HOW THE BANK OF ENGLAND
TRANSFERRED MONEY TO
THE WEALTHY WITHOUT CLEAR
DEMOCRATIC ACCOUNTABILITY
Radix Paper No. 1

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Foreword by
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RADIX

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QUANTITATIVE EASING:
THE DEBATE THAT NEVER HAPPENED

FOREWARD

They used to call it open market operations. But the term 'quantitative easing' came into use in the 1990s to describe the loose monetary policies of the Bank of Japan, the provision of liquidity to the banking system by using short term government liabilities to purchase long term assets held by the private sector. Since the financial crisis of 2008, Central Banks have employed this policy on an unprecedented scale.

But to what effect? We don't really know. Some impacts are obvious - the rise in asset prices, especially those of long dated bonds, the problem posed for funded pensions by unprecedentedly low interest rates. This paper highlights the impact on inequality: quantitative easing benefits those who have assets relative to those who have not, and favours those whose assets are securities rather than short term savings. And fragile financial institutions, and their customers, have gained as their balance sheets have been propped up by quantitative easing.

But has the policy been effective in stimulating consumption and investment? This paper raises the wider issue that there is really no forum in which this question is asked or answered. There has always been an atmosphere of mystery, even awe, about the activities of Central Banks. But the modern fashion for Central Bank independence, implemented in Britain in 1997, has reinforced the suggestion that these activities are technical matters inappropriate for public and political discussion.

But no democracy can accept that policy decisions which have large effects on the distribution of income and wealth, on financial stability and economic growth, are off limits. There is merit in delegating the analysis of complex questions to qualified experts: but in the end politicians have, and should have, responsibility for the outcomes. In discussing the origin of Britain's quantitative easing programme, this paper suggests that Central Bank independence may be a cover for the reality of political direction. At the very least, responsibility for both policy and outcome is diffused.

This is the first paper from Radix, a new think tank of the radical centre. It raises fundamental issues about both the effectiveness and legitimacy of a policy which has been central to the economic strategy of all governing parties over the last seven years, but which has not been central to political debate. I commend its rigour and its radicalism.

JOHN KAY CBE FRSE FBA

QUANTITATIVE EASING
THE DEBATE THAT NEVER HAPPENED

How the Bank of England transferred money to the wealthy without democratic accountability

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Bank of England report on Quantitative Easing, August 2012

"I TAKE NO COMFORT, AND SEE CONSIDERABLE RISK, IN CONDUCTING MONETARY POLICY THAT HAS THE CONSEQUENCE OF TRANSFERRING INCOME FROM THE POOR AND THE WORKER AND THE SAVER TO THE RICH."

Richard W. Fisher, President and CEO of the Federal Reserve Bank of Dallas

1. EXECUTIVE SUMMARY

Penelope and Tim Fisher are well-off professionals who work in the City of London. They own multiple properties and have an equity portfolio. As a result of the Bank of England's (BoE) quantitative easing (QE) programme, they are better off by at least half a million pounds, an amount equivalent to 36% of their net assets.

Jean and Jackie Morrison are relatively low earners. They live in rented accommodation, have no savings and a small overdraft. They have gained no financial benefit from QE. They are poorer in real terms. Increases in prices for basic goods has reduced their purchasing power and house price increases have made their hopes of home ownership less attainable.

Quantitative Easing (QE) has had a significant impact on the social and economic fabric of the nation. The combination of QE and low interest rates has resulted in a significant increase in wealth inequality by boosting asset prices and transferring resources to the wealthy, to those who own mortgage debt and to those who profit from a rise in equity prices – particularly the financial services industry.

In our view, the impact of QE raises major questions about the whole concept of central bank independence and the lack of transparent political accountability for decisions that are primarily political rather than technical. This paper is intended to start a public debate about the following questions:

- *What should be the limits of central bank independence?*
- *How does a well-functioning democracy build political accountability into monetary policy?*

There is bound to be a major issue of accountability when central bank independence has the potential to shield decisions that are undoubtedly political in nature – and politically influenced – from open political debate and political accountability.

QE AND WEALTH INEQUALITY

- *Since 2009, the Bank of England has injected some £375 billion into the UK economy by buying UK government debt. This has increased the price of asset classes mostly owned by the very wealthy where 5 per cent of households hold 40 per cent of these assets.*
- *Regional disparities are likely to have widened too, since median wealth is different between regions. It seems likely therefore that London and the South East have tended to benefit disproportionately from QE.*
- *QE has favoured certain sectors of the economy, predominantly financial services and real estate, which largely contributed to the financial crisis, and to the wider unbalancing of the UK economy.*
- *Over the same period, there has been a relative increase in the price of basic goods, such as food and commodities, which make up the bulk of poorer people's spending, and has therefore made these people worse off.*

WHAT THIS MEANS FOR REAL PEOPLE

We have applied some of the Bank of England's own figures to individuals to estimate the distributional impact of QE. To do this, we have constructed four theoretical model households and estimated the financial impact of QE on each one. Our results are summarised in the table below:

	Property Gains	Value of Other Assets	Total increase in net asset value
Penelope & Tim Fisher (High earners, multiple properties, financial investments)	PLUS £262,500	PLUS £175,000	PLUS £437,500
Martin & Amanda Barrett (Home owners free of mortgage, savings and investments)	PLUS £52,500	PLUS £17,500	PLUS £70,000
Jenny & Cameron Dalgliesh (Teachers, own a small flat with a mortgage, some savings)	PLUS £35,000	0	PLUS £35,000
Jean & Jackie Morrison (Renters, no savings, small overdraft)	0	0	0

QE has benefited those that already have financial and property assets – the more assets owned, the greater the gain. But for the poorest in society:

- *There has been no direct financial benefit*
- *They have been made relatively poorer as:*
  - *purchasing power has tended downwards*
  - *any dreams of eventual home ownership has been placed further out of reach*
  - *prices of basic goods such as food and fuel have increased (the poorest households spend three times more as a proportion of their income on household energy bills than the richest households).*
  - *The overall impact on the poorest in society also needs to be judged in light of the fact that, for much of the period over which QE was conducted, it was accompanied by fiscal consolidation (aka 'austerity') – a policy that also has differential impact across society with the poorest being most at risk.*

CONCLUSIONS

Monetary policy decisions have always had significant political implications – having, in the past, even been used to bring down elected governments. Such decisions are therefore properly political not merely technical:

- *While some sort of stimulus was probably essential following the financial crisis, there are many methods that could have been adopted, including issuing new money into the economy in ways that benefitted households and productive enterprise more directly.*
- *Monetary stimulus has significant distributional effects, and these effects may be different depending on the type of monetary stimulus that is used. The economy could have been pump-primed using alternative approaches that would have been less regressive and, potentially, with better social and economic outcomes. Such decisions are therefore properly the subject of political scrutiny, public debate and political accountability.*
- *Many are fully aware of the political nature of monetary policy decisions. For the credibility of both the government and the Bank, central bank independence cannot be allowed to develop into a convenient political shield. As was stated by one former Chancellor: "We were anxious that [QE] should be seen as part of the Bank's armoury and not as a political ploy".[1]*
- *The boundaries between political decision-making and central bank independence are clearly blurred. Such blurred boundaries have consequences both for proper democratic accountability and for the Bank's own credibility.*

RECOMMENDATIONS

Monetary policy is symptomatic of many areas of policy where, because of the complexity of modern society, decisions are delegated to a group of experts. Such experts have their own perspectives that are not value free. But technocracy risks hiding underlying values in technical jargon thereby shielding important decisions from public debate and political accountability.

We believe the solution is plurality and open, comprehensible debate. Monetary policy has political, social and economic impacts that are too important to be delegated to a single group of experts with no political accountability – however competent and well-meaning those experts undoubtedly are. We suggest that a better approach is a process by which the government continually obtains proposals from diverse groups with different political and economic viewpoints. Underlying values and assumptions should be explicit and comprehensible to the lay person – and, above all, visible and public.

The nature, shape and limits of central bank independence should be the subject of renewed debate and, we believe, re-definition. This is essential both in the interests of democratic accountability and also to maintain the credibility of the Bank itself. We propose the following:

- *The method of reflating the economy, and then reversing it, is not and cannot be presented as a purely technical decision to be developed by technocrats. It has to be a legitimate area of public debate accessible to the lay person.*
- *The Bank of England's independence has clear political limits, and – unless it wants to lose its credibility – the Bank would be well-advised to press for those limits to be set out clearly.*
- *Central bank independence should be interpreted as independence of opinion rather than independence of action. Monetary policy action should be explicitly a joint endeavour between the government, the Bank and others who can contribute to the debate.*
- *In view of the significant political implications of monetary policy, final decisions should rest with elected government of the day.*

2. THE WORLD OF QUANTITATIVE EASING

> "IF WE DO FALL INTO DEFLATION, HOWEVER, WE CAN TAKE COMFORT THAT THE LOGIC OF THE PRINTING PRESS EXAMPLE MUST ASSERT ITSELF, AND SUFFICIENT INJECTIONS OF MONEY WILL ULTIMATELY ALWAYS REVERSE A DEFLATION."
>
> Ben Bernanke, Federal Reserve speech on deflation, November 2002

The idea of 'quantitative easing'[2] or QE belongs in that peculiar slice of economic history following the banking crash of 2008, when the developed world had escaped economic disaster by bailing out its banks and found itself with short-term interest rates at close to zero. It began earlier than that, after crises in Japan and China, but reached its fruition in the western world when very low interest rates meant there was little room for the usual central bank prescription for recession: to lower those interest rates even further.

> Quantitative easing is not the same as 'printing money'

QE involves central banks creating money to purchase government or private sector bonds from financial institutions; or provide cheap or zero cost loans. It is an emergency measure deployed by central banks if they are unable or unwilling to cut rates any further, usually following an asset crisis. It is intended to increase the supply of base money, usually in cases when money velocity drops. Another important goal is to lower long-term rates and rate expectations (central bank rates are short-term rates) and to alleviate expectations of liquidity shortages. It remains a form of rare, emergency monetary easing that goes beyond rate cuts. QE is, in short, what central banks do when they want to expand monetary stimulus, but they are unable to cut rates any further.

