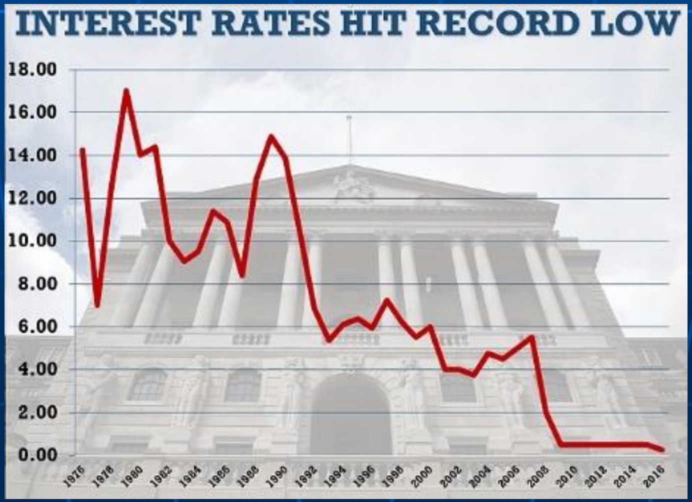
Unintended effects of Quantitative Easing

Baroness Ros Altmann
May 2017

blog: pensionsandsavings.com
twitter: @rosaltmann

QE – what's it all about?

- 2009 – fight deflation and economic collapse
- Short-rates near zero, wanted more stimulus
- BofE tried lowering long rates too – flatten yield curve
- Emergency £200bn new money printed to buy gilts
- Massive monetary experiment helps finance fiscal deficit
- BofE justification: would be worse without



Emergency measures becoming ‘mainstream’?

- Growth and employment increased but…
- Still creating new money to buy gilts: £375bn by 2012
- Maturing gilts reinvested (but not >70% of a gilt issue!)
- Most other central banks act too
- 2016 further QE: £60bn gilts + **£10bn corporates**
- Negative yields seem to be accepted internationally

Predicted theoretical benefits of QE

- Avoid deflation + boost asset prices, growth and jobs
  - Income effect
  - Substitution effect
  - Wealth effect
  - Portfolio balance effect
- But are these effects positive, benign or negative?
- Do theoretical models work in practice?

Impact of QE on growth?

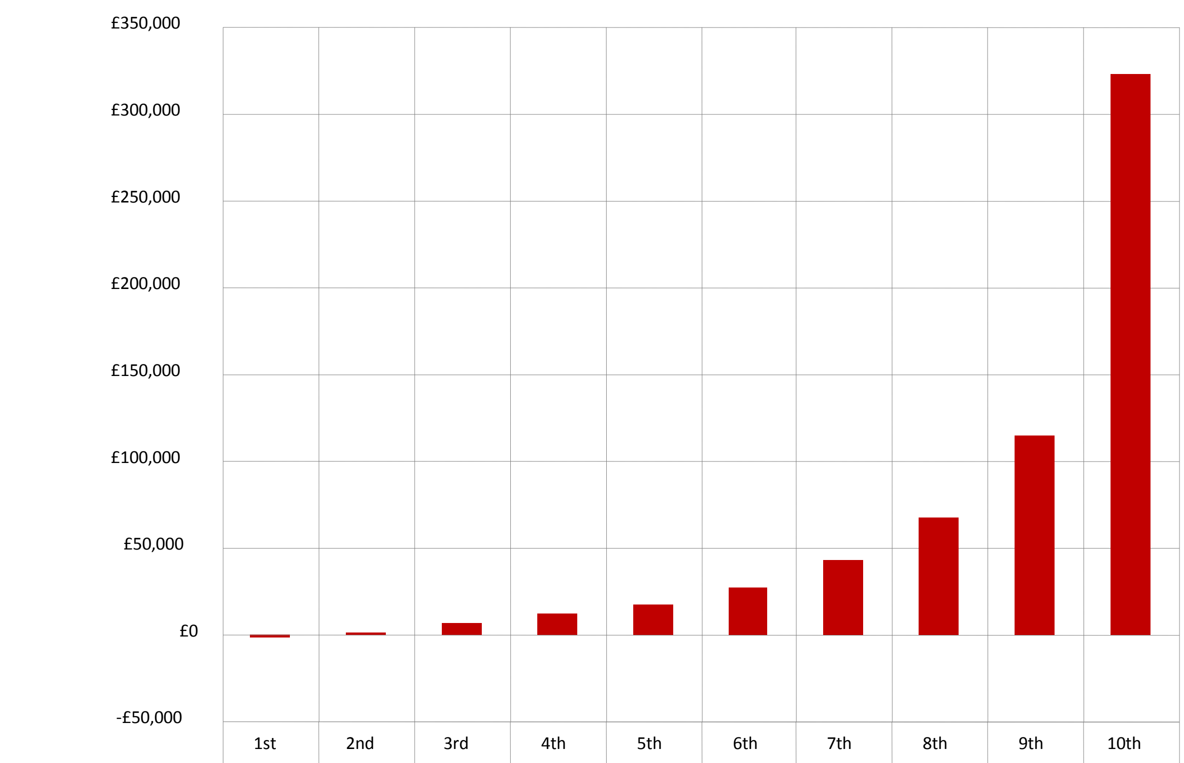
<u>Predicted reflationary impact</u>	<u>Potential deflationary offsets</u>
Lower corporate borrowing costs may raise capital investment	QE raises pension deficits, which may hit corporate investment
Income effect – lower household borrowing costs boost spending	Weak real income growth as pension deficits reduce pay rises
Wealth effect from higher asset prices (e.g. house prices)	Higher rental costs may reduce spending
Substitution effect as lower rates accelerate spending plans	Aging population and weak growth may hamper spending
Portfolio balance effect as investors buy riskier assets	Pension deficits and maturing DB/DC drive less risk

