# QE2 or Titanic –
## Unintended consequences of unconventional monetary policies

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17 April 2013
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# Outline

- Economic impact
- Social impact
- Pensions and financial markets
- Short-term vs. longer-term
- Alternatives to QE

# QE

- 2009 – fight deflation
- Short-rates near zero, wanted more stimulus
- Decided to lower long rates too – flatten yield curve
- BofE justification: would be far worse without – proof?
- BofE owns more gilts than pension/insurance funds
- Monetary experiment, strays into fiscal policy

# Huge rise in gilt issuance

doubled since 2008

| Date | All Gilts £bn | T Bills £bn |
|---|---|---|
| Dec 2004 | 343 | 25 |
| Dec 2005 | 398 | 21 |
| Dec 2006 | 438 | 19 |
| Dec 2007 | 473 | 18 |
| Dec 2008 | 636 | 40 |
| Dec 2009 | 864 | 48 |
| Dec 2010 | 1023 | 56 |
| Dec 2011 | 1150 | 67 |
| Dec 2012 | 1271 | 52 |

# BofE expected consequences of QE

- Avoid deflation + boost asset prices, growth and jobs
- Income effect
- Substitution effect
- Wealth effect
- Portfolio balance effect
- Do theoretical models work in reality?

# Reality - why QE theory may be wrong

- Banks impaired, don’t lend
- Consumers over-indebted, don’t spend
- Aging population with falling pension/savings income
- Damaged consumer confidence
- Increased income of groups who can’t spend more and reduced income of those who could
- Acted like tightening of fiscal policy
  - Income effect outweighs wealth effect

# Winners and losers from QE

Winners

- UK Government
- Banks
- Gilt traders
- Wealthiest asset owners
- Borrowers at risk of negative equity
- Especially mortgagees in South

Losers

- Older people with no debt
- People buying annuities
- Pensioners in drawdown
- DB pension sponsors
- Savers facing negative real rates
- Especially savers in North

# Negative effects underestimated

- Devalued pensions in an aging population
- Financial repression
- Ignored term structure of private sector balance sheet
- Artificially inflated asset prices as housing, equities, bonds in bubble – add risk to ‘risk-free’ rate
- Inflation?
- Eroded value of money – Cyprus direct, QE indirect

# Inflation

- **John Maynard Keynes:**
- *'By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens'*
- **Milton Friedman:**
- *'Inflation is the one form of taxation that can be imposed without legislation'*
- QE is another
- 5 yrs: inflation c.20%, ONS pensioner inflation >25%