Strictly speaking, this is not the same as printing money, though it is often referred to in those terms. In practice, it means that central banks act like private banks: creating money by making loans, which then stay on their balance sheets. In the same way, QE expands the balance sheet of the central bank. The Bank will normally claw the money back, as any bank would for a normal bank loan, by taking it out of circulation or by selling the bonds back onto the market.

The Bank of England's QE programme is more timid than, for example, the Japanese version that has been practiced since the early 2000s, in that it largely buys government bonds. It started in 2009 and saw the injection of some £375 billion into the UK economy by buying UK government debt. The QE programme launched by the European Central Bank (ECB) is a special case because it controls the currency for a number of different countries, and does so independently of political influence. Or, should we say, the ECB is nominally independent though it understands full well that it operates in a complex political context and the political pressures exerted on it are substantial – both in public and in private.

In practice, in the UK, QE means that the Monetary Policy Committee of the Bank of England decides how much stimulus is required. The Bank then extends a large loan to their Asset Purchase Facility that uses it to buy assets - government bonds in this case. This raises the value of the bonds and decreases their yields. The basic underlying purpose is to get new money into the banking system, to make banks feel more confident about lending and, by doing so, kick-starting the economy.

> QE and low interest rates have increased wealth inequality

This paper makes no comment one way or the other on the need for monetary stimulus. But, because of its impact on the social and economic fabric of the nation, it is concerned with the impact of QE on wealth distribution and the interplay between technocratic decision-making and political accountability. We will argue that the combination of QE and low interest rates has increased wealth inequality by boosting asset prices and transferring resources to the wealthy and to those who own debt or are dependent on companies that do, especially in financial services. We will also argue that QE has incentivised increased borrowing, largely to speculate on assets rather than for investment in productive enterprise.

There are manifold problems with the QE programme, most of which are beyond the scope of this short paper. The key point here is that QE proceeded for five years in the UK with almost no democratic debate about what the likely impacts would be, whether they would be desirable or merely an inevitable price to be paid for preventing a prolonged economic downturn. QE has been presented to the British public as a technical decision made by the experts. The implication is that this puts the programme beyond debate when, in fact, it is anything but that.

We argue that there were, and still are, other options available for monetary stimulus which would be distributionally neutral or progressive and that help investment in productive enterprise. We question why the current approach was chosen and where the political accountability lies for policy choices that prefer regressive to neutral or progressive policies. All of this has important implications for the future constitutional position of the Bank of England as we will show later in this paper.

THE PROBLEM

It used to be said that the private banks were controlled by the eyebrows of the governor of the Bank of England. Although governors had no formal legal controls available to them, their influence was such that even a facial expression would do the trick. Now that the Bank of England is operationally independent, big decisions operate the other way around. The Chancellor of the Exchequer appoints the governor and is responsible for renewing his contract, or not, as the case may be. The Chancellor's eyebrows will be pretty important in the opaque decision, for example, to start a programme of quantitative easing.

When the implications of that decision are politically vital and contested, then nudges and winks and talk of operational independence are neither transparent nor acceptable.

In practice, the decision to start QE was not made by the Bank but by the then Prime Minister Gordon Brown and his Chancellor Alistair Darling. But the ambiguity about the politics of it was apparent even then. Darling explains in his memoirs that: *"We were anxious that it should be seen as part of the Bank's armoury and not as a political ploy".*[1] The original decision therefore seems to have been largely political with the government of the day positioning it as a decision taken solely by the Bank of England, adopting ideas already put into practice abroad.

Once the decision to order QE has been made, the basic decisions about the form it should take and how much of a stimulus is needed are made by the Bank's Monetary Policy Committee (MPC). Its remit is to maintain price stability, where stable prices are defined by the government's inflation target. The Committee also has a responsibility to support the government's other economic objectives – in so far as they are clearly defined.

Subject to that, the MPC also sets monetary policy for the economy as a whole. All these decisions will have implications for the distribution of wealth, yet the Committee is designed to operate independently of elected politicians as if monetary policy were not a key element in the overall economic debate. In normal times, all this is intended to even itself out as interest rates go up and down, but these are far from normal times. Rates have been at an unprecedented low since March 2009. It is our contention that this makes all decisions – both on QE and on interest rate policy – incontrovertibly political.

Of course, there will always be political influence on the committee. It is appointed by elected politicians. It operates to objectives set by politicians. But, in the case of QE in particular, we argue that political debate was insufficient and hidden behind the idea of central bank independence. Vital decisions, with far-reaching social and economic implications, have therefore not been subjected to full public scrutiny and political accountability.

> Political debate around QE was both insufficient and hidden

HOW QE WORKS IN PRACTICE

QE for the Bank of England began in March 2009 when it was decided that, even with the prevailing low rates, and following the collapse of Lehman Brothers and the near collapse of many of the UK banks, the economy required additional stimulus. The Bank embarked on a gilt (government bonds) buying programme.

Something similar had been done by the Bank of Japan (BoJ) in 2001, when it flooded the commercial banking sector with liquidity to encourage lending. The Bank did this by buying more government bonds than would be required in order to bring interest rates back to zero. It also bought other financial instruments, including asset-backed securities and equities. This swelled the BoJ balance sheet by about $300 billion over four years.

The US Federal Reserve began buying mortgage backed securities from the end of 2008, reaching about $600 billion and kept buying to keep their total holdings at just over $2 trillion as the securities began to mature, when they needed to be replaced. It then launched a second round in 2010 and a third round in 2012, announcing that it would continue the programme through 2015 to keep the interest rates close to zero. In fact, the programme ended in 2014, after having bought $4.1 trillion in assets.

The intended effect of these programmes, in the UK and elsewhere, was that lower yields make it cheaper for businesses to borrow money, and to encourage investors to change over to other kinds of investments, like shares. They were also intended to reduce interbank overnight lending rates, which could take the pressure off hard-pressed private banks.

> QE should encourage business investment. Does it?

The European Central Bank was by then only just beginning to test out QE. By 2013, its holdings had reached 30 per cent of GDP (the Federal Reserve held bonds worth only 20 per cent of US GDP). Since March 2016, it had increased buying to €80 billion a month and started to include the purchase of corporate bonds. It also significantly reduced the cost of four-year loans to banks.

THE RESPONSE TO QE

Most of the debate about QE has been carried out in academic circles or among the more monetarist policy thinkers. There has been a reluctance to embrace the term *'quantitative easing'*. Professor Willem Buiter of the London School of Economics distinguished between QE and what he called 'qualitative easing', which the Bank of England has not been doing.[3] This means buying riskier assets to take them off the balance sheets of commercial banks – a kind of *'bad bank of last resort'*. Ben Bernanke, chairman of the US Federal Reserve, distinguished QE from their *'credit easing'*, the main purpose of which is the impact on borrowing for businesses and households.

Bernanke put it like this:

"OUR APPROACH — WHICH COULD BE DESCRIBED AS 'CREDIT EASING' — RESEMBLES QUANTITATIVE EASING IN ONE RESPECT: IT INVOLVES AN EXPANSION OF THE CENTRAL BANK'S BALANCE SHEET. HOWEVER, IN A PURE QE REGIME, THE FOCUS OF POLICY IS THE QUANTITY OF BANK RESERVES, WHICH ARE LIABILITIES OF THE CENTRAL BANK; THE COMPOSITION OF LOANS AND SECURITIES ON THE ASSET SIDE OF THE CENTRAL BANK'S BALANCE SHEET IS INCIDENTAL. INDEED, ALTHOUGH THE BANK OF JAPAN'S POLICY APPROACH DURING THE QE PERIOD WAS QUITE MULTIFACETED, THE OVERALL STANCE OF ITS POLICY WAS GAUGED PRIMARILY IN TERMS OF ITS TARGET FOR BANK RESERVES. IN CONTRAST, THE FEDERAL RESERVE'S CREDIT EASING APPROACH FOCUSES ON THE MIX OF LOANS AND SECURITIES THAT IT HOLDS AND ON HOW THIS COMPOSITION OF ASSETS AFFECTS CREDIT CONDITIONS FOR HOUSEHOLDS AND BUSINESSES."[4]

The inventor of the phrase 'quantitative easing', Professor Richard Werner, has also complained that his original proposal was different.[5]

Debate about these distinctions has largely been limited to the inner circles of central bankers and specialised economists. There has been no attempt to bring the discussion to the broader public. Rather than being helped to understand how QE actually works and its effects on them personally, members of the public have been encouraged to believe that this is a technical issue best left to the experts. Yet the impact of QE on people's lives is neither marginal nor even. Large sums of money have been pumped into the economy, via the existing financial system and this has had impacts that were largely predictable. This money has not been equitably distributed. Certain groups of people, specifically the wealthy, have benefited massively and disproportionally while the poor have, in effect, been made poorer.

> There has been no attempt to bring the QE debate to the broader public

3. THE EFFECTS OF QE ON ECONOMY & SOCIETY

> "BY PUSHING UP A RANGE OF ASSET PRICES, ASSET PURCHASES HAVE BOOSTED THE VALUE OF HOUSEHOLDS' FINANCIAL WEALTH HELD OUTSIDE PENSION FUNDS, BUT HOLDINGS ARE HEAVILY SKEWED WITH THE TOP 5% OF HOUSEHOLDS HOLDING 40% OF THESE ASSETS."
>
> Bank of England report on QE, August 2012

The contention that QE mainly benefits the wealthiest seems to be becoming generally accepted.

The Bank of England's own report concludes that 40 per cent of the gains went to the richest 5 per cent of UK households.[6] But, beyond that general statement, we need to be more precise because not everyone, even those collectively labelled as 'wealthy', will have owned the same assets and not all assets have shown the same gains.

QE has made the rich richer and the poor poorer

What might be reasonable to say is that the richest 5 per cent took more than 40 per cent of the gains because they hold a greater proportion of equities or property compared to deposits. There are no data we are aware of to confirm that assumption.

