to transfer the interest rate risk from the Government to the commercial banking sector, which would slow down the impact of any increase in short-term interest rates on the public finances, providing the Government with "breathing space in working out what to do in the event that interest rates go up."[159]

145. In March 2021, William Allen published a paper which set out how much interest is paid on reserves:

> "Simply not paying interest on a large chunk of bank reserves would solve the fiscal problem at a stroke. In effect, it would place all or nearly all of the burden on the shoulders of the banks. Bank reserves are currently around £800 billion, and will be over £900 billion by the time the quantitative easing programme is completed. The interest cost to the banks collectively would be £800 million a year before tax, which they could probably swallow, but of course it could be many times larger if short-term interest rates rose."[160]

146. Unlike other witnesses, William Allen thought any decision on central bank reserve policy was within the domain of the Bank of England, rather than HM Treasury. He said that the decision to pay interest on reserves is for the Monetary Policy Committee to decide as it falls within its remit to implement monetary policy. [161]

147. Anjalika Bardalai told us that William Allen's proposal would still represent a loss of interest for commercial banks, but on a lesser scale than the proposals made by Charles Goodhart and Lord Turner.[162]

148. The Governor did not support any of the proposals that had been put forward to the Committee:

> "It would complicate the transmission of monetary policy substantially, because that begins with us setting the short-term official rate—the official Bank Rate. That transmits through the interest rate we pay on the reserves that banks hold at the Bank of England … it would complicate and weaken the implementation of monetary policy." [163]

149. The Governor said that paying zero interest on central bank reserves would not be a decision for the Bank of England. He said, "it is a tax on the banking system. It is not monetary policy; it is fiscal policy."[164]

150. We asked the Chancellor what assessment HM Treasury had made of such proposals. He said that HM Treasury is not considering proposals to cease paying interest on central bank reserves. He wrote, "The governance for any

159 Q 160 (William Allen)
160 National Institute of Economic and Social Research, *Managing the fiscal risk of higher interest rates* (26 March 2021): https://www.niesr.ac.uk/sites/default/files/publications/NIESR%20Policy%20Paper%20025_0.pdf [accessed 6 July 2021]
161 Q 159 (William Allen)
162 Q 126 (Anjalika Bardalai)
163 Q 197 (Andrew Bailey)
164 *Ibid.*

future new policies would be based upon the current split of responsibilities between HM Treasury and the MPC. The independent MPC has sole responsibility for the operation of monetary policy, and the Treasury has responsibility for fiscal policy."[165] On 15 June 2021, we wrote to the Chancellor to request he tell us explicitly which institution would be responsible for taking any decision to stop paying interest on reserves.[166] The Chancellor replied, "… we have not made an assessment of the specific governance and responsibilities that would apply. Therefore, I hope the [Economic Affairs] Committee will understand why my previous answer instead set out the long-established division of institutional responsibilities that we would apply when considering any new policy in this area."[167]

151. **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.**

152. **Managing the UK's increased public debt accrued in response to the COVID-19 pandemic will require greater coordination between monetary and fiscal authorities. We heard a range of proposals setting out how the Bank of England and HM Treasury could mitigate the impact that interest rate rises could pose to the sustainability of the Government's debt. These proposals amount to fiscal policy as they would effectively be a tax on the banking sector—we heard that if Bank Rate was to rise to 1% without interest paid on reserves, commercial banks would forgo around £9 billion a year based on current reserve levels. HM Treasury needs to clarify and put beyond doubt whether any decision to cease paying interest on reserves would be taken by Ministers, not the Bank of England.**

Deed of Indemnity

153. Dr Will Bateman, an Associate Professor at Australian National University, said that the Deed of Indemnity for the Asset Purchasing Facility has not been published. He said the Deed of Indemnity provides the legal framework for the indemnification of quantitative easing and that the "secrecy" of the document is an "extraordinary feature of the UK's quantitative easing programme". It "is a contractual document between two governmental institutions which commits the UK's taxpayers to potentially enormous liability and appears to authorise quantitative easing in the UK. It should be published."[168]

154. We asked Lord Macpherson of Earl's Court, who was Permanent Secretary to HM Treasury at the time that the Deed of Indemnity was agreed, why it had not been published. He said, "I seem to remember that, at that time, we were pretty focused on being as transparent as we could be" and "I would hope that, if we forgot in some way to publish it, we could publish it, because

165 Letter from the Chancellor of the Exchequer to the Chair of the Economic Affairs Committee (10 June 2021): https://committees.parliament.uk/publications/6260/documents/69153/default/