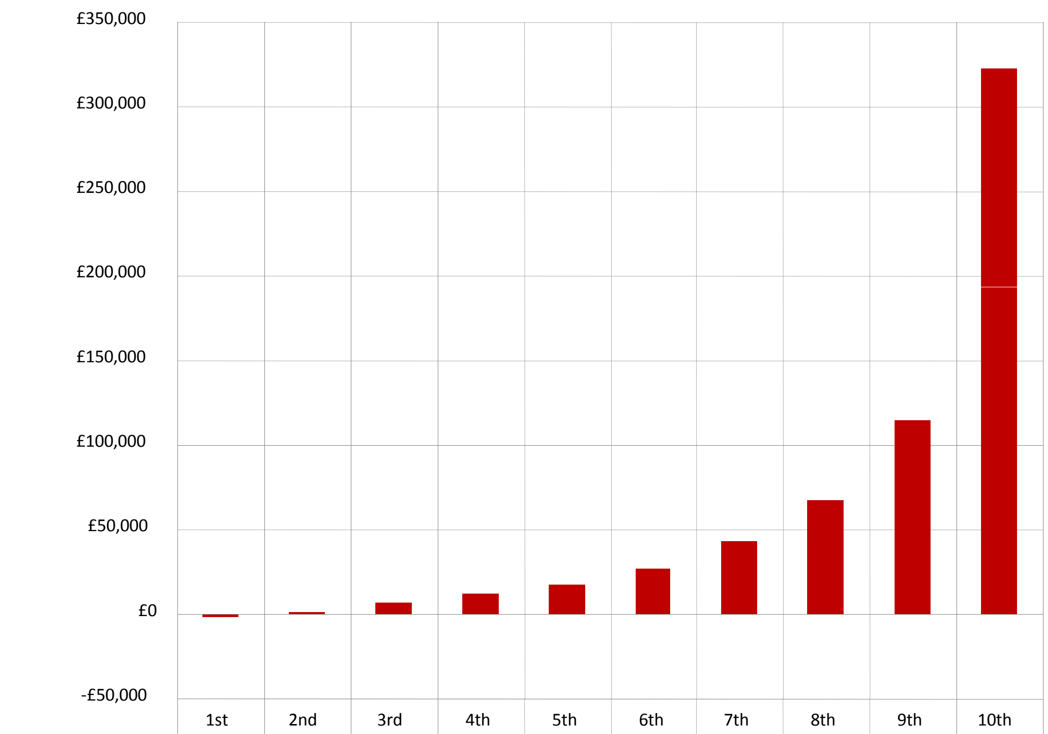
# Social consequences - distributional

- Regional and generational redistribution of income and wealth
  - From old to young
  - From north to south
- From savers to borrowers and banks
- Increased wealth of the top 5% - more inequality
- No democratic accountability

# Savers and borrowers 7:1

- Savings £1.1trn, borrowings £1.4trn
- Every saver loses from low rates: 90% <2yr maturity
- Not every borrower benefits from low rates
- Loan rates/overdraft/credit card rates have risen
- Savers have lost £220bn income with rates at 0.5%
- Funding for lending reduced saving rates sharply
  - August 2012 2.5%, now 1.5%-1.8%