Other commentators do, however, back the broad conclusion:

- *Richard Fisher, president of the Federal Reserve in Dallas said that QE money had made rich people richer, but had not done as much for working Americans.*[7]
- *Dhaval Joshi of BC Research said that: "QE cash ends up overwhelmingly in profits, thereby exacerbating already extreme income inequality and the consequent social tensions that arise from it."*[8]
- *Anthony Randazzo of the Reason Foundation said that QE is "fundamentally a regressive redistribution programme that has been boosting wealth for those already engaged in the financial sector or those who already own homes, but passing little along to the rest of the economy. It is a primary driver of income inequality."*[9]

QE - salvation or the road to ruin?

Even so, while the debate on the overall value of QE, warts and all, continues, it remains firmly locked behind doors to which only the erudite have the keys. Proponents argue that everyone would have been worse off without it. At a parliamentary committee hearing in 2012, the then Bank of England deputy governor Paul Tucker lost his temper, claiming that: *"If we were not, and had not been, running an easing monetary policy for the last three years or so now, this economy would have been destroyed."*[10] Others take a different view. German *Ordnungspolitik* asserts that supply side flexibility can always solve all problems. It abhors almost any sort of demand side economic stimulus, seeing it as the road to eventual ruin. A believer in that particular economic philosophy, German Finance Minister Wolfgang Schäuble has recently, and predictably, warned the ECB that its ultra-loose monetary policies would *"ultimately end in disaster"*.[11]

WHO IS RIGHT? AND CAN WE REALLY KNOW?

SAVERS AND BORROWERS

The reduction in the bank rate has had an immediate impact on wholesale money market rates. But the sustained lower level of the bank rate also feeds through to the rates offered to retail savers. The average interest rate on sight deposits (those repayable on demand) fell immediately in line with the bank rate, but not by so much. This partly reflects the fact that it isn't really practical to pay a negative rate on retail accounts (though some in Switzerland are now trying it). And partly because income from retail accounts became even more important to bank funding after the crisis, nervous as the banks were of borrowing money on the markets for investing on their own account. As lower rates have carried on, the average rate paid on time deposit balances (those repayable with notice or only on a fixed date) has gradually fallen so that it has become closer and closer to that paid on sight deposits (Figure 1). As a result savers have seen their interest income shrink.

Interest rates for savers have fallen differentially and over different time periods

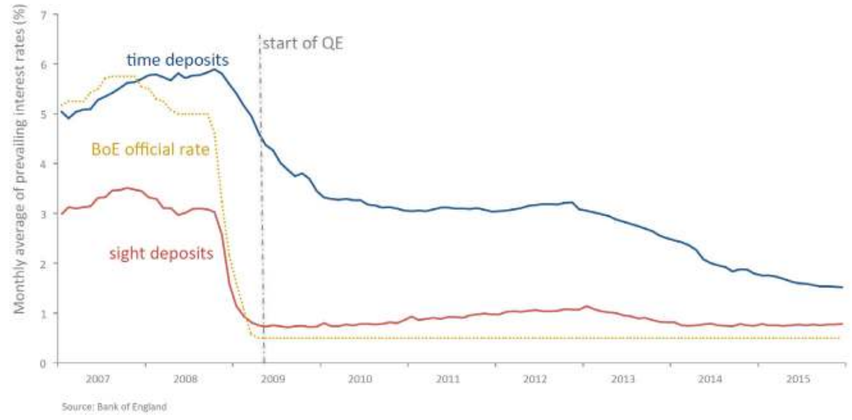


Figure 1

accordingly with interest rates on mortgages and personal loans both falling significantly (Figure 2).

Those who borrow through mortgages and personal loans are paying significantly less

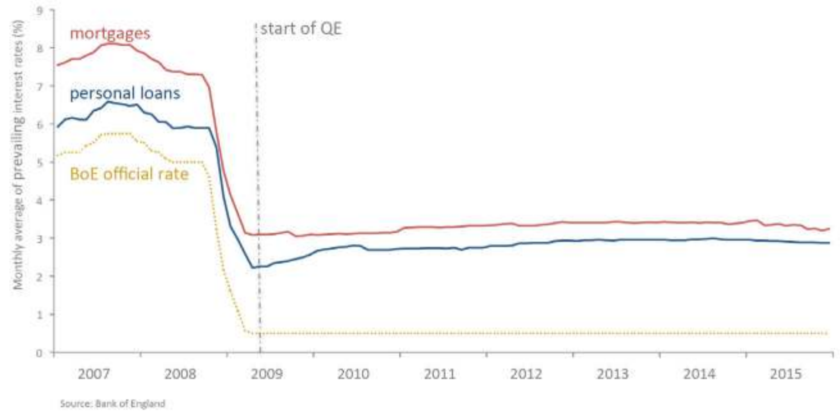


Figure 2

At first glance, this all seems obvious: persistently low interest rates have benefited borrowers at the expense of savers. But it is more complicated than that.

First, the reduction in lending rates has not extended to all kinds of debt. Figure 3 shows the average rates on credit card balances and on overdrafts.

These rates have not shown any reduction and are in fact slightly higher than in the period before the bank rate was cut – though one might argue that these rates would otherwise have been even higher. Also, the rate shown for personal loans includes only loans by monetary financial institutions. The rates charged by other institutions – such as pay-day lenders – may be much higher.

Interest rates on overdrafts and credit card balances are much higher than other forms of debt and interest rates have tended upwards rather than downwards

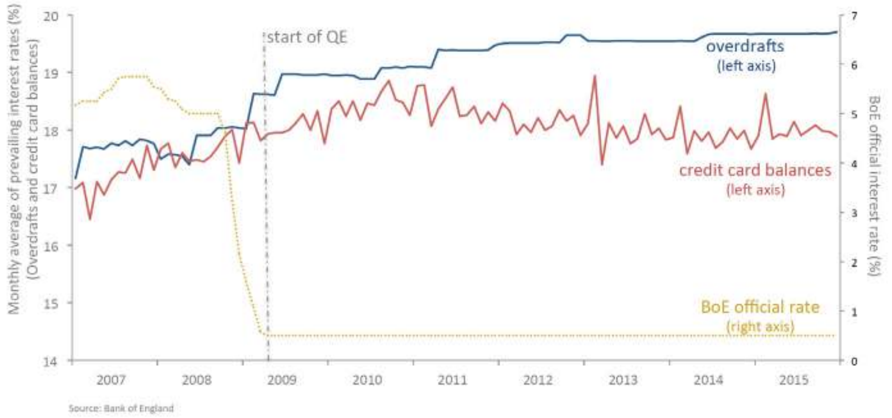


Figure 3

The market share of other financial institutions in the unsecured loan market has also risen over the same period (Figure 4)

Non-bank financial institutions have grown their market share

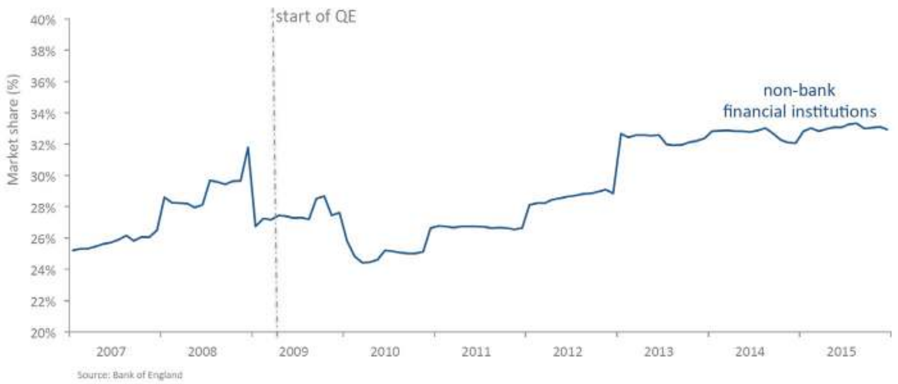


Figure 4

So here we see the first picture of the differential, and regressive impact of loose monetary policy.

Those who are well off enough to have secured a mortgage and have the credit rating necessary to obtain personal loans have seen their interest payments plummet, giving them more disposable income. This is partly – but only partly – offset by declining interest on any savings. The net effect is significantly positive for them.

Lower interest rates have not benefited the poorest

Those at the lower end of the income and wealth scale cannot afford a mortgage, are not eligible for personal loans and tend to have no savings. They are dependent for any credit on overdrafts, credit card debt and pay-day lenders. For them, interest rates have increased.

INVESTMENT PORTFOLIOS

Although the low interest rate policy has hit returns on bank savings accounts, capital returns on other asset classes have benefited.

In general, if the market expects a sustained reduction in short-term interest rates, this will raise the price of fixed interest instruments such as gilts. All other things being equal, if interest rates in the future are expected to reduce, then it is more attractive to hold higher yielding bonds as the rate you get on the bond will be higher than you will get in a bank. This means that investors will buy bonds, hence increasing the price and reducing their yield (as bond yields are the inverse of bond prices). This effect is supported by QE, where the Bank of England is actively buying bonds, hence increasing their price and reducing their yield.

Figure 5 shows how the yield on gilts at different maturities have responded to current monetary policy. The decline in gilt yields has two distinct components. At first, the whole fall in yield reflects a rise in the price of gilts currently in issue. But, over time, gilt stocks mature and new issues are made, with replacements stocks being issued with lower yields. While the former implies windfall profits for holders of gilts, the latter implies lower ongoing returns.