Negative effects underestimated

- Financial repression
- Eroded value of money and reduce pensions
- Ignored term structure of private sector balance sheet
- Artificially inflated asset prices - housing, equities, bonds bubbles?
- Exacerbated wealth inequality
- Exacerbated inter-generational inequality

Transfer of wealth to the wealthiest

<u>Bank of England analysis 2012</u>



	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
Benefit per household	-779	1,381	6,389	11,708	17,574	26,684	43,240	67,061	114,328	322,963

BofE 2012 analysis of QE effects

- Top 5% of households hold 40% of all assets
- QE boosted asset value of top 10% by £322,000 each!
- 80% of financial assets held by people aged over 45
- QE widens DB pension deficits
- Bottom half of US citizens own 2% of assets in equities, bonds, mutual funds

Consumer Debt has increased not fallen

- 2004 UK consumer debt hit **£1trillion**
- 2013 Consumer debt £1.4 trn + £1.5trn national debt
- BofE still trying to inflate asset prices to validate debt
- BofE said households not sitting on a 'time-bomb', as borrowing increase matched by rise in financial assets
- But much new debt is credit card/auto loans PCP

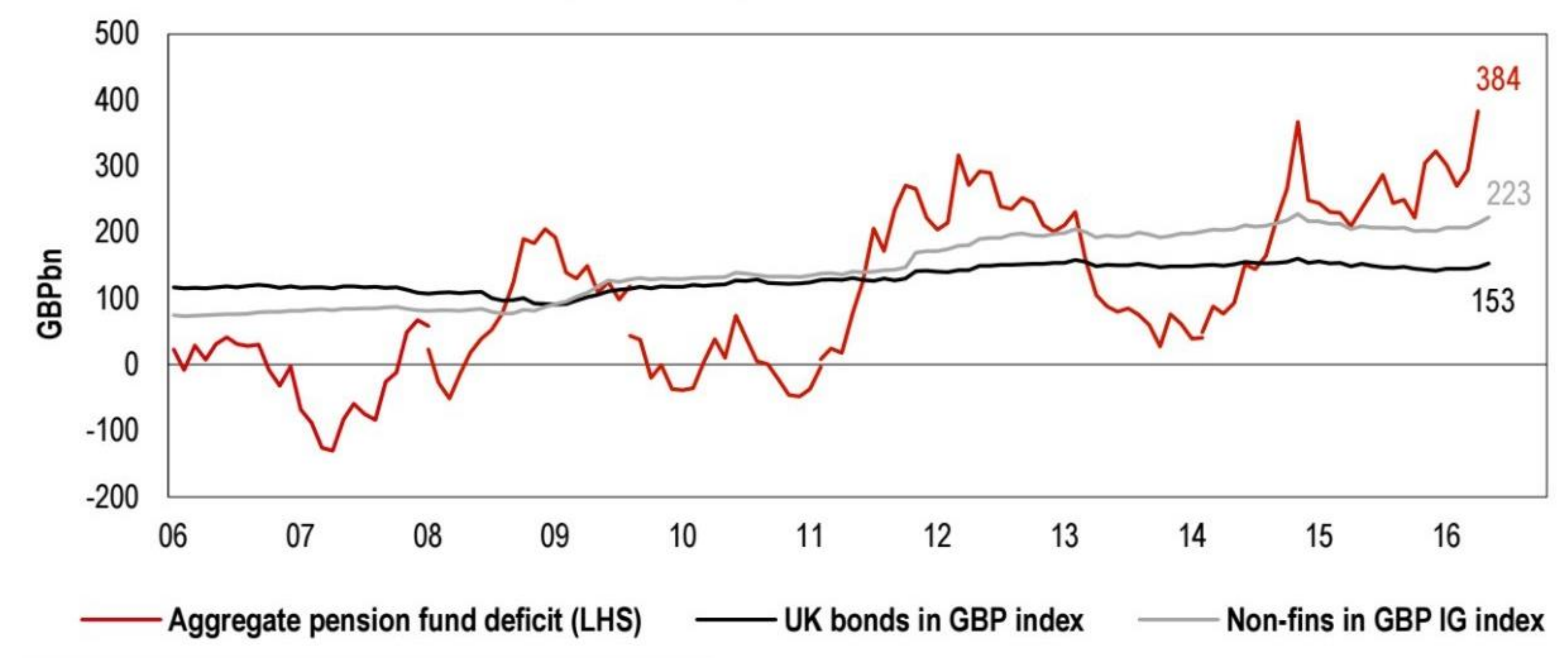
Some household interest rates have actually **risen**

Date	Credit Card %	Overdraft Rate %	Standard Variable Rate Mortgage %
Aug 2011	16.73	19.38	4.11
Aug 2012	17.26	19.53	4.27
Aug 2013	17.87	19.54	4.36
Aug 2014	17.39	19.67	4.52
Aug 2015	17.91	19.67	4.48
Aug 2016	17.96	19.68	4.33
April 2017	17.96	19.70	4.28
change over past 6 years	+1.23%	+0.32%	+0.17%

QE hits DB and DC pensions in aging population

- UK pension system underpinned by long rates
- Typical DB pension fund sensitivity to interest rates:
  - 1% point fall in long rates => 20% rise in liabilities
  - 1% point fall in long rates => 6-10% rise in assets
- Deficits up even as sponsors pay billions – vicious spiral
- Annuity rate falls also make buy-in/buy-out so expensive
- Make DC pensioners permanently poorer

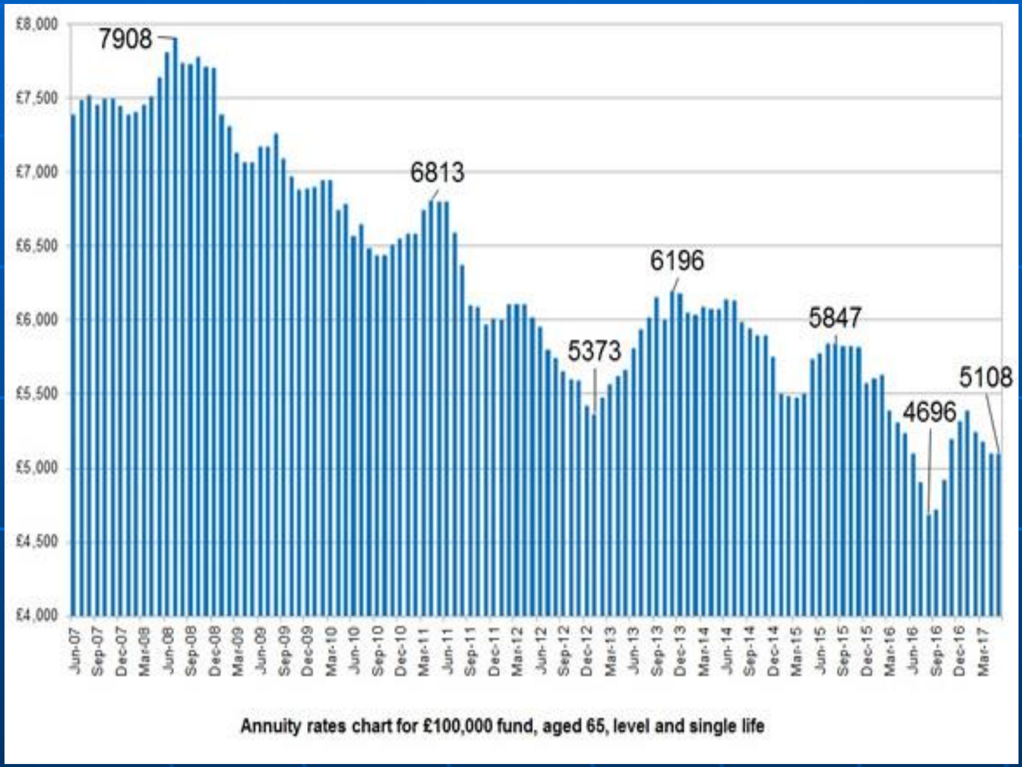
Massive rise in pension deficits post-QE



