The fiscal implications of recent monetary policy developments

Changes in monetary policy have implications for the funding costs faced by all economic agents, including the sovereign. We utilise the framework of Kirby and Meaning (2015) to examine the fiscal implications from elements of monetary policy changes announced in August 2016: a 25 basis point reduction in Bank Rate to 0.25 per cent and, over a six month period, the purchase of £60 billion of gilts, expanding the stock of government bonds held by the Asset Purchase Facility (APF) to £435 billion.[1]

As in Kirby and Meaning (2015), we narrow our focus to the impact on the sovereign's long-term borrowing costs and the effect via the treatment of the net interest payments from consolidated public sector accounts. That is, we ignore the second round impacts that stem from the effect of QE on the broader economy.[2]

First, the cut in Bank Rate and the announcement of the expansion of the asset purchase programme looks to have reduced yields on longer-term sovereign bonds by around 20 basis points. Lloyd and Meaning (2016) show that this has occurred predominantly through a reduction in the premia associated with these yields rather than a reduction in the expectations of the future path of short-term interest rates. This increases the market value of gilts relative to their nominal, or par, value and means that to raise a given quantity of cash, the Debt Management Office (DMO) needs to issue less nominal debt. Based on the DMO's latest projections of the UK government's future financing requirements, we calculate that the recent monetary policy measures will have lowered the nominal value of debt that has to be issued by around £7½ billion, or 1.77 per cent, over the next five years. As well as lowering the nominal debt stock in this way the government will also save the cost of the coupons that would have been due on the now unissued securities. Assuming that the average coupon rate on the unissued debt would have been equal to the average on debt issued since 2015, this would save the exchequer a further £400 million between now and 2020–21.

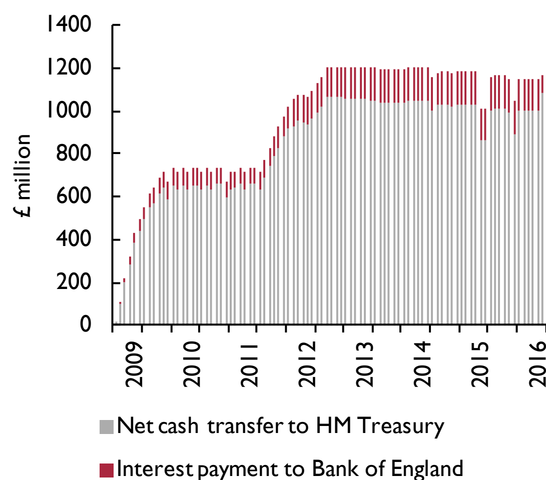
The design of the APF also means that it has wider fiscal implications than the channels outlined above, which could be said to be true of more standard monetary policy conducted purely through the manipulation of short-term interest rates. Following a change in policy in November 2012, the APF returns coupon payments to the Treasury, lowering the overall net interest payments of the public sector (ONS, 2012). Since then, almost £67 billion has been returned to the Treasury. The recent policy changes regarding the APF will have three major effects on the size of the payments between the APF and the Treasury;

1 They generate a new income for the APF by expanding the quantity of assets it holds which pay it a return.
2 They generate a new cost by increasing the size of the loan the APF requires from the Bank of England to fund its purchases of assets from the private sector
3 They reduce the financing cost of the existing purchases.

Taking each in turn, the purchase of an additional £60 billion of gilts will yield only a modest increase in the flow of coupons from the APF to Treasury coffers. This is determined not just through the magnitude of the increase in gilts, but also through the fact that the APF is paying above par for bonds. Note the £60 billion of purchases is for bonds at market not nominal prices. Since 4 August bonds have been purchased for an average price of around 29 per cent above their nominal value. The average coupon rate, weighted by the quantity of nominal bonds, is 3.2 per cent. If we assume this wedge persists over the next six months then the £60 billion of purchases will equate to just over £46 billion in nominal terms, while if we assume the average coupon rate does not change then this implies the APF will accumulate £1,487 million of coupons annually from these additional purchases.

However, to finance purchases the Bank of England provided a loan to the APF, financed by the creation of central bank reserves, for which the APF is charged Bank Rate (McLaren and Smith, 2013). With Bank Rate now at 0.25 per cent, the APF will pay £150 million annually for the additional £60 billion, giving additional net payments to the Treasury of £1,337 million per annum.

Figure 1. Redistribution of gilt coupon payments received by the Asset Purchase Facility



Source: ONS.
Notes: Accruals accounting basis. .

The fiscal implications of recent monetary policy developments (continued)

Finally, the cut in Bank Rate lowers the financing rate on the pre-existing £375 billion loan owed by the APF from ½ per cent to ¼ per cent. At Bank Rate of 0.5 per cent the APF was paying £1,865 million in interest to the Bank of England each year.[3] This has now reduced to approximately £938 million per year, further lowering the financing needs of the Treasury by just under £1 billion per annum.

Taken together, our analysis suggests that the policy measures announced by the MPC in August are likely, all else equal, to have increased the net transfers between the APF and HM Treasury by around £2 billion per annum.

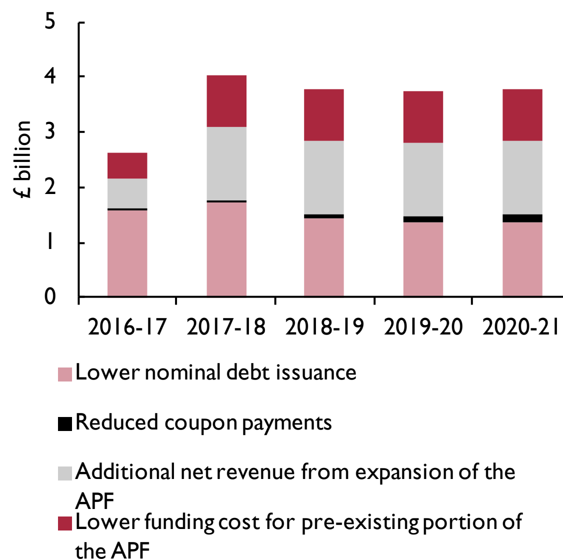
NOTES

1 The MPC also announced a £10 billion programme of corporate bond purchases and a £100 billion Term Funding Scheme to provide funding to banks and building societies. Both these schemes are operated as part of the APF, whose overall ceiling authorised by the Chancellor of the Exchequer is now £545 billion.

2 See Haldane *et al.* (2016) for discussion of the myriad transmission mechanisms of QE.

3 The loan liability the APF is paying interest on is not precisely £375 billion at all times.

Figure 2. Impact of August 2016 monetary policy package on the public finances



Source: DMO, Bank of England and NIESR calculations.

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