Yields have fallen on both short-dated and long-dated gilts

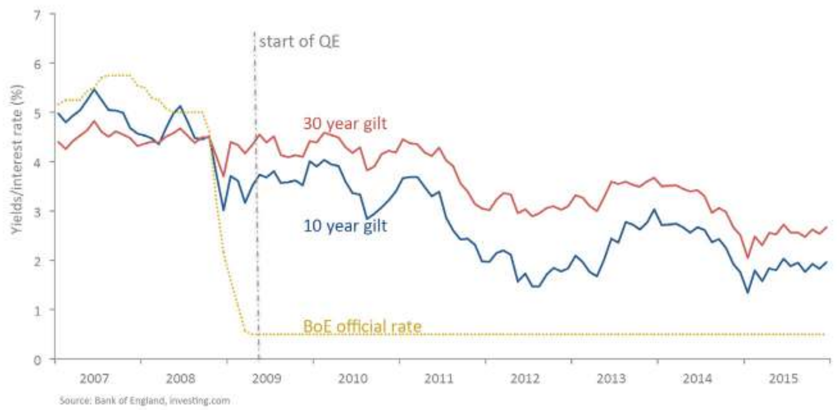


Figure 5

Even so, the fact that investment in gilts has generally yielded better returns in the period of low interest rates can be seen by looking at some total return measures. Figure 6 shows the total return on a sample long-dated gilt from October 2008, just before the sharp drop in the bank rate. [12] It shows that, in the early years of loose monetary policy, such holdings have yielded more than 12 per cent a year. Even over more than a seven-year period, they have yielded around 9 per cent. This is caused by the continued increase in price and reduction in interest over this period.

Total return on long dated gilts have held up in an era of low interest rates and QE

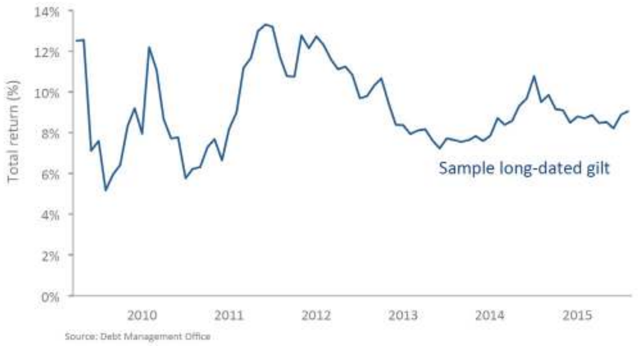


Figure 6

QE also plays a role here. In theory, there are two main channels through which QE might have a sustained impact on the gilt price – the signalling channel and the portfolio balance channel.

The *signalling channel* means that QE operations provide the market with more information about the future course of short-dated interest rates. Investors suppose that, by buying long-dated monetary assets with new money, the central bank is signalling to the market an intention to keep short rates lower for longer. But the signalling here is not clear-cut. It has been argued that, in undertaking QE, monetary authorities might actually cause the market to expect rates to rise sooner. The basis for this argument is the massive increase in money supply that QE entails. The argument goes that this monetary expansion raises the prospect of future inflation, which means that the central bank will be forced to reverse its low interest rate policy sooner rather than later. This line of reasoning has gained some support in the USA, where periods of QE have actually coincided with increases in bond yields. [13]

Even so, we should be careful not to read too much into this apparent correlation. In theory, the bond yield should respond not to the actual purchases but to the market's realisation that purchase will take place. This is difficult to pin down but, in general, announcements have been made before the actual operations. The analysis in Joyce et al of the impact of UK QE on yields attempts to look at the response around the time of announcements. [14] These results support the idea that, in relation to the signalling channel, QE leads to a reduction in term yields.

The impact of the *portfolio balance channel* is less ambiguous. This relies on the idea that investors are not risk neutral when it comes to deciding between holding short-dated and long-dated instruments. Some investors will be concerned about the short-term capital value of their holdings. These investors won't want to hold longer dated instruments where the market price can vary, and will require higher yields to induce them to do so. Other investors will prefer longer dated instruments.

Pension funds are a good example. They require assets that will deliver a reliable and known future cash flow, so that they can meet a string of future payments. They will therefore prefer to hold longer rather than shorter dated instruments.

QE reduces the supply of long dated assets and replaces them with short dated assets (in the form of reserves). Persuading investors to accept this change means providing them some premium on holding shorter dated investments. Since the short rate is effectively fixed by the BoE determined interest rates, this actually means reducing the returns available on longer assets.

If QE impacts only through the signalling channel, then we might conclude that what happens with short-term rates is crucial. We might assume that QE is merely improving the efficiency with which the Bank rate policy is communicated. On the other hand, if QE also operates through the portfolio balance channel, then we will have to conclude that it is having an impact on markets in its own right. Joyce et al tried to distinguish the impact of the two channels by comparing changes in gilt yields with movements in the fixed rates payable on Overnight Indexed Swaps. [15] They found that the effect of the portfolio balance channel is dominant, suggesting that QE is indeed important in its own right.

Portfolio balance effects extend beyond fixed income instruments. Falling returns on cash investments and gilts will increase demand for other assets – corporate bonds, equities and property. Low borrowing costs for secured debt will add to this demand, particularly for property.

Figure 7 shows how the value of equities and residential property have grown over the period of low interest rates with values rising in response to low interest rates and continuing to rise after QE was implemented.

The value of equities and house prices has risen significantly

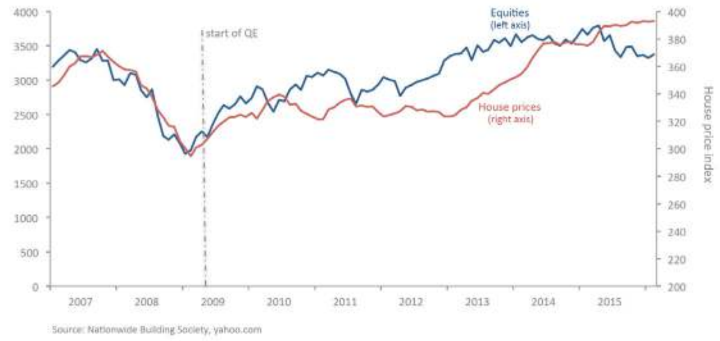


Figure 7

Since the first announcement of the QE programme, we have seen an annual price increase of 4 per cent in residential property and over 8 per cent in equities.

It is difficult to attribute rising prices to any particular cause, although the low interest rate environment and loose monetary policy are likely to have contributed significantly to increased asset prices. Bell at al estimate that the impact of asset purchase up to May 2012 was to add £600 billion to the value of household wealth.[16] This includes private pension wealth, but excludes property wealth.

The benefits of this are, of course, not evenly distributed for two reasons. First, because there is a great disparity in the ownership of assets. Second, because it is only the relatively wealthy that have any form of financial portfolio that they can re-balance to adjust to changing circumstances. The poor barely have enough to live on and are at the mercy of the economic weather.

Figure 8 shows UK wealth distribution by decile, including property and pension wealth (but excluding non-property physical wealth). The top decile owns between 45 and 50 per cent of total household wealth. The benefits of increased asset values will have accrued mainly to these households.

The top decile owns nearly 50% of total household wealth
(includes property, financial and pension wealth but excludes non-property physical wealth)

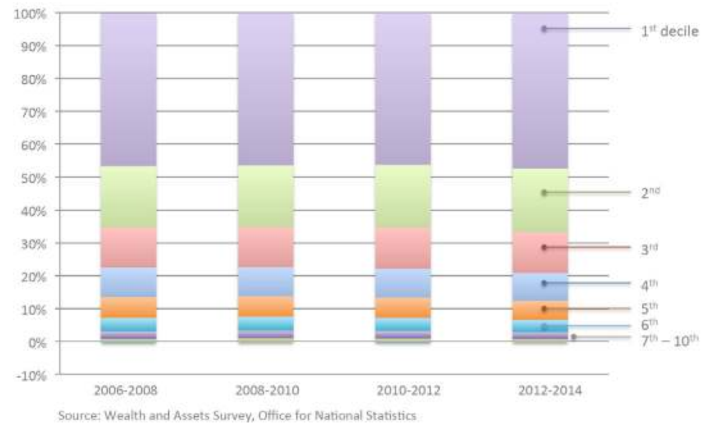


Figure 8

The benefits of asset price increase are far from evenly distributed

We have argued above that loose monetary policy is a mixed story for those holding assets. There have been gains on longer-term assets, but yields on shorter dated assets like bank deposits have fallen dramatically. This distinction matters because the type of assets that people hold is also not uniform across the different wealth groups. In particular, as described in Erosa & Ventura, poorer households tend to have a greater proportion of their savings in the form of bank deposits.[17]

This is because a large majority of households will hold some form of positive bank balance, but only the wealthier households will have excess funds available for investment in bonds, shares and other property.

This can be seen from the table below, which shows the percentages of British households holding different types of asset apart from their main home.

Percentage of households with formal assets: Great Britain, July 2006 to June 2014 GREAT BRITAIN	PERCENTAGE (%)			
	July 2012 to June 2014	July 2010 to June 2012	July 2008 to June 2010	July 2006 to June 2008
Current accounts in credit	91	90	90	85
Savings accounts	57	58	68	62
Cash ISAs	43	43	44	36
Stocks and shares ISAs	12	13	12	10
UK shares	12	12	16	15
Property other than main residence	11	11	10	10
UK bonds/gilts	1	1	1	1

Source: Wealth and Assets Survey, Office for National Statistics

The parliamentary Treasury Select Committee included a plea to the Bank of England in its report on the 2012 Budget to explain the costs and benefits of QE when it came to wealth distribution. The Bank responded with its own study, which largely confirms these conclusions – that the balance of costs and benefits favour the wealthy, and homeowners in particular.[18]

The Bank points out that:

"WITHOUT THE BANK'S ASSET PURCHASES, MOST PEOPLE IN THE UNITED KINGDOM WOULD HAVE BEEN WORSE OFF. ECONOMIC GROWTH WOULD HAVE BEEN LOWER. UNEMPLOYMENT WOULD HAVE BEEN HIGHER. MANY MORE COMPANIES WOULD HAVE GONE OUT OF BUSINESS. THIS WOULD HAVE HAD A SIGNIFICANT DETRIMENTAL IMPACT ON SAVERS AND PENSIONERS ALONG WITH EVERY OTHER GROUP IN OUR SOCIETY. ALL ASSESSMENTS OF THE EFFECT OF ASSET PURCHASES MUST BE SEEN IN THAT LIGHT."

> The overall economic benefits of QE are impossible to prove

This may, of course, be true. In the absence of the counterfactual, the statement that "Without the Bank's asset purchases, most people in the United Kingdom would have been worse off" is impossible to prove. Some will see it as self-serving. But even if we give the Bank the benefit of the doubt, the statement ignores the possibility that there may have been alternative, less regressive and less socially and economically damaging ways of organising the pump priming of the economy.