# Transfer of wealth to the wealthiest




| | 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 |

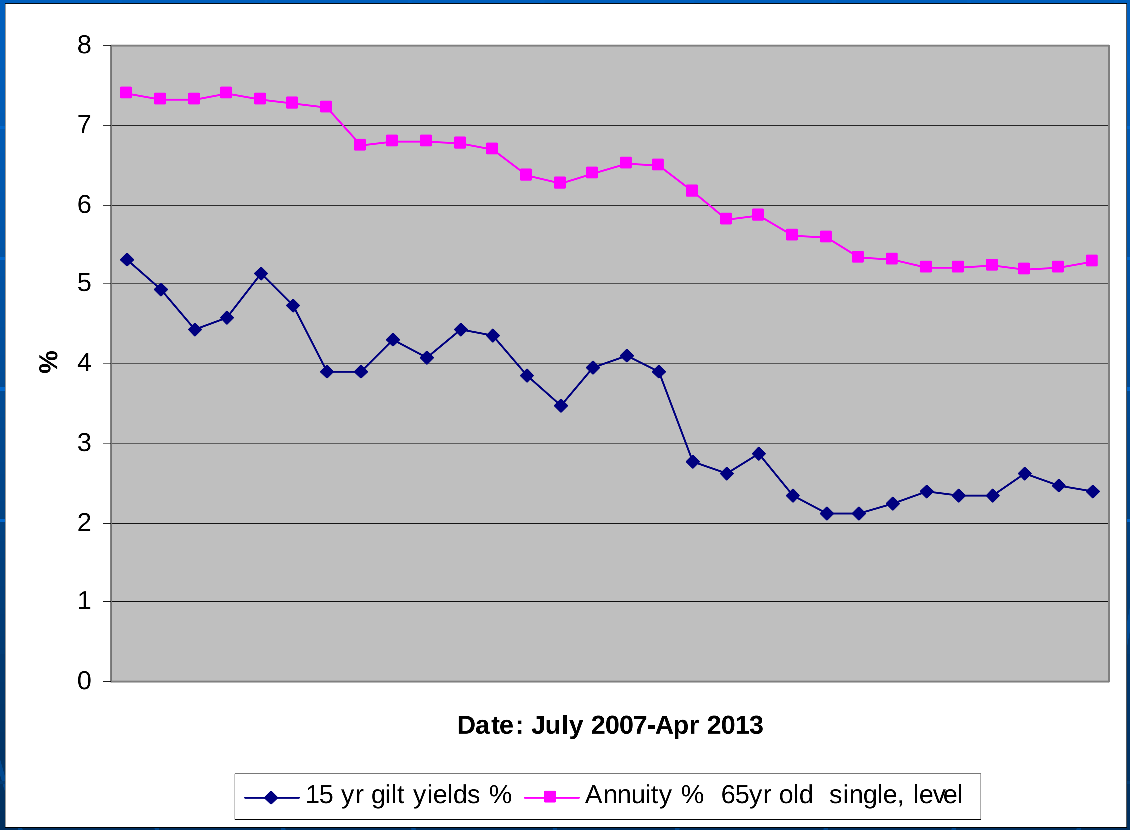
# QE consequences for pensions

- UK pension system underpinned by long rates
- Falling gilt yields have reduced DB and DC pensions
- Annuity rates and drawdown income fallen sharply
- DB deficits risen sharply as present value of liabilities marked to market at long rates
- Sponsors must support scheme at expense of jobs
- Buy-in and buy-out more expensive

# B of E denies QE damages pensions

- BofE says asset price rises offset liability/annuity rises
- BofE says QE impact on pensions ‘broadly neutral’
- Wrong!
- Many firms put in billions but deficits still risen
- Typical pension fund sensitivity to interest rates:
  - 1% fall in long rates -> 20% rise in liabilities
  - 1% fall in long rates -> 6-10% rise in assets

# Annuity rates and gilt yields



# QE and drawdown pensions

| Drawdown income | Male age 65<br>£100,000 fund |
| --- | --- |
| August 2009 | £7,920 |
| August 2012 | £5,300 |
| % change in max income | -33% |
| Increase in pension fund value to maintain Aug 2009 income | £49,434 |

# QE risks DB ‘death spiral’

- As deficits worsen, trustees told to ‘de-risk’
- Buying more gilts or swaps, drives gilt yields down
- Deficits worsen again - vicious spiral
- Record closures in 2012 – another nail in DB coffin
- Large firms with deficits underperformed by 28%
- Many small firms and charities have failed

# Volatility consequences

- QE has immediate impact on liabilities
- Asset prices more volatile
- Long-term pension funds distorted by QE short-term

| | **PPF deficits** |
|---|---|
| July 2011 | £8 bn |
| August 2011 | £117 bn |
| July 2012 | £300 bn |
| December 2012 | £200 bn |

- Such volatility problematic for trustees and companies
- Accounting and actuarial deficits both rising as rates fall
- e.g. BT, USS, JPM etc. put large sums in but deficits still rising

# Investment risks and LDI

- Is buying gilts ‘de-risking’?
- If just buy gilts, lock in deficits
- Need to outperform liabilities to fix deficit
- Search for yield and returns adds to portfolio risk
- Mature schemes need cash flow
- Find alternative alpha and beta

# Debt

- 2004 UK consumer debt hit £1trillion
- Charles Bean said UK households not sitting on a ‘time-bomb’, since borrowing increase has been matched by increase in financial assets
- 2013 Consumer debt £1.42 trillion
- Plus National debt £1.4trillion
- BofE still trying to inflate asset prices to validate debt
- And growth predicated on more debt

# Financial market consequences

- Are all asset markets ‘rigged’?
- Free markets distorted
- Bonds, real estate, equities– inflation?
- House prices too high, especially in South
- Long rates too low relative to fundamentals
- What happens when bubble bursts?

# Short-term vs. long-term

- Isn't policy just an illusion? Pretend debts affordable
- Politically expedient, financially incontinent
- Borrowing growth from tomorrow
- Short-term policies carry long-term dangers
- Markets addicted to new money and debt
- How will policy be unwound?

# Huge foreign gilt ownership

| Date | BofE holding | % | Ins Co/ pension funds | % | Foreign holding (inc CB) | % |
|---|---|---|---|---|---|---|
| Dec ‘09 | £190bn | **22%** | £249bn | **29%** | £224bn | **26%** |
| Dec ‘10 | £199bn | **19%** | £285bn | **28%** | £309bn | **30%** |
| Dec ’11 | £274bn | **24%** | £353bn | **31%** | £389bn | **34%** |
| Sep 12 | £386bn | **31%** | £335bn | **27%** | £398bn | **32%** |

# Alternatives to QE?

- QE relies on lending/borrowing/distorting yields
- Dangers of fiscal/monetary overlap
- Fails 'Heineken test' - money not reaching parts in need
- Bypass impaired banking system
- Temporary tax breaks for capital projects/SME support
- Use pension/insurance assets to boost growth directly

# Thanks for listening

Any questions?...

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