166 Letter from the Chair of the Economic Affairs Committee to the Chancellor of the Exchequer (15 June 2021): https://committees.parliament.uk/publications/6608/documents/71317/default/

167 Letter from the Chancellor of the Exchequer to the Chair of the Economic Affairs Committee (2 July 2021): https://committees.parliament.uk/publications/6609/documents/71318/default/

168 Written evidence from Dr Will Bateman (QEI0017)

it will add to the sum of human knowledge and therefore create a better debate".[169]

155. The Governor of the Bank of England told us that the Deed of Indemnity "basically sets out the terms of operations of the Asset Purchase Facility and how the indemnity that the Treasury gives us works. On the question of publication, it is a Treasury document, so it is not something that the Bank of England could agree on its own to publish." He added, "I could not see anything in it when I read it that I think would excite people if it were published, but it is not my decision—it is the Treasury's."[170]

156. We wrote to the Chancellor to ask whether HM Treasury would publish the Deed of Indemnity. On 10 June 2021, the Chancellor replied but did not say whether the Deed of Indemnity would be published. Instead he wrote, "I would reaffirm the Governor's remarks during his evidence, that the document does not cause the Bank to have to ask for permissions and it sets out the terms of operations of the Asset Purchase Facility and how the Indemnity works."[171] On 15 June 2021, we asked the Chancellor to clarify his answer and requested that he set out why the Deed of Indemnity had not been published and whether he would now do so.[172] On 2 July 2021, the Chancellor replied: "I have carefully considered the case for publishing the Deed of Indemnity and I do not intend to publish the document."[173]

157. **The asset purchase facility is indemnified by HM Treasury, but the Deed of Indemnity has not been published. This is a contractual document between two public institutions. We heard no convincing explanation for why the document has not been placed in the public domain, which has concealed it from parliamentary and public scrutiny. The Chancellor has repeatedly ignored our requests for an explanation on why the document has not been published. HM Treasury should publish the Deed of Indemnity.**

Unwinding quantitative easing

158. Unwinding quantitative easing is a process sometimes referred to as quantitative tightening, which is a contractionary policy applied to decrease the amount of money and liquidity in the economy. This process will involve central banks reducing the size of their balance sheets. They can do this by allowing their bond holdings to mature rather than replacing them, tapering or slowing the amount of asset purchases made, or selling gilts back to the market.[174] In 2013, the Federal Reserve announced it would begin to reduce or 'taper' the pace of its asset purchases. In reaction to the announcement, which was not expected by the financial markets, bond yields and financial market volatility rose significantly. This response by the financial markets was known as a 'taper tantrum' in the financial media.

169 Q 169 (Lord Macpherson of Earl's Court)
170 Q 189 (Andrew Bailey)
171 Letter from the Chancellor of the Exchequer to the Chair of the Economic Affairs Committee (10 June 2021): https://committees.parliament.uk/publications/6260/documents/69153/default/
172 Letter from the Chair of the Economic Affairs Committee to the Chancellor of the Exchequer (15 June 2021): https://committees.parliament.uk/publications/6608/documents/71317/default/
173 Letter from the Chancellor of the Exchequer to the Chair of the Economic Affairs Committee (2 July 2021): https://committees.parliament.uk/publications/6609/documents/71318/default/
174 UBS, 'What impact will QT have on financial markets?': https://www.ubs.com/global/en/wealth-management/chief-investment-office/market-insights/2019/quantitative-tightening-impact.html [accessed 6 July 2021]

159. The Monetary Policy Committee has set out the steps the Bank of England will take to reduce the stock of its purchased assets when it judges the time is right to do so:

- First, the Monetary Policy Committee does not intend to begin quantitative tightening until the Bank Rate has risen to a level from which it could be cut if required. The Monetary Policy Committee currently judges that to be 1.5%.[175]
- Second, quantitative tightening will be conducted over several years at a gradual and predictable pace, taking into account economic and financial market conditions at the time.
- Third, quantitative tightening will take into account the need to maintain order in gilt and corporate bond markets, including through liaison with the Debt Management Office.
- Fourth, the Bank says that quantitative tightening can be amended or reversed as required to achieve the inflation target.[176]

160. We heard that there are a series of risks facing the Bank of England when it looks to unwind quantitative easing. Dr Mohamed El-Erian identified three risks facing central banks: 1) market instability spilling over into the real economy; 2) a spike in inflation; 3) worsening outcomes of income, wealth and opportunity if the transition does not go smoothly.[177] Dr Jim Buller et al, academics from the University of York, identified similar risks: "There is a danger that unwinding quantitative easing will lead to greater price volatility in the bond markets as was experienced in US bond markets in 2013 when the Federal Reserve announced a tapering of its asset purchases."[178]