The Bank's report confirms that, although almost all of their buying has been of gilts, they have also pushed up the price of equities by at least as much as they have pushed up the price of gilts. As we have quoted at the start of this chapter, the Bank's conclusion that the benefits have accrued mainly to the top 5 per cent of households is pretty clear.

The Bank estimates that the total impact on household wealth of QE is likely to have been around £10,000 per household, if this had been distributed evenly (to May 2012). The difficulty of course is that it was not. As the Bank report says: *"In practice, the benefits from these wealth effects will accrue to those households holding most financial assets."*

The report goes on to estimate that median household assets were worth only around £1,500 of gross assets, while the top five per cent of households held an average of £175,000 of gross assets – or around 40 per cent of the financial assets of the household sector as a whole. Many more of the poorer households have money in the bank (the median is about £1,000). Most households have some kind of deposit accounts, which have paid out less in interest as a result of low base rates.

> All households are not equal. The wealthier have benefited at the expense of the poorer.

The clear conclusion is that, because all households are not equal, those which have a significant proportion of their wealth in property or equities have done well and those with the greatest proportion of their wealth in some kind of savings accounts have done badly – as have those at the bottom of the scale with no assets at all. The Bank estimates that there has been an increase on average per household of up to £322,000 in the value of the assets held by the richest 10 per cent of households in the UK.[19] The poorest may have benefited by the assumed (though unprovable) boost to the economy, but their own assets, should they have any, are not affected by QE in the same way because they tend to be in the bank.

PENSIONS

After their main home, the most important asset for households is their interest in their pension funds. QE has multiple effects on pensions some of which increase the value of assets held in pension funds while others reduce pension income that can be earned from those same assets. This makes it difficult to assess the net effect of QE on pensions, though our interest in this paper is limited to distributional rather than overall effects. In that regard, ownership of pension assets has similar wealth distribution to other assets. If QE has had a net benefit on pension assets, then that benefit will have accrued disproportionately to the wealthier citizens. If the overall effect has been negative, the wealthy will have borne most of the losses. Overall, we believe there is insufficient information available to make a judgement as to the real outcome.

REBALANCING THE ECONOMY?

> QE has further unbalanced the UK economy

A further issue arises that has not been adequately discussed. Not only have the distributional effects on households been uneven, but it is likely that the effects on different parts of the economy and different parts of the country has also been uneven. One of the government's stated objectives is to re-balance the UK economy (i) away from an over-dependence on financial services and property assets towards productive enterprise and (ii) away from growth accumulation in the South East relative to the rest of the country. It is part of the Bank's mandate to support government policy. Yet QE may have helped the process in the opposite direction.

FINANCE AND PROPERTY

Property prices have soared, the value of financial assets, and therefore the returns to be had from activity in the financial markets, have increased. And these increases have outstripped growth rates in the overall economy suggesting, once again, that gains have been uneven. One illustration of the uneven nature of the economic effects of QE was pointed out by the former Business Secretary Sir Vince Cable who said that the disparities between cheap mortgages and expensive SME credit *"seriously distort the economy"*.[20]

> QE has benefited those who have the greatest responsibility for the financial crash

We have shown that there has been a significant rise in the value of equities as a result of QE. Equally, though, the Kay Review makes it clear that: *"UK equity markets are no longer a significant source of funding for new investment by UK companies."*[21] Equity markets are becoming increasingly dissociated from underlying economic activity. They are driven rather by trading activity within the equity market itself – what some choose to call financial speculation. Any increase in the value of equities mainly benefits the holders of the equities, the intermediaries in the financial services industry that corner for themselves a proportion of the gains to be made, and the senior level employees within public companies whose compensation is tied to equity prices. All of these beneficiaries once again sit at the top of the food chain and benefits that accrue primarily to them further increase wealth inequality.

These developments also further reward speculation in the property and financial markets and increase the profits accruing to financial intermediaries – all effects that further unbalance rather than contributing to the stated government policy of re-balancing the economy. It could also be argued that the policy response to the financial crash has resulted in most of the rewards going to precisely those sectors that carried the most responsibility for the crisis.

REGIONAL EFFECTS

In the UK, median wealth is different between regions. Any policy that is regressive will therefore benefit the wealthier regions disproportionately. It seems likely therefore that London and the South East have tended to benefit from QE while other regions have not, at least not in the same way and to the same extent. QE in the form it has been implemented may therefore have exacerbated the north-south divide.

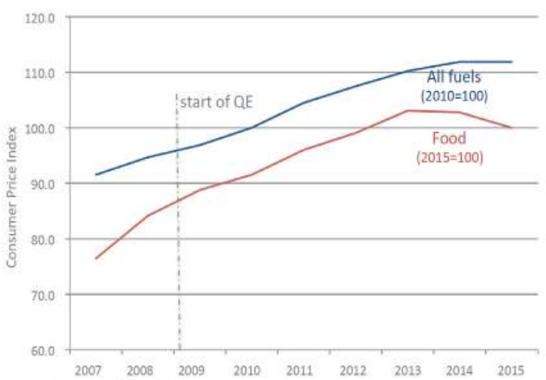
Apart from going against stated government policy, greater regional wealth disparity can make regional migration harder. Political tensions increase as a result. Regional disparities increase the pressure for devolution of power, and may also increase the sense of disappointment if this leaves the regional disparities untouched. These are all serious political issues and it is distorting and possibly patronising to exclude them from serious political debate.

> The overall economic benefits of QE are impossible to prove

THE EFFECTS ON REAL PEOPLE

To illustrate what the impact of low interest rates and QE has been for different people, we have constructed four theoretical model households with very different asset and liability profiles. As far as possible, we have used the Bank of England's own estimates of the impact of monetary policy on retail interest rates and asset values, but we have had to make our own assumption of what this has meant for house prices. We have not included any implications for pension assets (because of the mixed impact on pension income described above); nor have we said anything about how people might have been affected by the general health of the economy seeing as that putative effect of QE is unprovable. For illustrative purposes, we have taken a five-year period over which to consider the impact on interest income and expense.

Basic items have shown price inflation over the period



Source: Office for National Statistics

Figure 9

A. *Jean and Jackie Morrison*

- in rented accommodation, with no savings and with a small overdraft. One is a dinner lady in the local school; the other is training for a professional qualification.

This household has seen no financial gain from monetary policy. With no assets, it has not seen any of the absolute gains. As its only debt is in the form of overdraft, the costs of which have tended to increase, the couple has not benefitted from the lower interest rates on mortgage debt. This household has also suffered a number of negative effects. It is affected by higher barriers to mobility, like more expensive rental accommodation in larger cities. Any dream of eventual home ownership has been placed further out of reach. The couple has, in fact, been made poorer in real terms through having to cope with increasing prices of basic goods such as household and motor fuel and food (Figure 9). This is of particular importance since the poorest households spend significantly more as a proportion of their income on basics such as food and fuel making the impact of price rises particularly problematic for them.

B. *Jenny and Cameron Dalgliesh*

- own a small flat in Edinburgh valued at £200,000 with a mortgage of £150,000. They also have £2,000 in savings. They are both teachers and are trying for a baby.

This household has benefited from both the rise in property values (a gain of £35,000) and lower interest expense on their mortgage debt (£20,400) over five years. As their savings are relatively small, the impact of lower savings rates is limited. But, overall, this represents more than a doubling of their net worth.

C. *Martin and Amanda Barrett*

- retired and living in Derby. He was a manager in a printing company. They own their own home, valued at £300,000 and paid off the mortgage some time ago. They have £100,000 in savings: half in equities and half in deposits.

This household has seen gains on the value of their property and their equity investments but, with no mortgage, they have not benefited from lower interest rates and indeed have seen a significant reduction in interest income on their savings. Nevertheless, over the five-year period they are around £65,000 better off in terms of net wealth, a gain of around 16 per cent on their net assets.

D. *Penelope and Tim Fisher*

- both living in a £1m home in Vauxhall and working in the City. They have a buy-to-let property in Peckham worth £500,000 and £600,000 in total of mortgage debt. They also have an equity portfolio worth £500,000 and £50,000 in bank deposits.

In absolute terms, this household has done extremely well out of the loose monetary policy environment. They have seen gains in the value of their property holdings and their equity investments, as well as significant reductions in their mortgage interest expense. They have had reduced interest income on their deposits, but this is small compared with their gains. Overall, after five years, they are better off by more than £500,000, representing 36 per cent of their net assets. The value of their financial assets is up as well.

In addition to the above, there have been uneven changes in the purchasing power of different households. This has been caused by two major factors. First, the increase in relative prices of essential items, specifically fuel and food, differentially disadvantages poorer households since they spend significantly more of their money on such basic items. Second the reduction of real wages over the period of QE (though not as a result of QE itself) also differentially affects poorer households since wealthier households tend to have more sources of income other than wages, may benefit from increases in asset prices and, because of the skilled nature of their employment, tend to be subject to less downward pressure on wages than the unskilled.

The following table summarises these four theoretical households:

	Property Gains	Value of Other Assets	Total increase in net asset value
Penelope & Tim Fisher (High earners, multiple properties, financial investments)	PLUS £262,500	PLUS £175,000	PLUS £437,500
Martin & Amanda Barrett (Home owners free of mortgage, savings and investments)	PLUS £52,500	PLUS £17,500	PLUS £70,000
Jenny & Cameron Dalgliesh (Teachers, own a small flat with a mortgage, some savings)	PLUS £35,000	0	PLUS £35,000
Jean & Jackie Morrison (Renters, no savings, small overdraft)	0	0	0

The assumptions and details of these examples are set out in the appendix (page 29). We should be clear that we are not claiming that the QE policy created the situation that gave rise to this inequality. Neither are we taking a view on QE versus no QE – we are not claiming that these people have gained nothing from the implementation of QE through the putative increase in general economic activity. The limit of our argument is a distributional one – alternatives to the current QE programme could have been deployed that would have had less severe distributional consequences. We summarise some of the available alternatives in the next section.

