



QE may bring higher inflation rather than economic growth

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With the MPC embarking on another round of QE, there will be the usual questions about whether QE has had any effect on the economy at all.

The Governor's response to these questions usually includes a reference to the counterfactual: we don't know what would have happened if the MPC hadn't acted in this way, which implies that the current economic situation might be bad, but it would have been even worse without the QE tonic.

So why inject more cash when gilt yields are already so low? There are a number of arguments in favour and a few important ones against. Other things being equal, lower gilt yields should encourage investors to buy other assets such as equities and credit, which in turn supports households and firms.

QE gives a strong signal that interest rates are now on hold for a considerable period, at least until 2013, which means that mortgage borrowers can have confidence to plan ahead, safe in the knowledge that their monthly payments will be stable. The money from gilt purchases eventually ends up in bank deposits, which in theory should boost lending, except this mechanism has been damaged thanks to the banking crisis, with lenders reluctance to lend on anything but the safest projects and households and companies now less willing to borrow.

One major criticism of QE is that driving long gilt yields down creates problems for insurance companies, who use these rates to discount their liabilities.

Also, to date it appears that QE has just created more inflation rather than an improvement in economic growth rates. With inflation already more than double the target, there is a risk that the MPC loses long term credibility.

Source: rlam as at 6th October 2011 unless otherwise stated.

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