161. Frances Coppola told us that a significant reduction in central bank reserves could threaten the Bank's financial stability mandate and it is therefore "unlikely that QE will ever be unwound in full." She said that as a result the Bank of England's balance sheet will remain considerably larger in future than it was before the financial crisis.[179]

162. Professor Daniela Gabor told us that the central risk when unwinding quantitative easing is "that it happens too soon and too fast and puts undue pressure on the fiscal stance." She said that the Monetary Policy Committee should not contemplate unwinding quantitative easing until it has produced substantive research on the fiscal–monetary interlinkages of quantitative easing.[180] Donald Kohn, former Vice Chairman of the Board of Governors of the Federal Reserve System, told us that central banks should not begin to unwind quantitative easing until it is "no longer needed to achieve its goals for economic and price stability." He said that central banks would

175 This was adjusted down from around 2% in June 2018, reflecting revised estimates of the effective lower bound for Bank Rate. See Bank of England, *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending 20 June 2018* (21 June 2018): https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2018/june-2018.pdf [accessed 6 July 2021]

176 Andrew Hauser, speech on Waiting for the exit: QT and the Bank of England's long-term balance sheet, 17 July 2019, p 7: https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/waiting-for-the-exit-qt-and-the-boes-long-term-balance-sheet-speech-by-andrew-hauser.pdf [accessed 6 July 2021]

177 Q 65 (Dr Mohamed El-Erian)

178 Written evidence from Dr Jim Buller, Dr John Evemy and Dr Ben Whisker (QEI0013)

179 Written evidence from Frances Coppola (QEI0010)

180 Q 7 (Prof Daniela Gabor)

need to judge whether the economy was approaching full employment, whether inflation was stable and whether financial markets were functional. If central banks "saw inflation expectations rising above what you thought was consistent with your objective, that would be a very strong signal that it was time to back off very quickly, maybe even to raise rates."[181]

163. Christina Parajon Skinner, Assistant Professor of Legal Studies and Business Ethics at the Wharton School of the University of Pennsylvania, told us that the Bank of England should not attempt to normalise policy until it is sure that the banking sector is resilient enough, and that it would not cause market dysfunction.[182]

164. However, Aberdeen Standard Investments, an asset management company, said there is no reason to think that unwinding quantitative easing will trigger panic or result in dysfunctional financial markets. It said that the sale of gilts back to the market would "probably exert only very little upward pressure on long run interest rates." It could not foresee any issues for the Bank of England in setting interest rates "and exerting control and influence over various short-term funding rates with a permanently larger balance sheet."[183]

165. We received evidence that said the Bank of England was unlikely to unwind quantitative easing in full. Dr Mohamed El-Erian told us that central banks were increasingly facing a "no-exit paradigm" from quantitative easing.[184] The former Governor of the Bank of Japan, Masaaki Shirakawa, set out a risk that advanced economies such as the UK are on the same economic trajectory as Japan, which has experienced sustained deflation since the early 2000s. Masaaki Shirakawa told us that there are broadly four similarities between Japan's experience and the current macroeconomic environment in advanced economies:

- the development of a financial bubble, followed by a financial crisis;
- protracted low growth and low inflation following the most acute phase of the financial crisis;
- the similarity of the monetary policy response after the outbreak of financial crisis. For instance, low interest rates, the use of quantitative easing, huge expansion of the central bank balance sheet, the purchase of corporate bonds and the use of forward guidance;
- an overreliance on easing monetary policy to stimulate inflation and growth and slow progress in implementing reforms to address structural issues.[185]

166. Blonde Money, an independent macroeconomic research consultancy, told us:

> "All of the evidence from the major central banks that have engaged in QE is that it is almost never unwound. Balance sheets remain permanently higher. Central banks find it hard to find the moment at which it can be done without destabilising either the economy or the market, and if they

181 Q 175 (Donald Kohn)
182 Q 147 (Christina Parajon Skinner)
183 Written evidence from Aberdeen Standard Investments (QEI0009)
184 Q 65 (Dr Mohamed El-Erian)
185 Q 151 (Masaaki Shirakawa)

wait too long, another crisis emerges to which the answer becomes even more QE."[186]