Source: Pension Protection Fund (PPF 7800 data), HSBC calculations, Markit
Note: Breaks in the pension fund deficit series are due to changes in actuarial assumptions. UK corporates in GBP IG index is based on market value and country of risk

- Source HSBC
- Deficits now over £500bn on non PPF basis

Annuity rates and gilt yields 2007-2017



QE impact on asset allocation

- As deficits worsen, trustees told to ‘de-risk’
- Is buying gilts de-risking?
- Buying more gilts or swaps, drives gilt yields down
- DB in vicious spiral as deficits worsen again
- 85% of DB schemes now closed – small firms failing
- Turning non-financial employers into annuity providers

Financial market consequences of QE

- Interfered with risk-free rate – are risk models reliable?
- Risk-free returns or return-free risk – negative yields?
- Need to <u>outperform</u> liabilities to fix deficit
- Selling potentially higher return assets 'de-risking' or just locking in deficits?
- Are bonds, real estate, equities in a bubble?
- Will diversification/downside protection better manage risk

DB pension fund asset allocation trends

Year	Equities	Bonds	Other
2006	**61%**	**28%**	**11%**
2007	**60%**	**30%**	**11%**
2008	**54%**	**33%**	**14%**
2009	**46%**	**37%**	**17%**
2010	**42%**	**40%**	**18%**
2011	**41%**	**40%**	**19%**
2012	**39%**	**43%**	**18%**
2013	**35%**	**45%**	**20%**
2014	**35%**	**44%**	**21%**
2015	**33%**	**38%**	**19%**
2016	**30%**	**51%**	**18%**
Source: PPF	Purple Book 2016		

QE damages pensions and wages

- BofE scheme suggests 'low risk' DB requires employer contributions >50% of salary (up from 25% pre-QE)
- DC contributions lower while employer supports DB
- Research suggests employer DB support hits wages/jobs
- 10% of deficit financing comes from lower wages
- Low earners lose £200pa although never had DB pension

Short-term vs. long-term

- Short-term policies carry long-term dangers
- Borrowing growth from tomorrow – warnings ignored
- Record low savings ratio
- Is policy just an illusion? Pretend debts affordable
- Markets addicted to new money and debt
- Politically expedient, financially incontinent?

Overcoming QE drawbacks?

- QE relies on distorting yields and boosting asset prices
- Pass ‘Heineken test’? is money reaching parts in need?
- Possible alternative solutions?
  - Temporary tax breaks for capital projects
  - Direct SME investment support
  - Use pension/insurance assets to boost growth directly
  - Helicopter money?
- Ultimately, can QE really be unwound?

So what's next?

- Could Central banks just cancel bonds they've bought?
- Who would lose?
- Rebase currencies and markets - huge debt forgiveness
- Redistribution of income via hidden tax rises or tax cuts
- QE was back door central bank deficit financing – markets willing to be fooled in their self-interest
- Has monetary policy just replaced fiscal policy but with politically difficult distributional consequences

Unintended consequences summary

- Greater income and wealth inequality
- Higher consumer debt
- Higher Pension deficits
- Lower wages
- Political fallout - rise of populism as ordinary people lose out?

Any questions?...

Visit my website: www.rosaltmann.com

Follow me on twitter: @rosaltmann