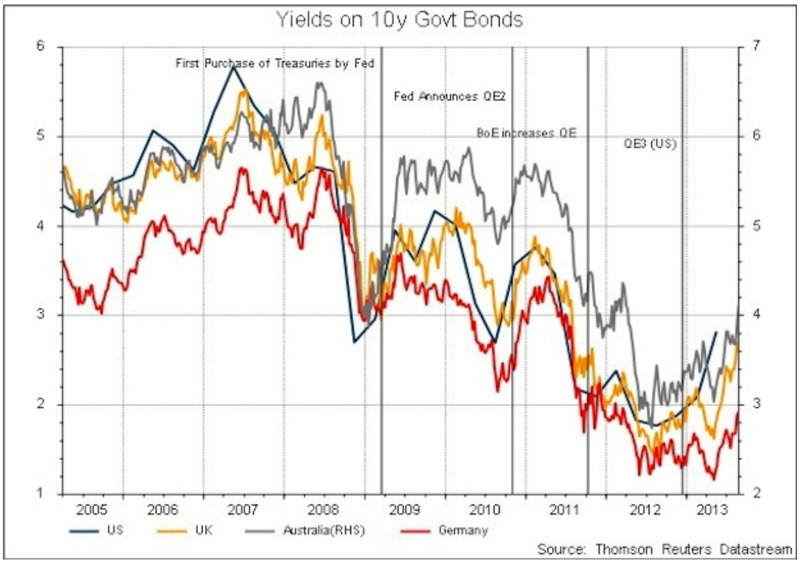
Is the Bank of England financing the Treasury? [1]

Written by **Christopher Papadopoullos** [2] | Thursday 3 October 2013



Many observers view the coincidence of quantitative easing (QE) and the recent decline of bond yields to very low levels as evidence that the Bank of England has played a significant role in pushing yields down, allowing the Treasury to borrow at lower rates. The reasoning behind this conclusion relies on the laws of supply and demand, and the inverse relationship between the price of a bond and its yield: by conducting large scale purchases of bonds, demand for those bonds increases and causes a rise in their price (decrease in their yield) and reduces the cost at which the Treasury can borrow [3]. There are even fears that should the Bank ever sell its bond holdings, the process would happen in reverse, pushing yields up, and forcing the government into a difficult fiscal position?a bond bubble.

These views are entirely plausible?I held them myself in the not too distant past. Nevertheless, I had to reconsider this position after coming across a presentation given by David Beckworth, assistant Professor of Economics at Western Kentucky University. I?ve recreated one of the charts from the presentation below but with different countries. It shows the yields on the debt of several of the world?s largest economies, with the UK & US having undertaken QE, Germany could be considered to have a small amount through OMT, and Australia has had none; a neat experiment.

Clearly there?s a strong correlation between the yields of these countries. Now, if UK QE drives UK yields down (and prices up) then why do the Australian, US, and German yields follow the UK so closely? The Bank isn?t buying their bonds. Why do the US and UK yields follow an almost identical path when their QE was conducted at completely different times? An overwhelming amount evidence supports the notion that QE reduces short term yields, but on this grander scale, one can hardly assert that the overall decline in UK yields over the last 5/6 years can be attributed largely to domestic monetary policy. Surely this is a global phenomenon.

Maybe it?s the Fed?

Perhaps a more disturbing conclusion can be drawn. What if the original reasoning was correct, but instead of the UK and the Bank of England, it?s the Fed and the world economy. After all, the US dollar is the world?s reserve currency, and it?s by no means unreasonable to suggest that the selected bonds are near perfect substitutes so that demand for one is demand for all. If such is the case, the Fed has a frightening amount of power over the world economy.

Again, the logic is sound. But the Fed only holds around 17% of total US treasury securities, roughly the same share it held in 2007. As Beckworth said to his American audience: ?85% (his numbers differ marginally from mine) of the largest dollar run up in US debt history was funded by you, me, our financial intermediaries, and foreigners.? So it?s unlikely that Fed QE is responsible for the global yield decline.

Liquidity Shortage, high Asian Savings rates, or neither?

If not QE, what is behind the global decline in yields? In my opinion, it?s due to the fact many central bankers are apparently unfamiliar with the lessons outlined in Bagehot?s 19th century classic Lombard Street. By failing to provide ample liquidity in the early stages of the crisis, when they had the opportunity to nip it in the bud, a routine cleanup developed into a full blown crisis. Investors, in a panic to increase their liquidity, rushed to the next best safe liquid asset?government bonds. Thus in a way they are keeping yields down, but only indirectly by not following the lessons outlined by Bagehot, which has stunted growth and created a liquidity shortage.

Another question remains with regard to what extend the decline since 2007 is a continuation of the trend of the last 30 years. Over this period there?s been a continued decline in yields. It could be high Asian savings rates leading to vast amounts of cash searching for interest baring assets. Furthermore, the Western world has (up until now) seen improved management of fiscal and monetary policy compared to the tumultuous 60s and 70s. Either way, it?s clear from the evidence presented here that QE is not likely to be causing any bond bubble, nor should it be seen as monetising government debt.

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