167. The TUC said that the "evidence of the past decade is of increased not reduced reliance on quantitative easing." Any unwinding of quantitative easing appeared to be a "distant prospect."[187] Chris Giles made a similar point. He said that it is likely quantitative easing will persist "for as long as interest rates are effectively on the floor." He said that the Bank would not be able to unwind quantitative easing until aggregate demand was strong enough for it to be able to raise interest rates.[188]

168. We heard that there was a risk that central banks would come under political pressure when they look to unwind quantitative easing. Otmar Issing said that central banks' increasing tendency to expand asset purchases will make unwinding quantitative easing more difficult for two reasons. First, the expansion of quantitative easing increases the amount of public debt that is exposed to the risk of rising interest rates, making it more difficult for central banks to unwind their asset purchases without creating issues for public finances. Second, central banks will come under political pressure to maintain their asset purchase programmes. He said that it will be a "tremendous challenge" for central banks to shrink their balance sheets in the face of political pressure.[189]

169. Dr Jim Buller et al said that the Bank of England may come under political pressure to avoid unwinding quantitative easing if unwinding clashes with the Government's other macroeconomic policy objectives. Dr Jim Buller et al said that there are legitimate reasons to expect the Government to pressure the Bank of England due to the "policy interdependence of quantitative easing and government fiscal policy." Were that to occur, markets were likely to respond with "increased volatility to any announced unwinding of quantitative easing due to increased uncertainty", which would further reduce the likelihood of quantitative easing being unwound.[190]

170. Witnesses told us that it is important that the Bank of England sets out a clear policy path that it will follow when it decides to unwind quantitative easing. Stephen G Cecchetti, Rosen Family Chair in International Finance at Brandeis International Business School, said that central banks need to set out with clarity and transparency a short-term policy that plans for restoring policy to sustainable settings.[191] Donald Kohn said that it is important central banks set out a framework that they will follow as they look to exit unconventional policies. He said that setting out a framework in advance would give markets "good warning" that the central bank was approaching the point at which it would consider unwinding its asset purchases. This would mean that any market volatility can be built into the model, meaning that it would cause less volatility than a sudden exit.[192]

186 Written evidence from Blonde Money (QEI0012)
187 Written evidence from the Trades Union Congress (QEI0016)
188 Q 7 (Chris Giles)
189 Q 175 (Otmar Issing)
190 Written evidence from Dr Jim Buller, Dr John Evemy and Dr Ben Whisker (QEI0013)
191 Q 118 (Stephen G. Cecchetti)
192 Q 176 (Donald Kohn)

171. Otmar Issing cautioned that unwinding quantitative easing is effectively a judgement call for central banks and "it is not as simple as having a kind of blueprint for future action because it depends on many variables."[193]

172. The Governor of the Bank of England told us that "there are no natural limits" to quantitative easing. He said that it is unlikely that central bank balance sheets will return to a similar level to before the financial crisis partly because "demand for liquidity in central bank reserves has risen, in good part because of the experience of the shortfall in liquidity … [during] the financial crisis."[194]

173. The Bank of England told us that the asset purchases undertaken since March 2020 have reduced the 'headroom' available within the Bank's self-imposed constraints, but "if needed, the Bank could re-evaluate some of its self-imposed constraints, to create more headroom should the MPC decide further quantitative easing is necessary."[195] We note that recent Monetary Policy Committee minutes have been dominated with discussion on options for loosening monetary policy rather than on options for tightening monetary policy.

174. The Bank said that in the event that panic is triggered in financial markets, "it is quite possible that there may be circumstances where the MPC would not act to quell market disorder if doing so ran counter to monetary stability." It said that an important area of future research and policy consideration is the development of new tools, besides quantitative easing, that could help deal with market dysfunction.[196] The Governor said that the Bank of England has been assessing its monetary policy options over the last year and pointed to its evaluation of negative interest rates. The Bank of England views its monetary policy options as "broad and not narrow"; "it is useful to have other possible tools."[197]

175. When we asked the Governor whether the Bank of England would publish a roadmap for its exit from quantitative easing, he would not commit to doing so. He said that the Bank would publish a roadmap "at a point when we think that is the appropriate thing to do, subject to the review [of its exit strategy] we are doing."[198]

176. The Governor told us that the Bank of England is reviewing whether to reverse the order in which it committed in 2018 to tighten policy.[199] The Bank's policy since 2018 has been to begin to unwind asset purchases only when interest rates had reached 1.5%. However, the Governor has recently expressed his preference to reduce the Bank's balance sheet prior to hiking interest rates in order to give the Bank more room for manoeuvre in future