But the four examples do set out clearly the conclusions we draw from the distributional effects of QE. This is that QE has benefited those that already have financial and property assets – the more assets owned, the greater the gain. For the poorest in society:

- *There has been no direct financial benefit*
- *They have been made relatively poorer as:*
  - *any dreams of eventual home ownership has been placed further out of reach*
  - *prices of basic goods such as food and fuel have increased (the poorest households spend three times more as a proportion of their income on household energy bills than the richest households).*
  - *their purchasing power has tended downwards*
- *The overall impact on the poorest in society also needs to be judged in light of the fact that, for much of the period over which QE was conducted, it was accompanied by fiscal consolidation (aka 'austerity') – a policy that also has differential impact across society with the poorest being most at risk.*

4. ALTERNATIVES TO QUANTITATIVE EASING

"ONE SHOULD ALWAYS LOOK FOR A POSSIBLE ALTERNATIVE, AND PROVIDE AGAINST IT."

Arthur Conan Doyle (via Sherlock Holmes)

The Bank justifies the use of QE in its current form by asserting that it rescued the economy and everyone would have been much worse off without it. But, even if true, this argument only holds if there were no other reasonable alternatives, and there were other policy alternatives that should have been debated, whether or not they would have eventually been pursued.

As we have shown, QE has transferred money to the wealthy and super-rich at the expense of ordinary citizens, to some sectors of the economy in preference to others, and to some regions more than to others. Alternative policy options would have had quite different economic, social and distributional effects. These policy alternatives have been discussed elsewhere and we summarise some of them in this section. We are not arguing for one or another of these alternatives. We list them here to merely to show that they do, in fact, exist. Given the different effects that each might have had, the choice between them is not merely a technocratic one but should properly have been the subject of political debate and political accountability. The assets used to benefit the richest were, after all, the money supply of the UK and therefore held in trust for the citizens of the UK.

> Monetary policy alternatives to QE should have been publicly debated

So, what are these policy alternatives?

INVESTMENT BONDS

This solution is perhaps most applicable to the eurozone where the former Greek finance minister Yanis Varoufakis has proposed a method whereby the purchases were not of government bonds but bonds in, for example, the European Investment Bank.[22] This would have done most to distribute the money into the real economy, so that the EIB could then invest directly in infrastructure, boosting demand and creating tens of thousands of jobs. In the UK, those institutions did not at the time exist: now perhaps using the Green Investment Bank would have been the way forward.

But central banks tend to object to weakening the dividing line between monetary and fiscal policy. Even so, purity in monetary economics is a political judgement, and should not be solely the decision of the central bank – an issue we discuss further in the next section.

Strictly speaking, this is an alternative to Funding for Lending (supporting lending and investments), not asset purchases (increasing M0 and cash in the system). It would, arguably, be a slower option because lending through the EIB involves lengthy, though appropriate, due diligence for each project, so any effective solution along these lines would also have had to propose ways of streamlining the decision-making process.

DEBT WRITE-OFF

An alternative would have been to write-off the debt that was so debilitating to the economy. That would have been a difficult political decision, given that it would potentially have reduced the balance sheet and hence importance of the banks and the other institutions which held the debt. But debt write-offs have a historic precedent and particularly recently, when Gordon Brown co-ordinated a write-off of un-repayable debt worth $35 billion so far.[23] The difficulty with writing off debts is that it may not be effective when new money is required. It also applies properly to insolvency rather than liquidity problems, but it is certainly possible.

HELICOPTER MONEY

Some economists and activists have proposed that the lack of co-ordination of fiscal, structural, and monetary policies, and prolonged risk aversion in the private sector, should be an argument for Japanese style 'helicopter money' Instead of buying government bonds or other securities by creating bank reserves, as the Federal Reserve and Bank of England have done, they could make payments directly to households. This proposal recently received support from Japanese economists.[24] Mark Blyth and Eric Lonergan also argued in Foreign Affairs that this would be the best solution for the eurozone.[25] They suggest that this could be effective at a cost of 5 per cent of GDP, which is a fraction of the value of recent QE. In 2015, nineteen economists including Robert Skidelsky signed a letter to the Financial Times appealing to the European Central Bank to use this direct approach. The campaign that followed argued that:

"Instead of flooding financial markets, money created through QE should be spent into the real economy, on essential public investment such as green infrastructure, affordable housing and/or distributed as a citizens' dividend to all residents."

Ben Bernanke described helicopter money (or citizen's QE) as "a co-ordination between fiscal and monetary policy." At the time of writing, some like Adair Turner are arguing forcefully for helicopter money while others like the German government look upon such an approach with a mixture of horror and disdain.

PUBLIC MONEY

This proposal would use the Bank of England's powers as a bank in a more strategic way, issuing money into the economy by providing the investment in new infrastructure or social housing that the nation needs, and struggles to achieve in the normal market. It would mean that the Bank's Asset Purchase Facility would buy bonds issued by agencies with a specific remit for productive investment within the UK, such as in housing (building and retrofit), infrastructure and small and medium enterprises (SMEs).

This is the basic approach set out by a group of green campaigners in 2008 as the Green New Deal.[26] There are legal issues associated with this if the investments are provided at below market rates, though the German Development Bank KfW does this effectively. The Industrial Development Bank of Canada supported Canadian SMEs from 1946-1972, and was capitalised entirely by the central bank without any taxpayers' money required. The New Zealand central bank extended credit for the building of new homes, helping the country out of the Great Depression.[27]

This is the approach that the New Economics Foundation calls 'strategic QE'. It is both a monetary and fiscal measure. Central banks are reluctant to mix these up, but, as we will argue in the next section, the failure to do so is also a political decision and needs to be debated in public.

The New Economics Foundation proposes a Monetary Allocation Committee that would be accountable to the Treasury and Parliament, but separate from the Bank of England's existing Monetary Policy Committee. This would decide how best to allocate new QE funding and any reinvestment of maturing gilts, after examining different sectors of the economy and spare capacity within them. Their report argues that:

"[This approach] would make allocation judgements based on a broad range of macroeconomic and policy criteria, such as sustainable GDP growth, employment, financial stability, the trade balance and inflation and ecological sustainability. Meanwhile, the independent MPC would remain in charge of determining the quantity of Bank of England reserves created and remain accountable for inflation. This would maintain an appropriate separation of powers and ensure that inflation expectations remained anchored."[28]

FISCAL STIMULUS

Another alternative would have been to use fiscal rather than just monetary policy to kick start the economy. Low interest rates could have been used to issue long-term government debt for spending on infrastructure. This approach may have been at odds with the government's focus on fiscal austerity. It could be argued that monetary policy was preferable because, being the BoE's purview, the government could continue to claim fiscal rectitude while pumping money into the economy through a decision that could be positioned as technical rather than political. Yet the distributional consequences of fiscal expansion would have been quite different and the choices made are properly the subject of political debate. The combination of monetary stimulus through QE with fiscal consolidation – and the dramatic social impact of that combination – is a political choice.

OTHERS

There are other, more radical proposals. There have been suggestions that a basic income might be funded this way. It would involve the kind of '100% Money' solution envisaged in the 1930s by Irving Fisher and later by Milton Friedman which would prevent private banks from creating money at all. Another proposal would be along the lines of the new currency called the ScotPound, which would be issued in parallel to the pound to prevent inflation.[29]

As we have said, we are not here arguing for one or other of these approaches. But the debate around which of these measures could best be deployed, including QE, never happened. The decision to deploy QE was made without public debate and with political accountability hidden under the shroud of central bank independence. Why? And should we carry on this way? This is the subject of the next section.

5. THE POLITICS OF MONETARY POLICY

"EVERY ORTHODOXY, EVEN AN INCIPIENT ONE, DESERVES TO BE QUESTIONED."

Guy Debelle and Stanley Fischer, Stanford University[30]

Why central bank independence? And what should 'independence' mean?

"The case for central bank independence from the political branches of government is simple. Central banks control the amount of money in the economy…if a nation's central bank is controlled by politicians, it can be expected to reduce short-term interest rates at particular times in the economic cycle."

This is the explanation provided by Richard Posner in the blog site he shares with Gary Becker.[31] In other words, it's all very simple – politicians cannot be trusted not to try to buy elections and the citizenry needs to be protected from them by central bankers. Yet, in the same blog entry, Posner also recognises the issues associated with central bank independence. He goes on to say that the US Federal Reserve is not constitutionally independent like, for instance, the US Supreme Court since:

"…[that] would create something close to a dictatorship over the business cycle, and this is too much power for a democratic society (perhaps any society) to cede to a bevy of economists and financiers."

He finesses this conflict by calling the Fed "quasi-independent."

Central bank independence treats elected governments like children

The caricature of this position is that politicians are like children. They can be trusted to go out and play and indulge in a number of other activities but they certainly should never be trusted to print money because they will just go out and party irresponsibly at election time. The objective of this section is to argue that such a perspective is both fallacious and dangerous. It goes to the very heart of what we understand by democracy; it severely undermines the very basis on which our liberal democracies are built and it regards mature, well-functioning and well-established democratic states as though they are no different to banana republics. In other words, it treats adults like children.

INDEPENDENCE AND POLITICAL POWER

The notion of central bank independence has, in some circles, come to be widely accepted and almost beyond question. Yet it is a relatively recent invention. The 'quasi-independent' US Federal Reserve was only set up in 1911. The Bank of England was founded in 1694, evolved in different ways over the centuries, initially being a private company that was nationalised in 1946. It was made independent by Tony Blair and Gordon Brown as recently as 1997. Great Britain somehow seems to have survived and prospered before 1997. And the biggest financial crash in living memory happened under the watch of an independent Bank of England, not as a result of profligate politicians printing money to fit the electoral cycle.

The Bundesbank was founded in 1948 when the Americans imposed the Fed model on a defeated Germany. Reeling from the catastrophic experience of pre-war hyperinflation and subsequent wartime defeat, independence of the Bundesbank was not only readily accepted but welcomed by the German public. As we shall see, until it was emasculated by the creation of the single currency, it was one of the most powerful institutions in the land. This had mixed consequences.

