HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Lord Higgins
House of Lords
London
SW1A 0PW

10 August 2010

Dear Terence,

M4 and Quantitative Easing

I would like to address the important issues you and Lord Skidelsky have recently been raising on quantitative easing and money supply in more detail than has been possible to date in the House, in particular the points made during the House of Lords Finance Bill debate on Monday 26th July.

To start, I should reiterate that decisions about monetary policy (including quantitative easing) lie with the Monetary Policy Committee (MPC) of the Bank of England because it has operational independence. The objective of monetary policy is to maintain price stability by targeting inflation at 2% in the medium term as measured by the 12-month change in the Consumer Prices Index (CPI). This institutional arrangement is necessary to ensure the MPC can anchor inflation expectations, which is vital for the effectiveness of monetary policy.

The Debt Management Office's policy of funding does not influence money supply. The Government's policy fully to fund its net financing requirement was first introduced in 1985 with the objective of ensuring precisely *"that the financial transactions in the public sector had no direct effect on the M4 money supply"*. While, in theory, it is possible to increase money supply by under-funding the Government's net financing requirement (which could be achieved by issuing an insufficient quantity of gilts), the Government does not support this for several reasons. First, as under-funding would effectively influence monetary policy, it would run counter to the institutional arrangements for an independent MPC. Second, the Government aims to provide maximum transparency to investors that it will fully fund its financing requirement by publishing its projected financing requirement four years in advance. And, in any case, such a policy would amount to borrowing from the central bank, which is illegal under Article 123 of the Maastricht Treaty.

Regarding your questions around the effects of quantitative easing on the money supply, this is really a matter for the MPC. The Bank of England's May 2010 Inflation Report (pages 17-18) points out that money holdings in 2010 Q1 grew at the fastest pace since 2008 Q2, though the four-quarter growth rate was well below the recent average. The report highlights that this trend partly reflects banks' attempts to repair their balance sheets. The report then states: "it is likely that broad money growth would have turned out to be even weaker in the absence of the Bank's asset purchases" and shows that compared to the early 1990s recession, broad money growth has fallen by relatively less, despite a much larger contraction in nominal spending. More recent data shows that the Bank of England's preferred measure of broad money, M4 minus the sterling deposits of intermediate other financial corporations (OFCs), has increased for four consecutive months from February to June 2010.

As the May 2009 Inflation Report (pages 16-17) shows, quantitative easing works through various channels other than money supply, including lower long-term interest rates and rising asset prices. An assessment of the impact on asset prices, in particular on the gilt market, is made in the May 2010 Inflation Report (pages 12-13): *"asset purchases appear to be having a sizeable downward effect on gilt yields….equity and corporate bond prices have increased significantly since early 2009. That is likely, in part, to reflect the exceptional monetary stimulus"*.

It is also worth noting the minutes of the MPC meeting in May 2010 in which the Committee assessed that quantitative easing is likely to have had some role in raising aggregate demand. The Office for National Statistics preliminary estimate for 2010 Q2 of 1.1 per cent showed the strongest quarter of growth since the beginning of 2006. This is a positive sign but there is, of course, still a great deal of work to be done. The Government's priority is to implement the Budget policies, which support rebalancing and help ensure sustained growth, including ensuring the availability of credit on appropriate terms to businesses and individuals.

I hope that this goes some way to addressing the issues you have been raising. I am copying this letter to Lord Skidelsky and placing a copy in the Library of the House.

Yours James

LORD SASSOON