193 Q 176 (Otmar Issing)
194 Q 190 (Andrew Bailey)
195 Written evidence from the Bank of England (QEI0015)
196 *Ibid.*
197 Q 190 (Andrew Bailey)
198 *Ibid.*
199 The Bank of England told us that it is currently planning for the eventual tightening of policy, when it deems it to be warranted. As part of this, it is considering "how and when the stock of [quantitative easing] purchases might be reduced." The Bank said that the Monetary Policy Committee "has asked Bank staff to commence work to reconsider the Bank's previous guidance on the appropriate strategy for tightening monetary policy." Written evidence from the Bank of England (QEI0015).

downturns.[200] He told us that, given the economic and health shocks since 2018, there is a "really strong case to re-evaluate that decision [to unwind asset purchases once interest rates hit 1.5%] in the light of what has happened since". Any decision the Bank comes to will be done on "a predictable basis, which is announced in advance."[201]

177. **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.**

178. **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.**

179. **The Bank of England needs to set out a short-term plan for restoring policy to sustainable levels. We recommend that it expedites its 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.**

200 Andrew Bailey, Bloomberg, 'Central Bank Reserves Can't Be Taken for Granted' (22 June 2020): https://www.bloomberg.com/opinion/articles/2020–06-22/andrew-bailey-central-bank-reserves-can-t-be-taken-for-granted [accessed 6 July 2021]

201 Q 190 (Andrew Bailey)

CHAPTER 5: CONCLUSION

180. **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 global 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.**

181. **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 downwards, 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 this uncertainty and to understand these effects.**

182. **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 stated 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.**

183. **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 needed 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.

184. **We sympathise with the Bank of England that it has had to meet its mandate in an economic environment in which its independence has been more difficult to define compared to when operational independence was granted in 1997. Dealing with the economic consequences of the COVID-19 pandemic means the Bank necessarily working more closely with HM Treasury to ensure policy is complementary. However, HM Treasury has not helped to clarify its relationship with the Bank in its ambiguous answers to us. Furthermore, adding additional roles to the Bank risks it losing focus on its primary responsibility to control inflation.**

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Bank of England independence

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. (Paragraph 28)

Impact of quantitative easing

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 crisis, when financial markets are dysfunctional or in distress. (Paragraph 49)

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 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. (Paragraph 50)

'Knowledge gaps'

4. 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: (Paragraph 55)

   - 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.

5. 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. (Paragraph 67)

6. However, the mechanisms through which quantitative easing effectively stabilised the financial system following the global financial crisis have benefited wealthy asset holders disproportionately by artificially inflating asset prices. On balance, we conclude that the evidence shows that quantitative easing has exacerbated wealth inequalities. (Paragraph 68)

7. The Bank has not adequately engaged with 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. (Paragraph 69)

8. The extent to which, and how, quantitative easing interacts with fiscal policy is still poorly understood. What is clear is that quantitative easing has distributional outcomes that exacerbate wealth inequalities that can be mitigated only through fiscal policy. We do not believe this is a reason for the Bank of England not to use quantitative easing as a monetary policy tool. Rather, more effective countervailing policies can be introduced by Government if these negative distributional effects are better understood. We therefore invite HM Treasury to reply to any research that the Bank produces on the distributional effects of quantitative easing. (Paragraph 70)

Clarity of communications

9. There is a widespread perception, including among large institutional investors in Government debt, that financing the Government's deficit spending 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. (Paragraph 88)

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. (Paragraph 89)

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 breakdown 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. We recognise that the quality of data on the effects of quantitative easing is limited but we believe that greater transparency will lead to improvements over time. (Paragraph 90)

Bank of England mandate

12. Any changes to the Bank of England's mandate must be considered carefully. HM Treasury has updated the mandate to reflect environmental sustainability and the transition to net zero. These are important issues, but HM Treasury's instruction is ambiguous, and its interpretation has been

left to the discretion of the Bank of England. Without some clarification from the Government, the Bank risks being forced into the political arena, exposing it to criticism unnecessarily. The Chancellor should write to the Governor to clarify the Government's expectations. (Paragraph 101)

Inflationary pressures

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. (Paragraph 119)

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 pressures 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. (Paragraph 120)

The effect on the public finances

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. (Paragraph 151)

16. Managing the UK's increased public debt accrued in response to the COVID-19 pandemic will require greater coordination between monetary and fiscal authorities. We heard a range of proposals setting out how the Bank of England and HM Treasury could mitigate the impact that interest rate rises could pose to the sustainability of the Government's debt. These proposals amount to fiscal policy as they would effectively be a tax on the banking sector—we heard that if Bank Rate was to rise to 1% without interest paid on reserves, commercial banks would forgo around £9 billion a year based on current reserve levels. HM Treasury needs to clarify and put beyond doubt whether any decision to cease paying interest on reserves would be taken by Ministers, not the Bank of England. (Paragraph 152)