Should control of money be ceded to unelected institutions?

The destruction wrought by the hyperinflation of the Weimar republic remains today the standard riposte to any attempt to question central bank independence. But there is very little discussion of the consequences of democracies ceding the control of money to unelected and largely unaccountable institutions. Taking Prime Minister's Questions after she had just resigned in November 1990, Margaret Thatcher was asked by Liberal Democrat finance spokesperson Alan Beith about whether she would continue to fight against an independent European central bank. Dennis Skinner, MP for Bolsover, quipped in his inimitable way: *"She's going to be the guv'nor."* Laughs all around. Thatcher's response was as follows:

"What a good idea! I had not thought of it. But if I were, there would be no European central bank accountable to no one, least of all to national parliaments. The point of that kind… of central bank is no democracy, taking powers from every single Parliament…a monetary policy and interest rates which take all political power away from us."[32]

Thatcher had no doubt that monetary policy carried significant political power. In fact, she used the words "all political power". And the extent of such power had been graphically demonstrated quarter of a century earlier, in 1966, by the powerful Bundesbank. Here is an extract from the latest book by Yanis Veroufakis:[33]

"Irritable German central bankers saw in Chancellor Ludwig Erhard a loathsome figure… So what did these bankers do?…Germany's central bank engineered a sharp recession to oust the government…And how do we know this? We know because the Bundesbank's president, Karl Blessing, admitted to it years later. Without a smidgeon of regret he said that "we had to use brute force to put things in order."

In 1966 the Bundesbank brought down the elected government of the day

Yet, while the hyperinflation of the Weimar republic has been indelibly imprinted in our collective consciousness and is used to terrorise the citizenry about the fickle nature of elected politicians, the Blessing coup has seemingly been erased from our historical memory. Neither is the 1966 episode unique. In 1982, in response to Chancellor Helmut Schmidt making a political decision for the government to go into deficit to boost employment, the Bundesbank increased interest rates to what is today an unimaginable 30 percent. This, combined with the demands by Schmidt's FDP coalition partner to reverse the deficit, caused unemployment to double, leading to the collapse of the coalition government.[32]

All this is not in any way to suggest that the Bank of England would act like Blessing or others in the Bundesbank. Simply that an independent central bank has the power to do just that. And such power is one that can be exercised in a purely political way. We should therefore all reflect carefully the extent to which democracy is compatible with ceding such a degree of political power to unelected technocratic bodies that have limited accountability.

Economics is a branch of politics

In his autobiography *A Journey: My Political Life*, Tony Blair explains the logic behind awarding the central bank its independence: *"I had been convinced long ago that for politicians to set interest rates was to confuse economics and politics."*[34] This is fundamentally mistaken. Economics and politics cannot be *"confused"* because they are inevitably and inseparably intertwined. While some economists like to portray economics as an objective, scientific and value free discipline, it is nothing of the sort. Economic decisions are all highly political in nature because they carry consequences for people that, in a democracy, should be decided within the political sphere. Economic decisions flow from the prevailing political ideology not the other way around. It could well be argued that, with the possible exception of going to war, economic decisions are the most important political decisions that any government can make.

Blair, in fact, goes on to explain that the decision to grant independence was itself highly political. *"I favoured doing it before the election to solidify our business credentials."* In the event, it was agreed with Gordon Brown to announce immediately after the election: *"For me, it was a very important moment. It defined not simply our approach to economic policy, but an approach to governing…it spoke of our determination from the outset to protect and enhance our economic opportunity as a nation."*

Referring to Gordon Brown, Blair writes: *"In that first statement on the Bank of England and his first budget, he was pretty clearly New Labour."* Whatever the 'economic' justification, the decision to grant central bank independence was fully political – a positioning statement for New Labour.

Democracies need political accountability for monetary policy decisions

We have shown in this paper that the Bank's decisions regarding QE have consequences that are nothing if not political. While central banks may well be non-partisan – and in that sense not politicised – that does not make either the Banks or their decisions apolitical. We suggest that a democratic society must have frameworks that both allow clear political influence and create clear political accountability around such decisions.

There are further ways in which institutional independence and lack of accountability undermine our political system. The more the narrative gains traction that our elected representatives cannot be trusted with power, the less confidence we retain in our democratic systems. Some time ago at an event with City bankers at which Nick Clegg, then Deputy Prime Minister, was present, one senior banker asked, without a hint of doubt or shame: *"If we are to have a stable and prosperous economy how can we remove more decisions from political influence?"*

Clegg responded by first citing Bank of England independence but moved on to state clearly: *"You cannot live in a democracy and remove decisions from elected politicians."* Yet the question itself made clear that the narrative has now entered the collective consciousness – that politicians simply get in the way of the proper management of the economy.

Removing crucial decisions from the political sphere undermines the basis of our democracies

Democracy is also undermined in other, more subtle ways. Varoufakis writes: "The more that crucial political decisions are turned over to unelected second-rate technocrats, the fewer gifted men and women enter politics."[32] And that cannot be good for any democracy.

Yet, we can hear the objections. The USA and Germany are the very models of central bank independence and they have done well over the long term. Maybe, but in neither country is central bank independence beyond question and shielded from debate.

In the US, the appropriate limits of Federal Reserve independence are the subject of constant political discussion – often vociferous. A paper by the Brookings Institution analyses the hundreds of bills introduced into Congress related to the Fed's independence.[35]

> Central bank independence is the subject of political debate both in Europe and the US

Since the 1980s, almost all those bills were aimed at constraining the limits of the central bank's independence with the number of bills introduced being more-or-less equally distributed between Democrats and Republicans. Activity has been particularly high in the era of quantitative easing. The authors note: *"Pumping trillions of dollars into the economy, via emergency lending programs insulated from congressional oversight, raised the ire of politicians on the left and right."* So, unlike in the UK, the nature shape and limits of Fed independence is the subject of almost constant political debate in the USA.

Post-war West Germany was a defeated and scarred country. Citizens had little confidence in the ability of their political class to build a functioning state. The memory of hyperinflation was still raw. In such circumstances, it is understandable that constraining the power of politicians was seen as desirable. Since then, Germany has developed into one of the world's best functioning states and its political institutions have gained the trust of the public. The Bundesbank's independence was widely accepted while it operated within the Ordnungspolitik and the belief in sound money that reflected German cultural norms. But things have changed. The Bundesbank has effectively been emasculated and Germans are now subject to the independent decisions of a multi-national, multi-cultural central bank currently headed by a non-German – a bank that has the unenviable task of trying to keep on the road a creaking Eurozone economy that is a nightmarish jigsaw of countries with widely varying economies, policies and political philosophies.

In this new scenario, the German government seems to have no qualms about exerting huge political pressures on the Bank – both privately and through newspaper headlines. Although the creation of an independent ECB on the Bundesbank model was done on German insistence – the price the Bundesbank demanded to acquiesce to monetary union - the ECB is now perceived to be behaving in a distressingly non-Teutonic manner. The principle of central bank independence has consequently started to have limits. And not just for the German government, but also for the German people. As an article in Der Spiegel puts it:

"The alienation between Germany and the ECB has reached a new level. Back in deutschemark times, Europeans often joked that the Germans 'may not believe in God, but they believe in the Bundesbank', as Germany's central bank is called. Today, though, when it comes to relations between the ECB and the German population, people are more likely to speak of 'parallel universes'."[36]

We argue that, as in the US and in Germany, so in the UK, things have changed with the introduction of QE and its political effects.

> Central bank decisions have intensely political effects

It has brought into sharp relief the political nature of central bank decision-making and made an open debate about what central bank independence should mean essential.

ABOUT OBJECTIVITY

Some argue that central bank decision-making is technocratic and therefore objective. This is a false argument. We will not re-hash here the whole mass of philosophical literature about the impossibility of objectivity. Suffice it to say that different economists hold different views about what are and what are not appropriate economic actions. And those different views flow from the political ideologies that the individual economists subscribe to. Were technocratic decisions fully objective, there would be little room for disagreement. Yet technocrats, even central bankers, routinely disagree about appropriate courses of action. So it was that in December 2012, the Bundesbank submitted a paper to the German Constitutional Court arguing that the ECB's Outright Monetary Transactions (OMT) programme lay outside the ECB's mandate. This was a legal challenge to a programme with which the Bundesbank violently disagreed on the grounds of economic and political ideology. The objectivity argument implies that there is always only one 'right answer' and it is the technocrats' job to find it. That is clearly a false premise.

ACCOUNTABILITY

How does one balance accountability and independence of the central bank?

In December 2014, Mark Carney, the Bank's governor, to his credit, tried to sweep aside some of the Bank's traditional secrecy and make its deliberations more transparent. Carney said:

> Who is politically accountable for the social and economic impact of monetary policy decisions?

"These changes will enhance our transparency and make us more accountable to the British people."[37] In the bill introduced subsequently to Parliament, the Treasury introduced a clause that would submit the Bank to audit by the National Audit Office to *"strengthen the bank's accountability to the public and to parliament, both as a public body and in its use of resources."*[34] The Bank pushed back against these provisions concerned that the approach that was suggested could threaten its independence. This led to the proposed provisions being watered down by broadening the scope of exemptions. In response, Sir Amyas Morse, who leads the National Audit Office, described the proposed restrictions as *"unacceptable"* because *"if enacted, [they] would create an impression of public accountability without reality."*[38]

We do not comment here about the rights and wrongs of the specifics but simply relate this episode to highlight the real difficulties that exist in trying to balance independence with accountability.

PROVIDING POLITICAL COVER?

The final question to be addressed is this: does central bank independence help stability by removing short-term political influence from monetary policy decisions; or does it simply provide political cover for decisions that are, in fact, still heavily politically influenced? Or maybe a bit of both?

Whatever the answer, significant problems arise if the decision-making process is not rendered transparent. It is clear to us that monetary policy decisions have major political consequences. What is not clear is why, of all the many interlinked economic policy decisions, it seems reasonable to pull out monetary policy and treat it fundamentally differently from any other policy decision that affects people's lives. After all, monetary policy does not live in its own bubble. It is an integral part of the full spectrum of policy decisions that underpin our economy and our social fabric.

