National Institute of Economic and Social Research

Summary of QE-QT Workshop Conclusions

National Institute of Economic and Social Research

Paula Bejarano-Carbo (NIESR), Francis Breedon (Queen Mary College, London)

March 2023

On 16 February 2023 NIESR held a workshop on Quantitative Easing (QT) to discuss a series of important policy questions. The Bank of England published its plans for QT in October 2022.

The questions under discussion were:

- Now that QT has commenced, what have we learnt so far about the appropriate speed, market reaction?
- At what level of reserves relative to GDP should we think of as the target in some broad sense?
- Do losses for the APF matter for monetary and fiscal policy setting?
- What are the arguments for continuing to pay Bank rate on all reserves?
- If we wanted to move to a system of tiered reserves, how would that affect the Bank of England's monetary operating policy?

1. Now that QT has commenced, what have we learnt so far about the appropriate speed, market reaction?

First, participants agree that QT should not be seen as a policy tool in its own right but was simply the means of decommissioning Quantitative Easing (QE) and, much like nuclear decommissioning, it was likely to be complex and costly.

In terms of the 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. The QE portfolio held by the Asset purchase facility (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 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.

Some participants 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.

It was noted that the market turbulence witnessed in September required the Bank to delay the start of its QT programme. Given that the Bank has committed to selling a fixed quantity of bonds each month, participants wondered if it would be better to tie QT sales explicitly to market sentiment or to risk premia estimates, for instance, to allow flexibility under exceptional circumstances like those of September.

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

The workshop discussed the Bank of England's proposal that the appropriate level of central bank reserves could be gauged by observing market reaction as reserves fell as a result of QT. This seemed a pragmatic approach as participants agreed that although the appropriate level of reserves was 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 seemed to be holding an excessive amount.

One participant proposed the concrete target for the level of reserves totalling 3 per cent of GDP. The discussion then moved towards thinking about a range encompassing 5 per cent 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 per cent.

3. 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, participants were concerned 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. Some attendees noted that if 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.

There was some discussion of 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. 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.

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

Almost all participants felt that 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 attempt 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, most felt that 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 the operating system for monetary policy.

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

All participants felt that 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.