Deed of Indemnity

17. The asset purchase facility is indemnified by HM Treasury, but the Deed of Indemnity has not been published. This is a contractual document between two public institutions. We heard no convincing explanation for why the document has not been placed in the public domain, which has concealed it from parliamentary and public scrutiny. The Chancellor has repeatedly ignored our requests for an explanation on why the document has not been published. HM Treasury should publish the Deed of Indemnity. (Paragraph 157)

Unwinding quantitative easing

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. (Paragraph 177)

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. (Paragraph 178)

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. (Paragraph 179)

Conclusion

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 global 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. (Paragraph 180)

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 downwards, 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 this uncertainty and to understand these effects. (Paragraph 181)

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 stated 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. (Paragraph 182)

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 needed 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. (Paragraph 183)

25. We sympathise with the Bank of England that it has had to meet its mandate in an economic environment in which its independence has been more difficult to define compared to when operational independence was granted in 1997. Dealing with the economic consequences of the COVID-19 pandemic means the Bank necessarily working more closely with HM Treasury to ensure policy is complementary. However, HM Treasury has not helped to clarify its relationship with the Bank in its ambiguous answers to us. Furthermore, adding additional roles to the Bank risks it losing focus on its primary responsibility to control inflation. (Paragraph 184)

APPENDIX 1: LIST OF MEMBERS AND DECLARATIONS OF INTEREST

Members

Lord Forsyth of Drumlean (Chair)
Lord Bridges of Headley
Viscount Chandos
Lord Fox
Baroness Harding of Winscombe (recused herself from this inquiry)
Lord Haskel
Lord King of Lothbury
Baroness Kingsmill
Baroness Kramer
Lord Livingston of Parkhead
Lord Monks of Blackley
Lord Skidelsky
Lord Stern of Brentford

Declarations of interest

Lord Bridges of Headley

Senior adviser to the Group Executive Chairman, Banco Santander

Editorial Consultant, The Evening Standard

Viscount Chandos

Chair, Credit Services Association

Lord Forsyth of Drumlean (Chair)

Chairman and non-executive Director, Secure Trust Bank plc

Lord Fox

No relevant interests declared

Baroness Harding of Winscombe

Baroness Harding recused herself from this inquiry

Lord Haskel

Lord Haskel's son, Jonathan Haskel, is an external member of the Bank of England's Monetary Policy Committee

Lord King of Lothbury

Governor (2003–2013), Bank of England

Member (2003–2013), Monetary Policy Committee, Bank of England. The Monetary Policy Committee instituted quantitative easing in 2009.

Baroness Kingsmill

No relevant interests declared

Baroness Kramer

No relevant interests declared

Lord Livingston of Parkhead

Non-executive Director, S&P Global Inc (provider of information services)

Lord Monks of Blackley

No relevant interests declared

Lord Skidelsky

No relevant interests declared

Lord Stern of Brentford

Climate adviser, The Royal Bank of Scotland/NatWest Group

Member, International Advisory Panel for Asian Infrastructure Investment Bank (AIIB, China)

A full list of Members' interests can be found in the Register of Lords' interests: https://members.parliament.uk/members/lords/interests/register-of-lords-interests

Specialist Adviser

Professor Rosa M Lastra

Expert witness (since 2020) for the Kingdom of Spain in PCA CASE No. 2019–17

Member (since 2016), Banking Union (Resolution) Expert Panel, European Parliament (ECON)

Member (since 2015), Monetary Expert Panel of the European Parliament (ECON) in preparation for the Monetary Dialogue with the European Central Bank

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at https://committees.parliament.uk/work/993/quantitative-easing and available for inspection at the Parliamentary Archives (020 7219 3074).