> Technocratic bodies cannot be allowed to be used to shield elected governments from the political impact of decisions

The consequences of monetary policy gone wrong can clearly be substantial. To us, that makes it even more important that there is clear political accountability rather than hitting such decisions into the opaque, technocratic long grass. In our introduction, we quoted Alastair Darling who suggested that there was a desire for the QE decision not to be seen as a *"political ploy."* There are two alternative explanations for such a remark. The positive interpretation is that if the government were to be seen to have embarked on a 'money printing' operation to get itself out of a hole, there might be significant negative consequences for the credibility and financial stability of the country. The negative interpretation is that of a government trying to shield itself from the political consequences of its decision. The latter is clearly unacceptable in a democracy and we do not need to discuss it further. We here assume the former interpretation. What are the implications of this?

The obvious one is that the Bank is saddled with carrying responsibility for the political consequences of such a decision. This has significant consequences the other way – the potential undermining of the Bank's credibility in the eyes of the public and, as we have argued here, the wisdom of the whole concept of central bank independence. This also appears to be the stance taken by the first chair of the FSA, Sir Howard Davies, who argues that central bank independence *"may be having ambiguous consequences. Indeed,"* says Davies, *"some central bankers are beginning to worry that their role has expanded too far, putting them at risk of a backlash."* Either way, we suggest that we have got past the time of unquestioning acceptance of central bank independence, whatever the concept might actually mean in practice – and that, in itself, is far from clear.

> Independence taken too far undermines central bank credibility

6. THE WAY FORWARD?

"IN MY ORIGINAL ARTICLE, I SPECIFICALLY ARGUED AGAINST EITHER LOWERING INTEREST RATES OR EXPANDING CENTRAL BANK RESERVES. THAT WAS MY WHOLE POINT - TRADITIONAL SOLUTIONS WEREN'T GOING TO WORK. ACTUALLY, IT WAS A BIT UPSETTING.""

Professor Richard Werner, the inventor of the phrase 'quantitative easing', interviewed on the BBC, October 2013

Our aim with this paper was to highlight that monetary policy is fundamentally political. The Bank of England's Quantitative Easing programme has had significant distributional effects across the population, across regions and across different sectors of the economy. It has affected the social fabric of the nation, increased wealth inequality and further unbalanced the UK economy. Arguing that such decisions are apolitical and technocratic is not only unsustainable, it is plain wrong. It risks undermining both the democratic process and the credibility of the Bank of England and the support and trust that it commands among the public.

There is no such thing as apolitical money

It is our view that final decisions about monetary policy should rest with the elected government of the day. This is the only way that decisions that have significant impact on the fabric of our society can be subject to democratic accountability.

However, who makes the decision is not the only issue. The process by which that decision is made is also a question of vital importance for transparency and accountability. The fact that the Bank's decision to publish minutes of its MPC meetings comes to be hailed as a great step forward in transparency shows just how far we still have to go before we have truly open and transparent decision making in key areas of policy.

In this regard, the debate, or lack thereof, over monetary policy, reflects a wider challenge for governing a democratic society. Many aspects of modern society and the economy are highly complex, so only a specialist expert can hope to have a detailed understanding. But experts are human beings, with their own set of beliefs and values, which do not necessarily reflect those of society, and conflict with other experts. So, for example a group of leading economists wrote to *The Guardian* criticising the government's austerity policies.[40] Another group of equally eminent economists have backed austerity measures.[41]

It is the job of a democratically elected government to balance in a transparent manner conflicting expert views and the interests of different groups of society in line with the values on which they have been elected. But how are they to achieve this when the underlying values and distributional impacts can be buried under a mass of technical details? Our view is that the best solution is transparent plurality.

In the past too often, governments have tried to overcome the issue of technical complexity by commissioning and relying on a single 'guru' in a given area, often with disastrous consequences. In monetary policy, this 'guru' is represented by the Monetary Policy Committee. While this is independent of Government, it is convened by the Bank of England and the majority of the committee are Bank of England employees. Its decisions are nominally transparent, they are highly technical and only intelligible to the few. The committee also necessarily reflects a particular perspective and, inevitably, the prevailing culture at the Bank.

Crucial economic decisions require a process of plurality and transparency

Plurality would work by having a variety of groups proposing monetary policy, with the government's role being to arbitrate the different views and deciding the way forward in a politically accountable manner. For instance, there already exists a self-proclaimed shadow monetary policy group run by the Institute of Economic Affairs.[42] Though this comes from an institution with a strong ideological focus, it consists of credible members, and often disagrees with the decisions of the MPC for valid reasons. If the government genuinely welcomed pluralism, we would be confident that many such groups would arise with diverging viewpoints.

The challenge with plurality is how best to arbitrate and come to a workable solution. Obviously this would not work in all situations. So, for example, in an emergency when an immediate decision is required this may not work. But such situations are the exception rather than the rule. The decision to employ QE, for example, was developed and employed over many years.

An illustrative precedent, which has been around for rather a long time, is the case of the law. Legal trials can be about highly complex and technical matters, yet the legal teams have to present a case that is intelligible to a non-expert judge and/or jury who then adjudicate on the technical matter, on the basis of which argument is better. The process of building a case, and cross-examining the opposing case, in a language that is comprehensible to a lay person, is a valuable one. It teases out the underlying values, assumptions and flaws in the opposing arguments. The judgement is explained in detail so that it can be subjected to scrutiny and used as a precedent. The current technocratic, opaque approach to crucial decisions on monetary policy would, in the legal sphere, be equivalent to abolishing trial by jury on the grounds that lay people are too stupid to have a view on such complex and often technical decisions. It relieves the technocrat from having to speak in open, intelligible language and be subject to public scrutiny.

Technocrats need to speak in a language that is accessible to the voting public

Another example of plurality are open source websites, or wikis. A celebrated example is Wikipedia, which is an open source encyclopaedia. Anyone can contribute and people are willing to do so for free.

The key to plurality, though, is to provide a suitable forum to benefit from the vast array of expertise that is available, and learn to synthesise different views to get to a final decision. We believe this is the main contemporary challenge for democratic governments – in many areas as well as in monetary policy.

RECOMMENDATIONS

In terms of monetary policy, we would make the following specific suggestions for immediate reform:

- *The method of reflating the economy, and then reversing it, is not and cannot be presented as a purely technocratic decision to be developed behind closed doors among the cognoscenti – to use Posner's phrase, "a bevy of economists and financiers." It has to be a legitimate area of public debate with due respect being given to the voting public whose lives are directly affected by such a decision in no minor way. This needs to be recognised explicitly in the way these decisions are reached.*
- *That Bank of England's independence has clear political limits, and – unless it wants to lose its credibility – the Bank would be well-advised to press for those limits to be set out clearly.*
- *We would suggest that central bank independence (at least as far as the UK is concerned – it is more complicated for the ECB) be interpreted as independence of opinion rather than independence of action. While the government should ultimately have the final say (see below), and consequently carry political accountability, the Bank should be free, and indeed required, to make public its own position even, maybe especially, if that is at odds with the government's position. This puts the Bank on a similar footing to, for example, the National Audit Office. It still gives the Bank significant power and it would be a reckless government that wilfully went against the Bank's publicly stated position without clear justification. But the government should be free to do so as it is the only institution that has the democratic legitimacy to take such vital decisions that are clearly political. Such an arrangement would also strip the Bank of the ability to mount something akin to the Blessing coup of 1966.*
- *We suggest that a process needs to be developed whereby a wider range of voices are encouraged and brought into these decisions. Groups with different political and economic philosophies should be encouraged to submit monetary policy recommendations to the Treasury on an ongoing and regular basis with the Bank being one, but only one, of those voices.*
- *All such recommendations should be public and should be required to be formulated in a way that they are intelligible to those who have an interest in these matters.*
- *Final decision-making power on monetary policy should rest firmly with the elected government of the day. The process should be open, transparent and comprehensible and should be based on a political and economic evaluation of the many different perspectives that a pluralistic process would generate.*
- *Such an open, pluralistic process would also allow bodies such as the Treasury Select Committee to have a broader and deeper basis on which to hold the government to account for the decisions taken*

Monetary policy decisions must ultimately rest with the elected government of the day

QE and central bank independence may seem arcane technocratic subjects to many. We believe they are far from being that. They have a direct effect on millions of people's lives. How monetary policy decisions are made, who is held politically accountable, and how, are questions that go to the very heart of our democracy. Money is power, after all. We believe that power must ultimately lie with our democratically elected government accountable to the voting public.

Money is power – and it must be accountable

APPENDIX

The examples of living people

	1 No assets, small overdraft	2 Own residence with mortgage, no significant other assets	3 Own residence with no mortgage, other savings	4 High value own residence with mortgage, significant other investment
Assets and Liabilities				
Bank Deposits	0	2,000	50,000	50,000
Overdraft	(500)	0	0	0
Own Residence	0	200,000	300,000	1,000,000
Other Property	0	0	0	500,000
Mortgage Debt	0	(150,000)	0	(600,000)
Equities	0	0	50,000	500,000
Net Assets	**(500)**	**52,000**	**400,000**	**1,450,000**
Wealth Effects				
Property Gains	0	35,000	52,500	262,500
Equity Gains	0	0	17,500	175,000
TOTAL	0	35,000	70,000	437,500
As percentage of net assets	0%	67%	18%	30%
Income Effects				
Loss of savings income	0	-210	-5,250	-5,250
Reduction in mortgage expence	0	20,625	0	82,500
TOTAL	0	20,415	-5,250	77,250
As percentage of net assets	0%	39%	-1%	5%
Combined Effects				
TOTAL	0	55,415	64,750	514,750
As percentage of net assets	0%	107%	16%	36%
Assumptions				
Change in property valuation	17.5%			
Growth in equity valuation	35%			
Drop in rates on savings	2.10%			
Drop in rates on mortgages	2.75%			
Period of income savings (years)	5			

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