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Managing the fiscal risk of higher interest rates

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Abstract

The coronavirus pandemic has led to a large increase in the U.K.'s government debt, and the Office for Budget Responsibility has warned that a rise in interest rates might imperil debt sustainability. If the Bank of England Monetary Policy Committee were obliged to raise short-term interest rates to meet the inflation target, the interest costs of the commercial banks' very large reserve balances, which the Treasury has guaranteed, would increase immediately, and the government might be pressed to reduce the primary deficit quickly. This note proposes a large compulsory swap of banks' reserve balances for short and medium-dated fixed-rate gilt-edged securities. If the proposal were adopted, the government would have more time to make fiscal adjustments in the event of a rise in interest rates.

Keywords: Central bank operations, quantitative easing, government bonds.

JEL classifications: E52, E58, E63, H63.

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Interest rates and the public finances

It is now widely understood that the United Kingdom's public finances are very sensitive to any increase in interest rates.[1] The Office for Budget Responsibility noted in its report:

> '…if short- and long-term interest rates were both 1 percentage point higher than the rates used in our forecast – a level that would still be very low by historical standards – it would increase debt interest spending by £20.8 billion (0.8% of GDP) in 2025 – 26. To put this in context, it is equivalent to roughly two-thirds of the medium-term fiscal tightening announced by the Chancellor in his Budget.' [2]

The 2021 Budget left the public finances close to the borderline of sustainability. The OBR forecast the ratio of net government debt to gross domestic product to increase to a peak of 109.7% in 2023/24 (up from 107.4% in 2021/22), and to fall back thereafter. The OBR warn that in some circumstances, higher interest rates might make it harder to stabilise the debt/GDP ratio. [3]

The 2021 Budget included the usual letter from the Chancellor to the Bank of England setting out the remit of the Monetary Policy Committee for the coming year. It reaffirmed the 2 per cent inflation target, and this was perhaps the most important aspect of the Budget, because it affirmed that the government did not intend to use the inflation tax to ease the burden of pandemic-related debt. The Monetary Policy Committee is now bound by statute to pursue the inflation target. It has discretion about the timing of policy adjustments, but it cannot pursue a policy inconsistent with the inflation target.

[1] See, for example, the evidence of the Chancellor of the Exchequer, Rishi Sunak, to the House of Commons Treasury Committee on 11th March 2021, Q201. The forecast was based on market interest rates as at 5th February 2021, since when they have increased by over 30 basis points at medium maturities.

[2] Office for Budget Responsibility (2021, paragraph 1.42).

[3] Office for Budget Responsibility (2021, Box 4.1).

Although the average maturity of outstanding government securities is over 15 years, after twelve years of on-and-off quantitative easing, the Bank of England now owns 39% of the gilts outstanding, and the percentage is rising steadily as the QE programme proceeds. The gilts have been paid for with deposits credited to the commercial banks' reserve accounts at the Bank of England, which bear interest at variable short-term rates. The average maturity of the consolidated debt of the government and the Bank of England (leaving aside banknotes) is therefore much less than 15 years, and about 40% of it bears interest at floating rates. For that reason, the public finances are very sensitive to changes in short-term interest rates.

If the Bank of England Monetary Policy Committee were to be obliged to increase short-term interest rates to contain inflationary pressures, then there would be an immediate and substantial increase in interest due to the commercial banks. This would be a budgetary cost, as the Treasury has accepted responsibility for the financial costs of QE. Unless the outlook for economic growth had improved, the sustainability of the public finances would be in doubt, and the government would be pressed to reduce the primary deficit quickly.

Remuneration or non-remuneration of bank reserves

As a matter of logic, the reduction of the primary deficit would have to consist of either reduced public spending or increased taxes. Either would be politically unattractive. In evidence to the House of Lords Economic Affairs Committee, Professor Charles Goodhart predicted that, in the circumstances, reserve balances held at the Bank of England would be made non-interest-bearing.[4]

[4] Evidence to House of Lords Select Committee on Economic Affairs, 16th March 2021, https://committees.parliament.uk/event/4065/formal-meeting-oral-evidence-session/

Simply not paying interest on a large chunk of bank reserves would solve the fiscal problem at a stroke. In effect, it would place all or nearly all of the burden on the shoulders of the banks. Bank reserves are currently around £800 billion, and will be over £900 billion by the time the quantitative easing programme is completed. The interest cost to the banks collectively would be £800 million a year before tax, which they could probably swallow, but of course it could be many times larger if short-term interest rates rose.

Paying no interest on any commercial bank's reserve balances with the Bank of England would be problematic for monetary policy. The rate which the Monetary Policy Committee adjusts when it wants to change its Bank rate is the rate paid on reserve balances, which would be zero. Therefore, the Bank would need a new method of imposing a higher level of rates on the market. With massive amounts of cash and liquid assets in the banking system, it is hard to see how a new method could be devised.