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with ** gave both oral and written evidence. Those marked with * gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

Oral evidence in chronological order

*	Philip Aldrick, Economics Editor, The Times	QQ 1–11
*	Professor Daniela Gabor, Professor of Economics and Macro-Finance, UWE Bristol	QQ 1–11
*	Chris Giles, Economics Editor, Financial Times	QQ 1–11
*	Sir Paul Tucker, Research Fellow, Harvard Kennedy School and former Deputy Governor, Bank of England	QQ 12–21
*	Fran Boait, Executive Director, Positive Money	QQ 22–32
*	Professor Tim Congdon CBE, Founder and Chairman, Institute of International Monetary Research	QQ 22–32
*	Liam Halligan, Senior Economics Commentator, The Telegraph Media Group	QQ 22–32
**	Professor Özlem Onaran, Professor of Economics and Co-Director of the Institute of Political Economy, Governance, Finance and Accountability (PEGFA), University of Greenwich	QQ 33–40
*	James Smith, Research Director, Resolution Foundation	QQ 33–40
*	Melissa Davey, Director, Independent Evaluation Office, Bank of England	QQ 41–48
*	Adrian Grey, Global Chief Investment Officer, Insight Investment	QQ 49–55
*	Nigel Wilson, Chief Executive Officer, Legal & General	QQ 49–55
*	Dr Mohamed El-Erian, President, Queen's College, University of Cambridge and Chief Economic Adviser, Allianz	QQ 56–67
*	Rupert Harrison, Portfolio Manager and Chief Macro-Strategist, Multi-Asset Strategies Group, BlackRock	QQ 56–67
*	Lord Darling of Roulanish, former Chancellor of the Exchequer (2007–2010)	QQ 68–85
*	Kenneth Rogoff, Professor of Economics and Thomas D. Cabot Professor of Public Policy, Harvard University	QQ 86–93

*	Adam Posen, President, Peterson Institute for International Economics	QQ 86–93
*	Lord Turner of Ecchinswell, Senior Fellow and Grantee, Institute for New Economic Thinking	QQ 94–100
*	Charles Goodhart CBE FBA, Emeritus Professor of Banking and Finance with the Financial Markets Group, London School of Economics	QQ 94–100
*	Daniel Gros, Distinguished Fellow, Centre for European Policy Studies	QQ 101–111
*	Peter Praet, former Chief Economist, European Central Bank	QQ 101–111
*	Stephen G. Cecchetti, Rosen Family chair in International Finance, Brandeis International Business School	QQ 112–124
*	Anjalika Bardalai, Chief Economist, TheCityUK	QQ 125–138
**	Richard Butcher, Chair, Pensions and Lifetime Savings Association	QQ 125–138
*	Professor Christina Parajon Skinner, Assistant Professor of Legal Studies & Business Ethics, The Wharton School of the University of Pennsylvania	QQ 139–147
**	Lord Tyrie, former Chair, House of Commons Treasury Select Committee (2010–2017)	QQ 139–147
*	Masaaki Shirakawa, former Governor, Bank of Japan (2008–2013)	QQ 148–156
*	William Allen, Visitor, National Institute of Economic and Social Research (NIESR)	QQ 157–163
*	Lee Buchheit, Visiting Professorial Fellow, Queen Mary University of London	QQ 157–163
*	Ed Balls, Professor of Political Economy, Kings College London	QQ 164–171
*	Lord Macpherson of Earl's Court, former Permanent Secretary, HM Treasury (2005–2016)	QQ 164–171
*	Otmar Issing, former Chief Economist, European Central Bank (1998–2006) and President, Center for Financial Studies	QQ 172–179
*	Donald Kohn, former Vice Chairman of the Board of Governors, US Federal Reserve System	QQ 172–179
**	Andrew Bailey, Governor, Bank of England	QQ 180–202
**	Dr Ben Broadbent, Deputy Governor for Monetary Policy, Bank of England	QQ 180–202
**	Sir Dave Ramsden, Deputy Governor for Markets and Banking, Bank of England	QQ 180–202

Alphabetical list of all witnesses

	Aberdeen Standard Investments	QEI0009
*	Philip Aldrick, Economics Editor, The Times (QQ 1–11)	
*	William Allen, Visitor, National Institute of Economic and Social Research (NIESR) (QQ 157–163)	
**	Andrew Bailey, Governor, Bank of England (QQ 180–202)	QEI0015
	Andre Baldwin, Chief at Price and Volume Measures Consultants	(QEI0007)
*	Ed Balls, Professor of Political Economy, Kings College London (QQ 164–171)	
*	Anjalika Bardalai, Chief Economist, TheCityUK (QQ 125–138)	
	Dr Will Bateman, Associate Professor, Australian National University	QEI0017
	Blonde Money	QEI0012
*	Fran Boait, Executive Director, Positive Money (QQ 22–32)	
**	Dr Ben Broadbent, Deputy Governor for Monetary Policy, Bank of England (QQ 180–202)	QEI0015
*	Lee Buchheit, Visiting Professorial Fellow, Queen Mary University of London (QQ 157–163)	
	Dean Buckner, Retired Senior Valuation Specialist, Prudential Regulation Authority	QEI0018
**	Richard Butcher, Chair, Pensions and Lifetime Savings Association (QQ 125–138)	QEI0020
*	Stephen G Cecchetti, Rosen Family Chair in International Finance, Brandeis International Business School (QQ 112–124)	
	Jagjit S Chadha, Director, National Institute of Economic and Social Research (NIESR)	QEI0021
*	Professor Tim Congdon CBE, Founder and Chairman, Institute of International Monetary Research (QQ 22–32)	
	Frances Coppola, Author, Coppola Comment	QEI0010
	CrossBorder Capital Ltd	QEI0004
*	Lord Darling of Roulanish, former Chancellor of the Exchequer (2007–2010) (QQ 68–85)	
*	Melissa Davey, Director, Independent Evaluation Office, Bank of England (QQ 41–48)	
**	Sir Dave Ramsden, Deputy Governor for Markets and Banking, Bank of England (QQ 180–202)	QEI0015

