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**Sam Hill, Fixed Interest Fund Manager at Threadneedle, examines the conundrum between quantitative easing and zero interest rates**

“The economic textbooks say that you can control the price of money or the quantity of money but not both.

“If the Bank of England uses quantitative easing to increase the economy's money supply then the focus for policy will shift to the money supply and away from the interest rate; the Bank will control the quantity of money instead of its price.

“The head-scratcher seems to be the possibility that the Bank of England will undertake quantitative easing without first reducing interest rates to zero. The conundrum at first glance is that having a positive interest rate target and a target for money supply growth makes it look like the Bank are trying to control both - flying in the face of the textbooks.

“The thing about economics textbooks is that they assume too much; there is a difference between borrowing and lending costs at any given Base Rate. With Base Rates at say 0.5% most commercial banks would probably pay zero percent interest on deposits so any further reduction just reduces their income from interest charged on loans but without any corresponding savings from payments to depositors. The Bank told us in the minutes of the last Monetary Policy Committee meeting that with Base Rates at 1% they are already concerned about this effect as it represents another headwind for banks' profitability.

“The reason for moving all the way to zero is straight out of the book though. With Base Rates at zero percent the Bank is maximising the chance that additional money created by quantitative easing will end up being lent into the real economy rather than deposited back at the Bank. This would not be the case were Base Rates positive - the higher the Base Rate the greater the likelihood that commercial banks choose the easy option and deposit newly created central bank money back with the central bank!

“In reality it is likely that the Bank will take both factors into account on Thursday and cut interest rates but not all the way to zero percent. The number of speeches on quantitative easing by MPC members recently following the Governor's press conference on the February Quarterly

Inflation Report suggests that we can expect the focus to shift to the quantity of money and that whatever nominal interest rate we are left with will be assumed to be practically zero even if it isn't absolute zero.”

- ENDS -

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\*US\$73bn, €52bn. Source: Threadneedle, as at 31.12.2008.

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