Instead, as Lord Turner suggested, the Bank of England could pay no interest on a large, fixed, quantity of the commercial banks' reserve balances, but continue to pay interest on the remaining marginal balances. The Monetary Policy Committee could adjust the interest rate on the interest-bearing component of the balances when it considered a rate change was necessary.[5]

In this arrangement, banks would have to be forbidden to draw on the non-interest-bearing part of their reserve balances, otherwise banks which ran down their reserve balances sufficiently would have a zero marginal cost of funds and would thus be subject to a different monetary policy from other banks. A large part of each bank's reserve balances would therefore be frozen.

[5] Evidence to House of Lords Select Committee on Economic Affairs, 16th March 2021, https://committees.parliament.uk/event/4065/formal-meeting-oral-evidence-session/

Implementing the Turner proposal would have adverse consequences for the financial system:

- Each commercial bank would have to be told what amount of its reserve balances would no longer bear interest, and would be saddled with a non-interest-bearing asset which it could not sell. It is doubtful whether the asset could properly be regarded as a high-quality liquid asset. Quantitative easing would metamorphose from an instrument of monetary policy into an instrument of taxation.

- The cost of financing the asset would rise and fall with interest rates generally. There would be no upper limit to the scale of the implicit tax. The higher the level of short-term interest rates, the heavier the tax.

- Commercial banks would be more heavily taxed than other financial institutions. They would become less competitive, and business would be diverted into other, less heavily-regulated and less visible financial channels. There would be a threat to financial stability.

- Commercial bank shares already trade at a discount to their net asset value, and banks find it difficult to raise capital. Zero-interest bearing reserves would make banks even less attractive to investors.

Another solution

There is no attractive solution to the question of how to finance the fiscal burden of higher interest rates. However, there is a better solution than ending interest payments on bank reserves. The government would make special issues of fixed-interest gilts over a range of maturities, which would initially be allocated compulsorily to the commercial banks: each bank would be allocated a quota. The new gilts would be paid for by a reduction in the banks'

reserve balances in the Bank of England. The maturities would need to be short enough to be consistent with the banks' portfolio preferences. The amount issued would need to be large enough to reduce reserve balances to a fraction of their current magnitude, which is currently £800 billion and rising. The yield of the gilts would be at current market levels, but it would have to be expected that yields would rise somewhat after the scheme was introduced.

The proposed scheme is similar to the one that was implemented in November 1951, when the Bank of England wished to absorb the very large amount of liquid assets that had accumulated in the banking system during and after the Second World War. The clearing banks were forced to convert a large part of their very large Treasury bill holdings into 1, 2 and 3 year gilts as a means of draining liquid assets from the banking system, and of insulating the public finances in some degree from the costs incurred when short-term interest rates were increased, as they were in March 1952. [6]

The characteristics of the proposed scheme are that:

- It would transfer interest rate risk compulsorily from the government to the banks. It would slow down the impact of any increase in short-term interest rates on the public finances, and give the government time to adjust.

- It would thus impose a tax on commercial banks, but only to the extent that the yield on the new gilts was lower than the level to which market yields adjusted after the operation. It would not impose an open-ended burden on the banks.

- At current yields, the interest cost to the government would be low.

[6] Howson (1993, pp 310 - 315), Allen (2014, pp 21 - 31).

- The banks would be able to sell the gilts in the market if they so chose. Their liquid assets would not be frozen. Their position under the Liquidity Coverage Ratio requirement would be unaffected, as reserve balances and gilts count equally as high quality liquid assets for LCR purposes.

- It would have to be expected that gilt prices would fall after the operation. The extent of the fall would be contained by flows of funds from other government bond markets. Moreover, the Bank of England's quantitative easing programme has several months to run, and would provide a degree of support. In addition, the Bank of England could offer to make a market in gilts for a limited period in order to contain falls in asset prices that might threaten financial stability.

- The scheme would therefore not have the same adverse effects on the competitiveness of the banks, and their attractiveness to investors, as the zero-reserve interest proposal.

- The Treasury could use the proceeds of the special gilt sales to repurchase gilts from the Bank of England Asset Purchase Facility. It could then either cancel the repurchased gilts, or retain them for later sale in routine debt management operations.

If such an operation were to be conducted, it would not be necessary to reduce the interest rate on reserve balances to zero. However, if reserve balances were reduced below a certain level, the Bank of England might need to change its method of managing interest rates. It could quite easily revert to undertaking repo and reverse repo operations in gilts and Treasury bills, and perhaps also high-quality commercial bills, as it did before the inception of quantitative easing in 2009.

The proposal is for an act of financial repression. The argument in favour of it is that some form of financial repression is unavoidable, and that the operation proposed here is less harmful than possible alternatives. It would not eliminate the need to reduce the primary deficit if interest rates rose, but it would allow the government more time to make the necessary adjustment.

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