National Institute of Economic and Social Research

Written evidence to the Treasury Select Committee inquiry on Quantitative Tightening[1]

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Have the Bank of England and the Monetary Policy Committee developed an appropriate strategy and framework for quantitative tightening?

First, Quantitative Tightening (QT) should not be seen as a policy tool in its own right but more a means of decommissioning Quantitative Easing (QE) and, much like nuclear decommissioning, it is likely to be complex and costly. The reduction of public debt holdings by the Asset Purchases facility (APF) from £895bn, which represented over 35% of GDP at its peak, was never going to be simple.

In terms of the optimal speed of QT there is a tension between the costs of execution which are likely to be lower if QT is conducted on the quiet (i.e. by simply waiting for the existing stock of bonds held to mature) and the risks involved in holding such an unbalanced portfolio for a long time. Should the holdings just be allowed to roll off the APF holdings would be down to £400 bn by around 2034.

The QE portfolio held by the APF is highly unbalanced as it consists of very short maturity liabilities – central bank reserves – and very long maturity assets – government bonds. Selling the bonds back to the non-bank financial sector more quickly reduces the riskiness of that portfolio but is more likely to depress bond prices and so increase losses. There is also a risk that rapid QT sales could destabilise the bond market, which has not adequately priced risk for some time. The risks inherent in the bond market have become more apparent as a result of the pension market crisis in autumn 2022 and a number of bank collapses in the first quarter of 2023.

It could still be argued that the QE portfolio could be technically re-balanced by swapping its long maturity assets for shorter term ones created in a transaction with the Treasury. This would effectively make the QE portfolio more balanced by reducing the maturity of outstanding government debt.

We note that the market turbulence witnessed in September required the Bank to delay the start of its QT programme. Given that the Bank had committed to selling a fixed quantity of bonds each month, it might be better to tie QT sales explicitly to market sentiment or to risk premia estimates, for instance, to allow flexibility under exceptional

[1] https://committees.parliament.uk/work/7261/quantitative-tightening/publications/

circumstances like those of September. It might be helpful for a regular report from the Debt Management Office on market participant demand or sentiment to be produced.

At what level of reserves relative to GDP should we think of as the target in some broad sense?

The Bank of England has proposed that the appropriate level of Central Bank reserves could be gauged by observing market reaction as reserves fell as a result of QT. This seems a pragmatic approach as although the appropriate level of reserves was substantively lower than its current level, it was likely to be higher than it had been historically. Operating with a relatively high level of Central Bank reserves seems sensible given the important role they have now taken in markets and in financial stability, however there was discussion of the idea that the interest rate on reserves could be lowered slightly if banks were judged to be holding an excessive amount.

While it may make sense to adopt a concrete target for the level of reserves totalling some 3 per cent of GDP. At this stage it may be more sensible to provide guidance about a range encompassing 5% as a rough guide for the long run level of reserves, given that it might not be possible to provide a more granular estimate that lay between 0 and 5%.

Do losses for the APF matter for monetary and fiscal policy setting?

In a mechanical balance sheet sense, losses of the APF only have a fiscal impact as the Treasury has indemnified the APF and will make good any losses it makes. However, there is a concern about the perception that the Treasury could be seen as bailing out the Bank of England itself (as the APF effectively sits with the Bank even if it is indemnified by the Treasury). Such a perception would not only be embarrassing for the Bank but could raise some concerns about its independence. We note that had the APF profits had been kept in a contained facility, rather than used to improve the government's fiscal position, current APF losses would not be so badly perceived, nor could they be so easily weaponised.

The Federal Reserve's approach of simply carrying QT losses on the balance sheet until they could be paid off by Central Bank income rather than the Treasury may have been an answer. However, since the Bank of England has a very limited income (it does not, for example, keep proceeds from seignorage) this would likely be a very long and somewhat risky process.

What are the arguments for continuing to pay Bank rate on all reserves?

Given the very high level of reserves that banks had taken on as their part in the QE process, removing the renumeration of reserves at this point would be close to a default and certainly in the area of financial repression with all the distortions such policies imply

(encouraging shadow banking, making banks unwilling to participate in QE should it be needed again, generally making market participants wary of UK money markets). In the longer term, whilst it is entirely possible to operate with a system of non-remunerated and tiered reserves and a legally mandated reserve requirement, the UK's own historical experience suggests that such a system can create money market volatility as banks' attempts to minimise reserve holdings and only those institutions required to hold reserves do so. Thus, it was felt that a system where banks willingly held reserves was probably preferable on financial stability grounds.

However, as noted above, if it became clear that banks saw reserves as preferable to all other assets due to their high security and liquidity, there may be a case of offering a slightly lower return on reserves – perhaps even in a tiered system where banks would still willingly hold reserves at the slightly lower return since they offered liquidity and security benefits. However, such a change should only be considered if it became clear that banks were unwilling to part with the reserves they currently held and as part of a discussion on a new operating operating system for monetary policy.

If we wanted to move to a system of tiered reserves, how would that affect the Bank of England's monetary operating policy?

Although measures such as tiered reserves would require some change to operating procedures, these would not be substantial. However, it was acknowledged that the Bank has many objectives it needs to take into account when altering operating procedures, including those related to financial stability. As discussed above the key issue would be whether banks willingly hold reserves. A system where reserves are only held due to a legally mandated reserve requirement is likely to increase money market volatility. Equally, a rise to minimum reserve requirements may aggravate illiquidity risks.

References

Allen, W., J. S. Chadha, P. Turner, (2022), From QE to QT: The Policy Framework, National Institute of Economic and Social Research, June 2022, https://www.niesr.ac.uk/wp-content/uploads/2022/08/From- QE-to-QT.pdf

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