	E Philip Davis, Fellow, National Institute of Economic and Social Research (NIESR) and Professor of Banking and Finance, Brunel University	QEI0019
	Kevin Dowd, Professor of Finance and Economics, Durham University	QEI0018
*	Lord Turner of Ecchinswell, Senior Fellow and Grantee, Institute for New Economic Thinking (QQ 94–100)	
*	Dr Mohamed El-Erian, President, Queen's College, University of Cambridge and Chief Economic Adviser, Allianz (QQ 56–67)	
	Dr John Evemy, Research Fellow, University of York	QEI0013
*	Professor Daniela Gabor, Professor of Economics and Macro-Finance, UWE Bristol (QQ 1–11)	
*	Chris Giles, Economics Editor, Financial Times (QQ 1–11)	
*	Charles Goodhart CBE FBA, Emeritus Professor of Banking and Finance with the Financial Markets Group, London School of Economics (QQ 94–100)	
*	Adrian Grey, Global Chief Investment Officer, Insight Investment (QQ 49–55)	
*	Daniel Gros, Distinguished Fellow, Centre for European Policy Studies (QQ 101–111)	
*	Liam Halligan, Senior Economics Commentator, The Telegraph Media Group (QQ 22–32)	
*	Rupert Harrison, Portfolio Manager and Chief Macro-Strategist, Multi-Asset Strategies Group, BlackRock (QQ 56–67)	
	Peter Hensman, Financial Analyst	QEI0011
*	Otmar Issing, former Chief Economist, European Central Bank (1998–2006) and President, Center for Financial Studies (QQ 172–179)	
*	Donald Kohn, former Vice Chairman of the Board of Governors, US Federal Reserve System (QQ 172–179)	
*	Lord Macpherson of Earl's Court, former Permanent Secretary, HM Treasury (2005–2016) (QQ 164–171)	
	Professor David McMillan, Professor of Finance, University of Stirling	QEI0006
	Ralph Musgrave, Author and blogger	QEI0008
	Kevin Newman, Consultant, Academic and Analyst on EU/Global Financial Regulation and Supervision	QEI0014

**	Professor Özlem Onaran, Professor of Economics and Co-Director of Institute of Political Economy, Governance, Finance and Accountability (PEGFA), University of Greenwich (QQ 33–40)	QEI0005
	Sean Paterson	QEI0003
*	Adam Posen, President, Peterson Institute for International Economics (QQ 86–93)	
*	Peter Praet, former Chief Economist, European Central Bank (QQ 101–111)	
*	Kenneth Rogoff, Professor of Economics and Thomas D Cabot Professor of Public Policy, Harvard University (QQ 86–93)	
*	Masaaki Shirakawa, former Governor, Bank of Japan (2008–2013) (QQ 148–156)	
*	Professor Christina Parajon Skinner, Assistant Professor of Legal Studies and Business Ethics, The Wharton School of the University of Pennsylvania (QQ 139–147)	
*	James Smith, Research Director, Resolution Foundation (QQ 33–40)	
	Billy Smith	QEI0002
	Trades Union Congress	QEI0016
*	Sir Paul Tucker, Research Fellow, Harvard Kennedy School and former Deputy Governor, Bank of England (QQ 12–21)	
**	Lord Tyrie, former Chair (2010–2017), House of Commons Treasury Select Committee (QQ 139–147)	QEI0022
	Dr Ben Whisker, Associate, University of York	QEI0013
*	Nigel Wilson, Chief Executive Officer, Legal & General (QQ 49–55)	